CORPORATE GOVERNANCE MODELS AND THEIR IMPACT ON FINANCIAL PERFORMANCE. EVIDENCE FROM ITALIAN UTILITY LISTED COMPANIES

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Abstract

This paper analyses the theme of the corporate governance models of Italian utilities companies and explores how the changes of ownership structure after a merger affects financial performance. The objective of this paper is to study whether the mergers of utilities are effective for companies to be more competitive. We compare the financial performance of four Italian utility listed companies listed (A2A, IRIDE, HERA and ENIA) before and after the merger. Specifically we analyse six financial ratios (P/L for period, Profit margin, EBITDA, ROE, ROA and Gearing). Our results show that utility mergers are effective to create a more competitive firm because of the changes in the ownership of the company and consequently in the corporate governance system. Results also indicate that a listed merger company has a higher financial performance that pre-merger companies.

Keywords: Corporate Governance Models, Financial Performance, Mergers, Utility, Italy

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1. Introduction

Public sector reform initiatives worldwide as parts of the New Public Management (NPM) movement have resulted in a variety of governance arrangements for public services delivery (Hood 1991, Kettl 2000). New governance forms such as government-owned companies, public-private partnerships, contracting-out or private companies together with the implementation of NPM elements (e.g. accountability on results, performance measurement and budgeting, and whole of government financial reporting) are often used by public organisations to react to external pressures and challenges related to public services provision (Doherty and Horne 2002, Torres and Pina 2002, Dexia 2004, Reichard 2006, Grossi 2007).

These changes of public governance associate closely with discussions about public services performance (Hartley and Skelcher 2008, Skelcher 2008, Osborne 2010) and give rise to questions on the relationship between governance and performance, since the public sector reforms in the Western democracies have been initiated in the name of performance improvement (Van Dooren *et al* 2010).

In the light of that, the present research focusing on the public governance and performance relationship contributes to a research area that is topical and is expected to be important for maintaining and enhancing public services in the years ahead.

In the context of public services, Skelcher (2008) shows that there is little systematic research conducted on the relationship between public governance and performance, the debate lacking 'an integrated corpus of empirically based knowledge.' In the same vein, a meta-analysis of the literature by Hill and Lynn (2005) on that field concludes that there is a large research gap as regards to the influence of governance on performance in public services. The present research seeks to fill this gap by applying a holistic in-depth research approach and mapping the patterns of governance influence on public services performance.

This paper analyses the context of the four Italian utility listed companies and explores how changes in the ownership structure after a merger affect financial performance (Wettenhall and Thynne, 2005; Gomes and Novaes, 2006; Sorensen, 2007).

The article is organised as follows. In the next section, we develop the theoretical framework. Section 3 describes de data and methodology employed. Section 4 shows results and, finally, in Section 5 the conclusions are presented.

2. Theoretical framework

2.1. Merger and models of corporate governance of utilities

A changing scenario and a higher level of competitiveness force smaller public service companies (mostly owned by local governments) to react and find the proper strategies to keep their market shares (Hughes, 1994; Osborne and Brown, 2005; Grossi, 2007). Well-established and territorial concentrated companies more easily overcome *free-rider* problems and better compete for political favours. Therefore, in the case of a utility merger, the main objective may be the pursuit of competitive advantage, through the sharing and combined development of resources and competencies, in order to compete with national and international rival companies (Bachiller and Grossi, 2012). Mergers of local utilities seem to be more popular in Italy, where local utilities often merge to constitute large-scale corporations (mainly in the cases of the largest cities, Rome, Genoa, Milan, Bologna and Turin).

The joint stock company is attractive in Italy, as local utilities have the opportunity to register at the Stock Exchange and thus have easy access to the capital market. Municipalities play two different roles in governing owned corporations: they are owners (shareholders) and they are contractors (purchasers) and regulators of services. Both roles can be in conflict (Grossi *et al*. 2010).

Governance mechanisms have to take account of this double role. Governance depends largely on commercial law, that is, the law on limited liability companies and stock corporations. This legislation focuses on the shareholders' interests and provides few mechanisms in favour of the purchasers' role.

