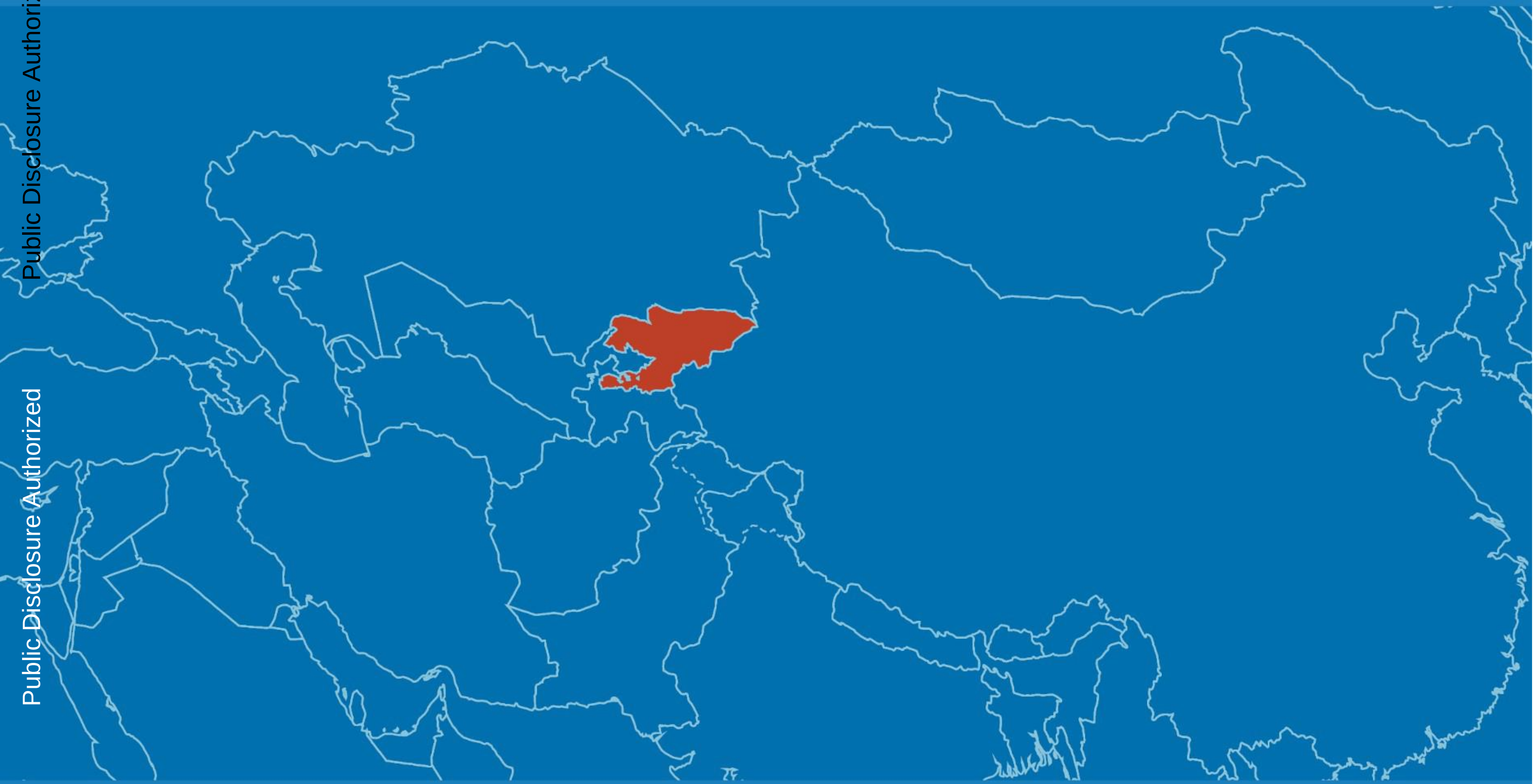

Kyrgyz Republic
Integrated State-Owned Enterprises Framework (iSOEF) Assessment

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Finally, the team wishes to thank the donor of the KAREP Project —the Swiss State Secretariat for Economic Affairs (SECO) — for their continued support.

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Abbreviations and Acronyms

CEO	Chief Executive Officer
CG	Corporate Governance
DSA	Debt Sustainability Analysis
EPP	Electric Power Plants
EU	European Union
GDP	Gross Domestic Product
GLC	Government Linked Corporations
HPP	Hydro Power Plant
ICRC	Independent Complaint Review Commission
IFRS	International Financial Reporting Standards
IFI	International Financial Institution
iSOEF	Integrated State-Owned Enterprise Framework
JSC	Joint Stock Company
KGS	Kyrgyzstani Som
KPI	Key Performance Indicator
LLC	Limited Liability Company
MOF	Ministry of Finance
MTTP	Medium Term Tariff Plan
NBR	Net Budgetary Requirements
NEHC	Open JSC National Energy Holding Company
NESK	JSC National Transmission Company
PCG	Putrajaya Committee on Government-Linked Companies' High Performance
PIP	Public Investment Program
PPD	Public Procurement Department
PPG	Public and Publicly Guaranteed
PPL	Public Procurement Law
PPP	Public-Private Partnerships
PSA	Public Service Agreements
PSO	Public Service Obligations
OE	Operating Expenses
QFD	Quasi-Fiscal Deficit
ROA	Return on Assets
SE	State Enterprise
SOE	State-Owned Enterprise
SPMF	State Property Management Fund
SSRSFM	State Service for Regulation and Supervision of Financial Market
UNCITRAL	United Nations Commission on International Trade Law

Currency Equivalents

December 31, 2018: Kyrgyzstani Som 68.84 = US$ 1
December 31, 2019: Kyrgyzstani Som 69.79 = US$ 1

Executive Summary

i. **The main objective of this integrated state-owned enterprises framework assessment (iSOEF) is to analyze the economic and fiscal impact of the Kyrgyz state-owned enterprise (SOE) portfolio, and identify ways to strengthen its performance and corporate governance**. This report describes the landscape and main characteristics of the SOE portfolio in the Kyrgyz Republic, provides an assessment of main fiscal costs and risks of the SOEs with a focus on energy sector SOEs, and analyzes the corporate governance and financial reporting frameworks and practices applied by Kyrgyz SOEs. The report is based on two modules of the iSOEF methodology capturing key aspects of the SOE sector, namely: "Fiscal Impact" (iSOEF Module 2), and "Corporate Governance and Accountability Mechanisms" (iSOEF Module 4). The primary audience of the iSOEF assessment is the Government of the Kyrgyz Republic, in particular the Ministry of Finance (MOF), the Ministry of Economy, the State Property Management Fund (SPMF), the State Service for Regulation and Supervision of Financial Markets (SSRSFM), and other relevant stakeholders.

ii. **Notwithstanding its significant downsizing due to the country´s transition from a planned to a market economy, the public sector in Kyrgyz Republic still owns 136 SOEs, with the largest ones operating in strategic and economically important sectors**. This report analyzes SOEs that are centrally owned at the national level; it does not cover the municipal SOEs. National level SOEs currently operate in key economic sectors such as energy, mining, transport, and banking. In 2018, the SOE sector in the Kyrgyz Republic generated revenues equivalent to 22.6 percent of GDP and employed a modest 2 percent of the country´s working age population. SOE-sector total assets reached almost 50 percent of GDP during the same year. The energy sector comprises the majority of SOEs' assets —48.5 percent of total SOE-sector assets and 62 percent of non-financial SOEs assets. It also holds 91 percent of non-financial SOEs liabilities, equivalent to 21.2 percent of the country's GDP.

iii. **Although SOEs have been contributing in aggregated net terms to the central government budget in recent years, there is growing concern of the Kyrgyz government related to the poor financial performance of energy sector SOEs**. The whole SOE sector contributed — through taxes and dividends— KGS 5.7 billion (USD 83 million or 1 percent of GDP) to the central government budget in 2018 and received government subsidies of a similar amount, this accounts for 0.8 percent of GDP. Growing SOEs' tax and dividend contributions are now at the top of Kyrgyz government priorities, aiming to increase SOEs' efficiency and contribution to the economy. Most Kyrgyz SOEs are profitable, with the clear exception of the energy sector which reported a combined loss of KGS 9.3 billion (USD 135 million) in 2017, and KGS 3.4 billion (USD 50 million) in 2018.

iv. **SOEs´ service delivery is also showing suboptimal results, markedly in the basic infrastructure segment**. The Kyrgyz Republic ranked 130 (out of 138 countries) in the transport infrastructure index of the World Economic Forum's (2016–2017) Global Competitiveness Index. Kyrgyz transportation system coverage is insufficient and restricts the development of the country´s export potential. Also, the World Bank's Doing Business 2019 report scored the Kyrgyz

Republic's reliability of electricity supply as "very poor". The country's largest power plant, the state-owned Toktogul hydroelectric power station, experienced breakdowns two winters in a row (2015 and 2016) due to cable line breaks. The hydropower units have a service life of 25 years but have been in use for 42 years. Equipment failure also affects the provision of heating services: in January 2018, Bishkek's Heat and Power Plant failed, leaving parts of the capital city without heat supply for several days, when winter temperatures were around -20° C. Water and sanitation services are also affected by significant infrastructure challenges, but they are provided by local-level SOEs and are not analyzed in this report.

Fiscal costs and risks of SOEs

v. **The main SOE-related fiscal risks faced by the Kyrgyz government are both explicit and implicit.** As mentioned, the amount of budget subsidies to SOEs is about the same as the tax and dividend revenues from SOEs, hence their net fiscal impact is roughly neutral. However, explicit risks arise because the Government also finances SOEs via sizable loans, in particular through on-lent Public Investment Program (PIP) loans —16.9 percent of GDP as of end-2018. The risk of non-repayment of these loans is high, given that the main recipients are energy sector SOEs that are not considered capable of servicing them in full without first making major reforms to strengthen their financial viability. Implicit risks, which in magnitude are potentially even larger, arise because the energy sector SOEs will need to undertake huge levels of capital investment to maintain the delivery of energy supplies to the population, but they do not have the resources to fund their investment requirements. Hence, unless there are major reforms to improve the financial viability of the energy sector SOEs and to attract private investment into the sector, the Government will have to fund the sector's investment requirements to avert a collapse of energy supplies.

vi. **The high debt levels, fragile financial condition, and significant investment needs of energy sector SOEs add pressure to a highly constrained fiscal space in the Kyrgyz Republic**. The WBG Public Expenditure Review (2020) concluded that, given recent and planned trends in overall fiscal deficit together with the current levels and forecasts of public debt, fiscal policy in the Kyrgyz Republic is sustainable, but that there is very limited fiscal space to accommodate larger fiscal deficits over the medium to long term without driving up public debt ratios. Furthermore, fiscal space has been significantly eroded by the recent impact of the COVID-19 crisis and the nominal public debt to GDP ratio is forecasted to rise to 69 percent of GDP at end-2020 from 54.1 percent at end 2019[1]. Hence, while SOEs do not currently appear to be a major fiscal threat in the Kyrgyz Republic, the extent to which the budget can accommodate increased resource flows to SOEs without jeopardizing fiscal sustainability or reallocating resources from other areas of the budget appears to be severely circumscribed over the medium term.

[1] IMF County Report No 20/158, Kyrgyz Republic Request for Purchase (2020)

vii. **A forecasting of energy sector SOEs´ net budgetary requirements to maintain the delivery of their services over the next 10 years, was carried out using different assumptions**. This simulation exercise focused on the flow of loan disbursements to the SOEs minus their servicing of existing loans and compared them to estimates of the Government's projected fiscal space. If SOEs' budgetary requirements exceed the projected fiscal space, fiscal sustainability will be jeopardized, unless there are offsetting cuts in other components of public expenditure or increases in tax revenue.

viii. **The "status quo scenario", which is defined as one in which current (2020) tariff levels remain unchanged until 2023, provides clear evidence of the need for energy sector reforms to avoid affecting fiscal sustainability over the medium term**. If tariff levels remain unchanged until 2023, and thereafter are adjusted upwards at the rate of inflation, the combined net budgetary requirements of the energy sector (both electricity and heating) would average 4.2 percent of GDP during 2021-2030. This represents an increase of 2.8 percentage points of GDP from the average level of net resource flows of 1.4 percent of GDP over the last five years (2015-2019).

ix. **Tariff reform is an important pre-requisite to achieve cost-recovery of the energy sector and to ensure continued investment into much needed infrastructure, including with private capital.** The financial condition of the largest energy companies requires urgent improvements and significant capital injections from public and private sources. However, it will only be possible to attract private investment into the energy sector if the sector is made financially viable. While tariff increases are understandably politically sensitive, they are necessary to stop the depletion of energy companies' resources and growing budget subsidies and to create the conditions for private sector co-financing in the medium-term.

x. **Even with tariff reform, simulations indicate that budget requirements from energy sector SOEs would be high over the next decade to address significant underinvestment in the sector**. The energy sector requires major new investments, especially in power generation, both to replace existing capital assets which are long past their normal working life and to meet growing domestic demand for power. The estimated capital investment requirements of the energy sector average 4.2 percent of GDP during 2021-2030. These investment requirements cannot be fully met by the Government without jeopardizing public debt sustainability. Simulations also reveal that tariff increases are a necessary but not sufficient condition to significantly reduce budget requirements from energy sector SOEs over the next decade. Therefore, if implemented, tariff reform must be combined with other measures, in particular: (i) private sector involvement (e.g., through public-private partnerships (PPPs); (ii) detailed analysis and monitoring of energy sector SOE expenses; (iii) systematization of SOEs' relationship with the budget in estimating and being properly reimbursed for delivering public policy objectives, such as providing energy to targeted groups at below-market prices; and (iv) alleviation of their debt burden.

Corporate Governance and Accountability Mechanisms

xi. **Kyrgyz legislation related to SOEs is fragmented and regulated by numerous legal instruments, sometimes conflicting with each other**. The existing legislation does not clearly specify grounds for the establishment, operation, and management of SOEs on a comprehensive and structured basis. SOEs are currently regulated by different legal acts from various branches of law: civil, labor, land, tax, administrative, etc. Current primary laws governing SOEs range from the National Constitution and the Civil Code, to more specific legislation such as the Law on Joint Stock Companies (2003) and the Law on Bankruptcy (1997) among others. In addition, there are many normative acts of secondary legislation —presidential resolutions, government regulations, internal acts of ministries and agencies, etc.— which also regulate specific issues related to SOEs' establishment and operation.

xii. **Kyrgyz SOEs operate under different legal forms, reflecting the legislative history and ongoing evolution from a planned to a market economy.** Presently, all SOEs can be grouped into two main categories according to their legal status: 32 are joint stock companies (JCSs) and 104 are state enterprises (SEs). There were also 10 SOEs functioning as limited liability companies, but due to small size these are not included into the analysis. The largest Kyrgyz SOEs have adopted the JSC legal status, and are subject to higher governance and reporting requirements, as well as closer oversight from the state. In contrast, SEs —non-corporatized public entities— are relatively small in terms of revenues and assets and do not always comply with minimum corporate governance standards, including annual financial reporting. This unincorporated legal form of SE carries significant risks for the Government, including fiscal, social, and reputational, that are not addressed by the existing legal framework.

xiii. **While some progress has been made by the Kyrgyz Government in corporatizing SOEs, many continue with the legal status of SEs.** SEs are not subject to corporate legislation, this resulting into low level of accountability as SEs are not required to publish their regular financial statements or to undergo regular independent audit, they are not subject to corporate governance requirements. SEs are typically managed by their general directors, who are responsible for day-to-day operations and do not have similar levels of scrutiny or oversight to their counterparts organized as JSCs.

xiv. **Over the past years, the Kyrgyz Government has taken several important steps in reforming SOEs, including the implementation of a clear policy towards the centralization of SOE ownership and oversight**. The Government started introducing changes towards a more centralized ownership structure, especially through empowering the SPMF with key responsibilities towards non-financial SOEs since 2012, and the establishment of the National Energy Holding Company (NEHC), which absorbed control over energy sector SOEs, in 2016.

xv. **In 2015, the Kyrgyz Government issued a Decree on Improving State Assets Management, outlining the main principles of SOE management, oversight, and governance, and identifying the main areas for reform**. The Decree took stock of existing arrangements for SOE governance, and set a course for reforms in key areas, including: (i) main principles of effective SOE ownership; (ii) transition to a more centralized state ownership function; (iii) implementation of strategic planning and stronger corporate governance practices; (iv) introduction of proper incentives for SOEs' management; (v) strengthening of accountability mechanisms; and (vi) improving disclosure and public access to SOE information.

xvi. **As a result of the ongoing SOE reforms, the current SOE ownership and oversight function in the Kyrgyz Republic has evolved into a "hybrid" model**, with centralized arrangements applying to energy sector SOEs, and a dual model structure applying to the remaining non-financial SOEs. In the energy sector, the NEHC is structured as a holding company, designed to govern subsidiary energy SOEs via unified decision-making. The NEHC reports to SPMF, as its ultimate shareholder. In practice, however, these arrangements are not yet fully effective. The NEHC has not yet managed to apply a robust corporate governance structure for energy sector SOEs, including consistent and streamlined financial reporting practices. For remaining non-financial SOEs, a dual model applies, where ownership, oversight and policy functions are split between the SPMF and corresponding line ministries. Modest progress has been observed so far in terms of strengthening both SOE corporate governance practices and SPMF oversight, and also in terms of separating the ownership function of the SPMF from the line ministries' sector policy making function.

xvii. **In 2018, the Government (through the SPMF) introduced a system of SOE key performance indicators (KPIs)**. The SPMF developed and approved the "Methodological guidelines for applying KPIs for assessing financial soundness and operational efficiency of JSCs with state participation above 50 percent". Financial KPIs apply to all SOEs and are based on common financial ratios, grouped in three categories: (i) profitability; (ii) solvency; and (iii) liquidity. Non-financial KPIs are determined on an individual basis for each SOE. To take effect, KPI targets need to be agreed between the SPMF and respective SOE boards and further documented in individual performance contracts with each SOE's senior management. Due to its recent implementation, it is still too early to assess the impact of this government initiative, but its effectiveness will be closely linked to eventual progress achieved in other key areas, such as improvements in SOE management and the quality and timeliness of SOE financial reporting.

xviii. **While the Government has made progress in setting up a proper policy framework and establishing clear mechanisms for SOE board-member nominations and appointments, implementation needs to be improved**. Board candidates are selected by an Interagency Commission comprised of representatives from different state bodies, also including private sector and civil society representatives. Selection criteria are very broad, and candidates are required to pass a standardized test rather than being appraised on the basis of their competence and experience.

xix. **In practice, few SOE boards can be considered professional and efficient**. First, although the current law stipulates that independent directors must make up at least a third of SOE boards, they are in short supply and in most cases SOE boards are primarily staffed by government officials, who may lack the objectivity, skills, or time vital to well-functioning boards. Second, SOE boards are often not functioning properly as a collegiate body and the role of the board chairman appears unclear and undervalued. Third, board level committees are rare among Kyrgyz SOEs; most instead have a "Revision Commission", a body inherited from the former Soviet economy, which is currently not effective, nor practical, and whose permanence brings little value to the SOEs. Fourth, the remuneration of SOE directors is relatively low compared to private sector practices. And fifth, although Kyrgyz SOE boards are legally subject to performance evaluation, this tool is not applied consistently, and hence neither contributes to improving board nomination processes nor to enhancing SOE board professionalism.

xx. **The Accounting Law establishes a solid accounting, reporting, and disclosure framework for all entities – private and state-owned – but is not fully observed in practice.** According to the Law, all JSCs (including SOEs under this legal status) must submit financial statements to shareholders. They are required to submit annual financial statements within 60 days after the end of the reporting year and must publish their financial statements within 90 days of the end of the reporting year, but not later than June 1st of the current year. For SOEs that are listed or designated as publicly interest entities, published annual financial statements must be audited, compliant with the International Financial Reporting Standards (IFRS), and approved at the annual general meeting of shareholders. Financial sector JSCs are subject to further legal requirements and must periodically disclose financial information in the form of annual and quarterly reports. SOEs under the legal status of SEs fall under the same Accounting Law, however their compliance with this legislation is not enforced as the SSRSFM does not regulate SEs and the SPMF has limited enforcement capacity.

xxi. **Empirical evidence indicates that most SOEs have difficulties with producing timely and quality IFRS-based financial reports**. SOE reports are often incomplete, lacking key statements or notes that would normally be an integral part of the financial reporting package. They also tend to be inaccurate in the treatment of technical or sensitive areas, delayed in their preparation, and rarely are publicly disclosed. The National Energy Holding Company (NEHC) does not comply with IFRS as it does not consolidate information on its subsidiaries and reports only limited aggregated financial information of its subsidiary energy companies to the SPMF. Overall, there is space to significantly strengthen reporting and disclosure practices to provide more SOE transparency in the Kyrgyz Republic.

xxii. **The quality of external audits of SOE financial statements is often weak**. Quality control for external audits is not yet established in the Kyrgyz Republic[2]. This allows auditors with varying degrees of qualifications and experience to compete for business with the same companies. In the selection of external auditors, the price of services often prevails over the expected quality of work. Hence, the quality of SOEs audited statements is frequently not reliable for taking informed economic decisions.

xxiii. **Internal audit requirements are weak for SEs and lacking for JSCs.** The Kyrgyz Law on Internal Audit (2009) requires SEs to set up an internal audit function but reporting to the SE´s

[2] The Audit Law (2002) is undergoing an update by the SSRSFM and is expected to be amended in 2021 to reflect the quality control requirements for external audits.

chief executive officer (CEO), which makes them fully dependent on management and reduces their autonomy. The (voluntary) Corporate Governance (CG) Code (2012) mentions the necessity of JSCs having an internal audit function, but this is not seen in practice.

xxiv. **Public procurement is the crucial component of the SOE institutional framework and is paramount to SOE financial accountability and transparency**. In the Kyrgyz Republic, there is a unified procurement framework for all public sector entities, including SOEs, which is ruled by the Public Procurement Law (2015) (PPL). The legislative and regulatory framework is generally comprehensive and uses competitive bidding as its default method. There are different methods of procurement and their conditions of use are outlined in the PPL. These conditions are generally aligned with international good practice, including the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Procurement that can be used for goods, works, services, and consulting services. All public procurement processes in the Kyrgyz Republic have been done electronically since 2015.

xxv. **Overall, this unified procurement framework is beneficial for SOEs.** The existing system enhances competition and facilitates access for all interested vendors to procurement opportunities and increases transparency and accountability of the procurement process. According to an assessment of actual SOE procurement practices conducted by the World Bank—based on data provided by the Public Procurement Department (PPD) for six selected SOEs in the period 2017-2019—the average time to procure goods, works, and services following an open tender procedure was between 43 and 55 days. This indicates that the process is generally efficient, presumably due in part to the mandated use of e-procurement through the procurement web portal.

Key Recommendations and Options for Reforms

xxvi. **Recognizing the commitment of the Kyrgyz Government to SOE reform, this iSOEF assessment proposes recommendations to improve SOEs governance and performance, while limiting their fiscal costs and risks**. Given that SOE reforms are multidimensional and require a holistic and integrated approach, this iSOEF assessment focuses on four intertwined critical areas for reform – (i) development of the SOE ownership policy; (ii) systematization of SOE relationship with the budget; (iii) improvements in SOE transparency; and (iv) strengthening of corporate governance. These four critical areas of reform should be supported and complemented by a set of additional important reform measures presented in the Action Plan (Chapter 5). In particular, recommendations for reform are to:

- **Formulate a unified and comprehensive SOE ownership policy**. Taking advantage of the significant changes made since 2012 towards achieving a more centralized state ownership and oversight function over SOEs, the Government should formulate a unified and comprehensive SOE ownership policy. This should define main strategic sectors, identify large enterprises pursuing important public policy objectives; address market failures; and promote high-level government accountability mechanisms linked to SOE performance. The respective roles of the state, ownership entities (SPMF, NEHC), SOE boards and management, and independent regulators should all be clearly specified, thus helping to avoid the frequent overlap of roles and responsibilities between SPMF and line ministries.

