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Overall Goals of Our Study

101 We carried out this study to:

- identify and analyse current and emerging issues about how local authorities govern their subsidiary entities¹;
- highlight the risks when governance arrangements do not work effectively; and
- recommend and illustrate good practice for proper accountability and effective governance.

Current and Emerging Governance Issues

102 In our 1994 report *Governance of Local Authority Trading Activities*² we commented on the relationships between local authorities and their commercial trading entities. In that report we examined issues concerned with:

- shareholder control; and
- monitoring the performance of local authority-owned companies.

103 We also commented in our 1994 report on the operation of business units and joint ventures.

104 Since then, local authorities have continued to explore new ways to carry out their responsibilities. The Local Authority Trading Enterprise (LATE) model has continued to evolve. Other developments in the local government sector include:

- differing governance philosophies, principles and approaches across local authorities;
- new organisational arrangements, such as regional collaborative ventures or shared services; and
- a growing variety of structural options for undertaking activities, including non-commercial functions.

1 In this report we use the expression “subsidiary entity” to refer to any entity over which (in this case) a local authority is able to influence the governance arrangements. Such an entity may or may not be a “subsidiary” within the meaning of either statutory definition or generally accepted accounting practice.

2 ISBN 0-477-02844-6, June 1994.

GOOD GOVERNANCE

- 105 In 1998 Parliament passed legislation governing the operation of two stand-alone entities with important roles to play in the development of Auckland's infrastructure: Watercare Services Limited and Infrastructure Auckland. Our case studies include these two entities because the legislation and the environment in which they are operating have created special challenges for all the parties concerned to make governance relationships work.
- 106 In this report, we discuss relationships between local authorities and many different types of subsidiary entity. Different entities are subject to various statutes, including company and trust legislation, port and energy company statutes, and entity-specific legislation. We do not comment in detail on all the individual statutes. But we are confident that our recommendations are broadly consistent with this array of legislation and are generally applicable to the circumstances and environments in which such entities operate.
- 107 We examined each of the different kinds of governance arrangements in its own context. Relevant influences and circumstances included:
- differences in legal form (for example, limited liability company, trust, or special-purpose body);
 - protocols, rules and other guiding documents (such as the Rules of the New Zealand Stock Exchange, or management agreements);
 - the subsidiary entity's role, functions and purpose;
 - the nature of the activity that the subsidiary entity performs (which may be as varied as water reticulation, energy supply, investment management and tourism promotion);
 - the strategic and financial importance of the activity; and
 - the local authority's circumstances (size, constituency and governance philosophy).

Principles of Good Governance

- 108 Our expectations of good governance practice for subsidiary entities are that:
- **The subsidiary entity should have a clearly defined purpose.**
We expect the purpose of the entity to be clearly stated and reviewed on a periodic basis. The influence exercised by the local authority over the finances, operations and direction of the entity should be consistent with that purpose.

- **The subsidiary entity's governing body should be effective.**
A local authority should have a process in place to appoint a governing body with the skills and competencies to carry out its duties effectively. Procedures should be in place for evaluating the performance of individual members and of the governing body as a whole.
- **The parties involved should be assigned clear roles and responsibilities.**
The roles and responsibilities of board members, shareholders, councillors and other parties (such as council and entity staff) should be clearly defined. Clear roles and responsibilities make the trade-offs among differing interests transparent and foster effective decision-making.
- **The local authority should be able to hold the subsidiary entity to account.**
A local authority needs the structures, systems, information and capability to –
 - promote its interests (for example, as shareholder or purchaser of services);
 - influence the direction of the entity, as appropriate within the accountability relationship; and
 - monitor performance.
- **Mechanisms for accountability to the community must be in place.**
A local authority should demonstrate that it is managing the community's financial and non-financial interests in the entity in an effective and efficient manner.

How We Carried Out Our Study

109 We carried out our field work between November 1999 and February 2000. We visited ten territorial local authorities, two regional councils and numerous related organisations, including:

- LATEs;
- trusts;
- port companies; and
- corporate entities with their own enabling legislation³.

3 For example, Canterbury Museum Trust Board established under the Canterbury Museum Trust Board Act 1993.

GOOD GOVERNANCE

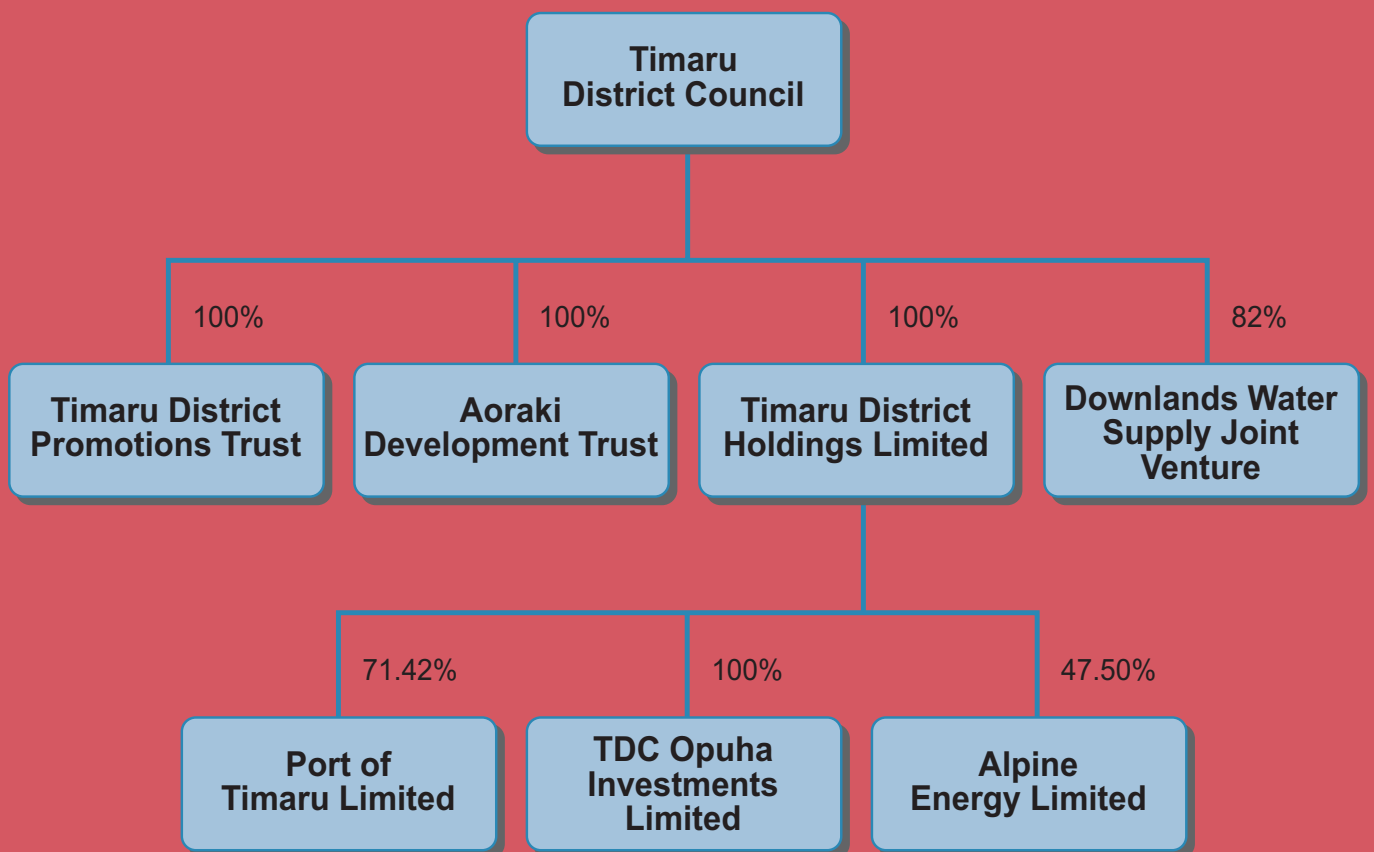
Statement of corporate intent – The directors

110 We interviewed elected members, chairpersons, chief executives and senior managers. We also:

- examined establishing documents – such as constitutions and trust deeds – together with accountability documents, council minutes and papers;
- read performance reports and general correspondence between the entities and councils; and
- reviewed file documentation and other relevant material.

The Structure of Our Report





TDC Opuha Investments Limited was deregistered on 21 February 2000.

- 201 In this part we discuss general themes and issues that emerged from our case studies, and recommend best practice. Many of our findings reinforce the views expressed in our 1994 report. Other findings relate to the varied governance arrangements that have developed since, as local government has continued to explore a range of structural options to achieve its goals.
- 202 Three main themes emerged from our examination of governance arrangements for subsidiary entities:
- roles and responsibilities;
 - governance structures; and
 - monitoring and accountability arrangements.

Roles and Responsibilities

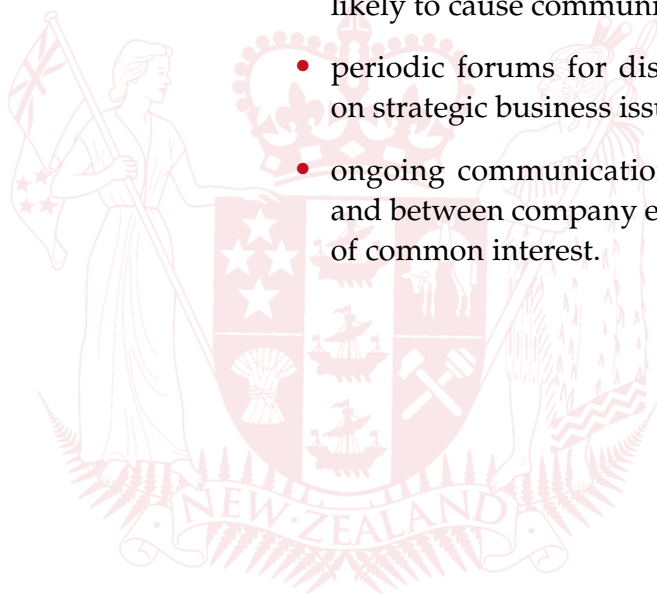
Council Representatives on Boards of Local Authority-owned Companies

- 203 The Local Government Act 1974 (the Act) requires at least two directors on the board of a LATE to be persons who are neither members nor employees of any local authority.⁴ Direct local authority representation is further limited in the case of port companies and passenger transport companies.
- 204 In our 1994 report we commented that:
- appointing councillors to boards of local authority-owned companies may create a conflict between their obligations as elected members and their duties as directors;
 - councillor directors were seldom selected through a competitive process against the same criteria as other members of the board; and
 - councillor directors were not an appropriate means by which to monitor the activities of the board.
- 205 Our findings in this study confirm these views. However, the local authorities we reviewed had a better understanding of the need for councillor directors to have regard to potential conflicts of interest.

4 Section 594R.

OVERVIEW OF GOVERNANCE ISSUES

- 206 The local authorities we visited were generally aware of the need for councillor directors to have the necessary knowledge and skills to perform the duties of a company director. Using skill-based criteria to appoint directors (including councillor representatives) provides some assurance that all board members will be able to contribute to the board's work.
- 207 Although councillor directors face potential conflicts of interest, they may also provide a useful service by:
- being a council voice;
 - providing a local community perspective; and
 - ensuring that the objectives of the board are aligned with those of the local authority.
- 208 The presence of councillor directors also enables the board to explore the likely response of the shareholding local authority to board proposals.
- 209 We observe that local authorities often appoint councillors as directors from a lack of confidence that non-councillor directors will be sufficiently responsive to the expectations of a local authority owner. Given the potential conflict of interest faced by councillor directors, we recommend that councils consider other ways to obtain the necessary assurance, such as:
- selection and appointment processes which require non-councillor directors to have a sound understanding and acceptance of the wishes, needs and priorities of the public shareholder, and the needs of the community;
 - a clear statement outlining the council's expectations of the board, including a commitment by the board to "no surprises" on matters likely to cause community concern or have political implications;
 - periodic forums for discussion between the company and councillors on strategic business issues and shareholder objectives; and
 - ongoing communication between the council and board chairperson, and between company executives and local authority officers, on matters of common interest.



*Council Representatives on Non-profit Entities*⁵

- 210 Special-purpose non-profit entities (such as trusts) are commonly formed to operate at arms-length from, but in close association with, a local authority. They undertake activities that contribute to the achievement of a local authority’s desired core social outcomes. Because of the close association, the considerations for appointing directors to commercial trading enterprises are not necessarily relevant to the circumstances of non-profit entities.
- 211 Of the local authorities visited, we selected four in which to review the trusts or other non-profit entities they had set up. Three had appointed no councillor representatives to the governing bodies, while one had a policy of appointing elected members in addition to people from the local business community. The benefits of the latter approach were seen to be:
- to promote alignment between the objectives of the non-profit entity and the local authority;
 - to provide a community voice on the governing body; and
 - to give the council a means to oversee performance of the non-profit entity.
- 212 Council representatives on the governing body of a non-profit entity are personally liable for the decisions of that body. In their role as trustees or governing body members, councillors owe a primary fiduciary duty to the interests of the entity – creating potential conflict with their duty as councillors.
- 213 Nor is council representation a transparent and effective means to hold the governing body to account and provide assurance to the council and the community about its performance. Performance monitoring should be undertaken by the local authority at arm’s length and with reference to a clear and agreed set of expectations about performance.
- 214 Local authorities should consider the role of councillors as trustees or representatives on non-profit entity governing bodies in the context of our other comments in this report about:
- appointment processes; and
 - the need for a service agreement framework within which to make the entities transparently accountable for the use of ratepayer funds or assets.

5 In other jurisdictions the equivalent description is “not-for-profit” entities.

OVERVIEW OF GOVERNANCE ISSUES

Appointing Members of Governing Bodies

- 215 A governing body – whether of a commercial trading enterprise or a non-profit entity – should have members with a mix of skills and experience appropriate to the entity’s activities.
- 216 The majority of local authorities we reviewed had documented processes for selecting directors for company boards. This provided a means of assurance that appointees had the skills and experience to meet their obligations as directors and contribute fully to the work of the board. The board appointment processes established by legislation for Infrastructure Auckland and Watercare Services Limited are a useful example for the appointment of directors to the boards of local authority companies.
- 217 The processes followed to appoint the governing bodies of non-profit entities were not as clearly documented. We recommend that, for non-profit entities, local authorities follow processes similar to those used for appointments to the boards of their commercial trading enterprises.

The Role of the Local Authority Chief Executive Officer

- 218 A key role of the chief executive officer (CEO) of any local authority is to act as its chief adviser. This includes advising the local authority on its relationship with the various organisations in which it has an interest.
- 219 In all local authorities we reviewed, the CEO had links (either directly or through senior managers) with the organisations in which the local authority had an interest. However, we found that not all CEOs were in a position to provide informed or independent advice to their council. Reasons for this included the absence of a framework for reviewing the council’s strategic interests, and the CEO’s involvement in the internal governance of the organisations.
- 220 To ensure that the CEO is fully able to discharge his or her advisory responsibilities, we recommend that:
- The CEO be kept fully informed – either directly by entity staff or through local authority management – of all material matters about the local authority’s subsidiary entities.

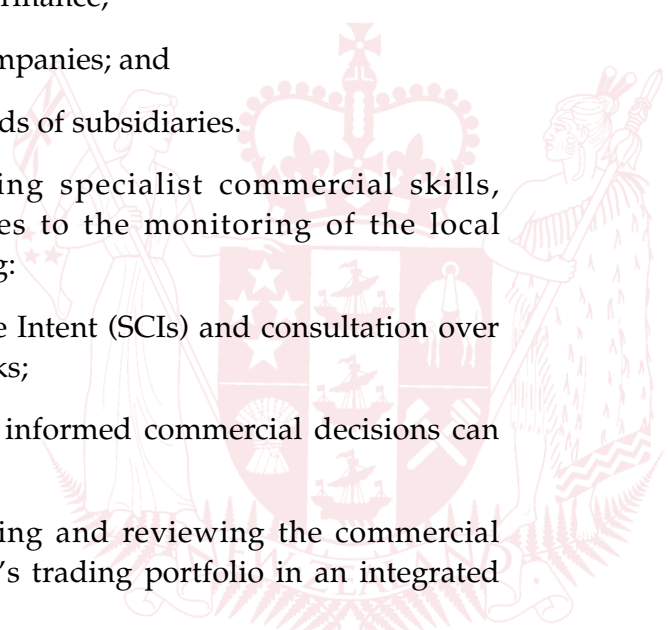
OVERVIEW OF GOVERNANCE ISSUES

- The CEO take no part in the internal governance of subsidiary entities. This ensures that the CEO is independent when assessing entity performance against expectations and providing independent strategic advice to the council. In many local authorities this advisory role will be delegated to local authority managers. For similar reasons, local authority employees should not, as a rule, sit on the governing bodies of such organisations.
- The CEO be assigned formal responsibility for reviewing, or commissioning regular reviews of, the local authority's interests in subsidiary entities, and for putting policy options to the council based on those reviews.

Governance Structures

The Role of a Holding Company

- 221 Three of the local authorities we reviewed had holding companies charged with monitoring the performance of the local authority's commercial trading companies. We examined the benefits and risks of this arrangement.
- 222 We found that a holding company had the potential to perform a number of useful roles on behalf of their parent local authority – including developing and promoting best practice in corporate governance processes for:
- evaluating board and director performance;
 - appointing boards of subsidiary companies; and
 - succession planning across the boards of subsidiaries.
- 223 A holding company may also bring specialist commercial skills, experience and business disciplines to the monitoring of the local authority's trading activities, including:
- scrutiny of Statements of Corporate Intent (SCIs) and consultation over business plans and strategic outlooks;
 - creation of an environment where informed commercial decisions can be made quickly; and
 - provision of a vehicle for managing and reviewing the commercial performance of the local authority's trading portfolio in an integrated manner.



OVERVIEW OF GOVERNANCE ISSUES

Statement of corporate intent – The directors

224 Local authorities that have established holding companies to oversee the performance of operating subsidiaries need to preserve their ability to exercise their rights as the ultimate owners on behalf of their communities. We recommend that local authorities retain the capability to:

- monitor the performance of their holding companies in managing their investments;
- obtain, and where necessary respond to, information about activities or intentions of the subsidiary companies which may have political implications or raise community concerns; and
- review their investment strategies at regular intervals, having regard to the objectives specified in their investment policies and balancing strategic, community, and commercial considerations.

225 Two of the holding companies we looked at had reserved the following key ownership control mechanisms to their parent local authority:

- approval of appointments to the boards of subsidiary companies; and
- ratification of the SCIs for those subsidiaries.

226 In our view, those reservations were appropriate, given the local authorities' responsibilities as ultimate owners to discharge governance responsibilities on behalf of their communities.

227 We recommend that local authorities define clearly – through the SCI – the role and reporting requirements for their holding companies. These reporting requirements need to ensure that elected members are appropriately informed about matters of community or political interest. In the SCIs we reviewed, we were not satisfied that such accountability requirements were sufficiently well defined. This lack of definition carries the risk that local authorities will not receive necessary information about the performance and prospects for their commercial investment companies.

228 At the time of our visit, one holding company had recently expanded the performance objectives in its SCI by incorporating a range of non-financial requirements in addition to existing financial targets. These non-financial requirements should strengthen the company's relationship with the local authority through explicit commitments to:

- maintain awareness of strategic and business issues in its subsidiaries, and advise the local authority where required;
- monitor the quality of the SCIs submitted by subsidiary company boards, and review their compatibility with the local authority's strategic aims; and

OVERVIEW OF GOVERNANCE ISSUES

- keep the local authority informed of all significant matters with two-monthly progress reports and twice-yearly seminars for councillors.
- 229 We recommend, as in our 1994 report, that the boards of holding companies include councillor directors. We consider that councillor directors are better placed on holding company, rather than subsidiary company, boards. A holding company (itself a LATE) is required to operate independently of the parent local authority. While the holding company is the legal owner of operating subsidiaries, the local authority is ultimately accountable to the community for the performance of the subsidiaries. Councillor directors on the holding company are a means of ensuring that commercial decisions have appropriate regard to the wider interests of the local authority shareholder.
- 230 In determining the balance of councillor and external directors on the board of the holding company, the local authority should consider:
- the desired mix of skills and experience for the holding company's role as the local authority's professional investment manager;
 - the nature of the local authority's investment portfolio; and
 - the relationship between the holding company and the local authority.

