

Policy Paper 3.3

The Relationship between Ariana and the Government of Afghanistan

Executive Summary

The relationship between the government and Ariana should be clarified. The objective should be to ensure that the government has adequate control over all substantive financial decisions, whilst Ariana has freedom to take commercial and operational decisions.

Substantive financial issues are those:

- Related to capital expenditure in excess of a certain amount (to be determined in negotiation between the government and Ariana).
- Related to incurring debt in excess of a certain amount (also to be negotiated between the government and Ariana).
- Related to a matter not provided for in the business plan approved by the government and requiring expenditure above an amount to be negotiated.
- Enabling Ariana to buy shares in or take a part of another company.

Ariana should have a principal objective “to operate as a successful business and to this end to aim to be as efficient as airlines not owned by a government with which it competes on international routes. With this end in view it should carry out the activities authorised by its Articles of Incorporation with a view to making a profit, taking one year with another”.

Ariana should also be given the objective “without prejudice to the principal objective to be a good employer, and to have regard to the interests of the people and economy of Afghanistan”.

Where the government wishes Ariana to carry out functions or provide services which Ariana regards as not conducive to the achievement of the principal objective, it may give Ariana a direction to this effect. The government and Ariana should enter into an agreement under which Ariana will carry out the functions or provide the services covered by the direction in return for payment by the government.

If over a significant period Ariana fails to meet its objectives, and in particular to achieve profitability, the government should have the power to intervene to strengthen the management of Ariana by means of a contract with a suitable provider of management services.

The Board of Ariana should be strengthened by the inclusion of non-executive directors with expertise in business in general and aviation in particular.

To achieve these changes, the government should:

- Draft and negotiate with Ariana a contract which incorporates the relationship indicated above and of which an indicative draft is in the Annex to the Paper.

- Propose to the general body of shareholders of Ariana to amend the Articles of Incorporation along lines suggested in Appendix 2 to the paper.

Recommendations:

The relationship between the government and Ariana should be clarified; the government should have adequate control and Ariana should have the freedom to act commercially.

Actions:

The government should draft and negotiate with Ariana a contract (draft in the Annex) incorporating the above principles, and propose to shareholders of Ariana to amend Articles of Association to effect these changes.

The Ministry should be assisted by the Capacity Building Unit (see Consultation Paper 3.7) to undertake this work.

Introduction

The TSR Phase 1 policy report notes that although Ariana is a corporate entity outside government it will be important that it be run as a private sector company would be run, subject to the constraints made necessary by the fact that the majority of its shares are held by the government itself and the rest by national banks and the national Chamber of Commerce. TSR took the view that both from the point of view of the efficiency of Ariana itself and from that of its acceptance as part of the international airline community, it was desirable that the powers of the government in relation to Ariana be more precisely defined. This paper is designed to suggest what these powers should be.

It should be made clear at the outset that nothing in this paper affects the responsibility of government for the safety of Ariana's operations. The regulation of safety is an essential governmental function which would be applicable to any operator of aircraft on the Afghan register, whether government-owned or privately-owned. This should be a completely arms-length relationship and quite separate from issues arising from the governmental ownership of Ariana.

The Issues to be Covered

The issues which arise are the following:

- The objectives of Ariana and how they should be set.
- The social and employment responsibilities of Ariana.
- The overall relationship between the Government and Ariana
- The financial relationship between Ariana and the government.
- The issue of non-commercial activities.
- The nature of the Board of Directors and how they should be appointed.

International Trends in State-owned Enterprises

The organisation - and purpose - of state owned enterprises has changed considerably over the years. Originally they were statutory corporations, set up by law, with duties and powers set out in detail in the statute. The motivation was sometimes economic (the need for investment beyond what the private sector could cope with in an industry considered vital), sometimes social (to create employment), sometimes political. This structure was predominant throughout the 1950's and 1960's. Over time, however, the statutory corporations became rigid. The markets in which they operated became more competitive, and the frequent link with pay and conditions in the civil services proved too inflexible in such markets to attract and keep management of the necessary quality. Many of them were developed as a result into limited companies structured like any company in the private sector except that the shareholding was held by the government. Very often this was regarded as a stepping stone on the way to privatisation, but even where it was not it was thought that the greater flexibility and efficiency of the private sector style of structure would remove the operations further from political influence, and from the rigidities inherent in state employment and thus give nationally owned enterprises a greater chance of success on the more competitive markets in which they had to operate. In consequence various devices were involved to enable

governments, who still often had to provide money for the publicly owned companies, to control their investment and safeguard the public interest whilst according to them commercial and operational freedom. Ariana is at the latter end of this process: it only remains to ensure that the benefits of it are fully realised.