- **Implement a medium term plan for reforming power and heating tariffs to achieve cost-recovery of the energy sector and to attract private capital.** The current tariff structure does not allow full cost recovery by energy sector SOEs and, as a consequence, the sector is not financially viable. Tariffs should be raised in real terms and the maximum monthly power consumption threshold for the social tariff should be reduced. In addition, energy sector SOEs should continue their efforts to reduce technical and commercial losses.

- **Systematize energy sector SOEs' relationship with the budget to properly calculate and compensate them for their quasi-fiscal activities and alleviate their debt burden.** Energy sector SOEs in the Kyrgyz Republic carry out several public service obligations delivered below cost, in particular in the energy distribution segment, which are only partially subsidized — implicitly or explicitly— by the state budget. These SOEs cannot become financially sustainable unless they are duly compensated, through further direct budget transfers, for the actual cost of their public social obligations. Also, relevant policy decisions need to be taken to alleviate energy sector SOEs' high debt burden and avoid the Government being caught in a perpetual SOE debt rollover exercise.

- **Improve the budget process and budget documentation to properly capture both the full impact of fiscal transactions with the SOE sector on the budget and the risks posed by the sector to fiscal sustainability.** The MOF should work with the SPMF to develop medium- and long-term forecasts of the financial demands which the SOE sector is likely to impose on the Government budget and the likely impact that this will have on public borrowing requirements and public debt. A summary of this analysis should be included in the section in the Explanatory Notes to the Budget entitled "Risks to the Republican Budget".

- **Strengthen SOE transparency by assuring compliance and reinforcing current reporting and disclosure requirements**. SOEs must use comprehensive and principles-based accounting standards (IFRS or IFRS for SMEs) as required by law. Periodic, aggregate SOE portfolio reporting, specifying main SOE performance trends, as well as the Government´s sector policy and ongoing reforms should be compiled, elaborated and published by the SPMF online on an official website at least annually. Regular publication of SOEs´ annual reports and audited annual financial statements should be enforced. Scrutiny of financial reporting should be strengthened by requiring independent audits by a reputable firm. A group of the largest SEs still in the process of reorganization should be identified and their financial reporting and audit requirements aligned with those applying to public and private JSCs. In the energy sector, it is also recommended that the nine subsidiary companies of NEHC be requested to directly submit their audited financial statements to the SPMF, until NEHC manages to implement full accounting consolidation.

- **Enhance SOE-boards´ professionalism and independence**. It is essential that SOEs increase their compliance with the Law on Joint Stock Companies (amended in 2017) and its requirement that at least one-third of total board members are independent directors. One way to improve corporate governance practices would be to gradually enforce the mandatory application of the CG Code, by focusing first on the most strategic and largest SOEs. This step would strengthen the SOE board nomination and appointment procedures, introduce a transparent and comprehensive system for selection of SOE board members, attract independent parties into the selection process, and establish a pool of potential board candidates. Other steps that require attention include: (i) empowering SOE boards —using further legislation if needed— to properly exercise their functions in terms of strategic SOE guidance, SOE management oversight, and financial supervision; (ii) establishing board level committees for taking well-informed and considered decisions in key areas, such as audit, risk management, and remuneration; and (iii) implementing adequate training programs, peer exchanges, formal induction-orientation programs, and ongoing learning opportunities for potential candidates and existing SOE board members.

xxvii. **The Kyrgyz Government strategy of optimizing and streamlining the SOE sector is appropriate and follows good international practice, however its implementation currently lacks momentum and sufficient political will.** Once defined, the SOE ownership policy will guide the segmentation of the SOE portfolio, allowing the Government to focus their scarce financial and human resources on the defined strategic SOEs and their performance. Other SOEs that do not satisfy the criteria for continued state ownership will need to be gradually exited by the Government via restructuring, mergers, or liquidation of nonviable entities.

xxviii. **During the preparation of this iSOEF assessment, the Government of the Kyrgyz Republic was implementing its Program «Unity-Trust-Creation» (2018-2022), which places significant emphasis on improving the management of state assets.** This Program defines state property management as one of the Government's priorities, focusing on achievement of a proper balance of interests among the state, business, and consumers, while also placing a strong emphasis on the transparency and efficiency of state ownership. The main areas of strengthening identified by the National Program include: (i) increased effectiveness of SOEs via enhanced management models and streamlined personnel policies; (ii) enhanced accountability and transparency requirements; and (iii) further collaboration with the private sector, including PPPs.

xxix. **The Kyrgyz Republic also joined the Open Government Partnership in 2018.** This decision was approved by a Government Resolution defined as "National Plan of Activities to Build Open Government in the Kyrgyz Republic for 2018-2020". The initiative, inter alia, includes measures on disclosure of information on state assets, including the requirement to publish an inventory of state and municipal level SOEs.

xxx. **Both initiatives aimed at improving efficiency and transparency of the Kyrgyz economy are expected to have a direct influence on SOEs.** These ambitious plans will take time to be properly implemented and will require effective support and commitment from Government authorities. If implementation is successful, the impact on the transparency and accountability of SOEs is expected to be substantial.

1. Introduction

1. **The main objective of this iSOEF assessment is to analyze the economic and fiscal impact of the Kyrgyz SOE portfolio, and identify ways to strengthen its performance and corporate governance.** This report analyzes SOEs that are centrally owned at the national level; it does not cover municipal SOEs. The primary audience of the iSOEF assessment is the Government of Kyrgyz Republic, in particular the MOF, the Ministry of Economy, the SPMF, and other relevant stakeholders.

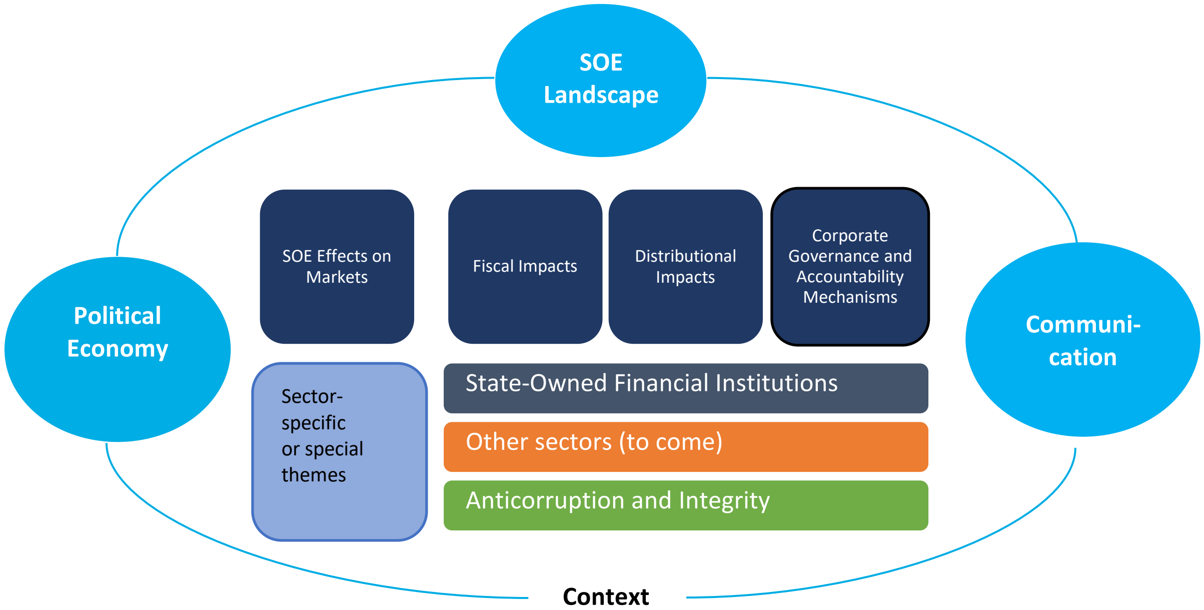
2. **This report applies the new World Bank iSOEF, developed by the Equitable Growth, Finance and Institutions Practice Group, to comprehensively assess the Kyrgyz Republic SOE sector and its current reform trends.** The report is the first comprehensive application of the World Bank's new iSOEF in the Europe and Central Asia Region, providing a landscape overview of SOEs in the Kyrgyz Republic and examining two key aspects for assessing SOEs, namely: their fiscal costs and risks with a focus on energy sector SOEs and corporate governance and accountability mechanisms. Leveraging the World Bank's expertise, this multidimensional assessment looks at the interrelationships of the challenges and opportunities faced by SOEs in the Kyrgyz Republic to propose holistic and sequenced recommendations to strengthen their governance and performance.

Methodology

3. **The report followed the modular structure of the iSOEF and its respective guidance notes.**[3] The iSOEF's modular structure allows for flexible implementation of various modules depending on their relevance, existing analysis, and available resources. For the Kyrgyz Republic, the iSOEF assessment scope covers the overall landscape of the SOE sector and provides an analysis based on two iSOEF modules capturing key aspects of the SOE sector, namely: "Fiscal Impact" (iSOEF Module 2), which offers an assessment of main fiscal costs and risks from SOEs in the Kyrgyz Republic with a focus on energy sector SOEs; and "Corporate Governance and Accountability Mechanisms" (iSOEF Module 4). Other modules can be added to the iSOEF assessment later depending on the Government's interest and availability of funding.

[3] The World Bank, "Integrated State-Owned Enterprise Framework" (iSOEF) Washington D.C, June 2019.

Figure 1: Integrated SOE Framework (iSOEF)



Structure of the Report

4. This report is organized in the following five chapters:

- Introduction (this Chapter).
- Landscape of the SOE Sector in the Kyrgyz Republic (Chapter 2).
- iSOEF Module 2: Assessment of SOEs Fiscal Costs and Risks with Focus on Energy Sector (Chapter 3).
- iSOEF Module 4: Corporate Governance and Accountability Mechanisms (Chapter 4).
- SOE Reform Recommendations and Options (Chapter 5).

2. The SOE Landscape

2.1 Background and recent developments in the SOE sector

5. **Since its independence in 1991 through the early 2000s, the Kyrgyz Republic privatized many of its SOEs, significantly reducing the state footprint in the economy.** The share of private sector activity in the Kyrgyz Republic is larger than in most other countries in the region because of early economic liberalization, rapid privatization, and new firm entry. The private sector is reported to account for more than 75 percent of GDP in the Kyrgyz Republic, compared to 60 percent in Kazakhstan and less in the other countries of Central Asia. However, Kyrgyz firms — both private and state-owned— face substantial constraints to expansion and their productivity growth appears to be lagging many comparators.[4]

6. **The Government's policy of reducing the state's share in the economy resulted in the rationalization of the SOE sector, but challenges remain.** Since the 1990's and through 2010, the Kyrgyz Republic privatized over 7,000 entities in all sectors of the economy, achieving the highest private sector share in GDP among CIS countries at that time. Over the past five years, the Interdepartmental Commission for Optimization of the State-Owned Enterprises implemented an SOE consolidation exercise, under which 46 SEs ("State Enterprises", un-corporatized Kyrgyz SOEs) were reorganized by mergers, another 90 transformed into state institutions, and 10 were liquidated. However, by the date of this iSOEF assessment, 104 SEs were still to be reformed, reorganized, or liquidated.

7. **Notwithstanding its significant downsizing due to the country´s transition from a planned to a market economy, the public sector in Kyrgyz Republic still owns 136 SOEs, with the largest ones operating in strategic and economically important sectors.** This report analyzes SOEs that are centrally owned at the national level; it does not cover the municipal SOEs. National level SOEs continue to operate in key economic sectors such as energy, mining, transport, and banking. In 2018, the SOE sector generated revenues equivalent to 22.6 percent of GDP and employed a modest 2 percent of the country´s working age population. SOE-sector total assets reached almost 50 percent of GDP during the same year. The energy sector comprises the majority of SOE assets —48.5 percent of total SOE-sector assets and 62 percent of non-financial SOE assets. It also holds 91 percent of non-financial SOEs liabilities, equivalent to 21.2 percent of the country's GDP.

8. **Although SOEs have been contributing in aggregated net terms to the central government budget in recent years, there is growing government concern related to the poor financial performance of energy sector SOEs**. Many SOEs are not running at high efficiency and profitability levels, thus raising concerns about being the recipients of significant government subsidies and loans, while their service delivery to citizens remains sub-optimal, and their contribution to the Government in the form of taxes and dividends insufficient. These factors, combined with low transparency and insufficient corporate governance standards, especially in the case of un-corporatized SOEs, have brought SOEs to the top of the government reform agenda.

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[4] World Bank Group, Kyrgyz Republic Country Economic Memorandum, 2020.

9. The stated strategy of the Kyrgyz Government towards optimizing and streamlining the SOE sector follows good international examples, but implementation is lagging. While the Government has developed an overall approach to optimizing the state ownership and improving the state assets management[5], practical implementation of this approach takes time. Lack of definition of the strategic entities or sectors in which Government intervention is required to address market failures and to deliver uninterrupted public service obligations to the citizens, diverts scarce public resources and slows down the much needed reforms.

10. In 2018, the Government announced its National Program for 2018-2022 «Unity-Trust-Creation»,[6] putting significant emphasis on improving the management of state assets. This Program defines state property management as one of the Government's priorities, focusing on a proper balance of interests among the state, business, and consumers, while putting a strong emphasis on transparency and efficiency of state ownership. The main areas of strengthening identified by the National Program include:

- Increased effectiveness of state enterprises of all forms, via enhanced management models and streamlined personnel policies;
- Enhanced accountability and transparency requirements;
- Improved models of collaboration with the private sector, including PPP.

11. The Kyrgyz Republic joined the Open Government Partnership[7] in 2018, aiming to achieve a greater level of economic transparency. This decision was approved by Government Resolution No. 360-r, defined as "National Plan of Activities to Build Open Government in the Kyrgyz Republic for 2018-2020". The Plan, inter alia, includes measures on disclosure of information on state assets, including the requirement to publish an inventory of state and municipal SOEs.

12. Both initiatives, aimed at improving efficiency and transparency of the Kyrgyz economy, are expected to have a direct influence on SOEs. They are ambitious and so will take time to be properly implemented and will require effective support and commitment from Government authorities. If implementation turns out successful, the impact over the transparency and accountability of SOEs is expected to be substantial.

[5] Government Resolution #244-p dated June 5, 2015.
[6] Government Resolution #413 dated August 30, 2018, Chapter 4.5 Management of state assets and public-private partnerships.
[7] The Open Government Partnership (OGP) was launched in 2011 to provide an international platform for domestic reformers committed to making their governments more open, accountable, and responsive to citizens.

2.2 The SOE Portfolio

Table 1: SOEs sorted by legal status and economic sector (2018)

Sectors	JSCs	SEs	Total SOEs
Agriculture, forestry, and fishing	-	33	33
Mining	3	7	10
Manufacturing	2	5	7
Energy & Energy Construction	13[8]	1	14
Transportation	2	7	9
Information and Communication	2	7	9
Financial	7	0	7
Other	3	44	47
Total	**32**	**104**	**136**

Source: State Property Management Fund (2019).

13. **As of 2018, the SOE sector in the Kyrgyz Republic comprised 136 SOEs at the national level.** These can be broadly classified in two groups according to their legal status: 32 JSCs, fully or majority state-owned, and 104 SEs, non-corporatized public entities which are fully state owned, and are remnants of the former Soviet system of state ownership. There were also 10 SOEs functioning as limited liability companies, but due to small size these are not included into the analysis. With a few exceptions, the largest Kyrgyz SOEs have adopted JSC legal status and are subject to more stringent governance and reporting requirements, as well as closer oversight from the state. In contrast, SEs do not always comply with minimum corporate governance standards, including annual financial reporting. Most SEs are relatively small in terms of revenues and assets, and they are grouped in sectors such as “Agriculture and Forestry” (33 SEs), “Other Activities” (a residual miscellaneous category, including 44 SEs), “Communication” (7 SEs) and “Mining” (also 7 SEs), among others.

14. **Most SOE revenues and assets are concentrated in a few firms (mostly JSCs) that provide essential goods and services in key economic sectors.** According to 2018 data reported by the SPMF, the largest 15 SOEs (by assets) accounted for 93.9 percent of total SOE-sector revenues and represented 92.6 percent of total SOE-sector assets. These 15 SOEs are all JSCs except for one SE, the national railway company Kyrgyz Temir Zholu. These large-scale SOEs operate in key strategic and economically important sectors, including mining, energy, transportation, and financial intermediation.

[8] OJSC National Energy Holding Company (NEHC) is presented as one entity in most of the official statistics. NEHC includes the Holding entity and its nine subsidiary-companies engaged in energy generation, transmission, and distribution. NEHC does not prepare fully consolidated accounts, as required by the International Financial Reporting Standards (IFRS) and only aggregates certain positions of its subsidiaries' financial statements. Therefore, a quantity of entities in the table above should be increased by nine to supplement the already statistically included OJSC National Energy Holding Company with its nine subsidiaries.

Table 2: Largest SOEs in Kyrgyz Republic (sorted by total assets, thousands of KGS, 2018)

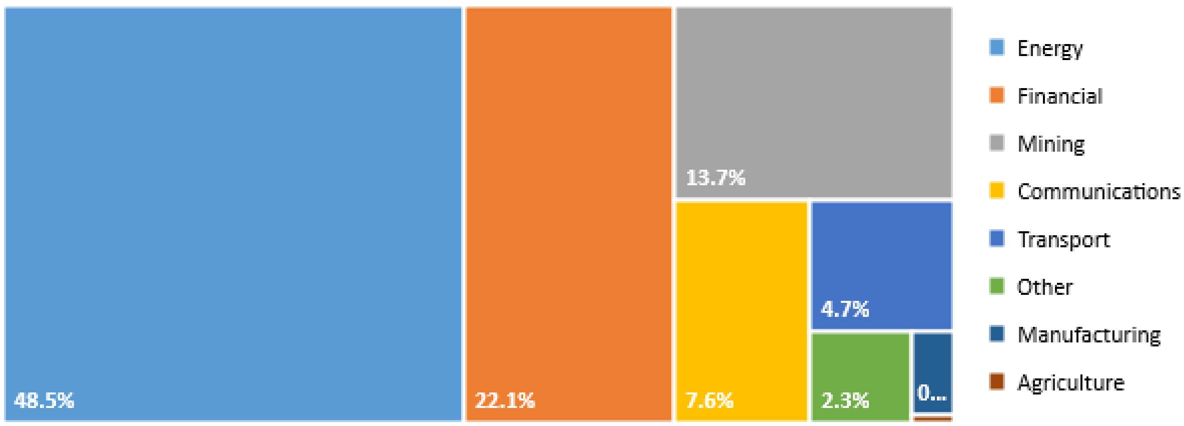
SOE Name	Legal Status	Sector	Total Assets	Total Employees
Electric Power Plants	JSC	Energy	55,934,423	4,600
National Transmission Company	JSC	Energy	38,684,145	2,500
Ayil Bank	JSC	Financial	29,253,248	1,500
Kyrgyzaltyn (Gold Mine)	JSC	Mining	28,593,988	1,700
RSK Bank	JSC	Financial	20,530,462	1,300
Severelectro	JSC	Energy	14,067,814	3,000
International Airport Manas	JSC	Transport	10,899,461	2,400
Alfa Telecom	JSC	Telecom	7,310,489	1,100
Kyrgyz Temir Zholu (Railways)	SE	Transport	5,780,031	4,700
Kyrgyzneftegas (Oil & Gas)	JSC	Mining	5,102,140	2,300
Rosinbank[9]	JSC	Financial	5,007,478	no data
Oshelectro	JSC	Energy	4,594,689	2,000
Gosipoteka (State Mortgage Institution)	JSC	Financial	4,314,592	45
Kyrgyztelecom	JSC	Telecom	3,806,856	2,700
Bishkekteploset	JSC	Energy	2,635,414	950

Source: State Property Management Fund (2019).
Note: There was no consolidated data reported by NEHC.

15. In 2018, the SOE sector in the Kyrgyz Republic generated revenues equivalent to 22.6 percent of GDP and contributed in net terms to the central government budget. Interestingly, 45 percent of these revenues were generated by just one SOE, the National Gold Company "Kyrgyzaltyn", but as gold mining activity is subject to both internally and externally driven fluctuations this cannot be considered a stable and sustainable source of revenue. SOE-sector total assets reached almost 50 percent of GDP during the same year. The energy sector has a majority of SOE assets (48.5 percent of total SOE-sector assets and 62 percent of non-financial SOEs assets) and most non-financial SOE liabilities (91 percent), equivalent to 21.2 percent of the country's GDP. Financial SOEs, including two fully state-owned banks, Ayil Bank and RSK Bank, accounted for 22.1 percent of total SOE-sector assets during the same year (see **Figure 2**). The whole SOE sector contributed —through taxes and dividends— with KGS 5.7 billion (USD 83 million or 1 percent of GDP) to the central government budget in 2018 and received government subsidies of a similar amount — 0.8 percent of GDP**.**

[9] Rosibank shares are held directly by the National Bank of the Kyrgyz Republic following its bail-out in October 2018, during an emergency-liquidity assistance.

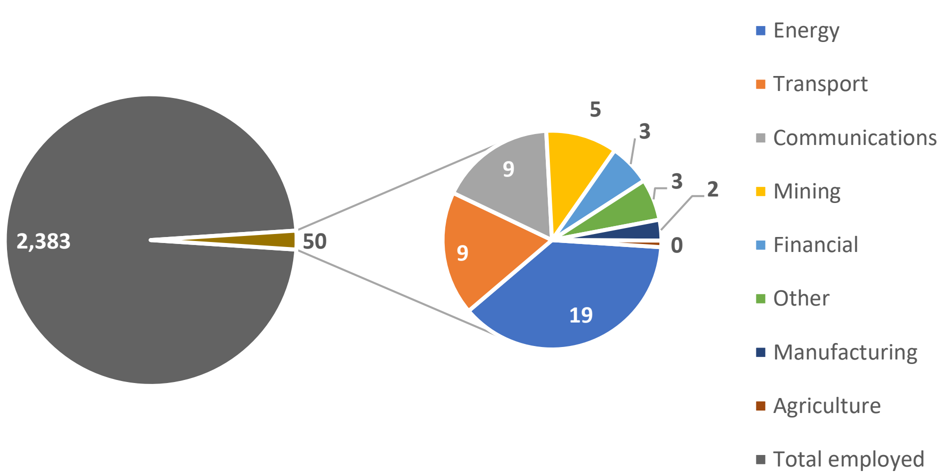
Figure 2: Distribution of SOEs Assets by Sector (2018)



Source: State Property Management Fund, energy companies' individual financial statements, World Bank staff analysis

16. **Kyrgyz SOEs employ a modest 2 percent of the working age population, confirming a clear growth of the private sector in the country.** The total number of people working in all legal forms of Kyrgyz SOEs is only about 50,000. The largest share of SOE employment is at energy sector companies (19,000 employees), followed by transport and communications at 9,000 employees each. SOEs in other sectors employ even smaller number of workers, as illustrated in **Figure 3** below.

