

Settings Priority Directions in the Development of Corporate Governance in Russia's Power Industry

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Abstract — The study identifies the strengthening of the board of directors as a priority direction of the development of corporate governance in Russian power generating companies so as to best serve the interests of their investors. This is due to numerous non-compliances of the current corporate practice with respect to those principles of the Corporate Governance Code that they shall be in charge of. These non-compliances are identified by generalized and in-depth appraisals as per the criteria set out by the Bank of Russia for complying with these principles. We propose a range of measures to strengthen the boards of directors. They are concerned with the stages of nomination, election, current activities, and performance evaluation. To this end, we delineate professional competencies of the board of directors members that are relevant under the shortening of strategic planning time frames and the advent of new technologies.

Index Terms — Corporate governance, Corporate Governance Code, Russian power generating companies, board of directors, investors.

I. INTRODUCTION

One of the key objectives of the Russian power sector reform in 2003-2008 in the course of its transition to a market economy was to set the stage for attracting investment. However, the power generating companies established back then as part of the reform were indemnified for their investment in new capacity additions as per a non-market driven procedure of capacity contracting (CC). After the

expiration of the CCs, the Government of the Russian Federation enacted another large-scale upgrading program for combined heat and power plants. The projects deemed eligible for the program will also be entitled to guaranteed break-even arrangements by imposing higher capacity tariffs on the consumer [1]. Under such circumstances, the issue of enhancing the investment appeal of the companies remains relevant. One of its key indicators adopted as part of international best practices is corporate governance. Its purpose is to facilitate the establishment of the environment of trust, transparency, and accountability required to provide incentives for long-term capital investment [2].

Apart from the guaranteed payback of investment through increased payments from consumers, which is practiced in Russia, the following main reasons impeding the development of domestic corporate governance are identified: relatively little experience in this area; insufficiently developed Russian corporate legislation and internal documents of the companies, which do not completely meet the internationally recognized corporate governance standards, their declarative and formal implementation; high concentration of ownership with the interests of major shareholders dominating those of minority shareholders, with characteristic violations of their rights (to membership in boards of directors and regulatory bodies; compulsory dividends; and access to complete, timely and reliable information about the company); permanent redistribution of ownership; mixing functions of the state as a major shareholder and regulator which contradicts the basic principle of corporate governance for state participation companies, which is established by the Organization for Economic Cooperation and Development and suggests separation of these functions; mixing powers and responsibilities between major shareholders and hired top managers; relatively weak external corporate control by the stock market and the banking system; lack of long-established traditions of corporate social responsibility, corporate ethics and business culture; lagging in the application of new management technologies.

The purpose of the study performed by the author is

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to identify a top priority direction of the development of corporate governance in Russian power generating companies that is aligned with the interests of investors and accommodates the changes that have taken place in the external environment.

The methodology behind this study is based on the Guidelines of the Bank of Russia on complying with the principles and recommendations of the Corporate Governance Code (Letter No. IN-06-52/8 of the Bank of Russia dated February 17, 2016) [3]. Identifying a priority direction of the development of corporate governance was carried out based on generalized data of comprehensive assessments of the current corporate practice adopted by 12 Russian power generating companies that made publicly available Addendum “On compliance with principles and guidelines of the Corporate Governance Code” to their 2017 annual reports. [4–15]. The proposals previously contributed by the author to this field have been updated to match the changes in the external environment [16]. The study makes use of the data provided by information agencies as well the research contributions made by the New Economic School and the Russian Institute of Directors to corporate governance studies [17, 18].

This study identifies the strengthening of the board of directors as a priority direction for the development of the corporate governance of Russian power generating companies. This proves to be in line with the findings obtained by the “Platforma” Center for Social Engineering, the Center for Strategic Studies at the Moscow State Institute of International Relations, the Association of Independent Directors, and the National Research University Higher School of Economics [19–21].

The findings of the study performed bear on further enhancing the investment appeal of Russian power generating companies and making more well-grounded and balanced decisions on the part of investors when investing their funds in these companies.

II. CURRENT PRACTICE IN CORPORATE GOVERNANCE

The practice currently adopted in corporate governance of Russian power generating companies was assessed by the methods of generalized and in-depth evaluation. The generalized evaluation was performed against the 79 corporate governance principles of Level 2 that have three-digit codes assigned to them ('1.1.1.' or '1.2.3.' and so on). The status of compliance to these principles (“compliant”, “partially compliant”, “non-compliant”) was treated without a further breakdown by the compliance criteria for each of them. This method of evaluation is common for the majority of the companies, which follows from their annual reports on the compliance with the corporate governance principles of the Code. For the rest of the companies, the “partially compliant” status was assigned in the case of their failure to meet at least one of the criteria. The findings of the evaluation of the compliance with the Level 2 corporate governance principles as stipulated in the Code

are presented in Table 1.

