Crown Entities:

Categories and Principles

A report for the State Services Commission

1.0 INTRODUCTION

1.1 This report has been prepared by McKinlay Douglas Limited ("MDL") for the State Services Commission ("the SSC") as part of its Whole of Government Perspective Series.

1.2 The brief for the report was in two parts:

- Identification of categories and types of Crown entities and identification of and placement within categories of all Crown entities established to date. This should include information on the Crown entities whose design conforms with the type/categories and those that include aspects of design that are different in some way.

- The principles for establishing a Crown entity. In other words what is the thinking that underpinned decisions on whether an agency would be a Crown entity, department or indeed some other body. To what extent is there consistency in the applications of these principles to the design of Crown entities.

1.3 As work on this paper proceeded, MDL arrived at the view that, if anything was to be categorised, it should be the interests of the Crown rather than Crown entities as such. The early part of this paper compares the implications, for the Crown, of categorising entities as opposed to categorising Crown interests and draws out the arguments in favour the latter approach. This includes a discussion of what are seen to be key interests of the Crown including:

- Ownership as a residual claimant interest
- Ownership as a means of pursuing other policy goals (for example retaining critical mass in certain activities)
- Purchase interest.

1.4 As a consequence of this approach, the paper does not include a categorisation of Crown entities by type. Instead, it develops a set of working principles to guide the choice of whether to use a departmental form or a Crown entity and concludes that the structuring of Crown entities should be carried out on a case by case basis. The principal reason for this is the need for specificity, in each instance, to ensure protection of the interests of the Crown.

2.0 BACKGROUND

2.1 The Nature of the Term

2.1.1 The term "Crown entity" is a structural rather than a process one. Its use, as a description, implies a set of entities possessed of common characteristics. This is inherent, also, in the first project component with its emphasis on "identification of categories and types of Crown entities".

2.1.2 In reality, the term has a process, not a structural, import. It is simply a shorthand reference to a series of crown influenced or controlled entities, outside the core Crown, which are subject to a specific accountability regime.

2.2 Public Finance Act Requirements

2.2.1 The immediate history of the term begins with the Public Finance Act 1989, the long title of which included "establish financial management incentives to encourage effective and efficient use of financial resources in departments and Crown agencies; and specify the minimum financial reporting obligations of the Crown, departments, and Crown agencies". The term "Crown agency" was defined as:

> Means any entity over which the Crown is able to exercise control as a result of -
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> (a) Its ownership of a majority of the shares of the entity; or
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> (b) Its power to appoint a majority of the members of the governing board of the entity; or
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> (c) significant financial interdependence, -
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> but does not include a department, an office of Parliament, or a State Enterprise listed in the first schedule to the State Owned Enterprises Act 1986.

2.2.2 The Act itself provided a statutory framework for the preparation, audit, and tabling of the financial statements of Crown agencies. They were not otherwise specifically subject to Public Finance Act requirements.

2.2.3 The definition was extremely all embracing. It both imposed very onerous reporting requirements, on a number of entities which were not yet well equipped to meet them (such as school boards of trustees) and brought into the reporting net a number which, on reflection, should have been omitted. As an example, the various community trusts established by the Trustee Banks Restructuring Act to own the equity in trust banks would have come within the definition of "Crown agency"; under their trust deeds, the power to appoint trustees is vested in the Minister of Finance.

2.2.4 The 1992 amendment to the Public Finance Act renamed "Crown agencies" "Crown entities" and substantially changed both the scope of the definition and the way in which it was applied. Under the 1989 Act, whether or not a body was a Crown agency was solely a matter of definition. From 1992, the approach shifted from one of definition to one of listing. Crown entities were either bodies which were listed in the fourth schedule to the Public Finance Act, or bodies which were, themselves, subject to defined levels of control by another Crown entities or entities.[1]

2.2.5 The 1992 definition was:

"Crown entity" -

(a) Means a body or statutory officer named or described in the Fourth Schedule to this Act; and

(b) Where a body named or described in the Fourth Schedule to this Act is a company, includes any subsidiary of that body; and

(c) Where a body or statutory officer or trust named or described in the Fourth Schedule to this Act is a member of a company that would, if that body or statutory officer or trust were a company, be a subsidiary of that body or statutory officer or trust, includes that company and every subsidiary of that company.

