Ghana

Corporatization of Distribution Concessions Through Capitalization

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Abbreviations and Acronyms

AGI	Association of Ghanaian Industries
ATC	Alexandria Tire Company
BOGOF	Buy-One-Get-One-Free
CONEPLAN	A government planning agency
DAV	Distribution Added Value
DIC	Divestiture Implementation Committee
EBITDA	Earnings before interest, taxes, depreciation and amortization
EC	Energy Commission
ECG	Electricity Corporation of Ghana
ESA	Employee shareholders association
ESB	End-of-service benefits
ESOP	Employee stock ownership plan
FINSAP	Financial Structural Adjustment Program
GDP	Gross domestic product
IMF	International Monetary Fund
IPO	Initial public offer
IPP	Independent power producer
IRR	Internal rate of return
LIBOR	London interbank offered rate
MOME	Ministry of Mines and Energy
NCB	National Commercial Bank of Jamaica
NTU	National Transmission Utility
PNDC	Provisional National Defense Council
PPA	Power Purchase Agreements
PURC	Public Utilities Regulatory Commission
SAYE	Save-as-you-earn
SEC	State Enterprises Commission
SOE	State-owned enterprise
TIC	Total investment income
TUC	Trade Union Congress
USAID	U.S. Agency for International Development
VRA	Volta River Authority
WSU	Worker-shareholders' union

Units of Measure

kWh	Kilowatt-hour
MW	Megawatt

Currency Equivalents

US$1.00 = 2,427 Ghanaian cedis as of April 19, 1999

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Executive Summary

1. The government of Ghana has initiated fundamental reforms to improve the performance of the electricity supply industry. The objective of the reforms is above all to allow the government to focus on its roles as policymaker and regulator for the sector and permit transfer of responsibility for operations and investment to the private sector.

2. Such reforms are expected to take place in the context of the government's public enterprise reform program, which was first formulated in 1985. Since the beginning of the privatization program, more than 200 transactions have been reported.

3. This study looks at the potential for using employee stock ownership plans (ESOPs) as a means of allowing employees of state-owned enterprises to obtain an ownership stake in the privatization of electricity distribution concessions. Privatization programs worldwide are increasingly including a focus on incorporating an element of employee ownership in order to ensure that ownership of the privatized enterprises will be shared broadly by its workers, not just wealthy investors. This study looks at the relevant international experience and offers guidelines for introducing appropriate legal reforms that could facilitate the implementation of employee ownership as a key element of the government's privatization strategy.

4. Dozens of countries have utilized employee ownership as a technique of privatization and scores more are actively considering such a strategy. This report addresses the rationale for incorporating the use of ESOPs in privatization transactions, analyzes the Ghanaian legal framework in the context of potential ESOP reforms, and includes a prefeasibility analysis for implementing an ESOP for electricity distribution concessions. It also includes recommendations for implementing reforms conducive to the introduction of ESOP strategies in Ghana generally.

5. The report also includes detailed discussions of the use of employee stock ownership strategies in Bolivia, Egypt, El Salvador, Jamaica, the United Kingdom, and the United States and the role of unions in employee ownership.

1

Electricity Sector in Ghana: Status of Reforms and Evolving Market Structure

1.1 The government of Ghana has initiated fundamental reforms to improve the performance of the electricity supply industry. The objective of the reforms is above all to allow the government to focus on its roles as policymaker and regulator for the sector and permit transfer of responsibility for operations and investment to the private sector. In a process coordinated through the Ministry of Mines and Energy (MOME), the relevant stakeholders participated in a Power Sector Reform Committee. The stakeholders also participated in various task forces under this committee to address restructuring options, tariff regime at commercial interfaces, and legal and regulatory requirements to address market structures.

1.2 Based on recommendations of the Power Sector Reform Committee Task Forces and the Energy Policy Advisor to the Minister of Mines and Energy, the government of Ghana enacted two legislative instruments: the Public Utilities Regulatory Commission Act 538 of 1997 and the Energy Commission Act 541 of 1997. These two legislative instruments have virtually created a whole new landscape in the electricity supply industry of Ghana. The Public Utilities Regulatory Commission (PURC) Act has led to the formation of the PURC, an independent multisectoral regulatory agency responsible for regulating tariffs of network industries, such as electricity, telecommunications, and water. In the electricity subsector, the PURC regulates the tariffs of the transmission utility and the distribution utility companies.

1.3 The Energy Commission (EC) Act requires vertical and horizontal unbundling of the Volta River Authority (VRA) and the Electricity Company of Ghana, respectively, and creates a National Electricity Market in Ghana. The National Electricity Market will establish a single wholesale market for electricity and an open access regime for the transmission and distribution networks. The key features of the proposed new market arrangements for the purchase and sale of energy are summarized below.

?? **Licensing:** Wholesale suppliers of electricity deemed to be "public utilities," transmission service providers, and distribution companies will be licensed under the EC Act. An independent power producer (IPP) selling directly to a "bulk customer" is not deemed to be a public utility

and therefore may not require a license. A “public utility” is an entity that has a public service obligation to sell electricity to retail service providers.

?? **Open access:** A new entity, the National Transmission Utility (NTU), will be responsible for operational planning, scheduling, and dispatch. To carry out these functions it will receive data on water inflows, reservoir levels, plant availability, and fuel costs. Using this information, it will plan system operations on successively shorter periods, ensuring hydrothermal optimization through use of merit-order dispatch procedures. The trading arrangements would be based on a tight, centralized approach to system optimization in which generators and distribution companies would submit technical data to the NTU. There would be no price bidding. The NTU would be responsible for operational planning, scheduling, and dispatch according to a set of explicit, agreed procedures. New software has been developed by MOME consultants. As part of the final stage of operational planning, it is envisaged that the NTU will calculate a price that represents the system marginal cost or the spot price at which supply and demand are in balance.

?? **Energy trading rules:** All energy flows will be considered in the determination of the optimum schedule, in the treatment of losses, and for other relevant purposes. Energy accounting in the pool market will therefore deal with metering data for all energy. Bulk supply tariffs and nodal transmission loss factors will be used to adjust generation and demand to a single point for use in settlement.

?? **Bilateral contracts:** Generators and the public service distribution companies will trade most of their energy under bilateral contracts, which will specify contract prices and fixed volumes for their entire duration. Initially there will be a set of bilateral contracts between suppliers and distributors, suppliers, and the transmission service provider to initiate the electricity market in an orderly fashion. The term, price, and volume profile of these initial contracts will be developed by MOME consultants once the EC is in place, which is expected to be sometime in September 1999.

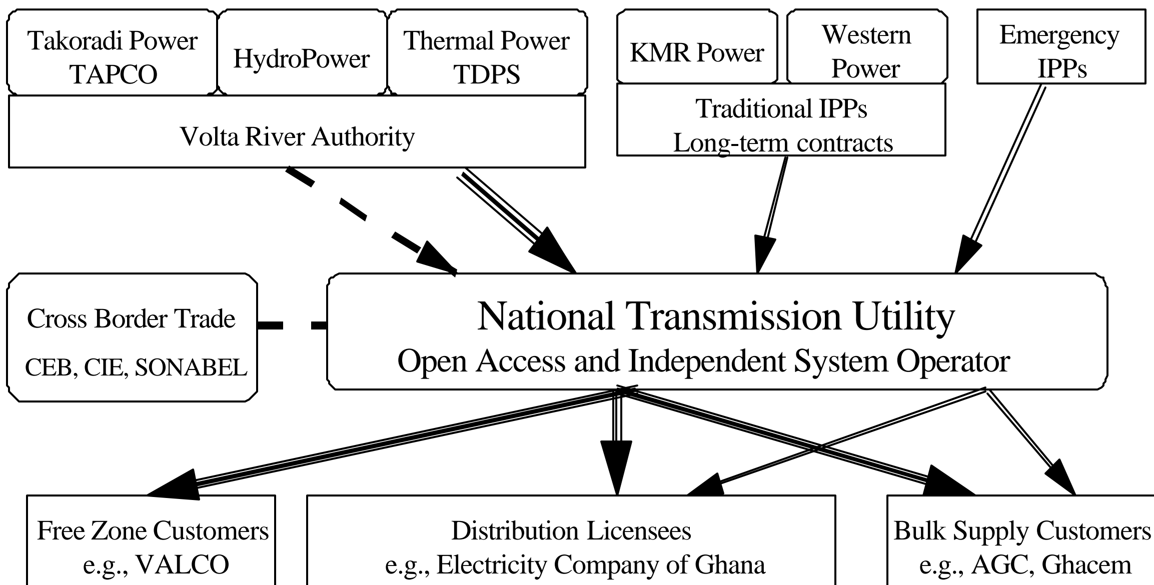
?? **System planning and new investment:** Recognizing the shift to a market-oriented system, in which there is no longer any deterministic central planning and in which purchasers and large customers have responsibility for acquiring energy at the lowest possible cost, the EC Act requires the preparation of indicative plans for the power sector by a joint technical committee.

?? **Indicative long-term expansion planning:** These indicative plans would identify least-cost system investment programs, including the specific hydro and thermal projects required, under a range of assumptions and scenarios. These plans would be for orientation only, and there would be no obligation on any party to undertake the investments. Information required for short-term transmission planning (that is, up to five years

ahead) would be identified by the NTU in the light of generation projects in progress and applications for new connections.

1.4 An overview of the new evolving structure is shown in figure 1.1. This shows the bilateral contractual arrangements between the retail businesses of the distribution companies, such as the Electricity Corporation of Ghana (ECG) (and other potential retailers), and generators, such as VRA Generation and IPPs.

Figure 1.1. Proposed Structure of Electricity Market, Electricity Commission Act 541 of 1997 for Ghana



1.5 It should be recognized, however, that these arrangements must also comply with (1) competition policy regarding the right of third parties to gain access to the services of a facility that is uneconomic to duplicate and is nationally significant (for example, electricity transmission networks), (2) nondiscriminatory access charges, and (3) obligations to provide ancillary services to assure the system integrity of the transmission network. Therefore, the EC, through its Technical Committee, will develop a transmission grid code that will set out the operational rules for the national electricity market. The national transmission grid code should address two distinct but interrelated elements: first, the wholesale electricity market rules including cross-border trading

arrangements, and second, the access arrangements to the transmission and distribution systems.

1.6 In contrast to the arrangements governing electricity generation and its wholesale and retail sale, the access arrangements are the rules governing connection to and use of the physical wires infrastructure for the transport of electricity. Therefore, the grid code will be characterized by a flexible set of arrangements covering diverse matters relating to electricity connection and pricing while being broad enough to encompass all of a network's customers (for example, generators, users, and retailers). This flexibility is necessary because, to a greater or lesser extent, every connection to an electricity network will affect the performance of that network and therefore other connected customers.

1.7 The grid code will also describe arrangements through which generators will physically deliver electricity into the market and will allow customers, such as bulk customers, to avoid retailers by separately purchasing wholesale electricity and its transport on transmission and distribution networks.

1.8 International "best practices" in grid code development show the need for flexibility, and therefore provide in some detail the following:

?? A framework for achieving and maintaining a secure power system.
?? A framework for generators and users to connect to an electricity transmission or distribution network, including a requirement to negotiate and sign a detailed connection agreement.
?? An agreement on connection equipment design and technical standards.
?? Inspection, testing, and commissioning requirements for connected equipment, and disconnection procedures.
?? Administrative planning processes, in the case of a general increase in demand within the network.
?? Regulatory pricing arrangements to be followed by the regulatory agency.
?? Dispute resolution and enforcement mechanisms.
?? Transitional arrangements for each of the stakeholder companies.

1.9 The consultants to the MOME have drafted a grid code that will be provided to both the ECG and VRA for their review and comments.

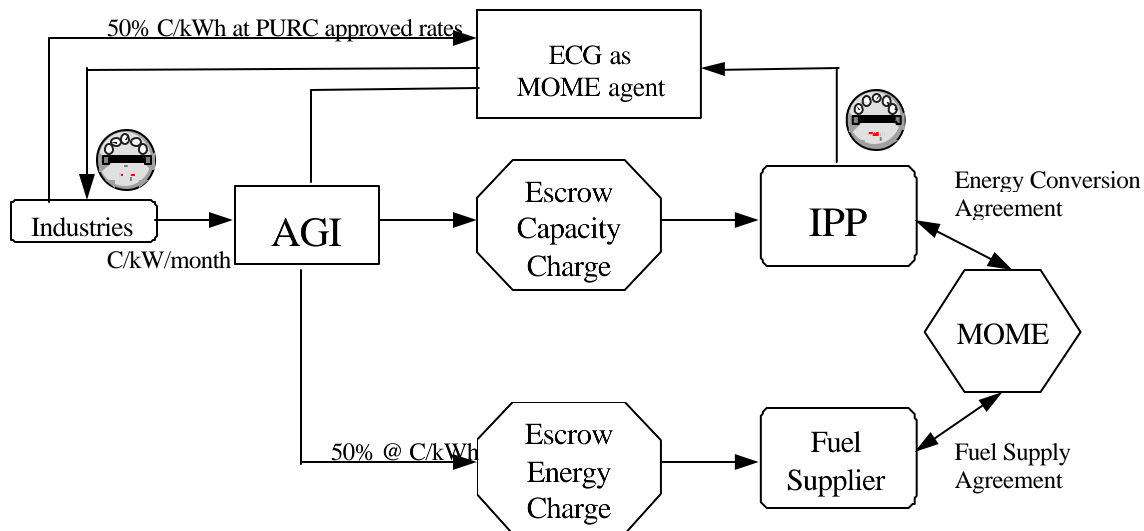
Emergency Power Purchases

1.10 The low water level in the Volta Lake has led to a nearly 50 percent reduction in energy generation at Akosombo. Power outages and rolling brownouts are a daily phenomenon. To redress this power shortage situation, the Ministry of Mines and Energy has entered into two power purchase agreements (PPAs) with two IPPs: one is a 30 MW diesel engine (AGGRECO) and the other a 70 MW gas turbine (FAROE) to be operated on diesel fuel, both to be located adjacent to the existing nonperforming diesel generating station at Tema. Both PPAs are for a term of two years, and the ECG will be the "purchasing" agent to facilitate and settle the energy transaction.

1.11 The PPAs are structured as "energy conversion" agreements, with the MOME taking responsibility for fuel procurement and delivery to the IPPs. The MOME is required to make an advance payment equal to capacity charges for one month. The MOME is also facilitating the sale of energy from the emergency IPPs to the industrial users through the Association of Ghanaian Industries (AGI).

1.12 The structure of project transactions between the MOME and other entities is shown in figure 1.2. Under this arrangement, the MOME designates the ECG as its purchasing and billing agent. A side agreement between the ECG and the AGI requires the AGI to pay capacity charges (which it collects from its membership) to an escrow account (capacity charge escrow) at the Bank of Ghana, and to pay fuel charges (which it collects from its membership at 5.3 U.S. cents per kWh) into an energy escrow account also at the Bank of Ghana. The ECG collects payment from the industrial customers for that portion that does not go to the account of the emergency IPPs. Under this back-to-back arrangement between the IPPs, the ECG, and the AGI, the MOME has been able to meet the energy crisis.

Figure 1.2. Emergency IPPs: Project Structure



2

The Reasons for Privatization in Ghana

The Government Portfolio

2.1 State participation in the commercial sector began during the colonial era. Participation was extended in the period following independence so that by the late 1960s, the public sector accounted for as much as a fifth of total manufacturing output and 26 percent of gross domestic product (GDP).[1] The public sector was seen as a necessary tool for development by assisting in redistributing incomes, fostering regional development, creating employment opportunities, and as a source of revenue for the government.

2.2 Public sector employment grew steadily from around 11,000 in 1960 to 241,000 in 1984, by which time it represented almost 28 percent of formal sector employment.[2] By 1990, due to steps to improve the efficiency of public enterprises, the removal of "ghost" workers from some payrolls, and the liquidation of some nonviable enterprises, employment dropped to just over 200,000. Employment was concentrated in 17 "core" enterprises which employed 78,000 people in the utilities, transport, petroleum, and agricultural sectors.

2.3 In a comparison of financial data for 100 state-owned enterprises (SOEs) for the years 1979 and 1983, annual losses had increased fivefold from 91.8 million cedis to 550.9 million cedis and debt had more than tripled from 495.4 million to 1882.2 million cedis.[3] In a separate survey of 100 enterprises between 1980 and 1982, it was shown that operating deficits had risen from 0.2 percent to 3.4 percent of GDP and were, in part, financed by subsidies equal to 9 percent of government expenditure.[4]

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[1] David Swanson and Teterra Wolde-Semait, "Africa's Public Enterprise Sector and Evidence of Reforms" (Washington, D.C.: World Bank, August 1988).
[2] World Bank, "Regional Study on Public Enterprise Reform and Privatization in Africa" (Washington, D.C.: World Bank, Africa Technical Department, August 1993).
[3] World Bank, "Regional Study on Public Enterprise Reform and Privatization in Africa" (Washington, D.C.: World Bank, Africa Technical Department, August 1993).
[4] David Swanson and Teterra Wolde-Semait, "Africa's Public Enterprise Sector and Evidence of Reforms" (Washington, D.C.: World Bank, August 1988).

2.4 By 1985 the public enterprise sector in Ghana was characterized by increasing operating losses, low productivity[5], rising debt, a volatile business environment, poor accountability, and insufficient investment. As the budgetary burden became too much to bear, public enterprise reform became an important element of the government's structural adjustment program. At that time, the lack of accountability for public enterprise sector performance was so pervasive that no one knew precisely the size of the sector.

How Privatization Has Been Implemented

The Privatization Program

2.5 In 1985, as part of the Ghanaian Economic Recovery Program initiated in 1983, the government began to formulate the first phase of its public enterprise reform program, which included divestiture. A major constraint in developing the divestiture component of the program was the dearth of data on the size, performance, and position of the public enterprises.

2.6 The initial push to privatize appears to have come from the World Bank during 1995–96. The Bank insisted on one implementing agency for both public enterprise reform and divestiture, which should be outside a government ministry. Responsibility for developing the privatization program was initially vested in the State Enterprises Commission (SEC). This agency, established in 1965, was designated by the State Enterprises Commission Act, 1987 [PNDC Law 170], to be the lead agency in the government's attempts to reform the public enterprises. Accordingly, during 1986 and 1987, the SEC undertook the early work of identifying and classifying SOEs and determining reform and divestiture priorities. In 1988, due to slow progress on all fronts, including a lack of discernible evidence of real efforts to begin liquidating or selling any enterprises, privatization was broken (?) off into a new unit, the Divestiture Implementation Committee (DIC). This was expected to free the SEC to concentrate on the then more critical job of reforming the major enterprises as well as allowing the DIC to focus on privatization. The DIC was, and remains to this day, responsible to the Office of the President.

Management of the Program

2.7 The role and functions of the DIC are set out in the Divestiture of State Interests (Implementation) Law, 1993 [PNDC Law 326] which states that the DIC's functions are "to plan, monitor, coordinate, and evaluate all divestitures, effectively communicate government policies and objectives for any divestiture, develop criteria for selection of enterprises to be divested and assume responsibility for preparing such enterprises for divestiture, making appropriate consultations, and ensuring consistency in procedures for evaluations, invitations for bids, negotiations of sales, and settlements of accounts. The DIC has a secretariat that is charged with the day-to-day management of the program including, but not limited to, receiving proposals, negotiating with investors

[5] Industrial public enterprises had an average capacity utilization of only 18 percent in 1984.

and submitting negotiation results to the committee. The committee's recommendations are then submitted to the government for authorization."