Collectively Managing Regional Investments

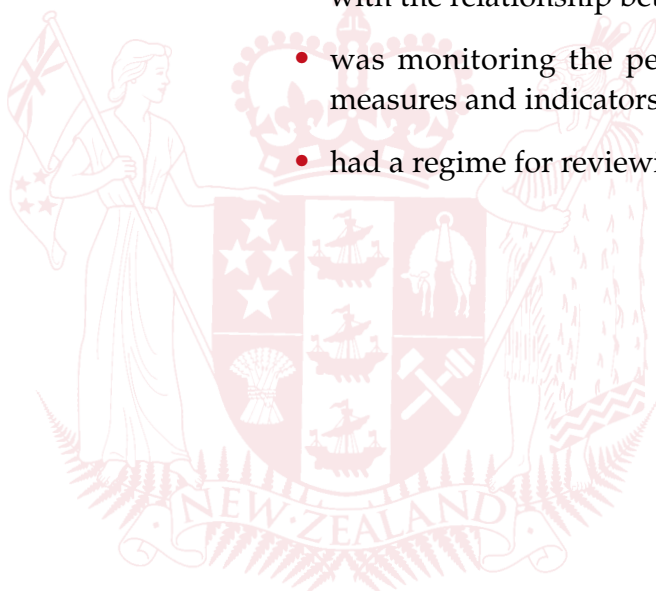
- 231 The framework for the Canterbury landfill joint venture project, and the governance arrangements for the operations of Watercare Services Limited and Infrastructure Auckland, provide useful guidance as to the factors essential to the success of a regional venture. Key factors are:
- A governance framework that creates a forum for effective collective decision-making, preserves the autonomy of individual local authorities, and maintains a balance of power and influence among the participants.
 - Delegations, authorities, and lines of communication that underpin the relationship between the joint venture partners collectively and each individual partner. These should reflect the commitments of the authorities to the partners collectively, on the one hand, and the ultimate accountability of each local authority to its community, on the other.
 - Agreed regional policies and strategies that ensure that a venture is based on common objectives at political and operational levels.
 - Provisions to promote the commercial viability of the venture and the proper control of current and future costs.

OVERVIEW OF GOVERNANCE ISSUES

- 232 The Canterbury landfill joint venture project is a particularly useful reference for other local authorities that are considering similar regional ventures. Participating local authorities and the private sector joint venture partner undertook lengthy consultation on a range of governance issues in reaching agreement on the ways in which they would work together.

Trusts and Other Non-profit Entities

- 233 A number of local authorities have set up stand-alone organisations as vehicles to undertake non-profit activities in an effective and efficient manner. Local authorities have used a number of different forms (including incorporated societies and trusts) for a variety of activities designed to provide community benefits (such as regional marketing, economic development and employment promotion).
- 234 Establishing stand-alone entities to undertake community activities on behalf of the local authority has the potential to remove such activities from public scrutiny. Local government legislation provides little guidance as to how such entities should account to the local authority (and the community) for the use of ratepayer funds, for stewardship of community assets, or for the delivery of services on behalf of the local authority.
- 235 We examined governance arrangements for a selection of stand-alone entities, with the objectives of establishing (for each authority concerned) whether the local authority:
- had clearly defined its roles and responsibilities in relation to the outcomes sought;
 - had adequate means to influence the direction of the entity, consistent with the relationship between the parties;
 - was monitoring the performance of the entity against clearly stated measures and indicators; and
 - had a regime for reviewing the roles and function of the entity.



OVERVIEW OF GOVERNANCE ISSUES

- 236 Our examination highlighted the risks associated with setting up entities independently of local authority influence and control, without an established statutory framework for public accountability. The local authorities we reviewed had, by and large, successfully addressed these risks through a variety of mechanisms. We found that:
- the roles of the entities were clearly defined, and their functions were clearly related to outcomes sought by the local authorities concerned;
 - a range of instruments was in place as a means for the local authorities to influence the direction and strategies of such entities; and
 - the funding of stand-alone entities was subject to public consultation and community input through the local authority's annual planning process.
- 237 There is potential, however, to strengthen some aspects of the accountability arrangements in order that:
- service agreements would be in place to ensure that entities meet the performance criteria required of them in delivering services on behalf of, or sought by, the local authority;
 - all such entities would recognise the need to consult with the community, having regard to their relationships with the local authority and the impact of their programmes or activities; and
 - all appointments of trustees and other governing bodies would be drawn from candidates across the community, and be based on identified skills and competencies (by using, for example, procedures similar to those for making appointments to the boards of their commercial trading enterprises).
- 238 Our findings highlighted the need for local authorities to specify key accountability arrangements when setting up trusts and other stand-alone entities. In the absence of effective arrangements, governance by the authority and accountability to the community is likely to be dictated largely by the goodwill of the governing body, its willingness to work with the authority, and informal personal relationships. While informal relationships contribute to effective governance, they do not provide a robust accountability framework over time.

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- 239 Accountability requirements will vary according to the degree of influence that the local authority is able to exercise in each set of circumstances. These requirements include:
- a formal service agreement which documents the scope and purpose of the association between the organisation and the local authority, defines the services to be provided, and specifies how the organisation will be held to account for delivery of those services;
 - an objective process for appointing the governing body, based on a documented set of competencies relevant to the functions and activities of the organisation;
 - a means (conceivably in the context of its own annual planning process) for the local authority to approve or endorse the organisation's philosophy, direction and strategies, planned programmes and activities, financial and non-financial targets, and outcome measures; and
 - an agreed framework for regular reporting against stated measures of performance, in order to provide the local authority with information as to how the organisation is meeting the terms of its service agreement and contributing to the achievement of agreed outcomes.

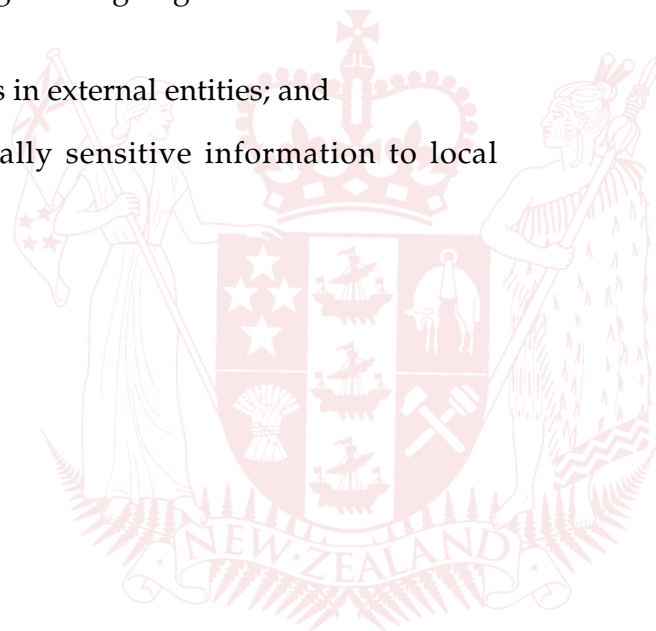
Group Structures

- 240 Stand-alone organisations may themselves set up subsidiaries or invest in other entities. This has the potential to:
- weaken accountability relationships with the local parent authority; and
 - change the nature of the risks faced by the local authority.
- 241 The parent local authority should establish the means to ensure that it is kept fully informed about the status and outcome of new business ventures. This can be achieved through specific reporting, or tailoring existing reporting, to provide necessary information about the plans and activities of such entities.
- 242 While some reporting to the parent local authority referred to such investments, the impacts on risk were not explicitly addressed. The absence of adequate reporting may mean that the local authority is not properly informed about the consequences for its own short-term or long-term interests.

Monitoring and Accountability Arrangements

Information Flows

- 243 A systematic flow of relevant information between a local authority and its subsidiary entities is crucial to good governance, by:
- building goodwill, trust and confidence; and
 - providing assurance that accountability requirements and performance expectations are being met consistent with the outcomes sought by the authority.
- 244 Significant changes within a subsidiary entity itself (such as rationalisation or restructuring), or in the environment within which it operates (such as the regulatory framework), may expose the local authority to additional risk but also offer new opportunities. Information needs should be reviewed periodically to reflect such changes. We assessed whether information flows were adequate in these circumstances, having regard to the local authority's interests.
- 245 Where a single entity was owned by one or more local authorities (such as jointly owned companies or collaborative arrangements) we compared the nature and extent of information available to investors or joint venture participants with differing levels of influence or control. In these circumstances we found governance arrangements were such that even participants with small investments had access to information which allowed them to manage their interests in an effective manner.
- 246 However, we did identify the following two ongoing issues to be addressed by local authorities:
- reviewing local authorities' interests in external entities; and
 - facilitating the flow of commercially sensitive information to local authorities or their agents.



OVERVIEW OF GOVERNANCE ISSUES

- 247 To address these issues, we recommend that local authorities regularly assess their interests in such entities and seek strategic information, as necessary, to:
- account to the community for management of their investments;
 - review the costs and benefits of holding those investments; and
 - discharge their obligations as diligent and informed investors.
- 248 Where necessary, local authorities should negotiate arrangements for the supply and handling of commercially sensitive information. These arrangements must meet their own information needs while maintaining confidentiality.

Business Planning and the SCI

- 249 Consultation on the SCI gives local authorities an opportunity to review the objectives and strategies of their companies and other LATEs against their own interests as shareholders. Most local authorities were making positive use of this opportunity to give careful attention both to the content of the SCI and to the review process itself.
- 250 In some instances, consultation on the SCI content had revealed significant differences in objectives and strategies between the local authority owner and the boards of companies and other LATEs. Consultation and negotiation on the SCI allowed such differences to be discussed and resolved.
- 251 The SCI should be the product of the board's annual strategic business planning. An understanding of the board's thinking and priorities is critical for effective consultation with the shareholding local authority. Effective consultation also requires the board to have a good understanding of the shareholder's goals and objectives, as they are an important focus for the board to plan its strategy for the business.
- 252 Most local authorities were responding actively to the issues raised in draft SCIs received from their company boards. However, we were not satisfied that consultation on the key features of their strategic business plans was always taking place between boards and shareholding local authorities prior to preparation of the draft SCI. In the absence of prior consultation on the assumptions underlying business plans, and on the risks and prospects for their companies, shareholding local authorities will be poorly placed to provide informed comment on the content of the SCI.

OVERVIEW OF GOVERNANCE ISSUES

- 253 Nor were local authority owners always considering draft SCIs in the light of their own assessment as shareholders of strategic, financial and management risks for their interest in the entity. Without its own strategic framework, the shareholding local authority will be less able to respond to board proposals in a considered and consistent manner.
- 254 We recommend that:
- local authority owners seek consultation on the key features of boards' business plans, including briefings on the strategic outlook for the company;
 - local authorities and boards reach a clear understanding of each other's interests and priorities;
 - drawing on the strategic outlook and business plan, shareholding local authorities review, or engage advisors to review, their interests in the light of issues facing the entity; and
 - local authorities use this information as a framework against which to consider the draft SCI and their own future options as an investor.

Capability to Monitor Performance

- 255 Specific responsibility for monitoring performance had been assigned by each local authority. In some instances oversight and scrutiny were regular and well directed, and incorporated in-depth exploration of issues affecting the risks for the authority. For two authorities, the holding company model was a valuable vehicle through which to monitor operating subsidiaries' performance, drawing on informed and specialist advice in-house and externally.
- 256 However, this task was not receiving the same attention in each local authority. In some cases infrequent reporting, little analysis of performance, and no formal provision for review, provided limited assurance that the authority's interests were being addressed.
- 257 Structures for the monitoring of non-profit entities were sometimes weak. In the absence of contractual agreements directly reflecting their interests, local authorities sometimes depended on other mechanisms for information on performance. These included the co-operation of stand-alone entities, informal communication channels, and councillor representatives on the governing body. None of these mechanisms constitute a reliable means of holding the governing body accountable for the use of ratepayer funds or for the delivery of programmes in the interests of the local authority.

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- 258 In some instances, local authorities had limited capacity to analyse reports received from informal sources, and so little such analysis was undertaken.
- 259 To strengthen accountability relationships and provide ongoing assurance that their interests are being met, we recommend that local authorities:
- establish a framework for monitoring performance, which should include reporting to the local authority, undertaking analysis, and conducting a periodic strategic review; and
 - identify and draw on the necessary skills and experience to perform an ongoing performance-monitoring role on their behalf.

Summary of Recommendations

- 260 We make a number of recommendations on three subjects:
- roles and responsibilities;
 - governance structures; and
 - monitoring and accountability arrangements.
- 261 Our recommendations are intended primarily for local authorities. However, effective governance relies on constructive, well-understood relationships among a number of different parties. In particular, governing bodies and individual board members play an important part in making governance arrangements work. We encourage all parties to consider how our recommendations could usefully be applied to their own circumstances.

Roles and Responsibilities

Responsiveness to the Expectations of the Public Owner

- 262 A local authority should ensure that a subsidiary entity's board is responsive to its expectations as a public owner, without compromising the board's responsibility as the governing body to direct and control the conduct of the entity's business. In consultation with the board, the local authority should establish:
- director selection and appointment processes which require non-councillor directors to have a sound understanding and acceptance of the wishes, needs, and priorities of the public owner, and the needs of the community;

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- a clear statement outlining the council's expectations of the board, including a commitment by the board to "no surprises" on matters likely to cause community concern or have political implications;
- periodic forums for discussion between the board and councillors on strategic business issues and ownership objectives; and
- ongoing communication between the council and the board chairperson, and between entity executives and local authority officers, on matters of common interest.

The Accountability of a Non-profit Entity

263 A local authority with an interest in a trust or other non-profit entity should ensure that:

- a service agreement framework is drawn up within which the entity can be held transparently accountable for the use of ratepayer funds or assets; and
- performance monitoring is undertaken at arms-length and with reference to a clear and agreed set of expectations.

Appointing the Governing Board of a Non-profit Entity

264 A local authority should:

- document clearly its processes for appointing the governing body of a trust or other non-profit entity; and
- consider following processes similar to those used for board appointments to commercial trading enterprises.

The Role of the Local Authority Chief Executive Officer

265 A local authority chief executive officer (CEO) has important advisory responsibilities to the council. To exercise these responsibilities in an independent and informed manner in relation to subsidiary entities, the CEO should:

- Be kept fully informed of all material matters about the local authority's subsidiary entities.

OVERVIEW OF GOVERNANCE ISSUES

- Take no part in the internal governance of subsidiary entities. In many local authorities this advisory role will be delegated to local authority managers – who also should not, as a rule, sit on the governing bodies of subsidiary entities.
- Be assigned formal responsibility for reviewing, or commissioning regular reviews of, the local authority's interests in subsidiary entities and for putting policy options to the council based on those reviews.

Governance Structures

The Role of a Holding Company

266 A local authority with a holding company should:

- monitor the performance of its holding company in managing local authority investments against measures of financial and non-financial performance specified in the company's Statement of Corporate Intent (SCI);
- obtain, and where necessary respond to, information about activities or intentions of a subsidiary company which may have political implications or raise community concerns;
- review its investment strategy at regular intervals, having regard to the objectives specified in investment policies and balancing strategic, community, and commercial considerations; and
- consider whether to reserve the right to approve board appointments and SCIs in order to obtain assurance about governance and strategic direction in operating subsidiaries.

267 The board of the holding company should ensure that the company is fully accountable to the parent local authority, by:

- defining, through the SCI, the role and reporting requirements of the holding company;
- establishing and reporting against a range of financial and non-financial performance measures;
- maintaining an awareness, and keeping the local authority informed where required, of strategic and business issues in subsidiary companies;
- monitoring the quality of SCIs of subsidiary companies, reviewing them for compatibility with the local authority's strategic aims; and

OVERVIEW OF GOVERNANCE ISSUES

- keeping the local authority fully informed of all significant matters relating to management of its investment portfolio through regular reporting and briefings to councillors.

268 In determining the balance of councillor and external directors, consideration should be given to:

- the desired mix of skills and experience for the holding company's role as the local authority's professional investment manager;
- the nature of the local authority's investment portfolio; and
- the relationship between the holding company and the local authority.

Joint Ventures

269 In establishing the governance framework for joint ventures, a local authority should have regard to the following key factors which are likely to be vital to the success of any such venture:

- A governance framework that creates a forum for effective collective decision-making, preserves the autonomy of the local authority, and maintains a balance of power and influence among the participants.
- Delegations, authorities, and lines of communication that underpin the relationship between the joint venture partners collectively and each individual partner. These should reflect the commitments of the local authority to the partners collectively, on the one hand, and the ultimate accountability of each local authority to its community, on the other.
- Agreed policies and strategies that ensure that a venture is based on common objectives at political and operational levels.
- Provisions to promote the commercial viability of the venture, and the proper control of current and future costs.

Trusts and Other Non-profit Entities

270 A local authority should:

- specify key accountability arrangements when setting up a trust or other non-profit entity;
- draw up a formal service agreement which documents the scope and purpose of the association between the entity and the local authority, defines the services to be provided, and specifies how the entity will be held to account for delivery of those services;

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Statement of corporate intent – The director

- follow an objective process for appointing the governing body, based on a documented set of competencies relevant to the functions and activities of the entity;
- establish a means (conceivably in the context of its own annual planning process) for the local authority to approve or endorse the entity's philosophy, direction and strategies, planned programmes and activities, financial and non-financial targets, and outcome measures; and
- put in place an agreed framework for regular reporting against stated measures of performance, in order to provide the local authority with information as to how the entity is meeting the terms of its service agreement and contributing to the achievement of agreed outcomes.

Group Structures

271 A local authority should ensure that it:

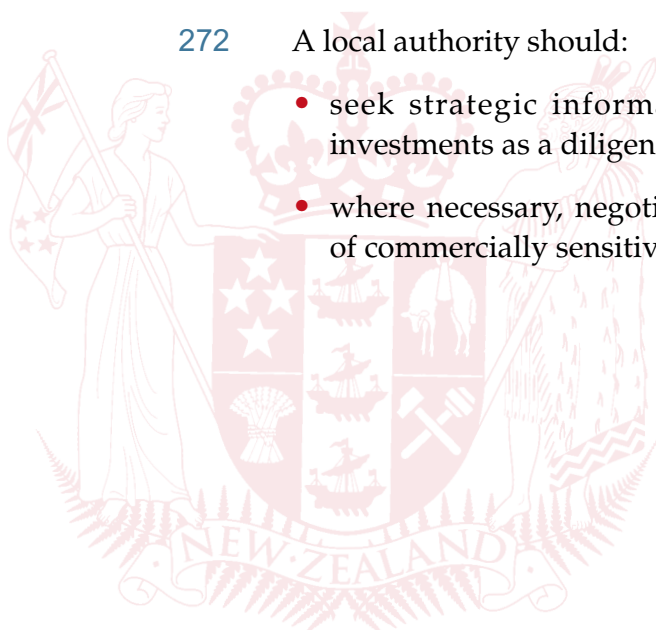
- has the opportunity to consider proposals by subsidiary entities to make significant investments, on the basis of a comprehensive assessment of risk and opportunities; and
- is kept fully informed about the status and outcome of new business ventures.

Monitoring and Accountability Arrangements

Information Flows

272 A local authority should:

- seek strategic information, as necessary, in order to manage its investments as a diligent and informed investor; and
- where necessary, negotiate arrangements for the supply and handling of commercially sensitive information.



OVERVIEW OF GOVERNANCE ISSUES

Business Planning and the SCI

- 273 A company board should consult its shareholding local authority on the key features of the board's business plan, and brief the authority on the strategic outlook for the company.
- 274 Drawing on the business plan and strategic outlook, a local authority should:
- review its interests in light of issues facing the company; and
 - use this information as a framework against which to consider the draft SCI and the local authority's options as an investor.

Disclosing Corporate Governance Practices

- 275 A company board should:
- include in its SCI a corporate governance statement disclosing how the board proposes to conduct its business and discharge its obligations; and
 - outline in the company's annual report how those commitments and obligations have been met.



- 301 Watercare Services Limited (WSL) was established by the then Auckland Regional Services Trust (the ARST) in 1991 as a LATE. An amendment⁶ to the Local Government Act 1974 (“the Act”) dissolved the ARST, and transferred all the shares in WSL to six Auckland local authorities with effect from 1 October 1998.
- 302 WSL is a limited liability company responsible for providing bulk drinking water and wastewater treatment services to the Auckland region. It is the largest bulk water and wastewater company in New Zealand, owning and operating assets with a combined replacement value of over \$2,000 million dollars. These assets include dams, treatment plants, water mains, reservoirs, pump stations, and sewers. The company’s principal customers for the supply of bulk water are the six shareholding local authorities (or their agents).⁷ It treats wastewater for four local authorities and over six hundred commercial customers.
- 303 We outline the governance framework for WSL and then focus on two elements –
- the discharge of ownership obligations by the shareholding authorities; and
 - WSL’s key business processes –
- before making some overall comments and recommendations.