Relationships between local governments and the various joint stock and limited companies used are regulated by service contracts. In order to allow for a tight results control, local governments need to arrange contracts which clearly state what the desired results are and set specific targets that are consistent with its strategic plans (Greve, 2008; Grossi, 2005). The municipality is at the same time purchaser, local regulator and shareholder, which may cause conflicts of interest. This applies not only to the companies which are totally owned by local governments, but also to the mixed ownership companies, including those which are listed on the stock exchange. The problem of interest conflicts is especially strong in the water, waste and transportation sectors, because in those sectors no strong national authorities exist and the municipalities are the only real regulators (Argento *et al*, 2010, p. 48).

Italian corporations are based mainly on a one-tier board system (so called Latin model), and the shareholders' meeting is quite influential. Additionally, there is a board of auditors, which inspects the financial reports. The board of directors is composed by independent members and former politicians (Grossi *et al*, 2010).

The shareholders' meeting is really only meaningful when a company is owned by more than one local government or has mixed public-private ownership. The meeting is formed by the mayors of the municipalities which are the owners of the company, along with other owners in the case of a mixed ownership company. The meeting approves (or does not approve) the annual report of the company (but seldom the budget). Sometimes, the shareholders approve 'strategic documents' for the company, which the directors must respect in managing the company. The board of directors is an independent body in managing the company. Shareholders cannot directly interfere in the management of the company. Directors are nominated by the mayor or mayors by a personal decree and are appointed by the shareholders' meeting, which decides the number of directors and their remuneration (Grossi, 2007). In some cases, local government representation on the board of directors is exactly proportional to a local government's participation in the equity of the company. In other cases, it can be more than proportional, with a local government having the right to appoint the majority of directors without holding the majority of the shares. The term of office for directors is three years. Internal financial control of a company is guaranteed by the board of auditors, appointed by the shareholders' meeting and consisting of independent personalities.

The one-tier model of governance outlined above continues to be used by a great majority of Italian listed companies, including those that operate in the sector of local public services, but we have a growing number of companies that they are using the two-tier system (so called German model).

In the two-tier model a part of the shareholder's powers, including those of nomination of the executive body and approval of the annual report, are assigned to the supervisory board which operates as a controlling body of the Board of directors. However, when compared to the previous model, the relationship of trust between the supervisory board and the Shareholder's Meeting seems to be weaker. The supervisory also carries out functions of supervision and control over management assigned in the traditional system to the Board of Auditors.

In the dualistic model, the role of the Shareholders' Meeting is certainly reduced in favour of the supervisory board. In the case of local public services, considering the current ownership structure configuration, adoption of the dualistic model should not, in theory, create particular problems, as it involves less direct involvement of the local government owner in processes of the nomination of the board's members.

A municipal council does not participate in the management of a company. It decides only on the

creation of new companies, on possible mergers and on liquidation. Mayors and members of the mayoral cabinet cannot be appointed to the boards of directors. Conflicts of interest are regulated by the commercial law (civil code). In the case of companies listed on the stock exchange, shareholders must respect a specific self-regulation code (the so-called Preda Code) in appointing the directors (Grossi, 2007).

In the case of companies owned by two or more local governments, relationships between the shareholders are regulated by specific 'shareholder agreements'; and in the case of companies with a mix of public and private ownership, the relationships are regulated by 'agreements between partners'. These agreements include methods for appointing the boards of directors, the company presidents and/or CEOs and the boards of auditors. The statutes of the company define the majority shareholding necessary to approve the balance sheet and other extraordinary decisions (such as liquidation) in the shareholders' meeting.

The legal framework for local governments in Italy has not been as stable over time. During the last two decades, the regulation of local public service provision has been changed several times. Currently, a distinction is made between the management of local services of economic relevance (energy, water, waste disposal, public transportation) and the management of local services without economic relevance (esp. theatres, museums). The arrangements for the provision of services of economic relevance are the subject of particular concern and debate. At the national government level, because of European Commission pressures, there is support for restricting both direct management and mixed ownership management in favour of the competitive selection of public and private providers through public tender (Argento *et al*., 2010). According to the new national law on public service provision of 2010, the private partners selected through public tender should be involved in the management of the service(s) and be owner at least of 40% of the shares. According to the same legislation, in the case of listed companies involved in the utilities, public owners (such as regions, and local governments) should reduce their shares to 40% by June 2013 and to 30% by June 2014.

