

A DRAFT GUIDE TO THE USE OF LOCAL AUTHORITY TRADING ENTERPRISES (LATEs) for NZ Department of Internal Affairs 2000

Author's Note, November 2010: This draft guide to the use of LATEs was prepared in 2000 by McKinlay Douglas Ltd for the New Zealand Department of Internal Affairs. Although it is now some years old, much of what it has to say remains relevant today in the governance and management of CCOs.

1.0 Introduction and Purpose

- 1.1 Six years ago the Local Government Amendment Act introduced the legal powers to create local authority trading enterprises ("LATEs"). Experience since then shows wide variation both in the extent to which individual local authorities have used LATEs and in how they have managed their establishment and operation.
- 1.2 Some clearly saw corporatisation of trading activities as a natural and logical step and have made extensive use of LATEs. Others have been much more reluctant. It seems clear that differing attitudes result not only from individual community views on the desirability of corporatisation but also on different levels of understanding of what this means and of how to manage the relationship between local authorities and their LATEs. There is evidence that a number have been reluctant to use LATEs because of a fear that this would somehow disempower the local authority or represent a first and irreversible step towards privatisation.
- 1.3 This guide has been written to provide councillors, and council officers, with an overview of the use and management of LATEs. It does not argue for or against corporatisation (or for that matter privatisation) so much as explain how a local authority, if it decides to establish a LATE, should manage the relationship with it. The emphasis is on assisting local authorities understand how best to manage their ownership interest, and pursue any related social objectives, whilst at the same time avoiding conflict with the commercial role of the board and management of the LATE.
- 1.4 The guide begins by setting LATEs in the context of the public sector reform process which began with the election of 1984 Labour Government. It looks at the evolution, within Government, of policy on corporatisation and shows how this was translated in to the local authority sector with the reforms of the late 1980s.

- 1.5 It then goes on to discuss the principles of public sector reform which underpinned the restructuring of government trading activities as Government and its advisors sought to unbundle the different functions which, in the pre-reform environment, were commonly treated as though they were one.
- 1.6 Readers who want to go straight to the parts of the guide dealing specifically with LATEs may wish to go to immediately to the remaining sections of the guide which deal with:
- The use of LATEs and related structures.
 - Separation of roles (between the council as owner, directors, management and councillors).
 - Key operational issues.
- 1.7 The writing of this guide has drawn, substantially, on the experiences of individual local authorities in the establishment and operation of LATEs and other external or internal structures for the management of trading activities. Their contribution, and the insights from their experience, have been an invaluable part of this work.

2.0 History

- 2.1 The power to create LATEs was included in the Local Government Amendment Act (No.2) 1989. This was the Act which put in place the accountability and other reforms which went hand in hand with the major restructuring of local government in 1988/89.
- 2.2 To understand their purpose and origin, it is necessary to go back to the process of public sector reform initiated by the Labour Government elected in 1984. The reforms themselves were part of a wider programme of reform of the New Zealand economy intended to deal with our then very weak economic situation.
- 2.3 The Government took the view that, in order to deal with New Zealand's difficulties, it would be essential to undertake a broadly focused programme of reform covering both the private and public sectors and in each case directed at improving both the efficiency and the effectiveness with which resources were used.
- 2.4 In the public sector, amongst the problems identified by Ministers and their advisors were:

- A lack of clear objectives for government departments.
 - Significant conflicts of interest within individual departments because of the nature of the responsibilities they were required to discharge (for example being responsible for both policy and operations with, as a consequence, a risk that policy advice would be captured by the operational arm of the department).
 - A focus on accountability for inputs rather than for outputs and outcomes, that is, on the resources you used rather than on what you did with them or what their use had achieved.
 - Lack of clear accountability and hence difficulty in holding people responsible.
- 2.5 Concern also focused on the range of activities with which Government was involved. A number were ones which, conventionally, were often carried out by the private sector. These included such things as banking, insurance, electricity generation and transmission, telecommunications, commercial air transport, rail (both passenger and freight) and large scale forestry.
- 2.6 Some of these activities were carried out through separate corporate structures but a number of them were traditional government departments (telecommunications, electricity generation and transmission and forestry were prime examples).
- 2.7 Government ownership of these activities, particularly in a departmental form, was seen as a major obstacle to improving their performance. As examples:
- There was no clear separation of commercial and non-commercial responsibilities; it was therefore difficult to hold managers accountable for the effective stewardship of the assets under their control.
 - They did not face the same requirement, as their private sector equivalents, to achieve normal rates of return on their investment.
 - As government owned entities, they enjoyed advantages (such as freedom from taxation) and suffered disadvantages (inability to raise equity or to borrow independently) which were not faced by their private sector competitors.
- 2.8 The Labour Government concluded that, in order to improve the performance of its major trading enterprises, they should be restructured along lines which mimicked, as far as possible, conventional private sector business structures. To achieve this, Government enacted the Stated Owned Enterprise Act 1986

which provided for the corporatisation of those government trading enterprises from time to time listed in the schedule to the Act.

2.9 SOEs, once formed, would operate on the basis that:

- Commercial functions would be separated from non-commercial functions (in practice, if SOEs were to be required to undertake any non-commercial functions, then this should be the subject of an explicit contract with the Crown providing an appropriate return for the SOE).
- Their managers would be required to run them as successful business enterprises.
- The managers would be responsible for using inputs, for pricing, and for marketing their products within performance objectives set by Ministers but without interference in their day to day decision making.
- They would be required to operate on a basis of competitive neutrality, that is, with no special advantages or disadvantages merely by reason of Crown ownership. This was seen as the essential pre-condition for the ability to measure the performance of SOEs against their private sector equivalents.
- Enterprises would be set up in a normal corporate form under the guidance of boards of directors modelled on and, generally drawn from, the private sector.

2.10 It is now common to see corporatisation as being simply the first step towards privatisation. Whilst it is true that, especially for SOEs, corporatisation has often been followed by privatisation, the one is not necessarily the logical consequence of the other. In the state sector, corporatisation has now been used for a very large number of trading and quasi-trading activities, many of which it is explicit government policy to retain in public ownership. Examples include the Crown Health Enterprises and the Crown Research Institutes. Their chosen structure reflects a belief that, in order to promote efficiency, they should be run as nearly as possible on commercial principles even although they are intended to remain in public ownership.

2.11 Experience with the SOE/corporatisation model quickly persuaded Ministers and their advisors that it was capable of making a very major contribution to performance improvement. One of the better known examples, the Forestry Corporation, achieved a \$130 million improvement in its operating surplus in its first year as an SOE.

2.12 When Government turned its intention to the reform of local government, it drew strongly on the policies it had developed, and the experience it had had,

with its reforms in the central government public sector. This can be seen in such things as:

- The similar changes made in the roles of the chief executives in the state services and in local government. As one example, prior to the reforms, the State Services Commission, and the council, respectively were the employers of staff. Post-reform, staff are employed by the chief executive of the department or local authority.
- The emphasis, at both levels of government, on improving accountability with an increasing focus on outputs and statements of service performance.

2.13 Central government also concluded that the model it had developed for corporatising its own trading activities should be extended to local government. The clearest statement of this is found in Section 36K of the Local Government Act which states the purposes of local government in New Zealand. These include “the operation of trading undertakings of local authorities on a competitively neutral basis”.¹

2.14 At the time of the 1988/89 reforms, there was considerable debate on whether to make corporatisation compulsory or to leave it to the decisions of individual local authorities.

2.15 In practice, the outcome was something of a compromise between the two, partly because there are considerable technical difficulties in making corporatisation compulsory, not the least of which is determining just which activities are and are not trading activities suitable for corporatisation. Certain specific activities, mostly undertaken by special purpose local authorities, were compulsorily corporatised; action on the balance was left over to individual local authorities.

2.16 Compulsory corporatisation included:

- Port companies formed to carry on the commercial activities of former harbour boards (see the Port Companies Act 1988).
- Energy companies, formed from the electricity distribution (and occasionally gas) undertakings of former electric power boards and the municipal electricity departments of some local authorities (Energy Companies Act 1992).

¹ This implies on a basis such that the local government trading undertaking neither enjoys any advantages nor suffers any disadvantages purely as a result of local authority ownership. To achieve this would require that trading undertakings pay tax, and be insulated from ratepayer support.

- Passenger transport; Section 594ZR of the Local Government Act prohibited local authorities from conducting a passenger transport operation after a stated date but provided that a local authority would not be in breach of the section solely by reason of having an interest in a passenger transport company.
- The competitive pricing provisions (CPP) mandated by the Transit New Zealand Act 1989 preclude any payment to local authorities for other than minor or ancillary works. Local authorities wishing to be eligible to undertake major work have been required to corporatise their in-house activities; the CPP are now being revised so this will apply, as well, to minor and ancillary works.