The Governance Framework

- 304 The governance framework for WSL is largely determined by legislation. The Act sets out general statutory accountability requirements for LATEs. As amended in 1998, the Act also:
- includes specific governance and accountability provisions for WSL; and
 - places additional obligations and constraints on WSL’s operations and on the roles and functions of the six shareholding local authorities.

⁶ The Local Government Amendment Act 1998.

⁷ Metrowater, a LATE, is responsible for the distribution of water in Auckland City, while United Water distributes water under a franchise agreement with Papakura District Council.

WATERCARE SERVICES LIMITED

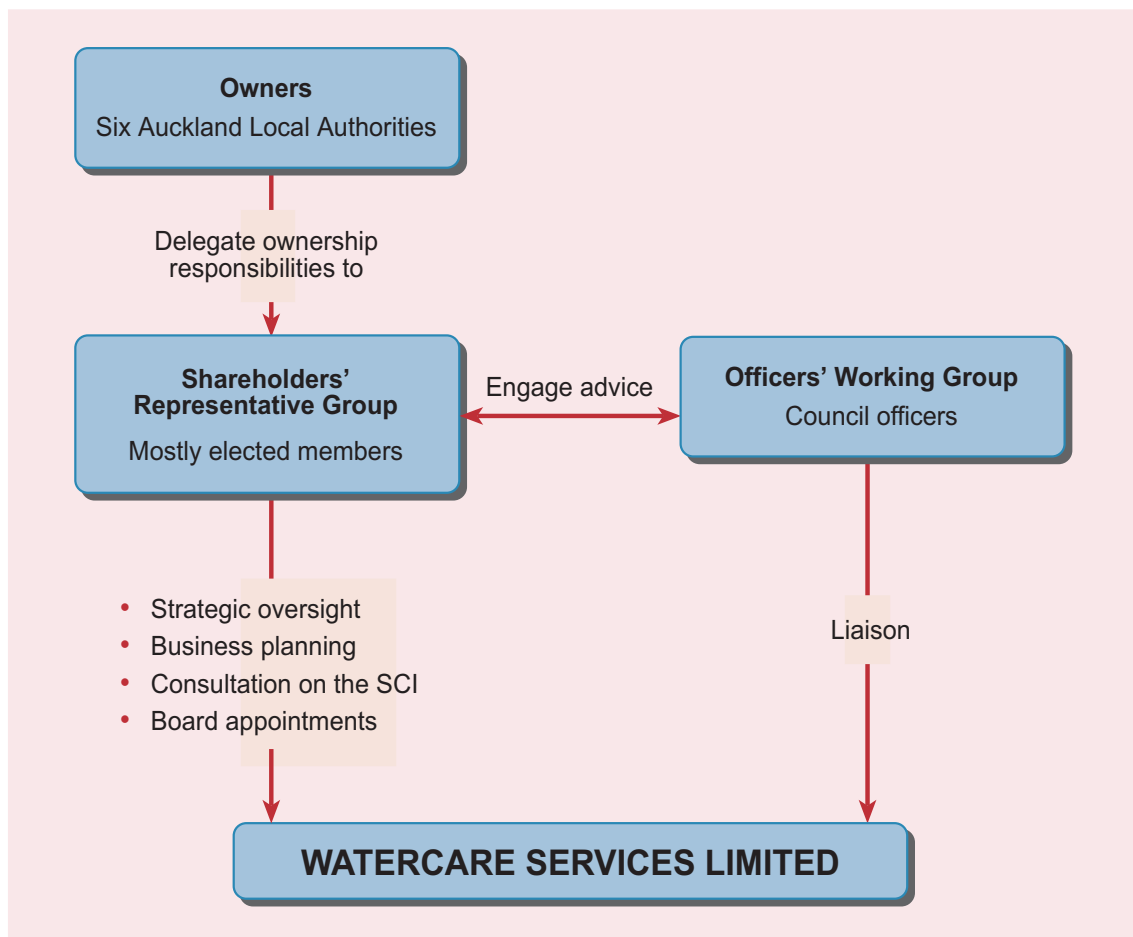
- 305 The most significant accountability requirements for WSL are:
- WSL must “manage its business efficiently with a view to maintaining prices for water and wastewater services at the minimum levels consistent with the effective conduct of that business and the long-term integrity of its assets” (section 707zzzs of the Act);
 - WSL is not permitted to pay a dividend to its local authority shareholders; any surplus must be either re-invested in the business or distributed to its customers; and
 - WSL must, each year, prepare and submit to each shareholder indicative asset management and funding plans. In preparing its draft SCI the company must consider any written submissions on those plans.
- 306 The most significant obligations and constraints for the six shareholding local authorities are:
- they are not permitted to sell or otherwise dispose of their shares in WSL;
 - they must, in their capacity as owners, act in the best interests of those who live in the Auckland region; and
 - they must enter into an agreement outlining the process to be followed in appointing directors to the board of WSL, setting their terms of office and remuneration, and specifying how they will approve:
 - the SCI for WSL;
 - any major acquisitions by WSL; and
 - the distribution of surpluses by WSL to its customers.
- 307 WSL’s shareholders are shown in Figure 1 (on page 39), and its governance framework in Figure 2 (also on page 39).
- 308 The then Government intended WSL’s governing legislation to be a temporary arrangement pending a proposed governmental review of water and wastewater services in New Zealand. The present Government has not, as far as we are aware, taken up that proposed review. However, the six Auckland local authorities decided late in 1999 to undertake their own review of water, wastewater and stormwater services in the Auckland region. The review group expects to report in 2001.

WATERCARE SERVICES LIMITED

*Figure 1
Shareholders of Watercare Services Limited*

Local Authority	Shares	
	No.	%
Auckland City Council	108,551,635	41.7
Manukau City Council	65,481,895	25.1
North Shore City Council	29,988,909	11.5
Papakura District Council	9,667,225	3.7
Rodney District Council	3,602,651	1.4
Waitakere District Council	43,400,849	16.6
Totals	260,693,164	100.0

*Figure 2
Governance Framework of Watercare Services Limited*



Ownership Obligations of the Shareholding Local Authorities

309 We expected that ownership arrangements in relation to WSL would have the following features:

- a framework which fosters effective decision-making;
- an effective process for the appointment and remuneration of the governing body;
- a process for consultation on the SCI; and
- an effective means of monitoring WSL's performance, and of holding the board to account.

A Framework which Fosters Effective Decision-making

310 The shareholding local authorities' relationships with each other are governed primarily by:

- the Act;
- a Shareholders' Agreement, approved by the Minister of Local Government in December 1998; and
- WSL's constitution, to a very limited extent.

311 The interests of the shareholding local authorities are represented by a Shareholders' Representative Group (SRG) to which each local authority sends two representatives, usually councillors. While the allocation of votes among the six shareholders gives the larger local authorities greater voting power, equal representation of each shareholder on the SRG, in theory at least, gives each an equal voice.

312 Our review of SRG documentation indicates that the group has been well aware of the various objectives it must try to reconcile in performing its functions. In May 1999 the SRG considered and endorsed the recommendations of a paper from its advisers which outlined the following range of objectives facing it:

- as investors, to increase the value of the company by maximising profits;

- as representatives of and advocates for the residents of Auckland (the ultimate consumers of WSL's services), to ensure that WSL provides high quality, healthy and reliable services, and minimises its prices;
- as advocates for the interests of the community, to allow WSL to make reasonable (but not excessive) profits while minimising its costs and carrying out its activities with minimal impact on the environment;
- as owners of the direct retail customers of WSL⁸, to encourage the company to provide high quality services and minimise its prices;
- as potential future competitors, to ensure that the company does not act anti-competitively; and
- as environmental guardian for the region, to ensure that WSL's activities have minimal impact on the environment and promote conservation.

313 An Officers' Working Group (OWG), on which each shareholder is represented, serves a similar co-ordinating function at officer level. The Auckland City Council services the OWG.

An Effective Process for Appointment and Remuneration of the Governing Body

314 The Act establishes principles for the selection and appointment of directors. The Shareholders' Agreement outlines the agreed recruitment and appointment processes, including:

- a process for reviewing the knowledge, experience, and skills of existing directors;
- preparation of a job description for directors;
- recruitment advertising; and
- systematic short-listing procedures.

⁸ With the exception of Papakura District Council, which has franchised its local water/wastewater activities, WSL's shareholders also own the local water/wastewater providers which are WSL's direct customers.

WATERCARE SERVICES LIMITED

- 315 In 1999 the SRG developed a list of competencies for WSL directors and engaged consultants to carry out an evaluation process to:
- review those competencies;
 - develop a process for reviewing directors; and
 - carry out the review.
- 316 We expect that the evaluation will:
- serve as a sound basis for appointment processes in the future; and
 - provide a means of assurance that the board comprises the appropriate mix of competencies and is working together well.

A Process for Consultation on the SCI

- 317 The legislation outlines how the SCI is to be prepared, consulted on, and finalised, giving the shareholders and the board the opportunity to:
- reach a mutual understanding of each other's interests and objectives; and
 - reach agreement on the strategic direction of WSL.
- 318 In considering the board's draft SCI, the shareholding local authorities need information and analysis from which to determine their own interests and priorities. The OWG provided the information and analysis to the SRG, and this information gave the SRG a framework to evaluate WSL's draft SCI for 1999-2000. In an April 1999 report to the SRG, to assist it in assessing the board's proposed SCI and funding plans against its own interests and perspectives, the OWG outlined:
- possible high-level objectives for WSL;
 - processes by which the shareholders' objectives might be incorporated into WSL's SCI; and
 - how performance targets might be developed to support those objectives.

- 319 In the process of consultation on the content and format of the SCI, fundamental differences in perspective between the parties were exposed. A series of communications took place between the board and the SRG, and between WSL management and the OWG. The SRG examined the document in detail and:
- analysed the company's proposed capital expenditure programme, asset management plans, and funding plans;
 - reviewed WSL's forecasts and assumptions;
 - modelled the impact of funding options; and
 - on the basis of that analysis, encouraged WSL to make a number of amendments to the content and emphasis of the document.
- 320 The consultation process thereby served a valuable purpose in identifying areas where there was a lack of clarity about the governance framework, and in providing an incentive to seek solutions.

An Effective Means of Monitoring WSL's Performance and Holding the Board to Account

- 321 WSL supplies a range of information to the SRG in a variety of ways. First, as required by the SCI, WSL provides the SRG with:
- asset management plans for its water and wastewater businesses;
 - funding plans for its water and wastewater businesses;
 - half-yearly and annual reports; and
 - an environmental report.
- 322 Correspondence from WSL to the SRG included a significant volume of additional information sought by the shareholders (including financial models, funding options, and capital expenditure projections).
- 323 The SRG also receives quarterly management reports from WSL, which are analysed by the OWG. These contain:
- an assessment of financial performance for the quarter;
 - operational information;
 - schedules of capital expenditure;
 - summarised progress reports on individual capital projects; and
 - explicit reporting against SCI reporting targets.

WATERCARE SERVICES LIMITED

- 324 The OWG raises questions to be addressed by WSL when the company presents these reports to the SRG at quarterly briefings.
- 325 Formal reporting by WSL to its shareholders is complemented by informal communication between the chairpersons of the SRG and WSL, and between local authority officers and WSL's senior managers.
- 326 The SRG has taken steps to hold WSL to account for its cost structures; for example, by seeking evidence of the reduction of operating costs over time. We endorse this approach. The SRG has also sought independent audits of the major capital projects managed by WSL.
- 327 WSL has responded to demands for a cost control regime in various ways. For example, in its SCI the company makes commitments to:
- a range of cost minimisation targets; and
 - quarterly reporting on participation in an appropriate performance benchmarking and information disclosure regime.

Key Business Processes

- 328 We identified the following business processes as particularly relevant to governance arrangements:
- asset management planning;
 - funding and pricing mechanisms;
 - the relationship between WSL and its customers; and
 - cost-efficiency considerations.

Asset Management Planning

- 329 The Act makes asset management a central function for WSL. Demand for water will increase as population growth and economic development continue in the Auckland region. New infrastructure will be needed for wastewater collection and treatment to:
- cater for continued growth and urban intensification;
 - meet the requirements of the Resource Management Act 1991; and
 - meet public expectations for a cleaner environment.

- 330 In response to demand projections for the region, WSL had approximately \$500 million of capital expenditure planned for the following five years. WSL has adopted a 20-year period for asset management planning, identifying projects required to:
- cater for growth;
 - meet changing customer service and environmental standards; and
 - provide for asset renewal and replacement.
- 331 Core functions of the WSL board include:
- approval of the asset management plan;
 - monitoring capital expenditure; and
 - oversight of major capital projects.
- 332 The asset management plan provides the basis for a credible financial plan and the framework within which WSL will design and build the necessary infrastructure to meet desired levels of service. Accordingly, the Act requires WSL to submit an asset management plan to each shareholder and to consider any submissions made on that plan in preparing the draft SCI. In this way asset planning is integrated into the accountability relationship between the company and the shareholders and, through them, with the public.
- 333 While under no obligation to do so, WSL makes a copy of its asset management plans available to its local authority bulk water and wastewater customers, recognising the potential efficiencies from joint planning.

Funding and Pricing Mechanisms

- 334 The funding plan draws directly on the capital and operating expenditure outlined in WSL's asset management plans, showing:
- how those assumptions translate into revenue requirements;
 - how prices and charges have been calculated at an aggregate level; and
 - a range of possible pricing profiles into the future.
- 335 The SCI, the asset management plan, and the funding plan are designed to determine the approach WSL must take in setting its prices.

WATERCARE SERVICES LIMITED

- 336 The funding plan is based on a range of assumptions – all of legitimate interest to any owner – about the timing of capital expenditure, levels of gearing (the debt/equity ratio), and target rates of return. Both the Act and the nature of WSL’s business as an infrastructure manager make scrutiny of the funding plan a central role for the shareholding local authorities.
- 337 However, the parties did not share a common view on the manner in which consultation should be undertaken. Confusion over the roles and responsibilities for funding and pricing decisions have led to disputes between WSL and its shareholders and customers. We discuss the implications of unclear roles and responsibilities below.

The Relationship Between WSL and Its Customers

- 338 We found that there were very different understandings of the roles of WSL and its customers in the price-setting process. In our view, these differences gave rise to a dispute over WSL’s right to include in its prices a margin for a return on equity.
- 339 In our view, WSL’s customers can reasonably expect WSL to consult them on:
- tariff structures, explaining its proposed pricing policies and considering comments on them;
 - delivery standards;
 - incentives to manage end-user demand;
 - security of supply; and
 - other contractual matters.
- 340 The local authority customers have the overriding goal of securing – for their end-user consumers, the residents of the Auckland region – an optimum mix of quality, security and value.
- 341 The Act provides for WSL to set its charges after consulting the shareholding local authorities on its asset management and funding plans. These matters were discussed with the shareholders and reflected in the company’s SCI.

- 342 Having consulted its shareholders, however, WSL was drawn into further negotiations with its customers in the second half of 1999. At issue were a similar set of pricing matters concerned with the funding plan, capital expenditure projections, and the target return on equity.
- 343 We examined records of the negotiations between WSL and the local authority customers or their agents. We also examined exchanges between the shareholding local authorities and the company over a number of months in 1999.
- 344 The documentation indicates that the SRG was aware of the need to keep the local authorities' interests as shareholders separate from their objectives as customers. However, there is a fundamental tension between the dual roles of local authorities as customer and owner. The lack of a comprehensive and clear formal contract between the local authorities as customers and WSL as supplier has heightened this tension.
- 345 The local authorities are faced with the following conflicting influences:
- their dual roles as owners and customers, which give rise to tensions between short-term and long-term objectives; and
 - statutory prohibitions on WSL paying a dividend and on the local authority shareholders disposing of their shares. Together, these provisions are likely to weaken the normal incentives for a shareholder to enhance the value of the company, or to seek an adequate return on their investment.
- 346 Inevitably, choosing pricing paths to achieve given revenue requirements involves trade-offs among profitability, service levels, and the timing of capital expenditure. Particular conflicts arise between, on the one hand, a short-term focus on prices and, on the other, the urgent need for long-term infrastructure investment.
- 347 At the time of our study, WSL and its local authority customers had begun discussions on a protocol to clarify the relationship between the company and the local authorities in their conflicting roles as customers and shareholders. In defining agreed principles underlying the governance relationships between the parties, the protocol represents a valuable opportunity to clarify the roles and governance responsibilities of each party.
- 348 Records of contract negotiations show that WSL had sought a long-term contract with its local authority customers to secure a degree of certainty about future income streams in order to meet the costs of its substantial capital expenditure programme. However, uncertainties about WSL's future and the planned review of the water industry have weakened the incentives for the parties to reach agreement, despite extensive discussions.

- 349 The commercial service relationship is defined simply by an historical operating agreement. The relationship between WSL and its local authority customers would be placed on a more solid footing by a comprehensive long-term contract incorporating initiatives such as options for demand management and risk-sharing.

Cost-efficiency Considerations

- 350 A monopoly supplier can be regulated by a comprehensive disclosure regime using accepted industry benchmarks and consistent targets against which to compare relative efficiency. In the absence of such requirements, a monopoly supplier has the potential to exploit its position in various ways. Possible monopolistic behaviour includes:

- overstating demand and inflating the capital expenditure needed to meet that demand;
- inflating asset values as a basis for driving up prices;
- hiding costs;
- failing to pass operating and capital efficiencies on to customers; and
- making inefficient choices about the mix of funding sources (principally retained earnings, borrowings and equity) to finance operational and capital expenditure.

- 351 In its capacity as a single supplier of essential services, WSL should be able to demonstrate that it runs its business in an efficient manner. As noted in paragraph 305, the legislation requires WSL to manage its business efficiently. Business processes that promote efficiency encompass:

- transparent information disclosure;
- cost benchmarking;
- a sound and effective contractual relationship with customers; and
- an agreed and well-understood process for setting prices.

- 352 The Act promotes transparency through, for example:

- the requirement for asset planning and funding documents; and
- the requirement that WSL cost its water and drainage services separately.

- 353 Our analysis of documentation and correspondence between the SRG, customers and WSL indicates that WSL has responded positively to demands for information.
- 354 Assurance of cost control, and operating and capital efficiency, requires:
- regular flows of comparative information prepared on a consistent basis; and
 - industry-specific measures for evaluating trends in service levels and unit costs.
- 355 Customer agreements provide for some disclosure of operating costs, and opportunities for cost and price minimisation have been discussed between WSL and its shareholders.
- 356 The records reveal a reluctance on the part of the local authority customers to enter into the long-term contract sought by WSL. Their reluctance arises from a desire that a contract should be sufficiently flexible to enable the parties to take advantage of changes to legislation and industry structure. In our view, the weak incentives for the parties to enter into arrangements which are in the best long-term interests of end-users are likely to be perpetuated by:
- continuing uncertainty about the contractual relationship between WSL and its customers; together with
 - a lack of clarity about their respective roles and responsibilities.
- 357 Documentation also revealed apparent confusion over the roles of shareholders and customers in the negotiation of WSL's prices. Revenue requirements, and thereby pricing paths, are set through a process prescribed in the legislation. This process entails consultation between the company and its shareholders on the content of the asset management plan, the funding plan, and the SCI. These three documents provide an agreed strategy and direction for WSL over the following year.
- 358 WSL's pricing negotiations with its customers, however, reflected a confusion of local authority roles between those of shareholder and customer. The local authority customers raised issues, including:
- the level of WSL's budget surplus;
 - the rate of return component underlying WSL's pricing profiles; and
 - the level of WSL's retained earnings.

- 359 The negotiations reflect ongoing tensions between the roles of the parties and the need for a shared understanding of price-setting processes within the broad legislative framework.