2.8 The DIC is comprised of 11 people and an executive secretary, all appointed by the president of Ghana. Six members of the DIC are from the government; the remaining five are from the private sector, including a trade union representative. The executive secretary has responsibility for the day-to-day management of the DIC secretariat. Interestingly, the same person who began work on divestiture when it was the SEC's responsibility, has held the position of executive secretary since the inception of the DIC. There are very few cases, if any, of the head of a privatization implementing agency remaining in office for 10 years.

The Delay in Giving the Divestiture Implementation Committee its Mandate

2.9 There are several significant features in the history of the management of the program. First, after several years of planning and preparatory work, the divestiture program was officially launched in 1988, although it took another five years before the DIC had a legal mandate to fulfill its role. The reasons for this are unclear; but the delay constrained the DIC's work because many SOEs argued (correctly) that the DIC has no legal basis to intervene in their affairs.

2.10 An unusual and fascinating feature of the DIC statute is that it precludes anyone from initiating legal action against the DIC for any matter relating to divestiture. It seems strange that such a provision should have been thought necessary; Ghana is not known to be more litigious than other African countries. It does, however, deepen suspicion about the privatization program when nontransparency is compounded by a lack of right to legal recourse.

The Divestiture Implementation Committee Not Authorized to Approve Deals

2.11 Second, the DIC only "recommends" a privatization deal; it has never had the authority to "approve" a divestiture transaction. The DIC officially submits requests for approval of negotiated deals to the Office of the President. The decision making process within the Office of the President is unclear. Approvals have been known to take as little as one week, although several months is the norm, and in a few cases the submissions have been held indefinitely. The issue here is the known potential delays that are a deterrent to investors. In the past, there have been a few occasions when the delay in approval has led to the successful bidder withdrawing, thus requiring the DIC to rebid the enterprise sale.

Ghana's Privatization Program Not Centralized

2.12 Third, the DIC has not been responsible for all divestitures. All the larger transactions have been handled by other government agencies, notably Ashanti Goldfields Corporation, the state-owned banks (managed by the Financial Structural Adjustment Program (FINSAP) unit in the Ministry of Finance), and Ghana Telecoms (managed by the Ministry of Transport and Telecommunications). Earlier in the program, the privatization of some smaller enterprises—such as the Ambassador Hotel,

Continental Hotel, Star Hotel, and Labadi Beach Complex—were also handled within the government. Mystery surrounds responsibility for the privatization of the Ghana Airways handling facility, but neither the DIC nor the Ministry of Finance was involved.

The Divestiture Implementation Committee Pressured to Introduce Uniform Divestiture Procedures

2.13 Fourth, several factors led, in the second half of 1995, to the preparation of the "General Procedures for the Divestiture of State-Owned Enterprises." The DIC reported that it adopted these procedures for all transactions that commenced after April 1996. These procedures are very detailed and thorough, and are a useful reference for other implementing agencies embarking on privatization. However, it is baffling that it took eight years for the DIC to introduce standard divestiture procedures that are available to interested parties. There was clearly a need for a consistent and open approach and to build on the experience gained. However, it appears that the introduction of the procedures was, at least to some extent, forced by criticisms in the press and elsewhere about transparency, as well as by the World Bank.

Insufficient Resources for Divestiture

2.14 Fifth, the DIC secretariat has throughout had few resources to undertake what is an ambitious program. For years it was well below its authorized staff complement. At the time of developing its accelerated divestiture program in 1995 (which began operations in 1996), the professional staff of the secretariat was comprised of the executive secretary, two financial analysts, a legal secretary, an assistant consultant, a public relations officer, an administrative officer, and three advisers. The number of professional staff has only marginally increased since then.

External Support

2.15 The World Bank has supported the government's privatization efforts through various credits including the following:

- Two structural adjustment credits, the first in 1987 for US$115 million, the second in 1989 for US$120 million.
- A private sector adjustment credit in 1995 for US$70 million.
- Implementation support for the DIC secretariat through two technical assistance credits, the first in 1987 for US$10.5 million and the second in 1996 for US$26.5 million. The latter credit is to meet consulting, training, and other costs for public enterprise reform (US$7.4 million), privatization (US$27.7 million) and program coordination (US$1.2 million). The privatization components comprise: (a) the DIC secretariat capacity strengthening (US$5.4 million); (b) outsourcing divestitures (US$12.7 million); (c) public information (US$2.5 million); and (d) labor redundancy management (US$7.1 million).
- Financial sector.
- Mining sector mines, which supported the privatization of the gold and diamond industries.

?? Forestry.

Enterprise Preparation

2.16 In Ghana, enterprises go through three important stages to prepare for privatization: (a) the conversion of statutory corporations to limited liability companies registered under the Companies Code, 1963; (b) the work undertaken by the SEC; and (c) the work undertaken by the DIC secretariat.

2.17 The Statutory Corporations (Conversion to Companies) Act, 1993 [Act 461], was an enabling statute for the conversion of 27 commercial, statutory corporations and 5 state-owned banks to public companies henceforth subject to the Companies Code, 1963. Following conversion, all successor companies are shareholder-owned companies with their shares vested in the Minister of Finance in trust for the state. The Act, drafted by the SEC as part of the ongoing reforms it oversees, was an essential first step in the process of privatizing some of the major public enterprises. When the privatization program began in Ghana, many of these enterprises were considered "strategic" and were slated for restructuring, not privatization. This, in large part, explains why it took so many years to adopt conversion legislation to facilitate privatization.

2.18 The SEC is responsible for managing the portfolio of wholly state-owned commercial enterprises not scheduled for privatization. As such, the SEC manages the transition of the enterprises' present government ownership to private ownership. In this role, the SEC seeks to (a) improve the financial discipline; (b) exercise government's rights as a shareholder; (c) ensure public accountability; (d) ensure that all enterprises have a comprehensive corporate plan and an annual performance contract; and (e) oversee the application of corporate governance rules as set out in the company regulations. These are important steps in preparing SOEs for privatization. It took the SEC several years to gain recognition of its role, and real progress has only been made in recent years (1993–97). Today the SEC is in a much better position to advise the government on the preparedness of the individual enterprises for privatization and the most appropriate methods to apply.

2.19 Why did the SEC take so long to gain recognition of its role and to be seen to make an impact? When the SEC began its reform and divestiture work in 1986, it suffered from a lack of information on SOEs. Not only was there no data on SOE performance and financial position, no one knew the identity of many SOEs and the extent of government ownership. The SEC's work to ascertain this information and to begin to improve SOE sector performance has been hindered by some SOEs and government ministries who have failed to respond to the SEC's initiatives, and the SEC has not had the legal or political clout to remedy this. Hence, it took many years of effort, with either disinterest or outright opposition from some SOEs and their parent ministries, for the SEC to get a firm handle on the SOE sector. Some suggest that this reflects the government's lukewarm commitment to reform and privatization. Corporate governance in the SOE sector has been weak and was compounded by poor coordination and rivalries between government ministries with respect to SOE sector management. Until the DIC

secretariat's efforts during the past few years to improve communications on privatization, SOE managers were further discouraged from cooperating with the SEC because of the government's and the DIC secretariat's failure to consult with them. The lack of consultation fueled employees' concerns over job security, which in turn led to obstructive behavior. As a result, asset inventories were incomplete, asset stripping occurred, and liabilities were hidden. Indeed, asset stripping has been a persistent problem in SOEs undergoing privatization or listed for divestiture.

2.20 In 1997 the SEC prepared dossiers on all nonprivatized SOEs in which the government held an equity interest. The resulting information formed the basis for decisions on the enterprises to pass to the DIC secretariat for divestiture. They also highlighted the constraints to divestiture. The SEC also reviewed the "subvented" institutions, that is, research organizations, semicommercial units, regulatory bodies, and other entities that rely on government budget support. As a result, the institutions were classified into those that should be closed down; those that should remain fully subvented; those that are essentially commercial in nature and should be privatized; those that are partially commercial, but will require some continuing government financial support; and those that should be contracted out to the private sector. (Preceding sentence okay as changed?)Both these exercises provided a useful basis for planning the next phase of privatization in Ghana. However, responses from the government and the DIC secretariat to the SEC's work and recommendations for further privatization have been slow in coming.

2.21 Up to mid-1996 the DIC secretariat prepared a profile for each enterprises it put up for sale. The profile was in the form of a sales memorandum that provided basic information about the enterprise (for example, its activities, principal assets, products, markets, work force, and opportunities). When an enterprise had reasonably up-to-date financial statements, they were made available to potential bidders. The long time taken to finalize deals, however, clearly indicates that insufficient preparatory work was undertaken to identify issues that might delay conclusion of each transaction. In particular, no attempt was made to verify land title, which often became an issue when winning bidders commissioned their accountants and lawyers to undertake due diligence work. Since mid-1996 the DIC secretariat has contracted out work on all new divestitures, and the outsourcing consultants have begun preparatory work.

Major Constraints to Privatization

2.22 Observers almost unanimously say that the principal constraint to privatization has been the lack of government commitment. This certainly looks to have been the case, but the situation has changed over time (see table 2.1).

A Lack of Commitment and Consensus

2.23 The inadequate resources for privatization referred to earlier, the delay in adopting legislation concerning the DIC secretariat's mandate, and the delay in processing and approving transactions are all regarded as evidence of a lack of commitment. While this may be true, it is not the whole story. First, there have been

several important constraints: the issue of employee end-of-service benefits, problems over land title, and misconceptions arising from valuations of SOEs. Perhaps the most damning evidence of a lack of government commitment has been the tardiness in dealing with these issues.

2.24 Even if we accept that the government was fully committed to privatization, it was not surprising that commitment was slow to become evident when popular support for divestiture was lacking.

2.25 In the late 1980s and early 1990s there was strong opposition to privatization from SOE managers, employees, and trade unions. Many people saw privatization as a threat to jobs in the public enterprise sector and as a potential sellout of publicly owned assets to foreigners and to the Lebanese minority community in Ghana. A lack of public information about privatization and a lack of transparency surrounding many of the early divestiture transactions compounded the problem. The lack of transparency made the business community suspicious of the government's motives; that suspicion still exists today. The current World Bank technical assistance credit includes a public information component, but this, too, is slow in materializing. This is all the more surprising when a key lesson from Ghana's privatization experience is the need for public information and consensus building early in the process.

Employee End-of-Service Benefits

2.26 The amount of end-of-service benefits (ESB) has been a constant problem and was a major cause of delay early in the program (1987to 1990). The issue of high benefit levels—usually calculated as eight months of final salary for every completed year of service—arose because ESB had been raised as a pension-enhancing scheme following the collapse of the social security system. The high cost of ESB rendered restructuring of SOEs impossible and the SEC—and later the DIC secretariat—were faced with the prospect that many divestitures would result in a situation where the contingent cost of these benefits alone would exceed likely sale receipts. In 1990, in response to this dilemma, a cap was put on these benefits both to limit the cost and to make them uniform. At the same time, the government accepted full responsibility for settling these benefits.

2.27 In theory, all ESB in the SOE sector should be calculated and paid on the same basis. In practice, they are negotiated on an individual enterprise basis. The government had hoped to settle all outstanding ESB by the end of 1996 but, more than a year later, several SOEs remain in which the assets have been sold, but in which amounts are still due to the employees. These employees are wondering what has happened to the government's undertaking to meet these benefits. They complain, understandably, that the delay in payment effectively means that the benefits they receive are worth less. They would be all the more annoyed if they were aware that the DIC secretariat has held divestiture receipts from other privatization transactions that could have been used to pay them their entitlements.

Land Title

2.28 Clear land title is a recurring issue. According to the DIC secretariat, up to mid-1997 privatization transactions reported as completed (approved and signed by the parties to the contracts) were finalized except for transfer of land title. The transfer of title was in all cases dealt with late. In some cases, it is still outstanding. The problem is that many SOEs did not have legal title to land they occupied or they held legal title but lacked documentary evidence. This is also true of many SOEs not yet slated for privatization. Despite this persistent problem little appears to have been done to resolve it. Indeed, although the DIC secretariat has been aware of this issue all along, it left the consultants to encounter the problem when they come to prepare enterprises for divestiture.

2.29 There is little excuse for not rectifying the problem of the lack of legal documentation when it is known that there is no dispute over title, although many cases exist where ownership of title is unknown or in dispute. This problem extends beyond the DIC secretariat's work; it is a generic problem that has also affected the government's program for divesting state farms and plantations.

2.30 The problem arose mainly from the nature of state land acquisitions during the First Republic. In the spirit of the time, individuals and local communities were encouraged to give up land for development. Many responded by yielding land, believing that this was for the common good. However, no title documents were prepared to cover land that was acquired by the state, and no compensation was paid to the beneficial owners. Since the announcement of the divestiture of state farms and plantations, there have been calls to return the properties to those people or their successors. For several years now, the government has been examining how to reconcile traditional claims with the economic realities facing these properties. Again, this is an issue that seems to have dragged on for an unnecessarily long period.

Enterprise Valuations

2.31 Valuation has been a sensitive issue since Ghana's privatization program began. The government has expressed its resolve to obtain the best possible deals, and securing a deal close to the expected sale value has been a major factor in the slowness of the program.

2.32 For every SOE to be divested, the DIC secretariat commissions an independent valuation of the assets. Private sector specialists carry out this work. Each valuation provides the DIC secretariat with a guide to the value of the SOE's assets (on the basis adopted by the appraiser) and also serves as an inventory of the assets. The valuation is said by the DIC secretariat to be used only as an indicative price and is not a reserve price. On this matter, the lesson of experience appears, at least in part, to have been learned. In the period up to 1991, some private investors reported that asset valuations had hampered possible privatization deals because the government refused to

consider offers where prices reflected the earning capacity of the assets, but where they were well below the values based on depreciated replacement cost.[6]

2.33 According to the DIC secretariat, each independent valuation report is sent to the respective enterprise management for review before it is accepted by the DIC secretariat. This prolongs the process of the DIC secretariat accepting a valuation as a reasonable guide, especially because it serves to provide a means for SOEs to delay the process. On the other hand, it can also serve to help build consensus and avoid later criticisms from the enterprises concerning valuation.

2.34 Valuations are sometimes difficult. For example, in the case of GIHOC Cannery, no accounts or book values were available. The assets were bought second-hand, and replacement assets were of a different type. Any value attributed to the assets could only be a rough, subjective guess.

2.35 Ghana's experience shows that SOE valuations are avoidable costs that do little except delay divestiture, and those delays result in a loss of value and are a deterrent to genuine investors. SOE valuations based on depreciated replacement costs or optimistic assumptions merely raise expectations of realizable value that, when through divestiture efforts the market indicates a lower price, cast unnecessary doubts about bid offers. A speedy competitive divestiture process, where the market determines the value, would surely be more efficient and probably result in higher proceeds.

Selection of Divestiture Methods

2.36 According to the DIC secretariat, the divestiture methods it has used have depended largely on the nature and size of the SOE and whether there are shareholders other than the government. Where an enterprise is small or does not have a strategic dimension in the economy or a critical role in supplying social services to the surrounding community—and that describes the large majority of SOEs which the DIC secretariat has divested—the DIC secretariat may move ahead to sell the selected SOE. In other cases, the DIC secretariat would investigate divestiture options for the SOE or appoint consultants to advise on the divestiture options. This may change in the future because of the preparatory work undertaken by the SEC, and may change where the DIC secretariat outsources divestiture.

2.37 In deciding on the appropriate strategy for divesting an enterprise, the SOE's parent ministry is consulted and kept informed of progress. The DIC secretariat decides which divestitures it will undertake and those for which it will engage outside private consultants. In the latter cases, the DIC secretariat manages the consultants' work through routine reporting. The consultants are required by their terms of reference to adhere to the established divestiture procedures. The DIC secretariat appoints a receiver where that course of action is warranted.

[6] Several cases exist, however, where delay in or withholding of approval have led to a significantly lower price (the sale of the State Fishing Corporation's fleet being a prime example).

2.38 The procedures for selecting and implementing appropriate divestiture methods, as described in the DIC secretariat's publication "Divestiture of State-Owned Enterprises," are those it intends to adopt and outside consultants should follow, since the procedures do not appear to reflect what has happened in the past. Many transactions, particularly those before 1995, appear to have been entered into without competitive bidding. This is not to say that the DIC secretariat did not talk with alternative potential investors, but there were few cases of a strictly organized competitive bidding procedure.

Competitive Bidding to Acquire Shares and Assets

2.39 Although not widely used until 1995, competitive bidding has become the norm and is required under the new divestiture procedures. Case study interviews revealed rumors of companies being discouraged from bidding in the period up to that time, but the use of independent contractors through outsourcing should help to assure the public that the process is now competitive and fair.

2.40 Even so, it will be hard to convince the business community in Ghana. They point to instances where, although a competitive bidding procedure was adopted, a negotiated deal was not approved and a transaction was concluded with another, later, surprise entrant. These instances, such as the cases of the Tema Drydock and Shipyard and the sale of the SEC's fishing fleet, have added to concerns about the transparency and fairness of Ghana's privatization program.

2.41 DIC secretariat technical personnel, together with a representative of the sector ministry, have carried out the opening of bids. Since 1995 bid openings have been carried out in public with the bidders invited to attend. This is now normal procedure.

2.42 On several occasions the DIC secretariat has selected a bidder who subsequently was found not to have the necessary funds available to support his bid. Because of that experience, the DIC secretariat now requires all bidders to produce at the bid opening a bid bond of 10 percent of the offer price that, if a bidder is selected, is converted into a nonrefundable commitment fee, which becomes a partial payment once the sale has been approved. Despite the new procedure, which was clearly spelled out in press advertisements in 1995 and which is contained in bid invitations, some bidders have failed to provide a bid bond and have instead presented personal checks. This has at times given rise to some misunderstanding. For example, in the case of the sale of Tesano Stores, the highest bidder had not presented a bid bond and was automatically disqualified and the second highest bidder, who fully met the bidding requirements was selected. Not all members of the public understood why the highest bidder was unsuccessful. In the same case, only 4 of the 10 bidders presented bid bonds.

2.43 The highest bidder is not necessarily selected by the DIC secretariat. Most enterprises divested to date by the DIC secretariat have been financially distressed or otherwise operationally inactive. Since it has not been possible to offer them for sale as going concerns, their assets have been offered for sale—sometimes collectively, sometimes as separate operating units. In these cases the government has been interested less in price (that is, in maximizing breakup value) and more in how best to ensure that

the divested assets will be employed in a successful business. To achieve this aim bidders are required by the DIC secretariat to demonstrate their capability to run the business by submitting a business plan together with their offer. For outsourced divestitures the firm contracted to assist the DIC secretariat reviews business plans. While the logic of requiring a business plan is understandable, its use as part of the bid evaluation process raises several issues. It allows possible undue discretion to enter the selection process that, in turn, affects transparency. For the smaller transactions, it may deter potential bidders who have little or no experience in preparing or presenting a business plan. In any event, a business plan is no more than an indication, since plan commitments are very unlikely to be legally enforceable. If a sale contract were to include a clause committing a buyer to investments according to the business plan, it would require follow-up by the DIC secretariat (whose resources are already overstretched). Policing capital investment would mean continuing government involvement in the affairs of privatized businesses. Such activity would more likely deter, rather than encourage, investors through privatization.