2.17 For other activities it was decided to make provision for corporatisation, at the option of the local authority, but to include strong signals in the legislation to encourage corporatisation where appropriate. The most important of these are:

- Including, as one of the purposes of local government, “the operation of trading activities of local authorities on a competitively neutral basis”.
- Providing, in Section 119D, that the (usually) chief executive officer is responsible to the local authority for “ensuring the effective, efficient, and economic management of the activities and planning of the local authority”. This provision arguably makes the chief executive responsible for selecting and, with the consent of the council where that is required, implementing optimal organisational arrangements for each aspect of the local authority’s activities.

2.18 With the passage of the 1989 amendment, local authorities then had a wide range of options open to them for the establishment of stand alone entities either to undertake what was formerly council activity and/or to carry out activities which councils were not currently engaged in. As well as LATEs, the options open to local authorities include:

- Under Section 246C “for the purpose of performing any function or duty or exercising any power conferred on it by or under this Act or any other Act, subject to this Act” to enter into a range of different relationships including forming or participating in the formation and operation of a company, trust, partnership, or other body.
- Under Sections 598 and 601 powers to make grants of money, or advances or guarantee repayment of money for organisations established for defined purposes (with no reference to whether or not the organisation is controlled by the council).

- 2.19 On the face of it, Section 246C represents an alternative, and much simpler, means of establishing stand alone companies or other organisations for much the same purposes as local authorities may wish to establish LATEs. It is unclear why the legislature included two apparently parallel but different processes.
- 2.20 Since the 1989 legislation, the definition of LATE has been extended and refined, substantially to limit the opportunity for local authorities to minimise tax. As a consequence of these changes, it is now unlikely that a local authority could establish a company or other arrangement using Section 246C without that being caught within the LATE provisions of the Act.
- 2.21 The provisions of Sections 598 and 601 have been used, extensively, by local authorities to support the establishment of trusts, in particular, to carry out recreational, cultural or community activities the local authority wishes to encourage. Typical examples are enterprise boards and museums or art galleries.
- 2.22 In the six years since the LATE legislation was put in place, its use by the local authority sector has varied widely. One or two local authorities have substantially corporatised their entire operations keeping within their core activities only such matters as policy advice, monitoring and the servicing of the democratic process. The majority, however, have made little or no use of LATEs beyond those areas where corporatisation has, in effect, been made compulsory.
- 2.23 Anecdotal evidence suggests that there are two principal reasons why many local authorities have not made greater use of LATE structures. These are:
- A lack of familiarity with the underlying structural issues combined with a fear that transferring activities into a LATE may result in an unacceptable loss of control.
 - A belief that it is inappropriate, whatever the technical justifications, to place certain activities in corporate form.
- 2.24 Whether or not to corporatise any particular activity is finally for the local authority in consultation with its community to decide. It is not the purpose of this guide to argue the case for or against corporatisation but simply to explain the issues and how they can be dealt with as a contribution to improving the quality of local decision making.
- 2.25 The remainder of this guide begins, where the central government reform process began, by discussing the separation of interests which are typically bundled up within an activity. It then looks at the possible uses of LATEs or similar structures, comments on what is and is not a LATE, discusses the

separate roles of owner, directors, management and councillors and deals with a number of key operational issues.

3.0 Separation of Interests

3.1 At the heart of the public sector reforms, from which the idea of SOEs and then of LATEs emerged, was the recognition that a number of different and potentially conflicting interests were caught up within the same activity. If public sector performance was to be improved, it seemed essential to identify each of these separate interests and eliminate, or at least minimise, the potential for conflict.

3.2 An excellent example of what was seen to be the problem is provided by the former New Zealand Electricity Department. As the authors of a study of the corporatisation of ECNZ comment:

“The overriding objective of NZED was to ensure that a reliable supply of electricity was made available to the country and its consumers. This orientation, over many years, had led to an oversupply of electrical generating capacity, non-commercial pricing, a high degree of cross subsidising in favour of residential consumers, and a lack of focus upon cost containment and efficiency. NZED provides an excellent illustration of the commingling of economic, social and political objectives ...”.²

3.3 With NZED, Government found that it was receiving its policy advice on construction of new capacity from the organisation which would build and run that new capacity; it was receiving its advice on the type of performance to be expected from the system, and whether that was being achieved, from the organisation which was undertaking that performance.

3.4 Awareness of these types of problems led to an analysis designed to separate out the different kinds of interests which Government had in the various activities which it undertook. Local authorities, in their activities, encompass the same set of interests which are:

- Owner
- Purchaser
- Provider
- Regulator
- Monitor
- Evaluator.

² Spicer B. et al (1991) *The Power to Manage*, Oxford University Press, Auckland p.16

Owner

- 3.5 In simplest terms, the ownership interest is about getting an acceptable rate of return on your investment. This is a combination of two things. The first is ensuring that current investments pay their way. It is the conventional focus of any owner. The second is ensuring that new investments are undertaken at the least possible cost to achieve the desired outcome. There is an obvious interaction between the two. Unless owners have a clear understanding of the rate of return they require from their investment, then they are unlikely to be focused on least cost options for new investment. This follows from the fact that the main cost, to an owner, is the cost of capital, that is, the rate of return it should be seeking to achieve.³
- 3.6 It is now generally argued (but not always accepted) that the public sector is a less efficient owner of business assets than is the private sector. One reason, lying outside issues of the relative competence of management, is that public sector owners are conventionally more risk averse, and less willing to provide additional capital, than private sector owners. As a consequence, assets in public ownership are likely to generate a lesser return than the equivalent assets in private ownership.
- 3.7 This line of argument suggests that there is little or no case for the public sector to own assets simply in order to generate a return. Almost invariably, inquiry will establish that the public sector body has an overriding reason for retaining ownership which is not simply related to return on investment. A rural local authority may see ownership of a contracting function, and the associated plant and equipment, as necessary to ensure that there is always available capacity to deal with emergencies such as flooding, slips etc. An urban authority may put similar emphasis on retaining key infrastructural assets, or a critical mass of capacity in certain technical or professional areas.

Purchaser

- 3.8 A primary rationale for the existence of local authorities is to ensure that their citizens have access to a range of goods and services which it is believed are best purchased collectively. Whether it is water supply and sewage disposal, recreational or cultural activities, roading or dog control, working through the collectivity rather than each ratepayer or resident making his or her own arrangements has obvious advantages. In this capacity, the local authority is concerned with issues such as formulating policy for the nature, type, quantity

³ Technically, this is the rate of return it could earn from an alternative investment with the same risk characteristics. In the case of local authorities, the best measure for this, ultimately, is the rate of return which their ratepayers, who ultimately provide the capital, would expect to earn from their own investment portfolios. Expressed this way, it can be seen as the opportunity cost of capital in the New Zealand economy as a whole.

or quality of the goods or services concerned, setting specifications and ensuring that what is delivered is what was ordered.

- 3.9 None of these interests carry with them any necessary implication that the local authority should also be the provider of the service. The primary interest, in the purchaser function, is the right mix of goods and services at the least cost to meet the quality and other requirements regarded as necessary to meet the needs of the people intended to benefit, and not who actually provides them (except to the extent that the nature and experience of the provider is seen as a key factor in determining the nature and quality of the provision).

Provider

- 3.10 This is the separate function of undertaking the delivery of the goods or services concerned. Conceptually, there are relatively few instances where the local authority or other public body needs to be both the purchaser and the provider. Whether it should undertake both of these roles should be a matter for conscious decision, based on the costs and benefits of different options, and not simply a matter of continuing to do things the way they have always been done. There is a concern that, if the authority itself is both the purchaser and the provider, it will tend to favour its own provider over other, possibly more efficient, alternatives.

Regulator

- 3.11 Local authorities have quite extensive regulatory activities including their responsibilities under the Resource Management Act, the Building Act and the Dog Control provisions of the Local Government Act to name three of the most sensitive. The Local Government Act, itself, in Section 223C(g) and (h) recognises the desirability of separating regulatory and non-regulatory functions. This is carried through, explicitly, in respect of LATEs, by the provision in Section 594E that “no local authority shall transfer or attempt to transfer any regulatory function to any local authority trading enterprise, whether or not that function is ordinarily carried out in conjunction with any undertaking that is being or has been so transferred”.
- 3.12 At the heart of these provisions are concerns such as:
- Policy advice to councils on regulatory matters should not come from people also involved with carrying out the regulatory function so as to

ensure that the advice is independent of any risk of capture by regulators.

- The risk that, if regulators are also responsible for service delivery, they may be less than rigorous in regulating their own activity (the risk usually cited is of councils taking a soft approach to their own consent applications, or to dealing with their own breaches under the Resource Management Act).

Monitor

- 3.13 The monitoring function is an oversight one; ensuring that either the activity concerned is undertaken to the performance standards specified or that any difference is identified and brought to proper attention. For this to be effective, it is clearly essential that the monitoring function be quite separate from service delivery or any other function which could result in a confusion of objectives (as an example, the monitor needs to be even handed as between the council's purchase interest on the one hand and its provider interest on the other).

