

# Corporate Governannce of Public Utilities

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## Corporate Governance

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## Corporate governance of public utilities

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

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

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

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# Board composition in the public utilities: A focus on independent directors<sup>a</sup>

Sara De Masi\* Andrea Paci \*\*

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

## Introduction

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

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

Although most of these studies focus on different industries, the role of independent directors is more relevant and more critical in the public utilities than in other companies. In this article we discuss the role of independent directors on corporate boards, focusing on public utilities. We challenge the conventional wisdom regarding their

influence on firm performance and we suggest other corporate issues on which independent directors may have a stronger effect.

## The debate over the independent directors

There is a long tradition of considering the independent directors within the debate on corporate governance. This discussion has paralleled the introduction of new rules and corporate governance guidelines regarding the increase in the number of independent directors on corporate boards<sup>1</sup>. Most of the European countries have enacted Corporate Governance Codes with similar requirements, clarifying the convenience of a higher representation of independent directors in the boards. For instance, in Spain, the corporate governance code argues «the number of independent directors should not fall below one third of the total members [...] The primordial mission of independent directors is to ensure that the interests of the floating capital are heard in the board of directors» (1998, p.13). According to the Italian corporate governance code, «the number of independent directors should be adequate in relation to the total number of non-executive directors [...] and in the FTSE companies, independent directors have to account at least for one third of the total members in the board» (2011, p. 16). The code specified that independent directors have to verify that potential conflicts of interests between the interests of the company and those of controlling shareholders and between the interests of the company and those of managers are assessed with adequate independence of judgment<sup>2</sup>.

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

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

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

a) This article was adapted from "Independent directors: Are they really effective or just a myth?" presented at the Conference on Corporate Governance in Network Industries, October 30-31, 2013 in Vienna, Austria.

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common view that independent directors are better able to contribute to positive firm results. On the one hand corporate governance codes specified clearly the opportunity to have independent directors in the board, on the other hand academic research has questioned the tasks the independent directors are supposed to carry out.

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

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

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

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

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

Agrawal and Knoeber, 2001; Rosenstein and Wyatt, 1997).

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

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

### **Independent directors in the public utilities**

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

<sup>3</sup> Cf. Article 3(1) of Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (Universal Service Directive), OJ L 108, 24.4.2002, p. 51.

versus the universality of the service.

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

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

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

### Independent directors and firm performance

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

resting, because, during this period, corporate governance codes in Europe have increasingly stressed the importance of having more independent directors in the corporate boards. This has led to a common behavior in European companies consisting in an increase in the number of independent directors<sup>4</sup>.

We look at European countries subject to the European Commission' guidelines regarding public utility services (Green Paper, 2003). Specifically, we focus on the largest European economies by GDP. They are France, the United Kingdom, Italy and Spain<sup>5</sup>.

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

Variable	Obs	Mean	Min	Max
Values in number				
Board size	271	10,68	3	23
Number of independent directors	250	5,30	0	16
Number of executive directors	255	2,28	0	9
Values in Percentage				
Independent directors scaled by board size	250	49%	0%	89%
Executive directors scaled by board size	255	25%	0%	100%

Table 1 – Board composition (Full sample)

<sup>4</sup> The starting year (2002) is due to the availability of corporate governance data and the firms' attitude to disclose information about their board composition.

<sup>5</sup> We exclude Germany. The reason is that German corporate governance model is profoundly different from the other companies in our dataset. Specifically, German companies have two separate governing bodies that operate independently: the supervisory board and the management board (so called "two-tier system"). The management board conducts the day-to-day management of the company, while the supervisory board has the monitoring function. In the management boards every members are executive directors. Without heterogeneity in the board composition, we cannot test the effect of independent directors. Hence, we exclude Germany and other companies adopting the two-tier system.

We use two measures for firm performance: EBIT (accounting-based measure) and Market Value of Equity (market-based measure).