2.44 One complaint from a frequent bidder was that the DIC secretariat gave no indication of when it would inform bidders of the outcome; they had to wait until the DIC secretariat reviewed business plans and payment terms and reached a decision. The new procedures and the use of outsourcing have helped alleviate this problem, but some delays still occur.

Deal Approval

2.45 The DIC secretariat recommends a selected bidder and deal to the Office of the President. The DIC secretariat's lack of authority to approve deals causes concern to some potential investors because it introduces an unknown element into the process. Among investors and the business community at large is a strongly held view that politics plays a part in deciding who shall, and who shall not, succeed in concluding a deal with the DIC secretariat. There have been several cases where the Office of the President has not accepted the DIC secretariat's recommendation—all the more surprising when one considers the membership of the DIC secretariat—but all too often in these cases nonapproval has taken the form of delay and silence rather than a direct refusal to approve the deal. Selected bidders have been kept in a state of uncertainty for many months, even longer at times. While he may be lucky, any serious investor in Ghana who is not close to the Office of the President must be prepared for a long delay even after reaching full agreement with the DIC secretariat.

Deferred Payment

2.46 Many deals involve payment on deferred terms. This has proved necessary to attract bidders and, in particular, to attract indigenous Ghanaian investors. The DIC secretariat negotiates deferred payment terms that normally include interest calculated on the following basis: (a) for local investors, the current Treasury bill rate; and (b) for foreign investors, London interbank offered rate (LIBOR) plus 2 percent. This raises an important policy issue: should the government's implementing agency act as lender of

last resort, especially concerning nationals who, for whatever reason, are unable to raise debt or equity in the financial market? While it may be difficult to raise capital in the market, easy access to credit through the DIC secretariat only discourages financial institutions from responding to the need for medium- and long-term credit. And, of course, the DIC secretariat is taking a risk in extending payment terms to buyers who lack the backing of a bank.

Completed Transactions through 1997

2.47 Since the beginning of the privatization program more than 200 transactions have been reported. Table 2.1 summarizes these on a year-by-year basis.

Table 2.1. Summary of Completed Divestiture Transactions, 1989–97

	Year of completion									
Transactions	1989	1990	1991	1992	1993	1994	1995	1996	1997	Total
Public flotations						9	2	3	1	15
Share sales:										
Competitive						1			1	2
Preemptive		2	5	3	2		1	1		16
Noncompetitive		4			2	4		1		13
Asset sales:										
Competitive		1		1	1	23	10	6	15	57
Competitive?					1	8	1	2		12
Noncompetitive		2	1	2	2	3	4	2	2	18
Joint ventures:										
Competitive					1	2			1	4
Noncompetitive		3		2		1	1	3		10
Debt-equity swap				1		1				1
Restitution						1	2	2	4	9
Leases		2				2				4
Liquidations	6	17	2	6	5	13	3	1	1	54
Management contract						1				1
Total concluded	6	31	12	15	14	69	24	21	25	217
Plus deals:										
Signed but later failed			1	6	1	1				
Negotiated but not signed				2	3	2	1			
Total negotiated		2	34	21	18	15	70			

Note: No transactions were completed in 1988. Concurrent flotations in Accra and London in 1994 of shares in Ashanti Goldfields Company Ltd. are treated as one transaction. The above table is a summary of completed transactions. Following liberalization, "privatization by displacement" has occurred in sectors where competition has been encouraged (notably in distribution, manufacturing, and services), but data are not available to gauge this aspect of privatization.

3

The Rationale for Employee Stock Ownership Plans in Privatization

3.1 Economic development efforts worldwide increasingly emphasize the importance of reducing the role of the state in the ownership of productive enterprises. Privatization is essentially seen as a process of replacing the single state owner with multiple owners who will be motivated to operate the business more efficiently in response to market signals. As the rate of privatization has increased around the world, privatization programs are increasingly including a focus on incorporating an element of employee ownership to ensure that ownership of the privatized enterprises will be shared broadly by its workers, not just by wealthy investors.

3.2 The advent of broad-based employee ownership plans in traditional market-based corporate structures, coupled with the growing acceptance of free market principles and the resulting pressure to diminish the role of the state in national economies, has increased interest in the use of employee ownership as a means of facilitating the transition from state to private ownership. Dozens of countries have used employee ownership as a technique of privatization, and scores more are actively considering such a strategy. Indeed, in some countries employee ownership is increasingly becoming a non-negotiable component of the privatization process, with the emphasis shifting from whether workers should own a stake to just how large a stake they should own and how that ownership should be achieved.

3.3 It is important to emphasize in this context that employee ownership does not necessarily mean ownership exclusively by employees. Particularly in the context of privatization of state-owned enterprises, "mixed" privatizations involving outside investors (both individual and institutional), foreign companies, and employees are likely to predominate. The experience with employee ownership in the United States, for example, indicates that the majority of companies with significant levels of employee ownership typically have employee stakes of 10 percent to 30 percent. Employees own a majority of the stock in less than 10 percent of these firms. While some privatization transactions worldwide have resulted in employees obtaining majority ownership stakes, more commonly employee groups obtain a minority interest in partnership with other investors. Indeed, in many cases it is preferable to ensure that employee ownership is

limited to a minority stake in the enterprise to avoid the problem of management entrenchment and insider control that may be antithetical to the introduction of market reforms.[7] (See box 3.1.)

Box A3.1. Forms of ESOPs

An ESOP is a general name for any organized and stable form of employee ownership. In some countries, however, such as in Hungary, the United Kingdom, and the United States, an ESOP is a specific legal form. In the United States, an ESOP is a legal trust separate from the corporation. Corporate shares are purchased by the trust for employees using borrowed money. The corporation pays off the loan, but is allowed to use the contribution of shares to workers as a deductible expense. The corporation buys back shares when employees terminate or retire.

3.4 Coincident with the confusion over the definition of employee ownership are common misperceptions of what employee ownership represents and how employee ownership might affect the privatization process and the operation of privately owned corporations in a free market economy. For example, emphasizing employee ownership in the privatization process does not necessarily mean giving away state assets to employees without compensation. Quite to the contrary, employee ownership rarely involves a giveaway of government assets. Employees are often encouraged to purchase stock (often at discounted prices with deferred repayment terms at subsidized interest rates), but since employees have limited or nonexistent investment capital, employee buyouts of state assets are more typically structured with the use of credit, either from the state itself, from strategic investors, or from third party lenders.

3.5 Various mechanisms have been used to facilitate employee ownership in privatized companies, including the transfer of share ownership in the form of grants (for example, in Poland), the sale of shares on preferential terms (for example, in France, Morocco, and the United Kingdom), and employee stock ownership plans (for example, in the United Kingdom, the United States, and Egypt). Employee stock ownership plans (ESOPs) are different from other schemes because they permit employees to access ownership throughout the life of their enterprise, instead of limiting the access to a "one-off" event at the time of privatization. ESOPs also enable employee shares to be financed and paid for with the future earnings of the corporation. Since most employees lack the financial resources to purchase stock, the use of leveraged ESOPS as a technique of corporate finance has in many cases allowed employees of privatizing enterprises to obtain a substantial ownership stake. Under this approach, part of the future profits of the newly privatized companies are used to repay the debt. As the debt is repaid out of corporate profits, the stock ownership transfers to employees. Alternatively, governments can offer favorable terms to employees through discounts, deferred payment terms, tax deductions to encourage corporations to fund ESOP contributions, or "earnouts," in

[7] The experience of the Russian privatization program is illustrative in this context. Following the first round of privatizations of medium-size and large enterprises, employees and managers owned an average of two-thirds of the enterprise stock in the majority of companies immediately following privatization. In the absence of shareholder rights and securities law standards, however, most of that ownership was eventually transferred to an elite minority within the enterprise or to well-financed outsiders.

which employees and managers earn their ownership by meeting predetermined financial goals for the privatized company. (See figures 3.1 and 3.2.)

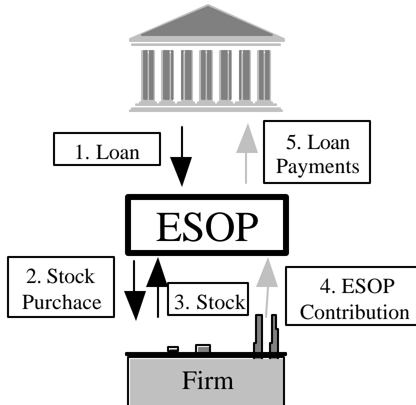

Figure 3.1. A Standard Leveraged ESOP

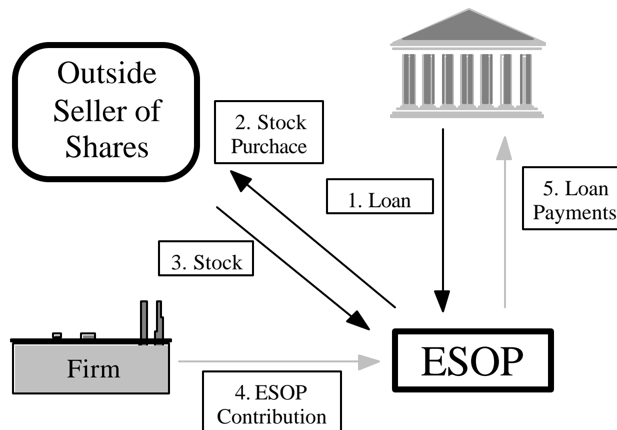

Figure 3.2. Leveraged Worker Buy-Out from Outside Seller

3.6 Among the former socialist countries of central and eastern Europe and in the successor states of the former Soviet Union, a great variety of measures have been used, with varying success, to promote at least partial employee ownership of privatized enterprises. These techniques include free shares, shares at deep discounts, and provisions that enable companies, directly or through an indirect borrowing mechanism, to buy shares for their employees, sometimes at least in part out of pretax profits. But it would take us beyond the resources available to this project to establish the relevant facts comprehensively or in any significant detail. (Appendix 1 includes a detailed description of the specific provisions of the employee ownership programs in Bolivia, Egypt, Jamaica, the United Kingdom, and the United States. The experience of each of these

countries is relevant in light of the implementation of potential employee stock ownership plan reforms in Ghana.)

Broadening Share Ownership and Creating an Ownership Culture

3.7 One of the main attractions of employee ownership is its broad appeal in terms of both macroeconomic policy and industrial organization. Employee ownership is considered an effective means of promoting economic efficiency through free enterprise while also promising fairness of economic opportunity through a widespread distribution of the wealth that is transferred from government to private control. This is particularly important in formerly socialist countries undertaking the transition to a market economy. The emergence of employee ownership in both Western economies and transitioning socialist economies represents a new dynamic of free enterprise that emphasizes widespread participation in the ownership of productive property. Establishing widespread capital ownership is therefore seen as a means of strengthening the constituency for free enterprise by giving large numbers of employees a direct financial stake in the performance of private corporations and the opportunity to reap financial rewards through ownership.

3.8 ESOPs are a particularly efficient tool for implementing such a strategy. They allow workers to become owners of their enterprise on a continuous basis instead of limiting the access to ownership to one discrete event—the privatization transaction—and therefore are more likely to promote the growth of an "ownership culture" within the Ghanaian corporate world. ESOPs also provide a mechanism whereby employees can become shareholders of their company and pay for those shares with the future profits of the company that employs them, allowing employees to obtain a larger ownership stake than what they can pay for out of current income and savings. Therefore, they are likely to attract even the smallest revenue earners. ESOPs also provide an effective means of ensuring that employees will hold their shares for enough time to allow for capital appreciation through wealth creation rather than selling them for a quick return. Finally, they provide the means for the workers to be collectively represented on the board of directors of their companies.

3.9 The Ghanaian privatization program provides the government with a window of opportunity to broaden share ownership beyond the realm of economically privileged Ghanaian nationals or foreign interests who can afford to purchase assets or shares. Experience in the United States, the United Kingdom, and in those developing countries that have followed a strategy of broadening share ownership demonstrates that the benefits of such a strategy are maximized when the sale of shares is accompanied by an effort to develop an ownership culture among the workers.

3.10 Ownership also goes beyond a mere bundle of rights and power. Ownership also involves a state of mind. It is an attitude which accepts risk and responsibility; it is a mind-set that actively seeks greater opportunity to earn a greater reward through improved corporate performance. An ownership culture means a business community composed of people sharing the values of ownership, and working together in

an organized way for their mutual benefit as co-owners. It implies a transformation in the attitude and daily habits of the workers-owners. Education, information sharing, and the sharing of risks, responsibilities, and rewards must become key values of the company.

Accelerating Privatization

3.11 Employee ownership also offers a practical means of jump-starting the privatization process by organizing a clearly defined, knowledgeable shareholder group that has a vested interest in working for the success of the privatized enterprise. Employees are typically the largest and most vocal interest group in the privatization process, and they are often the natural candidates to consider in fostering the privatization process. Such an approach can save on political, economic, and administrative costs associated with privatization strategies that do not address the legitimate economic concerns of the work force. Providing workers with a shared financial interest in the success of the enterprise, particularly when ownership is combined with participatory management techniques, can also help to accelerate the transition to a private sector environment and provide an incentive to improve productivity. As the employees of privatization candidates become active participants in the program, the size of the market for shares increases, and the government can increase the pace of divestiture. In countries where privatization is difficult to launch, employee ownership schemes may provide an opportunity for commencing the process, even though fewer proceeds might be realized.

Alleviating Labor Concerns and Overcoming Opposition from Organized Labor

3.12 In many countries there is often strong resistance to privatization from unions, workers, and consumer groups who feel that privatization requires them to give up something (for example, job security, subsidized wages, relaxed work rules, and other benefits) with little or nothing in exchange. More often than not the greatest resistance to privatization comes from employee groups themselves. Allowing employees to obtain a significant stake in the capital ownership of their enterprises can potentially overcome their legitimate fears over losing the protection of government jobs, while also providing a financial incentive to support private enterprise at the grassroots level. The more workers and their unions can participate in the privatization process, as well as in the potential fruits and ownership opportunities of the transfer to the private sector, the easier it becomes to overcome social and political barriers to privatization. An ESOP can also provide the opportunity to restructure labor-management relations.

3.13 Furthermore, employees are more likely to invest their own money in the one company they know something about and where their own efforts can have the greatest impact. In many cases, employees may actually be the only significant constituency interested in purchasing a particular company. Having the mechanisms in place to facilitate employee purchases can help speed the process of employee buyouts in cases where other investors are unavailable. For these marginal companies with uncertain prospects for success or an inability to attract outside interest, employees may be in the

best position to determine the viability of the enterprise as an independent entity. In addition, because they represent a readily identifiable buyer, sales to employees can often be conducted more expeditiously. (See Appendix 2 for a discussion of the role of labor unions in employee ownership.)

Building Support for Market Reforms and Privatization

3.14 Introducing a degree of participation by employees and managers in privatization operations is an effective way of building political support for privatization and reform. Employee ownership can soften the impact of privatization and give employees an incentive to assist with the restructuring effort that often accompanies successful privatizations. The inclusion of employees can affect the extent to which restructuring occurs in conjunction with privatization, and can help privatized companies retain employees with firm-specific skills. By broadening the constituency for corporate ownership, economic policies focusing on promoting the growth of the private sector will translate more readily into bottom-line financial benefits for larger numbers of citizens. And by creating large numbers of domestic shareholders as part of the privatization process, employee ownership can help to foster the development of capital markets from the ground up by promoting greater knowledge of share ownership and developing a future source of both shareholders and overall shareholdings.

Privatization and ESOP Financing

3.15 Typically an ESOP is structured as a separate legal entity, such as a trust fund, to which a corporation sells shares. Employees are each allocated a number of shares that are held for them according to the terms of the ESOP. The terms are established by those who set up the ESOP. Funds required for purchasing these shares for the ESOP come from three basic sources: (a) employee funds; (b) employer contributions; or (c) external funds. To the extent that an ESOP is financed with borrowed money to be repaid with employer contributions, it is called a self-financed leveraged ESOP. In either case, what distinguishes an ESOP from other employee ownership programs is that shares are paid for partly or fully out of future corporate earnings. This allows employees to obtain stockholdings significantly larger than what they can purchase with current earnings or savings. ESOPs can also be an additional source of demand for shares of privatized companies, particularly if leveraged ESOPs are enhanced through tax relief for sponsors, participants, and lenders. (See Appendix 3 for a discussion of the financing of ESOPs in Ghana in relation to the country's national savings and investments.)

Improving Enterprise Performance

3.16 There is considerable empirical evidence, especially from the United States, that points to the likelihood of measurable improvements in performance if employee ownership is significant and equitable; if the other elements in the employee involvement package reflect best practice; and if management, rank-and-file employees,

and the trade unions are reasonably committed to making the employee ownership a success. Conversely, the negative evidence from privatization experience in various countries suggests that rank-and-file employees and their unions may react negatively to ownership changes if what they see as their interests are not taken adequately into account.

3.17 It is important to recognize that employee ownership does not mean day-to-day control or management of companies by workers, nor does it mean that all important business decisions will be made collectively by a large group of workers. Just as in traditional corporations, boards of directors and management will continue to be responsible for developing long-range business planning in employee-owned companies, subject to oversight and ultimate control by the company's shareholders. The most effective employee ownership companies provide greater opportunities for participatory workplace environments and training and education programs to encourage employees to think and act like owners to help improve corporate performance. When best practice is followed, ESOPs can lead employees to agree to take less cash out of the company in the form of pay and benefits, if the company agrees to use these funds to buy shares for employees. Thus, a combination of wage restraint and future company earnings creates the cash flow needed for employees to purchase their ownership stake. As more cash becomes available to service employee ownership plan–related debt, the company's creditworthiness is enhanced.

Attracting Foreign Investors

3.18 Employee ownership can make companies more attractive to foreign investors because the workers' stake in the company is perceived to reduce the risk of nationalization. In addition, ESOPs can provide a means of exit from international investors when the company is not listed. Given the growth of employee ownership worldwide, many multinational companies are familiar with employee stock ownership and are increasingly receptive to ownership-sharing arrangements.

Integrating ESOPs into Overall Privatization Strategies

3.19 ESOPs are but one element of a successful privatization strategy. They will be more successful if they are integrated into a conceptual framework designed to foster the growth of the domestic capital market, allowing the participation of the public at large in the divestiture process, while attracting foreign direct investments. In this case, the various components of the privatization strategy feed upon each other and generate a virtual circle facilitating the privatization process and creating the conditions for the growth of the corporate sector. Obviously, employee share ownership will be optimized in an environment that clearly defines private property rights; shareholder rights, including voting and rights to information disclosure; and the provision of mechanisms for employees and other shareholders to sell their shares.