Evaluator

- 3.14 This is the function of determining whether councils' activities are achieving the desired outcome. As an example, a council may adopt a rental policy, for housing which it owns, because it believes this will achieve certain social outcomes. The role of evaluation is to determine whether that is indeed the case and whether this is the best way of doing so. It is separate from monitoring the role of which is confined to determining whether the policy was implemented and managed as required. The difference can be summed up as monitoring is concerned with efficiency and evaluation with effectiveness.

General

- 3.15 Understanding of the local authority's different interests provides a basis for analysing the activities which the local authority carries out so as to identify the different components of each activity and ensure that they can be structured so that each is properly recognised. The result may be, indeed often is, to conclude that what was apparently a single activity in fact contains within it a number of different activities. If a local authority is carrying out the service itself, then there will be at least a purchaser interest, a provider interest, an owner interest (a concern both with the efficient use of assets and with whether or not the local authority, for policy reasons, needs to retain ownership of the activity or can achieve its objectives purely as a purchaser), a monitoring

activity and, to measure effectiveness, evaluation. Depending on the nature of the activity, the council's regulatory function may also be involved.

- 3.16 This analysis also underpins what is becoming a more familiar and common approach within local government; distinguishing between core activities, which the local authority sees as an integral part of its undertaking, and non-core activities for which it is prepared to contemplate a range of different provider mechanisms.
- 3.17 Policy advice and the management of the democratic process are the two which most observers would see as the essential components of the core. Although local authorities may contract in certain services (as when they engage consultants on a particular project or contract or a professional provider of returning officer services) the ultimate responsibility must rest with the local authority. In terms of the analysis set out above, these are functions where the local authority has an overriding owner interest in maintaining a sufficient capability, itself, to discharge its functions. Issues such as scarcity of expertise, institutional knowledge, and the need, itself, to have the independent capability of assessing work which it has contracted in are all relevant.
- 3.18 For other activities, such as works and services, a local authority may be relatively indifferent as to whether it carries out the activity itself, vests it in a LATE, or disposes of it. The overriding considerations may simply be cost and the quality and timeliness of the service.

4.0 The Use of LATEs and Related Structures: Where they Fit in the Range of Instruments Available to Local Authorities

- 4.1 LATEs can be seen as part of a continuum of the range of options available to a local authority for undertaking, or facilitating the undertaking, of different types of activity. Briefly, the continuum includes:
 - The core council; activities which are maintained within the council's conventional structure.
 - Business units; stand alone operations which are still legally part of the core council. The Auditor General has defined a business unit as a "semi-autonomous group within the council which is run along broadly commercial lines and has the primary objective of recovering its costs or making a profit".
 - Contracting in where services are purchased from external providers (including LATEs).

- LATEs or other stand alone entities external to the council but still, in some form, controlled by or substantially accountable to it.
 - Provision by other parties where, if the council does have a function at all, it is as a regulator (as, for example, in its role under the Health Act of licensing and inspecting premises involved with the inspection or sale of food).
- 4.2 In order to decide what structure a council should use, it is first necessary to decide what it is the council is seeking to achieve. This is variously expressed in sayings such as “structure follows strategy” or “form follows function”.
- 4.3 One local authority’s approach to restructuring its roading division provides an illustration of how this might be done. It identified four separate functions which had previously been bundled within the one function. These were:
- Transportation planning. This function works alongside city planners to plan the roading network and determine what the authority’s requirements are for new roads, safety work and so on. As a policy function, it is substantially in-house but with private sector expertise being contracted in as required.
 - Asset management. This is substantially an in-house function with the primary function of overseeing the state of the assets, including maintenance, and contracting for new construction or maintenance work. This unit is also substantially in-house but with private sector parties employed for contract supervision.
 - Consultants. This unit provides design services under contract. This function is seen as contestable with the private sector.
 - Construction. This function has been corporatised and the LATE concerned is required to bid for work on a basis of competitive neutrality with the private sector. It wins some, but not all, of the council’s work and is also a successful bidder for work with other clients.
- 4.4 In terms of the analysis of interests outlined in the previous section, both transportation planning and asset management can be seen as policy units where the nature of the policy advice, and its closeness to the core of the council’s operations, justifies ownership for reasons such as maintaining a critical mass, institutional memory and the difficulty of monitoring and enforcing quality through conventional contractual arrangements.

- 4.5 The separation between the two units reflects the importance of avoiding capture. The asset management unit can be seen as a purchaser of policy advice on new roading requirements, and the transportation planning unit as a provider, quite likely with a vested interest in ensuring that its recommendations are accepted.
- 4.6 The consultants unit is a provider and of a service which is readily available in the private sector. There are no compelling reasons for retaining council ownership (the necessary critical mass of expertise, institutional knowledge etc should be found in the transportation planning and roading management units). Whether to retain the service in-house or corporatise it (or for that matter divest it, possibly to staff) is a matter of relative convenience and cost. The council may legitimately take the view that, for a relatively small unit, the cost of corporatisation may mean that it is not a priority. Putting at least a proportion of design work to tender, with outside parties competing against the in-house unit, should exert sufficient commercial discipline to maintain the efficiency of the in-house provider.
- 4.7 The construction unit is in a different situation. Ring fencing it as a provider is a pre-condition to encouraging efficiency. So is creating a suitable commercial structure including commercial expertise at board and management level and the ability for the unit to compete, on equal terms, with other providers (both in bidding to the council and in bidding to third parties).
- 4.8 Another example illustrating the potential for the use of LATEs is water and waste water, an activity which virtually all councils believe should remain in public ownership for reasons such as:
- Provision of water and disposal of sewage are natural monopolies as the associated capital costs are so high no one would replicate the systems. Public ownership is therefore seen as necessary to protect consumers from exploitation.
 - Water is an essential service and should not, therefore, be subjected to the risks of the market.
- 4.9 Assume that those are reasonable policy stances for a local authority to adopt. Does it follow from this that the function should be treated as indivisible or should it be broken down into its constituent parts. The latter approach is increasingly followed as, in much the same way as with the roading illustration above, many councils are now subdividing their interests in water and waste water into:
- Asset management
 - Design and supervision
 - Physical operations.

- 4.10 Typically, each of these will be structured as a business unit. In some cases the parent council will be inviting competitive bids from the private sector; in other cases, the business units are being encouraged to tender for outside work.
- 4.11 Closer analysis shows that there are a number of other subdivisions which either should or could be made. There is clearly a policy function advising the council not only on new works, and priorities for them, but also on options for their implementation. There is a regulatory function concerned, for example, with ensuring that industrial users comply with the relevant trade waste by-laws.
- 4.12 A whole series of other questions arise as well. Thus:
- The council may remain as owner of the network but does it also need to be the operator; there is a well established competitive market in the management, under franchise or otherwise, of water and waste water systems.
 - Is the business of operating the network one single business or a series of specialist businesses? For those councils which are engaged in metering, specialist metering services, supported by information technology or telecommunication companies are beginning to look an attractive option. Few local authorities have the scale to maintain proper laboratory testing services and these may, in any event, be better provided by specialist firms.
 - Do the council's regulatory and pricing frameworks deter the emergence of specialist options. Would re-writing these facilitate (say) the recycling of "grey" water or the use of composting toilets.
- 4.13 On a broader scale, the development of facilities management and out sourcing is becoming increasingly common. This is based on the principle that the firm or organisation should be freed up to concentrate on its core activities with the incidental or support functions being undertaken by specialist providers. The argued benefits include development of better career structures for staff, greater specialisation, the ability to invest in technology and the development of supporting software, and the shift of risk from the parent organisation to the contractor.
- 4.14 The purpose of this type of analysis is to identify the different components of any particular function so as to consider how best each may be managed.
- 4.15 Clearly, some principles need to be applied in doing this, apart from those which have been discussed so far. Thus:

- Expected benefits should outweigh expected costs. There is little point in overly fragmenting the council's business if all this does is to ratchet up administration and compliance costs.
 - In considering what form to adopt, particular attention should be paid to issues of monitoring and accountability. If equivalent goods or services are readily available through a competitive process, then it may be sufficient to rely on specifying quality and other characteristics of the service and to rely substantially on price (once the quality and other conditions are satisfied) as the means of discriminating between different providers. Effective performance, of the council owned function, can then be measured through its return on invested capital. If an appropriate return is achieved, then you know that your unit is meeting quality and other specifications (without which it would not have secured the work), is competitive on price and is making efficient use of its resources.
- 4.16 This suggests that some form of arms length structure may be quite acceptable, especially if there is an opportunity for better use to be made of the ratepayers' investment by seeking (on a competitively neutral basis) work from third parties.
- 4.17 Other activities may be less amenable to this process. Core policy advice is one example. Although the market for policy advice is now very active, with a number of competing providers available, it is much more difficult to define policy as an output and set performance standards than it is to define (say) the design of a new treatment works. Equally, when the product is delivered, it is more difficult to evaluate against objective criteria.
- 4.18 The problem does not end here. Policy advice is not solely something which can be bought by the metre. Effectiveness of this function depends on factors such as institutional knowledge, established confidence between the advisor and the advised and the ability to maintain a critical mass of requisite skills.
- 4.19 Functions with these sorts of characteristics are best kept in-house and monitored by close and informal contact between provider and recipient. The necessary external disciplines will come from such things as reactions to the council's own proposals, peer group evaluation of staff skills and the like.
- 4.20 For functions which are, potentially, capable of being carried out by some form of stand alone entity, councils have five possible options:
- Business unit
 - Contracting in
 - LATEs
 - Trusts

- Divestment.