2.2. Financial performance of utilities

The provision of public services by means of utilities has substantially changed in the past two decades. The public economy in many countries developed specific modes and different institutional arrangements of provision. In the European Union as well as outside, utilities have been involved in a liberalisation process. Enhanced competition has a positive impact on efficiency gains through stimulating managerial effort to face the risk of losing market share or providing greater opportunities for comparing performance across firms (OECD, 2007). To have efficient public utilities it is necessary to introduce competition, which will guarantee that private firms or even public firms will be obliged to act to lower costs and improve the quality of the good or service provided. Therefore, it is supposed that liberalisation policies in network industries have led to higher performance, better quality and, often, lower prices.

Economic and technological variables are also highly significant in explaining variations in the timing and extent of changes in utility sectors at both European and domestic levels. Progress in technology has contributed to redesigning service production and delivery. It has even caused the break up of those monopolies that were considered to be natural ones. Therefore, there are economic and technical possibilities of liberalization, which makes it possible for the new companies to enter the market. For local companies, on one hand, it means an opportunity of entering into the market (to which they have not had an access so far), but on the other hand, it appears the risk of being overtaken by other companies operating on an international level. This is especially a threat to Italian companies that are smaller than their foreign competitors (Rienzner and Testa, 2003). International market and technological forces increased the institutional resources, allowing the progress liberalization (Humpreys and Padget, 2006).

To understand the performance of utilities, we must consider the market regulation. The transition towards the free market, the rules governing the market, and the necessity to regulate certain aspects of service require new procedures regulating the production and the delivery of these services. For this, impartial authorities create benchmarking methods that involves decisions about data requirements, collection procedures, reporting formats, and quality of supply as well as regulatory governance issues such as commitment and transparency. Regulators are developing the so-called incentive regulation. The main objective of this method is to promote efficiency improvement by rewarding good performance relative to some pre-defined benchmark.

Farsi and Filippini (2009) assert that because of their considerable economies of scale, a direct introduction of competition is not optimal in sectors such as energy. Instead, incentive regulation can be used to ensure the productive efficiency of the utility companies. Incentive regulation differs from ROR regulation by allowing the earnings of the regulated firm to diverge from target levels. In particular, the firm is permitted to keep some or all of its incremental earnings. Consequently, incentive

regulation may provide the regulated firm with greater incentives than ROR regulation to increase its revenues and reduce its operating costs and managers may be more willing to correct possible inefficiencies in their regulated firms (Lewis and Sappington, 1989; Parker, 1999; Sappington, 2003; Armstrong and Sappington, 2006). Although regulated companies can reduce costs to prevent new companies from entering into the market, incentive regulation is more appropriate to ensure adequate competitive pressure and to avoid problems of opportunism. This regulatory system provides incentives to develop new technologies, which allow companies to save costs and, thus, to obtain more benefits. So, incentive regulation gives more productivity gains, even when the market is non-competitive and the company does not need to be efficient. In short, this regulatory system is adequate when the regulatory objective is to maintain the market efficiency until the market is really competitive.

In general, we can assert that the aim of the regulatory reforms is to provide the utilities with incentives to improve their investment and operating efficiency and to ensure that consumers benefit from the efficiency gains. A related aspect of regulatory reform is regulatory governance which emphasises the formal status of the regulator and rules of conduct in carrying out their duties and exercising power.

These changes in the environment result in a redefinition of the company's organizational processes and the reformulation of the strategy. A major consequence of liberalisation is that utilities can prefer merge to increase their market share, therefore several recent takeovers in Europe involved newly privatised firms. In the economics literature, the traditional motives for mergers and acquisitions involves such notions as synergies, economies of scale, marketing advantages and even better management. Managers of merged utilities are subjected to the pressure of the financial markets and monitors and disciplines profit-oriented investors. The accountability to shareholders and the introduction of incentive systems give a better incentive for utility companies to operate efficiently (Jia, 2009). Moreover, these companies are introducing instruments for performance measurement in order to enhance transparency and improve organisational learning (Johnsen *et al*., 2006; Van Helden *et al*., 2008).