The Objectives of Ariana

The current objectives of Ariana are set out in Article 2 of the Articles of Incorporation. These are as follows :

- To transport passengers, baggage, cargo and mail between the points specified within and outside the country.
- To establish and operate scheduled domestic and international air services between various important points and trading centres within and outside the country in order to promote the development of trade and tourism, to main and strengthen the commercial and economic relations between the inhabitants of the Republic of Afghanistan and foreign countries.
- To operate such charter flights and other non-scheduled services, as may be necessary to carry passengers and cargo.
- To operate the aerial photography and spraying services and to perform other economic work in the field of agriculture and public health.
- To engage in business, to coordinate and provide services for transportation of passengers, cargo baggage and mail at the airports concerned.
- To enter into commercial and technical assistance agreements with the airlines of foreign countries and authorised agents, subject to the approval of the competent authorities.
- To purchase and sell or charter and lease aircraft.
- To establish technical workshops and hangars in order to provide necessary services for overhaul and reparation of aircraft.
- To establish new techniques of aeronautics and to apply the modern and advanced technology in the technical and commercial services and other fields of aviation.
- To arrange the working time-tables and determine the salaries and remuneration of employees according to the needs and requirements of the Company complying with the Labour Law of the Republic of Afghanistan.
- To train employees of the Company and to promote their skills.

It will be clear that this comprises a list of the activities in which the company may engage, as would be normal in any Articles of Incorporation. It says nothing, however, about whether the company is to do these things as an agent of government or whether it is supposed to make a profit from doing them. This should be made clear. Thus Ariana should, in TSR's view, have an overriding objective along the following lines:

“Principal objective”

“The principal objective of Ariana is to operate as a successful business and to this end to aim to be as efficient as airlines not owned by a government with which it competes on international routes. With this end in view, it should carry out the activities authorised by its Articles of Incorporation with a view to making a profit, taking one year with another.”

Given the present needs of Afghanistan to generate employment, and to re-establish its economy, it would be reasonable that this aspect should also be included in its objectives. The current objectives of the Articles of Incorporation include the objective to promote the development of trade and tourism; and to train employees and promote their skills. These might be generalised into the following:

“Other objectives”

“It shall also be an objective of Ariana, without prejudice to the principal objective, to be a good employer; and to have regard to the interests of the people and economy of Afghanistan.”

The Overall Relationship between the Government and Ariana

It is desirable that the powers of the Government in relation to Ariana be more precisely defined. The Articles of Incorporation are able to prescribe this relationship only to a certain point and then it becomes necessary to develop a set of protocols in a separate document that establish the relationship and the powers of Government.

This paper strongly argues that the relationship needs to be at ‘arms length’ in order prevent (and be seen to prevent) conflicts of interest occurring and to provide Ariana with sufficient commercial independence to operate successfully. In keeping with the recommendation made in the next section to retain Ariana as a company and reporting along traditional company lines, it is appropriate that a ‘contract’ be executed between the Government and Ariana where the relationship is specified. That contract is transparent and is akin to standard documentation between a parent company and a subsidiary. It will allow for the performance of Ariana to be monitored.

The objectives of the ‘contract’ would be to:

- Provide Ariana with sufficient commercial independence to operate a successful airline - matters of substance would require government approval.
- Clearly set out the relationship between the Government and Ariana.
- Specify the reporting arrangements between Ariana and the Government.
- Specify the substantive matters that require Government approval.
- Provide the Government with an emergency power to intervene at ‘arms length’ in the management of Ariana.