2.2.6 The 1994 Public Finance Amendment repealed the 1992 definition and replaced it with a new definition which was actually the 1992 definition plus a further sub-paragraph:

and

(d) means -

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[1] *As a matter of practice, the same principles of Crown control were applied when considering whether to list an entity so that the underlying principles were not really changed. What had changed was the automatic inclusion of any entity which came within the broad scope of the previous definition.*

(i) any company where other Crown entities directly or indirectly own, or control the exercise of, more than 50% of the voting rights attached to the equity share capital (as defined in Section 158 of the Companies Act 1955) of the company; or

(ii) any company where other Crown entities are in a position to exercise, or control the exercise of, more than one-half the maximum number of votes that can be exercised at a meeting of the company; or

(iii) any company where other Crown entities hold more than one-half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital.

2.2.7 Essentially, this amendment was intended to deal with situations such as that in the health sector where the four regional health authorities are the joint owners of companies such Pharmacy Management Ltd and Health Benefits Ltd through which some hundreds of millions of dollars of public money is spent annually.

2.2.8 The 1992 Public Finance Amendment Act also made substantial changes to the accountability regime for Crown entities. It replaced the provisions in the Public Finance Act 1989, which dealt solely with financial reporting, with a more comprehensive regime which included:

* extended provisions for financial reporting, with sector specific regimes for some classes of entity (such as school boards of trustees);

* a requirement for a statement of intent (the equivalent, for non-company forms, of the statement of corporate intent required from Crown owned companies);

* explicit provision for the Minister of Finance to appropriate the surpluses of Crown entities.

2.2.9 In each case, application of a particular regime (financial reporting; SOI; appropriation of surplus) was dependent on the entity being listed in the appropriate schedule to the Public Finance Act.

2.3 Principles of Public Sector Reform

2.3.1 New Zealand governments have always pursued some of their objectives through non-departmental forms. Until comparatively recently, their establishment tended to be ad hoc; specific solutions for specific problems rather than the result of a careful consideration of the best structural means for achieving desired outcomes.

2.3.2 This changed with the public sector reforms of the 1980s. The principles guiding reform were agreed by Cabinet in October 1988 (SSC 1991a p1, 2) as:

> the aim was to arrange the machinery of government so as to ensure that:
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> * departments had clear and consistent objectives;
> * a high standard of accountability was achieved;
> * trade offs between objectives are explicit and transparent;
> * bureaucratic or producer capture was minimised;
> * the provision of advice and the delivery of services is contestable;
> * functions which complement each other are placed together in one agency while functions with conflicting or potentially conflicting objectives are separated;
> * the duplication of functions is minimised;
> * resources are used economically and efficiently.

2.3.3 At a practical level, the application of these principles had a number of consequences including:

* The separation of activities whose co-location was seen as giving rise to problems such as conflicting objectives, conflicts of interest, bureaucratic capture or blurred accountability. The best known example was the restructuring of the Ministry of Transport to give rise to a small policy ministry and a series of stand alone entities as well as the transfer of certain functions to other departments (traffic officers to police) or to the private sector (aircraft inspection).

* A conscious selection of structures which would best meet Government objectives. Much of this was driven by a concern that the conventional departmental form, because of its inherently non-market orientation, was, in many respects, least suited for this purpose. One expression of this was:

> "The inherent inability to develop a completely satisfactory accountability regime within the departmental form that would exert discipline on management performance implies that as much activity as is possible should be transferred to alternative organisational forms that could better provide such discipline, even if such forms have some flaws of their own". (SSC 1991b p4)

2.4 The Three Tier State

2.4.1 The State Services Commission developed a conceptual framework for categorising government activity depending on the closeness of that activity to market disciplines as one tool to use when dealing with public sector reform issues. The three tiers were described, in a series of 1991 reports, as:

* The first tier consists of the core agencies that are directly responsible to Ministers, carrying out policy advice, administration and regulatory functions. These agencies would be set up in departmental form.