3.20 Initial public offers (IPOs) are an efficient means of developing domestic capital markets and broadening share ownership by allowing small investors and institutional investors to participate in privatization transactions. They generate much of the same political benefits highlighted in the discussion about ESOPs and provide the privatized enterprise with a means to access much-needed, long-term capital to fund their growth. In addition, they strengthen ESOPs because they provide liquidity for the shares acquired by employees. Therefore, they facilitate the harvesting of shares. Without such a liquidity mechanism, provisions must be made by the company or the ESOP itself to repurchase the shares of their employees. In cyclical downturns or in times of difficulties for the company, this repurchase liability can worsen the company's financial health and create additional cash demands that depress share values.

3.21 Strategic investors provide capital, know-how, and potential openings for new markets to the privatized enterprise. They also often enhance the corporate governance of the privatized entity. The most effective way of selling shares to strategic investors is by means of open bid.

3.22 One of the most efficient ways of structuring privatization operations in developing countries is to divide the share for sale in several tranches. Each tranche is then sold to targeted investors in separate transactions. Hence, a public tender is used to sell a substantial block of shares to a strategic investor; an IPO is used to sell shares to the general public; and a private placement or negotiated sale is used to sell shares to employees of privatized companies. It may be appropriate to consider privatization transactions in the context of a simultaneous flotation of shares on the stock exchange to develop immediate liquidity for the shares. This can help support the value of the shares and enhance the attractiveness of the investment for strategic partners by creating a ready market for the shares.

3.23 This strategy could be followed for the privatization of the distribution companies, provided the companies themselves are put up for sale. This would be an attractive investment opportunity for both domestic and foreign investors. In the case where concessions are sold instead of the companies themselves, the IPO becomes difficult though not impossible, because concessions have a limited life span. A public listing is therefore more difficult to envisage. In this latter case, the concessions can still be placed in a Ghanaian company and an ESOP can be structured to allow the employees of the concession company to become shareholders of the latter.

3.24 The lessons learned from the international privatization experience can best be summarized in the following principles that should be incorporated into a privatization program to the greatest extent possible to ensure the viability of privatization transactions involving employee ownership.

3.25 **Ensure fairness of opportunity**—All employees should have an equal opportunity to acquire some stock ownership, though overly restrictive stock distribution rules should be avoided. Lenders to private employee buyout transactions often require that key employees be given greater performance incentives or require larger investments

on the part of key employees, so some flexibility should be allowed in structuring specific transactions and actual stock allocation strategies.

3.26 **Maintain transparency of the process**—Ensure widespread distribution of information on employee ownership options for privatization to employees of state-owned enterprises *and* to outside firms that may be interested in bidding on privatization transactions. In some instances employees may be the only bidders, whereas other companies subject to privatization may require a competitive bidding process.

3.27 **Be prepared for differing expectations**—Some will advocate employee ownership as a means to enhance corporate performance. Others will emphasize the benefits of making ownership available to a broad cross-section of employees. Employees may see employee ownership as a job preservation strategy. While these perspectives are not necessarily incompatible, different interest groups will approach employee ownership with different priorities.

3.28 **Allow for flexibility**—Functions that could be targeted for privatization with employee ownership will vary greatly in terms of the work performed. The program should therefore allow for transactions to be structured in a variety of ways to accommodate the needs of a particular program.

3.29 **Involve employee groups from the beginning of the process**—Employee groups, in particular labor unions, are typically the biggest roadblock to privatization initiatives. Giving them a financial stake in the privatization can help counter potential opposition, but employees need to feel that they have an opportunity to affect the outcome and not have their fate determined by dynamics entirely beyond their control that prevent their active participation in the process.

3.30 **Facilitate the use of credit to help finance employee ownership transactions**—Employees will not be in a position to bid directly on privatization proposals without assistance in the form of financing. Leveraged ESOP transactions are feasible if the government provides the winning bidder a contract term long enough to convince lenders of the ability of the newly privatized enterprise to meet debt payments. Alternatively, the government could allow for discounts on employee purchases of shares in privatized enterprise, allow deferred payment terms for purchases of stock, or create incentives for corporate contributions to ESOP participants.

3.31 **Do not dictate the permissible level of employee ownership**—In some instances, employee groups may be able to structure a complete employee buyout of a privatizing enterprise. In most cases, they will be required to partner with other investors. The government should allow employee groups to determine the best feasible deal without establishing arbitrary limits as to the amount of equity available to the employee group in a given transaction. Employee groups should be encouraged to negotiate for the best economic deal, not necessarily the largest ownership percentage.

3.32 **Policy reforms should facilitate the legal environment**—Some legal and regulatory changes may be required to facilitate long-term employee shareholding. To the extent that privatization transactions can be structured to accommodate significant levels of employee ownership, policymakers need to take into account legal and fiscal barriers to employee ownership and consider policy reforms to accommodate the goal of fostering broad-based stock ownership by employees. In the context of the Ghanaian experience, the importance of implementing privatization reforms could justify the development of policy reforms to facilitate employee ownership as a means of ensuring that privatization transactions will result in significant ownership opportunities for domestic workers.

3.33 **Balance privatization and revenue goals—**Given the limited means typically available to employees in privatization transactions, their ability to obtain meaningful levels of ownership will require the use of some form of deferred payment. The willingness of the government to incentivize employee share acquisitions or defer its income from the privatization transaction by allowing employees to pay for their shares over time can help ensure that employees will be able to obtain more than a token amount of stock ownership.

3.34 **Emphasize education and training**—Many employees have little or no experience in working in the private sector. Privatization promises to be a difficult transition, but programs focused on training employees in the fundamentals of ownership and free market principles, as well as participatory management techniques, can help prepare them for a new competitive environment. The most successful employee ownership firms combine the incentive of stock ownership with the motivation of employee participation in working to improve the operations of the enterprise. A privatization program will ultimately be judged in large measure not just by the total value of assets and services transferred to the private sector, but by the successful transition of government employees to the private sector. An investment in training and education can go a long way toward supporting that goal.

Conclusion: Employee Ownership Requires Policy Support

3.35 Privatization is a political process. It requires political will to get started and political savvy to ensure that it will be a continuous process that is perceived as fair by diverse interest groups. Properly designed and implemented, employee ownership programs offer a viable means of facilitating a privatization program by providing a key interest group—employees of state-owned enterprises subject to privatization initiatives—with an opportunity to make the transition to the private sector with a job and with a financial stake in the future success of their privatized company. Employee ownership is no panacea, but it does represent a practical technique of accomplishing a needed public policy objective in circumstances where state-owned companies can be effectively transferred to the private sector.

3.36 Absent government support for employee ownership reforms, however, the viability of employee ownership as a significant factor in privatization transactions will be limited. Employees lack the financial resources, the experience in negotiating the

complexities of financial transactions, and the support of legal structures intended to promote the acquisition of capital assets for a broad range of workers. By incorporating employee ownership as a practical means of accomplishing indigenization in the privatization process, however, and by creatively adopting employee ownership techniques to conform with the legal and financial structures already in place in Ghana today, it will be possible to ensure that Ghanaian workers will have the opportunity to reap significant financial benefits from the privatization process. This will require a willingness to implement policy reforms to facilitate the acquisition of shares by employees, but the viability of such reforms has been amply demonstrated in dozens of countries around the world.

3.37 Far from being an experimental concept, employee ownership has proved to be a flexible and adaptable strategy that can be implemented in a variety of economic conditions. The potential for employee ownership to address diverse policy concerns and to help streamline the transition from state to private ownership holds great promise for supporting long-term economic policy goals and merits the consideration of policymakers seeking to implement market reforms in Ghana.

4

A Legal Framework for ESOPs in Ghana

4.1 The first requirement for establishing an ESOP is for the statutory recognition of a second legal entity, separate from but affiliated with the company for which the employees are working and of which, through the ESOP mechanism, they become part owners. In the United Kingdom and the United States this second entity is in the form of an employee trust that is almost always corporate and must satisfy a number of conditions specified in the law. In some countries where trusts are not part of the legal system, the second entity will normally take the corporate form of a second, and private, company, or as an employee shareholders association (ESA).

4.2 Ghana is fortunate in having a basic trust law on its statute book. What is needed is the definition and recognition in the law of a special type of ESOP trust. The law would define the conditions such a trust would have to satisfy if it were to enjoy the law's protection. Some of those conditions could be specific to conditions of Ghana's economy. They might be expected to include provisions relating to the following:

- The range of functions the ESOP trust would be legally empowered to perform.
- The composition of the trustees.
- Fiduciary standards and liabilities.
- The distribution of shares between employees to ensure that all employees are covered by the scheme and that the distribution is based on objective criteria designed to satisfy a fairness test.
- The terms under which employees may sell their shares.

4.3 Additional qualification and statutory requirements should also include giving participants the right to determine how shares in their ESOP account are to be voted on certain corporate issues, rights to certain information related to the operation of the trust, and the right to demand that benefits be distributed in the form of employer securities. In addition, the ESOP should provide for annual independent valuations of the employer's securities and require that the employer repurchase any employer securities if the securities are not readily tradable on the open market.

4.4 Provisions will also need to be made to provide liquidity for the shares acquired by employees. If the company is publicly traded, employees may sell their

distributed shares on the market. In a privately held firm, the company usually gives the employee a "put option" on the stock for a limited period of time after the distribution.[8] If the employee chooses not to sell at that time, the company must offer another put option for a second period starting one year after the distribution. In the United States an ESOP company may make an "installment distribution" provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a "retirement distribution," and not to exceed five years in either case. The company must provide adequate security and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

4.5 Though enacted with their role in Ghana's privatization program mainly in mind, the ESOP trusts, which the new law would define and recognize, could also be used to facilitate other transitions involving employee ownership, such as stock purchase plans, stock options, and employee savings plans. It would also be appropriate to facilitate the indefinite sustainability of employee ownership to foster long-term shareholding and maximize wealth-creation potential.

Review of Legal Regime: Company Code, Trust Act

4.6 Although trusts are already part of Ghanaian Company Law, a vacuum in the Trust Act affects certain essential features of ESOPs. Specifically, there is a need to enact an appropriate set of tax relief laws to enable companies to use pretax profits—either directly or through the repayment of borrowings—to allow the newly recognized trusts to buy shares for employees.

4.7 In addition, three principal impediments in the Ghanaian Company Law should be removed to permit the creation of ESOPs in the country:

- An apparent ban on companies to make loans to their directors for the purpose of buying shares of their companies.
- Possible adverse consequences for prospective employee shareholders in the tax treatment of loans made to facilitate the purchase of employee shares by them.
- An unofficial need to meet high and expensive standards of "prospectus" detail and documentation if shares are offered to employees alongside offers to the public.

An Appropriate Range of ESOP Tax Reliefs

4.8 A freestanding ESOP trust law, not linked to any tax reliefs, would be entirely justified by virtue of its enhancement of the legitimacy of employee share ownership and its educational benefits. The implementation of broad-based employee share ownership, however, would be hugely increased if it were associated with an appropriate range of tax reliefs. It would therefore be highly desirable to put in place an

[8] A "put option" grants the employee the right to sell a specified amount of shares at a specified price for a specified time.

appropriate range of tax relief that would be available to those ESOP schemes approved by the government. This tax relief should include provisions that allow employee shares to be purchased—directly or through the repayment of borrowings—out of pretax profits.

4.9 Both common sense and the requirements of U.K. law suggest that any ESOP tax relief laws that may be enacted in Ghana should only become available to those ESOP schemes that enjoy the specific approval of the authorities. It would be important in that regard to specifically define the type of ESOP that could qualify for such relief, because a variety of forms of employee stock ownership are referred to as ESOPs. Normally the relevant authority for the purpose of granting or withholding specific approval is the Tax Authority. For example, in the United Kingdom the relevant authority is the Inland Revenue. The administrative capacity of Ghana's counterpart taxation authorities may not be able to make that a realistic strategy. A lesser degree of protection for ESOP transactions would, of course, always be available in the shape of a court challenge by the authorities against the legitimacy of any reliefs that had been claimed and taken by "ESOP" scheme companies.

The U.K. Model of ESOP Tax Incentives

4.10 Because Ghanaian law is generally modeled on British legal precedents, it is perhaps illustrative to refer to the tax reliefs provided to ESOP schemes in the United Kingdom, where there are basically four distinct schemes of the "ESOP" type covered by statute law that may qualify for relief. A company is free to introduce schemes of all four kinds concurrently:

?? **Profit-sharing schemes**—Under these schemes, the company may apply pretax profits to buy shares for employees up to specified limits, which are linked to payroll and which may, but need not, require a matching share purchase by the individual employees. The latter is the so-called buy-one-get-one-free variant of the straight profit-sharing schemes. The matching "purchased" shares may be paid for by individual employees, pretax. Both the "free" and the tax assisted employee purchase shares become free of any income tax liability for their employee owners at the conclusion of a three-year retention period. To be approved, these schemes must have "all-employee" coverage, and the distribution of shares among employees must be objective and satisfy a fairness test.

?? **Save-as-you-earn (SAYE) schemes**—Under these schemes it is the employees' earnings rather than the company's profits that finance the whole of the employee share acquisition. In companies with SAYE schemes, employees who choose to take advantage of them commit themselves to set aside from post-tax pay a fixed sum each month, within defined top and bottom limits. These moneys are then held in interest-yielding accounts with third parties—approved banks or building societies—for a minimum of five years. The interest income, which is tax exempt, is added to the principle. At the end of five years, the employee

may withdraw (with no tax liability) what has been accumulated in the interest bearing account and then either (a) apply the money to buy shares in the employing company at the price that prevailed when the original SAYE commitment was entered into, or (b) use it in any other way. Despite their name, these SAYE schemes in the United Kingdom should be understood as all-employee share option schemes—with the ability to opt out if the share price is no higher when the savings commitment ends than when it started.

?? **Company share option schemes—**In this case the employee is not required to make regular payments or any savings, and there is no all-employee coverage requirement. Management is in principle free to invite select employees to take part in these schemes with unfettered discretion. There is a relief from capital gains and income tax that might otherwise be payable when the option is exercised. On the other hand, the starting value of the shares over which an employee may be granted a "company" scheme option may not exceed £30,000, or roughly twice the current average annual pretax pay in the United Kingdom. This (relatively low) limit was introduced by Prime Minister John Major's Conservative government in response to widespread public criticism of the much higher previous limits, to the effect that they allowed huge tax benefits to those who were already well-paid "fat cats."

?? **Statutory ESOPs**—The key distinguishing features in this case are that the trust may borrow money to finance the purchase of shares for employees, and that the company may make payments to the trust out of pretax profits to enable the latter to pay back its borrowings, making both the principle and interest payments tax deductible to the sponsoring corporation. As with the profit-sharing schemes above, there is an all-employee coverage requirement, and the distribution of shares among individual employees must be objective and such as to satisfy a fairness test. As the U.K. law stands at the moment, all the shares in a statutory ESOP must eventually be distributed to individual employees, though the law allows this to happen over a period of up to 20 years. For maximum tax effectiveness, statutory ESOPs are normally operated in conjunction with profit-sharing schemes and sometimes with SAYE schemes.

4.11 For the purposes of any tax assisted ESOP component in the prospective privatization and recapitalization of electricity distribution in Ghana, the profit sharing schemes and the statutory ESOP models referenced above are far and away the most important to highlight. Moreover, in each of these two cases, and in general terms, the tax reliefs afforded to similar plans in the United States are very similar. Two main differences relate to the retention rules and the all-employee rules. A third difference is that the U.S. law permits the use of pension fund money to help finance the purchase of employee shares, whereas British law does not. The three outstanding features of these systems of ESOP law and tax reliefs are, however, common to both the United States and

the United Kingdom and were in fact derived from the former by the latter. They include the following:

- ?? Provisions that allow employee shares to be purchased, either directly or through the repayment of borrowings, out of pretax profits.
- ?? Provisions that permit a defined and recognized employee trust body to borrow money to buy shares from employees.
- ?? Provisions that ensure that the resulting employee share ownership is acceptably broadly based, and that the distribution of shares among employees is at least defensively fair.

4.12 Given the Ghanaian experience with broadly based employee share purchase schemes in previous privatization transactions, as well as the policy and attitudes of its leading representative body of organized labor, the Trade Union Congress (TUC), one final point is worth highlighting from among the United Kingdom's various tax reliefs: the so-called Buy-One-Get-One-Free (BOGOF) scheme under which employees may qualify for a free share for each one they purchase with their own money. This approach combines the concepts of financing acquisition of the shares to enhance employees' ability to acquire shares, which also emphasizes the importance of some level of financial commitment on the part of employees.

5

Financial Prefeasibility Analysis of ESOPs in Distribution Concession Capitalization

5.1 The objective of a financial prefeasibility analysis is to assess the potential of employee stock ownership while maintaining a viable business unit with returns that attract strategic investors and provide a reasonable purchase price to the seller, the government of Ghana. The pro forma model outlined below is intended to illustrate the process of an initial ESOP prefeasibility assessment. It is not intended to accurately reflect the actual financial circumstances of the electricity distribution concession, nor substitute for a more complete feasibility study for an actual transaction, but to provide a reasonably accurate illustration of the analysis that would be brought to bear on a privatization transaction involving an ESOP. For that reason, we have not included actual estimates of the value of the concession, but rather the relative impact of certain key assumptions on the government, prospective strategic investors, and employees.

Financing ESOPs: Issues and Options

5.2 The two main forms of ESOP employed in the United States and throughout Europe are the leveraged ESOP and the contractual or contributory ESOP. In the case of a leveraged ESOP, the sponsoring corporation borrows funds to finance the ESOP's acquisition of shares. These funds are in turn lent on to the ESOP on substantially similar terms and used to purchase stock from the seller. The purchased stock is allocated to employee-participant accounts on a pro rata basis as the loan is repaid. The sponsoring corporation makes annual contributions of cash to the ESOP that the ESOP uses to retire its debt to the company, which in return repays the third party lender. In some countries these contributions are tax deductible. These tax deductions enhance the cash flows of the sponsoring corporation.

5.3 With a contributory ESOP, the ESOP transaction is marked by a contractual agreement from the sponsoring corporation to contribute stock annually to the ESOP until the specified ownership threshold is met. Loan sponsorship is not necessary under this scenario. Again, the contributions made by the sponsoring corporation to the ESOP are usually tax deductible to the sponsoring corporation.

5.4 The leveraged ESOP tends to generate lower cash flows and returns for other investors, as any tax deductions are based on the stock's value at the time of the initial transaction. The contributory ESOP, conversely, allows the tax deduction to reflect the full increase in value of the contribution as those contributions are made in future years. In addition, because of the need to direct cash flow through the ESOP and back to the company for repayment of the sponsored loan, the leveraged ESOP represents a more complicated financial structure for a given transaction, sometimes including a series of equity tranches with varied terms for dividend policy and investment return realization. For these reasons the more simplified structure of a contributory ESOP structure is used in this evaluation.

Feasibility of Employees as a Financing Source for the ESOP

5.5 Staff of both the Trade Union Council and the Ministry of Mines and Energy have indicated that employees are limited in their ability to finance an ESOP with wage and benefits sacrifices. Although the wages are well above the national minimum wage, most employees could not afford reductions in base compensation. The benefits provided to the employees include contributions to the state pension fund and employee savings accounts, known as provident funds. Contributions to the state pension fund have not been adjusted in this modeling exercise.