Figure 3: Total employment and SOE employment in Kyrgyz Republic (Thousands of employees, 2018)



Source: State Property Management Fund, Statistics Committee, World Bank staff analysis

2.3. *Financial Performance*

17. Most Kyrgyz SOEs are profitable, with the clear exception of some energy sector SOEs. As illustrated in Table 3 below, the SOE-portfolio (136 SOEs) yielded a positive net income in 2018. At the same time, energy sector SOEs reported a combined loss of KGS 3.4 billion for 2018, and KGS 9.3 billion for 2017.[10] In fact, several energy sector SOEs, which are among the largest and most strategically important SOEs in Kyrgyz, have been chronically showing operating deficits. In 2018, for example, 20 SOEs were operating at a loss, and 61 percent of total SOE-sector losses (or 78 percent of non-financial SOE losses) were explained by just one energy sector SOE, the JSC National Transmission Company. On the other hand, the most profitable SOEs in 2018 were from the communication, transport, mining, and financial sectors.

Table 3: Financial position of the SOE-Portfolio (2018)

	KGS, Million	Percent of GDP
Non-financial SOEs		
Assets	195,080	35.0%
Liabilities	118,311	21.2%
Gross revenue	119,374	21.4%
Net income	1,349	0.2%
Financial SOEs		
Assets	55,372	9.9%
Liabilities	44,275	7.9%
Gross revenue	6,462	1.2%
Net income	723	0.1%
All SOEs		
Assets	250,452	45.0%
Liabilities	162,586	29.2%
Gross revenue	125,836	22.6%
Net income	2,072	0.4%

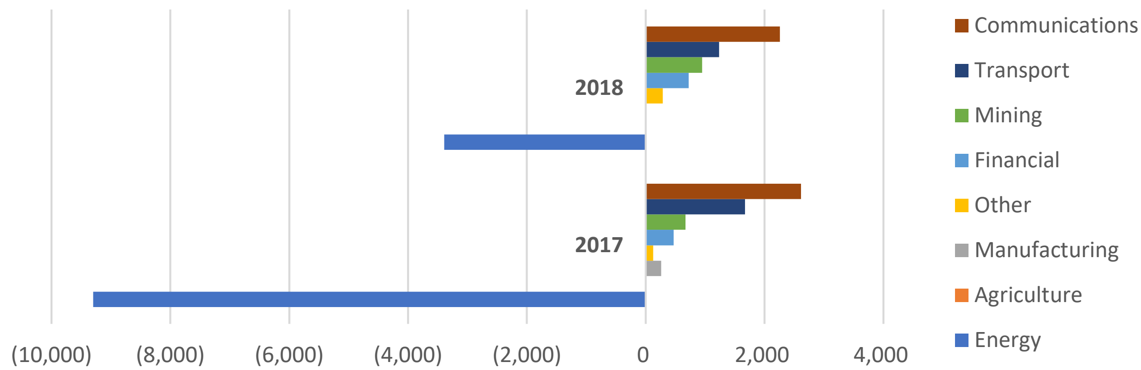
Source: State Property Management Fund, World Bank staff analysis.

18. The energy sector continues posting large losses. The energy sector loss in 2017 was exacerbated by the recognition in that year of losses amounting to KGS 10 billion related to the revaluation of foreign currency denominated loans and fixed assets by one SOE. The underlying trend is nevertheless one of substantial losses, in large part because the average power tariffs charged to customers are lower than the average full cost of service. Tariffs are determined by Government regulation and, for political reasons, the Government has been reluctant to raise tariffs to customers to levels which would ensure the financial viability of the energy SOEs. Furthermore, hydrological conditions for power generation, which are cyclical, were better than their long run averages in both 2017 and 2018, benefiting the financial performance of energy sector SOEs as it allowed more electricity to be exported at a profit and reduced the need for expensive fuel imports. Hydrological conditions are forecast to be less favorable (i.e. there will

[10] The majority of 2017 losses are attributable to a single adjustment posted by the JSC National Transmission Company (NESK) with respect to correcting the valuation of foreign currency denominated loans and proper valuation of fixed assets for approximately KGS 10 billion.

be less water in the dams) over the medium term, which will worsen the financial performance of the energy SOEs.

Figure 4: Profitability by sector, KGS millions



Source: SPMF, energy companies' individual financial statements, World Bank staff analysis.

19. The chronic lack of profitability of energy sector SOEs is also reflected in their very low levels of capitalization. The aggregate equity to asset ratio of energy sector SOEs was only 11 percent in 2018. The energy sector SOEs are heavily indebted because, given their lack of profitability, they have had to rely entirely on borrowing to fund their capital investment. In contrast, most SOEs in the other non-financial sectors are well capitalized, with capital to asset ratios of 60 percent or above (see **Table 4**).

Table 4: Assets, liabilities, and equity of SOEs by sector (2018, in KGS millions)

SOE sector	Assets	Liabilities	Equity	Equity to Assets (%)
Agriculture, forestry, and fishing	244	49	195	79.9
Mining	34,379	1,010	33,369	97.1
Manufacturing	2,230	881	1,349	60.5
Energy	121,517	107,803	13,714	11.3
Transport	19,098	4,005	15,093	79.0
Telecom	11,770	2,729	9,041	76.8
Other	5,842	1,471	4,371	74.8
Total non-financial	**195,080**	**117,948**	**77,132**	**39.5**
Financial	55,372	48,233	6,462	11.7
Total	**250,452**	**166,181**	**83,594**	**33.4**

Source: SPMF.

20. The performance of financial sector SOEs has been relatively sound and stable in recent years. In 2018, state owned financial institutions have achieved a 54 percent increase in net income. Financial sector SOEs comprise two banks, one insurance company, and three companies engaged in other financial services. Financial results from JSC Ayil Bank and JSC RSK Bank are the main drivers of the sector's performance. Currently, they together account for 90 percent of the sub-sector's assets and 95 percent of revenue, with the assets and liabilities accounting for 9.9 percent and 7.9 percent of GDP, respectively.[11]

21. Financial ratio analysis indicates a relatively low level of profitability among most SOEs. According to 2018 data, the average return on assets (ROA) ratio for the whole SOE portfolio was 4.39 percent —5.77 percent for JSCs and 3.81 percent for SEs.[12] Table 5 below shows average ROA ratios for SOEs operating in different economic sectors. Transportation and telecom SOEs showed the highest returns (10.26 percent and 9.08 percent, respectively), while the lowest ratios were found in energy and agriculture & forestry (0.21 percent and -0.56 percent, respectively).

Table 5: ROA of Kyrgyz SOEs, average by sector (2018)

Sector	**Assets (KGS millions)**	**ROA (%)**
Agriculture, forestry, and fishing	244	-0.59
Mining	34,379	3.17
Manufacturing	2,230	3.54
Energy	121,517	0.21
Transport	19,098	10.26
Telecom	11,770	9.08
Financial	55,372	4.33
Other	5,842	5.77
Total/ Average	250,452	4.39

Source: World Bank staff calculations, based on data from SPMF.

22. Several recent studies have indicated that, on average, SOEs demonstrate lower profitability and productivity than their private sector peers.[13] SOEs generate less revenue than their private counterparts, incur heavier costs of production, including due to higher labor costs, and as a consequence are significantly less profitable. The analysis identifies inefficient use of resources, notably labor, and larger expenses as the main underlying factors contributing to poor performance by SOEs. In regulated industries, this trend may be exacerbated by low tariffs that are insufficient to cover the cost of services provided.

23. In the Kyrgyz Republic, SOE are now primarily concentrated in infrastructure sectors that are often state-dominated across many countries, hence benchmarking of such SOEs performance efficiency vs. private-sector peers could not be conducted. At the same, the comparison of selected Kyrgyz SOEs metrics with their peers in other countries, presented in **Boxes 1-1 and 1-2**, suggests that Kyrgyz SOEs need to invest more into infrastructure, leading to

[11] The scope of this Note does not include Rosinbank, which was bailed out by the National Bank of the Kyrgyz Republic in October 2018, during an emergency-liquidity assistance. Rosinbank incurred on significant losses in 2018 (KGS 1 billion) and the first six months of 2019 (KGS 0.5 billion).

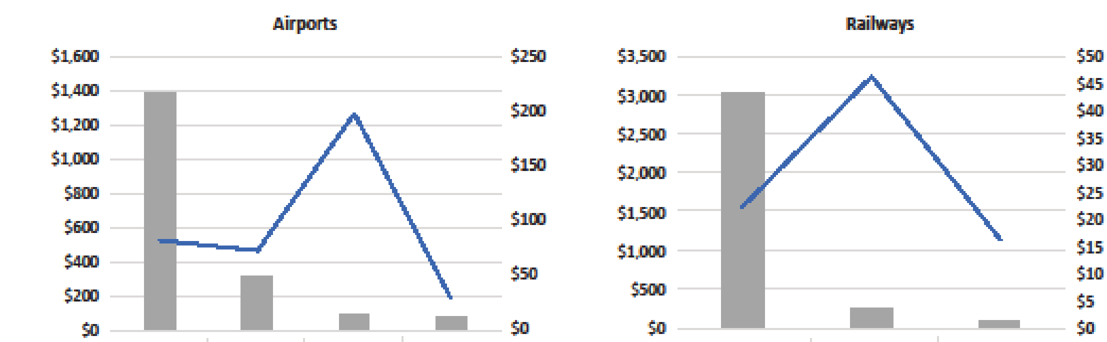
[12] For the calculation of ROA ratios, SPMF reported SOEs´ profits were used as a proxy of their "net income".

[13] IMF, Reassessing the Role of State-Owned Enterprises in Central, Eastern, and Southeastern Europe (2019)

revenue growth, eventually improving the quality of public services and contributing more to the budget.

Box 1-1. Comparison of Selected Performance Indicators for Kyrgyz Transport SOEs

The Kyrgyz transport SOEs operate at a profit but fail to invest into the necessary infrastructure. The comparative SOEs from other countries have lower returns but invest heavily and produce higher revenue per employee than their Kyrgyz peers. Leverage ratios are low for both analyzed SOEs, SE Kyrgyz Temir Zholu (Railways) and JSC International Airport Manas, suggesting that these SOEs may borrow for necessary infrastructure modernization but abstain from doing so. To improve the quality of public services and increase the profitability of these SOEs, necessary changes should be considered, including investment into infrastructure upgrade.



	TAV Holding (Consolidated)	Airport Pulkovo	Salzburg Airport	International Airport Manas
Employees	16,820	4,359	399	2,462
Net Margin	23%	17%	10%	35%
ROA	8%	6%	5%	15%
Debt to Assets	33%	62%	2%	0%

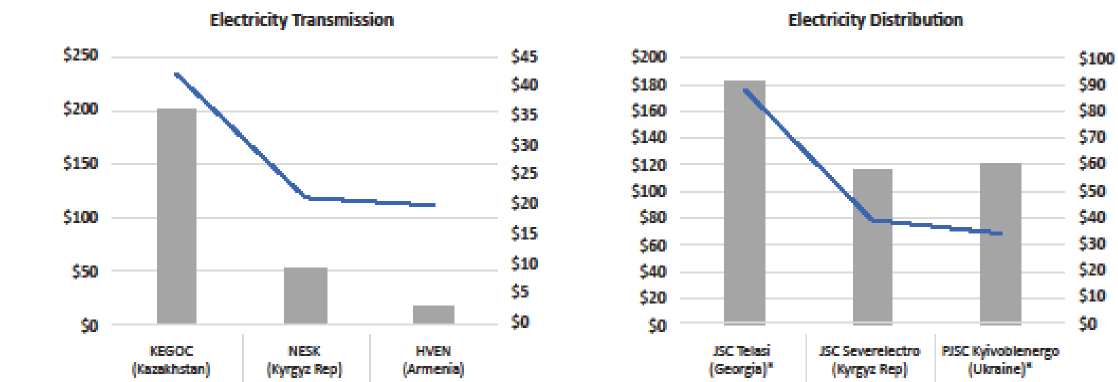
	Kazakhstan Temir Zholy	Azerbaijan Railways	Kyrgyz Temir Zholu
Employees	135,952	4,900	4,750
Labor Costs / Revenue	30%	23%	26%
ROA	Negative	Negative	8%
Debt to Assets	43%	75%	27%

Revenues, USD Million — Net Revenue per Employee, USD

Source: World Bank staff calculations, based on individual SOEs audited financial statements (2018),

Box 1-2. Comparison of Selected Performance Indicators for Kyrgyz Energy SOEs

Many Kyrgyz energy sector companies are overleveraged and undercapitalized, as detailed further in this report. The regulated tariffs constrain revenue growth and negatively impact cash flows and profitability. Low or negative equity and high external debts combined with insufficient operational cash flows make it highly unlikely for energy SOEs to become financially viable without additional reform measures to increase capitalization of this strategic sector.



	KEGOC (Kazakhstan)	NESK (Kyrgyz Rep)	HVEN (Armenia)	JSC Telasi (Georgia)*	JSC Severelectro (Kyrgyz Rep)	PJSC Kyivoblenergo (Ukraine)*
Employees	4,797	2,500	805	2,066	3,000	3,499
Labor Costs / Revenue	30%	31%	27%	12%	17%	12%
ROA	5%	Negative	2%	8%	Negative	2%
Debt to Assets	21%	99%	62%	15%	15%	4%

Revenues, USD Million — Net Revenue per Employee, USD

* Privately owned energy distribution companies.

Source: Individual SOEs audited financial statements (2018)

23. **Recent IMF analysis of SOEs' role in Central European countries[13] suggests that substantial economic gains could be made by SOEs if efficiency and performance gaps are narrowed.** In addition, the evidence identified by this recent study also provide a clear link between better governance and better SOE performance. These findings emphasize the view that improving governance of SOEs should be a priority for all governments interested to improve their SOE performance and accountability.

2.4 Service Delivery Performance

24. The World Bank's Doing Business 2019 report scored the Kyrgyz Republic's reliability of electricity supply as "very poor". The country's largest power plant, the state-owned Toktogul hydroelectric power station, experienced breakdowns two winters in a row (2015 and 2016) due to cable line breaks. The hydro units have a service life of 25 years but have been in use for 42 years. Equipment failure also affects the provision of heating services: in January 2018, Bishkek's Heat and Power Plant failed, leaving parts of the capital city without heat supply for several days, during winter temperatures of around -20° C.

25. The poor condition of assets in the energy sector affects the quality of service. Spending on maintenance and the rehabilitation of capital assets is insufficient. About 45 percent of generation assets are beyond their useful life. Depreciation of energy sector equipment is at 70-80 percent: more than 700 electricity towers (built in the 1960-70s) are in critical condition, and roughly 40 percent of the 928 kilometers of underground cable lines in Bishkek need replacement. Furthermore, several replacement parts required to rehabilitate the sector's capital assets are increasingly difficult to procure, as the original supplier, Russia, has stopped producing them.

26. The Kyrgyz transportation system coverage is insufficient and restricts the development of export potential. The Kyrgyz Republic ranked 113 out of 138 countries in the infrastructure sub-index of the World Economic Forum's 2016–17 Global Competitiveness Index, and 130 on the transport infrastructure sub-component of that index. It ranked 146 out of 160 countries on the Logistics Performance Index, and its evaluation for that index includes a score of only 1.9 out of 5 for trade and transport related infrastructure. On all components of the Logistic Performance Index, the Kyrgyz Republic scored worse than the average for both central Asian and landlocked countries.[14] Road and rail densities are low and lag behind regional peers, and the quality of much of the road network is poor.

27. The railway network is operated by SE "Kyrgyz Temir Zholu", which relies on the infrastructure and technical standards of the former Soviet railway system. The Kyrgyz railways are a network of multiple, not well interconnected, lines within the country. Several northern lines are connected to and compatible with the rail systems of the neighboring Kazakhstan, and through them, with the Russian Federation, while southern lines are connected with Uzbekistan. However, the railways are not connected with neighboring Tajikistan or China. The country has been aiming to connect its railway with China since the 1990s, but this project requires massive investments. SE "Kyrgyz Temir Zholu", while operating at a profit (2018: KGS 483 million), does not have sufficient funds to satisfy its massive investment needs. The absence of a railway connection with China hinders the Kyrgyz Republic from growing inter-regional trade and impedes its export potential.

[14] Kyrgyz Republic Systemic Country Diagnostic (2018). Rankings and scores are derived from the BEEPS surveys.

28. The Kyrgyz Republic is also poorly connected by air. The country's airlines are not permitted to fly within the European Union due to safety concerns, so international services are provided by foreign carriers. The Kyrgyz aviation sector is operated by three SOEs: International Airport Manas, Kyrgyz Avia Navigation, and Air Kyrgyzstan. Airport Manas remains profitable (2018: KGS 1.6 billion) and has good potential to increase its operational efficiency even further. At the same time, the sole air carrier - Air Kyrgyzstan - has been losing market and revenues, and essentially had to stop its operations in 2018, laying off most of its employees. The Government has attempted to privatize the company several times, the latest attempt in 2018 failed due to lack of investor interest.

29. Lack of institutional commitment and no strategy to attract private capital into the transport sector has resulted in low connectivity and an underserved population. The Government has not been able to implement a sound reform agenda in the transport sector, including to set up an adequate budget for road maintenance or attract private sector involvement in rail and aviation sectors. Weak corporate governance practices and lack of investor confidence in accountability mechanisms contribute to this challenge.

30. Water and sanitation services are also affected by significant infrastructure challenges, but they are provided by local-level SOEs. The water supply system in the Kyrgyz Republic inherited a Soviet infrastructure. However, low local public expenditure in the sector, low tariffs and collection rates, and limited metering coverage have all led to unsustainable operation, and poor maintenance and investments in the sector. The responsibility for water supply and sanitation service rests entirely with local governments, and as such, its analysis goes beyond the scope of this iSOEF assessment report.

3. iSOEF Module 2: Assessment of Fiscal Costs and Risks from SOEs

31. The analysis presented in this chapter focuses on energy sector SOEs, due to their significant fiscal impact in the Kyrgyz Republic. Data on the whole SOE sector is used when applicable, but the main focus of this chapter is on SOEs from the energy sector. As seen in Chapter 2, energy sector SOEs are among the largest in the Kyrgyz Republic — contributing to 62 percent of total non-financial SOEs´ assets. They also impose the largest fiscal burden on the government budget and are considered a source of significant fiscal risk for the Government over the medium and long term. The energy sector SOEs raise concerns of their financial sustainability due to significant leverage and massive losses caused by high operational costs and low energy tariffs that do not cover the full cost of service.

3.1 Fiscal Costs of SOEs

32. This section looks at the fiscal costs of SOEs by quantifying transfers between the central government and SOEs. Direct transfers from the Government to SOEs include subsidies and equity injections. Indirect state support includes deferred taxes, tax credits or tax arrears, non-payment of dividends, and any other preferential treatment. Capturing both direct and indirect state support is equally important for measuring fiscal costs of SOEs. However, this section covers only direct transfers, as data on indirect support is not available and very difficult to estimate.

33. There are direct flows of resources between the Kyrgyz government budget and SOEs through four main channels: taxes, dividends, subsidies, and on-lending. SOEs pay taxes to the budget (these would also be paid by private owners/companies providing the same types of goods and services) and pay dividends on their profits to the Government. In 2018 dividends paid by SOEs amounted to 0.4 percent of GDP while taxes paid by SOEs were 0.5 percent of GDP. On the other hand, SOEs receive subsidies from the budget, which over the last five years have averaged around one percent of GDP and have been a relatively stable component of the budget. The net impact of SOE operations on the current budget is approximately neutral, as revenues in the form of taxes and dividends roughly match subsidies. Both total revenue receipts and total subsidies comprise small shares of the general government budget, approximately 3 percent of current revenue and current expenditure, respectively.

Table 6: Government subsidies and net on-lending to SOEs (2014-2018)
KGS millions and % of GDP

	2014	2015	2016	2017	2018
Subsidies					
to non-financial SOEs	2,936 (0.7)	3,040 (0.7)	3,978 (0.8)	4,297 (0.8)	3,636 (0.6)
to financial SOEs	423 (0.1)	478 (0.1)	589 (0.1)	1,040 (0.2)	913 (0.2)
Net on-lending	15,792 (3.9)	8,750 (2.0)	11,046 (2.0)	8,072 (1.5)	3,257 (0.6)

Sources: Ministry of Finance and World Bank.

34. Most subsidies to non-financial SOEs are destined to finance below market prices for electricity and heating. Kyrgyz non-financial SOEs receive direct budget transfers from both central and local governments, amounting to KGS 3.6 billion in 2018. Most of these transfers comprise subsidies to energy companies —mainly to the SE Kyrgyzteploenergo— to reimburse them for the cost of supplying heating to residential customers and power to remote or difficult to access areas.

35. The Kyrgyz Republic operates with a quasi-fiscal deficit (QFD) from the sale of electricity in the domestic market, which approximated 0.8 percent of GDP in 2018[15]. The deficit is assessed using the "end-product" approach[16] and is calculated as the sum of losses resulting from the following three components: (1) less than cost recovery tariffs; (2) under-collection of revenue; and (3) excessive technical losses. The real level of QFD is much higher, as it must take into account the minimum depreciation of the existing infrastructure, and once achieved, must target the minimum level of profitability. The current estimate of QFD, 0.8 percent of GDP, is attributed to several factors: (1) an incomplete level of expenses covered, that is, excluded depreciation numbers and other direct non-cash expenses; (2) cross-subsidization between different end-user groups; and (3) debt restructuring.

36. Another channel of resources flowing between the budget and Kyrgyz SOEs takes place through direct budget loans and on-lending of concessional funds. The Government lends to SOEs using budget funds and also on-lends PIP funds, which are project loans contracted by the government from external lenders, mostly on concessional terms.[17] The budget also receives repayments of these loans and interest payments from the SOEs. The data on net lending in the budget includes loans to entities other than SOEs, but the majority of these loans are to SOEs, and energy sector SOEs in particular. Net on-lending (total disbursements minus repayments) has varied greatly from year to year. In 2014 net on-lending amounted to almost 4 percent of GDP but it was much lower in subsequent years.[18] The on-lending numbers are not detailed explicitly in the budget documents. However, from the information that is available it appears that gross disbursements of loans, including PIP loans and budget loans, averaged just under KGS 10 billion a year during 2015-19 while repayments averaged about KGS 2.8 billion, hence net lending including the PIP loans averaged about KGS 7 billion or 1.4 percent of GDP during this period.

37. Overall, the high debt levels and fragile financial condition of energy sector SOEs add pressure to a highly constrained fiscal space in the Kyrgyz Republic. The WBG Public Expenditure Review (2020) concluded that, given recent and planned trends in the overall fiscal deficit and the current levels and forecasts of public and publicly guaranteed debt, fiscal policy in the Kyrgyz Republic is sustainable, but with only very limited fiscal space to accommodate larger fiscal deficits over the medium to long term without driving up public debt ratios. Fiscal space has since

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[15] World Bank, Public Expenditure Review, (2020)

[16] Camos, D., A. Estache, and M.M. Hamid, 2016. "Quasi-Fiscal Deficits in the Electricity Sector of the Middle East and North Africa Sources and Sizes, World Bank Policy Research Working Paper 8280. Washington, DC: World Bank.

[17] These are referred to as "budgetary loans" and "foreign loans" respectively in MOF budget documents and are treated by the MOF as below the line items, rather than as items of expenditure. According to the IMF´s Government Financial Statistics Manual (GFSM), these kinds of loans should be treated as "above the line" components of the budget, because they have a policy rationale.