Conclusions and Recommendations

- 360 Our analysis points to inherent tensions in governance arrangements. Tensions in the relationships between WSL and the local authorities in their dual roles of shareholder and customer arise from:

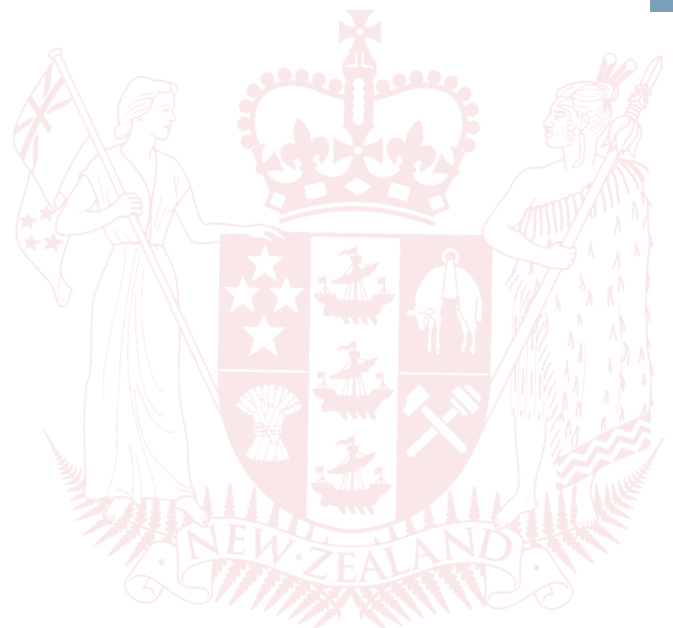
- Confused roles and responsibilities, leading to competing incentives for the local authorities as shareholders and as customers.
- Expectations about the manner in which WSL will conduct its operations. WSL is expected to follow a corporate commercial model, applying business disciplines to management of infrastructure, but also to adopt a pricing regime which has regard to a range of public interest considerations.
- A governance framework which precludes the shareholding local authorities from pursuing the normal interests (value maximisation for potential sale and a dividend stream) of commercial owners.
- Weak incentives for cost efficiency and limited measures for benchmarking performance given the single supplier status of the company.

- 361 The Act recognises these tensions. It requires the local authorities to exercise their ownership rights in the public interest. At the same time, it preserves a commercial structure (other than the restrictions on dividends and selling out) to the extent that the governing body of WSL has the usual powers and rights of a company board along with significant powers to set prices.

- 362 Structures and ownership throughout the water industry create the potential for similar tensions over pricing and investment issues. We identified a need to manage the competing interests inherent in the current governance arrangements for WSL. To date these arrangements have generated incentives and behaviour that present obstacles to the long-term resolution of these underlying tensions.

- 363 WSL operates under legislation that was intended to be temporary. The previous Government's proposed review of the water industry in New Zealand has not made significant progress. Uncertainty about the future of water and wastewater services in the Auckland region has not promoted effective business planning and strategic decision-making.

- 364 However, the Auckland region’s local authorities are currently carrying out a review of regional water, wastewater, and stormwater services. We suggest that the Government gives careful consideration to its findings, and we recommend that, as soon as practicable, the Government declare its intentions for the structure of the water industry in Auckland. A sound and effective governance structure and long-term certainty need to be provided to both WSL and its shareholding local authorities.
- 365 In the interim, WSL and its shareholders should take every step to improve their relationships. Immediate steps that could be taken are:
- negotiating long-term contracts between WSL and its customers; and
 - developing a comprehensive protocol between WSL and its local authority shareholders to define the roles and relationships between the company and its owners and customers.
- 366 We understand that, since the time of our study, discussions have continued on negotiation of contracts and development of a protocol. We encourage the parties in their efforts to put their relationships on a firm business footing.



401 Infrastructure Auckland (IA) was created on 1 October 1998 by an amendment to the Act.⁹ The amendment dissolved the former Auckland Regional Services Trust (ARST) and vested the majority of the ARST's assets in IA. A significant asset not vested was the ARST shareholding in WSL. The governance arrangements relating to WSL are discussed in Part Three (pages 37-39).

402 The principal purpose of IA is:

to contribute funds, by way of grants, in respect of projects, or parts of projects, undertaken in the Auckland Region for the purpose of providing –

- (a) *Land transport; or*
- (b) *Any passenger service; or*
- (c) *Any passenger transport operation; or*
- (d) *Stormwater infrastructure, –*

*where the projects or parts of projects generate benefits to the community generally in addition to any benefits that accrue to any identifiable persons or groups of persons.*¹⁰

403 IA performs two distinct functions:

- **to manage:**
 - (a) the region's investments in Ports of Auckland Limited (POAL) (80% owned), America's Cup Village Limited (ACVL) (100% owned), Northern Disposal Systems Limited (NDSL) (100% owned); and
 - (b) its Treasury Fund; and
- **to fund** infrastructure projects in the region by way of grants generated through its revenue and capital base, although it must use income in preference to capital.

404 The two functions are closely related as IA is charged with using the income stream and, in the event of sale, capital proceeds from its investment portfolio to fund infrastructure development for the region.

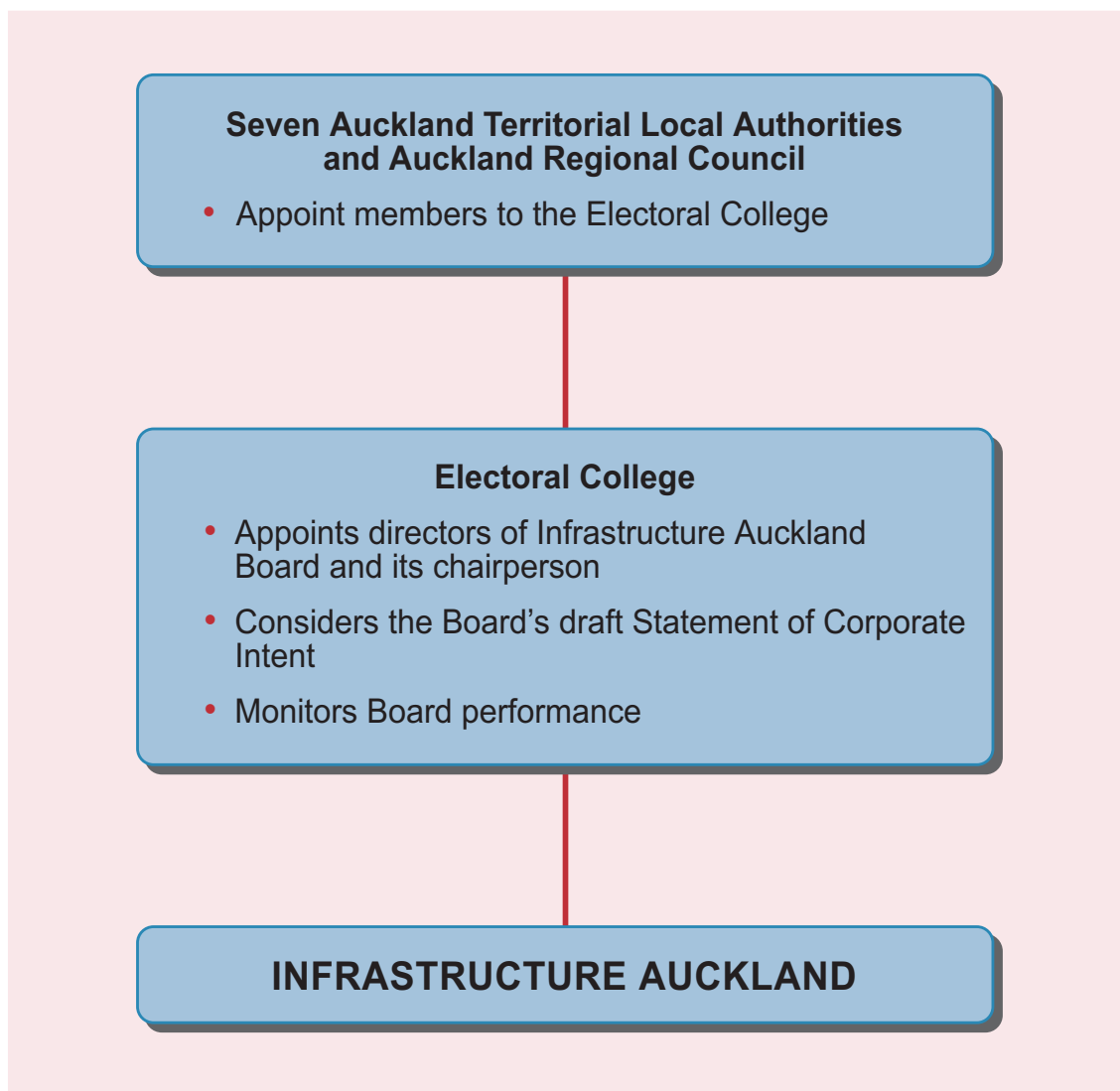
⁹ Local Government Amendment Act 1998.

¹⁰ Local Government Act 1974, section 707zzk(1).

The Governance Framework

- 405 IA is a hybrid body. It has an appointed board and the powers of (variously) a territorial authority, a regional council, and a statutory corporation. The governance structure comprises the Electoral College, the Board of Directors, and the executive management team.
- 406 The Act largely determines the structure and operation of IA and prescribes the IA Deed (“the Deed”). See Figure 3 on opposite page. The Deed sets out the functions and powers of IA and specifies:
- the manner in which appointments will be made by the Electoral College;
 - the general criteria to be used when evaluating applications for grants; and
 - the information to be included in the SCI.
- 407 The Deed may be amended only by Order in Council on the recommendation of the Minister of Local Government after consultation with the Electoral College.
- 408 The Act and the Deed place certain special obligations on IA. The most significant of these are that IA must:
- act in the best interests of the inhabitants of the Auckland Region;
 - adopt the special consultative procedure in the Act for any proposal to sell or dispose of shares in its subsidiary companies;
 - manage its assets in accordance with sound business practice;
 - avoid acquiring other assets (except in specified circumstances); and
 - not sell or dispose of more than 24.9% of its shares in POAL without first receiving a majority vote in favour of such a decision through a referendum of Auckland residents.
- 409 In addition, the activities of IA are governed by its SCI.

Figure 3
Governance Framework of Infrastructure Auckland



410 We visited IA in November 1999, at which time it had been in existence for only fourteen months. Nonetheless, we were keen to examine elements of the governance arrangements at an early stage in development and implementation. We focused our examination on two elements of the governance framework:

- the role of the Electoral College; and
- the key business processes for IA.

411 We examine each of these elements in turn before making some overall comments and recommendations.

INFRASTRUCTURE AUCKLAND

The Role of the Electoral College

- 412 IA is overseen by an Electoral College that has eight members – one from each of the Auckland region’s seven territorial local authorities and one from the Auckland Regional Council. The Electoral College elects one of its members as chairperson. The Electoral College members were the mayors of the territorial local authorities and the chairman of the Regional Council.
- 413 The voting entitlements of the members are:
- | | |
|---------------------------|---------|
| Auckland City Council | 3 votes |
| Manukau City Council | 3 votes |
| North Shore City Council | 2 votes |
| Waitakere City Council | 2 votes |
| Franklin District Council | 1 vote |
| Papakura District Council | 1 vote |
| Rodney District Council | 1 vote |
| Auckland Regional Council | 1 vote |
- 414 The Electoral College meets four times a year. Its main functions are to:
- consider and comment on the content of IA’s SCI;
 - monitor IA’s performance;
 - appoint the directors and the chairperson of the IA Board; and
 - consult as necessary with the Minister of Local Government about any proposed amendments to the Deed.
- 415 When IA was established, the Board had nine directors, six of whom were elected members from the ARST. The Electoral College appointed the other three directors, and the chairperson, in accordance with the process prescribed in the Act. From 1 July 1999 Board membership dropped to seven, and from 1 January 2000 the Electoral College has had the power to appoint all the directors.
- 416 The Act and the Deed prescribe the process to be followed for selecting and appointing directors. The Electoral College must:
- publish a job description;
 - advertise vacancies; and
 - use an independent recruitment consultant to assess the suitability of applicants.

417 The strategic focus and activities of IA were under discussion at the time of our visit. Consultation on the content of the Board’s draft SCI had led to an exchange of views between the Electoral College and IA. Discussions were also occurring between IA and the Electoral College on the Board’s quarterly report. The quarterly report outlined progress against the objectives set out in IA’s SCI and covered:

- progress against SCI objectives;
- grant activity;
- staffing issues;
- communications, relationship management, and liaison;
- environmental improvement and issues for IA and its three subsidiaries;
- value of its investment portfolio;
- investment activity, summarising monthly reports from its three subsidiaries;
- detailed schedule of grant applications in hand; and
- financial performance, including investment reports from AMP Asset Management New Zealand Limited which manages IA’s Treasury Fund.

418 Establishing IA and appointing the Board largely dominated the workload of the Electoral College for its initial meetings, and at the time of our study the College was still developing its monitoring role. Over time, we expect the Electoral College to take a more systematic approach to examining IA’s SCI and monitoring performance against its objectives. We understand that an Officers’ Group was established by the Chief Executive Officers’ Forum in February 2000 to provide analysis and assistance to the Electoral College. This role involves analysing documents such as IA’s SCI and quarterly reports, and providing comments and advice for consideration by the College.

419 At the time of our study, the Electoral College did not have a structure for evaluating the performance of the Board. Evaluating the Board’s performance will help to provide some assurance that the board has the right mix of skills, is working well, and has the necessary systems in place to fulfil its dual functions. The College had, however, recognised this need. We understand that a system for measuring the performance of the chairperson and directors of IA has now been developed and was to be used for the first time before the end of 2000.

INFRASTRUCTURE AUCKLAND

- 420 The six local authorities we visited endorsed the role of the Electoral College and its decision-making framework. There was also support for the role of mayors as Electoral College members given:
- their understanding of the region's needs; and
 - the need to manage the political issues surrounding the activities of IA.

Key Business Processes

- 421 The key business processes of IA relate to its two distinct functions:
- To **manage its investments** in POAL, ACVL, NDSL and in the Treasury Fund. The **ownership and investment** role involves management of investments and discharge of ownership obligations.
 - To **fund infrastructure projects** through grants, drawing on income and capital from those investments (subject to the requirements of its legislation).

Owner and Investment Manager

Investment Management

- 422 IA's investment portfolio was worth \$813 million at 30 June 2000, in the following proportions:
- | | |
|---|-----|
| • Ports of Auckland | 52% |
| • Northern Disposal Systems | 2% |
| • America's Cup Village | 6% |
| • Treasury Fund and Commercial Property | 40% |

423 The legislation requires these assets to be managed in accordance with sound business practice. IA's stated aim is to "optimise returns within an acceptable level of risk to maximise funds available to make grants."¹¹

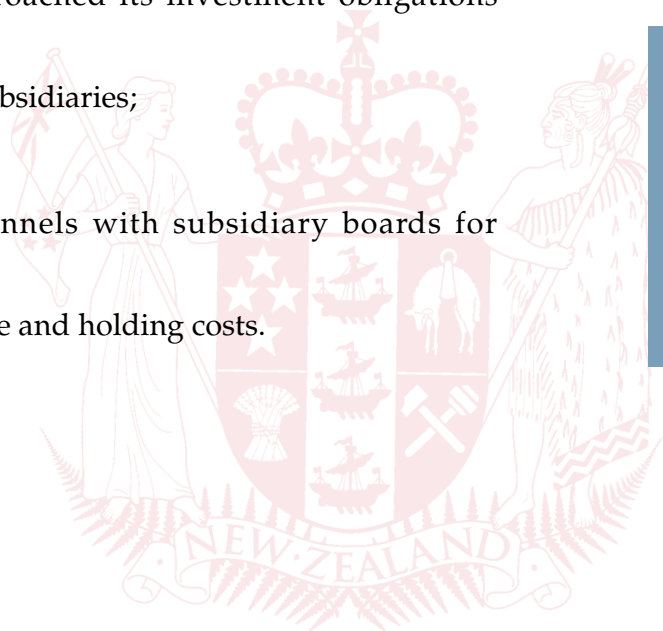
424 The Treasury Fund transferred to IA from ARST has grown from subsidiary companies' dividend receipts and from interest earned on the Fund. A private asset management company was appointed to manage the Fund on IA's behalf. The range of potential investments is limited by IA's Treasury Management Policy.

¹¹ Final Annual Plan 2000, page 22.

- 425 IA's investment portfolio is dominated by its shareholding investment in POAL. This raises the following two significant issues:
- The likely realisable value of IA's investment portfolio is heavily influenced by the market value of POAL shares. There have been significant fluctuations in the share price. The size of the shareholding held by IA, and the statutory constraints on IA's ability to trade in those shares, also mean that the share price may not be an accurate reflection of the potential value.
 - The statutory requirement for public consultation before IA can sell its equity investment to fund infrastructure projects may affect its ability to realise optimal value. IA may have to liquidate assets at a time when share prices are low, and the market may under-value shares if it perceives a forced sale.
- 426 IA has made clear in its SCI for 2000-2003 and its Annual Plan for 2000-2001 that it has no plans nor current intention to sell or otherwise dispose of any of the shares in POAL.

Discharging Ownership Obligations

- 427 The relationship between IA and its wholly owned subsidiaries, NDSL and ACVL, is managed through the SCI. The relationship with POAL – a subsidiary but also a publicly listed company – is determined by POAL's constitution and the requirements of the New Zealand Stock Exchange.
- 428 IA is establishing an effective framework for managing its investments. From our observations, IA has approached its investment obligations actively by:
- pursuing strategic issues with its subsidiaries;
 - reviewing subsidiaries' SCIs;
 - establishing communication channels with subsidiary boards for ongoing monitoring; and
 - initiating reviews of long-term value and holding costs.



INFRASTRUCTURE AUCKLAND

- 429 In its role as owner of POAL, NDSL and ACVL, IA is committed to acting in the role of a “diligent, constructive and enquiring shareholder”,¹² focusing on strategic issues and leaving the subsidiary companies to manage their own business on a day-to-day basis. There is evidence of IA undertaking extensive and rigorous evaluation of its ownership interests at regular intervals.
- 430 IA appoints the directors of its subsidiary companies. However, at the time of our study a system for monitoring the performance of directors and boards of subsidiaries had not been put in place. IA undertook to introduce such a system in 2000.
- 431 IA was receiving monthly reports from NDSL and ACVL, in addition to formal quarterly reports against SCI objectives. POAL also provided monthly and quarterly reports and quarterly and six-monthly briefings to IA. However, consistent with listing requirements, POAL was supplying only limited financial information in addition to that released to the market through publication of its six monthly and annual results.
- 432 There was some evidence that the reporting relationship between IA and its subsidiaries has not yet fully developed to the satisfaction of all parties. Occasionally, IA had experienced resistance to its requests for information. It had investigated ways to obtain more information than it was currently receiving – for example, by entering into a confidentiality agreement with the boards of its subsidiaries.
- 433 In the private sector, parent companies may appoint directors or employees to the boards of subsidiaries to align their strategic interests. This mechanism is not available to IA, as it is expressly prohibited by the legislation. The view was put to us that this provision constrains the ability of IA to manage the governance relationship with its subsidiaries in the same manner as its private sector counterparts.

Funder of Infrastructure Projects

- 434 IA provides grants for transport and stormwater projects in the Auckland region. The grant application process has the following four stages, which are simplified for grant applications under \$500,000:
- expression of interest;
 - grant application;
 - project evaluation; and
 - grant determination and allocation.

¹² *Final Annual Plan 2000*, page 25.

- 435 Initial demand for grants was low. By 7 March 2000, IA had approved only 12 grants totalling \$1,683,709, with no single grant exceeding \$500,000. However, by the same date IA had received a total of 62 expressions of interest which, if approved, would require total capital expenditure of nearly \$3,000 million.
- 436 In considering grant applications, IA is required to act in the best interests of Auckland as a whole. The Regional Growth Forum and working parties and liaison groups at political and officer levels have developed a set of regional strategies, such as the Regional Land Transport Strategy. These strategies provide IA with the necessary framework within which to consider infrastructure priorities and make funding decisions.
- 437 IA's capacity to fund grants for infrastructure depends on the performance of its investment portfolio – in particular, decisions about its investment in POAL. Those decisions rest with the political leadership and the public in the Auckland region.
- 438 IA faces a tension between its dual roles as asset manager and as funder of the infrastructural needs of the region. IA has signalled its intention not to sell or dispose of its shares in POAL in the short to medium term. However, demands for infrastructure funding and possible changes within IA's investment portfolio suggest that this will not be a sustainable long-term position.
- 439 The future investment strategy of IA – in particular, the relationship between its investment functions and funding obligations – needs to be clarified. While recognising the relationships between these dual roles, we consider it important that IA treat the two roles as discrete functions. IA's investment portfolio is fundamentally unbalanced and its value can change significantly over time.
- 440 The timing of any sale may affect the funds available for infrastructure expenditure. IA should continue to monitor the opportunity costs of its investments actively, working closely with the board of POAL in particular. Monitoring requires continual review of the investment options available against which to assess the relative risks and returns of its current investment portfolio.