Divestment

- 4.21 Divestment, as an issue, arises when a council concludes (or is persuaded) that it has no need to be involved with the actual provision. It may, however, have an ongoing role as regulator or as the purchaser of services (as an example, several councils have divested themselves of roading LATEs but still continue to purchase services from them).

Contracting In

- 4.22 Contracting in is most frequently resorted to when a council wishes to expose its own provider to competition as a means of improving performance, when it requires access to specialist services which it lacks or which it would be uneconomic for it to possess in-house, or when it has divested itself of an activity from which it still wishes to purchase services from time to time.

Trusts

- 4.23 The use of Trusts has stood a little aside from the main thrust of restructuring council trading activities. They have normally been used when the following conditions apply:
- There is a dimension of public purpose involved with the activity of a kind not usually associated with a purely business undertaking.
 - There is an expectation of significant public support, by way of voluntary effort, donations, sponsorship or otherwise.
 - The activities it is intended to undertake have a substantial public good involvement.
 - The activity is not intended to be profit making in the sense that any party outside the trust (private individual, council or otherwise) can expect to share in the earned surplus of the entity.
- 4.24 There is greater scope for local authorities to make use of Trust structures, as stand alone entities for undertaking what was previously council activity, than is commonly recognised. Because Councils do not have direct ownership of Trusts, or of their assets, they have tended to be seen as vehicles for peripheral activity or for encouraging particular initiatives where the Council wants a substantial input from the community (as with Enterprise Boards).

- 4.25 They have also been seen as inappropriate for activity which may have a substantial commercial component. In fact, Trusts can be, and are, used to undertake very major commercial activities where that is consistent with their overriding public purposes.⁴ Trusts, especially charitable trusts, can be a very suitable vehicle to which to divest substantial council activities which are best operated on commercial lines but within a context of an overriding public purpose. Pensioner housing is a possible example.
- 4.26 There are technical issues concerning the structuring of Trusts, and their relationship to the local authority, which are outside the immediate scope of this paper but which need to be handled with some care. They include:
- If the objective is establish a charitable Trust, in the expectation that its income will be free from tax, a prior clearance must be sought from the Inland Revenue Department.
 - If the Council has direct control over the Trust and it will be engaged in some form of trading undertaking, it will be a LATE. If there is any possibility of a Trust being involved in trading activity, then appointment of Trustees should be outside the control of the Council. There are other means, such as contract, for achieving the degree of influence and accountability the Council will require.

Trading Activities

- 4.27 The main options for the establishment of semi-independent entities to undertake trading activities are business units (within the formal legal structure of the council) and LATEs (external to that formal legal structure). The decision to establish either presupposes that there is a separate function or activity capable of being defined and separated from the balance of council activity as a discrete unit. The focus may be on a specific activity (say) forestry, it may be on an input or inputs which the council currently acquires in-house but which it believes could be provided on a competitive basis. Provision of administrative support could be set up in this way.

Business Units

- 4.28 Recall that the Auditor General's definition of business unit is a "semi-autonomous group within the council which is run along broadly commercial lines and has the primary objective of recovering its costs or making a profit". This has a number of implications. For example:

⁴ It is often not recognised that the Sanitarium Health Food Company, a major food manufacturer, is actually the business arm of a substantial charitable trust which operates Sanitarium as a means of earning revenue for its overriding charitable purpose.

- Payment, both to the business unit for services it provides council, and from the business unit for services provided by the council should be priced on commercial lines, where possible using external benchmarks. This is not the same as allocating costs in accordance with some pre-determined formula. In particular, items such as the costs of democracy are inappropriate components in a council's charge to its business units.
 - Business units should be established with a balance sheet reflecting norms for the type of activity. This implies treating part of the capital as debt and part as equity. They should be charged an appropriate interest rate on the debt component and expected to earn a market related return on equity.
 - Decisions on the amount of capital the local authority should invest in its business units should be made on a commercial basis. If a business unit is earning less than its required rate of return then there is a case for reducing the level of investment. Conversely, if it is exceeding the required rate, then there is a case for further investment, at the very least, by retaining the excess earnings. (Unless in either case the shortfall or excess results from non-commercial factors such as inappropriate pricing, in which case the first priority should be to deal with that.)
 - Business units should be free to purchase inputs from non-council providers if their managements believe this will be more efficient or, alternatively, compensated for the requirement to use council provided inputs with the compensation assessed as the difference between the council charge and a market benchmark.
 - The relationship between the business unit and the council should be established on a contractual basis with the business unit management having autonomy as to how its responsibilities are discharged subject only to such restrictions as may be included within the contract or which arise out of the structure itself. (Inevitably there will be some, such as the fact that the business unit itself has no separate legal identity and so cannot borrow or contract in its own right and is not the legal employer of its staff).
- 4.29 The purpose of the business unit model is to provide, within the limitations of the council structure, as close as possible a parallel with a conventional commercial structure so that management can be held properly accountable for the efficient use of the resources under their control.
- 4.30 The business unit model represents a substantial improvement on the normal bureaucratic model in terms of identifying the true costs of an activity and

improving its efficiency through such measures as giving management relative autonomy and being able to benchmark performance against comparable organisations. However it does have some difficulties in comparison with a truly stand alone entity.

- 4.31 Ideally, if business units are to operate in a commercial context, they need to face competition when they bid for council business and they need to be able to bid for business from external clients. There are substantial obstacles in the way of business units bidding for work from external clients including:
- As part of the legal structure of the local authority, business units have only the legal powers of the local authority itself. In a number of areas, it is doubtful that the local authority has power to contract with external parties for the services concerned.⁵
 - Business units do not operate on a basis of competitive neutrality. Unlike their commercial competitors, they do not pay income tax. Even although their balance sheets may be structured along commercial lines, they do not face the risk of failure in the same way that their commercial competitors do as they are backed by the full resources of the council and, ultimately, the ratepayer.
- 4.32 This presents a genuine dilemma for a council wishing to require its business units to operate commercially. If it permits them to bid for business against third parties, then it risks claims of unfair competition (this will be the case even if it requires its business unit to price its services as though it were subject to income tax, as they will still have the benefit of direct local authority backing).
- 4.33 If the local authority decides that its business units should not seek third party business (or they are legally constrained from doing so) then it may be difficult to agree that third parties should be allowed to compete for council business as the business unit would then be placed in the very difficult situation of being unable to win business from third parties but at risk of losing business to them.
- 4.34 The inability to operate on a fully commercial basis may also have a significant morale impact. One of the arguments for a business unit structure is to replicate, as closely as possible, commercial incentives for managers. One of the strongest incentives (or perhaps consequences of operating within a commercial structure) is the urge to grow the business. Some local authorities are beginning to find that, when they combine the inability to bid for business externally, with the efficiency demands they impose on their business units,

⁵ This is an issue which needs to be examined, case by case, whenever the possibility of a particular business unit contracting to third parties is under consideration.

they are effectively telling managers that they are in a permanent downsizing mode.

LATEs

- 4.35 For these sorts of reasons, amongst others, a number of local authorities now see the main rationale for establishing a business unit as that of a transition to full LATE status. The business unit phase is the time during which staff and management become accustomed to working in a more commercial manner, a proper commercial balance sheet and business planning process is put in place and the process of separation from the parent local authority put in train. This may include the establishment of what amounts to a separate board.⁶
- 4.36 The decision to establish a LATE is qualitatively different from the decision to establish a business unit. As part of a council structure, business units remain under council direction and governance, separation of commercial and non-commercial objectives is a matter of good practice and not of legal requirement and the terms of reference for a business unit, and the unit itself, can be revised at any time with a minimum of formal procedure.
- 4.37 The decision to form a LATE is normally made when the council believes that using a fully commercial structure, with its own independent powers and governance, will bring net benefits for the council. As the discussion of business units has already illustrated, there are a number of areas where this can be achieved. They include:
- Freedom from the restrictive powers of the Local Government Act, which may mean that there are particular activities that a business unit cannot undertake, simply because the parent local authority lacks the necessary powers.
 - Ability to borrow in its own right.
 - Establishing the competitive neutrality essential if the council activity is to be active, in the market, competing for business from third parties.
 - Providing a fully commercial structure, including an experienced board of directors.

⁶ Under Section 114R of the Local Government Act, local authorities may appoint committees or sub-committees with significant scope for external membership. The actual provision is “at least one member of every committee, other than a sub-committee, shall be an elected member of the local authority”. Governance of a business unit can, therefore, be vested in a sub-committee of the council comprised exclusively of people appointed for their commercial or other relevant experience and not (necessarily) of elected councillors.