[18] To avoid confusion, we use the term "net on-lending, including PIP loans" to refer to the gross disbursement of all loans minus all loan service payments to the budget.

been significantly eroded by the impact of the COVID-19 crisis, with nominal public debt to GDP forecast to rise to 69 percent of GDP at end-2020 from 54.1 percent at end 2019[19]. Hence, while SOEs do not currently appear to be a major fiscal threat, the extent to which the budget can accommodate increased resource flows to SOEs without jeopardizing fiscal sustainability or reallocating resources from other areas of the budget appears to be severely circumscribed over the medium term.

3.2 Fiscal Risks from SOEs

38. This section analyzes medium- and long-term risks to fiscal sustainability posed by the SOE sector in the Kyrgyz Republic, with a focus on energy sector SOEs. It begins with an assessment of the nature of fiscal risks posed by the SOEs using a fiscal risk matrix approach, as suggested by iSOEF methodology. It then provides a quantitative analysis of the most significant fiscal risks, posed mainly by the budgetary requirements of the energy SOEs, and discusses the fiscal impact of different reform options to address the challenges of the sector.

Table 7: Fiscal risk matrix

	Operating Statement		Balance Sheet	
	Revenues	Subsidies	Direct Liabilities	Contingent Liabilities
Direct	- Tax payments (0.5% of GDP) - Dividends (0.4% of GDP)	- 0.8% of GDP		
Explicit Obligations			- Long term debt contracted with international financial institutions (IFIs) to finance infrastructure projects (on-lent loans to SOEs, in particular from energy sector) (16.9% of GDP).	- No sovereign guarantees for SOE debt. - The Government has explicit liability for obligations of SEs. - Legal protection of natural monopolies from bankruptcy. - Legal obligation to support financial sector SOEs if they suffer financial distress.
Implicit Obligations			- Capital investment required to maintain quality of power supply and meet growing demand.	- Bail out to energy sector SOEs (in cases of full or partial non-repayment of on-lent PIP). - Natural disasters (e.g. effect of droughts on energy sector SOEs).

[19] IMF County Report No 20/158, Kyrgyz Republic Request for Purchase (2020)

				- SOE liabilities clean-ups (e.g., in cases of privatization). - Unexpected SOE liabilities associated with adverse shocks (e.g., COVID-19 pandemic).

Source: World Bank staff consolidation.

39. There are substantial fiscal risks on the Government's balance sheet – both explicit and implicit. Fiscal risks emanating from the current budget are relatively small because, as mentioned above, explicit budget subsidies to SOEs are matched by taxes and dividends from SOEs, hence their net fiscal impact is roughly neutral. However, the Government has explicit claims on the SOEs amounting to 19 percent of GDP related to the loans it has made to them, including the on-lent PIP loans, but the value of these claims is uncertain because the energy sector SOEs, which are the major debtors, are not capable of servicing them in full without reforms to strengthen their financial viability. Hence the value of these assets is conditional on the implementation of energy sector reforms, especially tariff reform. The Government has contractual liabilities to external lenders for the PIP loans which it has on-lent to SOEs and which it must service irrespective of whether or not the SOEs service their obligations to the Government.

40. Total outstanding government lending to SOEs is highly concentrated in the energy sector. As shown in **Table 8,** Government loans to SOEs amounted to 19.3 percent of GDP, and 95 percent of these outstanding debts are with the energy sector. Of the total outstanding SOE debt, 87 percent comprises on-lent external loans and the rest are loans from general budgetary resources.[20] The former are on-lent in the currency in which they were originally contracted by the government, and hence borrowing SOEs bear the respective exchange-rate risk.

Table 8: Outstanding debts of SOEs by sector, 2018.

Sector	**KGS millions**	**% of GDP**
Energy	103,827	18.2%
Manufacturing	189	0.0%
Banking	5,293	0.9%
Mining	13	0.0%
Transport and communication	729	0.1%
Agriculture	94	0.02%
Total	**110,144**	**19.3%**

Source: State Agency for Management of Budgetary Lending

[20] On-lent funds are used to fund infrastructure projects, predominantly in the energy sector. The JSC NESC and JSC EPP are the two largest beneficiaries, holding 94.3 percent of these loans.

41. Although their borrowings are long term and on highly concessional terms, energy sector SOEs have been unable to fully service their debts to the Government in recent years. On-lent funds are used to fund infrastructure projects, predominantly in the energy sector. The JSC NESC and JSC Electric Power Plants (EPP) are the two largest beneficiaries by far, holding 94.3 percent of these loans. Due to their chronic financial losses, the repayment of these loans has been subject to repeated rescheduling. A total of KGS 7.7 billion (USD 112 million) of SOE loan payments were rescheduled during 2015-18. Debt restructuring provides only a temporary solution, as due payments are rolled over into future years and SOE debt continues to accumulate. As mentioned above, the probability that the Government will fully recover these loans is low, unless there are effective reform actions to improve the financial viability of energy sector SOEs.

42. Due to the existence of a large capital investment gap, there are further implicit government liabilities involved in ensuring that energy sector SOEs can adequately meet future demand. As already noted, the existing tariff structure does not cover the full cost of service, including the capital investment required to replace ageing capital assets and to expand capacity to meet growing demand. Hence, virtually all capital investment in the energy sector is funded through loans from the government budget and on-lent PIP loans. However, evidence shows that the amount of capital investment undertaken in recent years is far too low to ensure sustainable supplies of energy in the medium term, given the poor physical state of much of the energy infrastructure. Energy sector SOEs' requirements for budgetary resources are therefore likely to rise substantially to meet expected future demand.

43. SOE arrears associated with budgetary loans are currently low (0.3 percent of GDP at the end of 2018) but this was achieved through massive debt rollovers. The low level of arrears must be interpreted with caution. In recent years, the Government has regularly restructured SOE debts, rolling over their principal repayments. For example, in 2018 the combined arrears of nearly KGS 2.8 billion related to two largest energy SOEs (JSC NESK and JSC EPP) were rolled over to 2019–2040.

44. By law, SOEs cannot directly contract loans from international or foreign sources other than via the Government. SOEs are not restricted to borrow locally from local commercial banks. Loans from commercial banks are very small, and government loan guarantees for this kind of SOE borrowing are not permitted under the Budget Code.

45. The Government faces explicit contingent liabilities in case of non-payment of SEs obligations. Kyrgyz legislation stipulates that the Government bears secondary liability for the obligations of SEs if the assets of the latter are insufficient to pay off their debts. However, since SEs are mostly of limited size, the magnitude of these explicit conditional liabilities is likely to be small —SEs' total liabilities in 2018 amounted KGS 7.4 billion (1.3 percent of GDP).

46. Further implicit contingent liabilities associated with SOEs may pose additional risks for the Kyrgyz Government. There are risks of implicit contingent liabilities related to unplanned SOE obligations caused by (i) natural disasters —in particular, hydrological risks for energy sector SOEs; (ii) SOE debt clean ups, —e.g., in cases of privatizations or PPP agreements; or (iii) major adverse shocks, like the recent COVID-19 pandemic. Once again, in case such liabilities materialize and SOEs are unable to honor them, the Government would have to fund them from the budget, especially if they affect SEs or strategic SOEs.

47. The fiscal risks and quasi-fiscal deficit of SOEs are not being adequately evaluated and reflected in budget documents. The Explanatory Notes to the Draft Budget include a section on the risks to the Republican Budget which focuses on short term risks for the forthcoming fiscal year. The Explanatory Notes to the Draft 2019 Budget noted the arrears on outstanding SOE loans and the difficulties of recovering them, as well as highlighting risks to the scheduled loan repayments from energy SOEs. The budget documentation lacks an assessment of long-term fiscal risks or comprehensive disclosure of quasi-fiscal deficit generated by SOEs. Disclosure of the aggregate SOE performance, as well as quasi-fiscal activities, as part of the budget documentation is essential for ensuring a comprehensive disclosure of major fiscal risks. As the first step, the energy sector quasi-fiscal deficit should be disclosed and published as part of the annual budget documentation.

3.3 Forecasting the long-term fiscal impact of energy sector SOEs

48. The approach used in this section entails forecasting the financial resources that energy sector SOEs would require from the government budget in order to maintain the delivery of their services over the next 10 years. The forecast of these energy sector SOEs' long-term budgetary requirements is then compared to estimates of the Government´s fiscal space. If the budgetary requirements of the SOEs exceed the projected fiscal space, then fiscal sustainability will be jeopardized, unless there are offsetting cuts in other components of public expenditure or tax rises.

49. This approach focuses on the net budgetary requirements (the flow of loan disbursements to SOEs minus their servicing of existing loans). In the Kyrgyz Republic, the Government is the only source of financial resources for energy SOEs other than the revenues they earn from selling energy. Therefore, the net budgetary requirement of energy sector SOEs is the difference between the total expenditure they need to maintain their services —excluding debt servicing— and their revenue. This is shown in the formula below, where NBR denotes net budgetary requirements, OE denotes operating expenses, *d* denotes depreciation, CE denotes capital expenditure and R denotes revenue from customers.

$$NBR = OE - d + CE - R$$

50. An excess of expenditure over revenue has to be met by a net flow of resources of equal magnitude from the budget. Expenditures must include all operating costs plus the capital costs needed to rehabilitate or replace the depreciation of existing capital assets and to expand capacity to meet growing energy demand. This assessment does not include depreciation in the operating costs because our estimates of capital expenditure requirements include the investment needed to replace depreciation.

51. The SOEs' net budgetary requirement is a similar concept to that of the QFD. Both concepts aim to estimate the gap between the costs needed to maintain a particular service, such as the supply of power, and the revenues raised by selling the service to customers. The World

Bank's Public Expenditure Review (2020) provided estimates of the QFD of the energy sector. The current estimate of QFD is 0.8 percent of GDP, but its real level is much higher, as it must take into account the minimum depreciation of the existing infrastructure, and once achieved, must target the minimum level of profitability. Our estimates of the NBR are similar in magnitude to the estimates of the QFD in the short term but over the medium term the former is larger than the latter mainly because it incorporates a higher projection of capital expenditures to take account of the need to rectify the chronic under-investment of the last two decades.

52. The "status quo" scenario, which is defined as one in which current (2020) tariff levels remain unchanged until 2023, provides clear evidence of the need for energy sector reforms to avoid affecting fiscal sustainability over the medium term. This means that the real value of tariff rates falls by around 20 percent between 2018 and 2023, but remains constant thereafter.[21] Then, revenue forecasts are made by applying tariff rates to estimated energy demand. Demand grows at a slower rate than real GDP because the estimated income elasticity of demand is only 0.5. Most of the operating costs of the energy companies increase in line with the growth of production and consumer price inflation, except for wages which are assumed to be constant in real terms (hence there is a gradual increase in output per worker). The assumed growth in aggregate operating costs for the energy sector is fairly modest, at around 1.4 percent per annum in real terms over 2020-2030.

53. Forecasting the long-term capital investment needs of the energy sector entails serious difficulties and as such our forecasts are unavoidably tentative. There is no long-term investment plan for the sector from which to derive forecasts. It is evident, however, that the investment requirements of the energy sector are very large for two reasons. First, the sector needs to make substantial capital investments to maintain or replace the existing capital stock, large parts of which are nearing or are beyond their normal useful life, as discussed in Chapter 2. Unfortunately, there are no comprehensive estimates available of the cost of rehabilitating or replacing the existing capital assets that have passed the end of their normal lives. Second, the sector needs to expand its capacity to meet the forecasted long-term growth in demand. Domestic demand is likely to grow by around 25 percent over the next decade.[22] The country already faces an excess demand for power in the winter months with an average monthly demand being double that of an average summer month. This demand is being met by importing power at a higher cost than that of domestic generation. The unmet winter demand (above current generating capacity) is forecasted to rise to 833 GWh by 2030.[23] The estimates of the capital cost of new electricity generating projects[24] have been used in the investment forecasts.

54. The forecasts of energy sector capital investments comprise two components: (i) rehabilitation or replacement of existing capital stock, and (ii) expansion of existing capacity to meet growing demand. As a proxy for the investment needed for the rehabilitation and replacement of existing assets, we have used the average annual levels of capital investment implemented over the last six years in real terms — KGS 11.5 billion (in 2018 prices). This

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[21] If nominal tariff rates were to be unchanged throughout the period of analysis, their real value would fall by 40 percent between 2018 and 2030, which seems rather implausible.

[22] Demand growth could be slower if there are large tariff rises in real terms, but the estimated price elasticity of demand is low.

[23] See World Bank, Kyrgyz Republic, Country Economic Memorandum, 2020, figure IV.1.

[24] World Bank, "Analysis of the Kyrgyz Republic's Energy Sector", annex E (2017).

assumption is based on the fact that almost all energy sector investment over the past six years was in rehabilitation and repair, including the Bishkek Combined Heat and Power Plant and high voltage transmission lines. The cumulative amount of such investment implemented over the past six years approximates to 60 percent of the entire electricity sector's value of property, plant, and equipment in 2018.[25]

55. For the second component, it is assumed that the two lowest cost investment options — in terms of the economic cost of supply— for generating capacity will be implemented over the next decade. These two projects are the Uch-Kurgan hydro power plant (HPP) rehabilitation project, which would add only 40MW to capacity, and Kambarata 1 HPP, which would add 1,860 MW to capacity. [26] This would amount to an increase in generating capacity of about 50 percent (the current installed generating capacity is 3,781 MW), or more realistically it would allow a combination of increased generating capacity and the retirement of the most obsolete of the current generating assets.

Main forecasted results

56. In the electricity sub-sector, forecasted revenues decline as a share of GDP. As shown in

57.

58. Table 9, electricity revenues decline steeply as a percent of GDP up to 2023, and then decline more gradually from 2023 to 2030. This decline is attributable to two factors: (i) the fall in the real value of tariffs up to 2023 —when nominal tariff rates are unchanged; and (ii) the fact that real growth in electricity consumption lags that of real GDP. The latter means that operating costs also decline as a share of GDP.

59. On average over 2021-2030, forecasted capital investment costs for electricity are almost double operating costs. The assumption that the Kambarata 1 HPP will be built during 2024-2030 drives up projected capital investment sharply in that period. Kambarata 1 accounts for almost two thirds of capital investment expenditures (in constant prices) during 2021-2030. The net budgetary requirements of the electricity sub-sector average 3.8 percent of GDP over the 2021-2030 period.

60. In the heating sub-sector, although forecasted capital investment costs are relatively small, expected revenues are insufficient to cover operating costs throughout the 2021-2030 period. As a consequence, the heating sub-sector requires net budgetary resources averaging 0.4 percent of GDP over the 2021-2030 period.

61. The combined net budgetary requirements of the energy sector (both electricity and heating) average 4.2 percent of GDP during 2021-2030. This represents an increase of 2.8 percentage points of GDP from the average level of net resources flows of 1.4 percent of GDP over the last five years (2015-2019).

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[25] Based on the analysis of the individual financial statements of the energy companies.

[26] The capital cost of these two projects is estimated at USD 3.05 billion. A loan agreement to finance the Uch-Kurgan HPP has already been signed and the government has announced that it intends to implement the Kambarata 1 HPP. The capital costs of Kambarata 1 are huge (around a third of current GDP) but it is the most cost-efficient project of the available options by a considerable margin, with the exception of the Uch-Kurgan HPP.

Table 9: Forecasts of energy sector revenues, costs, and net budgetary requirements (no-reform scenario, 2018-2030, % of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Electricity													
Revenue	3.2	3.2	3.0	2.8	2.6	2.4	2.4	2.3	2.3	2.2	2.2	2.1	2.1
Operating costs	2.8	2.6	2.6	2.5	2.4	2.3	2.3	2.2	2.2	2.1	2.1	2.0	1.9
Capital investment	0.9	0.8	1.9	1.6	2.2	2.1	5.5	5.3	5.0	4.9	4.7	4.5	4.3
Net resources required from budget	0.5	0.3	1.5	1.3	2.0	2.0	5.4	5.2	4.9	4.7	4.5	4.3	4.1
Heating													
Revenue	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Operating costs	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital investment	0.2	0.1	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Net resources required from budget	0.4	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Total Energy Sector													
Net resources required from budget	0.9	0.6	2.1	1.8	2.5	2.5	5.8	5.6	5.4	5.1	4.9	4.7	4.5

Source: World Bank estimates.

62. **Overall, forecasted net budgetary requirements from energy sector SOEs over the next 10 years are not fiscally sustainable.** There is very little fiscal space to accommodate additional budgetary spending in the Kyrgyz Republic, given the need to control public debt ratios and also to comply with the proposed fiscal rule. Additionally, the unexpected adverse impact of the COVID-19 pandemic on public borrowing will constrain fiscal space even further. Average net budgetary requirements of the energy sector of 4.1 percent of GDP would push the central government´s average fiscal deficit above 5.5 percent of GDP during 2021-2030, and raise public and publicly guaranteed (PPG) debt to 77 percent of GDP, which is not fiscally sustainable.[27]

Fiscal impact of proposed reforms on energy sector SOEs

63. **This section assesses the fiscal implications of main reform proposals for the energy sector SOEs made by several IFIs, including the World Bank**.[28] The purpose of this section is to estimate the potential fiscal impact of eventual alternative reforms to the energy sector, which

[27] The Debt Sustainability Analysis (DSA) prepared by the IMF and International Development Association in March 2020, as part of the request by the Kyrgyz Republic for IMF support to address the COVID-19 crisis, projects the nominal value of PPG debt at just under 60 percent of GDP in 2030. Underlying this projection is the assumption that overall fiscal deficit will not exceed 3 percent of GDP from 2022 onwards. If the fiscal deficit were 2.5 percentage points of GDP higher during 2021-30 than in the DSA projections, to fully accommodate the budgetary requirements of the energy sector SOEs, the nominal value of PPG debt would be driven up to around 77 percent of GDP by 2030.
[28] See World Bank, Public Expenditure Review (2020) and Country Economic Memorandum (2020).

can then be compared with the "status quo" situation (i.e. no reform) projections presented in the former section (**Table 9**). Naturally, more than one option of reform could be simultaneously considered by the Government, but the idea in this section is to isolate the effect of each for illustrational purposes.

64. The main proposed reforms for energy sector SOEs in the Kyrgyz Republic include the following:

i) Energy tariff reform to raise average tariffs through a combination of reducing the consumption threshold for the social tariff[29] and tariff increases for residential customers below the threshold;

ii) Systematization of SOE relationships with the budget to fully compensate the SOEs for quasi-fiscal activities such as providing subsidized electricity;

iii) Reduction of the debt burden on SOEs through a debt equity swap with the Government;

iv) Attraction of private investment into new energy projects (e.g. power generation).

Energy Tariff Reform

65. Tariff reform is considered essential for the financial sustainability of the energy sector. A Medium-Term Tariff Plan (MTTP) 2014-2017 for electricity tariffs was adopted in 2014 but it was not fully implemented. In fact, electricity tariffs have been unchanged since 2015. The State Regulatory Agency for the Energy Sector, responsible for setting tariffs (with the agreement of the Government), has drawn up a Medium-Term Tariff Plan, 2018-2023, which sets out a roadmap for raising energy tariffs and lowering the threshold for the social tariff. This roadmap —implementation of which has not yet begun— includes the following measures:[30]

i) A reduction of the social tariff threshold to kWh 350 per month from kWh 700 per month;

ii) An increase of the electricity tariff below the social tariff threshold by 68 percent over 5 years, from KGS 0.77/kWh to KGS 1.33/kWh;

iii) An increase in the pumping station tariff from KGS 0.78/kWh to KGS 1.3/kWh;

iv) An increase in all end-user tariffs for heat and hot water to KGS 1800/Gcal.

Table 10: Forecasts of energy sector revenues, costs, and net budgetary requirements (MTTP 2018-23 tariff increases scenario, 2018-2030, % of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Electricity													
Revenue	3.2	3.3	3.1	3.1	2.9	2.8	2.8	2.7	2.7	2.6	2.6	2.5	2.5
Operating costs	2.8	2.6	2.6	2.5	2.4	2.3	2.3	2.2	2.2	2.1	2.1	2.0	1.9
Capital investment	0.9	0.8	1.9	1.6	2.2	2.1	5.5	5.3	5.0	4.9	4.7	4.5	4.3

[29] The social tariff aims to ensure that power is affordable for customers. It entails a low tariff rate being charged on all monthly consumption per residential customer below a threshold, which is currently 700 kWh/month. The current level of the social tariff is approximately half the average tariff required to fund the full cost of electricity service. A higher tariff is charged on all monthly consumption above the social tariff threshold.

[30] The World Bank, "State of the Kyrgyz Energy Sector" 2019.

Net resources required from budget	0.5	0.1	1.4	1.0	1.7	1.6	5.0	4.7	4.5	4.3	4.1	4.0	3.8
Heating													
Revenue	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Operating costs	0.6	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital investment	0.2	0.1	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Net resources required from budget	0.4	0.3	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Total Energy Sector													
Net resources required from budget	0.9	0.4	1.9	1.4	2.1	2.0	5.3	5.1	4.9	4.7	4.5	4.3	4.1

Source: World Bank estimates.

66. Tariff increases would improve the financial condition of the energy sector as compared to the no-reform baseline scenario, but it will not significantly reduce the net budgetary requirements. If tariffs were increased in line with the MTTP 2018-23, by 2023 the revenue of the electricity sub-sector would rise by 17 percent relative to the no tariff increases scenario.[31] Revenue for the heating sub-sector is projected to increase by 40 percent. Despite this, as shown in Table 10, average net budgetary requirements over the 2021-2030 period would be 3.7 percent of GDP — as compared to 4.1 percent of GDP in the no-reform scenario.

67. Large net budgetary requirements remain for the energy sector over the next 10 years despite the tariff increases proposed in the MTTP 2018-23. The main reason behind this result is the large capital investment requirements of the energy sector. The scale of the projected investment costs reveals that an increase in tariffs cannot plausibly fund both operating and capital costs of the energy sector over the 2021-2030 period. Furthermore, the MTTP proposed tariff adjustment is rather moderate, as it leaves tariffs for residential consumption above the social tariff threshold and the tariff for non-residential consumption unchanged.

68. Tariff increases are important pre-requisite to achieve the cost-recovery of the energy sector and to attract private capital. The financial condition of the largest energy companies require improvement and significant capital injections, including through private sector-based solutions. Given the political sensitivity of tariff increases for Kyrgyz society, it is understood that this reform may be difficult. However, the tariff increases will be necessary to stop the depletion of energy companies' resources, growing budget subsidies, and to allow the groundwork to be established for future private sector co-financing in the medium-term. To achieve financial viability of the sector, revenues must fully cover all operating costs, interest, and depreciation, and provide a competitive return on capital. This would attract private investors into the sector and mobilize the funds required for capital investment through debt and equity. It is beyond the scope of the present study to estimate the tariff levels which would be needed to ensure the financial viability of the electricity sub-sector, but this exercise is clearly an essential component of any medium to long term plan for energy sector reform.

[31] The revenue projections incorporate the tariff reforms proposed in the MTTP 2018-23. Tariffs are assumed to increase at the rate of inflation after 2023 (the same assumption as used in the no-reform scenario, Table 9). All of the operating and capital costs of the energy sector are also the same as those used in Table 9.

69. **Cost-recovery tariffs are the cornerstone of the long-term financial viability of the power sector.** International evidence indicates that below cost-recovery tariffs lead to poor quality of electricity service and sector companies' accumulation of unsustainable liabilities, which ultimately become a direct liability for the state budget. **Box 2** illustrates the effective energy reforms carried out by Armenia over the past decades, achieving cost recovery of the energy sector and reducing budget pressure related to electricity subsidies and other fiscal costs.