Conclusions and Recommendations

- 441 The Electoral College has important functions in relation to Infrastructure Auckland. The local authorities we visited endorsed the College’s role and decision-making framework.
- 442 With the IA Board now established, the Electoral College can take a more systematic approach to monitoring IA’s performance, especially in respect of progress in meeting the objectives set out in its SCI. The College is also addressing the need for an effective structure to evaluate the performance of IA’s board, to ensure that the Board:
- has the right mix of skills;
 - is working well together; and
 - has the necessary systems to fulfil its investment and funding obligations.
- 443 IA is actively managing its investment obligations, seeking strategic information to meet its needs as owner, and regularly reviewing its ownership interests. At the time of our visit, it was planning to establish a system for monitoring the performance of directors and boards of its subsidiaries.
- 444 Some issues of communication between IA and its subsidiaries need to be addressed. At the time of our visit, IA was continuing to negotiate with its subsidiaries for flows of information. In its opinion, this information was needed to meet its statutory obligations, to monitor the risk profile of its investment portfolio, and to fulfil the role of an informed and diligent shareholder.
- 445 For its infrastructure funding role, regional strategies have created a planning framework within which IA will be able to make necessary funding decisions about the overall needs of the region.
- 446 IA faces a tension between its dual roles as “asset manager” and “funder”. The relationship between the two roles needs to be clarified. IA’s capacity to fund grants in the future will be influenced significantly by decisions about its investment in POAL. Those decisions rest with the political leadership and the public in the Auckland region.
- 447 IA should continue to monitor actively the performance of its investments, having regard to the composition of its portfolio and opportunity costs.

448 The future of IA's investment in POAL is both a commercial and a political issue. Long-term regional planning requires some certainty, and in turn this requires some clarification at political and community levels about the preferred use of the public funds that are currently invested in POAL. Factors influencing this decision are judgements about:

- the relative value of retaining the region's equity investment as a source of future capital gain and dividend income;
- preservation of other perceived strategic benefits; and
- using the capital to make improvements to the region's infrastructure.



THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

The Governance Framework

- 501 On 31 March 1999 six Canterbury territorial local authorities and a private sector company, Canterbury Waste Services Limited (CWSL)¹³, incorporated a joint venture LATE – Transwaste Canterbury Limited (Transwaste) – to develop and operate a landfill to meet the Canterbury region’s waste disposal needs. At the time of our study, investigations were being carried out to find a suitable site for the landfill.
- 502 The six shareholding local authorities together hold 50% of Transwaste. The local authorities, and their shareholdings, are shown in Figure 4 below.

*Figure 4
Local Authority Shareholdings in
Transwaste Canterbury Limited*

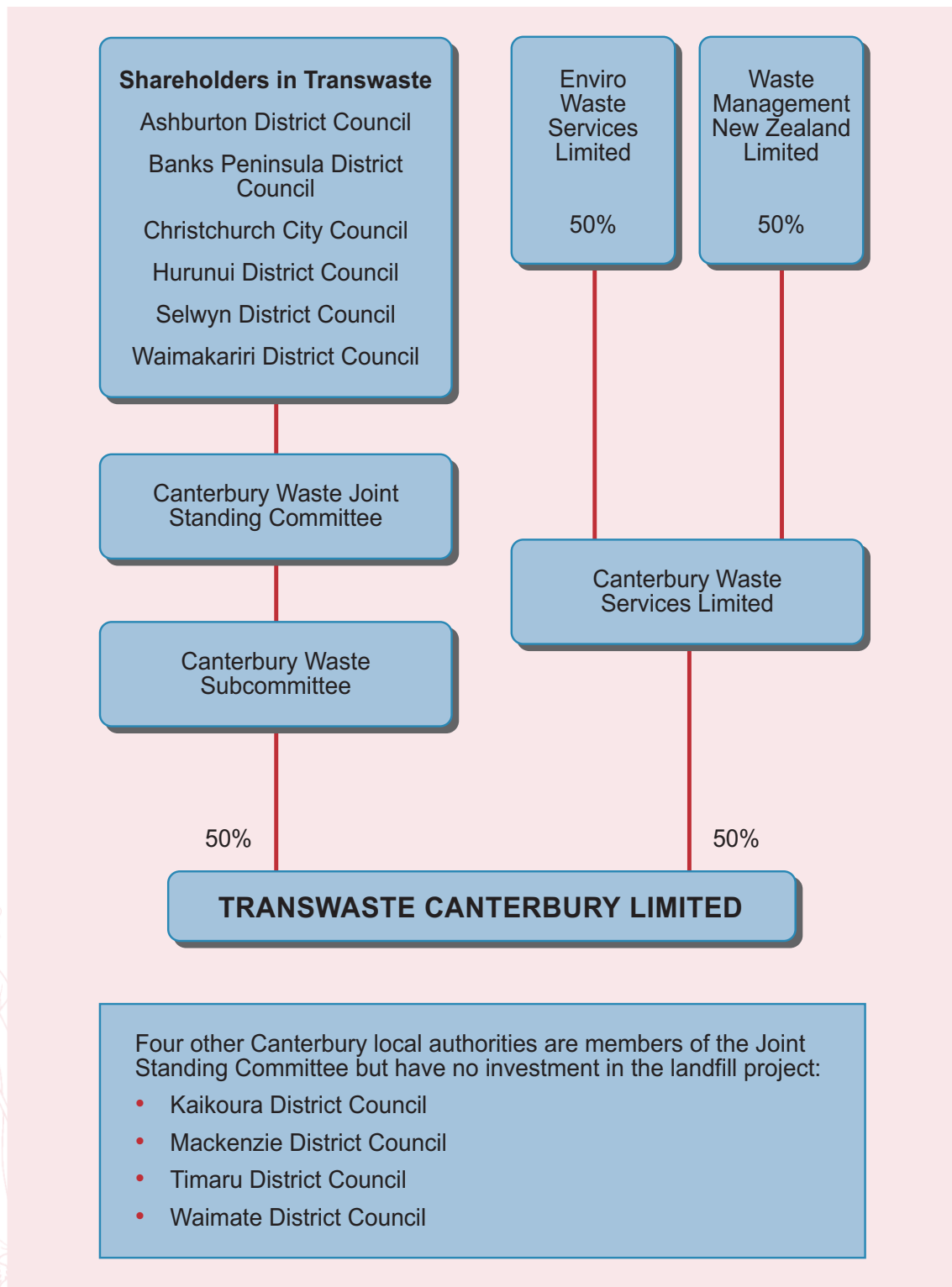
Local Authority	Shares	
	Number	%
Christchurch City Council	757	37.85
Waimakariri District Council	78	3.90
Ashburton District Council	60	3.00
Selwyn District Council	60	3.00
Hurunui District Council	24	1.20
Banks Peninsula District Council	21	1.05
Totals	1,000	50.00

- 503 The organisation structure of the Canterbury landfill joint venture project is shown in Figure 5 on the next page.

13 CWSL is owned by two waste companies – Envirowaste Services Limited and Waste Management New Zealand Limited.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

*Figure 5
Governance Framework of the Canterbury
Landfill Joint Venture Project*



THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

- 504 The joint venture governance arrangements have two distinctive features:
- Extensive collaboration between a number of local authorities, each of which is accountable to a different community and may share few political interests with its joint venture partners. Collaboration among the six authorities is vital for the success of the Canterbury landfill joint venture.
 - Bringing together parties with potentially opposing objectives and priorities. A durable joint venture depends on the local authority and private partners maintaining a working partnership that recognises the full range of goals they are seeking to achieve through their investment.
- 505 Our observations of local government developments indicate that, for local authorities, joint ventures will increasingly be seen as cost-effective regional solutions to common problems. Such arrangements can create significant risks but also offer major benefits. Their success rests, above all, on the governance framework within which the parties operate and the quality of their relationships.
- 506 In this study, we have identified the risks associated with such arrangements and assessed the extent to which they were addressed by the joint venture partners. We did not seek to determine whether governance arrangements were appropriate to the achievement of environmental goals or outcomes.
- 507 Drawing on our findings, we outline some key requirements for such joint ventures to work effectively.

The Risks Associated with the Landfill Project

- 508 The landfill project poses significant risks for the public and private joint venture partners. For example:
- reaching agreement on a regional waste management strategy;
 - maintaining a balance of power;
 - fostering consensus decision-making;
 - achieving regional collaboration as shareholders;
 - discharging shareholder functions and powers;
 - establishing delegations, authorities, and lines of communication;
 - managing contractor relationships; and
 - maintaining the viability of the landfill operation.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

- 509 Landfill governance arrangements should ensure that the desired environmental outcomes are achieved and statutory obligations met. The former include efficient resource use and environmental viability; the latter the duty of local authorities to promote waste minimisation. We did not analyse whether key governance arrangements, such as the regional waste management strategy and Memorandum of Understanding between the joint venture partners, are consistent with the achievement of environmental outcomes or with the requirements of environmental legislation.

Reaching Agreement on a Regional Waste Management Strategy

- 510 For any joint venture to work, there must be consensus as to the goals to be achieved. An agreed regional waste management strategy was clearly vital for all participating authorities.
- 511 The six shareholding local authorities, together with four other local authorities in the region that are not shareholders, set up a joint standing committee to develop an agreed waste management strategy and to identify objectives for a regional landfill. The committee's role is to ensure that the joint venture operation is consistent with the agreed waste management strategy. The joint standing committee subsequently established a subcommittee (the Canterbury Waste Subcommittee) to which it delegated all its functions, duties and powers.

Maintaining a Balance of Power

- 512 The six shareholding local authorities hold differing proportions of their 50% ownership of Transwaste, and have different populations and waste volumes. Although shareholdings differ, the governance arrangements are designed to provide a balance of power between the urban local authority (Christchurch City Council) and the rural local authorities, and between the local authorities and CWSL. This balance is preserved through:
- voting arrangements;
 - shareholding provisions in Transwaste's constitution; and
 - equal representation on the board of Transwaste.

Fostering Consensus Decision-making

- 513 We assessed whether the governance arrangements provided the necessary framework for effective administration, decision-making, and consensus among the parties. All parties (shareholders and others) to the landfill joint venture project have a strong incentive to make the venture work. We expected governance arrangements to be consistent with the objectives of promoting collaboration and minimising the potential for conflict between the participants.
- 514 The governance framework for the joint venture incorporates two devices that together provide a strong impetus for collaboration:
- *Casting vote provisions.* A casting vote is a device that can be used to resolve irreconcilable disagreements between the members of a committee or governing body. While the chairperson of the joint standing committee is authorised to exercise a casting vote, he or she may do so only in the best interests of the Canterbury community and of the local authorities collectively.
 - *Avenues for dispute resolution.* A Shareholders' Agreement between CWSL and the six authorities contains detailed dispute resolution procedures to be followed in the event of a dispute among the directors of Transwaste.
- 515 Political consensus is vital for the effective discharge of the authorities' obligations as shareholders in the joint venture. The subcommittee of the joint standing committee:
- ensures that political consensus is reached at a regional level; and
 - serves as the shareholders' group, exercising the shareholding rights of the individual authorities and managing their collective investment in the LATE.

Achieving Regional Collaboration as Shareholders

- 516 In any regional joint venture representing a range of interests, local authorities may find it difficult to exercise effectively their rights as shareholders, individually or collectively. To overcome this difficulty an arrangement is needed by which the common goals of the authorities can be achieved, and their ownership rights can be exercised effectively. This, in turn, requires appropriate delegations of responsibility and limits on authority.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

- 517 The primary arrangement through which the shareholding local authorities sought collaboration was the joint committee. Other working parties and groups convened by elected members and officers were also important. The regional working parties or committees formed by the Canterbury local authorities played a vital role in developing an agreed governance framework for the joint venture.
- 518 The joint committee also had a direct role in:
- selecting the joint venture partner; and
 - negotiating with the partner the legal documents central to the governance framework.

Discharging Shareholder Functions and Powers

- 519 The six Canterbury local authorities have agreed to work co-operatively as a regional group in managing their collective investment in Transwaste. Their shareholding rights are to be exercised through the joint committee.
- 520 The joint committee also undertakes a number of key tasks associated with the oversight of their financial and non-financial interests in the landfill project (such as environmental interests). These tasks include:
- performing obligations under the Memorandum of Understanding and Shareholders' Agreement;
 - appointing nominee directors to the board of Transwaste;
 - appointing local authority representatives at shareholders' meetings of Transwaste;
 - considering and making comments, as appropriate, on Transwaste's draft SCI;
 - promoting regional waste management objectives through the joint venture; and
 - authorising costs associated with site selection investigations and land ownership under a consultancy agreement between Transwaste and CWSL.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

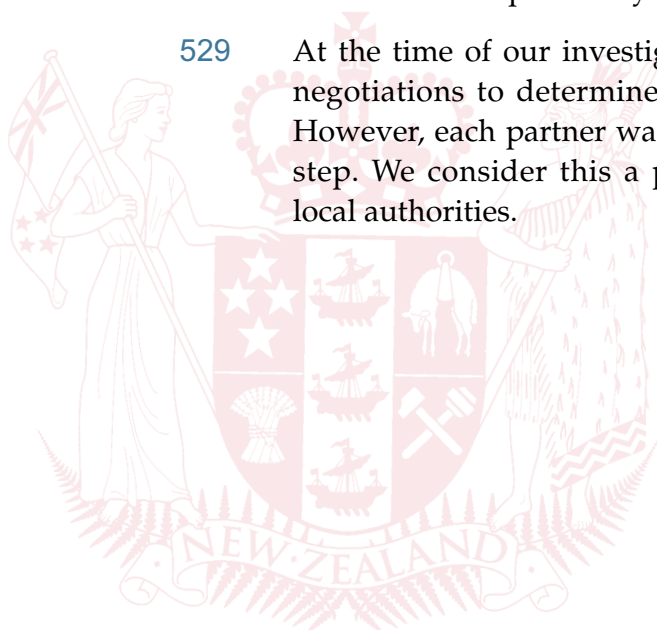
Establishing Delegations, Authorities, and Lines of Communication

- 521 The relationship between the individual local authorities and the joint committee is central to creating the trust and confidence necessary for effective governance. Each local authority needs to preserve the right to consider and endorse strategies or decisions affecting:
- the management of its investment; and
 - the achievement of its waste management objectives at key stages of the project.
- 522 In examining the documentation held by individual local authorities, and in our discussions with local authority officers, we sought to establish the accountability relationship between the joint committee and the local authorities. The local authorities:
- received minutes of meetings of regional working parties and the joint committee; and
 - were involved in key decisions and policy debates leading to formation of the joint venture, with consultation occurring at key decision points.
- 523 CWSL and the local authorities' representatives on the board of Transwaste have also made presentations to the councillors of shareholding local authorities. These presentations keep the local authorities informed on the site selection process and on solid waste management issues. We note that ongoing briefings of the shareholding local authorities will need to be continued to keep councillors fully informed.
- 524 The two councillor directors of Transwaste nominated by their respective shareholders (Christchurch City Council and the rural local authorities) take their directions from the Canterbury Waste Subcommittee. This is largely informal as both representatives attend meetings of that subcommittee. However, we were advised that, on one issue, the local authority representatives had received a formal voting instruction from their nominating local authorities. This practice is expected to be followed on other issues as necessary over the future course of the project.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

Managing Contractor Relationships

- 525 Transwaste has contracted CWSL to select a suitable landfill site on its behalf and obtain the necessary consents for operating the landfill. CWSL will also design, build, and manage the landfill and transport waste from transfer stations to the landfill.
- 526 For the private sector partner in the joint venture, such a contract can offer significant commercial and strategic opportunities. For the local authorities, the private sector partner brings proven expertise in undertaking such activities. However, awarding long-term exclusive contracts creates the potential for the chosen contractor to exploit their position. We looked for evidence that the authorities had identified and addressed this risk through the governance arrangements concluded with their private sector partner.
- 527 We found that the Memorandum of Understanding:
- recognises those activities in respect of which there is limited contestability;
 - provides for an independent assessment of costs by a party appointed by the joint venture company board;
 - records the right of access to all information necessary for such independent reviews and assessments to be undertaken; and
 - outlines detailed criteria by which to determine a reasonable rate of return to the contractor.
- 528 Either the joint committee or CWSL may seek independent verification of the basis for aftercare and contingency funds associated with closure of the landfill and the possibility of environmental accidents.
- 529 At the time of our investigations the joint venture parties had not begun negotiations to determine an appropriate rate of return for Transwaste. However, each partner was intending to take professional advice as a first step. We consider this a prudent course of action for the shareholding local authorities.



Maintaining the Viability of the Landfill Operation

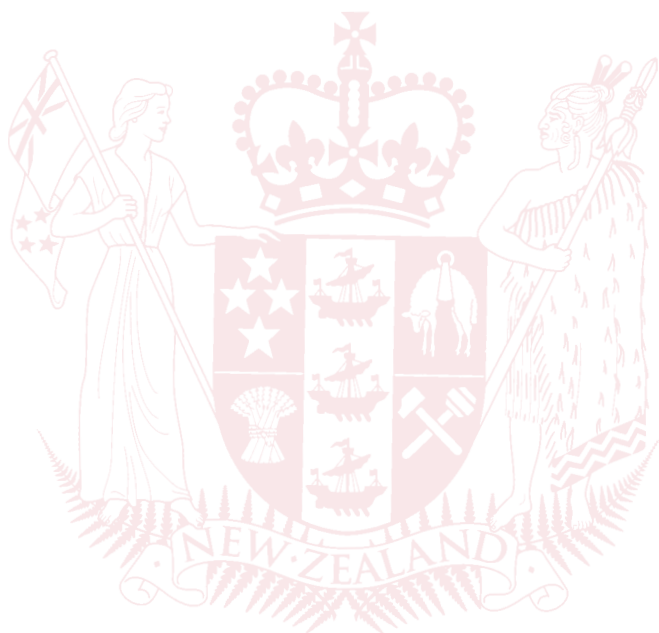
- 530 Many different factors will have a bearing on the viability of the landfill once it is operating. The joint venture agreements contain the following important provisions designed to promote the viability of the landfill operation:
- a prohibition on the joint venture partners being involved in competing landfills; and
 - a commitment by the local authorities and the shareholders of CSWL to transport their total waste volumes to the landfill for a fixed period.
- 531 Control of the waste stream is important in:
- securing the commitment of the partners;
 - safeguarding waste volumes at an economic level; and
 - providing a viable basis for investment.
- 532 The shareholding local authorities also have an interest in ensuring that the activities of Transwaste are compatible with the regional waste management strategy and with their own waste management plans. The Memorandum of Understanding recognises the commitment of the joint venture partners to waste minimisation. It also gives the parties flexibility to consider feasible alternatives other than landfills.