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

Figure 1 – The ratio between the average number of independent directors and the average board size among the countries (2002-2006)

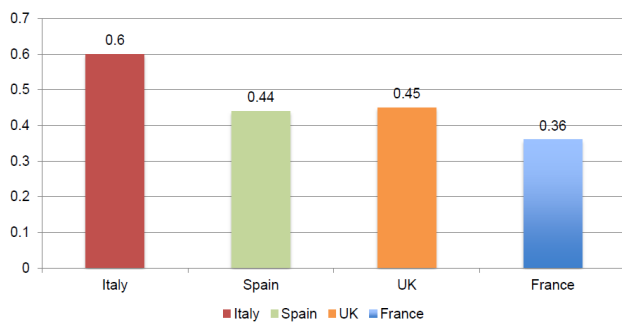
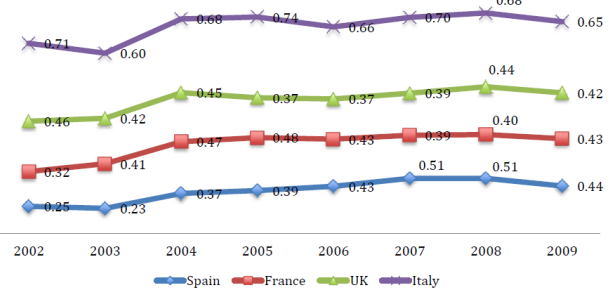


Figure 1 reports the ratio between the average number of independent directors and the average board size among the countries. Italy shows the highest value. This means that in Italy the average percentage of independent directors in the board is 60%, 45% in the UK, 44% in Spain and 36% in France. Interestingly, Figure 2 reports the path of ratio of the average number of independent directors over the average board size from 2002 to 2009.

The European countries in the dataset exhibit a similar path. This empirical evidence shows the convergence, among European countries, towards a higher number of independent directors in the boardroom. Specifically, in these years, European corporate boards have followed the corporate governance guidelines that suggested an increase in the number of independent directors.

Figure 2 – The path of the ratio between the average number of independent directors and the average board size

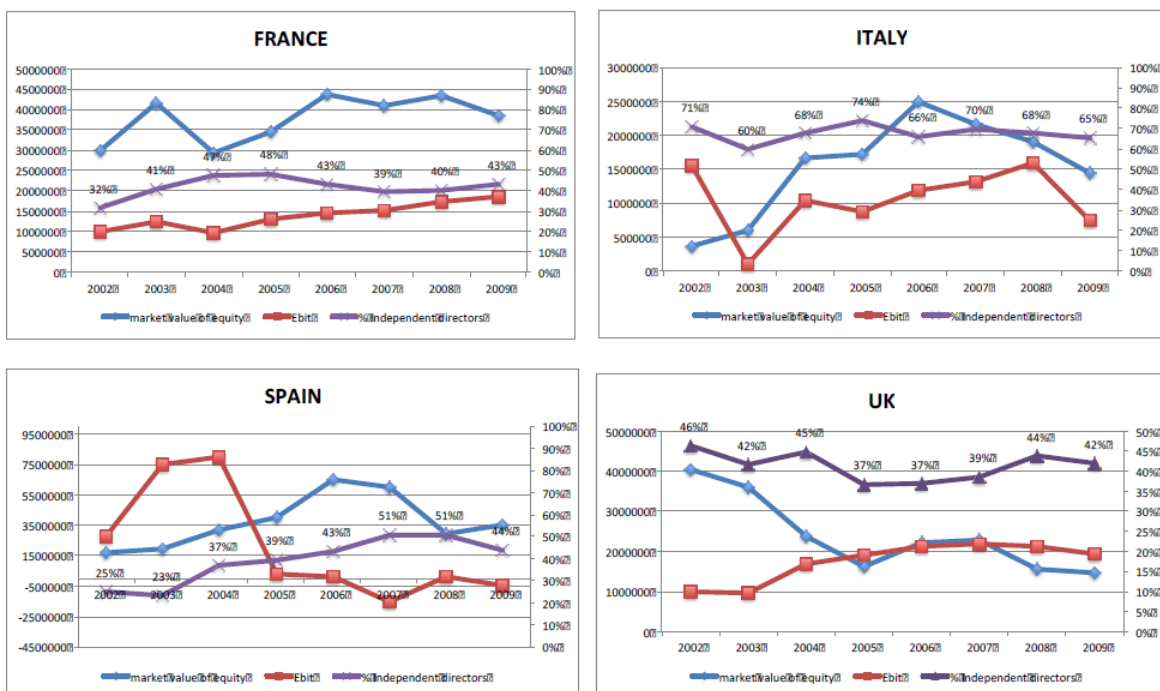


In Figure 3, we report, country by country, the path of the average percentage of independent directors in the boardroom and the path of two measures of firm performance: Ebit and market value of equity. The average percentage of independent directors and the firm performance do not exhibit a similar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

**Conclusions**

Corporate governance—and, in particular, board composition—has been a topic of much attention lately.

Figure 3 – The path of the average percentage of independent directors and the firm performance



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

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

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

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

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