Box 2. Reducing Electricity Subsidies and Reforming Tariffs: The Case of Armenia

In the 1990s, Armenia's power system was in a state of near collapse. An earthquake forced the shutdown of a nuclear plant supplying almost one third of total generation and an economic blockade cut the only source of gas and oil for power plants. This led to scheduled rationing of electricity supply to little more than two hours per day. The sector was running a huge quasi-fiscal deficit equivalent to about 11 percent of GDP in 1995. Collections were barely above 50 percent, and commercial losses were nearly 25 percent.

The government took a number of steps to address these problems, including improvements in the energy supply, linking better supply with bill payments, and introducing metering system improvements to address unaccounted losses and collection failures. This was followed by a privatization program. Several factors contributed to Armenia's ability to raise prices and eliminate subsidies:

- ✓ The government was able to improve supply before it started on the program of raising tariffs, improving bill collection, and reducing unaccounted losses. This gave credibility to the whole of the subsequent reform agenda.
- ✓ The government increased social transfers during this period of reform. Between 2001 and 2004 social spending increased from 6.5 to 7.2 percent of GDP despite an overall decrease in fiscal expenditure. Although this could not fully compensate the effect of the tariff increases on the poor, it was an important factor both materially and psychologically.
- ✓ The new private sector company showed itself willing to disconnect non-payers even when they were important government clients. This provided credibility to the reform and subsidy removal process. The private sector energy operator was not only able to raise wages, but also gave a significant variable component to its employees based on improvements in losses and collections.

During 2003-2010, the sector was transformed and achieved financial viability. Collections reached nearly 100 percent, and commercial losses reduced to 4 percent. Tariffs set by a regulator were near medium-term cost-recovery levels, that is, recovering short term-cost of service, depreciation, and some part of new investment. The implicit and explicit subsidies to the power sector were eliminated and the largest sector companies became the top taxpayers in the country.

Sources: The World Bank, "Subsidies in the Energy Sector: An Overview" (2010) and the World Bank "From Crisis to Stability in the Armenian Power Sector" (2006).

Systematizing SOE relations with the budget

70. This reform proposal would entail the Government providing SOEs with explicit compensation from the budget for the costs that they incur in implementing public policy objectives, such as providing energy to targeted groups of consumers at prices below the cost of service. The Kyrgyz Government provides subsidies through the budget to compensate energy sector SOEs for below cost heating services and power supplies to remote areas. However, this only partially compensates these SOEs for all of the costs they incur in fulfilling social objectives. An obvious extension of this would be for the Government to explicitly subsidize the losses to the electricity sub-sector at the social tariff rate.[32]

71. This reform would have the advantage of improving budget transparency by making the fiscal cost of subsidizing electricity consumption explicit. This could promote more (and better informed) debate among policy makers and legislators as to whether such subsidies are the best way to allocate scarce budgetary resources. A second advantage of this approach is that it would improve the financial position of the electricity SOEs, because an explicit budget subsidy is recorded as direct revenue in their operational statement, whereas a loan from the Government is a liability on their balance sheet.

72. Explicit subsidization of energy sector SOEs losses due to social policy objectives would most likely foster the implementation of other key needed reforms. In this sense, tariff reform appears to be a prerequisite for ensuring the financial soundness of the energy sector. Average tariffs must be high enough to enable energy SOEs to earn profits after covering all of their operating costs, including depreciation, as well as their interest costs. The State Regulatory Agency for the Energy Sector should be given a stronger statutory mandate to set tariffs with the explicit objective of ensuring the financial viability of the sector. The Government can also help the SOEs to improve their financial condition by swapping their debt for equity (see below). Finally, if the Government wants to continue providing power at subsidized rates for social policy reasons, it would be preferable to fund this fully through explicit budget subsidies, approved by the Parliament.

73. It is a widely spread global practice for SOEs to be mandated with special responsibilities and obligations for social and public policy purposes. The OECD's Guidelines on Corporate Governance of State-Owned Enterprises[33] recognize that SOEs are frequently expected to fulfill special responsibilities and obligations for social and public policy purposes that may go beyond the generally accepted norm for commercial activities. The OECD Guidelines recommend that such special responsibilities and obligations are clearly mandated and legislated. In addition to formalizing these public service obligations (PSO) mandates in legislation or regulations disclosed to the public at large, the OECD Guidelines suggest three steps for implementing PSOs without compromising SOE efficiency relative to other market players:

[32] Even under the MTTP 2018-23 tariff reform scenario, the social tariff rate would still be 40 percent lower than the full cost of service in 2023.
[33] OECD (2015).

a. Define and calculate the costs of PSOs;

b. Finance these costs through a specified budget transfer to SOEs so that the cost is explicit both in the budget and in the SOEs' financial statements.

c. Monitor the performance of PSOs to enhance transparency and ensure their relevance and effectiveness.

74. In line with good practices, once PSOs are defined and costed they can be funded directly from the budget and the size of the government transfer can be divulged. The government can then purchase PSO services from SOEs under arm's-length commercial contracts and signal to non-SOE suppliers the price against which to compete as a future provider of those services. Where PSOs are met through restrictions on competition or other regulatory distortions, a similar costing and value-for-money exercise should be conducted. The economic costs of preferential regulatory treatment should be assessed against the value of the objectives achieved. Box 3 illustrates the Italian government's use of public service agreements (PSAs) with SOEs to meet and compensate for public service obligations.

Box 3. Italian Public Service Agreements

Special obligations for SOEs that provide services of general interest are usually set forth in a PSA signed by the company and the relevant ministry, in accordance with the Ministry of Economy guidelines, for a period of at least three years.

The agreement aims to ensure that end-users have safe, reliable services at reasonable prices and that market competition is always maintained. The agreement defines the standards applicable to the characteristics and quality of services, the level of tariff (typically using the price-cap method), productivity targets, and the production costs per unit.

In general, PSAs have improved the efficiency of public services. The agreements define the services that each SOE must provide (but whose costs are not covered by tariffs) and the related compensation from the state. SOEs that receive state funds to provide public services are required to keep separate accounts to show the distinction between these and all other SOE activities, their associated costs and revenues and the methods used to allocate costs and revenues. This system, in accordance with European Union (EU) laws, is required to avoid cross subsidies that harm competition in the relevant sector.

Source: The World Bank "Corporate Governance of State Owned Enterprises. A Toolkit" (2014)

Converting SOE debt to equity

75. **Energy sector SOEs bear a huge debt burden, which poses a challenge to their repayment capacity**. The outstanding debt stock of energy sector SOEs amounted to 89 percent of their assets in 2018. These SOEs were unable to fully service their debts as originally scheduled, resulting in the Government having to restructure them by lengthening their maturities. Operational losses of energy sector SOEs raise their debt/asset ratio further every year, making it unlikely that they will ever be able to fully repay their debts to the Government.

76. **Energy sector SOEs' financial position would be improved if at least part of their debts were converted into equity by the Government, reducing debt pressure and making the first step in attracting private capital.** This potential conversion of existing PIP loans into the additional capital of energy sector SOEs would increase their capitalization and reduce their annual debt service payments to the Government. The net impact of this initiative on the budget would be zero: the SOEs would pay less in debt service to the Government but the savings that they would thereby make would mean that they would need to borrow less from the budget, by an equivalent amount, to finance their operating costs and capital investments.

77. **The main advantage of converting energy SOEs debt into equity is that it would contribute, alongside other reforms, to strengthening their financial viability.** As discussed below, the financial viability of the energy SOEs is likely to be a prerequisite for mobilizing private capital into the energy sector. This is especially important for the electricity transmission SOE (NESK), which by the end of 2018 was technically insolvent (negative equity). Any future private sector funded electricity generating project would have to sell its power to NESK under a long-term contract, which is unlikely to happen if the national transmission company remains insolvent.

Attracting private investment into the energy sector

78. **The forecasts shown in Tables 9 and 10 demonstrate that even with moderate tariff increases, the costs of major new investments in electricity generating capacity, such as Kambarata 1 HPP, far exceed available fiscal resources**. Consequently, for these investments to take place private capital will be needed to finance them, which will only be possible if the rate of return is attractive and major risks can be mitigated, given the long payback period.

79. **Collaboration with the private sector would enable the Government to decrease its direct contribution to capital costs for a project like Kambarata 1 HPP, and therefore, decrease the net budgetary requirements of energy sector SOEs.** For example, if the project was financed with a debt/equity ratio of 2:1 and the Government contributed to one third of the equity, it would have to directly contribute to around 10 percent of total investment costs. That would entail a budgetary outlay of USD 300 million —as compared to almost USD 3 billion that the Government would have to spend to fund the entire cost of Kambarata 1 HPP. This would substantially decrease the net budgetary requirements of the energy SOEs, by an average of 2.2 percent of GDP over the 2021-30 period. If MTTP 2018-2023 tariff reform is also implemented,

the net budgetary requirements of energy sector SOEs would average 1.5 percent of GDP over the next decade, which is approximately the level it has averaged over the last five years.[34]

80. A key factor which will determine the degree of private sector involvement in the energy sector is the Government's tariff policy. Private sector companies´ willingness to invest in Kambarata 1 HPP and similar projects is subject to the price at which they can sell power over the lifetime of the project, which ultimately depends on the power tariffs charged to consumers. Hence, raising tariffs to levels sufficient to ensure the financial viability of the sector, and a commitment by the Government to maintaining them at those levels, is a prerequisite for attracting private capital into the new investments required in the sector. As mentioned above, tariff reform alone is not sufficient to ensure that energy sector SOEs do not undermine fiscal sustainability, but it is a precondition for attracting the private investment that could enable the energy sector to develop in a fiscally sustainable manner.

81. Cooperation between private investors and the public sector, including SOEs, should be done on market terms, transparently, and in accordance with the law and public interests.[35] The benefits of private sector participation are enhanced by efforts to create a competitive environment, even within the limitations of natural monopoly in some state-dominant sectors. Where private and public infrastructure companies are in competition, specific measures should promote a level playing field, including with respect to SOE governance, transparency of public service obligations, and direct and indirect government support. The entry of private investors through a competitive and transparent process, as per best practices, should result in competitive tariffs (and consequently fewer contingent liabilities) and affordable services for customers. Please refer to **Annex 1** for the main principles on attracting private capital into public infrastructure.

[34] The willingness of the private sector to invest in the equity of a project such as Kambarata 1 HPP will depend on the expected rate of return to equity, which will be sensitive to the cost of the project's loan finance. In order to lower the cost of loan finance, it might be necessary for the government to guarantee at least part of the project's debt. However, this would raise public debt ratios, and would require a change in budget legislation. In addition, the amount of debt which the government could guarantee without jeopardizing public debt sustainability is limited.

[35] The OECD Principles for Private Participation in Infrastructure, OECD Recommendation on PPP Governance, World Bank PPP Diagnostic, OECD Guidelines on SOE Corporate Governance.

4. iSOEF Module 4: Corporate Governance and Accountability Mechanisms

82. Good corporate governance is the foundation for stable, financially healthy SOEs. Compared with private sector companies, SOEs face distinct governance challenges that directly affect their performance. These challenges include multiple principals, competing goals and objectives, excessive protection from competition, undue political interference, and low levels of transparency and accountability. Facing such challenges and considering their strategic role in providing key infrastructure and public services, it is vital to ensure that SOEs follow good corporate governance practices.

83. Following the iSOEF methodology, this chapter assesses six dimensions of corporate governance for Kyrgyz Republic SOEs. As stated in the iSOEF Overview Notes,[36] these six dimensions of SOE corporate governance are: (i) legal and regulatory framework; (ii) ownership and oversight function; (iii) performance monitoring; (iv) boards of directors; (v) transparency and disclosure; and (vi) procurement.

4.1. Legal and Regulatory Framework

84. Kyrgyz legislation related to SOEs is fragmented and regulated by numerous legal instruments, sometimes conflicting with each other. The existing legislation does not clearly specify grounds for the establishment, operation, and management of SOEs on a comprehensive and ordered basis. SOEs are regulated by different legal acts from various branches of law: civil, labor, land, tax, administrative, etc. Primary laws governing SOEs range from the National Constitution and the Civil Code, to more specific legislation such as the Law on Joint Stock Companies (2003) and the Law on Bankruptcy (1997), among others. In addition, there are many normative acts of secondary legislation —presidential resolutions, government regulations, internal acts of ministries and agencies, etc.—, which also regulate specific issues related to SOEs' establishment and operation.

85. Kyrgyz SOEs operate under different legal forms, reflecting the legislative history and ongoing evolution from a planned to a market economy. Moreover, the legislation does not define the circumstances or requirements for the establishment of SOEs. Historically, the following legal forms of SOEs operate in the country:

i) State Enterprises (SEs) - the specific legal form (a remnant of the Soviet system) that refers to an un-corporatized legal form operating on the basis of the right of economic management[37] or on the basis of the right operational management[38];

ii) Joint Stock Companies (JSC) – the regular form of JSC, the Government may own any proportion of shares – from a minority stake to 100 percent; and

iii) Other types of commercial entities, such as limited liability companies (LLCs).

[36] The World Bank, "Integrated State-Owned Enterprise Framework" (iSOEF) Washington D.C, June 2019.

[37] Civil Code of the Kyrgyz Republic (1996): Article 158. State enterprises based on the right of economic management is a legal entity which property and profit are owned by the state and are assigned to such enterprise to carry out its business activities.

[38] Civil Code of the Kyrgyz Republic (1996): Article 159. State Enterprises Based on the Right of Operative Management, carrying out operative management of the property assigned to it, may be formed based on the state property.

86. The Civil Code is a foundational legislative framework for all types of legal entities, including SOEs. The Civil Code defines different types of legal entities, commercial and non-profit. It sets out rights and obligations of their participants, including procedure for their establishment and management. The Civil Code is the only legal instrument that explicitly defines state property rights and SEs.

87. In 2015, the Kyrgyz Government issued a Decree on Improving State Assets Management,[39] outlining the main principles of SOE management, oversight, and governance, and identifying the main areas for reform. The Decree took stock of existing arrangements for SOE governance, and set the course for reforms in key areas, including: (i) the main principles of effective SOE ownership; (ii) transition to a more centralized state ownership function; (iii) implementation of strategic planning and stronger corporate governance practices; (iv) introduction of proper incentives for SOEs' management; (v) strengthening of accountability mechanisms; and (vi) improving disclosure and public access to SOEs information.

88. Existing corporate governance arrangements differ among SOEs, depending on their legal status. JSCs are subject to key essential corporate governance rules regarding the general meeting of shareholders, board of directors, and management. In contrast, SEs are not ruled by specific legislation on their corporate governance, creating conditions for excessive direct intervention by the state in their management.

SEs: State Enterprises

89. While significant progress has been made by the Kyrgyz Government in corporatizing SOEs, many continue with the legal status of SEs. As of the date of this analysis, 104 SEs remained under central government ownership, reporting to the SPMF. SEs are a remnant of the former Soviet system of state ownership and have a low level of accountability as they are not required to publish their regular financial statements or to undergo regular independent audit, and are not subject to corporate governance requirements. SEs are typically managed by their general directors, who are responsible for day-to-day operations and do not have similar levels of scrutiny or oversight to their counterparts organized as JSCs.

90. On the positive side, SEs are legally subject to accounting and internal audit requirements. SEs are subject to the provisions of the Law on Internal Audit.[40] Also, in accordance with the general requirements of the Accounting Law, they must prepare financial statements following IFRS for SMEs standards, and submit their annual financial statements to SPMF within 60 days after the reporting year.

91. The Government continues working on strengthening the SOE framework and recently introduced new guidelines for the establishment, reorganization, and liquidation of SEs.[41] These guidelines are aimed at streamlining the activities of SEs and ban the establishment of new SEs until January 1, 2021. They also address important aspects and procedures in SEs'

[39] The Kyrgyz Government Decree #244-r dated June 5, 2015.
[40] The Law on Internal Audit #25 dated January 26, 2009.
[41] Government Resolution #468 dated September 11, 2019 "On streamlining the activities of state enterprises."

management and oversight, including: coordination of SEs' structure and staffing; approval of SEs' annual budget; reporting on financial and economic performance; approval of key performance indicators for SEs' directors; and internal audit procedures, among others.

JSCs: Joint Stock Companies

92. **Most strategic Kyrgyz SOEs adopted the legal status of JSC and are currently governed by the Law on Joint Stock Companies.** This Law sets up the procedure for the incorporation, reorganization, and liquidation of JSCs, and protects the rights and interests of shareholders. JSCs are subject to general company legislation, such as accounting and audit legislation, also applicable to private sector entities. JSC corporate governance norms are regulated by government decrees, such as Decree No. 525 on Increasing Effectiveness of Corporate Governance in JSCs with State Share (2003), later replaced by Decree No. 523 (2009).

93. **The Kyrgyz Republic has made initial steps to legally introduce good corporate governance practices for JSCs.** Corporate governance-related topics, applied to JSCs, are outlined by respective clauses contained in the following legislation:

1) Civil Code[42]

2) Law on Joint Stock Companies[43]

3) Law on Securities Market[44]

4) Law on Business Partnerships and Limited Liability Companies.[45]

94. **In accordance with the Law on Joint Stock Companies, JSCs must submit their financial statements (quarterly and annual audited) to the SSRSFM.** SSRSFM guidelines, dated January 25, 2011, contain a brief description of the complete set of financial statements (including notes and accounting policies) and the preparation of financial statements in accordance with IFRS accounting standards which apply to JSCs. JSCs also report to the SPMF.

95. **The CG Code, in line with internationally accepted good corporate governance practices, was issued in 2012, although its voluntary adoption is not frequent among JSCs.** The Code outlines the main areas of good corporate governance: shareholders' rights, boards of directors, management responsibilities, disclosure policies, and effective control systems. The application of the CG Code is voluntary by any company in Kyrgyz Republic (private or state-owned) and is therefore not widespread, especially among state-owned JSCs.

96. **Further corporate governance procedures for JSCs are regulated by scattered secondary legislation, thus diluting accountability and weakening enforcement.** The Government has approved several regulations on corporate governance for JSCs at different times. Additional regulations on board of directors, management board, revision commission, corporate secretary were adopted by SSRSFM in 2003, but have not been updated since their adoption, or

[42] Civil Code of the Kyrgyz Republic of January 05, 1998 # 2.
[43] Law of the Kyrgyz Republic on Joint Stock Companies of March 27, 2003 # 64.
[44] Law of the Kyrgyz Republic on Securities Market of July 24, 2009 # 251.
[45] Law of the Kyrgyz Republic on Business Partnerships and Limited Liability Companies of November 15, 1996 # 60.

systematically enforced. The fact that such important regulations are scattered among various normative legal acts has led to the dilution of JSCs' accountability and weakens enforcement.

97. JSCs enjoy preferential bankruptcy protection, which impacts the competitive environment and has potential fiscal implications for the state budget. While JSCs are not fully excluded from bankruptcy procedures, they are eligible for preferential treatment. The Law on Bankruptcy specifies that legal entities with majority state ownership, (i.e. JSCs) might be subject to special bankruptcy procedures. Moreover, the Law on Bankruptcy does not apply to JSCs that are considered as natural monopolies.

LLCs: Limited Liability Companies

98. The existing legislation includes contradictory norms about the state's right to establish SOEs as LLCs. The Civil Code prohibits Government agencies from becoming founders or investors in limited partnerships, unless otherwise provided by specific laws. The Law on Business Partnerships and Companies stipulates that, if not prohibited by other legislation, state executive agencies may become shareholders of limited partnerships. The same law says that the Government and local government bodies may become shareholders of limited or joint stock companies. Therefore, the right of the Government to become shareholder in corporate entities with limited liability is possible, but not clear.

4.2. Ownership and Oversight Function

99. In recent years, the Kyrgyz Government has taken several important steps in reforming SOEs, including the implementation of a clear policy towards the centralization of SOE ownership and oversight. Prior to 2012, SOEs followed a typical decentralized model, where line ministries exercised the ownership and oversight functions of the SOEs under their respective areas of influence. Since 2012, the Government started introducing changes towards a more centralized ownership structure, especially through empowering the SPMF with key responsibilities towards non-financial SOEs.[46] The Government initiative of transitioning towards a more centralized state ownership function was then reinforced by several actions, including the Decree on Improving State Assets Management (2015), the creation of the NEHC, and the Resolution on Streamlining the activities of SEs (2019).

100. As a result of the ongoing SOE reforms, the current SOE ownership and oversight function in the Kyrgyz Republic has evolved into a "hybrid" model, with centralized arrangements applying to energy sector SOEs, and a dual model structure applying to remaining non-financial SOEs. In the energy sector, the NEHC is structured as a holding company, designed to govern subsidiary energy SOEs via unified decision-making, based on the energy sector strategy developed by the Government. The NEHC reports to the SPMF as its ultimate shareholder. For the remaining non-financial SOEs a dual model applies, where the ownership, oversight and regulatory functions are split between the SPMF and corresponding line ministries. The SPMF acts as SOE shareholder and exercises its shareholder rights in corporate governance,

[46] The analysis of financial sector SOEs (e.g. state-owned Banks) —legally owned by the SPMF, and subject also to the oversight of the Central Bank— is not included in this section.

performance monitoring, and financial oversight, while line ministries handle respective industry policies. Please refer to **Annex 2** for international models of state ownership arrangements and examples of good practices.

101. In practice, however, these SOE ownership and oversight arrangements are not yet fully effective. The NEHC has not yet managed to apply a robust corporate governance structure for energy sector SOEs, including consistent and streamlined financial reporting practices. Although structured as a parent company owning the majority of its nine subsidiary companies, the NEHC does not produce consolidated financial statements, as required by IFRS 10 *Consolidated Financial Statements*. Modest progress has been observed in other non-financial SOEs, in terms of strengthening both corporate governance practices and SPMF oversight, as required by the Decree on Improving State Assets Management (2015). To achieve proper implementation of this decree, the central oversight function by the SPMF will require significant strengthening, as well as capacity building improvements at all levels.[47]

102. The NEHC reports to the SPMF with limited aggregated financial information on its nine subsidiary energy companies. This limits the SPMF's ability, as its shareholder, to analyze and process NEHC consolidated financial data to take informed decisions. Given the importance of energy sector SOEs, this process must be strengthened and brought into closer alignment with good international practices by making NEHC fully consolidate its subsidiaries' financial statements as required by IFRS accounting standards. Once the NEHC introduces consolidation of subsidiary companies' financial reporting, oversight of the NEHC will be sufficient. For the moment, though, financial information elaborated by the NEHC does not provide a complete financial assessment of the energy sector SOEs to the SPMF and the government, and it must be analyzed on an individual basis.

103. For the case of non-energy SOEs, there is no clear line differentiating ownership roles and responsibilities of the SPMF and line ministries. These state bodies are actively involved in ownership and oversight function of SOEs, but they coexist amid an absence of well-established roles and communication channels between them. In practice, line ministries frequently act simultaneously as owners, policy makers, and regulators, by exercising key ownership functions, including the appointment of the CEO, the drawing up and approval of the SOE budget, and the development and approval of the SOE strategy. The SPMF also acts as a SOE owner through the appointment of the board of directors, the evaluation of the board´s performance, and the monitoring of SOE financial results.