The Financial Relationship between Ariana and the Government

Under the Articles of Incorporation, it is the responsibility of the shareholders “to approve the annual balance sheet, to appropriate the profit and loss (it is assumed that this means to approve the accounts) and to determine the aid and relief funds”. To the extent that the Ministers of Civil Aviation and Finance are shareholders and sit on the Board of the company, it might be argued that the control of public money is adequately assured. It would be desirable, however, to formalise the relationship so that the government’s control over the finances of Ariana is transparent; and so that in consequence it is clear what financial objectives the government has set and how far Ariana has achieved them.

There are two ways of doing this. The first is to set out in some sort of formal governmental instruction how the governmental shareholders should exercise their power. These would be designed to complement the principal objective, and might be as follows:

- To require Ariana to submit annually to the government its business plan for its approval.
- To require that investments above a certain level should be specifically approved by the government. The threshold should be set fairly high so that it gave the government control only over major investments (e.g. the purchase of aircraft).
- To set a target rate of return for a specified period; and the dividend to be payable to the government.
- To be able to lend money to Ariana and to establish and maintain reserves at a certain level.
- To establish rules on the payment of interest on, and the repayment of, loans granted by the government.
- To control the extent to which Ariana may borrow money on the market.

The second would be to require the Board of Directors of Ariana annually to submit to the shareholders for their approval a draft statement of corporate intent. This should specify in respect of the financial year in which it is delivered and each of the immediately following 2 financial years, the following information:

- The objectives of the group.
- The nature and scope of the activities to be undertaken.
- The ratio of consolidated shareholder's funds to total assets, and definitions of those terms; an estimate of the loans that will be required to maintain the activities to be undertaken.
- The accounting policies.
- The performance targets and other measures by which the performance of the group may be judged in relation to its objectives.
- An estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the government.
- The kind of information to be provided to the government during the course of those financial years, including the information to be included in each half-yearly report.
- The procedures to be followed before Ariana subscribes for, purchases, or otherwise acquires shares in any company or other organisation.
- The Board's estimate of the commercial value of the government's investment in Ariana.
- Such other matters as are agreed by the government and the Board.

The shareholders would be required to consult the government before giving their approval.

The intent of both options is the same i.e. to provide the government with a transparent control of the finances of Ariana and to ensure that it has no powers apart from these. Of these two options, (i) is more suitable to a statutory corporation; (ii) is more suitable to an entity structured as a commercial company but owned by the government or quasi-governmental institutions. It is also more flexible, and leaves more initiative to Ariana. Since Ariana is currently structured as a company, and since this is the form most conducive to the

Government's objective of privatisation in due course, TSR recommends to keep this structure and to adopt Option (ii) above.

There would need to be one consequential change in the terms of the current Articles of Incorporation. Article 24.4 requires the Board of Directors to submit proposals to the Council of Ministers for the purpose of establishment or suppression of the company's representative offices within Afghanistan and abroad. This should be regarded as an operational decision and lie entirely within the discretion of Ariana's Board.

The Issue of Non-commercial Activities

It is inevitable that from time to time the government will wish Ariana to carry out tasks which the government regards as necessary in the public interest but which Ariana regards as not conducive to the fulfilment of its principal objective. TSR recommends that the government should have a power to give Ariana a direction in the public interest; but that any activities which the government requires Ariana to undertake in this way should be paid for explicitly by the government at a price to be agreed between them. There should therefore be a clause in the contract along the following lines:

“Where the government wishes Ariana to carry out functions or provide services which Ariana regards as not conducive to the achievement of the principal objective, it may give Ariana a direction to this effect. The government and Ariana should enter into an agreement under which Ariana will carry out the functions or provide the services covered by the direction in return for payment by the government. Any such direction should be published in the Official Gazette and in Ariana's annual report”.

The Government's Right to Intervene

It would be wise to cover the eventuality that Ariana may not succeed in meeting its objectives; in particular that it may not succeed in reaching profitability. In those circumstances the Government may wish to intervene to do something about it, e.g. to give a management contract to a suitable entity (possibly, a non-Afghan airline) to run Ariana for a certain period on its behalf. This possibility should be envisaged in any contract along the following lines :

“If over a significant period Ariana fails to meet its objectives, and in particular to achieve profitability, the Government may intervene to strengthen the management of Ariana by means of a contract with a suitable provider of management services”.