5.6 In some of the other capitalizations of state enterprises, provident fund balances and ongoing contributions have been employed to finance the employee stock purchase plans. Information on the existing value in provident funds at the ECG has not been made available. The current contribution requirements dictate that the ECG contribute the equivalent of 5 percent of employee salary or wage and the employee contributes another 3 percent of salary or wage base from the employee's earnings. For purposes of this analysis, these contributions are redirected for a period of five years to reflect a partial financing of the ESOP through employee sacrifice. However, these funds represent a small fraction of the equity value allocated to the employees' ESOP accounts.

The Strategic Investor as an ESOP Financing Source

5.7 Strategic investors can finance the ESOP by contributing shares at their own expense. This offering directly reduces the rate of return realized by the investors. The willingness of equity investors to forgo returns depends on the pre- and post-ESOP rates of return. Any tax incentives offered for ESOP contributions are an important part of this evaluation.

5.8 International firms in the electric generation and distribution industry are expected to bid on the available concessions. In addition to a capital infusion, a strategic investor will bring expertise to further enhance the efficiency of the concessions. According to officials at the Ministry of Mines and Energy, potential strategic partners have already expressed interest in acquiring distribution concessions.

The Ghanaian Government as a Source of ESOP Financing

5.9 As a member of the acquisition team, the government's contribution to the ESOP is equivalent to the contribution of the strategic investor—sacrificed returns. As the seller, the government could facilitate the formation of an ESOP in the following ways:

?? Accept a reduced purchase price in favor of an equivalent value of shares being allocated to the ESOP.

?? Accept deferred payment terms for the ESOP's shares.

?? Provide tax incentives for ESOP contributions.

?? Subsidize lending rates for loans to the sponsoring corporation for ESOP loans.

?? Increase margin opportunity for the concession through the adjustment of the tariff.

The Proposed Analysis Model

5.10 A prefeasibility financial analysis is composed of a proposed transaction, projected cash flows, and a valuation. The implementation of an ESOP is included as part of the cash flows, the ownership structure, and investment returns.

5.11 At this stage of the capitalization project, many issues and questions remain open. In preparing a financial model of one of the sample concessions, financial statements were generated using information derived from the following sources:

?? "Economic Pricing Methodology for Bulk Sales and Transmission and Distribution Services," a report produced by SYNEX Consulting Engineers in April 1996 (SYNEX report).

?? "The ECG/NED Business Concessions Project," a report prepared by Kwame Asante & Associates in August 1997.

?? Conversations with staff of the Ministry of Mines and Energy.

?? ECG 1996 audited financial statements.

5.12 The Achimota or Accra region was selected for the purpose of generating a sample financial model of a concession. This area is an ideal candidate because it consists of only one region or locality, the City of Accra. The other concessions have been assembled by shifting several regional localities from one zone to another to create viable and attractive concessions. Limited data for these zones were available during this mission, although the capital city zone, Accra-Achimota, has the most available and consistent data at this point.

5.13 To ascertain the projected cash flows, pro forma income statements and balance sheets for the concession must be developed. The key in constructing the income statement is the focus on the distribution added value (DAV) concept. The SYNEX report suggests this methodology for developing tariff rates based on the sum of node prices and distribution costs. The distribution cost, or the DAV, consists of operation and

maintenance costs, energy losses, and an annuity for required capital expenditures. The result of this complex formulation is a sum of the cost figure with some additional margin. This methodology differs from traditional concession agreements that guarantee the concessionaire's rate of return. It is felt that this structure forces the concession owner to increase efficiency in order to control and increase returns.

5.14 Because the tariffs are based on a buildup of specific economic costs to the concession, the segments can be used to generate the revenues and expenses of the business to thereby create a projected income statement.

Balance Sheet

5.15 No historical or pro forma balance sheets exist for the individual concessions. The Ministry of Mines and Energy has provided a balance sheet for the entire distribution operation, the ECG. Based on historical ECG financial statements and the projected revenues and expenses of the Achimota concession, a balance sheet was generated. Along with a projection of capital expenditures derived for SYNEX replacement costs, the income statement and balance sheet were used to create the statement of cash flows. Cash flows are used to complete the initial and ongoing valuation of the concession. Given the transaction purchase price and the ongoing concession valuation, investor returns can be calculated.

Transaction Structure

5.16 The purchase price can be derived using a Discounted Cash Flow valuation (see Appendix 4 for a discussion of Discounted Cash Flow). Transaction fees typically include legal fees, audits, due diligence expenses, loan processing fees, and other incidental items. This fee is typically in the range of several million U.S. dollars.

5.17 Based on the review of the capital structure of the average publicly traded U.S. energy firm, a capital structure consisting of 50 percent debt and 50 percent equity was assumed for the pro forma model of the sample concession. Debt financing is assumed to carry an 11.5 percent rate of interest, with a seven-year term and level principal payments in years one through seven. Presumably, potential strategic investors will have the desire and ability to fund this lending based on comfort in the projected cash flows and without substantial guarantees from the government of Ghana.

5.18 In addition to the transaction financing requirement, the concession requires short term funding to manage the shift in the working capital discussed previously. A revolving line of credit is assumed to be available to the concession at the same interest rate as the long-term financing. This analysis assumes the concession draws on this line of credit during the first two years.

5.19 The equity financing fulfills the remaining finance needs. The structure can be complicated by including levels of debt and equity, such as senior term and cash flow loans, subordinated debt tranches, preferred stock, and common stock. The

ownership structure for each concession is expected to consist of a strategic partner, the government, and the ESOP.

Tax Implications

5.20 As the internal analysis of the Ministry of Mines and Energy is in its early stages, tax matters have not been formally addressed. The use of tax incentives may be a key to encouraging employee ownership and enhancing investor returns, but the offering of such tax incentives obviously results in forgone revenues to the government treasury in the short term. This forgone revenue can be recaptured in the long term through increased taxes paid by a successful corporation and by taxation of eventual sales of the ESOP shares by individual employees. The Divestiture Implementation Committee's brochures indicate elevation of certain tax burdens in the context of prior capitalizations.

5.21 For this analysis, it is assumed that contributions to the ESOP are tax deductible. Unlike in the U.S. system, there is no limitation on the contribution in relation to employees' compensation. Because personnel compensation represents a relatively small figure in comparison to the company valuation, such a contribution limitation would significantly impair the ESOP's ability to receive a consequential share of the equity ownership.

5.22 This analysis does not assume the tax deductibility of the amortization of goodwill and transaction costs arising in the transaction. The government of Ghana may be willing to consider the allowance of such a deduction as a mechanism to enhance cash flows to the concession.

5.23 As a participating shareholder in the concession, the government does recapture some of the forgone revenue in the form of increased common equity returns.

5.24 Adjustments can be made to evaluate and accommodate the level of tax incentive with which the government is comfortable.

Shares Held by the Government

5.25 The degree of retained ownership by the government has not been determined. Because of the national importance of the distribution of energy, the government is expected to maintain some portion of the equity. It is assumed that the government will participate in the common equity and receive the same returns as the strategic investor. In this analysis, the government would invest a portion of the purchase price proceeds to fund its share purchase in the concession.

Dilution

5.26 The retirement of stock arising from the repurchase obligation often results in the dilution of ESOP ownership (unless the shares are reallocated to employees). Based on the repurchase liability assumptions in this analysis, the ESOP ownership stake migrates from 5 percent at opening to 4.8 percent on a fully diluted basis

at the end of year 10. Because the ESOP does not hold a controlling block of the concession's equity, dilution is not likely to be a major concern.

Share Allocation and Governance

5.27 The ESOP shares are typically allocated to individual employee accounts on the basis of individual wage earning as a percentage of total concession wages. The alternative method is to provide an equal allocation to each employee or perhaps to provide credit for years of service. For the purpose of evaluating the employee return in this financial model, it is assumed that the shares are allocated based on a pro rata share of wage earnings.

5.28 When employing an ESOP in the context discussed in this study, it is important, especially in a privately held company, that the voting rights of the shares held by the ESOP can reflect the interests of the collective body of participants. This enables the ESOP to move as a block much like any other substantial equity investor. This structure can allow for the pass-through of voting rights for the shares held in employees' individual ESOP accounts and can reflect the status of the shares in terms of vesting or debt repayments on the ESOP loan.

Post-Transaction Valuation of the Concession

5.29 To provide an ongoing valuation of the concession, a multiple is applied to the annual earnings before interest, taxes, depreciation, and amortization (EBITDA) to determine the value of total invested capital. Debt is subtracted from, while cash on the balance sheet is added to, total investment income (TIC) to compute the equity value. Based on the assumed purchase price and the estimated 1997 EBITDA, the implied multiple at the time of the transaction is 3.4 times EBITDA. For the purposes of future valuation, a multiple of 5 was applied to EBITDA.

Rate of Return

5.30 Based on the assumptions presented in this exercise, the common stock investors could expect a compounded annual rate of return of approximately 27 percent. Adjustments to any of the key assumptions are likely to affect this return. The strategic investor should find this rate of return reasonably attractive.

ESOP Participation

5.31 The ESOP has been allocated a 5 percent stake in the common equity. Though the employees are assumed to forgo provident fund contributions for a period of five years, this sacrifice represents a small portion of the ESOP's equity allocation. The funding of the ESOP is essentially provided by the other equity partners. A five-year level vesting period is assumed to create an incentive for continuing employment. At the end of year 1, projected ESOP value equates to 23 months of employee salary or wage. With the vesting strategy, the individual employee account exhibits a right to one-fifth (or 4.7 months) of value. With the growth in electricity demand projected, the year 5 ESOP

(and fully vested ESOP accounts) represents a value equivalent to 4.2 years of salary or wages for the typical employee.

Scenario Analysis with Larger ESOP Stake

5.32 While the version of the model discussed and included with this report is considered to be the base case model, some other scenarios have been considered. At a 5 percent ownership stake, the ESOP could provide substantial value to the concession employees. The effect of increased ESOP participation levels is outlined below. Assuming that the purchase price is unchanged, an increase in the ESOP's stake decreases the rates of return accepted by other (non-ESOP) investors. The purchase price could be reduced to allow for increased ESOP participation without a return sacrifice by the other concession investors. Table 5.1 details this effect.

Table 5.1. The Effects of Increased ESOP Participation Levels

	5% ESOP	*10% ESOP*	*15% ESOP*
Internal rate of return (IRR)	26.7%	25.4%	24.0%
Year 1 20% vested ESOP value	0.39 x wages	0.77 x wages	1.16 x wages
Year 5 100% vested ESOP value	3.97 x wages	8.07 x wages	12.17 x wages
Purchase price (assuming 26.7% IRR is maintained)	100%	95.7%	91.4%

5.33 The number of scenarios adjusting other cash flow factors, such as changes in the DAV or capital expenditures, is endless. The same type of tradeoff between investor returns and acceptable purchase price, however, can be made for any aspect of adjustments to cash flow. The purchase price may be lowered or raised to maintain a given return threshold. Alternatively, the investors may be willing to accept a lower rate of return to enter the Ghanaian market.

Repurchase Obligation

5.34 A repurchase obligation arises when an ESOP participant retires, dies, resigns, or terminates employment with the sponsoring corporation. In any case, the ESOP participant should be able to liquidate the equity holding. Without work force demographics, estimating the effect of the repurchase obligation with any certainty is difficult. However, employees are assumed for purposes of this analysis to retire or terminate at a rate of five persons per year.

5.35 The repurchase liability is assessed based on the equity value at the time of the exit event. In the model, the company meets 20 percent of this obligation at the time of employee exit. The remaining balance is repaid evenly over the next five years.

5.36 Another situation that creates a repurchase obligation is the provision of a "put right" for ESOP participants. A put right allows ESOP participates to sell their shares back to the company after achieving full vesting and share allocation, or upon a break in service with the company.

5.37 If the concession becomes a publicly traded entity, the repurchase obligation can be eliminated by allowing the participants to sell the stock they receive from their ESOP distribution on the Ghanaian stock exchange.

Conclusions

5.38 Based upon this financial prefeasibility analysis, it is apparent that the concessions can be constructed as viable business units to include employee ownership. A minimum ESOP ownership stake should be 5 percent of total equity. Furthermore, the government of Ghana and the strategic investor should consider a larger employee equity stake and permit the allocation of additional shares for the benefit of employees who may join the company after the initial ESOP transaction.

5.39 Several prerequisites exist for establishing a firmer view of these new equity partnerships for each concession. It is important to develop a firmer idea of potential strategic investors and their investment criteria, including required rates of return on similar projects and any experiences with employee ownership.

5.40 The government of Ghana must set guidelines for purchase price requirements, sale terms, and the government's desired ownership stake in the concession. It is also important for the government to explore specific legislation toward ESOPs, including formalized trust legislation to handle governance and administrative issues. ESOP tax legislation can encourage employee ownership by providing an economic advantage to companies willing to adopt ESOP structures outlined by the government.

5.41 Employee education and communications regarding the financial and operational details on the ECG and specific concessions are a fundamental step toward achieving the full benefits of employee ownership. Educating employees about ESOPs is also key to this effort.

6

ESOPs in the Privatization of Ghana's Electricity Distribution: Steps and Conceptual Framework

6.1 While the prefeasibility model discussed in the previous chapter can serve as a guideline for determining how an analysis of an ESOP privatization transaction might be structured in the context of Ghana's electricity distribution sector, an actual ESOP transaction will require a more thorough feasibility analysis to determine both the viability of an ESOP and the most appropriate means for structuring the transaction. In conducting such a feasibility analysis, strategic investors and any third party lenders to the transaction require a detailed analysis of a company's operations that typically includes the following:

- **Financial statements**—Where available, financial statements from the previous five years are necessary to assess the company's financial circumstances and cash flow capacity.
- **Corporate tax returns**—Optimally for the previous three years.
- **Financial projections**—These typically include budgets and strategic plans prepared by the company's management team.
- **Appraisals**—Any appraisals of the business or its assets that have been performed in the past two years.
- **Real estate**—Information on any real estate owned by the company that is not currently used directly in the business.
- **Patents**—Description of any patented or unique technology or expertise owned by the company.
- **Corporate articles of incorporation and bylaws**—This information is used to assess any special legal or ownership agreements that may affect a change-of-control transaction.
- **Securities filings**—Any information or memoranda relating to securities filings that have been prepared in the previous two years or similar information describing the company in detail, such as packages that accompanied any attempts to sell the company.
- **Shareholder lists**—These lists should include the number of shares owned by each shareholder.

?? **Shareholder agreements**—These agreements should include any information related to terms and conditions of sales of the company's shares.

?? **Resumes**—Required for all principal managers of the company.

?? **Organization chart**—Needed to depict the structure of the company's operations and lines of managerial responsibilities.

?? **Company reports**—Any information that includes detailed descriptions of the company and its operations.

?? **Term sheets**—These are summaries of all existing debt instruments, together with some record of any defaults that have occurred under them.

?? **Summary plan description**—This includes information on any existing employee benefit plans and similar benefits provided by the company to its employees.

?? **Other information**—Any additional information that management feels would be relevant to a financial analysis of the company.

6.2 In addition to analyzing the information collected from the company, the team conducting the feasibility study will typically conduct additional analysis, including the following:

?? **Asset appraisals**—To determine the current value of plant and capital equipment owned by the corporation.

?? **Market analysis**—To assess the current state of the company's market, demand for its products and services, and opportunities to expand its market share or diversify into other markets.

?? **Competition analysis**—To determine key competitors and assess the impact that a change in ownership might have on the company's competitive position, as well as prospects for new competitors to enter a more open market economy.

?? **Management analysis** —To assess the skills and experience level of senior managers to determine whether any gaps exist in managerial expertise, particularly in regard to the transition from the public sector to a competitive market environment.

?? **Analysis of employees**—To assess employee skills, their compensation structure and expectations, cultural issues associated with private ownership, and overall economic circumstances that may influence long-term compensation strategies.

?? **Analysis of strategic investors**—To determine potential interest among strategic investors in the company and the terms that may be required to attract such investors.

?? **Analysis of domestic market conditions**—An assessment of legal, financial and infrastructure conditions to determine the protection of stockholder rights; prospects for shareholder liquidity, including the potential of a sale of shares on an established stock exchange; and

prospective partnerships with other potential strategic partners or investors.

6.3 The information collected from these sources would be used to assess the company's current financial situation to produce an initial assessment of both the overall value of the firm and the terms under which the ownership can be restructured to facilitate an acquisition of shares by an ESOP. This process generally takes place over several weeks and can take even longer for more complex organizations and transactions.

6.4 At the end of the process a detailed feasibility report should include a financial audit of the company's balance sheet, including a report on the key issues referenced above. It should also include conservative projections for cash flows from postprivatization activities that will be required to finance the ESOP and should optimally include sufficient detail and recommendations for how the transaction can be structured to accomplish the goal of employee equity participation through an ESOP, including the terms of the ESOP's internal structure and administrative procedures. These issues should be addressed in sufficient detail to allow for an actual transaction to take place, assuming that the feasibility report indicates the terms and conditions under which such a transaction would be viable.

Steps for Implementing ESOPs in the Electricity Distribution Concessions

6.5 Best practice derived from experience in the United States and the United Kingdom suggests that the process by which an ESOP is set up is crucial for the success of the scheme. Typically this is a two-stage process. The first step is to form an ESOP working committee that represents the various players. In the case of Ghana's electricity distribution, they would include representatives of the government, the management, the unions, and the nonunionized work force, if any, who are staying on. Legal and financial advisors would need to be retained to represent the ESOP's interest and to negotiate the best terms possible for employees. Because of the character of this project as both a pilot and a potentially exemplary one, the TUC's contribution to the ESOP working committee's discussions would be crucial. It might also be advisable to include representatives of the Accra stock exchange, particularly if the government intends to float the distribution companies on the exchange.

6.6 The task of the ESOP working committee is then to submit detailed proposals about the prospective ESOP, including proposals about its size, the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution and put options, employee disclosures, and provisions for plan amendments. The financing of the ESOP will be a key feature of information prepared for the distribution concession. Therefore, it is important that the intention of the government to set up ESOPs as components of the privatization strategy of the distribution companies be included in the bidding documents and that a detailed feasibility study be conducted to support the assumptions made about the ESOP's acquisition of shares.

6.7 It is clearly premature to embark on a detailed discussion about how the employee shares associated with the ESOP specified in the bidding documents might be financed. In light of evidence cited elsewhere in this report, however, a few points are worth highlighting:

?? It would not be contrary, either to recent practice in Ghana or to the policies of the TUC, if a portion of the employee shares were to be significantly financed by the employees themselves, perhaps on a BOGOF basis.

?? The financing of the "free" BOGOF share might in principle be split three ways: between the seller, by way of a price with an appropriate reduction; the incoming strategic investor, by agreeing to "absorb" part of the extra cost; and the Ghanaian taxpayer through the mechanism of a commitment by the government to introduce an appropriate set of tax reliefs.