However, concentration is another important obstacle to both the development of more vigorous competition in the sector and the development of liquid wholesale markets. In the EU, concentration in the sector remains high, with the exception of the Nordic and UK markets which now have between five and ten major competitors plus a range of smaller companies in the generation sector (OCDE, 2007). Mulherin *et al*. (2004) claim that mergers of privatised entities result in wealth creation and better performance. In the merger process, companies introduced instruments for performance measurement in order to enhance transparency and improve organisational learning (Johnsen *et al*., 2006; Van Helden *et al*., 2008). Moreover, the capital markets work as a mechanism to establish management incentives for the companies previously non-quoted.

In energy sector, reforms are transforming the structure and operating environment of this industry across many countries. The central aims of these reforms are to introduce market-oriented measures and to improve the efficiency of the natural monopoly activities of distribution and transmission (Jamasb and Pollit, 2001). The main feature of many sector reforms is the market-orientation by using the discipline of the product and capital markets to achieve efficiency through competition, privatisation, and the price mechanism (Vickers and Yarrow, 1988). These reforms generally involve design of organised power markets and, as we have commented, the introduction of benchmarking that improves the performance.

The re-organization of energy companies resulted in the implementation of an expansionist strategy by companies. In this sector, horizontal integration strategy allows the multi-utility companies to save on cost by exploiting the economies of scope and to provide customers with an integrated set of services. The perceived need for some utility companies to expand in order to increase profits is supported by the wider global liberalization of the energy industry, the need for greater performance by utilities and the support by the EU Commission to promote an internal energy market. The common legal framework brought about EU membership does influence the strategic thinking and asset management of utilities. Importantly, it affects their strategic movements, which reflect the broader influence that EU enlargement has on the operation of utility companies. In the long term, both EU and company strategies aim to increase coordination and cooperation across country borders, allowing greater emphasis to be given to regional coordination of companies (LaBelle, 2009). EU membership played a key role in fostering a common legal framework in each country and encouraged the opening of national markets for investments. The newest task for countries in the EU, and those looking to join in the future, is the development of regional markets. Such markets may allow greater coordination of assets, greater efficiency for energy producers, and the potential for a higher level of competition.

3. Sample and Methodology

3.1 Corporate governance models

A2A, Hera, Iride and Enia are multi-utility companies, which are listed in the electronic stock market. These four companies have a very solid financial structure and a market capitalization of more than one billion euros. The criteria for the selection of these four companies lie in the particulars, as they are:

- Companies that are partially owned by local governments,
- Companies that are managing local utilities,
- Companies that are listed on the stock exchange and,
- Companies that were interested in merger process during the last years.

Table 1. Corporate Governance Models of Italian utilities listed on the Stock Exchange

Company and year of birth	Ownership structure	Model of corporate governance	Location of business	Business Sector
ENIA (2005)	21,85% City of Reggio Emilia 17,20% City of Parma 4,6% City of Piacenza 7,97% Other municipalities 38,88% Private owners	One-tier board system	Emilia Romagna Region	Water, gas and environmental services
HERA	18,8% City of Bologna 3,3% City of Ferrara 13,95 City of Modena 26,0% Other Local Governments of Emilia Romagna 7,5% Banks 30,5 % Private owners	One-tier board system	Emilia Romagna and Marche Regions	Water, electricity, gas and environmental services
IRIDE (2006)	58,9% FSU 4,7%,Intesa Sanpaolo Bank 4,0% Foundation CR TORINO 31,7% Private owners 2,0% Generali Insurance Company	One-tier board system	Piemonte, Liguria, Lombardia, Toscana and Marche Regions	Water, and electricity
A2A	27,5% City of Brescia 27,5% City of Milano 2,0% City of Varese 2,0% City of Bergamo 7,5% Private owners 34,8% Shareholding	Two-tier system	Lombardia Region	Water, gas and electricity

This is situation is updated to June 2010.