The values presented in Table 1 show that there are substantial differences with respect to the extent Russian power generating companies comply with the corporate governance principles. The top ranking companies here are PJSC Inter RAO, PJSC Enel Russia, and PJSC RusHydro. Of the total of 79 principles covered by the study, they comply with 73, 62, and 59 principles respectively. PJSC Quadra and PJSC TGK-2 are the lowest ranked companies. They scored well below the rest with 33 and 32 principles to their credit respectively. The comparative analysis of the “partially compliant” status among the companies that rank both in the top and the bottom yields practically the same correlation. PJSC Inter RAO, PJSC Enel Russia, PJSC RusHydro partially comply with 4, 13, and 17 principles respectively. The corresponding values for PJSC Quadra and PJSC TGK-2 are 27 and 32 principles respectively, thus lagging behind PJSC Inter RAO scoring 7 to 8 times lower. The disparity between the companies that perform best and worst with respect to the number of principles they fail to comply with proves even more pronounced. In particular, the number of corporate governance principles PJSC Quadra does not comply with exceeds that of the PJSC Inter RAO by a factor of 9.5.

No less significant are the differences between all companies in their status of being compliant with corporate governance principles. It follows from the data presented in Table 1 that in the companies that scored best on corporate

Table 1. With compliance level 2 principles of the code.

Companies (PJSC)	Compliant	Partially compliant	Non-compliant
Inter RAO	73	4	2
Enel Russia	62	13	4
RusHydro	59	17	3
TGK-1	57	21	1
TGK-14	52	20	7
Unipro	45	27	7
OGK-2	41	25	13
T Plus	41	23	15
Mosenergo	39	30	10
Irkenergo	34	30	15
Quadra	33	27	19
TGK-2	32	32	15

Table 2. Meeting the criteria of complying with the principles of the code.

Companies (PJSC)	Compliant	Partially compliant	Non-compliant
Inter RAO	116	8	4
Enel Russia	104	16	8
RusHydro	100	25	3
TGK-1	102	23	3
TGK-14	81	38	9
Unipro	83	29	16
OGK-2	82	20	26
T Plus	56	50	22
Mosenergo	66	48	14
Irkenergo	50	59	19
Quadra	65	28	35
TGK-2	60	39	29

governance principles, the percentage of the components that make up their compliance status (i.e., “compliant”, “partially compliant”, and “non-compliant”) of the total of 79 principles they were assessed against was as follows: PJSC Inter RAO – 92%, 5%, 3%; PJSC Enel Russia – 75%, 22%, 3%; PJSC RusHydro – 74.7%, 21.5%, 3.8%. In the case of the worst scoring companies we observed a relative shift towards an increase in the number of the principles a company “partially compliant” or “non-compliant” with: PJSC Quadra – 41.8%, 34.2%, 24.0%; PJSC TGK-2 – 40.5%, 40.5%, 19.0%.

In order to arrive at a more in-depth and unbiased view of the corporate governance practice in Russian power generating companies we have performed an additional study against the complete set of 128 evaluation criteria of compliance with the principles stipulated by the Code. The findings of such analysis are presented in Table 2.

Under the above evaluation method, we observed a well-anticipated increase in the number of the principles that the companies fail to comply with. To a larger extent this holds true for the worst scoring companies. As per the data of Table 2, the share the criteria they do not meet makeup of the total of 128 criteria of compliance to the principles stipulated by the Code saw an increase to 26% and 23% in the case of PJSC Quadra and PJSC TGK-2 respectively.

We have identified which of the evaluation criteria of the principles stipulated by the Code are not complied with. Those of them that are most frequently not complied

with are highlighted by listing them in dedicated Table 3. They are arranged in ascending order of the share of the companies that failed to comply with the above criteria;

All of the criteria listed in Table 3 refer to the scope of responsibilities of the board of directors, to the extent of the authority was delegated to it:

- To back the observance of rights and equal terms for shareholders.
- To approve internal corporate documents.
- To establish and to approve the policy of the companies with respect to remuneration, to ensure control over the implementation and enforcement of this policy, and, if required, to revise it and introduce amendments to it.
- To define the principles and approaches behind the system of risk management and internal control, monitor the compliance of the adopted system and the efficiency of its operation as judged against them.
- To ensure the development and implementation of the information policy, transparency, timeliness, and completeness of information disclosure, and unhindered access to it granted to shareholders.
- To exercise control over the corporate governance practice, to play a key role in material corporate actions.
- To approve third-party appraisal officers when performing material corporate actions to protect the rights and legitimated interests of shareholders.

The poor efficiency of the boards of directors in Russian

Table 3. Criteria the companies do not comply with.