6.8 The optimum strategy of the Ghanaian government to promote ESOPs is to first develop a pilot scheme that could be launched to take advantage of the privatization of the electricity distribution companies. Then, on the strength of the pilot scheme, ESOPs could be promoted more easily on a nationwide basis. However, for various reasons, in particular the need to modify the current legislation on corporate taxation in order to render the Ghanaian ESOPs tax efficient and sustainable, it is preferable not to limit the applicability of ESOPs in Ghana to the electricity distribution companies. Otherwise, it might be difficult to justify the use of parliamentary time for an important body of new laws that would apply to only one of the country's industries. Members of parliament might also be less inclined to approve the proposed tax changes.

6.9 A way out of the impasse might be reached through a declaration by the government, to be issued concurrently with the invitations to bid sent out to potential strategic investors, to the effect that, assuming the details of the prospective ESOPs could be agreed to on a sound basis, the government would take steps to introduce the necessary supporting legislation. The latter might conceivably take the form of a one-sentence piece of primary and enabling legislation, followed by whatever will be necessary to complete the desired level and detail of support.

A Strategy to Promote ESOPs

6.10 Because this is a new concept in Ghana, the strategy of the government to promote ESOPs should begin by building support from all constituencies. A one- or two-day conference focusing on a combination of the theoretical case for ESOPs and the relevant experience, should be staged in Accra. Attendees should include senior managers of Ghanaian corporations, trade union representatives, local bankers and other financial institutions, government officials, and opinion makers, such as journalists and academics.

6.11 At this seminar, an announcement should be made by government officials of the following:

- ?? The government is contemplating using the privatization of the electricity distribution companies as a pilot scheme for ESOPs.
- ?? A legal review will be undertaken by a government-appointed committee of legal experts to determine whether the existing legislation on trusts should be modified to foster the growth of ESOPs in the country.
- ?? A delegation of managers, trade union representatives, government officials, and one lawyer from the government-appointed committee, including representatives of the electricity distribution companies, will go to the United Kingdom (and perhaps Egypt) to assess for themselves the benefits of ESOPs and formulate an opinion as to whether the concept can be applied in Ghana.

6.12 The delegation would then report to the government and make recommendations regarding the desirability of pursuing an ESOP scheme in Ghana. The government should commit to make this report public so that Ghanaian opinion leaders who will not have participated in the mission abroad can also benefit from this study.

6.13 Assuming that the delegation reports favorably, and once the committee of legal experts has completed its review, the work of structuring the ESOP could then begin, which would include a feasibility study of the electricity distribution concession. At the same time, an extensive program of education should be launched to educate the workers on the risks and rewards and the responsibilities associated with share ownership, and to rally their support for the scheme.

6.14 In conclusion, the recent experience of El Salvador (see box 6.1) in restructuring and privatizing its electricity distribution concessions serves as a potentially useful model, since their successful privatization strategy resulted in significant employee ownership for the employees of the privatized enterprises.

Box 6.1. Employee Ownership in the Privatization of the Electricity Distribution Concession in El Salvador

El Salvador is currently in the process of finalizing the privatization of its electricity distribution concessions. The Salvadoran model is interesting not only from the perspective of the means whereby employees were given the opportunity to obtain an ownership stake in the privatized entities, but also because this very successful privatization initiative resulted in the government of El Salvador realizing net income from the sale of the electricity distribution concessions of approximately US$500 million.

As in Ghana, El Salvador's electricity distribution had been an entirely state-owned corporation. As is proposed for Ghana, the state-owned corporation was first subdivided into four separate companies based on geographical divisions for the distribution concessions. A separate entity (CEL) was maintained for the electricity generation capacity. This company was not privatized.

During a 120-day period prior to the actual privatization transaction, employees of the electricity company were given the opportunity to purchase up to 20 percent of the shares of each of the four companies at a preestablished price. The shares were offered to employees at 80 percent of the net asset value per share as of the beginning of the offer period. As an additional incentive for the employees to purchase the shares, a commercial bank was authorized by the government to provide loans to employees at an 8 percent interest rate (less than half the commercially available rates), with the value of the "*pasivo laboral*" (a pension benefit calculated by multiplying a percentage of annual salary by years of service) serving as collateral for the loans, which had a term of up to 10 years. Individual employees were authorized to purchase shares up to a limit of 150,000 colones or 100 percent of their *pasivo laboral*, whichever was greater. The value of the *pasivo laboral* for longer-term employees could be as high as 500,000 colones.

Employees of each company were permitted to purchase shares only in the company for which they worked. Employees of CEL, the central power generation company that owned the four distribution concessions, had the right to buy shares of any of the four concession distribution companies. Executives of CEL were forbidden to purchase any shares through this program. The concession containing the capital, San Salvador, was perceived to be the more attractive investment, and shares in that particular concession were oversubscribed (nearly 60 percent of the employees wanted to purchase shares in that particular concession). These oversubscribed shares were diverted to shares in the other three concessions after ensuring that all employees were allowed to purchase some shares in the favored concession. Overall, 19 percent to 20 percent of total electricity concession shares were sold, but the percentage varied between the four concessions and only the one most preferred concession was completely subscribed.

The net result was that "employee ownership" was accomplished in principle by allowing all the employees of the formerly state-owned electricity corporation to purchase shares in the privatized companies, though employees were able to diversify their ownership position by stakes in multiple or alternative concessions to the one where they work.

In addition to setting aside the 20 percent of the shares for sale to the concession employees, the government also withheld 5 percent of the shares to sell on the stock exchange. The unsubscribed employee shares were added to this total and sold to the public at large. The remaining shares were sold to strategic investors based on an open, competitive bidding process. Each of the four concessions attracted one or more strategic buyers.

Annex 1

International Best Practice with Employee Ownership

A1.1 The widest experience with ESOPs is in the United Kingdom and the United States. Both countries have used this type of ownership transfer mechanism extensively as part of their privatization programs and as a technique of corporate finance for private companies. ESOPs are found in Anglo-Saxon enterprises spanning the economic spectrum: from grocery store chains, hospitals, car rental agencies, and insurance companies to apparel manufacturers, airlines, and consulting firms. This is where best practice can be found and lessons can be learned for other countries interested in broadening share ownership beyond the realm of their citizens who are already affluent. The U.K. and U.S. experiences are described below.

A1.2 In addition, a number of developing countries with less efficient legal and administrative frameworks have successfully emulated the U.K. ESOP scheme. In all cases, these countries have taken advantage of their privatization program to spur interest from employees in obtaining stock ownership. The Bolivian, Egyptian, and Jamaican experiences are presented below. The case of Bolivia is included in the discussion even though the government did not develop an ESOP scheme to facilitate the purchase of shares by employees of privatized companies. The Bolivian privatization program, however, is idiosyncratic in many respects, and the lessons learned in selling shares to employees of enterprises of developing countries are particularly interesting.

The United Kingdom

A1.3 In the United Kingdom four distinct schemes of ESOPs are covered by statute law. Each of these schemes may qualify for tax relief. A company is free to introduce schemes of all four kinds concurrently:

- Profit-sharing schemes.
- Save-as-you-earn (SAYE) schemes.
- Company share option schemes.
- Statutory ESOPs.

Profit-sharing schemes

A1.4 Under this scheme the company may apply pretax profits to buy shares for employees up to specified limits, which are linked to payroll and which may—but need not—require a matching share purchase by the individual employees. The latter is the so-called buy-one-get-one-free variant of the straight profit-sharing schemes. The matching "purchased" shares may be paid for by individual employees, pretax. Both the "free" and the tax-assisted employee purchased shares become free of any income tax liability for their employee owners at the conclusion of a three-year retention period. To be approved these schemes must have "all-employee" coverage, and the distribution of shares among employees must be objective and satisfy a fairness test.

Save-as-You-Earn (SAYE) Schemes

A1.5 Under these schemes, it is the employees' earnings rather than the company's profits that finance the whole of the employee share acquisition. In companies with SAYE schemes, employees who choose to take advantage of them commit themselves to set aside from post-tax pay fixed sums each month—within defined top and bottom limits. These moneys are then held in interest-yielding accounts with third parties—approved banks or building societies—for a minimum of five years. The interest income, which is tax exempt, is added to the principle. At the end of five years the employee may withdraw (with no tax liability) what has been accumulated in the interest-bearing account and then either apply the money to buy shares in the employing company at the price that prevailed when the original SAYE commitment was entered into, or use it in any other way. Despite their name, SAYE schemes in the United Kingdom are also all-employee share option schemes—with the ability to opt out if the share price is no higher when the savings commitment ended than when it started.

Company Share Option Schemes

A1.6 In this case there is no requirement on the employee to make regular or any savings, and no all-employee coverage is required. Management is in principle free to invite employees to take part in these schemes—or not—with unfettered discretion. There is a relief from capital gains and income tax which might otherwise be payable when the option is exercised. On the other hand, the starting value of the shares over which an employee may be granted a "Company" scheme option may not exceed £30,000, or roughly twice the current average annual pretax pay in the United Kingdom. This (relatively low) limit was introduced by Prime Minister John Major's Conservative government in response to widespread public criticism of the previous much higher limits: to the effect that they allowed huge tax benefits to those who were already well paid "fat cats."

Statutory ESOPs

A1.7 Statutory Employee Stock Ownership Plans are also sometimes known as Statutory Employee Share Ownership Trusts. The key distinguishing features in this case are that the trust may borrow money to finance the purchase of shares for employees; and

that the company may make payments to the trust out of pretax profits to enable the latter to pay back its borrowings including the principle as well as interest.

A1.8 As with the profit sharing schemes, above, there is an all-employee coverage requirement, and the distribution of shares between individual employees must be objective and such as to satisfy a fairness test. As the U.K. law stands at the moment, all the shares in a statutory ESOP must eventually be distributed to individual employees, though the law allows this to happen over up to 20 years. For maximum tax effectiveness statutory ESOPs are normally operated in conjunction with Profit Sharing Schemes and sometimes with SAYE schemes as well.

The United States

A1.9 Employee ownership has a long history in the United States, but the ESOP in its current form was devised and perfected in 1956 by a San Francisco attorney and economist, Dr. Louis O. Kelso (see Box A1.1). Since the mid-1950s, the United States has enacted 25 pieces of federal legislation designed to encouraged ESOPs, including loan programs, loan guarantees, and a range of fiscal incentives directed at ESOPs' participants, sponsor companies, lenders, and shareholders selling to ESOPs.

Box A1.1. The First ESOP

The first ESOP, implemented by Peninsula Newspapers, Inc., in the United States in 1956 arose when ESOP inventor Louis O. Kelso restructured the firm's profit-sharing plans to produce a financing mechanism to purchase 72 percent of the shares of a newspaper chain. The shares were acquired from three major shareholders and paid for from future company profits. The selling shareholders also acted as lenders by accepting interest-bearing notes from the company-sponsored profit-sharing plans, and the company guaranteed the note. Each year during the term of the note, the company made a tax-deductible contribution to its profit-sharing plans. Those funds, in turn, were used to repay the notes. The key characteristics that distinguished the ESOP from a conventional plan were that (a) it enabled employees to use leveraged financing to acquire a block of shares at the current price and have those shares paid for with the company's future pretax earnings, and (b) the ESOP's share acquisition debt was based on a corporate guarantee, so that individual employees bore no personal liability for that debt.

A1.10 The concept has been embraced by a large number of companies in many different industry sectors. By 1998 there were approximately 15,000 companies in the United States that shared ownership broadly with employees. More than 10,000 of these are ESOPs involving more than 11 million workers, about 2,000 are companies that give stock options to most employees, and another 2,000 are companies whose 401(k) savings plans invest heavily in employer stock.

A1.11 As in the United Kingdom, the ESOP is the most tax-advantaged mechanism for companies to share ownership with employees. The ESOP operates through a trust that accepts tax-deductible contributions from the company to accumulate company stock, which is then allocated to accounts for individual participants. The ESOP can acquire both new and existing stock. The trust can borrow money to purchase the stock, with the company repaying the loan by making tax-deductible contributions to the ESOP.

A1.12 In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust, which will enable the trust to amortize the loan schedule, or if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division, the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions or buy back publicly traded stock, or for any other corporate use. (Box A1.2 contains an example of a leveraged ESOP buyout.)

Box A1.2. United Airlines ESOP Buy-Out

A Union coalition–led ESOP buyout of United Airlines in July 1994 converted this commercial airline into the largest majority employee-owned company in the developed world (79,000 employees with 56,000 participating in the ESOP). The purchase took the structure of a leveraged buyout financed largely by a concession-for-equity swap. Employees initially acquired 55 percent of the outstanding shares of this listed company via an offer to current shareholders (who received cash plus one-half share for every share they previously held).

In support of the buyout, employees agreed to a 5-year package of wage and benefit concessions valued at approximately US$5 billion, with the money saved paying off the ESOP-related debt. Various worker groups agreed to different schedules of concessions (for example, pilots took a 15.7 percent pay cut, while machinists took a 9.7 percent cut and gave up a scheduled pay increase). Work rule changes and a no-strike clause formed part of the agreement. Unions obtained veto power on the sale of certain operations. Pilots received approximately 46 percent of the employee stake, machinists 37 percent, and nonunion employees 17 percent. The flight attendants' union declined to participate.

A1.13 Two tax incentives make borrowing through an ESOP extremely attractive to companies that might otherwise never consider financing their employees' acquisition of stock. First, since ESOP contributions are tax deductible, a corporation that repays an ESOP loan in effect gets to deduct principal as well as interest from taxes. This can cut the cost of financing to the company significantly, by reducing the number of pretax dollars needed to repay the principal by as much as 34 percent, depending on the company's tax bracket. Second, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing.

Bolivia[9]

A1.14 Bolivia's privatization program is one of a kind. Privatization as we normally understand it, that is, through the sale of state-owned shares or assets to private

[9] The following discussion is based on a working paper prepared by Santiago A. Nishizawa and José A. Valdez entitled "Employee Participation in the Capitalization Process in Bolivia," June 1997.

investors, was indeed used to divest small and medium-size enterprises. For the divestiture of the largest state-owned companies, though, another innovative scheme was used. It involved a two-step process known as "privatization by capitalization."

A1.15 In privatization by capitalization, the company first doubles its number of shares in issue by means of an increase of capital, and the newly issued shares are offered for sale to strategic investors. Then the state contributes its diluted stake in the company (50 percent minus one share) to a series of pension funds created to provide every Bolivian citizen with a pension upon retirement.

A1.16 Article 5 of the Privatization Act of 1992 provided for the participation of workers and employees "through compensation for their social benefits and/or other types of contribution, under the preferential conditions established by CONEPLAN" (a government planning agency). However, in the first wave of privatization that focused on medium-size enterprises and used the conventional method of divestiture, participation from employees was fairly limited. In the case of privatization by capitalization, the process created a special way of facilitating participation by workers with a minimum of risk, and much better results were achieved.

The Capitalization Act

A1.17 To offer shares of companies privatized by capitalization to strategic investors, the Bolivian Commercial Code required that the state-owned companies be first transformed into mixed-ownership companies.[10] This necessary legal step implied that the employees of these companies should become shareholders of their company before newly issued shares could be offered to strategic investors and thus provided the framework into which employee participation was structured.

A1.18 Article 1 of the Capitalization Act made it possible for the employees of state-owned companies to become founding shareholders in new semipublic companies (see table A1.1), together with the government. The government contributed the assets and rights of the state-owned companies, and the workers were offered the opportunity to buy one share of the new company. The purchase would give them a preferential right to "underwrite" shares of the new company. The preferential right took the form of an option contract.

Table A1.1. Employee Participation in Capitalized Companies

Company	*Employee shareholders*	*Percentage*
ENDE	457	90.00
ENTEL	1,515	92.41
LAB	947	59.67

[10] Article 424 of the Commercial Code establishes that mixed companies are companies instituted jointly by the government or some other public sector entity and private capital. They are formed to operate companies in the collective interest or to establish or develop industrial, commercial, or service activities. Article 427 stipulates that at least two partners are required.

ENFE	1,809	46.73
EMV	936	99.68
YPFB	4,044	86.54

Option Contract

A1.19 The option contract formed part of the government's offer to employees, subject to the condition that they (or at least one employee) buy one single share in their company. By doing so, they gained the right to buy the shares owned by the state or public shareholder at book value, up to the total of their social benefits, after the results of the international public bidding to select the strategic investor were known.

A1.20 Thus, employees were not required to commit or risk any capital, except for approximately US$20 for a share, and they only had to decide whether they would buy additional shares after the results of the bids were in, that is, once they knew whether the winning bidder paid more than the book value. In most cases employees were allowed from 15 to 30 days after the date of the award to exercise the option and sign a contract to purchase shares. The contracts allowed for the shares to be paid up over periods ranging from 12 to 24 months with a minimum deposit of 5 percent of the total purchase price as an additional means of facilitating participation by employees.

A1.21 Therefore, the option contracts eliminated the risks of investments and uncertainty prior to knowing the results of the bids and gave employees a virtually assured business opportunity. For the mechanism to be truly effective, assurances had to be given that the shares could be converted by selling them freely. Thus the shares were quoted on the Bolivian stock exchange after 50 percent of company shares had been sold and the capitalized company was being operated by the private sector.

Registration of Shares on the Stock Exchange

A1.22 Although undoubtedly there were other reasons, such as protecting minority shareholders in general and promoting stock market development, the sales and purchase agreements with the capitalizing investors contained the obligation of registering the shares on the stock exchange within two to four years to permit free trading by shareholders in general and employees in particular.

The Offer to Labor and the Results

A1.23 Because of the poor results of the initial wave of privatization in the country during 1989–93 when employees were dismissed in order to sell companies free from labor liabilities, employees associated company reform with dismissal. Employees were so certain they would lose their jobs that the first subject raised at every meeting was the package they would receive. In the mining sector, workers were asking for between US$1,000 and US$3,000 compensation for every year they had been employed.

A1.24 Employees also viewed the "freedom-to-hire" policy passed into law in 1985 as creating acute job uncertainty. They reacted against any discussion of labor policy and refused to debate it.

A1.25 Like most Bolivians, workers were unfamiliar with company shareholding. Those who had some information associated shares with the telephone companies, which are now cooperatives, but at the time were companies in which the shareholders never received any dividends and the price of shares dropped considerably.

A1.26 When the first presentations of the program began in June 1994, employees did not believe that the government would be able to complete capitalization of the companies. By August 1995, after the first successful capitalization had been completed and very shortly after the second, the Ministry of Capitalization began to gain credibility with workers.

A1.27 The initial mistrust hampered the presentations of the offer to labor because employees did not view the opportunity to buy shares as important, particularly since they had to pay for them with their own money. However, looked at from another angle, this mistrust had positive consequences in the case of the first company that was capitalized, since it permitted the company to go ahead with the process without major resistance.