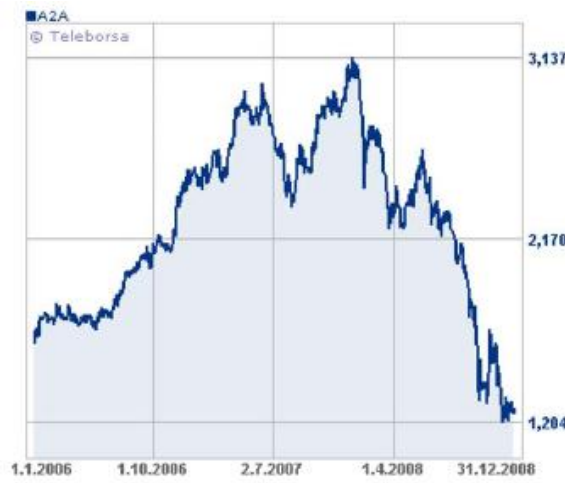
IREN was set up on 1st July 2010 through the merger of Enìa and Iride and is at the top in the Italian multi-utilities sector occupying a leading position in its business areas, a balanced mix of regulated activities and free activities and a close integration between upstream and downstream activities. Due to its production assets, its past and present investments, its position in all business areas, in all phases in the energy chain, and its roots within the country, IREN is now one of the main Multi-utilities Groups on the Italian scene.

3.2 Financial performance (for utilities)

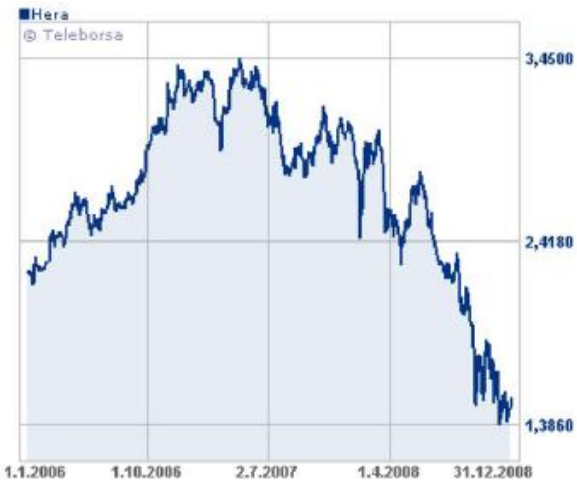
The companies analysed are listed in the stock market. Figure 1 shows evolution of share price in the Italian stock market.

Figure 1. Evolution of price share in the Stock Exchange (2006-2008)

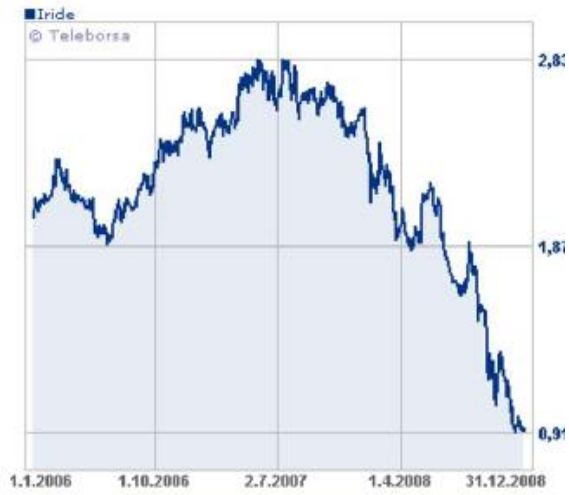
A2A



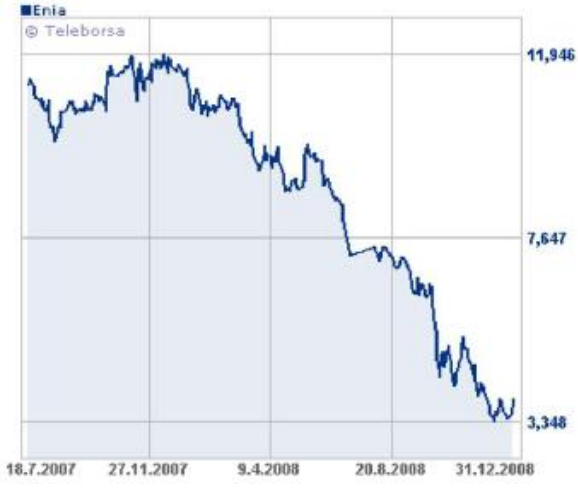
HERA



IRIDE



ENIA



- All the companies showed a negative tend in capital markets from 2007, except to A2A that achieve to improve its value in the middle of this year.