- 4.38 There is evidence that a number of local authorities see the shift from a business unit to a LATE as creating an unacceptable loss of control, by the local authority, over the activity concerned and also as imposing additional costs on the ratepayer as the LATE seeks to earn a normal rate of return on its assets and has to pay tax on its profits.
- 4.39 The fear of loss of control is genuine and commonly results from inadequate information on how a local authority should deal with its LATE. This is discussed in more detail in the section on key operational issues.
- 4.40 Concern about profit and tax looks at only one side of the equation; it overlooks factors such as:
- The cost reductions which can result from the increased efficiency which corporatisation should bring.
 - The greater opportunities to make more effective use of the council's assets as its trading undertakings are able to carry out activity for third parties.
- 4.41 The council whose experience with restructuring its roading division was examined above reports substantial savings including:
- The cost of roading maintenance contracts reduced by 15% on average.
 - The cost of drainage maintenance was down by 35%.
- 4.42 Savings of this magnitude more than offset the apparent additional costs arising from the need to provide for profit and for tax.
- 4.43 Two other points should also be noted:
- Profit is more than just an accounting figure or an apparent cost to those receiving the service. It should be closely related to the opportunity cost of capital (see footnote 2 at page 6). It is also an important element in making decisions on new investment. Unless you know, **and charge**, an appropriate return on capital, there is a real risk that you will over invest and thus impose potentially substantial costs on ratepayers.
 - Value of the council's (the community's) assets is a function of the return earned on them. In this sense, failure to earn a normal profit significantly de-values the community's investment.
- 4.44 As far as tax is concerned, it may serve simply to quote the chief executive of one local authority, which has made use of LATEs. His comment was:

“There was the issue of tax, I think this is one of the largest mythological monsters to kill ideas that could be invented. Local authorities tend to be terrified by tax which any other company in the private sector is perfectly at ease with even though they may not like it. There are a variety of legitimate tax arrangements as well as a recognition that proper pricing includes a recognition of tax. Resistance to new ideas based on this which can be brushed up into a bush fire quite readily is a foolish notion”.

5.0 Separation of Roles

- 5.1 One of the most difficult areas, for local authorities, in dealing with LATEs, is understanding and working with the separate roles of owner, directors, management and councillors. This section discusses the different roles and their responsibilities.

Owner

- 5.2 As owner, the local authority is accountable to its ratepayers for the performance of its LATEs, and its stewardship of the community's investment in them. This does not give the local authority an unfettered right to act as it pleases. In particular, it does not give the authority the right to intervene in the day to day management of the LATE.
- 5.3 Instead, as owner, the local authority's powers are to make decisions on matters such as:
- The nature and extent of the council's continuing investment in the LATE (including whether to dispose of that investment in whole or in part subject, of course, to the special consultative procedure).
 - Stipulate, to the directors, its requirements as owner. This is the function of setting the framework within which the board of directors is then free to manage the business against performance indicators agreed between the owner and the board.
- 5.4 These issues are normally dealt with through the statement of corporate intent (which is discussed below) and encompass such matters as the nature of the business or businesses which the LATE will undertake, key financial indicators, the procedures to be followed when making major investment or divestment decisions, target debt:equity ratios and related matters. The objective is to set a framework within which directors may then exercise their commercial discretion and against which they will be held accountable.
- 5.5 It is not within the authority of the owner to interfere in the day to day management of the company. If it does so, then it will be unable to hold directors properly accountable; they will always be able to refer back to the owner's interference as the reason why they were not able to achieve agreed objectives.
- 5.6 This is sometimes seen as preventing the council from pursuing social objectives associated with the now corporatised function. This is not the case. Instead the issue for the council is simply that of selecting a mechanism for

doing so which does not create conflict with the commercial responsibilities of directors. An example is given below in discussing the role of directors.

Directors

- 5.7 The directors have the primary responsibility for the management of the company. Typically, the articles of association or constitution will provide that subject to any matters reserved to shareholders, the directors are to manage the company. As a measure of the extent of their discretion, there is case law supporting the right of the directors to disregard shareholders' resolutions which would interfere with the directors' discretion. The proper remedy, for an owner dissatisfied with the performance of directors, is to replace them, not to interfere in what they do.
- 5.8 Directors have an overriding obligation to act in the best interests of the company. This further reinforces the fact that it is for them, and not for the owners, to be responsible for the operation of the company's business.
- 5.9 In practice, of course, a board of directors will normally have regard to the owner's concerns and seek to ensure that these are accommodated.
- 5.10 The likeliest situation in which this will arise, in respect of a LATE, is when a local authority owner wants it to undertake some activity which, in the judgement of directors, would be non-commercial. If this happens, then the proper way to deal with it is by discussion between the board and the local authority seeking to find a way in which the activity can be carried out but with the LATE receiving compensation for any non-commercial element. Directors should be expected to agree to this provided it did not require them to step outside their commercial role.
- 5.11 As an example, assume that a local authority wishes a service operated by a LATE to be provided to interests within the community on a subsidised basis. Perhaps the LATE is a property owning company and the local authority wishes certain of its assets (houses, offices) to be made available to community groups at a reduced rental. Options for achieving this, without infringing on the directors' commercial role, include:
 - The council rents the properties concerned at normal market rates and on-lets them, to community groups, at a reduced rental.
 - The properties are let, by the LATE, to community groups at normal market rentals but the council makes a grant towards the cost.
- 5.12 In applying such a policy, care should be taken to ensure that:

- The council does not interfere with the LATE's discretion on whether or not the property should be let to the party or parties concerned. The LATE may have its own perfectly good reasons for declining to make a particular property available or to make it available to a particular party.
- The council, and not the LATE, should make the decision as to which community groups should receive subsidised rentals. It is no part of the role of a board of directors to act as a welfare agency.

5.13 This discussion has focused on the role of directors and their legal obligations. Broadly the same principles apply to the governing bodies of other entities the Council may wish to use, such as Trusts or incorporated societies. In particular, whatever the nature of the entity, the governing body will have an overriding duty to act in the best interests of the entity.

Management

- 5.14 Within the LATE itself, there will be a division of responsibility between the board of directors and the management. Typically, the board will be responsible for setting policy and the management for implementing it. The board's role will concentrate on setting, for management, broad targets, agreeing the assumptions which should underpin the LATE's business plan and then approving it, setting performance targets with management, and monitoring performance on a regular basis. This will include taking any corrective action which the board regards as necessary.
- 5.15 Finally, a critical role for the board is that of hiring, and where necessary, replacing the chief executive.

Councillors

- 5.16 Councillors are the elected representatives of ratepayers and, as such, accountable to them for the good governance of the district. This is a significantly wider brief than the purely commercial one which directors of LATEs have.
- 5.17 Inevitably, councillors will be under pressure to keep their publics informed on what is happening with the council's activities, including its LATEs. They will often be the subject of pressure to require LATEs to act, or not act, in particular ways which interest groups within the district see as desirable.
- 5.18 Both councillors, and LATE directors, need to recognise that they have different responsibilities and these can sometimes be in conflict. Directors have both an interest, and a legal obligation, to protect commercial confidentiality. Councillors may feel a responsibility, to their publics, to provide them with

information. They may also wish to interfere in board decision making to secure outcomes they regard as desirable.

- 5.19 Whilst councillors and directors are separate individuals, these conflicts are normally capable of being managed without difficulty. The most significant risk is that, if individual councillors take a different view on confidentiality from that held by directors, then the board is likely to withhold information which council would normally receive, simply in order to protect the LATE's interests.
- 5.20 Where the conflict can become acute, is if a councillor is also a director of a LATE. In this situation, the councillor needs to be very aware of matters such as:
- The duty of a director to act in the best interests of the company. This requires him or her, for example, to keep confidential information confidential. Failure to observe this duty could result in the councillor being sued.
 - When acting as director, the councillor is required to consider the interests of the company and *not* the interests of the owner.
- 5.21 Experience with LATEs shows that councillors, acting as directors, may frequently find these conflicting obligations extremely difficult to manage, especially if the LATE is of substantial size or involved in significant service delivery to individual ratepayers.

6.0 Key Operational Issues

This section considers six key operational issues which are central to the effective establishment and operation of stand alone entities. They are:

- The definition of LATEs.
- Transition from the Council to a separate entity.
- Selection, appointment and accountability of directors.
- Statements of Corporate Intent: Making them the effective governance instrument.
- Information.
- Holding companies versus direct ownership.