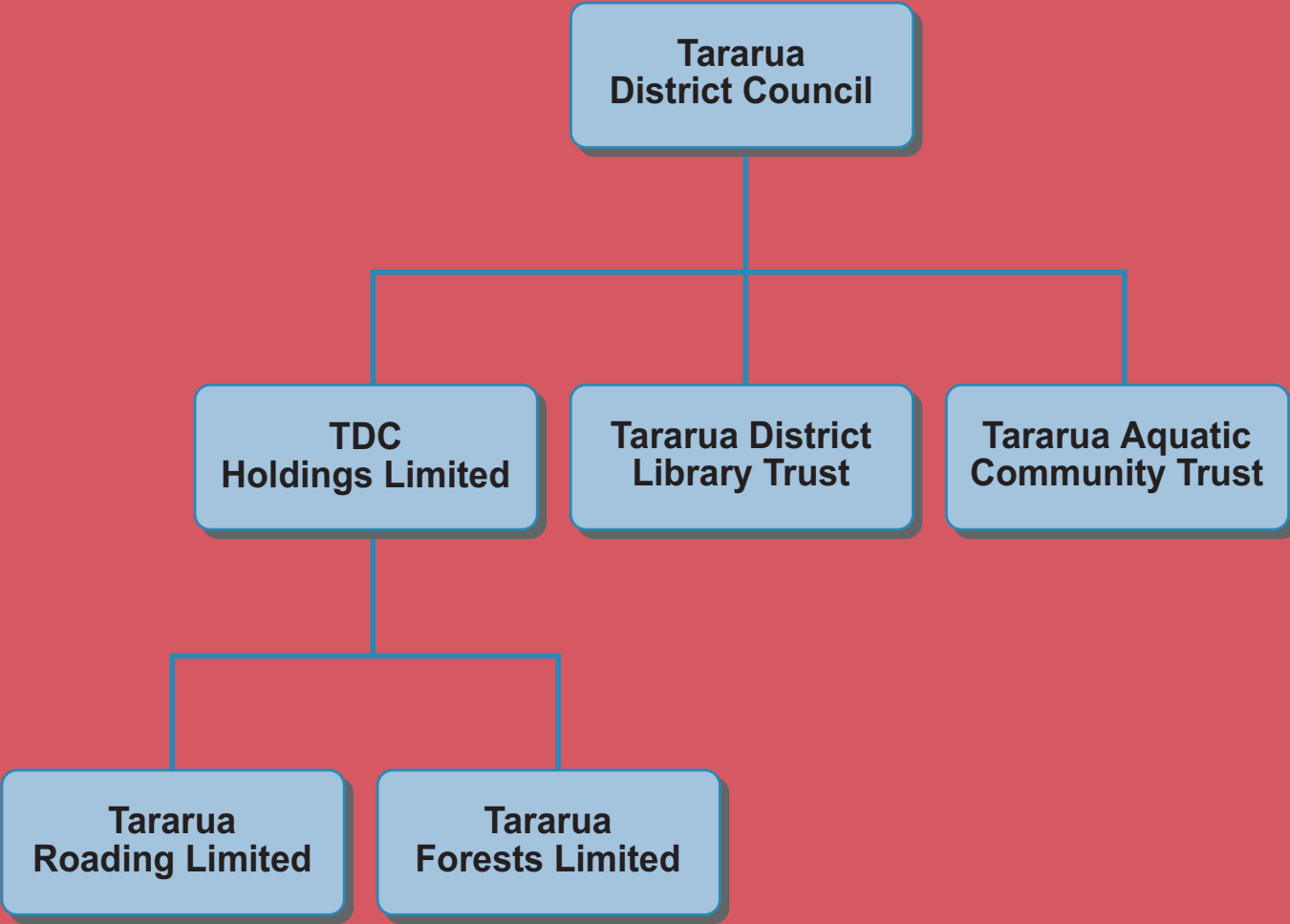
Conclusions

- 533 Our examination indicates that the local authority shareholders in the joint venture have established a sound and workable governance framework for the project. The governance framework will provide a sound basis for an ongoing working relationship between the parties for the achievement of common regional goals. The framework and practices associated with the joint venture's formation and day-to-day operation should provide a useful model for other authorities considering collaborative solutions to regional issues.
- 534 However, the joint venture is in its early stages and circumstances and relationships are bound to change over time. We are unable to provide any view on the likely future viability of the landfill; nor on the durability of the joint venture as a vehicle to achieve the goals of the local authority investors.

THE CANTERBURY LANDFILL JOINT VENTURE PROJECT

- 535 Reaching agreement on governance arrangements required lengthy and extensive negotiation between the parties. At the time of our review, the decision-making framework for the joint venture had yet to be fully tested on a variety of issues and in a range of circumstances. In particular, negotiations were about to begin on the appropriate rate of return for the LATE and a suitable landfill site had yet to be found.
- 536 As regional arrangements become more common, local authorities will increasingly look to collaborative models. The Canterbury joint venture parties may find it useful to draw on the experience of the Auckland shareholding local authorities (as described in Part Four) for lessons relevant to future management of the landfill joint venture.





TRUSTS AND OTHER NON-PROFIT ENTITIES

- 601 The Local Government Act 1974 (the Act) gives local authorities wide discretion about how best to carry out a range of activities. Many authorities have set up stand-alone entities or other arm's-length arrangements to undertake non-profit activities in an efficient and effective manner.
- 602 Local authorities have used this approach for a variety of functions, including regional marketing, economic development, the operation of leisure and recreational activities such as museums and libraries, and employment promotion. Entities set up for these purposes take a number of different forms – including incorporated societies, trusts, and special statutory bodies – and a variety of unincorporated forms, such as partnerships.
- 603 In this report we refer to these entities as “stand-alone entities.” The advantages of stand-alone entities are that they may:
- be free to take a more commercial (although not profit-making) approach to the delivery of services or other activities than the local authority;
 - provide the opportunity for direct community involvement and participation in governance;
 - attract third-party funding more readily; and
 - have a quicker decision-making ability.
- 604 Stand-alone entities can play an important role in enabling the local authority to achieve outcomes for the community, and many of them depend heavily on ratepayer funding. Allowing a stand-alone entity to undertake community activities on behalf of a local authority (using ratepayer funds) may have the disadvantage of partly removing the activities from public scrutiny – despite a close relationship with the local authority.
- 605 A local authority itself must disclose general information about the activities of stand-alone entities. In particular, the following statutory provisions provide for the disclosure of information to the public about the intentions and performance of a range of stand-alone entities:
- section 223D of the Act requires every local authority to prepare an annual plan in respect of every organisation under its control or in which the authority has a significant interest; and
 - section 223E requires a local authority to prepare an annual report that contains audited financial statements for companies or organisations under the authority's control, or in which the authority has a significant interest.

TRUSTS AND OTHER NON-PROFIT ENTITIES

- 606 However, local government legislation provides little specific guidance on how the stand-alone entities themselves should account for:
- their use of ratepayer funds;
 - their stewardship of community assets; and
 - the performance of functions on behalf of the local authority.
- 607 In addition, stand-alone entities may be under no obligation to provide for public consultation detailed information about their planned activities, nor to report publicly on their performance.
- 608 We are not confident that existing provisions of the Act are adequate with regard to local authority reporting about the intentions and performance of stand-alone entities (as discussed in paragraph 605). In consequence, any public reporting on the activities of some stand-alone entities in which local authorities have an interest is likely to be limited.
- 609 This problem has been magnified by recent changes to the definition of a LATE in the Act. The Local Government Amendment Act 1999 removed from the definition those trading entities which are not companies and which do not exist for the intention or purpose of making a profit. This has meant that such entities are no longer required to comply with the accountability requirements – including the obligation to prepare and publish an SCI. The Act has no equivalent requirements for such entities if they are not LATEs.
- 610 In the absence of statutorily defined accountability arrangements, there may be a lack of clarity as to:
- the purpose and objectives of a stand-alone entity;
 - what relationship it has with the local authority; and
 - the manner in which the entity will account to the local authority and the community for its performance.
- 611 A final important factor is the legal autonomy of trusts, which has a direct bearing on:
- the independence with which the members of the trust's governing body are required to act; and
 - the trust's accountability relationship with the local authority.
- 612 Trustee law requires trustees to act independently in the interests of beneficiaries of the trust or, in a charitable trust, for charitable purposes. The requirement for independence is a potential constraint on the local authority's ability to influence entity direction and hold the governing body to account.

How Did Local Authorities Address Key Issues?

613 We identified the following issues as being particularly relevant to an appropriate governance and accountability relationship between local authorities and stand-alone entities:

- the roles of the entities and their relationships with the local authority;
- the establishment of instruments for accountability;
- the use of ratepayers' funds;
- openness and community involvement in decision-making;
- an effective governing body; and
- the role of councillors on governing bodies.

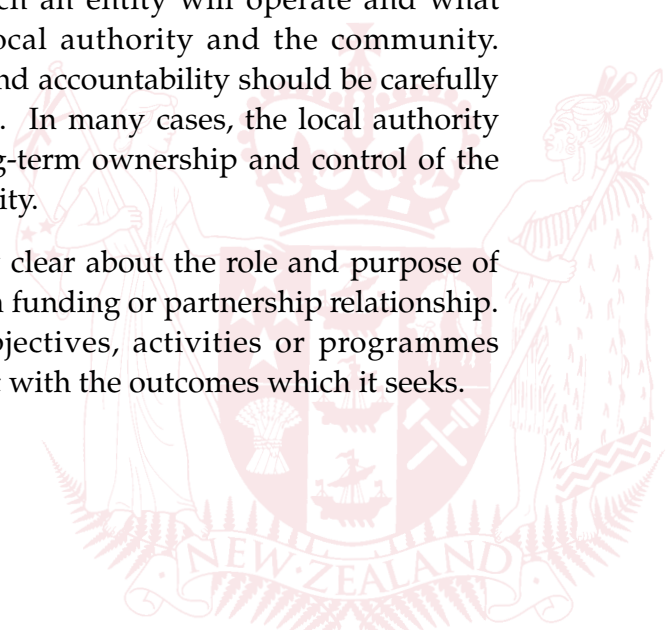
Entities' Relationships with Local Authorities

614 The trusts and other stand-alone entities we reviewed had been set up for a variety of reasons, including:

- as a product of specific legislation;
- for tax efficiency;
- for business efficiency; and
- to create an arm's-length relationship.

615 In setting up a trust or other stand-alone entity, local authorities have considerable freedom about how such an entity will operate and what relationship it will have with the local authority and the community. Purpose, structure, powers, funding and accountability should be carefully considered when the entity is created. In many cases, the local authority will have a strong interest in the long-term ownership and control of the assets being transferred to the new entity.

616 A local authority should be especially clear about the role and purpose of stand-alone entities with which it has a funding or partnership relationship. It should ensure that an entity's objectives, activities or programmes undertaken on its behalf are consistent with the outcomes which it seeks.



TRUSTS AND OTHER NON-PROFIT ENTITIES

- 617 The roles of the entities we examined were generally clearly defined. A variety of documents were used to define these roles, such as trust deeds, heads of agreement, annual plans and SCIs. In some cases, we identified potential to amalgamate these documents.
- 618 As part of annual planning, a local authority needs to make links between:
- its funding plan;
 - its relationships with stand-alone entities receiving those funds; and
 - the planned programmes and activities of those entities.
- 619 The functions of each entity we reviewed were clearly related to outcomes sought by the local authorities.

Establishing Instruments for Accountability

- 620 Local authorities must put the statutory accountability arrangements in place when first setting up a stand-alone entity. The annual plans and reports of the local authority should tell the public about:
- the authority's relationship with each entity;
 - the nature of its investment;
 - the purpose and objectives sought from that investment; and
 - the performance of the entity in meeting those objectives.
- 621 All local authorities we reviewed had addressed the need to put in place appropriate instruments for holding stand-alone entities to account and for exerting influence over their direction and strategy. Accountability instruments included:
- the requirement to justify requests for funding through the local authority's annual planning process;
 - formal council approval of the business plan;
 - the use of protocols and other written understandings specifying the relationships between the parties; and
 - the inclusion of summarised plans, budgets, financial and non-financial performance results in the local authority's own annual plan and report.

TRUSTS AND OTHER NON-PROFIT ENTITIES

- 622 In some instances, local authorities had drawn up formal relationship documents defining the parties' respective roles and responsibilities. These documents can serve a useful purpose as an agreed governance framework as well as a means of clarifying the accountability relationship.
- 623 The relationship documents that we saw typically covered:
- the objectives and purposes of the stand-alone entity;
 - corporate behaviour;
 - financial management; and
 - the manner in which the entity and the local authority would work together.
- 624 We noted the importance of such documents, including relevant and (where possible) quantifiable indicators against which to assess the performance of the entity.
- 625 A stand-alone entity that is directly accountable to the local authority may itself be able to create subsidiaries or other structures. This could have the effect of limiting the local authority's direct influence on strategic direction and the development of community programmes. In such circumstances, control or influence, as appropriate, should be preserved through the local authority's accountability relationship with the parent body. This approach is outlined below.
- 626 One trust had set up subsidiary entities to carry out community activities as agreed with the local authority. The trust consulted the local authority on the broad nature of its planned programmes through its business plan. However, delivery of the community programmes themselves was the responsibility of the two subsidiary entities – another trust and a company.
- 627 That structure created a risk that the local authority would lose direct access to information about the planned implementation of the community programmes – including changes in programme mix, the target audiences, and proposed new initiatives. The local authority addressed this risk by seeking assurance about the expenditure plans and operations of the operating subsidiaries through the business plan of the parent trust. The two subsidiary entities were also reporting quarterly to the local authority on progress against their own individual business plans.
- 628 Being subject to regular audit is also an important aspect of accountability. The Public Audit Act, when enacted, will ensure that the Auditor-General is the auditor of all stand-alone entities of which local authorities have direct or indirect control.

TRUSTS AND OTHER NON-PROFIT ENTITIES

Using Ratepayers' Funds

- 629 The stand-alone entities we reviewed were all funded to some degree, directly or indirectly, by the local authority. However, the trust deeds we examined did not generally contain accountability requirements in respect of ratepayers' funds, either to the public or the local authority. We looked for evidence that local authorities were using other means to obtain assurance about the use of funds.
- 630 Stand-alone entities will normally seek grant funding through the local authority's annual planning process. This process provides for public consultation and comment on the activities to be publicly funded.
- 631 However, not all stand-alone entities we reviewed were funded explicitly by a mechanism disclosed in the annual plan. Where other funding mechanisms are used, there may not be the same opportunity for the views of the public to be heard; nor may the expenditure of such funds be open to public scrutiny.
- 632 Stand-alone entities may, in special circumstances, seek local authority funding outside the annual planning process. In such cases, local authorities should ensure that the public is adequately informed and consulted before committing significant funds.
- 633 For commercial reasons, one local authority needed to respond quickly to a request to meet the capital costs of developing a significant trust-managed community facility. In reaching its decision, the local authority examined the trust's proposal in detail and, with the trust, consulted the local community by distributing publicity material and seeking public submissions. This process was important to keep the community informed and involve them in the decision-making process.
- 634 Local authorities should consider setting specific requirements for the way in which stand-alone entities spend funds held for community use. One trust, for example, held significant trust funds generated from the sale of local authority assets.¹⁴ The trust's use of those funds was controlled by provisions in its trust deed, which specified the manner in which capital and income could be used.

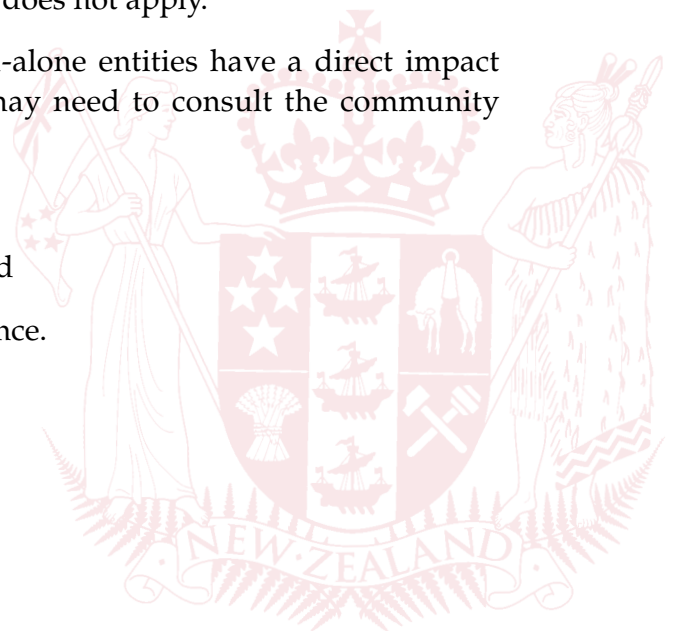
¹⁴ Section 225c of the Act allows a local authority to transfer to a community trust proceeds from the sale of shares or equity securities in a port company, LATE or LATE subsidiary.

TRUSTS AND OTHER NON-PROFIT ENTITIES

- 635 Formal, comprehensive service agreements are desirable and we are aware that some authorities are already using such agreements. Some entities reported to the local authority against well-defined service objectives and performance indicators.
- 636 However, in the local authorities we reviewed, few service agreements were in place between the authority and stand-alone entities – although one authority told us it was planning to put such agreements in place. In our view, service agreements are an important part of the accountability relationship between local authorities and entities delivering services.

Openness and Community Involvement in Decision-making

- 637 The relationship between stand-alone entities and the local community in which they carry out their activities is an important dimension of accountability. Local authorities and some other defined classes of public entity are subject to the information and disclosure provisions of the Local Government Official Information and Meetings Act 1987. Stand-alone entities are not subject to those same disclosure obligations. In consequence, their meetings are not generally open to the public, and the public may not have direct access to information about their activities.
- 638 Activities that are carried out in conjunction with, or on behalf of, the local authority are likely to have a direct community impact and will generate public interest. Access to information should be an important part of any accountability relationship and should be specified in service agreements or relationship documents – especially if the Local Government Official Information and Meetings Act does not apply.
- 639 In cases where the activities of stand-alone entities have a direct impact within the community, the entities may need to consult the community directly to:
- develop and deliver programmes;
 - seek feedback on their activities; and
 - account publicly for their performance.



TRUSTS AND OTHER NON-PROFIT ENTITIES

- 640 Such consultation was clearly occurring in some instances. Community or customer feedback was sometimes used as a measure of the entity's success in meeting its performance objectives. In general, however, non-profit entities were not required by the terms of their accountability documents to seek the views of their communities on their proposed activities, nor to account to the public for their performance.
- 641 In some circumstances (such as when considering the purchase, development or sale of community facilities), stand-alone entities should be encouraged to hold public meetings to seek the community's views on specific plans and proposals or to report on their activities. Annual surveys of residents can be used to provide assurance to the local authority about the level of community satisfaction with the facilities or programmes managed by the stand-alone entity.

An Effective Governing Body

- 642 An effective governing body is vital for good stewardship and effective delivery of services for the community. The trust deed or other founding document provides a ready opportunity for a local authority to specify its power to appoint some or all members of the governing body of a stand-alone entity. This was a common approach, and allows the local authority to ensure that the direction of the stand-alone entity remains consistent with its own interests.
- 643 Nomination and selection processes for trustees or board members should provide assurance that:
- local authorities have drawn as widely as possible on the pool of possible candidates across the community; and
 - appointments have been based on an objective process focused on obtaining the best possible mix of skills and experience.
- 644 Key elements of an effective selection and appointment process include:
- a person specification and job description defining the skills, attributes and experience needed for the position;
 - a thorough process for seeking possible candidates; and
 - a transparent procedure for drawing up the shortlist and making the appointment.

TRUSTS AND OTHER NON-PROFIT ENTITIES

- 645 We reviewed the processes followed to appoint trustees or other board members.
- 646 Two local authorities had, or were building up, databases of individuals with the skills, interest and commitment to serve on their boards. With this information, the local authorities will be able to draw on a pool of prospective appointees as the need arises.
- 647 The board of a stand-alone entity may (or in some cases must, as a requirement of the trust deed) draw on particular constituencies. A board with a constituency membership may not have the necessary professional skills and experience to discharge its governance responsibilities fully; nor to direct and oversee the operations of the entity in the most effective way. Using competency-based selection criteria can provide a desirable balance of skills and experience on the board, along with a membership mix which is representative of stakeholders.
- 648 We found that there was potential to make appointment processes more systematic. Some appointments were based on an objective assessment of skills. In general, however, appointment processes were less objective, formal, transparent, and consistent than those followed for appointing directors to the boards of commercial trading enterprises. We recommend that, while having regard to the different mix of skills and experience required for non-profit entities, local authorities should use appointment processes similar to those followed for appointing directors of their commercial enterprises.

The Role of Councillors on Governing Bodies

- 649 Views differ in local government on the merits of appointing councillors to be directors or members on the governing bodies of commercial or non-profit entities. Of the four local authorities we reviewed, only one had a practice of appointing councillors to the boards of non-profit entities. We explored the benefits and disadvantages of councillor appointments.
- 650 Arguments in favour of appointing councillors to governing bodies of non-profit entities include:
- aligning their activities with the outcomes sought by the local authority;
 - overcoming the difficulty of specifying desired outcomes in contractual terms;
 - lifting the profile of the entity in the community; and
 - reflecting the social and community focus of the entity's activities.