* The second tier are those agencies that are owned by the Crown which provide goods and services purchased by (or on behalf of) the core agencies. This tier consists of organisations, legally separate from departments, and established under their own legislation.

* The third tier are those organisations from the private sector from which the State purchases goods and services.

(SSC 1991c p1)

2.4.2 There was an underlying assumption that, generally, activity should be undertaken as close as possible to the market because of the perceived benefits, for efficiency, which flow from subjecting activity to market disciplines. In terms of this analysis, Crown entities belong in the second tier; agencies owned by the Crown and providing goods or services purchased by or on behalf of its core agencies but legally separate and established under their own legislation.

2.4.3 The transfer of government science activities to a series of Crown research institutes, the selection of a variety of stand alone agencies, each with their own legal identity and board, to undertake many of the functions of the former Ministry of Transport, and the establishment of school boards of trustees as separate legal entities all reflect this three tier analysis.

2.4.4 Other factors were also relevant in the establishment of separate entities and the design of their structure. Thus, the SSC was concerned at the shortage of management skills within New Zealand. The use of boards was seen as one means of addressing this:

> "Another issue is whether these agencies are responsible directly to ministers or to a board. The use of a board mechanism reinforces the responsibility of the agency for its own management within the funding constraints imposed by Government. In its turn the board can be responsible to the Minister (in the case of large or otherwise significant organisations) or to the parent or contracting department in others. The wider use of boards is an approach that could make better use of New Zealand's scarce managerial resources". (SSC 1991b p5)

2.4.5 However, there were also seen to be costs in the establishment of separate entities. In a December 1991 paper, the Commission noted:

> "A second issue is that change should not be promoted purely for the sake of enshrining a conceptual framework. There are often high transitional costs associated with forming second tier agencies (the CRIs being a case in point). The cost effectiveness of structural change should be rigorously examined before any major change is embarked upon". (SSC 1991c p3)

2.4.6 The need for specific legislative authority, on a case by case basis, was also an issue, and one which could retard the process of change because of constraints imposed by the legislative programme (something which, if it seemed to be a problem in 1991, is much more likely to be so with the advent of MMP). In this respect the Commission's comment was:

> "There are also legislative issues to be considered before implementing a wide ranging programme of structural change. Currently most second tier organisations are established by their own legislation. This means that a programme of reform soon becomes constrained by the extent of the legislative programme. It may be more effective to consider umbrella legislation entailing the addition of new second tier* agencies

> to a schedule within one or a limited number of acts . (SSC loc cit)
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> * All Crown entities are, in terms of the Commission's analysis, second tier agencies.

2.4.7 The potential benefits, and risks, associated with the use of Crown entities, rather than departments, were described by the Commission, in a March 1991 paper, in the following terms:

* Second tier agencies can be established with clearer goals and objectives than departments.

* The use of board-type arrangements brings a greater level of management skills to bear than are available in the public sector.

* Agencies with clearly defined tasks are potentially subject to more contestability which is probably the key factor driving productivity changes. (SSC 1991b p5)

2.4.8 Perceived risks included:

* The accountability mechanisms for second tier agencies that perform non-commercial activities are currently no stronger than those in the departmental form. Success is therefore dependent upon adequate output specification and pricing which still requires substantial work (the 1992 and 1994 amendments to the Public Finance Act were part of this).

* In the social policy areas the boards can be captured by producer interests with consequent fiscal risks.

* The paucity of management capability and shortages of other skills makes it difficult to successfully manage the multiplicity of agencies. (SSC loc cit)

2.4.9 The Commission went on to conclude:

> However, all these risks are also present in one way or another within the departmental form. The present legislative framework has not yet resolved them, but has more clearly exposed them. On balance the argument for change rests on the following two factors:
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> – There are equal risks of high costs associated with not changing. The highest cost is the likelihood that little or no productivity growth will occur within current structures.