The Board of Directors

Under the current Articles of Incorporation, the General Body of Shareholders is responsible for the election of the members of the Board of Directors, who have to be elected “from amongst the shareholders”. (Article 22)

It is normal that majority shareholders should have representation on the Board of Directors. It is however important, and in commercial activities normal, that the Board of Directors

should include at least the Chief Executive (President) and Finance Director of Ariana; together with non-executive members with expertise in business in general and aviation in particular. On this concept, the Board of Directors would consist of:

- A number of Ariana executives.
- One or two representatives of the shareholders.
- A number of non-executive directors with expertise in business in general and aviation in particular.

For this to happen, the Articles of Incorporation should be amended (Article 22) to read as follows :

“The members of the Board of Directors shall be elected by the General Body of Shareholders and shall include the following:

- *The Chief Executive (President) and the Finance Director.*
- *Up to two representatives of the shareholders.*
- *Up to four members with expertise in business in general and aviation in particular.”*

If this were accepted, it would be sensible to amend Article 21 to increase the maximum size of the Board of Directors from seven to eight. The selection of Directors should reflect the government’s policy on gender.

An Article on the composition of the Board of Directors reflecting the above changes to the Articles of Incorporation should be reflected in the statute / instructions / contract.

Although the representatives of the shareholders would be in a minority, the interests of the government would be adequately protected by the arrangements envisaged in this paper.

Impact on the Organisation of MCAT

The changes suggested in this paper would not entail any significant changes in the organisation of MCAT. There would have to be a relatively small section to act as the link between Ariana and the government, and to negotiate and monitor the implementation of the contract.

Recommendation

The relationship between the government and Ariana should be clarified; the government should have adequate control and Ariana should have the freedom to act commercially.

Action

On the assumption that Ariana remains a company the shares in which are owned by the government and quasi-governmental institutions, the suggestions made in this paper require the following actions:

- The government should draft, and negotiate with Ariana, a contract which incorporates the relationship suggested above. An indicative draft of such a contract is at the Annex.
- The government should propose to the General Body of Shareholders of Ariana to amend the Articles of Incorporation as set out in this Policy Paper.

The Ministry should be assisted by the Capacity Building Unit (see Consultation Paper 3.7) to undertake this work.

ANNEX TO POLICY PAPER 3.3

INDICATIVE DRAFT CONTRACT - GOVERNMENT OF AFGHANISTAN AND ARIANA AIRLINES -

Definitions

Ariana means Ariana Airlines established as a company under the Companies Law 19??

Government means the Government of Afghanistan.

Matter means a legal, equitable, contractual, statutory or other right, power, authority, benefit, privilege, immunity, remedy, discretion or cause of action.

Substantive Matter means a contractual matter in relation to Ariana or the operation of Ariana which :

- a) Is related to capital expenditure in excess of US\$(to be determined) or
- b) Is related to incurring debt in excess of US\$(to be determined) or
- c) Is related to a matter not provided for in its business plan and requires expenditure in excess of US\$ (to be determined) or
- d) Enables Ariana to purchase shares in or take a part of another company.

Preamble

Ariana Airlines is a wholly owned company of the Government.

The Government wishes Ariana to be an efficient and profitable enterprise of the government.

The Government is intent on establishing an 'arms length' relationship with Ariana in order for it to be able to operate with commercial independence and in the manner of a privately owned airline.

The relationship between the Government and Ariana requires specification in order to achieve :

- a) The level of operational independence required for Ariana to operate commercially and profitably;
- b) A fully transparent relationship in relation to financial management;
- c) A fully transparent relationship in relation to Government directives to Ariana that are not profitable.

Purpose of the contract

The purpose of this contract is to :

- a) Provide Ariana with sufficient commercial independence to operate a successful airline;
- b) Clearly set out the relationship between the Government and Ariana;
- c) Specify the reporting arrangements between Ariana and the Government ;
- d) Specify the substantive matters that require Government approval;
- e) Provide the Government with an emergency power to intervene at 'arms length' in the management of Ariana.

Duration of the contract

This contract remains in force for a period of 5 years.