TRUSTS AND OTHER NON-PROFIT ENTITIES

- 651 Local authority representation can be seen as necessary:
- to align the direction of the entity with the objectives and priorities of the local authority;
 - to secure local authority support for strategic initiatives; and
 - to co-ordinate and rationalise the activities of non-profit entities performing complementary functions.
- 652 Local authority representation can also be seen as a way to provide a mechanism for monitoring performance, to communicate with the local authority, and to be a voice for the interests of the community.
- 653 Councillor appointments may also have the following significant disadvantages:
- Trustees and members of governing bodies are expected to give priority to the interests of the stand-alone entity, and they have certain legal and professional obligations.
 - Councillors face a potential conflict between their roles as trustees or board members and their interests as elected representatives.
 - Direct involvement of councillors in the internal governance of the entity may also inhibit the effective operation of an arm's-length accountability relationship with the local authority. This may make it more difficult to hold the governing body to account for its performance. In particular, a strong councillor presence on the governing body has the potential to undermine the operating independence of the stand-alone entity.
 - Councillors are unlikely to have the time and resources to analyse and monitor the performance of the governing body objectively. In our view, this monitoring role is best assigned to local authority officers.
 - In their role as members of the governing body, councillors may become personally liable for the decisions of the body.



Conclusions and Recommendations

- 654 Establishing stand-alone entities to undertake community activities potentially removes such activities from public scrutiny. We found that local authorities had generally addressed accountability issues in an effective way through a variety of accountability instruments. A range of relationship documents specified the power of the local authority to comment on (and, if necessary, influence) business planning, and to receive regular reports on performance and other relevant information.
- 655 Local authorities should ensure that stand-alone entities are fully aware of a need to consult the community in carrying out their activities. While we found that this was often occurring, it had not generally been specified as a requirement of the entity in carrying out its activities.
- 656 We recommend that all local authorities develop formal agreements as a means of holding stand-alone entities to account for their delivery of services. Such agreements should be the basis for ongoing monitoring of performance, information collection, reporting, co-ordination, and consultation between the parties. Suggested elements of a service agreement are outlined in Appendix B on pages 114-115.
- 657 We identified the need for local authorities to adopt a more systematic approach to the appointment of trustees and members of the governing bodies of stand-alone entities. Explicit skill-based selection criteria should be used. Procedures should also be in place to review the performance of board members individually and of the board as a whole.
- 658 Local authorities should consider the benefits and advantages of councillor appointments. A balance is needed between maintaining a close working relationship and policy alignment, on the one hand, and an appropriate arm's-length monitoring relationship, on the other.
- 659 We are aware that consideration is being given to undertaking a review of local government legislation. The current legislation does not adequately define the accountability relationships between trusts or other non-profit entities, and local authorities or the community. Should such a review take place, we recommend that consideration be given to addressing this shortcoming by putting in place clear accountability requirements which reflect an appropriate balance between the interests of the local authority on the one hand, and the autonomy of the stand-alone entity on the other.

DIRECTORS OF TRADING ENTERPRISES & REPRESENTATION ON OTHER ORGANISATIONS

Listed below are the trading enterprises in which the Council has an interest, together with the directors of the trading enterprises. Also listed are other organisations on which the Council is represented. The 1999/00 Statements of Service Performance for nearly all these organisations are detailed on pages 68 to 83.

Christchurch City Holdings Limited (100% owned)

Alister James (Chair) (Cr)	Garry Moore (Mayor)
Paddy Austin (Cr)	Barbara Stewart (Cr)
Craig Boyce	David Stock
David Close (Cr)	Peter Taylor
Pat Harrow (Cr)	

Christchurch International Airport Limited (75% owned)

Peter Lecuing (Chair)	Denis O'Rourke (Cr)
Syd Brasley	Barry Thomas
David Lyall	Gail Sheriff (Cr)
Robin Mann	

Orion Group Limited (87.625% owned)

Linda Constable (Chair)	Peter Rze
Philip Carrer	Don Sollitt
John Gray	Sir Allan Wright
Chris Laurie	

Lyttelton Port Company Limited (65.38% owned)

Brent Layton (Chair)	Donald Stewart
Peter Cookley	Bob Todd
Ian Howell (Cr)	David Viles
Sue McCormack	

Red Bus Limited (100% owned)

Ann Urwin (Chair)	Ishtar Ganda (Cr)
Craig Boyce	Barry McFudries
Evan Frew	

Selwyn Plantation Board Limited (39.32% owned)

Doug Marsh (Chair)	Peter Coaldey
David Buist (Cr)	Allan Burye
Don Cameron	Graham Hecman

City Care Limited (100% owned)

David Spence (Chair)	Ron Wright (Cr)
Bob Foster	Paul Young
Doug Marsh	

Jade Stadium Limited (100% owned)

Bruce Irvine (Chair)	Hanlin Johnstone
Paddy Austin (Cr)	Mike Prendergast
Vicki Buck	Ron Wright (Cr)
Erin Baker (Cr)	

Christchurch City Facilities Limited (100% owned)

Peter Taylor (Chair)	Barry Corbett (Cr)
Graham Condon (Cr)	Dennis Sheard

Canterbury Technology Park (Joint Venture)

Mary Harvey (Chair)	Jim Lee
Ian Hay	

Travis Group (100% owned)

Bob Lincham	Peter Taylor
Mark Russell	

Canterbury Development Corporation

Stewart Leck (Chair)	Doug Marsh
Carole Anderson (Cr)	Garry Moore (Mayor)
Paddy Austin (Cr)	Barbara Stewart (Cr)
Ian Howell (Cr)	David Walker
Garth Carnaby	Ian Hall

Canterbury Museum Trust Board

Paddy Austin (Cr) (Chair)	Ian Leggat
Tony Azps	Gaye Stanley
Peter Fitzgerald	Barbara Stewart (Cr)
Leo Hayward	Murray Thacker
Jim Hopkins	Sally Thompson (Cr)
Lesley Keast (Cr)	

Riccarton Bush Trust Board

Charles Deans (Chair)	Brian Mulloy
Helen Broughton	Mike Mora
David Buist (Cr)	Barbara Stewart (Cr)
Brian Deans	Alison Wilkie
Ishtar Ganda (Cr)	Pamela Wilson

Recovered Materials Foundation Board

Denis O'Rourke (Cr) (Chair)	Chris Pickrill
Sally Buck (Cr)	Mark Pratt
Ian Howell (Cr)	Mike Stockwell
Gracene King	Tom Thomson
Dison Melvor	Peter Townsend

Transwaste Canterbury Limited (37.85% owned)

Denis O'Rourke (Cr) Chair	Alton Jamieson
Noeline Allan	Ray Harris
Gil Cox	Jim Fulton
Gerald Clemens	Peter Drummond

COMMERCIAL TRADING ENTERPRISES

701 In our 1994 report we discussed the governance relationships between a selection of local authorities and their commercial trading enterprises. Since then, although the LATE model has evolved, many issues fundamental to effective governance remain subjects of debate across the sector. In this part, we:

- re-state briefly the principles of good governance against which all local authorities should assess their practices;
- record and evaluate governance practices across a further selection of local authorities;
- identify and comment on issues relevant to the governance of commercial trading enterprises in local government; and
- promote best governance practice.

702 We examined the relationships between five local authorities and their commercial trading enterprises – four LATEs, one energy company and three port companies. Our more general findings are covered in Part Two, “Overview of Governance Issues”. In this part, we address issues concerned with the relationships between shareholding local authorities and their commercial trading enterprises; specifically:

- the role of holding companies;
- monitoring company performance; and
- disclosure of corporate governance practices.

The Role of a Holding Company

703 Some local authorities have transferred their shareholdings in operating subsidiaries, and thus their legal rights and responsibilities of ownership, to a holding company. In our 1994 report, we noted the implications of the holding company structure for the governance of LATEs. In particular, the local authority needs to keep close control over its holding company.

704 As part of this study, we examined the roles of three holding companies, and three governance issues in particular:

- monitoring the performance of operating subsidiaries;
- relationships with the parent local authority; and
- composition of the holding company board.

COMMERCIAL TRADING ENTERPRISES

Monitoring the Performance of Operating Subsidiaries

705 A holding company can be effective for monitoring the performance of operating subsidiaries. The three holding companies we reviewed performed a monitoring function, each in a different manner. In our view, essential elements of an active and informed monitoring function are:

- consideration of draft SCIs submitted by the boards of operating subsidiaries;
- detailed analysis of quarterly, six-monthly and annual reports from operating subsidiaries; and
- regular strategic reviews of individual investments and of the local authority's trading portfolio as a whole.

706 Regular reviews are essential for proper management of a local authority's investments in commercial trading enterprises. Holding companies are well placed to perform these reviews on behalf of the local authority parent.

707 The value of the holding company role was well illustrated in the case of one local authority we visited. The local authority had made a commitment in its Borrowing Management and Investment Policy to periodically review the rationale and status of its equity investments against strategic and financial parameters. The holding company was:

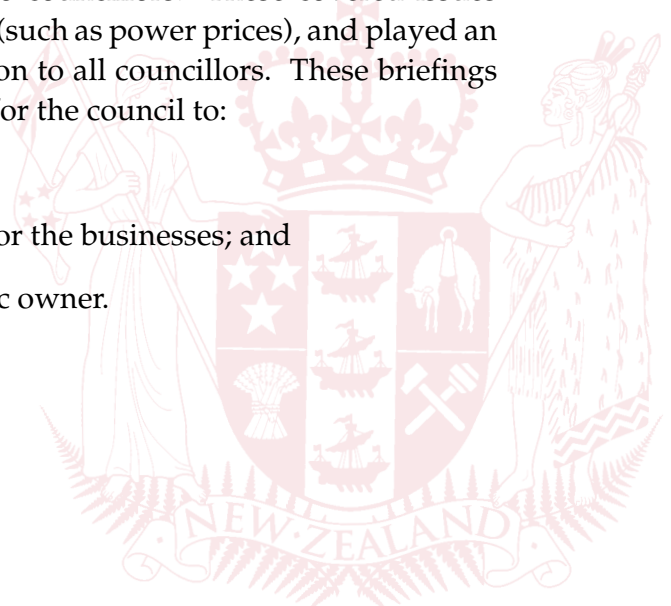
- acting as the investment vehicle, responsible for managing the local authority's investments in a professional and commercial manner; and
- commissioning regular valuations of its three subsidiary companies, measuring movements in value over time.

708 Estimates of market value provided the local authority shareholder with a valuable benchmark against which to assess the ongoing costs and benefits of each investment, including alternative investments or opportunities for expenditure in the community.

709 Effective monitoring and liaison requires analysis and support. The holding company may have this expertise or may employ a contractor. Each holding company we reviewed had access to resources to perform these tasks. Two of the three holding companies used parent local authority staff for advice and support, reflecting the local authority's close working relationship with its holding company. This arrangement can also provide a useful means of integrating the financial strategies of the holding company and the parent local authority.

Relationships with the Parent Local Authority

- 710 The three holding companies we examined had different relationships with their parent local authority, and were performing a number of important functions, such as:
- preserving the operating autonomy of the local authority’s commercial trading enterprises;
 - applying business disciplines to the professional management of the local authority’s commercial investments;
 - acting as a channel of communication between the local authority and its operating companies;
 - promoting best practice in corporate governance; and
 - providing a source of information and analysis for local authority review of investment options.
- 711 One holding company had been set up as a tax-efficient means of funding the establishment of its sole subsidiary LATE. The holding company structure enabled the LATE to operate independently of the local authority while retaining formal reporting structures.
- 712 The second holding company had a closer relationship with its parent local authority, supplying it with advice and information for the management of its commercial investments. Lines of communication between the local authority and the operating companies were an important source of information about the direction and activities of its various businesses.
- 713 The boards of the holding company and the operating companies gave periodic briefings and presentations to councillors. These covered issues generating strong community concern (such as power prices), and played an important part in providing information to all councillors. These briefings also provided a valuable opportunity for the council to:
- put questions to the boards;
 - articulate their strategic objectives for the businesses; and
 - outline their expectations as a public owner.



COMMERCIAL TRADING ENTERPRISES

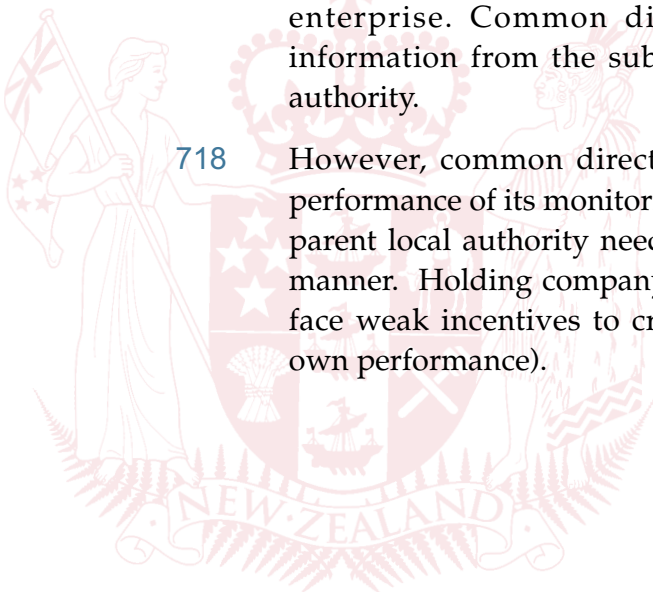
Statement of corporate intent – The director

- 714 The holding company was also a leader in promoting best practice in corporate governance. For example, the company had adopted a policy for evaluating the performance of its own directors. It had also drawn up a code of conduct, and guidelines on directors' responsibilities, for directors in local authority-owned companies.
- 715 The third holding company operated with the greatest independence from the parent local authority. The company:
- had responsibility for maximising the performance of the local authority's equity investment portfolio; and
 - engaged its own professional investment advice.
- 716 On occasions, the parent local authority drew on contestable advice from its own staff. The local authority had also engaged the holding company to assess the commercial viability of new investment opportunities against financial investment criteria and the scope of the company's activities as defined in its SCI.

Composition of the Holding Company Board

Should holding and subsidiary company boards have common membership?

- 717 One of the three holding companies we reviewed had no directors on the boards of its commercial trading subsidiaries; the second had at most one director on each company board. Two of the five board members of the third holding company were also board members of its sole operating subsidiary. We were told that this governance structure facilitated holding company scrutiny of subsidiary performance and was efficient for managing the local authority's relationship with its single trading enterprise. Common directorships can also enhance the flow of information from the subsidiary to the parent company, and the local authority.
- 718 However, common directorships may weaken the holding company's performance of its monitoring role. Ownership monitoring on behalf of the parent local authority needs to be carried out in a rigorous and detached manner. Holding company directors who also sit on the subsidiary board face weak incentives to criticise the latter's performance (in effect, their own performance).



COMMERCIAL TRADING ENTERPRISES

594z. Reports and accounts – (1) Within 2 months

719 This arrangement may also increase the risk that the subsidiary will withhold information necessary for a fully informed assessment of its performance. A free flow of information will be better supported by:

- systematic analysis of subsidiary performance;
- a close accountability relationship between the local authority and its holding company; and
- a clear set of expectations for the holding company to oversee and report to the local authority on the subsidiary’s performance.

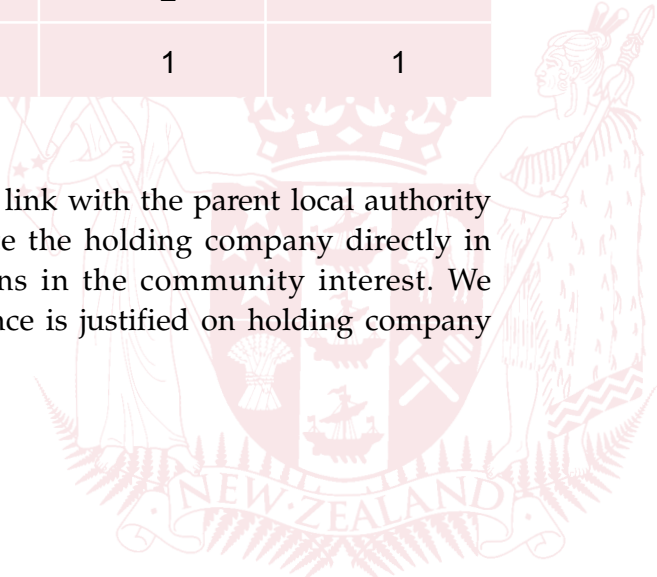
What was the mix of councillor and non-councillor directors?

720 As shown in Figure 6 below, councillor representation on holding company boards differed across local authorities. There was no consistency as to whether councillor directors were in a majority or a minority, or constituted half the membership.

Figure 6
Councillor and Local Authority Officer Directors in the Holding Companies We Reviewed

	Total membership of the board of directors	Number of directors who were councillors	Number of directors who were local authority officers
Holding Company A	9	6	–
Holding Company B	4	2	–
Holding Company C	5	1	1

721 Elected members can be an important link with the parent local authority and allow it, if necessary, to influence the holding company directly in discharging its ownership obligations in the community interest. We believe that a strong councillor presence is justified on holding company boards.



COMMERCIAL TRADING ENTERPRISES

- 722 When accountability relationships between the holding company and the local authority are well established, we suggest that local authorities review the balance of councillor and external directors. Strengthening the holding company board's commercial skills can enhance its capability to advise the local authority on strategic options for diverse business portfolios.
- 723 We recommend that holding companies develop a process for evaluating the performance of subsidiary board members and the board as a whole. Effective evaluation processes should reveal:
- to the board, whether it is working effectively; and
 - to the shareholding local authority, the quality of stewardship across its portfolio of trading enterprises.

Monitoring Company Performance

- 724 The free flow of information between companies and their shareholding local authorities:
- provides ongoing assurance that the company is meeting the performance targets specified in planning documents such as the SCI;
 - alerts the owner to issues of interest or concern in the community; and
 - enables the owner to review its investment.
- 725 We identified the following as issues affecting the flow of information to shareholding local authorities:
- business planning and the SCI;
 - the nature and frequency of reporting;
 - reporting on the activities of subsidiary companies or ventures;
 - the disclosure of commercially sensitive information;
 - listing on the New Zealand Stock Exchange;
 - responsiveness to the expectations of the local authority owner; and
 - selecting and appointing councillor directors.



Business Planning and the SCI

- 726 We examined what consultation took place on the development of SCIs. We expected that consultation would take place in the context of strategic business planning discussions between the company board and the shareholding local authority. We did not analyse the content or format of SCIs as part of this study.¹⁵
- 727 In most instances the content and format of the SCI was discussed. However, boards did not always consult the parent local authority about company direction, prospects, risks and opportunities; nor was such consultation sought. Shareholding local authorities had not always reviewed their interests in the entity, which would have provided a framework in which to consider strategic initiatives proposed by the board.
- 728 Without a clear understanding of the board’s thinking, or a considered and informed view on its own interests, a shareholding local authority is poorly placed to make informed comment on the board’s draft SCI.

The Nature and Frequency of Reporting

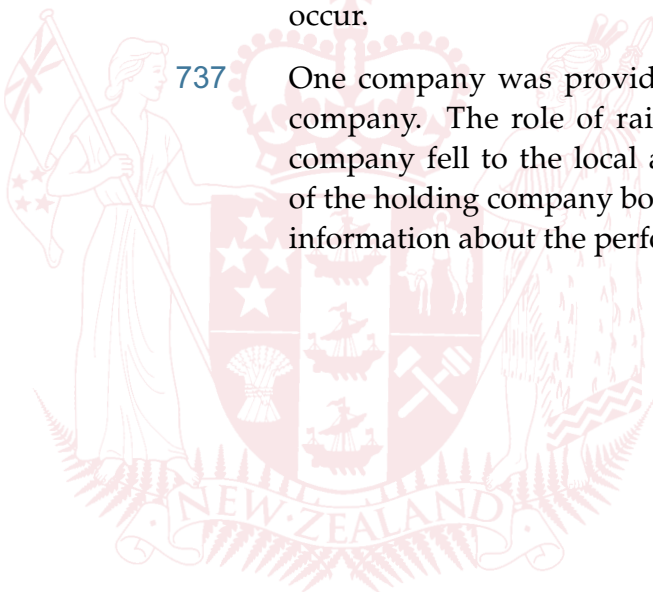
- 729 The Act requires annual and six-monthly reporting to shareholders. As we noted in our 1994 report, reporting to local authority shareholders needs to be both more frequent and more comprehensive than the legislation requires.
- 730 In our 1994 report, we recommended as a minimum that the shareholding local authority should receive quarterly reports. These should supply information about:
 - trading levels;
 - revenue and expenditure;
 - financial position;
 - investments and divestments; and
 - key non-financial performance indicators.