4.3. Performance Monitoring

104. Until recently, Kyrgyz Republic SOEs were not subject to any mechanism of performance monitoring, leading to high levels of SOE inefficiency. Performance monitoring is a core function of the state as an owner to ensure transparency, efficiency and accountability in the use of public funds. The absence of SOE performance measurement in the Kyrgyz Republic is closely related to the lack of a result-oriented approach by SOE management, which typically serves the interests and priorities of line ministries, which do not necessarily coincide with those of the SOEs. This in

[47] Further actions are needed to implementing central monitoring of SOEs, appointing qualified cadre to SOE boards and executive management, as well as enabling them to take informed decisions and be responsible for their performance.

turn has led to several other undesired outcomes, including low SOE productivity, low profitability (or loss-making), increased administrative costs, etc.

105. Concerned by this situation, the Government (through the SPMF) introduced a system of SOE KPIs in 2018. The SPMF developed and approved the "Methodological guidelines for applying KPIs for assessing financial soundness and operational efficiency of JSCs with state participation above 50 percent". The performance monitoring based on KPIs is consistent with international good practice. Financial KPIs apply to all SOEs and are based on common financial ratios, grouped in three categories: (i) profitability; (ii) solvency; and (iii) liquidity.[48] Non-financial KPIs are determined on an individual basis for each SOE. To take effect, KPI targets need to be agreed between the SPMF and the SOE board and documented in individual performance contracts with SOE senior management. SOEs' boards of directors are in charge of monitoring the achievement of KPI targets on a quarterly and annual basis. For an example of the successful implementation of a SOE performance monitoring system in Malaysia, please refer to **Box 4**.

106. In the energy sector, the uniform set of financial KPIs applies only to the NEHC as a holding entity. It is uncertain whether the NEHC will apply these KPIs to its nine subsidiaries, as typically required in holding-type structures. A uniform approach to KPIs, applicable to the holding entity and to all its subsidiaries, is considered an integral part of the proper functioning of the holding structure, its strategic orientation towards improved profitability and maximizing of shareholder value. However, until then, the set of financial KPIs should be agreed with and monitored by the SPMF for each of the nine subsidiaries of the NEHC, on an individual basis.

107. It is still early to assess the effectiveness of introducing the KPIs, but this will be closely linked to progress in other areas. According to the SPMF Guidelines, performance monitoring using KPIs was to take effect for all SOEs starting in the 2019 financial reporting year. However, at the time of elaboration of this report, no data were available to assess preliminary results. International experience shows that successful implementation of a performance monitoring system is typically a challenging and time-consuming process, generating results over a period of time. The effectiveness of this initiative will be closely linked to eventual progress achieved in other key areas, such as improvements in SOE management, the quality and timeliness of SOE financial reporting, etc.

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[48] In the particular case of financial sector SOEs (e.g. state-owned banks), financial KPIs are complemented by specific ratios reflecting prudential norms prescribed for banks and insurance companies.

Box 4. Performance Monitoring in Malaysia: Using the "Blue Book"

As part of its Transformation Program, Malaysia introduced performance management measures for its Government Linked Corporations (GLC) including KPIs, performance linked compensation, and performance contracts. The Putrajaya Committee on Government-Linked Companies' High Performance (PCG) conducted an audit on the implementation of the KPIs. Based on that audit, PCG recommended personal performance reviews on a semi-annual basis, where each GLC Manager's performance is reviewed against targets, resulting in differentiated evaluations and compensation levels linked to GLC performance.

The PCG launched the "Blue Book: Guidelines on Announcement of Headline KPIs and Economic Profit" in 2006. They provide a comprehensive reference to GLCs to ensure uniformity and consistency in their reporting. Each GLC should have 5 to 8 KPIs with targets along financial, customer, operational, and organizational dimensions that are tightly linked to its strategy. The targets of each KPI are benchmarked against comparable international peers. The GLC CEO is responsible for the implementation of quality KPIs and for reporting them to the market. Business performance reviews are conducted every quarter to identify major shortcomings and to chalk out action plans to further improve performance.

The Blue Book Implementation Assessment showed that, for the majority of GLCs, corporate scorecards were in place, KPIs had been formally set for CEOs and senior management and headline KPIs were being monitored. To enhance performance and to promote results-orientation, GLCs have announced their headline KPIs annually which have shown overall improvements over time.

Source: OECD (2010)

4.4. Board of Directors and Executive Management

108. Existing corporate governance arrangements in the Kyrgyz Republic differ depending on SOE legal status and mainly apply to the SOEs under the JSC legal form. This section refers mostly to SOEs registered as JSC. Kyrgyz law provides a two-tier board structure for JSCs, thus separating the supervisory and management function into different bodies. These SOEs are regulated by the Law on Joint Stock Companies and have almost all essential corporate governance elements: general meeting of shareholders, board of directors, and management, with accompanying mandatory procedures. In contrast, entities in the legal form of SEs do not have specific legislation regulating their corporate governance, and therefore, they are governed by general directors (CEOs), appointed by and reporting directly to the corresponding line ministry. The SPMF does not have any mechanism to influence the appointment, assessment, and/or dismissal of directors of SEs. These arrangements deviate from internationally accepted good corporate governance practices and set up conditions for excessive state intervention in SOE management.

109. Following good practices, Kyrgyz law[49] prohibits the participation of government officials and political figures in SOE boards, and the board member selection and appointment process is regulated by specific legislation. To make the process of selection professional and transparent, the Government of the Kyrgyz Republic developed and approved official procedures[50] for nominating and appointing qualified members to SOE boards. These procedures define the selection criteria for all potential candidates and require a special test to be passed, which verifies potential candidates' knowledge of the legal framework, accounting/financial issues and general corporate governance topics.[51]

110. While the Government has made progress in setting up a proper policy framework and establishing clear mechanisms for SOE board-member nominations and appointments, implementation needs to be improved. First, the criteria for selection are very broad and practically the same for all SOEs.[52] Second, the selection of board candidates is carried out by an Interagency Commission, comprising 17 representatives from different state bodies, who perform their duties in addition to their main work. As a result, the Commission is not as effective as it could be in searching for the best candidates, structuring the nomination process, and enhancing the quality of the selection process. Third, passing a standardized test is not the best instrument for nomination of candidates. The nomination process should be based on appraisal of competence and experience requirements that complement existing board skills set and needs to be related to the enterprise's long-term strategy.

111. SOE boards are primarily staffed with civil servants, who may lack the time, motivation, and sometimes also objectivity and skills vital to well-functioning boards. The state is the majority or full owner of most SOEs in the Kyrgyz Republic. As such, it is commonly in a position to define and formally mandate the fulfillment of specific objectives, usually through directors nominated by the SPMF. Due to the weaknesses in the nomination process, these board directors may lack the objectivity and skills vital to well-functioning boards, and may be biased towards pleasing the shareholder, rather than acting in the best interests of the SOE. Furthermore, about 80-90 percent of SOE directors are reappointed several times, possibly to save time and minimize the effort required to appoint new directors. This process impedes the evolution of SOE boards by preventing the entry of new talent which could offer new perspectives and skills to the board room.

112. The mandatory requirement for the appointment of independent directors to SOE boards is an implementation challenge for Kyrgyz SOEs and responsible state bodies. The current law[53] stipulates that independent directors must make up at least a third of SOE board members. However, directors that meet the independence criteria are in short supply and there is no reliable database and/or procedures for their selection and nomination. Establishing a rotating pool of qualified and skilled independent directors would help in building the necessary skillset. Appointing independent directors would enable SOE boards to run more efficiently and

[49] Law of the Kyrgyz Republic "On State Civil Service and Municipal Service" of May 30, 2016 # 75
[50] The Resolution of the Government of the Kyrgyz Republic #716 of December 19, 2014 "On New Principals of Development and Use of Pool of Candidates for Board of Directors, Revision Commissions, and Secretaries for State Share Enterprises"
[51] Source: http://www.fgi.gov.kg/index.php?act=view_material&id=2212
[52] Resolution of the Government of the Kyrgyz Republic #716 of Dec 19, 2014.
[53] Amendments to the Law on Joint Stock Companies of July 28, 2017 # 154

address issues with unbiased judgment for the benefit of Kyrgyz SOEs. Experience in other countries suggests that attracting independent directors from other countries can also strengthen the SOE board's skills set and reduce the level of undue political influence on SOEs.

113. Board level committees are still rare among Kyrgyz SOEs, but SOEs must have a "Revision Commission"[54] with a reporting line to the general meeting of shareholders. Revision Commissions[55] are a legacy of the Soviet planned economy structure, primarily tasked with internal investigations, aimed at finding legislative violations or misuses of funds. These bodies, currently imperfectly emulating a board level audit committee, are neither functional nor practical and their permanence brings little value to the SOEs. Such commissions have been fully reformed and removed in most companies of Eastern and Central Europe. Progressively, the requirement for a Revision Commission does not apply to financial sector SOEs in Kyrgyz Republic.

114. SOE boards do not properly function as a collegiate body. There are no regular meetings of boards or board committees convened for discussions. The role of board chairman is undervalued and unclear, while the corporate secretary position is purely formal. There is no statutory requirement for SOE boards (except for banks) to form specialized committees, although the CG Code recommends them.[56] Finally, good corporate governance practices expect that each of these committees should comprise or at least be headed by independent directors, which is not yet the case in the country.

115. The current remuneration policy for SOE board members is not adequate. The remuneration of SOE directors is not linked to the long-term performance of SOEs. Existing compensation levels are relatively low as compared to private sector practices, insufficient to incentivize senior executives and attract the most qualified candidates[57]. Market-based compensation is key to attracting and keeping competent board members and motivating their good performance.

116. Kyrgyz SOE boards are legally subject to performance evaluation, but this tool is not effective. SOE boards are to be evaluated in accordance with the government Resolution on Evaluation of SOE Boards (2015), which includes three goals: (i) to provide material incentives for SOE directors; (ii) to decide if a director will be reappointed for a new term or removed due to poor performance; and (iii) to develop recommendations for SOE boards' improvement. However, evaluation of SOE boards is not considered as a practical tool for improving the board nomination processes or for enhancing SOE board professionalism.[58] It is formally divided into subjective and objective parts, the latter carried out by SPMF twice a year, and boards themselves are not involved.

117. In practice, only a few SOE boards can be considered to be professional and efficient. According to the SPMF authorities, interviewed for this iSOEF assessment report, most JSC boards

[54] Law of the Kyrgyz Republic on Joint Stock Companies # 64 of March 27, 2003, (Articles 36, 62).
[55] Law on Internal Audit #25 of January 26, 2009, (Articles 62 (1).
[56] Kyrgyz Republic Corporate Governance Code #36 approved by the State Agency on Financial Supervision on December 18, 2012, (Chapter 3).
[57] On average, an SOE board member makes KGS 3,500 gross per month (approximately USD 500).
[58] To date, there have been no cases for removal or replacement of a SOE board director as a result of their poor performance.

do not play a key role in SOE governance. To do so, they would need to change their focus from being a rubberstamping body to a professional body acting in the best interests of the SOE, with sufficient expertise on setting business strategies and effective management oversight. Please refer to **Box 5** below for some good practice examples to improve SOE board composition and the nomination process.

Box 5. EU Country Reforms to SOE Board Composition and Nomination Processes

Croatia: A new framework for the selection of supervisory boards was adopted in August 2015, to be followed by further reform of management board nominations. The regulation strengthens the qualification requirements for applicants and puts candidates from the private sector on a more equal footing with incumbents.

Lithuania: The process of professionalizing SOE boards has been formalized – with an organized process of nominating board members, creating a database of potential board members, evaluating the competencies of existing boards, and direct participation in the boards of SOEs. The country also approved new ownership guidelines, which included criteria for the nomination and appointment of CEOs, and criteria for competence and independence of SOEs' boards.

Portugal: A 2015 reform introduced delegation of appointments to SOE boards to the scrutiny of an independent committee (CReSAP), this process increases transparency, impartiality, accuracy, and independence in the recruitment and selection of candidates.

Romania: The November 2011 Corporate Governance Rules specific to SOEs aim, among other things, to assure the transparent and professional selection of board members and management by: (i) introducing an independent external advisor for large companies to run the selection process; (ii) establishing a minimum of one half of the members of the boards to be independent, i.e. they cannot be government representatives or civil servants. Once selected, the board of directors prepares and submits an administration plan for approval at the general shareholder meeting.

Sweden: New guidelines issued in April 2009 enhance the operation of SOE boards and regulate the terms of employment and remuneration for senior executives of SOEs.

Source: State-owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context, European Commission (2016)

4.5. Transparency and Disclosure

118. Reporting and disclosure requirements for Kyrgyz SOEs are specified in the provisions of the Accounting Law (2002, amended in 2013). According to this law, JSCs must submit their financial statements to the shareholder(s). They are required to submit annual financial statements within 60 days after the end of the reporting year and must publish their financial statements 90 days after the end of the reporting year, but not later than June 1st of the current year. For the entities that are classified as public interest entities under the Accounting Law, published annual financial statements must be audited, compliant with the IFRS, and approved at the annual general meeting of shareholders. SEs fall under the same Accounting Law, however, their compliance with this legislation is not enforced as the SSRSFM does not regulate SEs and the SPMF has limited enforcement capacity. Therefore, most SEs have weak reporting and disclosure practices.

119. All public companies, including SOEs, are required to report and disclose important financial and non-financial information as defined by the updated legislation, but SEs' reporting practices lag significantly behind. In addition to the above legislation, there are several government regulations, which specify requirements related to financial reporting[59]. One such important updates is the Regulation on Financial Reporting #417 2018 which obliges all public interest entities, including SOEs, to report and disclose important nonfinancial information such as information on corporate secretary, material risk factors, securities information, and related party transactions.

120. Also, according to Article 30 of the Law on Securities Market, JSCs that are considered as public interest entities must periodically disclose financial information in the form of annual and quarterly reports. Public interest entities are companies whose securities are listed on the stock exchange; banks or other financial and credit institutions licensed by the National Bank of the Kyrgyz Republic; and investment funds, insurance companies, and non-state pension funds. Their financial statements included in the annual and quarterly reports should be prepared in accordance with IFRS accounting standards. The annual report must contain the annual financial statements and the audit report. A condensed version of quarterly and annual reports must be publicly disclosed no later than 90 calendar days after the end date of the reporting period.[60]

121. The Accounting Law, establishes IFRS and IFRS for SMEs as the only accepted accounting standards for financial reporting for all Kyrgyz companies, including SOEs. According to this law, the unified standards for accounting and financial reporting for public interest entities, regardless of their form of ownership, are IFRS, issued by the IFRS Foundation and the International Accounting Standards Board. The law also requires the application of IFRS and IFRS for SMEs to all entities, except budgetary institutions.

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[59] Government Resolution on Providing Economic and Financial Reporting and Conducting Monitoring of the Largest SOEs' Performance of October 24, 2011 # 666, Government Resolution on Approval of Procedures for Cash Transactions of Businesses and State-Financed Organizations of June 12, 2018 #281, etc.

[60] The quarterly and annual reports shall be submitted to the authorized state body for the regulation of the securities market (SSRSFM) no later than 35 calendar days after the end date of the reporting period. In addition, the general meeting of shareholders must approve the annual report before submission. http://cbd.minjust.gov.kg/act/view/ru-ru/202677/40?cl=ru-ru

122. In practice, however, most SOEs have difficulties with producing timely and quality IFRS-based financial reports. SOE reports are often incomplete, lacking key statements or notes that would normally be an integral part of the financial reporting package; inaccurate in the treatment of technical or sensitive areas; and so delayed that they lose their timeliness and relevance. Even when SOEs produce financial statements, they rarely publicly disclose them, impacting the level of transparency and accountability of these entities. Also, as mentioned above, the NEHC does not comply with IFRS standards, as it does not consolidate the financial information on its subsidiaries and only reports limited aggregated financial information on its subsidiary energy companies to the SPMF. An example could be drawn from the IFRS implementation support provided to JSC Severelectro under the World Bank's Electricity Supply Accountability and Reliability Improvement Project, which enabled the entity to produce complete and timely IFRS-based financial statements that undergo a quality external audit. This practice could be replicated with the largest SOEs, including the NEHC.

123. The quality of external audit of SOE financial statements in Kyrgyz Republic is often weak. Quality control for external audits is not yet established in the Kyrgyz Republic. Therefore, the quality of information in SOEs' audited statements is often not reliable for taking informed economic decisions. Efforts are needed to modernize and improve the external audit function, which in turn may positively influence audit quality and thus the quality and reliability of SOEs financial statements. To address this issue, the SSRSFM is currently working on the drafting of a new audit law in line with leading international practices.

124. Internal audit is not required for SOEs established as JSC and lacks independence and authority in the case of SEs. The Kyrgyz Law on Internal Audit (2009) set up internal audit requirements only for SEs. Internal auditors must report to the SE´s CEO,[61] which limits their autonomy by making them fully dependent upon management. Also, the Law on Joint Stock Companies contains no provisions for the internal audit function for JSCs. The voluntary CG Code[62] mentions the necessity of having an internal audit function by these companies, but it does not provide practical recommendations, nor is its implementation mandatory.

125. Aggregate reporting on the Kyrgyz SOE portfolio is not available. Although it is commonly accepted that financial transparency is enhanced through regular, open (web-based) aggregate reporting, such aggregate reporting on the Kyrgyz SOEs is not available, which prevents public access to key information such as the total value of the SOE portfolio, and a general statement on the state-ownership policy for SOEs. Please refer to the Box 6 for good practices in aggregate reporting on SOE portfolios.

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[61] Law on internal Audit #25 of January 26, 2009, Chapter 4 (articles 13, 14, 15).

[62] Kyrgyz Republic Corporate Governance Code #36 approved by the State Agency on Financial Supervision on December 18, 2012, (Chapter 6).

Box 6. Good Practices in aggregate SOE reporting

Several countries in Europe have developed robust and informative reporting on their SOE portfolios. Lithuania, Norway, and Sweden are often cited as examples of global best practice in SOE oversight and disclosure. These countries provide comprehensive information on the entire SOE portfolio as well as individual SOE snapshots, and they also report on the costs related to public policy objectives carried out by SOEs and the commensurate compensation provided by the state budget. They disclose a list of all SOEs, and the amount of subsidies/appropriations provided to them during the reporting year. The Netherlands provides an interactive online report on the SOE portfolio and individual SOEs that allows users to analyze the portfolio in different ways.

Lithuania

Annual Report: https://vkc.sipa.lt/wp-content/uploads/2018/09/SOE_Report_2018_EN_WEB.pdf

Periodic Reports: https://vkc.sipa.lt/apie-imones/vvi-portfelio-informacija/

Norway
Annual Reports: https://www.regjeringen.no/en/topics/business-and-industry/state-ownership/statens-eierberetning-2016/the-state-ownership-report/id2395364/

126. **The SPMF uses a local software allowing both JSCs and SEs to enter required financial information, and it is currently working on its update**. This financial information is then verified by the SPMF by comparing it with the paper version of SOEs-provided financial statements, which is a slow and inefficient process. The SPMF is currently working on development of a new information portal that would aggregate information on JSCs. In addition to individual and aggregate financial information, the portal is expected to integrate the calculation of KPIs for assessing financial soundness and operational efficiency of these SOEs.

4.6. Public Procurement and SOEs

127. **Public procurement, being the crucial component of SOE institutional framework, is paramount to SOE financial accountability and transparency**. SOEs often receive different treatment in different countries in terms of public procurement. In some countries, for example, fully or majority state-owned enterprises are covered by the same public procurement rules as

other State entities (e.g. central and sub-central government). In other countries, SOE procurement rules are defined as a separate category, and thus subject to specific legislation.

128. In the Kyrgyz Republic, there is a unified procurement framework for all public sector entities, including SOEs, which is ruled by the PPL. The legislative and regulatory framework of the Kyrgyz Republic is generally comprehensive and uses competitive bidding as its default method of procurement. The different methods of procurement and their conditions are outlined in the PPL, and are generally aligned with international good practice, including the UNCITRAL Model Law on Procurement that can be used for goods, works, services, and consulting services. All public procurement in the Kyrgyz Republic has been done electronically since 2015. In particular, the PPL:

- Establishes Independent Complaint Review Commission (ICRC);
- Allows challenges to procurement planning or procurement method of awarding contracts;
- Mandates publication of intent to use direct contracting;
- Introduces modern procurement methods such as framework agreements and e-reverse auction;
- Mandates development and use of standard bidding documents;
- Prohibits splitting of requirements with a view to avoiding competitive procedures;
- Requires establishment of clear criteria for rejecting a bidder from the bidding process;
- Introduces an anti-bribery clause, violation of which is among the criteria for inclusion on the database of unreliable suppliers and prohibits bidding that is not included in the procurement plan.

129. The PPL covers all SOEs with at least 50 percent of state equity share and provides them with a flexible platform to conduct their business. The PPL provides a suitable electronic procurement platform for Kyrgyz SOEs, which is conducive for competition and facilitates access to procurement opportunities for all interested vendors, thus fostering transparency and accountability of the procurement process. The PPL provides great flexibility for SOEs, taking into consideration the specificities of their business and management model, particularly in terms of the possibility of applying higher thresholds for various procurement methods.

130. All public procurement opportunities are published and available through the web portal. The portal provides detailed information to better inform potential bidders about tender opportunities. There are no restrictions on the participation of foreign bidders, although most procurement contracts are awarded to Kyrgyz companies.

131. The PPL also provides for the establishment of an Independent Complaints Review Commission (ICRC). The ICRC consists of representatives of ministries, state committees, departments and the public, as well as certified specialists in the field of public procurement. The Secretariat of the ICRC is the authorized state body for public procurement (PPD). The ICRC examines the complaint in electronic format.

132. An assessment of actual SOE procurement practices in the Kyrgyz Republic was conducted using data provided by the PPD, under the Ministry of Finance. PPD-data covered the period 2017-2019 for the case of six selected SOEs.[63] This included a total of 18,284 procurement contracts, totaling USD 390 million (see Table 11).

Table 11: Procurement contracts by six-selected SOEs (2017-2019, in USD)

Procuring entity (SOE)	2017	2018	2019	Grand Total
State Insurance Company OJSC	$101,243	$42,900	$67,530	$211,673
TNK Dastan OJSC		$55,778	$381,576	$437,354
RSK Bank OJSC	$3,628,364	$5,842,619	$4,094,617	$13,565,600
Alfa Telecom CJSC	$17,652,661	$7,460,547	$43,519,266	$68,632,474
Manas International Airport OJSC	$30,330,661	$23,851,591	$30,884,289	$85,066,541
Electric stations OJSC	$68,165,356	$83,731,813	$70,241,584	$222,138,754
Grand Total	**$119,878,285**	**$120,985,249**	**$149,188,862**	**$390,052,396**

Source: Public Procurement Department, Ministry of Finance.

133. The assessment of this SOE sample dataset showed the following encouraging results:

- The number of days between date of invitation to bid and date of signing the contract were rated as "good". The procurement lead time is enough for successful procurement.
- The time from bid opening to contract signature was "satisfactory".
- Competition level was "adequate". It is recommended to additionally publish advertisements for one-stage tenders on popular business websites to attract foreign participants.
- All procurement records were securely maintained on the public procurement web portal and were kept accessible to all interested parties.

134. The average time to procure goods, works, and services following an open tender procedure was between 43 and 55 days. This shows that the process is efficient in general, presumably due in part to the mandated use of e-procurement through the procurement web portal.

135. Overall, the country's laws and regulations provide a comprehensive control framework for public procurement, including for SOEs. The Government is increasingly creating opportunities for the public to participate in decision-making and monitoring of budget execution, including contracts processed via public procurement. Civil society has an opportunity to monitor the public procurement system and also comment on proposed changes to legislative drafts. The Ministry of Finance /PPD maintain a list of bad-faith companies and individuals that have provided fraudulent information during previous procurement procedures, refused to sign a public contract upon award, or performed poorly on signed contracts. For more details on the analysis performed, please refer to **Annex 3**.