A1.28 The offer presented to employees had the following components:

?? **Job continuity**—Under Bolivian legislation are two options for dealing with labor when a company changes its nature. Either all the employees are dismissed with compensation and social benefits, or the ownership changes, but employees are kept on. The Ministry of Capitalization applied the second option in all the companies that were capitalized. Job continuity was the offer made to employees. The contracts signed with strategic partners specified that all employees were to be transferred with their social benefits and wage levels maintained. However, the newly capitalized companies had no obligation to keep their employees for any set period.[11]

?? **Preferential purchase of shares**—As discussed above, the employees of the capitalized companies were able to buy shares under preferential terms up to their social benefits. Initially the employees were against it, since they felt that using their social benefits meant indirect dismissal. In view of this reaction, a new plan was devised based on reinterpretation of

[11] In companies such as ENTEL and LAB, which had no residual enterprises, all employees kept their positions. In ENDE and ENFE a few, but not enough, workers were transferred and in a short time, the companies had to hire more employees directly or indirectly. Residual enterprises were maintained in these last two companies where the remaining employees with indefinite labor contracts were retained, although they had little work to do in some instances (ENFE, for example). In those cases, the employees negotiated their retirement with additional benefits over and above their normal entitlements.

Article 1 of the Capitalization Act, which defined social benefits simply as a right to purchase shares. Employees, however, continued to see a risk in buying shares because they did not know exactly what they could be used for. To eliminate both these doubts, the Ministry of Capitalization designed the two-stage offer described above.

Promotion

A1.29 The offer to employees, and the subject of buying shares in particular, required detailed explanations and the distribution of information material. The information campaigns were adjusted as more experience was gained, and the campaigns were tailored to the requirements and nature of each company. In all cases, the campaigns were carried out through the managers or presidents of the companies to avoid negotiations with the union. As a result of the lessons learned in the three companies that were capitalized first, it was decided to program seminars for greater effectiveness in selling shares to employees.

A1.30 The following guidelines were used in designing more effective seminars:

- Presentations to groups of not more than 200 employees.
- Total length of not more than four hours.
- Venue outside the company, preferably in a good hotel.
- Comfortable premises with enough seating for all employees.
- Provision of notepads and informative materials upon registration
- Presentations lasting no more than 20 minutes with question and answer periods lasting no more than an hour.
- Twenty-minute break with a snack and a meal at the end (lunch or dinner).

A1.31 All seminars were carefully organized, since any delays or technical failures could have caused employees to react negatively. Support personnel were used to staff tables, with 3 people for every 40 employees. Their role was to provide personalized information for each employee and to sell shares. Apart from permitting closer control and follow-up, in some cases, this arrangement even led to competition between tables to see who could sell more shares.

A1.32 After the presentations, a relaxed atmosphere was created in which employees could question the speakers. In some cases, particularly where there was greater resistance to buying shares, incentives such as door prizes of television sets and radios were provided to encourage employees to take part.

A1.33 Four factors can explain the results of employees' participation in buying shares:

- The level of education of employees and the information provided.
- The influence of the union and its attitude toward the capitalization process.
- The degree of leadership provided by the company executives.

?? The demonstration effect of companies with positive results.

A1.34 Employee education and executive leadership explain the high level of participation in ENDE, which is particularly impressive since it was the first company to be capitalized.

A1.35 The high participation in ENTEL, a company with many employees appointed as a result of political patronage, was due to the instructions issued by its president and the union, which had ties to the party in power. The employees bought shares with little resistance.

A1.36 The rates of participation in LAB and ENFE were lower for several reasons, including stiff opposition from the companies' unions, weak leadership by executives, and the scant credibility of the Ministry of Capitalization at that time. In the case of ENFE, particularly in the Andes network, the employees also had a very negative impression of the company's economic situation and did not find investing in it attractive.

A1.37 In the case of EMV and YPFB, employee participation was high because of the profits received by workers who had bought shares in ENTEL and ENDE (the figures were public at the time). Dividends and the considerable increase over the book value spurred employees to buy shares in those companies.

Profits

Table A1.2 shows that employees who bought shares at the book value saw the strategic partners pay almost double on average of what they had paid (with the exception of ENFE, Andes network).

Table A1.2. Market Value of Companies

Company	Book value (US$)	Amount offered (US$)	Percentage increase
ENDE:			
CORANI	20	37.40	87.00
VALLE	20	23.27	15.85
HERMOSO	20	28.06	40.30
ENTEL	20	95.25	376.25
LAB	20	41.39	206.95
ENFE:			
ANDES	20	20.00	0.00
EASTERN	20	22.51	12.51
YPFB:			
CHACO	20	38.10	90.50
ANDINA	20	39.40	97.00
TRANSREDES	20	52.45	62.25

Average	20	39.87	98.86

A1.38 The prices paid by the strategic partners led to an increase in the market value of the shares bought by employees as a result of the public auctions held every 15 days by the Bolivian stock exchange, as is apparent from the third column in table A1.2.

A1.39 Employees obtained returns on their investments in the form of dividends, as shown in table A1.3.

Table A1.3. ESOP Return on Investment

Company	*Return on shares (%)*
ENDE:	
CORANI	
VALLE HERMOSO:	3.0
GUARACHI	8.0
ENTEL	19.2
ENFE:	
ANDES	12.6
EASTERN	27.6
LAB	0.0

A1.40 As table A1.3 shows, employees of the railway companies and ENTEL obtained dividends with returns higher than those paid by any other investment alternative on the formal financial market.

A1.41 The profits were even higher than shown, since dividends were paid on all shares reserved by employees even if they had not yet fully paid for them.

Egypt

A1.42 The Capital Market Law No. 95, passed in 1992, specifies the terms of ESOPs in the Arab Republic of Egypt. It applies to all companies with capital of more than 1 million Egyptian pounds (US$330,000) and at least 50 employees. Under the law, the company sets up an ESA, which operates as an independent legal entity. Members are all full-time employees.

A1.43 The ESA can borrow money to acquire the shares, usually from the government, repaying the loan out of dividends. If the dividends are inadequate to repay

the loan, the loan is renegotiated or additional private financing is sought. When an ESA buys shares in a privatization, it often purchases the shares at up to a 20 percent discount, although this is currently not legally mandated. Loans in privatization are for 10 years, usually from the government, and sometimes at a reduced rate of interest. There are, however, no tax incentives issued for employee ownership.

A1.44 The ESA is run by a board of directors and a general assembly, whose powers are defined by the trust document. The ESA board is made of employees, with nonhighly compensated employees eventually gaining full control. Shares are allocated according to a formula devised by each ESA. Salary and years of service are usually included. The ESA must be approved by the government. When employees leave, they receive cash for their shares. Those shares are then returned to the trust and allocated to new employees. Under existing Egyptian law, employees already have representation on boards of directors of all companies in which the government has an ownership interest.

Results

A1.45 As of July 1997, there were 280 ESAs, of which 41 had actually purchased shares (the rest were in the process of doing so). Of these, 18 were in private sector companies; the rest were in public sector companies being privatized. Ten of these held 95 percent of the stock, 1 owned 40 percent, 1 owned 25 percent, and 29 owned between 5 percent and 10 percent. Five more government-owned companies were in the process of becoming majority employee-owned in the next several months. The largest of the majority employee-owned companies was the Wadi Kom Ombo Company, with 1,200 employees. Its ESA was set up in 1994. A land reclamation company, it has performed very well since it was privatized. The Upper Egypt Dredging Company has 650 employees, and has an ESA that owns 95 percent of the company. (An example of another company is discussed in box A1.3.)

A1.46 Generally, the employee ownership companies have been performing very well, but some are struggling and cannot pay enough dividends to cover the loan. The company may end up reacquiring the shares in these cases. Moreover, very few companies have made any steps at all toward anything remotely like an ownership culture. Employee participation in work-level decisions is rare, and worker education about employee ownership limited. Still, the government remains a supporter of the idea of employee ownership, and it is likely eventually to cover a substantial portion of the Egyptian work force.

A1.47 There is some concern that many of the initial ESAs have resulted in majority employee ownership, and efforts are under way to encourage greater reliance on partnerships with strategic investors who can help stimulate more rapid market reforms. In addition, there have been some problems with the ongoing valuation of ESA shares and the procedures whereby employees may sell their shares.

Box A1.3. The Alexandria Tire Company of Egypt

The Alexandria Tire Company (ATC), supported jointly by the Egyptian government and the U.S. Agency for International Development (USAID) mission in Cairo, was the first practical application in the developing world of the expanded ownership paradigm and the power of productive credit as a catalyst for economic democratization. The project started in 1989. Trenco, an Egyptian engineering company, and Pirelli, the Italian tire manufacturer, participated in the project.

The project consisted of the construction and operation of an all-steel radial truck tire manufacturing plant at a site at the Ameriya Industrial Complex near Alexandria. The project created 750 new private sector jobs. Project costs amounted to £E 370 million (or more than US$160 million). The funds were used to build a facility capable of producing 350,000 heavy-duty truck and bus tires annually for the domestic Egyptian market, roughly 30 percent of the total market demand. In addition to tire production, the project also included the manufacturing of carbon black, at an annual capacity of over 15,000 tons. Of the total project capitalization, 56 percent was in debt financing and 44 percent in equity.

A worker-shareholders' union (WSU) was formed, using an ESOP as the model for its bylaws, to acquire 25.83 percent, or 421,000 of the founding common shares of the new venture, 252,600 shares to be divided among 750 newly hired employees and 168,400 shares among the 3,500 employees of TRENCO, the mother company of the new venture.

The ESOP

The ESOP used self-liquidating productive credit to enable workers to become shareholders without reducing their savings or paychecks. The WSU, originally called an employee shareholders association (ESA) was invented to substitute for a legal trust, which does not exist under Egyptian law.

To finance the acquisition of the 25.83 percent of founding common shares by employees, the Egyptian government, through its Ministry of International Cooperation, approved a loan of £E 42.1 million (US$16.5 million) from funds generated by the sale of U.S. commodities under the USAID Commodity Import Program. The loan, on Islamic banking terms, has a maturity of 16 years, with a six-year grace period. The loan is repaid out of dividends only. The sole source of security of the loan is the workers' shares. As the loan is repaid, the personal accounts of all participating employees reflects shares that have been paid for during the current year and allocated among all employees according to the formula contained in the WSU. Terminated employees' shares are cashed out by the WSU.

Impact on Employees

According to the WSU, the average ATC employee can expect to accumulate through the ESOP more than £E 33,000 worth of shares. Considering that an average employee earns about £E 4,000 (about US$1,600) annually, the potential gains amount to more than eight times his annual wages. In addition, since the beginning of 1998 ATC workers have started receiving a second income from dividends over and above the dividends used to repay the ESOP debt or set aside for repurchasing their share rights upon retirement. After the ESOP loan is repaid, the average worker's capital income is expected to amount to about £E 11,800 per year. And through the voting of their shares in the WSU, workers have a voice in selecting 30 percent of ATC's board members and in other matters subject to shareholders voting.

Source: John H. Miller, ed., *Curing World Poverty—The New Role of Property*; 1994.

Jamaica[12]

A1.48 Jamaica's privatization program includes a comprehensive set of incentives for employee ownership in both private and privatizable companies, with legislation providing for share grants, share discounts, and loans on favorable terms. Incentives are directed at ESOP participants, sponsor companies, and lenders. (One example is discussed in box A1.4.)

[12] The source was Jeffrey R. Gates and Jamal Saghir, "ESOPS, Objectives, Design Options and International Experience" (Washington, D.C.: Cofinancing Services, World Bank, September 1995).

A1.49 ESOP participants are permitted a tax deferral on shares allocated to their ESOP accounts, a tax exemption on personal funds (salary deductions, bonuses, or retroactive pay increases) used to acquire shares, and a personal deduction for 25 percent of the principal and 100 percent of the interest for servicing a loan used to acquire shares. Dividends received on ESOP-held shares are exempt from tax. Shares held in an ESOP for more than six years are received tax free.

A1.50 ESOP sponsors are given a number of incentives:

?? Where a company loans its funds to employees to acquire shares, the company can claim a tax deduction equal to one third of the amount lent (50 percent where the board of directors includes at least one employee-elected director).

?? Where a company borrows funds from a lender and either (a) on-lends those funds to employees to buy shares, or (b) makes a grant to the ESOP to acquire shares, this expense is deductible to the extent of 100 percent of interest payment and 25 percent of principal payments (50 percent for companies with at least one employee-elected director).

?? Where a loan is made directly to an ESOP and the company is obliged to make grants to the ESOP to repay the loan (that is, a leveraged ESOP), the company can deduct 100 percent of that expense.

A1.51 ESOP lenders are allowed an exemption on 50 percent of the interest earned on ESOP loans. This exemption increases to 100 percent for loans that result in an ESOP acquiring 15 percent or more of a company's shares. Banks are allowed a one percentage point reduction in the rate of corporate income tax (up to five percentage points) for each 3 percent of their total loan portfolio that consists of ESOP loans.

Box A1.4. The Privatization of the National Commercial Bank of Jamaica

Even prior to enactment of this legislation (February 1994), Jamaican policymakers were encouraging employee ownership. The privatization of the National Commercial Bank of Jamaica (NCB), was structured to encourage share ownership by employees. The bank was 51 percent privatized and was floated on the stock exchange. In the first phase of that privatization, 13 percent of the shares were reserved for employees via a "step approach" comprising four categories of employee preference shares: grant shares, matching shares (one-for-one), shares purchased at a discount, and shares purchased at full price. The overall first-round ceiling was 2,070 shares. This 13 percent block of shares was held in a trust, with the purchase from the government financed with a loan from NCB repaid out of future employee earnings, either in cash or in installments (via the "Easy Payment Plan") over a two-year period. Ninety-eight percent of eligible employees participated. Shares unsold after the first round were offered again to employees in a second round at less preferential rates and with a ceiling of 50,000 shares per person. Payment arrangements were similar to the first round. Employees' access to the shares depended on the payment terms. Grant shares were not tradable for two years, matching and discount shares were tradable only to other employees via internal trading within the trust, and full-price "priority" shares were freely tradable.

Employee Ownership Incentives in Other Countries

A1.52 **Chile**—Chile developed a strategy for "labor capitalism" to build support for its privatization program. As a general rule, workers were offered 5 percent to 10 percent of a privatized company's shares at a discount price. To pay for the shares workers were allowed to borrow up to 50 percent of their severance pay, with the company promising to repurchase the shares at retirement at a value at least equal to the forgone severance payments. Thus, employees could buy shares at below market price with no cash outlay, with no risk of loss, and a potential for gain if the shares increased in value. This scheme proved to be quite attractive, and approximately 15 privatized companies ended up with significant levels of employee ownership.

A1.53 **China**—Though the word "privatization" is not acceptable to the Chinese government, they have nevertheless introduced experiments in "social ownership" whereby workers in large factories can receive stock ownership in their companies. More significantly, many of the village enterprises have been turned over to the local communities in which ownership is shared broadly among both the workers and the local citizens.

A1.54 **Czech Republic**—The Czech concept of privatization is based on citizen vouchers. Each citizen over the age of 18 was given the opportunity to purchase vouchers and use these vouchers to buy shares in approved companies. Employee ownership was limited to 10 percent of a privatized company where employees were given no additional incentives to purchase stock. In most cases, the employees received little or no ownership in the privatized company.

A1.55 **Egypt**—Because Egyptian law does not recognize trusts, Egypt has approved the use of ESAs to acquire shares on behalf of employees in privatization transactions. These shareholder associations hold shares on behalf of employees. Several dozen ESAs have already been established, some of which own minority stakes and some owning a controlling block. Up to 150 ESAs are in various stages of implementation.

A1.56 **Germany**—By law, all government-owned companies in eastern Germany must be privatized. The main techniques for privatization are sale to foreign companies, liquidation, and management buyouts. Management buyouts occurred mainly in service industries and in small and mid-sized companies. Sixty percent of management buyouts include public financing, and approximately 10 percent include broad-based employee ownership. The method and amount of employee ownership is not stipulated in the privatization laws.

A1.57 **Hungary**—The Hungarian privatization legislation gave strong preference to the use of leveraged ESOPs based on the U.S. and U.K. models. Employee groups that organize themselves into ESOP companies are allowed to purchase a company's shares with payments spread over a 15-year period, with an optional 3-year grace period of interest payments only. The interest rate is 3 percent plus the intermediary bank's 4 percent margin. Banks may lend up to 85 percent of the value of the shares. A required down payment of 2 percent, 15 percent, or 25 percent is based on a formula linked to the

average price per participant for those shares proposed for ESOP financing. ESOP companies qualify for a tax deduction of up to 20 percent of their pretax profits to fund an ESOP or to repay ESOP-related privatization debt. In addition, dividends are deductible by the corporation, if the dividends are applied to debt repayment. ESOPs have played a significant role in approximately 150 privatization transactions.

A1.58 **Jamaica**—Jamaica's privatization program includes a comprehensive set of incentives for employee ownership in both private and privatizable companies. Employees are eligible for a tax deferral on shares allocated to their ESOP accounts, a tax exemption on personal funds used to acquire shares, and a personal tax deduction of 25 percent of the principal and 100 percent of the interest for servicing a loan used to acquire shares. Dividends received on ESOP-held shares are exempt from tax. Shares held in an ESOP for more than six years are received tax free. Corporations can claim a tax deduction of varying amounts to facilitate employee acquisition of ESOP shares, and lenders are allowed a tax exemption on 50 percent of the interest earned on ESOP loans, increasing to 100 percent for loans that result in an ESOP acquiring 15 percent or more of a company's shares.

A1.59 **Poland**—For larger companies slated for privatization, employees are limited to a maximum ownership stake of 20 percent, with the shares offered at a 50 percent discount. National mutual funds acquire the remaining shares. For smaller firms, however, a "liquidation" option enables employee groups to structure a management-employee lease buyout if at least 50 percent of the employees agree to participate. This has proven to be the most popular and most successful form of privatization and has resulted in more than 1,000 new employee-owned companies.

A1.60 **Russia**—On paper, Russia can claim to have one of the largest numbers of employee-owned companies in the world. Of the approximately 12,000 medium-size and large enterprises privatized after 1992, about two-thirds were majority owned by their employees following privatization. Workers were given some free shares and were provided significant purchase discounts. Managers were also allowed to purchase shares prior to any shares being sold to the public. Russian citizens at large were granted privatization vouchers to invest in privatizing companies, and many employees used their vouchers to purchase additional shares in their own companies. Following the first round of privatization, the level of employee ownership has been falling rapidly as employees have begun to sell their shares to outside investors.

A1.61 **Slovakia**—Privatization is based on public auctions and direct sales. Employee participation in ownership takes two forms. Employees can buy shares in their own company on favorable terms requiring a 10 percent to 15 percent deposit with 10 to 15 year repayment terms at low interest rates or through management buyouts whereby management gets no special incentives.

A1.62 **Slovenia**—Most management-employee buyouts in Slovenia are structured with the assistance of a holding company that acts as the seller. Typically, the state company transfers assets into one or more new companies and becomes the holding

company with 100 percent ownership of the subsidiaries. The state-owned company then sells shares on favorable terms to employees, providing long-term financing. The privatization transactions typically combine a free transfer of up to 20 percent of the shares to employees at no charge: 20 percent is distributed to investment funds owned by citizens at large, 10 percent to the national pension fund, and 10 percent to the national compensation fund. The remaining 40 percent is sold either to employee groups or sold in a public tender or auction, or in a public offering of shares.