6.1 *Definition*

- 6.1.1 The definition of LATEs set out in section 594B of the Local Government Act is a complex one. It begins by including any company in which a local authority or a combination of local authorities hold(s) equity securities that carry 50% or more of the voting rights at any general meeting of the company. It then exempts airport companies, port companies, energy companies, and the New Zealand Local Government Association Limited or any company or other organisation controlled by it.
- 6.1.2 It goes on to include any organisation through which a local authority or authorities operate a trading undertaking with the intention or purpose of making a profit or any other company or organisation (through which a trading undertaking is operated) which a local authority or local authorities directly or indirectly have control of by any means whatsoever.
- 6.1.3 The effect of this very wide definition is that there are a number of entities or arrangements, with which local authorities are involved, which may turn out, as a matter of law, to be LATEs. The consequences are twofold:
- A requirement to observe the procedural requirements of the legislation, including the preparation of a Statement of Corporate Intent.
 - More importantly the fact that **any income received by a local authority from a LATE is taxable**. This is not simply a matter of profits which a LATE may return to a local authority. It includes such things as rental, payment for administrative services or whatever.
- 6.1.4 Joint venture airports provide a current illustration of the difficulty with this definition. The Ministry of Transport has a legal opinion stating that joint venture airports are LATEs and must be dealt with accordingly. One local authority has obtained a legal opinion from a firm with very substantial experience of local government matters which concludes that joint venture airports are not LATEs.
- 6.1.5 The operational implication is straight forward. Any local authority involved in any arrangement (joint venture, partnership, union of interests or any of the other options mentioned in the legislation) should specifically consider whether or not the arrangement concerned

may be a LATE and, if in doubt, act as though it is, at least as far as the tax implications are concerned.

6.2 *Transition*

- 6.2.1 The LATE legislation is written to provide for a relatively quick and straight forward process of taking an existing Council activity and placing it in a stand alone entity.
- 6.2.2 Case studies of successful experience with the formation of LATEs suggest that a staged process is likeliest to result in a successful outcome.
- 6.2.3 Changing an activity which is currently embedded within a conventional Council structure, so that it is able to succeed as a stand alone commercial entity involves major work, both in terms of organisational structure and practice and with staff. As part of the Council structure, the activity is unlikely to have a commercial balance sheet, may not price its outputs on a commercial basis nor, at least in respect of inputs provided by other parts of Council, be charged on a commercial basis. Neither management nor staff may have commercial experience or an understanding of what it means to act commercially.
- 6.2.4 If this is the situation, then as a first step, the Council should consider establishing it as a business unit. This provides the opportunity to create an appropriate commercial balance sheet, put in place commercial pricing arrangements, develop arms length relationships with the Council (as a purchaser of outputs and a supplier of inputs) and, perhaps, bring in a commercial board (established as a sub-committee of the Council). It will also give staff time to become accustomed to a more commercial way of operating before the transition to LATE status takes place.
- 6.2.5 With some larger activities a further step may also be useful. This is the creation of a management LATE. One or two Councils, involved in the restructuring of large works and services activities, have done this. The effect is to place the management of the activity on a fully commercial basis whilst ownership of the assets and employment of the majority of the staff still remains with the Council. The advantage of this approach is that it allows management and a fully commercial board to demonstrate their capability before the Council takes the final step of transferring a major operational activity into LATE ownership.

6.3 *Selection, Appointment and Accountability of Directors*

- 6.3.1 An earlier section has emphasised the responsibilities of directors and the difficulties which can arise when one person is both a director and a member of the parent Council.
- 6.3.2 A review of legislation shows that Government's attitude towards the dual role has been hardening. The LATE legislation, itself, which was introduced in 1989 provides that at least two directors of a LATE must be persons who are neither members nor employees of any local authority. The Energy Companies Act, passed in 1992, provides that no more than two directors may be persons who are either members or employees of a local authority.
- 6.3.3 Both the Local Government Act and the Energy Companies Act stipulate that directors shall be persons who, in the opinion of those appointing them, will assist the company achieve its principal objective (which is to operate as a successful business).
- 6.3.4 The role of director is an onerous one. The Companies Act 1993 (and the equivalent amendment to the 1955 Companies Act) codifies directors' duties. These extend well beyond acting in the best interests of the company. Directors are responsible for managing the business in a manner which protects the interests of creditors and other claimants. Failure to measure up to the standard of conduct required can result in significant personal liability.
- 6.3.5 Many of the activities now in the hands of local authority trading enterprises, or likely to be corporatised in the next few years, are very substantial. They represent tens or even hundreds of millions of dollars of ratepayer investment. Commonly, high level commercial skills are required in order to be effective.
- 6.3.6 The legislation provides very little guidance, apart from the general principles cited above, to the approach which should be taken. It is now considered desirable that the process for selecting and appointing directors to publicly owned companies should be objective and as free as possible from political interference. This suggests a process which is operated relatively independently of the Council itself whilst recognising that the final decision must be that of the Council as owners. A possible approach is:
- The process of selecting directors should be managed by an advisor, independent of Council, with experience in selection of directors and senior executives.

- Selection should be against a job description and a person requirement developed by the independent advisor in conjunction with both the Council and the Chairman of the LATE (this latter point is particularly important; one of the Chairman's roles is ensuring that the LATE has a well balanced board with a suitable mix of skills). The Council should be explicit on whether or not it regards councillors as eligible for appointment. If it does, they should be required to go through the same selection process as non-councillor applicants.
 - The process of selecting a shortlist, from which to draw the successful appointees, should also be managed independently of the Council and result in a recommendation, to the Council, of individuals from whom it can appoint.
- 6.3.7 Accountability is both collective in the sense that it is the board, as a whole, which is charged with management of the company, and individual in the sense that each director's performance is ultimately what should determine his or her continuance in office.
- 6.3.8 Effective accountability requires both an answer to the question "accountable for what?" and a process for holding the director accountable.
- 6.3.9 As far as the board, as a whole, is concerned, performance against agreed performance indicators is the primary measure. Achievement of agreed targets is, *prima facie*, evidence of good performance. Failure to achieve (or in some cases over achievement) of agreed targets is *prima facie* evidence of poor performance which may require shareholder attention.
- 6.3.10 As a first step, it should be for the board to demonstrate, to the shareholder, that appropriate measures are being taken to deal with non-performers. Only if those prove inadequate should the shareholder itself take steps (although closer monitoring, and on a more regular basis, may be desirable as soon as non-performance comes to notice).
- 6.3.11 Continuing non-performance is a justification for shareholder intervention. The form of that intervention, up to and including dismissal of some or all of the board, will depend on the nature of the non-performance and the judgement which the shareholder (or its advisers) makes regarding the underlying causes.
- 6.3.12 Directors owe their responsibility to the Company. One of the primary roles of the Chairman should be to institute and manage an evaluation process which, on a regular basis, provides for review of each

individual director's performance by way of self assessment and review with the Chairman whose role, in this respect, would ultimately be to recommend to the owner that a particular director should not be reappointed, or in an extreme case, should have his or her appointment terminated early (assuming that the director concerned had not previously tendered a resignation).

- 6.3.13 Review of the Chairman's performance is partly a matter of self assessment and peer review within the board and partly a matter of the owner's review of performance against objectives. The primary trigger, for Council concern, should be failure on the part of the LATE to achieve agreed objectives and the absence of what the Council is prepared to regard as an acceptable explanation.

6.4 *Statement of Corporate Intent*

- 6.4.1 The Statement of Corporate Intent should be seen as the critical document defining the relationship between the local authority as owner and the board as managers of the business of the LATE.
- 6.4.2 Under the Local Government Act, the initiative for preparing the statement of corporate intent rests with directors. They are required to have regard to the views of shareholders but are not bound to adhere to them. In practice, of course, given that it is the shareholders who appoint directors, it is unlikely that the latter would ignore important requirements put forward by their owners, unless these were seen as conflicting with the directors' commercial responsibilities.
- 6.4.3 The Local Government Act does contain a provision which allows owners by resolution to require directors to include certain provisions in a statement of corporate intent. In practice, exercise of this formal provision would come very close to expressing a vote of no confidence in the directors.

Preparation of the Statement of Corporate Intent

- 6.4.4 Sections 594S and 594U of the Local Government Act require the directors of a LATE to:
- Deliver a draft Statement of Corporate Intent to the local authority within one month of commencement of the LATE's financial year.
 - Consider any comments within two months of the commencement of the financial year.

- Deliver the completed Statement of Corporate Intent to the local authority within three months of the commencement of the financial year.
- 6.4.5 In practice, especially when the LATE is of any size, the Statement of Corporate Intent will be preceded by the development of a business plan for the year concerned. In effect, strict reliance on the timetable in the Act has the effect of shutting local authorities out of the business planning process including the right, normally asserted by an owner, to be consulted on the key assumptions on which that plan is based.
- 6.4.6 A better approach is for the local authority and the board of the LATE to agree that they will confer from time to time on matters such as the assumptions on which the business plan will be based so that, when the SCI is delivered to the local authority it is on a “no surprises” basis. This is important both as a means of ensuring that the local authority itself does not feel disempowered and as a means of building confidence in the performance of the board.
- 6.4.7 It will be important for local authorities to recognise that, if this process is to work effectively, they will be receiving information which is subject to commercial confidentiality. Council staff, and elected members, who have access to this information should acknowledge this and take whatever measures are necessary to protect confidentiality.
- 6.4.8 Experience with LATEs, so far, has shown that where commercial confidentiality is breached, the response on the part of the LATE is to reduce the flow of information. In extreme cases, protection against this risk may lead to the need for special structures, between the Council and the LATE, in order to exclude people who are not prepared to respect confidentiality.