136. The unified public procurement framework for the Kyrgyz Republic is beneficial for SOEs. The existing system enhances competition and facilitates access for all interested vendors to procurement opportunities and increases transparency and accountability of the procurement process.

[63] 2 large-size companies: (JSC International Airport Manas (all branches) and JSC Electric stations (all branches); 2 medium-size companies: (JSC Alfa Telecom and JSC RSK Bank); and 2 small companies: (JSC State Insurance Company and JSC TNK Dastan).

5. Action Plan for SOE Reforms

137. Recognizing the Kyrgyz Government's commitment to SOE reform and building on the country's progress achieved over the past years, this iSOEF assessment proposes recommendations to further improve SOEs' governance and performance, while limiting their fiscal costs and risks. SOE reforms are multidimensional and require a holistic and integrated approach. As such, this iSOEF assessment focuses on key intertwined options for reform: (i) development of the SOE ownership policy; (ii) systematization of SOEs' relationship with the budget; (iii) improvements in SOE transparency; and (iv) strengthening of corporate governance. These four critical areas are summarized below, and also presented in a prioritized summary in **Table 12**.

Recommended key SOE reforms

138. Formulate a unified and comprehensive SOE ownership policy. Taking advantage of significant changes made since 2012 towards achieving a more centralized state ownership and oversight function over SOEs, the Government should formulate a unified and comprehensive SOE ownership policy. This should define the main strategic sectors, identify large enterprises pursuing important public policy objectives or addressing market failures, and promote high-level government accountability mechanisms linked to SOE performance. The respective roles of the state, ownership entities (SPMF, NEHC), SOE boards and management, and independent regulators should all be specified, thus helping to avoid the frequent overlapping of roles and responsibilities between the SPMF and line ministries.

139. Systematize energy sector SOEs' relationship with the budget —to properly calculate and compensate them for their quasi-fiscal activities— and alleviate their debt burden. Energy sector SOEs in the Kyrgyz Republic carry out several public service obligations which are delivered at below-cost, in particular in the energy distribution segment. These obligations are only partially subsidized —implicitly and explicitly— by the state budget. These SOEs cannot become financially sustainable unless they are duly compensated —through further direct budget transfers— for the actual cost of their public social obligations. Additionally, relevant policy decisions need to be taken to alleviate energy sector SOEs' high debt burden and avoid the Government being caught in a perpetual SOE debt rollover exercise.

140. Consider implementing comprehensive tariff reform to improve SOEs cost-recovery and reduce the quasi-fiscal deficit generated by the energy sector. Tariff increases are important pre-requisite to achieve cost-recovery of the energy sector and to attract private capital. The financial condition of the largest energy companies requires urgent improvements and significant capital injections, including through private sector-based solutions. Given the political sensitivity of tariff increases for Kyrgyz society, it is understood that this reform may be difficult. All necessary considerations for a proper social safety net for the poor must be ensured. The tariff increases will be necessary to stop depletion of the energy companies' resources and growing budget subsidies, and to begin the groundwork enabling future private sector co-financing in the medium-term. To achieve financial viability of the sector, revenues must fully cover all operating costs, interest, and depreciation. This will allow for a competitive return on capital that can attract private investors into the sector and mobilize the funds required for capital investment through debt and equity.

141. Strengthen SOE transparency by assuring compliance and reinforcing current reporting and disclosure requirements. All SOEs must comply with the use of comprehensive and standardized accounting standards (IFRS) as required by law. Donor support for entity-level implementation should be requested where necessary. Periodic, aggregate SOE portfolio reporting should be compiled, elaborated, and published by the SPMF, at least annually, on an official website. This should specify main SOE performance trends, as well as the Government´s sector policy and details of reforms underway. Regular publication of SOEs´ annual reports with the audited financial statements and non-financial information should be enforced. Scrutiny of financial reporting should be strengthened by requiring independent audits from reputable firms.

142. Align financial reporting and audit requirements for the most strategically important and largest SEs with the requirements applicable to public and private JSCs. In the energy sector, the 9 subsidiary companies of NEHC should be requested to submit their audited financial statements directly to the SPMF, until the NEHC manages to implement full accounting consolidation.

143. Enhance SOE boards´ professionalism and independence. It is essential that SOEs increase their compliance with the Law on Joint Stock Companies (amended in 2017) requirement of independent directors representing at least one-third of total board members. One way to improve corporate governance practices would be to gradually enforce the mandatory application of the CG Code, focusing first on the most strategically important and largest SOEs. A transparent and comprehensive system for selection of SOE board members should be introduced to attract independent parties into the selection process and a pool of potential board candidates should be established. Consideration should be given to attracting independent directors from other countries who may be able to strengthen SOE boards' skills sets and reduce the level of undue political influence on SOEs. SOE boards should be empowered —using further legislation if needed— to properly exercise their functions in terms of strategic SOE oversight and management supervision. Board-level committees should be established to facilitate the boards in taking well-informed and considered decisions in key areas, such as audit, risk management, and remuneration. Adequate training programs, peer exchanges, formal induction-orientation programs, and ongoing learning opportunities should be implemented for potential candidates and existing SOE board members.

Other important reform options

- Corporatize most strategically important and largest SEs by converting them into joint stock entities.
- Link key performance indicators (both financial and non-financial) and associated targets to the SOE strategy and objectives, to facilitate the measurement and evaluation of results. Link SOE management incentives and compensation to SOEs´ performance and KPIs.
- Conduct detailed analysis of SOEs' operational expenses, to be followed by regular vigorous monitoring of financial KPIs.

- Estimate and include fiscal space in the state budget to mitigate fiscal risks resulting from SOEs' inability to meet their excessive debt obligations.
- Develop a strategy to attract private investors to SOE markets. Design a system for selecting projects of high priority for the Government, considering a range of instruments: PPPs, concessions, management contracts with private sector, minority stake equity participation, etc.
- Build up political and technical consensus on the necessity of further attracting private capital to key economic sectors through government advertising and other dissemination mechanisms such as seminars, workshops, conferences, etc.

Table 12: Action Plan Matrix

Reform Area	Recommendation	Priority
MAIN RECOMENDATIONS		
SOEs Corporate Governance: Ownership and Oversight Function	• **Formulate a unified and comprehensive SOE ownership policy** - Define main strategic sectors. - Identify large enterprises pursuing important public policy objectives or addressing market failures. - Promote high-level government accountability mechanisms linked to SOE performance. - Specify the respective roles of the state, ownership entities (SPMF, NEHC), SOE boards & management, and independent regulators, to avoid the frequent overlap of roles and responsibilities between SPMF and line ministers.	Short term
SOEs Fiscal Impact	• **Consider implementing comprehensive energy tariff reform to improve SOEs cost-recovery and reduce the quasi-fiscal deficit generated by the energy sector.**	Short term
SOEs Corporate Governance: Transparency and Disclosure	• **Strengthen SOE transparency by assuring compliance and reinforcing current reporting and disclosure requirements** - The use of comprehensive and standardized accounting standards (IFRS or IFRS for SMEs) must be complied with by all SOEs, as required by law. - Regular publication of SOEs´ audited annual financial statements must be enforced. - Scrutiny of financial reporting should be strengthened by requiring independent audits from reputable firms. - Request the 9 subsidiary companies of NEHC to submit their audited financial statements directly to the SPMF, until the NEHC manages to implement full accounting consolidation.	Short term

SOEs Fiscal Impact	• **Systematize energy sector SOEs' relationship with the budget —to properly calculate and compensate them for their quasi-fiscal activities— and alleviate their debt burden** - Duly compensate energy sector SOEs —through further direct budget transfers— for the actual cost of their public social obligations. - Alleviate energy sector SOEs' high debt burden, to avoid the government being caught in a perpetual SOEs debt rollover exercise. - Estimate and include fiscal space in the state budget to mitigate fiscal risks resulting from SOEs' inability to meet their excessive debt obligations. - Expand the scope of the existing statement of fiscal risks by including reporting on fiscal risks from SOEs and include it in the Explanatory Notes to the annual Budget.	Medium term
SOEs Corporate Governance: Transparency and Disclosure	• **Strengthen SOE transparency by assuring compliance and reinforcing current reporting and disclosure requirements** - Require periodic, aggregate SOE portfolio reporting by the SPMF (specifying main SOE performance trends and the government´s sector policy and reforms) compiled, elaborated, and published at least annually on an official website. - Identify a group of the most significant SEs and align their financial reporting and audit requirements to those applying to public and private JSCs.	Medium term
SOEs Corporate Governance: Board of Directors Practices & Procedures	• **Enhance SOE-boards´ professionalism and independence** - Comply with the Law on Joint Stock Companies (amended in 2017) requirement of independent directors representing at least one-third of total board members. - Gradually mandate the application of the CG Code (2012), focusing first on the most strategic and largest SOEs. - Introduce a transparent and comprehensive system for selection of SOE board members aiming to attract independent parties into the selection process and establish a pool of potential board candidates. - Empower SOE boards —using further legislation if needed— to properly exercise their functions in terms of strategic SOE oversight and management supervision. - Establish board-committees for taking well-informed and considered decisions in key areas, such as audit, risk management and remuneration. - Implement adequate training programs, peer exchanges, and learning opportunities for potential candidates and existing SOE board members.	Medium term

Reform Area	Recommendation	Priority
	OTHER IMPORTANT REFORM OPTIONS	
SOEs Corporate Governance: SE Corporatization	- Corporatize most strategically important and largest SEs by converting them into joint stock entities.	Short and Medium Term
SOEs Financial Oversight	- Conduct detailed analysis of SOEs' operational expenses, to be followed by regular vigorous monitoring of financial KPIs.	Short and Medium Term
SOEs Corporate Governance: Performance Monitoring	- Link KPI (both financial and non-financial) and associated targets to the SOE strategy and objectives, to facilitate the measurement and evaluation of results. - Link SOE management incentives and compensation to SOEs´ performance and KPIs.	Medium term
Private Sector Development in SOE Dominated Markets	- Develop a strategy for SPMF to attract private investors to SOE markets. Design a system for selecting projects of high priority for the Government, considering a range of instruments: PPPs, concessions, management contracts with private sector, minority stake equity participation, etc. - Build up political and technical consensus on the necessity of attracting further private capital to key economic sectors through government advertising and other dissemination mechanisms such as seminars, workshops, conferences, etc.	Medium term

Annex 1: Maximizing Finance for Development and Attracting Private Capital

Legislative Framework

The Kyrgyz Republic is moving ahead with making the best use of the public-private interface. In order to simplify procedures and reduce timelines in the process of preparing PPP projects, a new version of the Law of the Kyrgyz Republic on Public-Private Partnership was adopted in 2019. The new legislation optimizes the approval of PPP projects with an authorized state body, the powers of the authorized state body to approve PPP projects are replaced by the obligation of the state partner to notify the authorized state body about the preparation of the PPP project. In particular, the authority of the state body to manage financial risks to approve tender documents has been replaced by the authority to agree on tender documents only if the PPP project receives funding from the state budget.

To facilitate private investors' cooperation, the Government established the "Center for Public-Private Partnership" (PPP Center) in 2019. The PPP Center will support and accelerate the development of infrastructure projects of national and municipal importance and improve the quality of public and municipal infrastructure development services through the use of various PPP tools. The main task of the PPP Center, under the Ministry of Economy, will be the qualified preparation, organization, and support of PPP projects and assistance to ministries, departments, and municipal authorities to improve PPP tools.

Ongoing Cooperation with the Private Sector

The Kyrgyz Republic is presently implementing 23 PPP projects for a combined cost of about USD 300 million. Major sectors include transportation, healthcare, education, and tourism, as outlined in Table A1. In addition, in order to expand access to high-quality school infrastructure, the Ministry of Education of the Kyrgyz Republic initiated a new PPP project to build 20 schools in the cities of Bishkek and Osh. This project aims to attract private investors for the design, financing, construction, operation, and maintenance of the schools. The new projects will be funded from the PPP Project Preparation Financing Fund that allocated USD 1.3 million for feasibility studies of 8 projects for total project costs of more than USD 79 million.

Table A1: Existing PPP Projects in Kyrgyz Republic, 2019

Sector	Number of Existing PPPs
Transportation	6
Healthcare	5
Education	5
Sports and Tourism	4
Logistics, hotels and culture (one in each)	3

Source: Ministry of Economy.

With the new PPP legislation in place, the Government is developing three new PPP projects. The projects would be in healthcare, public transportation, and cultural development:

- "Hemodialysis services in the cities of Bishkek, Osh, and Jalal-Abad" for the total amount of euro 10 million. The centers are already open and functioning in the cities of Jalal-Abad and Bishkek, Osh is in progress;
- "Electronic ticketing of public transport" aiming to introduce a unified system of electronic ticketing on public transport in Bishkek. The project cost is USD 2 million; and
- "Reconstruction of the cinema Kyzyl - Kyrgyzstan", located in central Bishkek for a total cost of USD 30 million.

Basis for Successful Collaboration between Public and Private Sectors

Any cooperation between private investors and the public sector, including SOEs, should be done on market terms, transparently, and in accordance with the law and public interests.[64] Public infrastructure services are provided by a wide range of entities, ranging from traditional government organizations, SOEs operating on market terms, and partially or fully private utility companies. Infrastructure services often have limited competition, giving providers some market power and raising concerns about protection of the public interest. Public ownership of infrastructure operators creates scope for lack of arms-length relationships and non-commercial behavior. Because infrastructure investments are often large and immobile, a sound enabling environment for infrastructure investment is critical to attract private investment, including a wide range of laws and administrative practices that affect private investors.

The benefits of private sector participation are enhanced by efforts to create a competitive environment, given the limitations of the natural monopoly in some infrastructure sectors. Where private and public infrastructure companies are in competition, specific measures are required to promote a level playing field, including with respect to SOE governance and transparency of public service obligations and of direct and indirect government support.

SOEs can be a good conduit for enhancing private participation. While SOEs may be necessary in order to combat market failures in particular sectors at particular times, there is little doubt that careful introduction of increased private participation in delivery of services has been overwhelmingly successful throughout the world in terms of providing increased value for money for citizens. Private participation can be undertaken in various ways: at one end of the continuum might be full privatization where the state plays no particular sectoral role, to private ownership of an asset that is heavily regulated (e.g. utilities), to various concession (user pays) and PPP (government pays) arrangements, to service concessions, where the asset remains in public hands but is operated by a private contractor, to traditional public works contracts, where the private sector constructs an asset that upon completion passes to the public sector that then operates it. The SOE can play various roles in all these models, depending on the public service that it is created to perform and the country's development path.

[64] The OECD Principles for Private Participation in Infrastructure, OECD Recommendation on PPP Governance, World Bank PPP Diagnostic, OECD Guidelines on SOE Governance.

When examining whether SOEs in a particular sector may be ripe for increased private participation a number of questions arise. These include whether:

- There are grounds to believe that private participation might introduce greater efficiency and effectiveness into the sector.
- The extent to which the current corporate governance arrangements for the SOE are sound and transparent, performance reporting is formalized and clear PSO commitments are established and costed.
- The gap, or market flaw, that the SOE was meant to alleviate has disappeared or can be managed.
- The SOE operates in a competitive market.
- There is reason to believe that the private partner can be offered a sensible return on the risks it will be taking.

Existing Challenges in SOEs Governance that Impede Cooperation with the Private Sector

As noted in the report, the Kyrgyz Republic is lagging behind in implementation of important reforms related to SOE transparency and corporate governance. Moreover, there have been multiple attempts to limit Public Procurement Law provisions related to SOEs' procurement practices, which would negatively impact the new transparent procurement practices. These reforms are critical to enabling effective cooperation between the public and private sectors. Once implemented, corporate governance and financial transparency reforms will create and foster an operating environment that is more conducive to effective public-private collaboration, with fair and transparent distribution of costs and benefits.

The Kyrgyz Government has identified a number of opportunities for private sector collaboration, the majority of which are pending political decisions and underlying governance improvements. For example, the Ministry of Economy outlined several large SOEs that are candidates for increased private sector participation in infrastructure service delivery:

- **Air Transportation:** Air Kyrgyzstan was put up for privatization several times but failed due to lack of investor interest. Presently, the airline is in a dire financial situation.
- **Energy Sector:** The Government is considering various types of cooperation with the private sector, although, privatization is not among the options. The Kyrgyz energy sector has investment needs surpassing the Government's ability to fund it. As described earlier in the report, the energy sector is overleveraged and requires more funds to sustain the existing infrastructure, as well as new investments to meet the growing demand for power.
- **Railways and Airports:** These typical candidates for public-private collaboration have not yet been made available for interested investors, including IFIs, despite the urgent need to upgrade the existing facilities in Bishkek and throughout the country.

- **Other Sectors:** Water infrastructure could be an option for public-private collaboration; however, its ownership and operation lie with the municipalities making a centralized approach and decision making difficult. Roads are state property and offer an opportunity for toll roads in the future, subject to building clear mechanisms of cooperation with private sector investors.

The Kyrgyz Government has not yet finalized its strategy for engaging with private sector investors. The Investment Strategy 2021-2025 is yet to be adopted. This leads to unclear priorities on the part of the Government and a lack of market interest from private investors. The Government needs to carefully assess what role the public and private sectors should have with respect to delivering public services in light of its strategic development direction and the national context. To do this, the Government will need to define the state's ownership role in various sectors, while balancing legitimate public interests, the country's long-term strategic interests, the current efficiency and effectiveness of SOEs, and SOEs' social functions. Finding the right balance for an effective public-private interface entails addressing two major issues:

- Ensuring that when a private party participates in sectors that were previously fully controlled by the state, it does so in a productive, fair, and transparent manner; and
- Creating the environment and mechanisms for SOEs to become profitable, effective, and accountable to the government and the public.

A proper public-private interface allows the public and private sectors to work in tandem, addressing significant gaps in infrastructure, building effective mechanisms for service delivery, and right-sizing the state footprint in the country. Building frameworks that allow for such an effective collaboration between the state and private sector requires proper legislation, capacity, and trust between the actors.

Effectiveness, transparency, and accountability must be central to the way the public-private interface operates. Any mechanism selected – including PPPs and investments via SOEs – should be properly managed, allowing the Government to act as an active and professional owner of the country's resources, and should ensure affordability, value for money, and integrity. To be an effective owner, the Government must minimize the risk of failure by properly preparing and planning investment arrangements, assessing risks and benefits, and searching for optimal solutions.

A transparent and inclusive reform process can help set the priorities and achieve the reform objectives. Structuring the reform process and sequencing it properly are the most critical steps to reduce state capture and minimize corrupt practices. Engaging with political parties and with economic and civil society actors in a complex reform process may provide the necessary checks and balances to achieve reform objectives. Similarly, good experiences, challenges, and lessons learned from around the region may provide useful guidance and enable reformers to avoid common mistakes. A key issue in all countries is ensuring that public sector actors with appropriate capacity – skills, know-how, and resources – are available to steer the reform and interact with highly experienced private actors.

The key pillars of such reforms are legislation, equal treatment, governance and oversight, transparency and disclosure, public consultation, and capacity building (see **Figure A1**).

Figure A1: Key reform elements in the public-private interface

Annex 2: State Ownership Arrangements and Models

One of the state's primary responsibilities toward SOEs is to act as an informed and active owner. In this role, the state should ensure that the governance of SOEs is carried out in an informed and accountable manner, with a high degree of professionalism and effectiveness.[65] To carry out this important function, countries establish different models for exercising their ownership rights – similar to shareholder rights – over SOEs.

State ownership arrangements have evolved over time as SOEs have changed their legal form and as governments have sought to improve SOEs' productive capacity. While countries' legal frameworks vary substantially, ownership models today fall broadly into four models: decentralized, dual, advisory, or centralized. The decentralized and dual models are typical in the ECA Region, as many countries share a similar economic past. There are no bold lines separating ownership models; in fact, many countries may be categorized under one type of ownership model[66] but may also retain aspects of other models for some or all SOEs.[67]

- ***Decentralized model:*** SOE ownership responsibilities are dispersed among different line ministries
- ***Dual model:*** ownership responsibilities are shared by line ministries and a centralized ministry or agency—the Ministries of Finance or Economy, or a state ownership agency.
- ***Advisory model:*** ownership remains dispersed, but an advisory or coordinating body provides high-level input into SOE governance and ownership matters.
- ***Centralized model:*** SOE ownership is centralized in a single ownership entity, which may be either independent or a part of the government.

The decentralized model emerged from the region's historic tradition of organizing state ownership functions. Historically, governments organized their activities under the line ministries, which were responsible for all aspects of SOE management and oversight. The decentralized SOE ownership model, in which line ministries exercise ownership functions, creates a conflict between sectoral policy-setting and the state's ownership function: line ministries must pursue both public policy objectives and ownership objectives, while the SOEs are required to fulfill public obligations without proper reimbursement when such obligations adversely affect their operational performance. The decentralized model also dilutes accountability for SOE performance, as responsibility for SOEs' financial reporting and for overseeing them and enforcing legislation is spread among several ministries or agencies. The decentralized model still exists in several ECA countries, including Azerbaijan, Belarus, Bosnia and

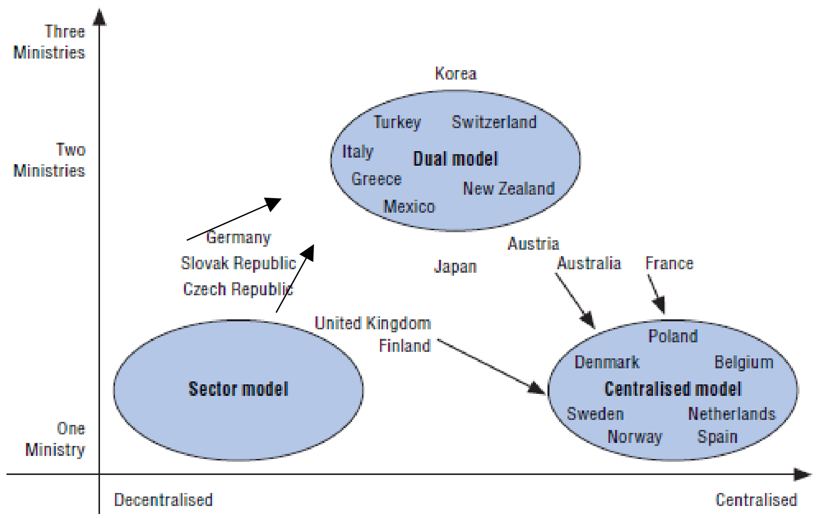
[65] OECD, 2015, op. cit.

[66] For the purposes of this Survey, the term "ownership model" does not refer to what entity is the legal owner of SOEs or their shares, but rather to the manner in which ownership rights are exercised.

[67] World Bank, 2014, op. cit.)

Herzegovina, Romania, Tajikistan, and Uzbekistan. But in many other countries, it has evolved to dual, advisory, or centralized models, as the OECD reports[68] (see **Figure A2**).

Figure A2. Evolution of SOE Ownership Models among OECD Countries



Source: OECD (2015).

The dual model evolved to introduce checks and balances and promote both technical and financial oversight over SOEs. One advantage of the dual model over the decentralized model is that it enables both financial oversight of individual SOEs and aggregate analysis of SOEs. In this respect, the dual model balances the interests and objectives of line ministries – ensuring that the SOE is fulfilling its policy and service delivery roles, and that the government's financial performance objectives are being achieved at the aggregate level. Examples of dual and advisory models are presented in **Box 7** and **Box 8**.