A1.63 **United Kingdom**—The laws in the United Kingdom have been adapted to accommodate the use of leveraged ESOPs similar to the United States. Leveraged ESOPs have played a significant role in privatization transactions, as well as in private transactions among U.K. companies. Under Prime Minister Margaret Thatcher, the U.K. government's privatization program included a goal of providing employees of privatized companies opportunities to purchase discounted shares. The success of this program was key to building political support for privatization and contributed in large measure to the government's claim to have quadrupled the number of shareholders in the country. Today several hundred U.K. companies have substantial levels of employee ownership. Employees in privatization transactions were typically offered some free shares (subject to a two-year holding requirement), priority in the allocation of shares, a discount of 10 percent on share purchases, and the opportunity to buy shares on a matching basis (buy one, get one for free). Tax incentives to encourage the development of employee ownership include a corporate tax deduction for principal and interest payments on ESOP loans and a deferral of capital gains taxes for sales of stock to ESOPs in privately held companies if the ESOP owns a minimum of 10 percent of the company stock.

A1.64 **United States**—Today in the United States upwards of 15,000 companies have some amount of broad-based employee ownership. The aggregate value of employee holdings is estimated to be in the range of US$300–US$400 billion, or approximately 7 percent of the market capitalization of U.S. companies. The most typical form of employee ownership is an ESOP, but a variety of other mechanisms, such as retirement plan investments in employer securities, stock purchase plans, stock bonuses, and stock options made available to a broad cross-section of employees, are frequently used. A growing number of multinational companies are now beginning to offer shares to their international employees as well.

A1.65 A unique feature of U.S. employee ownership law is the use of leveraged ESOPs to allow employees to purchase shares on credit, using the credit capacity of the company itself to secure the loan which is then repaid out of future corporate cash flows. This enables employees to obtain larger blocks of shares than they would otherwise be able to purchase on their own and has resulted in ESOPs playing a significant role in corporate restructuring and ownership transition strategies. To encourage the growth of ESOPs, the U.S. Congress has granted ESOPs important tax advantages. They include a corporate tax deduction for the principal and interest payments on ESOP loans, a corporate tax deduction for dividends paid on ESOP shares, a deferral of capital gains taxes for individuals selling shares to an ESOP in a nonpublicly traded company (if the

ESOP ends up with a minimum of 30 percent of the shares), and an exemption from taxes of 50 percent of the income earned on loans to ESOPs (subsequently repealed). For smaller, limited shareholder companies registered under Subchapter S, ESOPs are exempt from taxation until the proceeds are distributed to employees upon a break in service.

A1.66 In addition, many U.S. companies are using employee ownership techniques to help them meet various business objectives, including the recruiting and retention of key employees and the use of stock as a form of compensation. In many cases, these employee ownership programs are used for a limited number of employees instead of for broad-based use.

Annex 2

The Role of Labor Unions in Employee Ownership

A2.1 Historically, labor unions have resisted the idea of members owning shares in companies for which they work, partly out of a fear they will be "co-opted" and partly due to concerns about how to conduct labor negotiations when workers are also owners ("bargaining with ourselves"). Recent experience in the United States and the United Kingdom suggests that ESOPs conceived by and adapted to the needs of unions can play a positive role in transforming traditional adversarial labor-management relationships. The U.S. steelworkers union, which embraced ESOPs as part of a job and pension preservation strategy during the 1980s (see box A2.1) illustrates this point.

A2.2 Trade unions can play a critical role in setting up ESOPs. Unions can take the initiative in instigating the process of setting up the ESOP instead of waiting for management to propose such a participatory scheme. The union can also assume the responsibility of negotiating with management the ownership incentive systems, participatory structures, accountability systems, voting rights, allocation rights, vesting schedules, and mutual assessments systems on behalf of its members.

A2.3 While protecting the basic wage rights and working conditions of its members, the union in an employee-owned company can also begin promoting and protecting its members' ownership rights. It can play a crucial role in educating its members on the rights and responsibilities of ownership, and ensure that employees have access to vital financial information available to any shareholder. Thus, its role expands within the new ownership framework.

A2.4 ESOPs also provide an opportunity for trade unions to secure greater job security for their members under hardship conditions. In times of economic crisis, the union can play a role in reducing hiring levels by attrition and avoid layoffs by across-the-board "hardship sharing," cuts in base compensation, and work-sharing. It can also offer relocation assistance, compensatory ownership benefits, and sufficient severance payments to help those unable or unwilling to share in the burdens of corporate "belt-tightening."

A2.5 To prevent weakening its specialized institutional role or building unchecked power into its own leadership, the union should do the following:

?? Avoid any direct role in hiring and firing management. Instead, the union should ensure that its members, through access to the right tovote for board directors, can participate in the process of hiring and firing management.

?? Avoid taking a managerial role. Instead, the union should encourage decentralized decisionmaking within all operational levels of a company.

?? Avoid voting as a bloc where the votes of dissenting individuals are not counted. Rather, the union should ensure that each of its members has a vote, and trust that informed employee-owners will apply common sense in assessing the best alternatives.

Box A2.1. Employee Ownership and the United Steelworkers of America

One of the oldest and most militant of industrial unions in the United States, the United Steelworkers of America, faced the dilemma of protecting an aging membership at a time when domestic steel markets were progressively opening to lower-cost foreign imports and being subjected to new labor-saving minimills and continuous casting. Confronted with the reality of needing to draw less money out of their employer companies in order to ensure their ongoing viability, the steelworkers bargained for an ESOP stake in those companies.

The Union's ESOP strategy further altered the dynamics of collective bargaining as employees realized that the money they had formerly regarded as "lost" in negotiations (that is, pay benefits) was being invested in the company or used to finance their acquisition of shares. This "forgone" money was instead helping secure their jobs (and pensions) while simultaneously allowing them to accumulate an asset whose value they could affect.

The union's dual role served its agenda well. Ownership provided union officials with better tools and information with which to shape their long-term job and pension preservation strategy. Typically the union bargained for preferred shares, forfeiting some potential share appreciation in return for a priority claim on company earnings to help offset some of the direct compensation swapped in exchange for their ESOP stake. As a general rule, the steelworkers insisted on the inclusion of three features in their contracts: (a) that ESOP be kept separate from pensions, (b) that unlisted shares be valued independently, and (c) that employees vote their shares.

As a result of the ESOPs, union leaders reported a change not only in workplace rules and expectations, but also in relationships within the workplace as workers began to be treated as shareholders. In the case of majority employee-owned companies, workers and union leaders found it advisable to coalesce around strong, experienced managers and to support them as long as they performed.

One of the more transformative aspects of this strategy affected labor union leadership. Employee-owner union members began to expect and insist on leaders with greater financial sophistication and commercial orientation, and with the ability to understand how to preserve jobs in an increasingly global market. The rhetoric of the class struggle gave way to the need for financial literacy and operational flexibility. As more mechanisms were designed and implemented to enhance interaction between workers and managers, negotiations became more continuous and incremental, and less periodic and dramatic, while strikes became a last rather than a first resort.

As the steelworkers continue to refine this ownership strategy, they steadily devise new ways to reflect their members' concerns. Recently they negotiated several contracts that include a "right of first refusal" whereby an employer company must first be offered to employees via an ESOP before it can be sold to others. With support from the government's Federal Mediation and Conciliation Service, the steelworkers union in October 1994 established a Worker-Ownership Institute designed to provide training and information, particularly in the area of problem solving and financial understanding related to employee ownership.

Annex 3

Ghana's National Savings and Investment, With Special Reference to the Financing of ESOPs in Privatized Successor Businesses of the Electricity Corporation of Ghana

Long-Term Trends

A3.1 As is well known, Ghana's savings and investment have substantially and continuously increased since the early 1980s. There are some discrepancies in the actual numbers among different sources, but there can be no doubt that the direction of change has been positive. Nor can there be any real doubt about the turning point that led to these increases. When it first seized power in 1981, the then ruling Provisional National Defense Council (PNDC) was state socialist in its main economic outlook and policies. Two years later, however, in 1983 it introduced a National Economic Recovery Programme drawn up with help from the International Monetary Fund (IMF) and the World Bank. The program was designed to promote the private sector and encourage more market-based economic relationships. The adoption of that recovery program was the turning point.

A3.2 For the savings and investment aggregates, measured as percentages of GDP, annual five-year averages published in the 1997 annual report of the African Development Bank offer the clearest statistical evidence of the long-term trend (table A3.1).

Table A3.1. Gross Domestic Savings and Gross Investment as a Percentage of GDP, Annual Averages

Year	Savings	Investment
1981–85	4.6	5.6
1986–90	11.4	14.4
1991–95	10.4	15.6

The Investment Growth Trend Continues, 1990–96

A3.3 Figures by the World Bank show that, notwithstanding a dip in 1991 and an only partial recovery in 1992, gross domestic investment, measured again as a percentage of GDP, continued to grow between 1991 and 1996 (table A3.2).

Table A3.2. Gross Domestic Investment as a Percentage of GDP, 1991–96

Year	*Percent*
1991	15.9
1992	12.8
1993	14.8
1994	16.9
1995	18.6
1996	18.7

A3.4 On the other hand, the same World Bank publication shows a huge fall-off in private investment between 1991 and 1992 followed by no more than a slow recovery from 1993 to 1996 (table A3.3).

Table A3.3. Private Investment as a Percentage of GDP, 1991–96

Year	*Percent*
1991	7.6
1992	2.5
1993	3.1
1994	2.9
1995	3.9
1996	4.1

A3.5 For national savings, as opposed to investment, the World Bank data for the six years up to and including 1996 show a remarkable bounce back after a fall to almost zero in 1993 (table A3.4).

Table A3.4. National Savings as a Percentage of GDP, 1991–96

Year	*Percent*
1991	8.9
1992	3.6
1993	0.4
1994	8.1
1995	12.1

1996	10.3

A3.6 Data from Ghana's *Quarterly Digest of Statistics* show a similar trend, but rather different actual numbers compared with those above (table A3.5).

Table A3.5. National Savings as Recorded by Ghana Statistical Service (percent)

Year	*Percent*
1991	9.7
1992	7.1
1993	4.4
1994	11.7
1995	14.6

A3.7 For gross investment, the actual numbers in Ghana's *Quarterly Digest of Statistics*, as well as the trend, coincide quite closely with those of the World Bank (table A3.6).

Table A3.6. Gross Investment as Recorded by Ghana Statistical Service (percent)

Year	*Percent*
1991	13.5
1992	13.8
1993	15.8
1994	15.9
1995	16.1

A3.8 Finally, the Ghana Statistical Service has estimated foreign savings within the National total (table A3.7).

Table A3.7. Ghana Statistical Service Estimates of Foreign Savings (percent)

Year	*Percent*
1991	3.8
1992	3.8
1993	11.4
1994	4.2
1995	1.8

A3.9 It may be worth suggesting that the otherwise astonishing estimate of foreign savings coming into Ghana in 1993 may be associated with two rather specific events in that year:

- ?? The first listing on the Ghana stock exchange of shares in Ashanti Gold Fields.
- ?? The opening of the exchange to dealings by foreigners.

The Relevance of Ghana's Recent Savings and Investment to the Prospective Financing of ESOPs in any Privatization of the Electricity Corporation of Ghana

A3.10 From the data presented above, some general points are worth highlighting in relation to the financing of any possible privatization of the ECG and of any possible ESOPs that might be associated with those transactions.

A3.11 The first point to highlight is that though both investment and savings have shown a healthy long-term growth that has broadly been sustained in the 1990s, the savings still lag a long way behind investment. Given the combination of Ghana's investment needs (together with some international recognition of them) and the prevailing levels of its citizens' incomes, that should not surprise anyone. This suggests that a focus on financing share acquisition for employees rather than requiring them to use their limited savings to acquire shares is a more effective means of broadening ownership of wealth.

A3.12 The second point to highlight is the extreme volatility in the 1990s of Ghana's national savings and, within those, of its foreign investment. Neither should come as a real surprise, after what happened in the Far East in the latter months of 1997, particularly as it relates to foreign investment.

A3.13 Taken together and taken separately, these two points are persuasive arguments for seeking to encourage the component of domestic savings in the financing of any privatization of the ECG and of any ESOPs within it. The positive policies toward employee share purchase espoused by Ghana's TUC offer an important potential advantage in relation to the financing of ESOPs.

Annex 4

Discounted Cash Flow Analysis

Valuation

A4.1 The initial transaction value of the test concession was estimated using the Discounted Cash Flow methodology. An owner or prospective owner of a company will evaluate the anticipated investment return in determining the company value. To take into account the time value of capital, it is typically appropriate to value the company's cash flows using a discounted cash flow approach (Discounted Cash Flow analysis).

A4.2 Discounted Cash Flow analysis is a valuation method that isolates the company's projected cash flows available to service debt and provide a return to equity (Free Cash Flow to Capital) and computes the net present value of this Free Cash Flow to Capital over a projected period given the perceived risk of achieving such cash flow. The following section describes the methods and assumptions used to conduct the Discounted Cash Flow analysis for the sample concession.

Cash Flow Projections

A4.3 To conduct a Discounted Cash Flow analysis, the Free Cash Flow to Capital of the company must be determined. To do this, a detailed financial model of the company (the model) has been constructed. The model integrates historical financial performance of the company with future projections of the company and includes an income statement, balance sheet, cash flow statement, and a set of assumptions.

A4.4 The computation for Free Cash Flow to Capital, Less Taxes is as follows:

Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA):

—Less: Capital Expenditures

—Less: Increases in Working Capital.

This equals Free Cash Flow to Capital

(To determine a debt-free cash flow, working capital has been adjusted so as not to include changes in the current portion of debt; cash is also excluded from this figure because it is considered separately.)

—Less: Taxes on Earnings Before Interest and Taxes

This equals Free Cash Flow to Capital, Less Taxes.

A4.5 Taxes are computed using the effective Ghanaian corporate tax rate of 35 percent. The tax rate is applied prior to allowance for ESOP contribution deductions.

Investment Horizon

A4.6 A 10-year time horizon is employed.

Terminal Value

A4.7 It is impossible to build a model that extends indefinitely, although an owner may expect cash to flow to capital over an indefinite period of time. Therefore, it is necessary to represent the value of the cash flow that can reasonably be expected to extend beyond the 10th year of the projections. This is called the Terminal Value. The Terminal Value is often calculated by multiplying the 10th year cash flow by a constant growth multiple. The constant growth multiple is computed by dividing the sum of the first and the 10th year growth rate by the difference between the discount rate and the 10th year growth rate.

A4.8 The 12.2 multiple (the Selected Multiple) is applied to the 10th year free cash flow after-tax figure. The result is then discounted for the time value of money over the 10-year period prior to its realization.

Discount Rate

A4.9 The cash flow available to an owner of the concession is not all available in one day; it is spread over many years. Cash in hand today is worth more to someone than the same amount of cash projected over some future period. To compare future cash flows to current cash, it is necessary to discount the future cash flows by a factor (the Discount Rate) that takes the cost of capital and the risk of achieving the projected cash flows into account. To determine the Discount Rate, it is necessary to determine the normalized cost to the concession of both debt and equity and calculate a weighted average cost of capital of these two components of the concessions capital structure.

Debt

A4.10 It is assumed that the concession will be required to pay an interest rate equivalent to the prime rate plus a premium. The current prime interest rate in the United States is 8.5 percent. A 4 percent premium has been added to the prime rate to reflect the added risk in this transaction based on the lack of collateral and the country risk. This is equivalent to the interest rate assumed in the transaction structure.

A4.11 Since the interest cost of debt is deductible for a corporation, it is necessary to adjust the capital cost of debt to reflect this tax advantage. To tax adjust the cost of debt, a 35 percent tax rate was used because it is the current effective corporate tax rate in Ghana. The Adjusted Cost of Debt is 8.125 percent.

Equity

A4.12 The cost of equity for the concession is determined by adding to the risk-free rate an equity premium and the premiums necessary to offset the risk associated with the industry, the smaller size of the company, and other company-specific risks.

Risk Free Rate

A4.13 The risk-free rate is the rate at which the market is willing to lend to the most accredited borrower, plus an amount of interest that the market concludes is necessary to offset the impact of inflation over the life of the investment. One of the most accredited borrowers is the U.S. government and the least risky of investments for this investment horizon is thought to be the 10-year U.S. Treasury Bond (the T-Bond). The 10-year T-Bond rate as of October 31, 1997, was 6.01 percent.

Equity Risk Premium

A4.14 It is necessary to add a premium that the market considers necessary to offset the relative risk to common equity. The equity premium is developed by finding the difference between the average market return (the Standard & Poor's 500 is the proxy) and the risk-free rate. This equity premium is adjusted by a multiple of the industry-specific beta.[13] Hydroelectric companies in the United States include Bangor Hydro-Electric and DTE Energy Company. The betas indicate a slightly lower than market risk associated with hydroelectric companies. The adjusted equity premium used for this analysis is 5.6 percent.

Size Premium

A4.15 A size premium is necessary to compensate small-cap equity investors for additional risk exposure. Ibbotson Associates' annual publication, *Stocks, Bonds, Bills, and Inflation 1997 Yearbook*, suggests the application of a 3.5 percent size premium for companies with capitalization below US$149 million.

Company- or Project-Specific Premium

A4.16 An additional 12 percent premium has been applied because of the uncertainty of cash flows in the case of the concession. The key considerations in this regard are the uncertainty related to the Ghanaian economy and the lack of diversification in the concession's business operations.

[13] The risk of the portfolio relative to the market is known as its beta. It is a statistic that is estimated by equity analysts and gives an indication of the relative movement in the stock compared to the movement in the market excess return. For example, if the excess market return over a given period is 2 percent, then a stock with a beta of 2 will increase by 4 percent, and a stock with a beta of 0.5 will increase by 1 percent. The beta of the stock can be regarded as the risk of the stock; that is, a high beta will fluctuate to a greater extent than the market portfolio, and a low beta will have a more stable set of returns. For example, certificates of deposit will have a beta of 0.

Adjusted Cost of Equity

A4.17 Adding the risk-free rate, the comparable companies risk premium, the small stock premium, and the company- or project-specific premium, the result is an Adjusted Cost of Equity of 27 percent.

Weighted Average Cost of Capital

A4.18 After computing the Adjusted Cost of Debt and the Adjusted Cost of Equity, it is necessary to weight each to compute the Weighted Average Cost of Capital. The average proportions of the total debt to equity as seen in U.S. energy companies over the past 10 years has been used to determine the relative proportions of debt to equity in computing the Weighted Average Cost of Capital for this analysis. These proportions are 50 percent debt and 50 percent equity. Upon applying these weightings to the two components of capital, the Weighted Average Cost of Capital was concluded to be 17.6 percent.

Discounted Cash Flow

A4.19 Applying the Weighted Average Cost of Capital to the Free Cash Flow to Capital, Less Taxes and to the Terminal Value in the 10th year, the Discounted Cash Flow Analysis yields an implied total invested capital requirement.

Implied Equity Value

A4.20 The implied equity value is determined by adding the cash balance on the concession and subtracting the debt. It is understood that the government of Ghana intends to free the concession of debt obligations at closing. Though this does not prohibit the purchaser from using debt in the new capital structure, the entity considered for valuation is the concession as offered prior to the transaction. Therefore, it is assumed that there is no deduction for debt obligations. By estimating the cash balance using the assumption based on days of sales, there is assumed to be a cash balance transferred to the concession at the close of the transaction, which would represent the price of the entire sample concession.