- The price of shares for all the companies decrease significantly in 2008, probably due to Italia, as the rest of countries, has experienced the international crisis. The significant recovery of A2A in 2007 may indicate that the German model of corporate governance used by the company is seen positively by the investors in the stock markets.

3.3 Methodology

We compare the financial performance of four Italian utility companies listed in the Stock Exchange (A2A, IRIDE, HERA and ENIA) before and after the merger. We analyse six financial ratios (P/L for period, Profit margin, EBITDA, ROE, ROA and Gearing) (Table 2).

Table 2. Ratios for financial performance of companies analysed

Variable	Ratio
P/L for period	Profit/Loss before tax
Profit margin	Profit/Loss before tax / Operating revenue
EBITDA	Earnings before interest, taxes, depreciation, and amortization
ROE	Earning before taxes / Equity
ROA	Earning before taxes / Total net Assets
Gearing	Long term financial debts + other long term liabilities / Capital + other shareholders funds

4. Results

We explore the financial performance of 4 Italian firms. The seven ratios are described in Table 2. (to create table with description of ratios). The table 3 reports company's ratio for each company during the period 2006–2008.

Table 3. financial performance

	A2A S.P.A.				IRIDE S.P.A.			
Th Euros	2006	2007	2008	2009	2006	2007	2008	2009
P/L for period	462000.00	486000.00	347000.00	107000,00	595.41	7089.53	10922.49	8863.35
Var. %		5.19	-28.60	-69,16		2.66	3.73	2.75
Profit margin	7.68	8.35	9.17	2,22	2.54	15.29	19.26	16.80
Var. %		8.72	9.82	-75,81		2.66	3.73	2.75
EBITDA	1400000.00	1473000.00	1068000.00	1021000.00	n.a.	12649.11	10927.66	9938.47
Var. %		5.21	-27.49	-4.40		n.a.	-13,61	-9,05
ROE	12.75	12.44	11.84	2.33	0.83	9.08	13.11	11.77
Var. %		-2.43	-4.82	-80.33		988,73	44,36	-10,22
ROA	4.10	4.54	5.01	0.88	0.28	2.66	3.73	2.75
Var. %		10.73	10.35	-82.43		867,27	40,11	-26,24
Gearing	161.72	133.66	99.32	132.12	20.12	18.12	16.60	18.23
Var. %		-17.35	-25.69	33.03		-9,93	-8,41	9,82

	HERA S.P.A.				ENIA S.P.A.			
	2006	2007	2008	2009	2006	2007	2008	2009
P/L for period	100238.00	109903.00	110264.00	84964.00	31025.83	30328.20	37839.54	38056.39
Var. %		9.64	0.33	-22.94		-2.25	24.77	0.57
Profit margin	7.01	4.54	4.67	3.70	4.42	4.40	4.08	6.09
Var. %		-35.26	3.07	-20.75		-0.50	-7.18	49.16
EBITDA	426678.00	453378.00	528301.00	525301.00	127726.41	138217.11	148982.92	163147.36
Var. %		6.26	16.53	-0.57		8.21	7.79	9.51
ROE	6.61	7.14	6.98	5.00	6.88	4.33	7.12	7.13
Var. %		8.05	-2.24	-28.45		-36.99	64.38	0.14
ROA	2.30	2.30	2.00	1.45	1.78	1.58	2.09	2.00
Var. %		0.13	-12.99	-27.41		-11.23	32.07	-4.41
Gearing	120.49	134.34	140.96	164.02	173.48	91.54	142.04	181.45
Var. %		11.49	4.93	16.35		-47.23	55.16	27.75

Note: Var. % indicates the increase or decrease of the figure between one year and the previous one.

This table shows the variables of the financial performance of the companies analysed from 2006 to 2009. These variables are Profit/Loss for period, profit margin, EBITDA, ROE, ROA and gearing. To extract relevant results, we analyse the variation of these variables between one year and the previous one.