Box 7. Dual SOE Ownership Model: Czech Republic and Germany

In the Czech Republic, line ministries vote the state's shares, while the MOF oversees the financial and operational performance of the SOEs.

In Germany, the MOF sets out the framework for managing state holdings, oversees their performance, and publishes the annual performance report, while the line ministries are responsible for oversight of SOEs in their technical area of expertise.

[68] *Ownership and Governance of State-Owned Enterprises A Compendium of National Practices* (OECD, 2018)

Box 8. Advisory SOE Ownership Model: Lithuania

Lithuania's ownership model may be classified as advisory. The Governance Coordination Centre (GCC) is responsible for coordinating SOEs, collecting relevant information, and monitoring and analyzing the state's policy toward SOEs. The GCC is a specialized government agency operating under the Ministry of the Economy and Innovation. The Ownership Guidelines define five functions for the GCC: (i) analysis of financial and nonfinancial information disclosed by SOEs and of the trends in the activities of these enterprises; (ii) preparation and publication of aggregate SOE reports; (iii) good practice advice on and coordination of strategic planning in SOEs; (iv) assessment of the strategic objectives set by SOEs; and (v) monitoring of strategy implementation indicators.

The GCC also takes part in the process of nominating board members by providing technical advice to the institutions representing the state in their search and selection of SOE board members. Finally, the GCC evaluates SOEs' compliance with the Ownership Guidelines and the Transparency Guidelines and submits its opinion and recommendations to the Lithuanian Government.

Globally and in ECA, ownership arrangements have been steadily evolving from a decentralized or dual model toward greater centralization, to strengthen the focus on ownership issues and help resolve many of the problems associated with SOE governance. In more and more countries, the state has become an active and professional owner of its assets, while giving SOEs operational independence. This approach envisages that SOEs are insulated from political influence and from day-to-day intervention in their operations and are able to keep an arm's-length relationship with the state. Under centralized ownership arrangements, ownership entities may be housed in ministries or within ministerial departments, in dedicated ownership agencies, or in company-type structures. An example of the centralized model applied by Sweden is presented in **Box 9**.

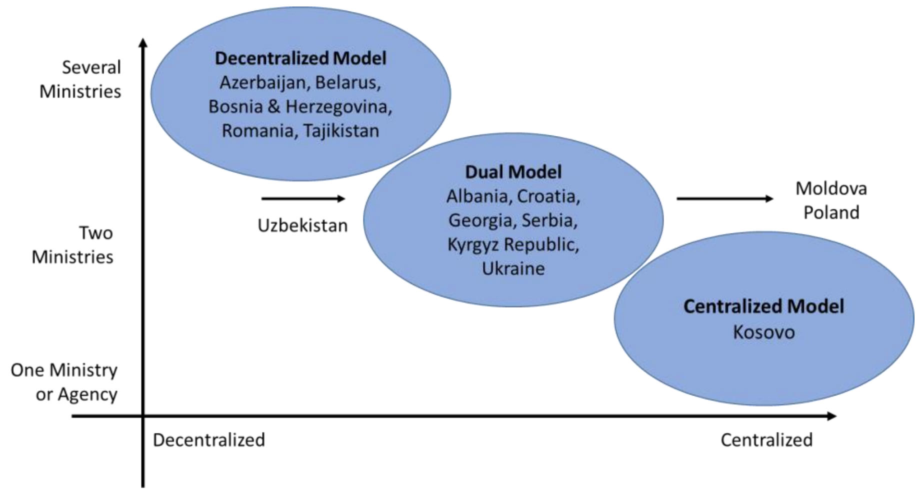
Box 9. Centralized SOE Ownership Model: Sweden

The Swedish Government has a mandate from the Parliament to actively manage SOEs to ensure optimal long-term value performance and, where applicable, to ensure that specifically adopted public policy assignments are duly performed.* Sweden's SOE ownership function is centralized with the Division for State-Owned Enterprises at the Ministry for Enterprise. The Government is responsible for (i) developing SOE ownership policy and other guidelines; (ii) setting SOEs' financial targets; (iii) setting the public policy targets for SOEs that have specific public policy objectives; (iv) appointing Boards of Directors; and (v) deciding on dividends.
There were 46 SOEs under the SOE Division's supervision in 2018. Seven more SOEs fall under line ministries, but they are subject to central coordination with the SOE Division.

* Sweden SOE Ownership Policy (2017): https://www.government.se/49f639/contentassets/c6382135343d45fe8685ab7fa53a2fa3/the-states-ownership-policy-and-guidelines-for-state-owned-enterprises-2017.pdf

As Figure A3 shows, many of the developing countries in the ECA Region use either a dual model or a decentralized model, split relatively evenly between the two. The advisory model is not specifically used in any responding country, but some features of the model are attributable to Croatia and Ukraine. Only one country uses a centralized model. The variety of SOE ownership models is often complicated by additional clustering of SOEs into subgroups, such as commercial and noncommercial enterprises, or a sector-specific approach. Such a subgrouping often leads to different ownership models for various clusters within a single country.

Figure A3: SOE Ownership Models among Selected ECA Countries

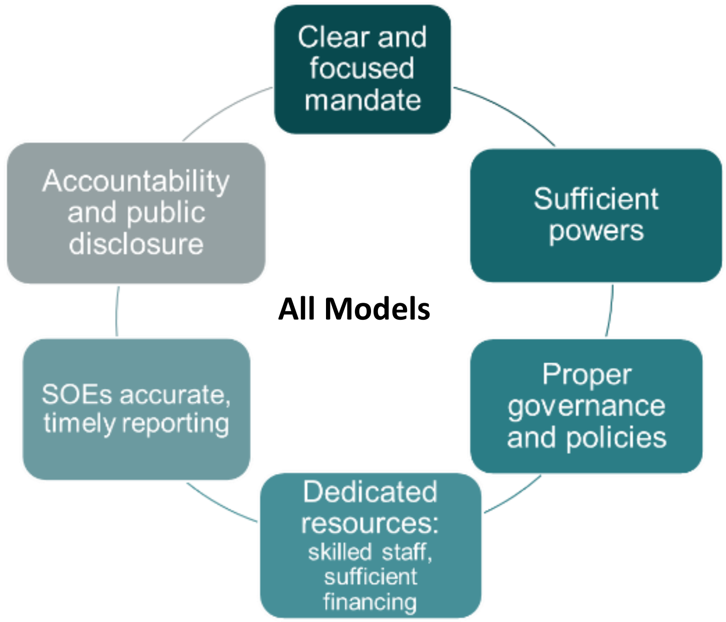


Source: World Bank, Corporate Governance of SOEs in Europe and Central Asia (2020)

Changing the SOE ownership model takes time. Not only does the process require changes to legal frameworks, but it also needs strong political will, significant investment in human resources, and capacity building at all levels. For example, creating a centralized ownership entity may involve a radical change that may not be feasible in the short term because of the political situation or lack of institutional capacity.

Regardless of the SOE ownership model used, the SOE ownership entity(ies) must have the capacity and competencies to effectively carry out their mandate, as illustrated in **Figure A4**. A pragmatic approach is required to improve SOE ownership arrangements and build a more effective oversight system. Sometimes, centralization of SOE oversight may not be feasible. In this case, decentralized and dual ownership arrangements can be improved by creating or strengthening an advisory or coordinating body, building its capacity, and empowering it with the authority to oversee the entire SOE portfolio or a group of the country's most significant SOEs. Such capacity and authority must be supported by formal regulations and procedures that are consistent with those applicable to the SOEs for which it exercises the state's ownership rights.

Figure A4: Features of Strong SOE Oversight System



Annex 3: Public Procurement and SOEs

This annex offers insight on how centralized electronic public procurement benefits both SOEs and the Government in securing value for money, economy, transparency, and fairness in SOE procurement.

The legislative and regulatory framework for public procurement in the Kyrgyz Republic is comprehensive and relies on competitive bidding as the main method of procurement. The different methods of procurement and their conditions are outlined in the PPL enacted in April 2015, which are generally aligned with international good practice, including the UNCITRAL Model Law on Procurement that can be used for goods, works, services, and consulting services.

Since 2015, all public procurement in the Kyrgyz Republic is processed electronically via the e-Procurement platform. All public procurement opportunities are published and available through the dedicated web portal, providing detailed information to better inform potential bidders about tender opportunities. There are no restrictions on foreign bidders. Procurement of goods, works, and services must be performed using one of the following methods.

Method	Description
Single Stage Bidding and Single Stage Bidding (Two Envelopes)	The key public procurement method under the PPL. The number of suppliers/ contractors is not limited.
Two Stage Bidding	The first stage invites bidders to submit initial bids containing their proposals without specifying the bid price. In the second stage, the procuring entity invites all bidders who didn't have their initial bid rejected to submit their final bids with specification of prices based on the revised procurement terms.
Simplified Acquisition	Simplified acquisition is used when procuring finished products that do not require special manufacturing, as well as works and services with specific descriptions valued less than the thresholds. To ensure competition, bids must be considered from at least two contractors. The successful bid shall be an eligible bid with the lowest price that meets the needs of procuring entity.
Reverse Auction	Procuring entities may conduct electronic reverse auction for the procurement of goods and services if such goods and services have established standards of quality and a specific description of services. There must be at least three suppliers to ensure efficient competition.
Direct Contracting	Direct contracting enables the procuring entity to sign a contract with one supplier after the monitoring of prices. Within two days prior to the direct contracting, the procuring entity shall publish on the e-Portal information about the procurement.

SOEs with 50 or more percent equity share owned by the Government procure according to the PPL. This provides flexibility for SOEs to apply considerations and attend to specificities of their business and management model particularly in terms of the higher thresholds for various procurement methods. Additional flexibility concerning special period of time for SOEs was added to the PPL.

The key strengths of the legal and regulatory framework can be summarized as follows:

- The legal procurement framework is relatively well established, with an adequate hierarchy and corresponding precedence levels (PPL, regulations, instructions, standard templates), all of which are freely accessible on the public procurement web portal www.zakupki.gov.kg.
- The legal framework provides a broad description of permissible procurement methods and their procedural requirements.
- The legal and regulatory procurement framework requires SOEs to prepare realistic annual procurement plans. The plans for all procurement activities are published through the web portal.
- The use of a single electronic procurement system (public procurement web portal) is mandated and, with few exceptions, is largely consistent with the PPL.
- Tender documentation available through the portal includes model procurement documents and standard contracts for all types of procurement except consulting services.
- The PPL stipulates that if an international treaty ratified by the Kyrgyz Republic stipulates procurement rules other than those stipulated in the PPL, the procurement rules of the international treaty shall apply to procurement subject to international treaty.
- The functions of the regulatory and normative body are specified in the legal framework. The responsibilities of procuring entities are adequately defined in the legal framework.

Procurement data is the best indicator of how the procurement system functions. In preparation of this report, the PPD under the MOF provided the EGP data for 2017, 2018, and 2019 for selected SOE/JSCs. Analysis covered the performance of SOE/JSCs based on the selected samples: two large companies (OJSC International Airport Manas (all branches) and OJSC Electric Power Plants (all branches), two medium companies (OJSC Alfa Telecom and OJSC RSK Bank), and two small companies (OJSC State Insurance Company and JSC TNK Dastan). In total, 18,284 contracts with the total sum USD 390,052,396 of six SOE/JSCs were included in the review.

Table A2: Volume of procurement sample of the selected SOE by categories, USD

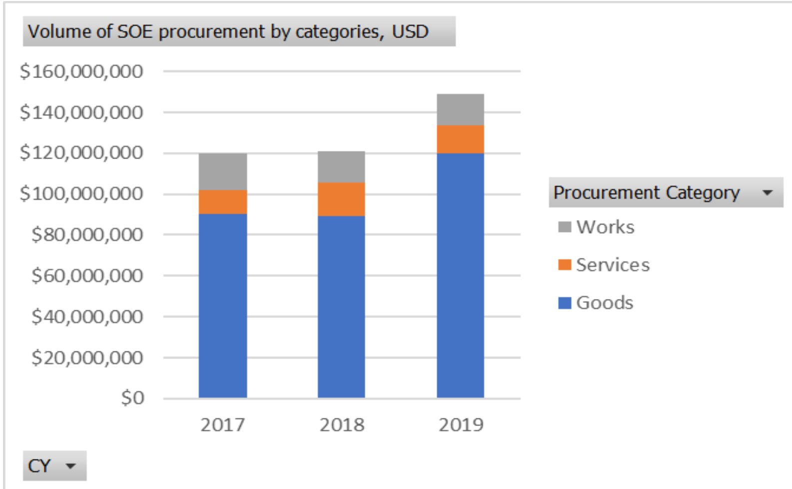
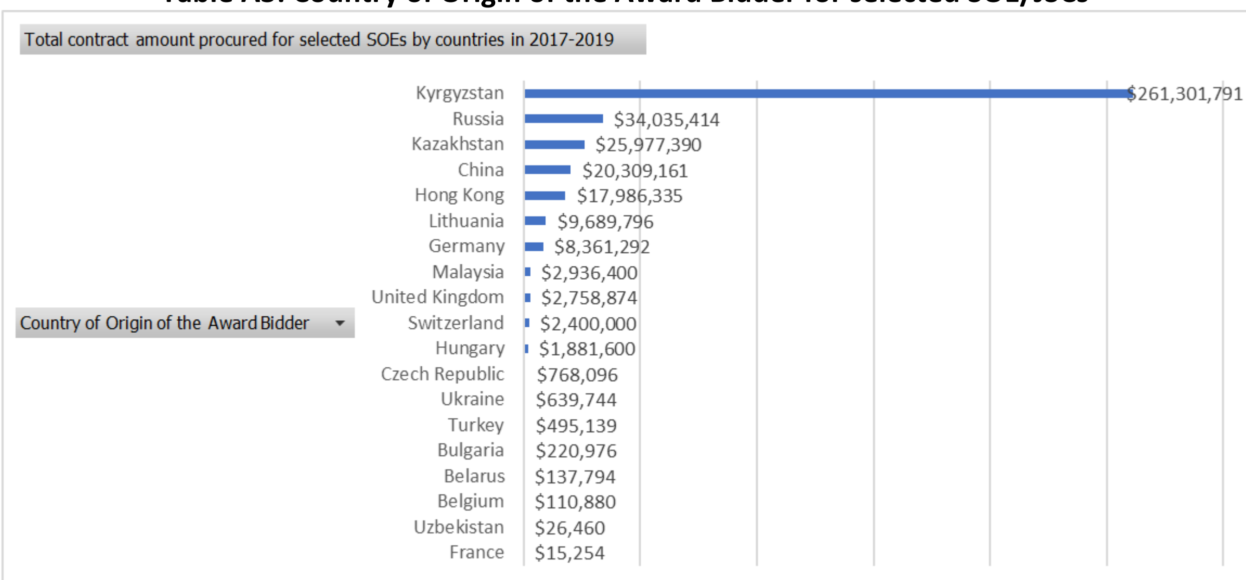
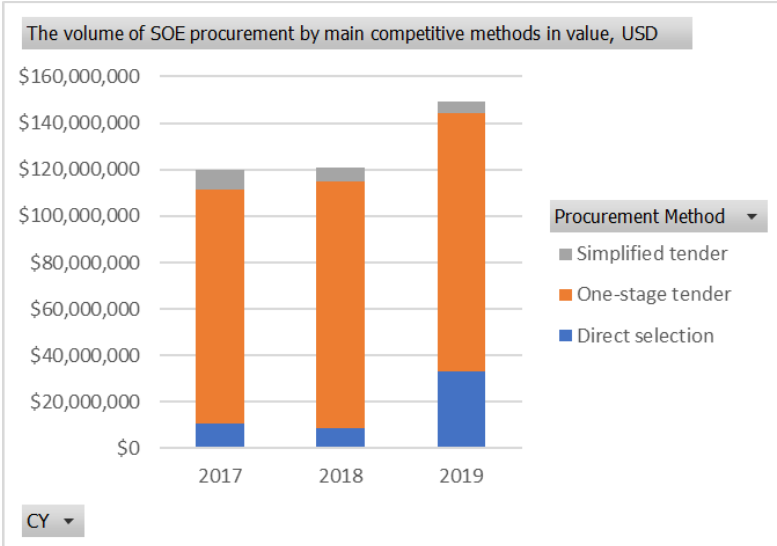


Table A3: Country of Origin of the Award Bidder for selected SOE/JSCs



The legislation allows for two-stage bidding in case of complex procurement contracts. The review shows that the share of direct contracting is growing due to changes made to the PPL in January 2019, allowing new justifications for direct contracting. Before its recent amendment, PPL already allowed for more possibilities to use SS method in case of different reasons. Because of this additional flexibility in the law, the direct selection method was used more in 2019 than in 2018.

Table A4: The volume of procurement of the selected SOEs by methods, USD



Quantitative assessment of the sample demonstrated relative efficiency of the procurement process and the use of e-procurement. The assessment found that the average time to procure goods, works, and services via open tender procedure takes between 43 and 55 days through the procurement portal, as detailed below. Overall, the assessment demonstrated the following encouraging results:

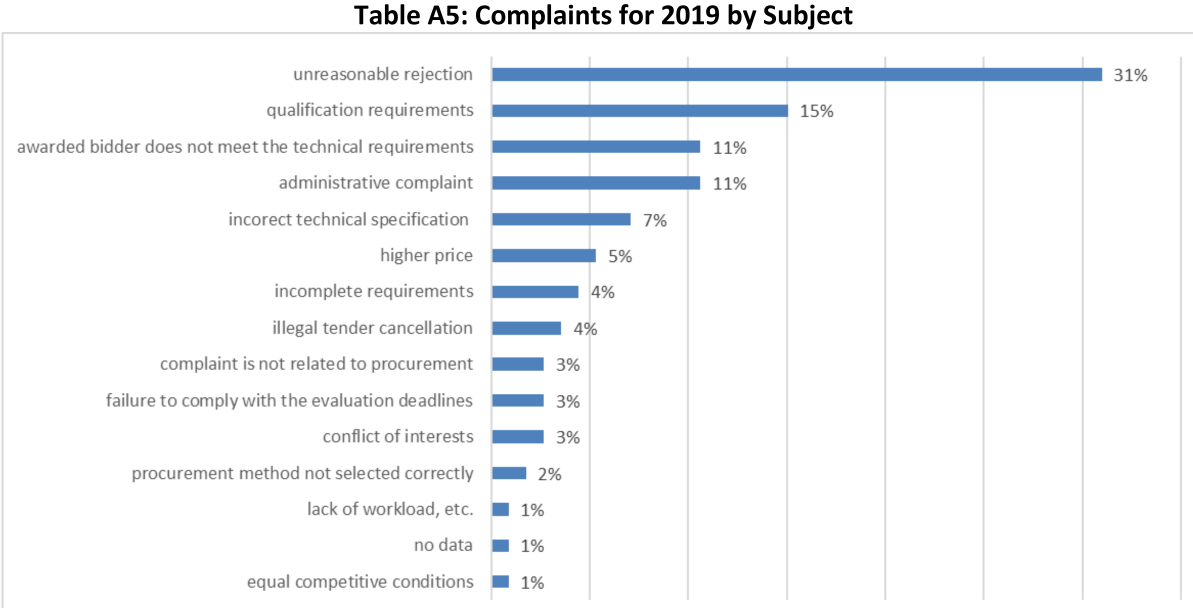
- ✓ The procurement lead time is sufficient for successful procurement: the number of days between date of invitation to bid and date of signing the contract by method are satisfactory.
- ✓ Competition level is adequate: it may be further improved by publishing advertisements for one-stage tenders on popular business websites to attract foreign bidders.
- ✓ All procurement records are securely maintained on the public procurement web portal and are accessible by all interested parties.

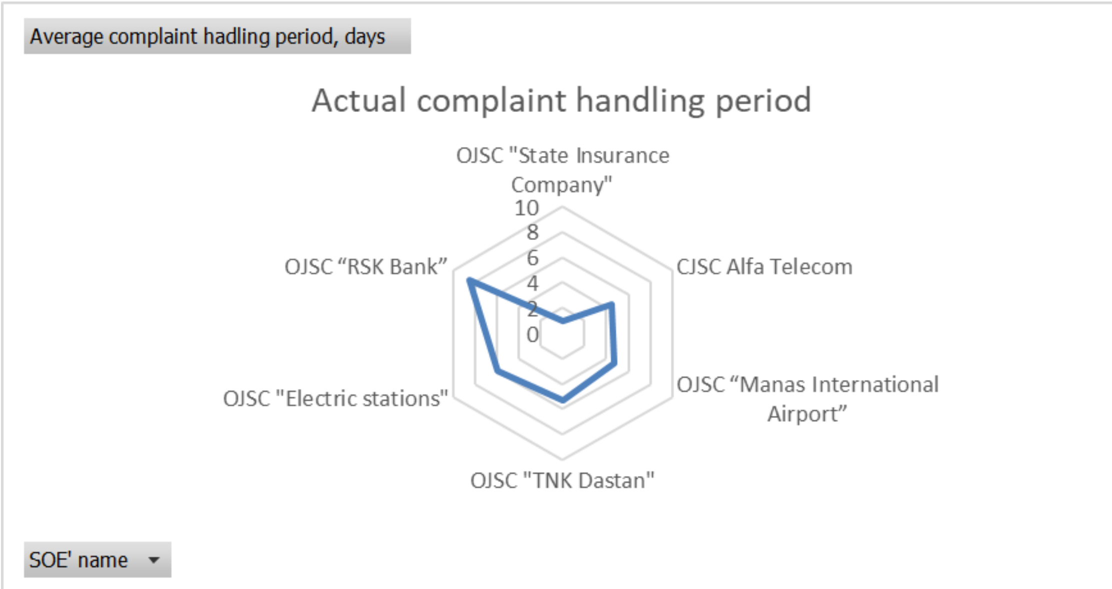
	Indicator	Measure	Method	Target	Baseline
1	*Procurement lead time*	Number of days between date of invitation to bid and date of signing the contract by method:			
			One-stage tender (one-envelope)	Not more than 44 days	43 days
			One-stage tender (two-envelopes)	Not more than 51 days	55 days
			Simplified tender (shopping)	Not more than 37 days	29 days
2	*Time from bid opening to contract signature*	Time from bid opening to contract signature by method:			

			One-stage tender	Not more than 30 days	32 days
			Simplified tender (shopping)	Not more than 30 days	22 days
3	*Average number of bids received by method*	Competition level			
			One-stage tender	More than 5 bids	4 bids
			Simplified tender (shopping)	More than 5 bids	6 bids
4	*% of re-bid*	Number of unsuccessful bidding processes versus number of successful (re-tenders)	All methods	Less than 5%	0.85%

The complaint process is well structured and handles complaints effectively. PPL establishes the ICRC, which consists of representatives from several ministries, state committees, departments and independent specialists certified in public procurement. Upon receipt, the ICRC examines the complaint in electronic format. Complaints are reviewed by a panel of experts who have completed the mandatory procurement training. The complaints sample is presented below by complaint subject. The assessment confirmed that the ICRC reviewed all complaints within the allocated time for 113 selected complaints of the six companies in 2019.

Table A5: Complaints for 2019 by Subject





The conducted analysis corroborated by data, confirms that the unified public procurement framework is beneficial for Kyrgyz SOEs and the Kyrgyz Government. This framework enhances competition, facilitates access for all interested companies to procurement opportunities, and increases transparency and accountability of the procurement process.

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