Principles	Evaluation criteria for compliance with the Code principles
1.1.6.	3. When making decisions on arranging and holding general meetings of shareholders, the board of directors should consider the issue of making use of the means of telecommunication to provide remote access to shareholders so that they could take part in these meetings during the reporting period.
2.1.7.	1. During the reporting period, the board of directors considered the issues of the corporate governance practice.
2.2.1.	2. The annual report covers the information on key results of the board of directors performance evaluation.
2.7.4.	1. Decisions on most important issues relating to the company's business should be made at a meeting of the board of directors by a qualified majority of at least three-quarters of the votes or by a majority vote of all elected board of directors members.
6.1.1.	2. The board of directors (or a committee thereof) should consider the issues pertinent to compliance with the information policy at least once during the reporting period.
2.9.1.	1. An internal evaluation or a third-party performance evaluation of the board of directors should be carry out in the reporting period covered the performance evaluation of committees, individual members of the board of directors and the board of directors as a whole. 2. The findings of an internal performance evaluation or a third-party performance evaluation carried out in the reporting period should be reviewed during a meeting of the board of directors held in person.
4.1.2.	1. During the reporting period, the remuneration committee should consider the remuneration policy and its implementation practice and submitted the relevant recommendations to the board of directors as required.
4.2.2.	1. If an internal document provides for a transfer of shares to the board of directors members, there should also be provided and disclosed the clearly stated rights of their ownership aimed at long-term incentives to hold them.
7.1.2.	1. There should be a procedure set out for independent directors to state their opinions on material corporate actions prior to their approval.
2.9.2.	1. A third-party company should be involved at least once in providing an independent performance evaluation of the board of directors during the three most recent reporting periods.
4.3.2.	1. The company should put in place a long-term incentive programme for the members of the company's executive bodies and other key managers involving the company's share (or derivative financial instruments with its share serving as the underlying asset). 2. The long-term incentive programme for the members of the company's executive bodies and other key managers should provide for the right of disposing of shares or other financial instruments employed by such programme to arise no earlier than in three years from the date when they were provided. In addition, the right to dispose of the same should be made conditional on the achievement of certain targets by the company.
2.4.3.	1. Independent directors should account for at least one-third of all directors elected to the board of directors.
7.2.2.	3. Internal documents should expand a list of grounds on which members of the company's board of directors as well as other persons referred to in respective laws, are deemed to be interested in transactions of the company.

power generating companies served as the defining factor when deciding on the priority direction of the development of their corporate governance.

III. DEVELOPMENT PROSPECTS

The priority direction for the development of corporate governance in Russian power generating companies should be the strengthening of the boards of directors. Their role as the key managerial body is getting truly strategic one. This is mainly due to the paradigm shift in corporate governance from a system of exercising control over the management team to a system of strategic governance and risk mitigation. The above is supplemented by the challenge thrown down by the advent of information technology that makes the flexibility and adaptability of companies stand out. The major driver behind the development of corporate governance in Russia nowadays is the set of tools enforced by formal requirements of the Central Bank of the Russian Federation acting as the regulating body. Notably, the strong board of directors is thought of as a key tool that ensures a leading position of companies with respect to corporate governance [19]. The board of directors is a key source of efficiency and sustainability of companies. The risks that investors face in the majority of Russian companies are those of poor governance, low rates of adoption of the state-of-the-art managerial techniques, an underdeveloped culture of the processes of working out and implementing the most important decisions [20]. Investors value more the companies that have the lack of the board of directors approaching the best practice, its crucial role in enhancing the quality of their corporate governance is one of the main takeaways from the research conducted by the Association of Independent Directors and the National Research University Higher School of Economics [21].

To establish a strong and qualified board of directors in Russian power generating companies one has to re-envision and bring up to date the approaches to the:

- A. Nomination.
- B. Election.
- C. Current activities.
- D. Performance evaluation.

A. The nomination of the candidates to the board of directors members

- To compile a checklist of select competencies for candidates to possess, so as to be in line with the objectives and tasks set out to further the development of companies. This is a required action to take due to higher requirements to be met by professional competencies given the shortening of the strategic planning time frames and the advent of innovations and information and digital technologies.
- To give due consideration to the commitment of candidates to moral and ethical values as based on the principles of reasonableness, integrity, justice, impartiality, incorruptibility, respect for the interests

of their company, its partners, customers, the society in general, neither causing them any harm nor circumventing the law by pursuing illegal or otherwise deliberately unscrupulous ends.