¹⁵ We commented on the operation of the SCI model in our Third Report to Parliament for 1998, *Statements of Corporate Intent: Are They Working?* (parliamentary paper B.29 [98c], pages 99-137).



COMMERCIAL TRADING ENTERPRISES

- 731 We assessed the quality and quantity of reporting to local authority owners (or to their holding companies as agents) against that benchmark.
- 732 In two of the five local authorities we reviewed, the quality and quantity of reporting met our expectations. The holding companies for those local authorities were receiving comprehensive quarterly reports from all their operating subsidiaries. This regular reporting was supplemented by periodic reporting on current issues – for example, one energy company was reporting on the possible impact of changes in its regulatory environment. The two holding companies then provided summarised financial results to their parent local authorities.
- 733 In a third instance, the holding company received quarterly reports from all operating subsidiaries. However, we were not satisfied that reporting from the holding company to the council was sufficient to meet councillors' information needs.
- 734 The remaining two of the five local authorities we reviewed received reports that, in our view, were neither frequent nor comprehensive enough to provide them with the necessary ongoing information about subsidiary performance and activities. In these two cases, communication between the local authority owner and the subsidiary relied largely on informal discussions between the board chairperson and the mayor or local authority managers.
- 735 Informal communications are important in building trust and goodwill. But formal reporting of key financial and non-financial performance information is needed for the local authority to effectively monitor board performance and systematically assess investment value.
- 736 The company board should keep the shareholding local authority fully informed about its activities. Effective communication did not always occur.
- 737 One company was providing quarterly operating reports to the holding company. The role of raising any issues of concern with the operating company fell to the local authority's chief executive, who was a member of the holding company board. The council itself had access to only limited information about the performance of the company.



COMMERCIAL TRADING ENTERPRISES

- 738 The Act requires every local authority to adopt an investment policy outlining how it will manage its investments, and a report on the management to be made to the council. Periodic reviews of investments are a key component of any investment policy. The responsibility for reviews rests with the chief executive. In the five local authorities we reviewed, the chief executive had the necessary independence from day-to-day governance of the trading enterprises to undertake such reviews in an impartial manner.
- 739 However, such reviews were not always taking place and the objectives of the legislation were not always met. Three authorities had neither gathered the information nor carried out the analysis necessary to undertake such reviews.

Reporting on the Activities of Subsidiary Companies or Ventures

- 740 A company wholly or partly owned by a local authority may in turn invest in joint ventures or subsidiary companies. Investment may be by merging with or taking over existing businesses or investing in new ventures. Investments may change the nature of a business and may lead to the restructuring of the investing company.
- 741 Reasons to invest may include:
- expanding market share;
 - seeking economies of scale;
 - acquiring further processing capability;
 - undertaking research and development; or
 - diversifying business activities.
- 742 Investments create new opportunities and risks, including:
- moving away from core business;
 - adding uncertainty to projected financial results; and
 - involving the company in experimental operations.
- 743 We expected to find reporting processes which kept the shareholding local authority informed about new business ventures – in particular, the impact of such changes on the value of the business and shareholder returns. This reporting may need to be more frequent and detailed than usual, particularly on potential financial impacts.

COMMERCIAL TRADING ENTERPRISES

- 744 In some cases, the shareholding local authority was kept well informed about the financial impact of investments, including particular strategic or financial risks for the subsidiary. For example, one contracting company had purchased a neighbouring business in July 1998, raising a loan for the purpose. The board had briefed the holding company on the financial benefits and estimated returns from the purchase. Quarterly meetings between the operating company and the holding company provided a means of monitoring the impact of the purchase. The annual report for the 1998-99 financial year recorded that the newly purchased company's sales and net profits both exceeded budget.
- 745 In other instances, we were not satisfied that reporting regimes provided adequate information to shareholding local authorities about the risks and opportunities associated with such investments, and the subsequent changes to business structure. In these cases, the local authorities were less able to oversee subsidiary company activities and, if necessary, influence company direction.
- 746 We found that reports to the local authority contained limited reference to:
- the operations of subsidiary entities or ventures; and
 - their impact on the capital structure, asset base, income stream or other aspects of financial performance.

Disclosing Commercially Sensitive Information

- 747 Shareholding local authorities must decide what information they will make public. If company boards are concerned about how their public owners will handle commercially sensitive information, this may seriously impede the flow of information between the board and the local authority.
- 748 Concerns about the handling of commercially sensitive information were raised in both interviews and documentation. Such concerns, and their underlying lack of confidence in the other party, may affect the relationship between the board and the shareholding local authority and the effectiveness of governance arrangements.

COMMERCIAL TRADING ENTERPRISES

- 749 The Local Government Official Information and Meetings Act 1987 provides for local authorities (as public bodies) to make information available to the public wherever possible, and to promote the open and transparent transaction of business at their meetings. However, that Act also provides for withholding official information and specifies grounds on which a local authority may do so. As an example, a local authority may withhold information where necessary to carry out commercial activities without prejudice or disadvantage, subject to an overriding public interest test.
- 750 The Local Government Act allows LATEs not to disclose in public documents any information which could be properly withheld under the Local Government Official Information and Meetings Act.
- 751 Local authorities need strategic commercial information to act as diligent shareholders, including:
- details of the board's forward strategy;
 - business cases for major investments;
 - the financial outlook for the business;
 - operational and investment projections; and
 - expected turnover.
- 752 We recommend that shareholding local authorities consider establishing with their boards:
- protocols for handling sensitive information;
 - a common understanding of respective interests; and
 - a clear set of expectations about how such information will be handled.

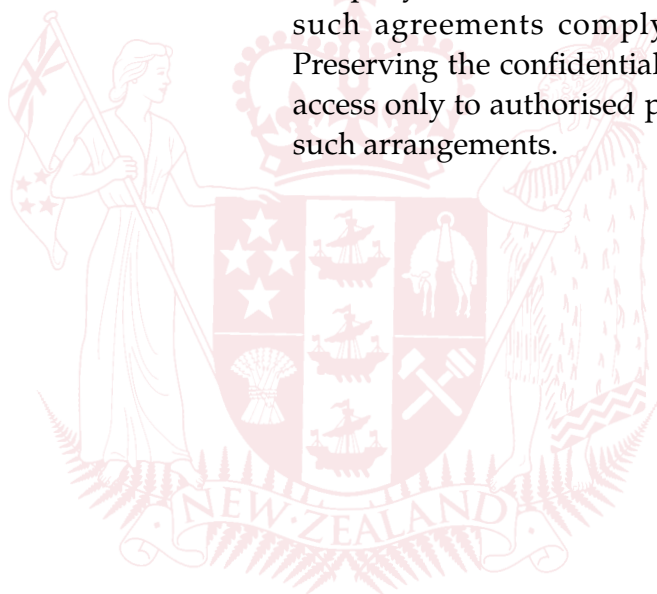


COMMERCIAL TRADING ENTERPRISES

Statement of corporate intent – The director

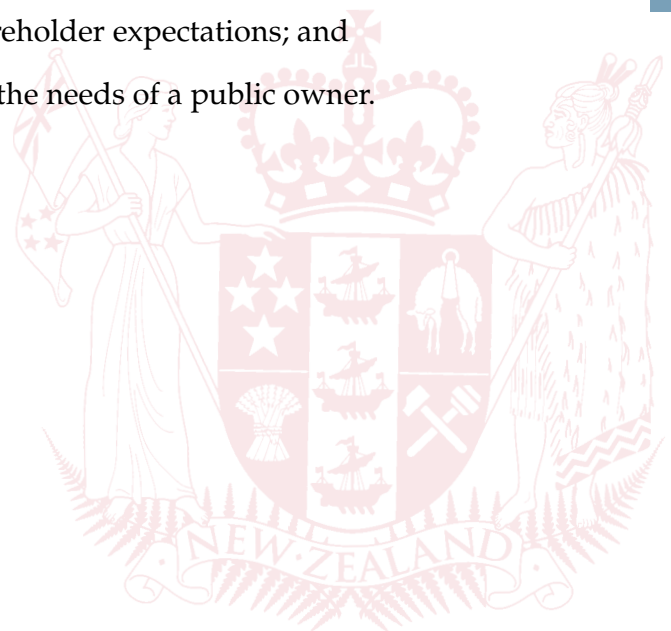
Listing on the New Zealand Stock Exchange

- 753 If a subsidiary company obtains a listing on the New Zealand Stock Exchange (NZSE), the shareholding local authority's access to information held by the company board will be affected.
- 754 Some entities, including port companies, may seek an exemption from the requirement to prepare an SCI. All three port companies we reviewed were listed on the NZSE, and two had taken advantage of this exemption. This removes one source of key information for the shareholding local authority about board strategy and the outlook for the business.
- 755 In our 1998 report *Statements of Corporate Intent: Are they Working?* (see footnote 15 on page 101) we recommended that the SCI model be applied consistently to all entities in a sector. We recommended that exemptions be permitted only where public sector control ceases to exist.
- 756 The NZSE Listing Rules also constrain information flows. The Rules aim to create a fair and informed market for the trading of securities in which all shareholders have equal access to information likely to influence the traded price of the securities. The Rules govern the relationship between shareholding local authorities and listed companies and also set standards for the behaviour of listed entities.
- 757 Listed companies that pass information to one party without public disclosure to all shareholders expose their boards to allegations of insider trading. But without relevant information, shareholding local authorities may be constrained in monitoring the performance of their investments and in reviewing short and long-term options for ownership.
- 758 We recommend that local authorities explore arrangements with their company boards for the supply of strategic information, ensuring that any such agreements comply fully with the requirements of the NZSE. Preserving the confidentiality of the information and taking action to limit access only to authorised persons are measures that need to be included in such arrangements.



Responsiveness to the Expectations of the Local Authority Owner

- 759 In a local government environment, commercial decisions can be politically sensitive. One factor which has led local authorities to appoint their own representatives to boards has been the desire to bring a community perspective to the boards' deliberations, and thereby make the companies more responsive to the expectations of their public owners.
- 760 In our 1994 report we noted that local authority owners can expect that they should be informed about matters which are likely to arouse public interest or political controversy. Local authority shareholders should ensure that they select directors who are likely to be responsive to their particular interests as public bodies.
- 761 In general, we observed that boards had kept their public owners informed of matters likely to generate significant public interest. For example, one port company had informed its shareholding local authority of its intention to make changes to its waterfront land, recognising that the board's decision would generate public comment. Another company briefed its shareholder before issuing media statements likely to generate public controversy.
- 762 Nonetheless, local authorities must rely heavily on the judgement of boards to be sure that they are alerted to any such issues in a timely way. It is not feasible to define each set of circumstances under which such communication should take place.
- 763 One local authority had adopted two practices that promote responsiveness to the views and perspective of the public owner:
- promulgation of a statement of shareholder expectations; and
 - an appointment process tailored to the needs of a public owner.



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- 764 A Statement of Shareholder Expectations (SSE) draws on a model used by the Crown Company Monitoring Advisory Unit of the Treasury. The SSE can help to clarify how the shareholding local authority expects the board to meet its responsibilities, covering:
- the roles of the board and shareholders;
 - communication flows between the company and the shareholder, including the functions of advisers;
 - the shareholder's expectations for its involvement in business processes, such as strategic planning; and
 - the shareholder's expectation to be informed of matters likely to be controversial before they become public.
- 765 We recommend that local authorities consider outlining, in consultation with their boards, their expectations as owners and the means by which those expectations will be met. We suggest also that shareholding local authorities should appoint to company boards people who:
- are responsive to its interests and to the communities in which the company operates;
 - demonstrate a positive attitude to its model of local authority ownership; and
 - demonstrate that they have a good understanding of the needs of a public owner.

Selecting and Appointing Councillor Directors

766 In our 1994 report we commented on the roles of councillor directors on the boards of commercial enterprises. In this study we heard a variety of arguments for and against such appointments.

767 The benefits of appointing councillor directors include:

- providing a local authority voice on the board; and
- making the company more sensitive and responsive to community views.

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- 768 Concerns about such appointments include:
- councillor directors may face difficulties in reconciling their dual roles as councillor and company director; and
 - local authority representatives may be expected to pass information from the company to the shareholding local authority outside established communication channels, which is inappropriate behaviour.
- 769 Some local authorities have a policy of appointing councillors to the boards of their commercial trading companies. Of the ten companies we reviewed, only three boards did not include a councillor representative.
- 770 Councillor directors need to have the commercial skills, background and experience to make a fully informed contribution to board discussions. A formal process for selecting directors is an effective way to meet this requirement.
- 771 One holding company periodically sought expressions of interest from councillors wishing to be appointed to the boards of local authority-owned companies. The skills and experience of those interested can then be assessed against the competencies for appointment to a board. This preserves the transparency of director appointments. It also ensures that all councillor appointees have the necessary competencies to fill director positions and participate fully in governance of the company.

Disclosing Corporate Governance Practices

- 772 SCIs and annual reports contain a range of information about the manner in which the governing body:
- meets its obligations;
 - conducts its business;
 - discharges its stewardship responsibilities; and
 - is accountable to its stakeholders.
- 773 Currently, corporate governance information is spread over several documents. Some accountability documents make no mention of important dimensions of good governance such as systems for managing risk, strategies for liaison with stakeholders, and procedures for the appointment and evaluation of the board. The roles and responsibilities of the board as governing body may not be apparent from the information supplied.

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- 774 Corporate governance statements can bring governance and accountability information together coherently. Such statements also provide stakeholders with information to assess whether governing bodies are meeting desired standards. Of the companies we reviewed, five had included corporate governance statements in their annual reports – one LATE, three port companies, and one energy company.
- 775 The NZSE requires every listed company to include in the annual report a statement of the main corporate governance practices in place during the reporting period.¹⁶ Similar requirements are set by overseas stock exchanges. The Australian Stock Exchange, for example, has listed those matters that an entity might take into account when making its statement of corporate governance practices.
- 776 A corporate governance statement discloses how the governing body will conduct its business and discharge its obligations. This statement can serve as a clear and comprehensive commitment to good corporate governance practice, and has the potential to enhance public accountability and transparency.
- 777 We recommend that shareholding local authorities encourage company boards to include a corporate governance statement in their SCI. The annual report should then outline how those commitments and standards have been met.
- 778 A corporate governance statement could include:
- a description of the board’s roles, and structure;
 - an outline of how the board will manage its activities;
 - a summary of the board’s risk management policies; and
 - an outline of the board’s strategy for communicating with shareholders.
- 779 Appendix C on page 116 lists in more detail elements that a corporate governance statement could include.

¹⁶ See NZSE Listing Rule 10.5.3(h).

Appendices

APPENDIX A

Evaluating the Performance of Boards and Board Members

Throughout our report, we discuss aspects of monitoring performance. In this appendix, we outline three elements of evaluating the performance of boards and board members:

- the benefits of *formal performance evaluation*;
- the principles of *good practice in evaluating performance*; and
- an *evaluation process* to use.

Further advice and guidance on performance evaluation can be obtained from the Institute of Directors and personnel consultants.

The benefits of *formal performance evaluation* include:

- providing feedback to individual directors;
- identifying directors' training and development needs;
- reducing the risk to the shareholder that directors or the board as a whole will under-perform;
- providing input into the director selection process;
- identifying the special attributes of directors;
- identifying opportunities for experienced directors to support new appointees;
- reinforcing the accountability of the chairperson for the effective performance of the board; and
- identifying any skill gaps in the composition of the board.

Principles of *good practice in evaluating performance* are that:

- it should be undertaken regularly, preferably each year;
- a formal method provides an objective framework for evaluation;
- director peer review is consistent with the self-appraisal principle whereby professionals monitor their own performance; and
- confidentiality should be observed to allow for the free expression of views.

Steps in an *evaluation process* begin with the board assessing its own performance in relation to its key responsibilities. These responsibilities include:

- communicating with shareholders and meeting their expectations;
- managing relationships with stakeholders;
- balancing the mix of skills on the board;
- strategic planning;
- discharging legal and ethical obligations;
- monitoring company performance;
- maintaining relationships with management; and
- meeting regularly and ensuring the proper conduct of board meetings.

Each director should assess the performance of the chairperson against a checklist of the chairperson's duties. Directors should also evaluate their own performance against stated attributes, and individually have an interview with the chairperson.



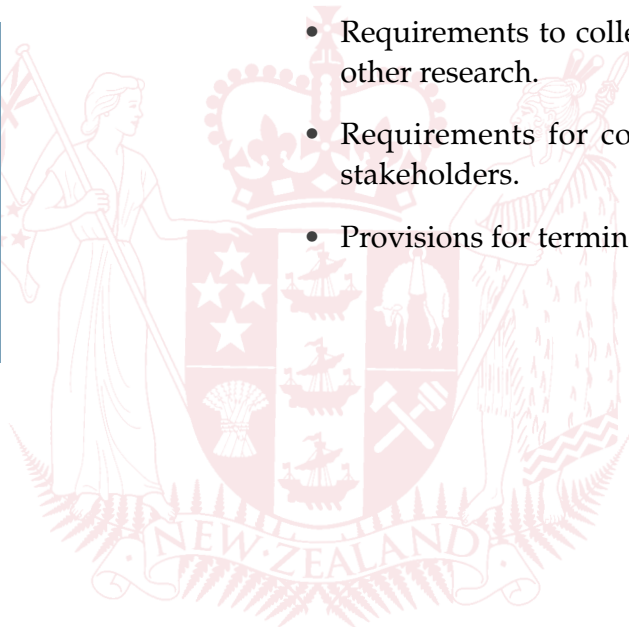
APPENDIX B

Elements of a Service Agreement With a Non-profit Entity

In paragraph 655 on page 91 we suggest that all local authorities develop formal agreements with their non-profit entities. These agreements can then be a means of holding the entities to account for their delivery of services.

Our suggested elements for a service agreement with non-profit entities include:

- *Obligations* of the entity, such as –
 - Definition of the scope of services to be provided and service objectives – including timeliness, quantity and quality, and the means by which performance will be measured and recorded. The entity may be engaged to provide advice to the local authority where requested to do so.
 - Definition of key performance criteria to be met in fulfilment of the agreement terms.
 - Specification of the obligations of the parties.
 - Meetings with local authority officers at (say) 6 monthly intervals to discuss progress with the agreement.
 - Requirements to collect data for economic monitoring, statistics, and other research.
 - Requirements for consultation with the community and specified stakeholders.
 - Provisions for termination of the agreement.



- *Legal and managerial aspects of the relationship, including –*
 - term, scope and intent of the agreement;
 - requirement to prepare an annual business plan, and to consult with the local authority on its content and format;
 - lines of communication with the local authority, including the naming of designated officers where appropriate and an outline of those circumstances in which consultation should occur;
 - the entity's association with the local authority, including its ability to act as its agent or acknowledge local authority support;
 - provision for a periodic audit of compliance with the terms of the agreement; and
 - provision for arbitration in case of agreement variations, non-performance, or dispute.
- *Issues covering funding, reporting, and monitoring, including –*
 - applications for local authority funding to be made on the basis of a cost/benefit analysis, with an accompanying detailed work programme;
 - requirement to provide the local authority with regular reports (containing financial and non-financial information) on the achievement of objectives outlined in the business plan, including reporting on performance, achievements, activities, issues and initiatives;
 - provision of financial statements in relation to the annual plan and budget, within a specified timeframe following the end of the financial year; and
 - the basis for payment for the performance of services.



APPENDIX C

A Corporate Governance Statement

In paragraph 777 on page 110 we recommend that shareholding local authorities encourage company boards to include a corporate governance statement in their Statement of Corporate Intent. A corporate governance statement could cover the following elements.

- *Structure, function, and obligations of the board, addressing:*
 - role of the board;
 - mix of executive and non-executive directors;
 - size and structure of the board, including the composition and roles of board committees;
 - obligations of the board in relation to the SCI, the annual report, and the statement of shareholder expectations;
 - policies for the provision of services to the company by directors; and
 - customer service obligations.
- *Guidance and resources provided to directors, identifying:*
 - resources available to directors to carry out their duties;
 - ongoing director training programmes;
 - succession planning for the board;
 - the code of conduct for the organisation, including a commitment to having appropriate regard for its social obligations, environmental responsibilities and community welfare; and
 - processes for evaluating the performance of the board and of individual directors.
- *Significant policies in place for accountability, including:*
 - specific policies for communicating with shareholders and other stakeholders;
 - risk management policies and procedures; and
 - policies for the selection and remuneration of directors and the chief executive.