The profit for period decreases during the period analysed. Specially, for A2A and HERA, whose evolution is extremely negative in 2009. In general terms, the profit of IRIDE and ENIA increase and it is notable the increase of 24.77% in 2008 for ENIA.

In A2A, the profit margin has had a favourable evolution until 2009, when this magnitude slumps. In this year, the same occurs for HERA, whose result is also negative in 2007. The profit margin of IRIDE remain steady and that of ENIA decreases until 2009, when shoots up. The evolution of these variables is consistent with the previous one.

As for the EBITDA, by one hand, the evolution of three companies –A2A, IRIDE and HERA- decreases in 2009. By other hand, ENIA obtains good results each year. This variable is indicative of the operative efficacy of the company; therefore, the decrease shows that these companies are not able to carry out an adequate activity in its sector.

The variation of ROE for A2A and HERA is negative during the period analysed. In line with previous magnitudes, this variable plunges in 2009. For IRIDE and ENIA, evolution is positive except to ENIA in 2007.

Results for ROA magnitude are contradictory. The ROA for A2A is higher than other companies, however, this variable decreases in 2009. This decrease also appears for IRIDE, HERA and ENIA, which is consistent with crisis period.

Similar to ROA variable, the gearing shows a negative result for each company in 2009 by increasing its value. Especially significant, it is the increase for A2A and ENIA. This indicates that companies have needed more debt to operate in markets by increasing their leverage until undesirable rates.

As previous results indicate, the evolution of performance of A2A and HERA is negative. By contrast, ENIA obtains good values followed by IRIDE. This is confirmed by the strength of ENIA to acquire IRIDE and stablish the new merged company IREN.

The four lised companies have different models of corporate governance, the German model for A2A and the Latin model for other three companies, so the results indicate that the former model is more appropriate for utilities companies.

Table 4 shows results for IREN in 2010 and the average for ENIA and IRIDE (2006-2009), the merged company compounded by ENIA and IRIDE. As we can see in Table 4, the Profit for period and EBITDA of IREN are extremely higher than that of pre-merger companies (Enia and Iride). The Profit margin is higher than the average of all the companies in Table 3, but this variable is not higher than the average of IRIDE. ROE of Iren is similar to pre-merger companies and the same occurs with the ROA variable. Finally, the gearing is higher for IRIDE than IREN, but lower for ENIA than IREN. According whit data, we can assert that merger has lead to better results for IREN by improving the P/L for the period and EBITDA and maintaining similar results to pre-merged companies for the rest of variables.

Table 4. financial performance

	IREN SPA (2010)	ENIA (2006-2009)	IRIDE (2006-2009)
P/L for period	150,391	34,312.49	6,867.70
Profit margin	8.38	4.75	13.47
EBITDA	473,753	144,518.45	11,171.75
ROE	9.00	6.36	8.70
ROA	2.21	1.86	2.35
Gearing	197.50	147.12	220.29

5. Conclusions

The aim of this research was to analyze the context of Italian utility listed companies and explores how post-merger changes in the ownership structure affect the governance systems and financial performance. The four companies analysed used different corporate governance models, the German and the Latin model and our results indicate that the Latin model is more appropriate for utilities companies to have better financial performance.

According to our data, we can assert that merger of ENIA and IRIDE has lead to better financial results for IREN (the new merged company) by improving its profit and EBITDA.

In conclusion, the evolution of the financial performance of utility listed companies analysed is favourable when they adopt the Latin model of corporate governance. Moreover, we can assert that mergers generate good financial results in the four listed companies. This indicates that sharing control is optimal and increases firm value, as it increases

the equity stake of decision markets. Thus, incentive to obtain private benefits from managers is decreased. Additionally, shareholders in merged company try to prevent decisions that harm minority shareholders. Mergers create control distribution among shareholders and moderate the discretion of main shareholder.

One limitation of this study is that we have only used data from 2006 to 2009, when crisis started to appears in Italy. Therefore, we need to be cautious about evidences. However, this is the period relevant to study mergers in utility companies in the country.

The study has implications for politicians and managers because shows that the one-tier (Latin) model is still preferable to the dualistic (German) model. So, owners should be considered to implement this system to improve financial performance of companies and to be more competitive.

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