Strengthening the accountability mechanisms is a key issue here; and

- The benefits are closely associated with greater contestability and having agencies that have clearer goals and objectives. (SSC loc cit)

3.0 METHODOLOGY

3.1 The development of this paper has included:

- A series of meetings with officials from central agencies, purchase agencies, monitoring bodies, and selected Crown entities.
- Analysis of a selection of statements of (corporate) intent to determine how matters such as separation of the Crown's purchase and ownership interests, risk management and incentive issues are dealt with in practice.
- Review of background papers and legislation.
- Dialogue, with the State Services Commission, during the course of the project on key policy issues raised by it.

3.2 Resource constraints limited the extent of coverage, particularly of Crown entities, but also of other government agencies and key stakeholders. As an example, it has not been possible to undertake detailed reviews of each Crown entity or set of Crown entities. The conclusions and recommendations in this report should be read with this limitation in mind. We are satisfied, nonetheless, that the major issues identified in this report have substance and merit further consideration.

4.0 CATEGORISING CROWN ENTITIES

4.1 Current Status

4.1.1 From a machinery of Government perspective, the three tier State framework developed by the SCC in 1991, and the revised accountability framework contained in the 1992 and 1994 amendments to the Public Finance Act, represent the current state of thinking about Crown entities as a class. Work has continued, at a more micro level, with specific categories, such as the work being undertaken by the Crown Company Monitoring Advisory Unit ("CCMAU") on Crown Health Enterprises ("CHEs") and Crown Research Institutes (CRIs"), work which is focused on the detail of their reporting requirements within the existing Public Finance Act framework.

4.1.2 There has been less emphasis on the question of Crown entities as such; what are they, how should they be constituted, and when do they represent the appropriate option. That this should be the case can be seen as reflecting the reality that the term "Crown entities" covers a very large and disparate grouping, making the task of classification far from straight forward.

4.2 The Dominant Interest Approach

4.2.1 The nature of the work so far, both in terms of the principles of public sector reform, and the accountability framework for Crown entities, has made the focus on structure seem a natural one. The apparently logical questions are ones such as:

* What are the defining characteristics of this set of organisations?

* Are there distinct sub-sets which should be recognised as such?

4.2.2 This approach underlies one recent piece of work on categorising Crown entities.

4.2.3 The approach taken was to codify Crown entities according to the nature of the Crown's overriding interest.

4.2.4 Four Crown interests are identified:

* Ownership: optimising the value of the Crown's investment in the entity.

* Purchase: enabling the Crown to purchase goods and services in the most cost effective and efficient manner to achieve its desired objectives. There is an inherent implication that purchasing will take place, substantially, in a non-market environment.

* Regulatory: the exercise of regulatory and quasi-judicial power in an independent and objective manner.

* Transfer interest: the desire to see transfer distributions determined in a way which gives rise to particular confidence in the processes deciding distribution; in particular, freedom from the appearance of political interference.

4.3 The Interests Considered

4.3.1 Arguably, the last two interests could be collapsed into a single interest; the Crown's policy interest. The Crown itself is neither a significant purchaser, nor has any substantial ownership interest in these entities. Instead, its interest is one of due process and the integrity of outcomes.

4.3.2 There may, also, be a different and more useful way of thinking about the Crown's ownership interest. The analysis under discussion is looking at the ownership interest at the moment of creation of the Crown entity. The interest is seen in residual claimant terms and the structure selected to optimise the value of the assets being transferred to the entity. By definition, this approach captures only those entities which are receiving significant assets from the Crown and which the Crown expects to operate along normal business lines. As is discussed below, placing an activity in an independent legal entity may, of itself, see the management of a previously non-trading function looking for business opportunities. As seems to be the case, for example, with a number of entities in the education sector, the potential business developments may be quite major.