Contents of Statement of Corporate Intent

- 6.4.9 The statement of corporate intent ("SCI") is the key document regulating the relationship between directors and management of a LATE on the one hand and its public owners on the other. Technically, it is prepared by directors, discussed in draft form with shareholders, and then finalised by directors. In practice, the SCI should represent the agreed views of directors and owners regarding the future operation of the company. Preparing a draft SCI will require the Council to focus on those issues of greatest concern to the Directors, and demonstrate how they will be dealt with so as to leave the Directors free to operate the company subject only to reasonable commercial constraints.

- 6.4.10 Section 594T of the Local Government Act sets out the various matters for inclusion in the SCI. Each requirement is discussed, in turn, and recommendations made as to the provisions which Councils should be prepared to require/accept.

Coverage

- 6.4.11 Coverage is required to be of the LATE and any subsidiaries and in respect of the financial year in which it is delivered and each of the two following financial years. The focus, of the SCI, is therefore on capturing both the immediate activities and the LATE's medium term planning and performance. This is broadly similar to the requirements imposed on local authorities in the preparation of annual plans.

Objectives

- 6.4.12 Section 594T(a) requires the SCI to specify the objectives of the group. That may be interpreted as a mission statement; it could simply be a more commercially focused statement such as "to maximise shareholder wealth". In practice most LATEs will take a mission statement approach to this item.

Activities

- 6.4.13 The SCI is to specify the nature and scope of the activities to be undertaken. This is an extremely important provision. Its purpose is to fix limits on the business activities which the LATE can undertake. It is in this provision of the SCI that questions such as diversification should be addressed. If, for example, the LATE wanted to move into offering its services in different parts of the country or to undertake a major new activity, then this should be specified in this part of the SCI. It would make good sense to include a general requirement restraining a LATE from undertaking new activity without first taking proper steps to satisfy itself both that it had done everything it reasonably could to minimise risk and that the risk/reward relationship was acceptable.
- 6.4.14 From a Council's perspective, this provision should be written in terms of identifying each separate major activity within the LATE's business, in somewhat the same way as the Council itself identifies each significant activity for annual planning purposes. This will allow the Council, as owner, to consider the appropriateness of involvement in the activity or activities concerned (recognising that, ultimately, it is the ratepayers' money which is financing the business) and as a means of informing the Council of the board's plans, in respect of new activities, for the period covered by the SCI. It is also an important first step in

risk management and in determining an appropriate rate or rates of return.

Gearing

6.4.15 The SCI is to specify the ratio of consolidated shareholders' funds to total assets, and definitions of those terms. This would be a relatively simple requirement to satisfy, if it was focusing simply on one point in time. The requirement to specify this ratio, for each of three financial years, means that the LATE and the Council will have to have a clear idea of how the components of this ratio will vary over time. The main factors which will influence it are:

- The anticipated profit level.
- The dividend policy.
- Changes in assets over time as a consequence of further investment, sale of assets, depreciation, and how those changes are financed or impact on the LATE's balance sheet.
- The mix of debt and equity seen as appropriate for each of the LATE's activities and for its business overall. This will be a function, amongst other things, of the degree of risk in the business including the predicability of cash flows. The Council should be satisfied that target debt:equity ratios are set with the assistance of expert financial advice.

6.4.16 Effectively, it will only be possible to specify that ratio once decisions have been made on the expected rate of return, the LATE's investment programme, and its financing strategy; what external funds it will need to raise and whether these will be provided by debt and/or equity and in what proportions.

6.4.17 This latter point is particularly important if there is any prospect at all that the Directors may have plans for business expansion/diversification.

Accounting Policies

6.4.18 LATEs should adopt the statements of standard accounting practice prescribed by the New Zealand Society of Accountants with any variations which may be agreed between the LATE and the Audit Office as its auditor. Compliance with the financial management provisions contained in the Local Government Law Reform Bill 1995 will be the main factor in determining suitable accounting policies.

Performance Targets

- 6.4.19 The SCI is to set out "the performance targets and other measures by which the performance of the group may be judged in relation to its objectives".
- 6.4.20 There has been some debate over the extent to which LATEs should seek to earn a normal rate of profit on their activities. The equivalent provision, in the Energy Companies Act 1992, requires the SCI to set out "the performance targets and other measures (*including the rate of return on shareholders' funds after payment of tax*) by which the performance of the Group may be judged in relation to its objectives". One implication of this difference is that the Government wanted to make quite clear, in respect of energy companies, what was thought to be in doubt in respect of LATE's, namely, that they should include profit as an objective.
- 6.4.21 There are other indicators which strongly suggest that LATEs are intended to pursue profits in the same way as businesses which are privately owned. These include:
- The statement, in section 36K, of one of the purposes of local government as being "for the operation of trading activities of local authorities on a competitively neutral basis". A trading activity is not operating on a competitively neutral basis unless it is taking the same approach to profits as do other businesses.
 - The requirement for the long term financial strategy, provided for in the forthcoming financial management provisions, that the strategy shall cover "the estimated expenses, *including an allowance for the cost of capital...*"
- 6.4.22 There is also some concern, within local government, as to what normal profits might be. There is in fact a very well established approach to assessing this, the use of what is known as the capital asset pricing model. That is a widely accepted and relatively objective way of assessing the rate of profit which a company should target.
- 6.4.23 This section of the SCI should also include a number of other performance targets focused on improving efficiency within the business. Depending on the nature of the business, this might include such things as customer response time, time taken to deal with complaints, annual productivity improvement, targets for training/qualification of employees, improvements in customer satisfaction ratings and such other measures as the directors consider will provide a good overview of performance both on a snapshot basis and over time. Chosen indicators should all

have a commercial rationale and Council should avoid seeking to impose ones which do not.

Dividend Policy

6.4.24 The SCI is to include "an estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the shareholders".

6.4.25 The dividend policy should reflect the particular circumstances of the LATE. Directors, in recommending a policy (and it is their prerogative to do this) should be able to take account of factors such as:

- The desirability of building up shareholders' funds, within the LATE, to support present and future borrowing. Bankers, if the LATE needs to borrow, will want to see that directors are taking a conservative approach in this respect.
- To the extent that directors believe that the Council may be reluctant either, itself, to subscribe for further capital when needed, or to admit third parties into ownership on terms which would attract such parties, they may take the view that they should retain the bulk of earnings as the only prudent course if they are to maintain a reasonable equity base and have the ability to expand the business. It will obviously assist directors adopt a generous dividend policy if they know and can have confidence in the parent Council's intentions.
- The fact that New Zealand's present low inflation environment means that the returns on cash will be relatively small; as a general principle, it makes good sense to avoid accumulating significant amounts of cash when they can, instead, be paid out to shareholders. In general, directors should seek to retain cash only if they do anticipate requiring it within the near term future.

6.4.26 For companies registered or re-registered under the Companies Act 1993, the scope for distributions is much wider than for companies still registered under the Companies Act 1955. At the same time, the responsibility of directors, in determining what to distribute, are more onerous. They are required to certify that, immediately after the distribution, the company will satisfy the "solvency test". Briefly this means certifying that the company will be able to pay its debts as they become due in the normal course of business and that the value of the assets will be greater than the value of its liabilities, including contingent liabilities.

6.4.27 As a matter of principle, directors should generally set, and owners accept, a dividend policy structured on the principle that monies will be retained by the company only if:

- the funds are reasonably required for the purposes of the company's business; and
- funding through retention, to the extent proposed by the directors, is consistent with minimising the company's overall cost of capital (commonly referred to as the weighted average cost of capital, the combination of cost of debt and cost of equity).

Half Yearly Report

6.4.28 The SCI is to specify the type of information to be given shareholders between annual reports including the content of half yearly reports. On this matter, normal accounting practice should be seen as acceptable subject to any input from the Audit Office and any specific requirements the Council itself may need to satisfy under its own reporting obligations.

Acquisition

6.4.29 The SCI is to state "The procedures to be followed before any member of the group subscribes for, purchases, or otherwise acquires shares in any company or other organisation". The SCI should range wider than the statutory provision just quoted. It should encompass situations such as:

- Acquisition, by the LATE, of another business, whether it is by acquiring shares or acquiring the business itself.
- Mergers which might involve the acquisition of the LATE itself, or part or all of its business, by another party.

6.4.30 The Directors should have freedom to undertake such transactions, up to a threshold limit but beyond that require shareholder approval. The threshold limit may be different if the means of acquisition is payment in cash or by issuing debt securities or if it involves issuing shares to an outside party. The latter situation, no matter how small the issue, would need to involve the Council, if only because it would be required, as shareholder, to authorise the issue of new shares.

6.4.31 The SCI should include, at least in broad terms, the criteria which the directors will apply in assessing any acquisition including how they would decide whether the expected returns from the acquisition were adequate.

6.4.32 The SCI should also outline the criteria which the Council would apply in respect of any proposal which involved acquisition of the LATE by third parties.