- To have a preliminary review by shareholders of behavioral traits of candidates, on a par with their readiness for collaboration and trade-offs for the sake of effective decision making. One should not nominate to the board of directors the advocates of “support groups”, bystanders, conventionalists, and “constant” critics. Unlike with the Code that recommends competencies, personal qualities, and behavioral traits as the criteria to judge the performance of the board of directors members against, we propose to apply these criteria in the course of their nomination and election. Preliminary discussions by shareholders of the candidates to the board of directors as well as the voting procedure may be held by means of online bulletin boards, teleconferencing, and video conferencing. In a sense, these are to be treated as the primaries held at the corporate level. They are required to identify the most worthy candidates to be nominated and subsequently elected to the board of directors members during the actual election.
- To increase the number of independents among the candidates nominated for the board of directors. This is required, in particular, to strengthen the board of directors competencies, including the mastery of cutting edge managerial techniques. There should be a preliminary and thorough examination of such candidates with respect to their independence as per the guidelines provided in the Code, which is mainly due the nowadays common issue of “independent directors” who actually fail to act impartially.
- To select candidates to the board of directors who are supported by shareholders based on the actual evaluation of their contributions and the programme of development of the company during the next fiscal period.

B. The election of the board of directors members

- To timely disclose the information by the date of the general meeting of shareholders, including that on alterations of internal documents.
- To make available the comprehensive information on the results of the preliminary evaluation of the candidates to the board of directors in the documents on the preparation for and holding of general meetings of shareholders (nominators, biographical data, professional and personal qualities, education background, working experience, conflict of interest disclosure, data on independent candidates, etc.).
- To grant remote access to shareholders to participate in general meetings of the reporting period by relying on the means of telecommunication.

- To increase the involvement of professional investors with respect to voting during general meetings of shareholders.

C. Current activities of the board of directors

- To improve the work of the board of directors committees done with respect to the preparation for the decisions taken to enable higher operational responsiveness in having them reviewed by the board of directors members and their efficacy.
- To involve the board of directors members in the company's business and to strengthen the participatory principle in their activities by holding comprehensive discussions on the matters they deal with and on the decision-making that is informed by various opinions. Running meetings in person is preferable to written consents that have gained wide acceptance. Given the telecommunication means made available in the companies, they can be extended to enable the remote access for all Board members to participate in the discussion of the issues reviewed.
- To develop unified corporate standards of ethical conduct due to the lack of respective guidelines in the Code.
- To enable all interested parties to report on violations or suspicions thereof via dedicated channels established by the company. One of such tools is the confidential communication channel for informants to report on corruption. At the companies that run such hotline service, this channel generally boils down to an e-mail address or a phone number. This model of interaction is not very efficient and cannot guarantee feedback and complete confidentiality for the informant. The development of a dedicated electronic form for informants available at the official website of a company is a more up-to-date version of this model. It assigns each of them a unique pin code, whereas the claim is submitted for review to a third-party audit company with the feedback system put in place. Companies have to face penalties for any violations

D. The board of directors performance evaluation

- To develop a procedure for the board of directors performance evaluation due to the lack of respective guidelines in the Code. To develop a set of tools for the evaluation (the contents of the question lists that form the basis of the questionnaire) and an analysis of the data obtained thereby. To this end, one may involve third-party advisers. Their involvement will enable solving the issues related to overcoming the subjective bias inherent in such evaluation activities and make the analysis of the findings more balanced.
- To develop the Regulation "On the board of directors performance evaluation" which is subject to approval by the board of directors. Its content should cover

the following: the development of the tools for the evaluation (the contents of justification of the need to perform the evaluation; evaluation types; procedures and employed evaluation tools; the format of the notification on performing the evaluation as intended for public disclosure (as it appears in the annual report on company's activities, at its corporate website, and so on).

- To modify the approach recommended by the Code with respect to the annual remuneration of the board of directors members by introducing its fixed and variable components in contrast to the fixed-only remuneration advocated by the Code. That said, the variable component of the remuneration shall not be the payments for attending the meetings of the board of directors or its committees as they are deemed to be a basic responsibilities of a director as per the Code. The variable component of the remuneration shall be linked to the financial performance achievements of the company (free cash flow, EBITDA, etc.) to align the financial incentives of the board of directors to those of the shareholders. When deciding on the amount of such remuneration, one shall account for objective grounds as based on the performance evaluation results of its members.

IV. CONCLUSION

The issue of enhancing the investment appeal of Russian power generating companies still remains relevant. Corporate governance is one of the key factors that contribute to its improvement. We have performed an evaluation of the current practice adopted by these companies. The evaluation was made against various criteria of the compliance of such practice with the Corporate Governance Code. As per the results of such evaluations, the majority of the companies have been found to have relatively poor corporate governance: the number of the criteria the companies that rank among the lowest fail to comply with, as yielded by the first appraisal method, is 7 to 8 times that of the leading companies. The second method yields the value of 9.5 times. We have identified the evaluation criteria that the companies fail to meet most frequently. All of them have proved to belong to the scope of responsibilities of the boards of directors. The strengthening of the boards of directors is identified as a priority direction of further development of corporate governance in Russian power generating companies. For the purpose of their strengthening under present-day circumstances; we have proposed certain changes applicable to nomination, election, current activities and performance evaluation of their members.

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