4.3.3 For categorisation purposes, it may be more useful to divide Crown entities into two broad groupings; entities which, quite specifically, do not and are not intended to undertake trading activity and entities which, whether or not they currently undertake trading activities, may well do so. Such a separation would recognise that the Crown's ownership interest is more than just a matter of optimising owner

wealth in entities which have major assets at the point of establishment; it is also a matter of ensuring that the Crown's interests, as owner, are adequately protected in entities which may develop substantial trading activities and that those entities, themselves, are subject to the discipline of an informed owner setting an agreed framework within which trading activities can develop.

4.3.4 Arguably, the presumption which should apply to all Crown entities is that, to the extent they can do so without compromising the Crown's interests (whether as owner or as purchaser), they should have the opportunity to pursue trading opportunities. This is consistent with the objective of ensuring efficient use of Crown owned resources and it would also provide greater scope for attracting, retaining and rewarding competent management. The presumption should be rebuttable where the interests which the Crown wishes to pursue through the entity concerned are seen as inconsistent with trading activity. Thus, the Crown may take the view that regulatory bodies should be prohibited from undertaking trading activity but have no objection to specialist policy advisory bodies doing so.[2] Where it was considered that entities should have the power to undertake trading activity, if their managements considered this desirable, then their legal powers should be consistent with this, for example, powers to borrow, hold equity in other organisations, undertake joint ventures and so on. Likewise, the statements of intent or corporate intent should specify accountability requirements including matters such as risk management policies, procedures to be gone through before undertaking major investments etc and scope of intended activities.

4.3.5 Where the Crown considered that trading activity was inconsistent with its interests in the entity, its legal form should be restricted accordingly and its statement of intent include prohibitions on trading activity.

4.4 The Analysis Continued

4.4.1 Starting from the four interests it identifies, the analysis then identifies the following Crown entity types:

- Purchase entities through which the Crown exercises its purchase interest. These fall into the following sub-classes;
  - devolved purchasers, through which subsidiaries of the Crown purchase from other suppliers, including other wholly owned subsidiaries of the Crown (examples include

[2] *In practice, we expect that these judgements would be made on a case by case basis albeit against general principles (presumptions).*

the four Regional Health Authorities and the Foundation for Research Science and Technology);

- de-centralised suppliers through which the Crown de-centralises some aspects of decision making (examples include school boards of trustees and the Museum of New Zealand);

- advisory entities from which the Crown purchases advice separate from the legal Crown apparatus (examples include the Law Commission and the Public Health Commission).

* Regulatory entities: examples would include the Commerce Commission, the Securities Commission, the Human Rights Commission and the Privacy Commissioner.

* Ownership entities: examples would include the CRIs and the CHEs.

* Transfer entities; the principal one identified is the Lottery Grants Board.

4.4.2 Conceptually, this approach is attractive. Crown entities (current or potential) are categorised by a dominant interest. This in turn determines the organisation form which is designed around optimising the dominant interest. As an example, if ownership is the dominant interest, then the limited liability company is the logical form.

4.4.3 The impact of competing Crown interests on a single Crown entity is dealt with through treating the dominant interest as endogenous and other Crown interests as exogenous. As examples:

* CRIs and CHEs are structured to meet the needs of the Crown's ownership interest; it is internal to the governance of the organisation. In contrast, the Crown's purchase interest is handled on an "arms length" basis through contracts with purchase entities or other parties.

* The Crown's interest in school boards of trustees as decentralised suppliers is internalised in their constitutional structure; its specific interest in the outputs/outcomes arising from their activity is managed through quasi-contractual arrangements (the Charter) and through external review by the Education Review office.

4.4.4 In MDL's view this approach carries with it a serious risk of confusing function and structure with significant risk to the interests of the

Crown. The basic assumption is that, by careful analysis of functions, in accordance with agreed principles of public sector reform, it would be possible to identify discrete functions such that there are clear objectives, an absence of major conflicts of interest (such as the classic one between purchasers and providers) and a proper basis for accountability. The function is then categorised in terms of the interests of the Crown and assigned to the appropriate organisational structure. Typically, this will see different functions, bundled in one activity, each allocated to a different structure (eg, policy to the Ministry of Health, purchasing to RHAs, provision to CHEs or other competing providers, ownership monitoring to CCMAU and so on).