6.4.33 Councils should recognise that any merger or acquisition could involve dealing with shares in one or more of the following ways:

- The issue of new shares, by a LATE, to the vendor(s) of a business it is acquiring.
- The issue of new shares, by a LATE, to third parties, for cash, to raise part or all of the funds for an acquisition.
- The exchange of shares, in a LATE, held by the Council, for shares in another company, as the means of effecting a merger with or a takeover of the LATE.
- The sale of shares, for cash, as the consequence of a merger or takeover of the LATE.

6.4.34 Some, but not all, of these different options will involve the Council in undertaking the special consultative procedure under Section 616A of the Local Government Act. This obligation arises whenever a local authority (or a group of local authorities) holds 50% or more of the voting securities in a LATE and the local authority proposes either to dispose of voting securities, or take some other action (for example, consenting to an issue of new shares to a third party) which would reduce its shareholding, or the combined shareholding if more than one local authority is involved, beneath 50% of the total voting securities on issue.

Company/Council Transactions

6.4.35 The SCI is to specify details of all transactions intended to be entered into between the LATE and the Council. One purpose of this is to highlight transactions, in respect of services the LATE provides, which may be negotiated on other than commercial terms simply because the Council is the owner. Purchase transactions would need to be specified; it would be desirable to include an overriding provision in the SCI that transactions between the LATE and the Council were to be on arms length commercial terms.

Commercial Value

- 6.4.36 The SCI is to include “the directorate’s estimate of the commercial value of the shareholders’ investment in the Group and the manner in which, and the times at which, the value is to be reassessed”.
- 6.4.37 Often, this requirement is addressed simply by including the book value of the business. This is *not* a satisfactory way of complying with the requirement. Instead, what is required is a proper assessment of the value in market terms. This part of the SCI should identify the methodology to be applied including a brief statement justifying the selection of the chosen methodology. The purpose of this is to give the Council, as owners, a clear understanding of the actual value of their business both at the moment of reporting and over time as one means of assessing the effectiveness of the board’s stewardship of the assets under their management.

Other Matters

- 6.4.38 The SCI is to specify "such other matters as are agreed by the shareholders and the directorate".
- 6.4.39 There are two "other matters" which every SCI should cover, the Directors' discretion to undertake further investments and their policy on risk management. For investment the SCI should include:
- An outline investment budget by broad area of activity and magnitude.
 - An indication of the expected source or sources of funds (retention, issue of further equity, debt).
 - Specific delegations, up to agreed threshold levels, to the Directors to commit further investment, within the budget, and to raise funds. Procedures beyond that may simply include notifying shareholders on the basis that Directors could proceed within a specified period of time unless shareholders objected. They might require positive shareholder agreement. This is likely to be the case, particularly with large scale investments or the issue of shares.
- 6.4.40 Depending on the size of the LATE’s business it may be desirable for these arrangements to be underpinned by a comprehensive financing strategy. Bankability is a critical issue in accessing finance on acceptable terms and is judged, primarily, on free cash flow. This is a function, amongst other things, of expected profit levels and dividend policy. It emphasises, incidentally, the very important relationship between earning

normal profits and bankability if the LATE is to undertake any substantial investment.

- 6.4.41 The SCI should also set out the arrangements which the Council wishes to have in place for achieving any non-commercial objectives. Essentially, the achievement of these objectives should be seen, by the Council, as the purchase from its LATE of services on commercial terms. The housing example above is an illustration of this point.
- 6.4.42 There is one further matter which it may be useful to include in the SCI; this is a provision to the effect that the directors will endeavour, where possible, to ensure that the Council is adequately briefed on any measures intended or announcements proposed by the LATE which could have political implications for the local authority (an obvious example would be a price increase in an area of sensitivity such as housing). The purpose of such a provision is not to imply that the Council has any veto over the decision but simply to ensure that it has adequate time to be briefed so as to be able to answer the inevitable questions from citizens or the media.
- 6.4.43 This part of the SCI should also specify any other arrangements which may exist regulating the flow of information.

Conclusion

- 6.4.44 The major emphasis, throughout the preparation of the SCI, is the focus on giving the Directors discretion to manage the business on commercial terms whilst providing for accountability, back to the shareholders, on key ownership issues. The SCI can be used as a vehicle for dealing with non-commercial activities but, where this involves a cost to the LATE, this should be handled on a specific contractual basis with the LATE fully recompensed.

6.5 *Information/Accountability*

- 6.5.1 The Statement of Corporate Intent, if drawn in accordance with principles set out in this report, will make explicit provision for the information requirements which the local authority, as owner, will have both for its own purposes and so that it can meet its obligations, through its annual plan and annual report, to its ratepayers, at least as far as the local authority's statutory obligations are concerned.
- 6.5.2 As owner, the local authority may well wish to have information going beyond the specific requirements of the Statement of Corporate Intent. Some of this may come into the category of "we could tell you that we want to know it if we knew what it was that we wanted to know but until

you tell us what it is we won't know that we want to know it". This is a common problem when significant assets or interests are being administered by one group of people at arms length from another who may have a strong ownership interest in it.

- 6.5.3 This is now recognised, explicitly, by the 1993 Companies Act (and a parallel amendment to the 1955 Companies Act). Under the legislation a director of a company "who has information in his or capacity as a director... being information that would not otherwise be available to him or her, must not disclose that information to any person, or make use of or act on the information, except a director of a company may, unless prohibited by the board, disclose information to a person whose interests the director represents".
- 6.5.4 The effect of this provision is that a director of a LATE may disclose any information he or she receives, in that capacity, unless the board has prohibited the director from doing so.
- 6.5.5 This is a situation which requires careful handling. Because the local authority appoints all of the directors, it may believe that it could obtain an assurance, from each of them, almost as a condition of appointment, that he or she would not oppose release of information to the local authority.
- 6.5.6 Such a requirement would be inappropriate. Directors have a primary obligation to act in the best interests of the company. There may well be situations in which, quite properly, directors would see this as requiring a prohibition on the release of certain information to a local authority shareholder.
- 6.5.7 What is required is an information disclosure policy, determined by the board but discussed with the local authority. Possibilities include:
 - A prohibition on the release of information, other than as provided in the SCI and through formal procedures laid down by the board, unless in any particular case the board agrees the information may be released.
 - A general policy that information may be released to the local authority unless, in any particular case, the board deems that it is too commercially sensitive to go beyond the board. In this latter case, it would be sensible to spell out how the information would be released. As a matter of courtesy and good practice, the board might require that any release be in writing and a copy made available to the Chairman.

6.6 *Holding Companies*

- 6.6.1 Some local authorities have introduced a holding company between the local authority as owner, and their trading LATE or LATEs. Typically, where this has been done, a primary motivation has been to create structures which are more efficient for borrowing and for tax purposes.
- 6.6.2 There are other reasons which could justify the use of a holding company structure, even if there were not benefits in terms of better access to capital markets or reduced taxation costs.
- 6.6.3 These arise from the changing nature of local authority activity. Ten years ago, most local authority activity was thought of and run as a series of services to the ratepayer funded by the general rate. Today, there is an increasing emphasis on local authorities as businesses producing goods or services which, in terms of their underlying principles, are little different from the goods and services produced by the private sector.⁷
- 6.6.4 As earlier discussion has shown, even core services, such as water and sewage, can be broken down into a number of different activities which are substantially commercial in character or which have direct commercial equivalents.
- 6.6.5 This is requiring a different set of skills from those which were needed ten years ago. Local authorities are now, quite explicitly, engaged in managing major businesses which face substantial commercial and other risks (property development or, for that matter, property ownership is an obvious example).
- 6.6.6 It is unlikely that a local authority will be able to employ, on its own staff and junior to the chief executive, the type of high level commercial skills which would be available to a private sector organisation of equivalent size. Nor is it desirable that these sorts of skills be contracted in, from time to time, from consultants or other temporary sources of expertise. The local authority's need is for an ongoing source of expertise within its own organisation.
- 6.6.7 There may, indeed, be a statutory obligation on the chief executive to ensure that some appropriate arrangement, to achieve this, is in place. Section 119D of the Local Government Act makes the chief executive "responsible to the local authority for ensuring the effective, efficient, and economic management of the activities and planning of the local authority".

⁷ The concern here is with the dynamics of the activities themselves, rather than purposes for which they are undertaken which, in the case of local authority activities, would often be for public good reasons which do not apply to private sector equivalents.

6.6.8 The use of a holding company is one means of providing this expertise. The brief of the holding company's board, as expressed in its SCI, can include an overview of the Council's activities, identifying and reporting to the chief executive on the commercial issues raised by those activities and options for dealing with them.

6.6.9 As well as this, the holding company can act as a very effective intermediary between the parent council and LATEs which undertake trading activities. An experienced commercial board can be very well placed to deal with matters such as:

- Selection, appointment and accountability of directors of trading companies.
- Monitoring performance of trading companies.
- Advising the Council on major policy issues, in respect of trading companies, which require an owner decision.

7.0 Conclusion

7.1 Insert words to wrap up the guide. The exact form should be settled following discussion with the Department of Internal Affairs.