Appointment of Ariana as the national airline

The Government appoints Ariana as the National Airline of Afghanistan. No other Airline will be the National Airline of Afghanistan.

Establishing an ‘arms length’ relationship

The Guiding Principle

The Government recognises that the regulation of safety is an essential governmental function which would be applicable to any airline, whether government-owned or privately-owned.

The Operational Principle

The Government through its Ministry will apply and enforce international aviation standards fully and transparently upon Ariana.

Operational independence

The guiding principle

The principal objective of Ariana is to operate as a successful business and to this end to aim to be as efficient as airlines not owned by a government with which it competes on international routes. With this end in view, it should carry out the activities authorised by its Articles of Incorporation with a view to making a profit, taking one year with another.”

The Operational Requirements

Ariana has the freedom to operate in accordance with the approved business plan and budget and any other approval required under this contract.

Ariana must always act within the limits of its authority as set out in this contract and its articles of incorporation – any doubt must be clarified with the government.

Ariana must obtain the approval of the Government on a substantive matter and has no right to bind the Government on a substantive matter without that approval.

The Government will not interfere in the day-to-day operation of Ariana unless it is a substantive matter.

TRANSPARENT FINANCIAL MANAGEMENT

The Guiding Principle

The management of Ariana should be as close to that of a privately owned airline as possible. The financial reporting should be undertaken on commercial lines and be transparent. The government’s control over the finances of Ariana must also be transparent so that it is clear what financial objectives the government has set and how far Ariana has achieved them.

The Operational Requirements

Ariana will submit each year to the shareholders and to Government for their approval a business plan. The business plan will be for the current year and next succeeding two years. The business plan will contain the following information:

- The objectives of Ariana.
- The nature and scope of the activities to be undertaken.
- The ratio of consolidated shareholder's funds to total assets, and definitions of those terms; an estimate of the loans that will be required to maintain the activities to be undertaken.
- The accounting policies.
- The performance targets and other measures by which the performance of Ariana will be judged in relation to its objectives.
- An estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the government.
- The kind of information to be provided to the government during the course of those financial years, including the information to be included in each half-yearly report.
- The procedures to be followed before Ariana subscribes for, purchase, or otherwise acquires shares in any company or other organisation.
- The Board's estimate of the commercial value of the Government's investment in Ariana.
- Such other matters as are agreed by the Government and the Ariana.

Transparency in relation to Government Directives

The Guiding Principle

“Where the government wishes Ariana to carry out functions or provide services which Ariana regards as not conducive to the achievement of the principal objective, it may give Ariana a direction to this effect. The Directions are to be open and transparent and should be available publicly”.

The Operational Requirements

The Government and Ariana will negotiate an agreement to carry out the function or provide the service directed by Government - the agreement will include reporting requirements for Ariana in the implementation of the direction and an assessment of the achievements made. The Government will pay the cost (or the differential cost) of undertaking the function or providing the service.

Cost will include any actual loss of profit incurred by Ariana in undertaking the function or providing the service.

The Government will publish any such direction in the official gazette.

Ariana will publish any such direction in its annual report along with an assessment of the achievements made or whether the direction has been achieved.

Ariana will account for separately and also publish in its annual report the costs of undertaking that function or providing that service.

Government's reserve powers

The Guiding Principle

If Ariana does not succeed over a significant period in meeting its objectives and in particular that it does not succeed in reaching profitability, the Government may wish to intervene to strengthen the management and viability of Ariana.

The Operational Requirements

The Government will send a notice to Ariana that it has not succeeded in meeting its objectives and will explain how it has not met its objectives.

Ariana will have the right of reply to that notice.

If the Government is not satisfied with the reply (on the basis of professional advice) then it may determine to intervene in the management of Ariana but retaining an 'arms length' approach.

The purpose of an intervention must be to strengthen the management of Ariana may include the following:

- a) Issuing a contract to a suitable provider of management services to manage Ariana.
- b) Developing a business plan and action plan for Ariana to apply to its business.
- c) Issuing a contract to another airline to operate Ariana on behalf of the Government.
- d) Dismissing the Board or any member of the Board and appointing a new Board or a new member.

In serious financial circumstances the Government may act to wind up Ariana.