4.4.5 Following this process, there should be a close identity between the interest of the Crown in that specific function and the structure in which it is placed. If the identified Crown interest is ownership, the function is optimising the value of that interest and the structure is a conventional limited liability company. For policy purposes the focus is then on the structure; establishing a proper operating and accountability framework for the ownership structure should, on this line of reasoning, be sufficient to ensure the efficient discharge of the function concerned, that of managing the Crown's investment, and thus optimise the Crown's ownership interest.

4.4.6 In turn, the best means of developing the second tier state should be that of creating a series of organisational types, each designed to fit the specific interest (function) to be allocated to it. Development of a set of standard designs should then facilitate enabling legislation so that, when the establishment of new Crown entities (or revising the constitutions of existing ones) was at issue there was a template readily available without the need for specific legislation. Where the Crown had more than one significant interest in a given entity, the different interests would be expressed through different means; as an example, where the Crown had both an ownership and a purchase interests, one would be expressed through the structure and the other through contract.

4.4.7 This approach assumes that there are unlikely to be any consequences, for the achievement of Government's objectives, if categorisation of structures is accepted as a reasonable proxy for categorisation of the interests encapsulated in that structure. To express this another way, the knowledge that what is being dealt with is an ownership structure will be sufficient to identify the policy issues involved; they will be concerned with optimising the Crown's ownership interest (as a residual claimant interest). The same identity would apply with purchase, regulatory or transfer agencies.

4.5 **What to Categorise: Entities or Interests?**

4.5.1 In MDL's view, no such identity exists. Categorising entities, rather than the interests which the Crown has in any particular function, runs the risk of effectively concealing from sight any interests of the Crown other than the dominant interest which drove the selection of the organisational form. Separately, it also appears to be a static rather than a dynamic analysis; the interests of the Crown are defined at or prior to the moment at which the new organisational structure is selected. The impact on those interests, or the emergence of new interests, as a consequence of the shift from the core Crown to a stand alone entity seems blurred.

4.5.2 Both of the factors identified in the previous paragraph gain their major significance from the passage of time. What may have been clear and separately identified by policy advisors and decision makers at the point of establishment may become less clear over time. The clearly identified need to have regard to (say) different types of ownership interest may disappear from sight as the entity moves from its establishment phase to one of routine monitoring, especially if the monitoring responsibility is placed with an agency whose primary focus is on one, only, of the Crown's several interests. This points to the importance of an approach which is able to give weight to each of the Crown's interests on its own merits; different skills, and different agencies may be needed for this purpose. Thus, the skills required to determine and monitor the commercial objectives of a Crown Research Institute may be different from those required to advise on critical mass or "benefit of New Zealand" issues.

4.5.3 The Crown's ownership interest provides a useful illustration of this problem. Arguably, considerations arising from optimisation of shareholder wealth, and those arising from policy, as reasons for Crown involvement with Crown entities, increasingly lead to opposite conclusions. It is now virtually in the realm of the "taken for granted" that the Crown is not an appropriate owner of commercial undertakings. Typical arguments associated with this include the implicit guarantee (the risk that third parties dealing with the entity will expect government support in the event of failure) and the relative lack of commercial disciplines on management (the absence of a market for corporate control and relatively weak debt market monitoring to the extent that lenders believe there may be an implicit government guarantee).

4.5.4 The Government is also, as a matter of policy, a risk averse investor. The practical effect of this is that government owned businesses will be managed in such a way that, over time, they generate less surplus, and therefore value for the owner, than the equivalent businesses would in private ownership. The conclusion which follows from this is that, at any given moment, a Crown owned business will be worth more in the

hands of a private owner or owners than it will be in the hands of the Crown.

4.5.5 This line of argument, of itself, suggests that ownership, in terms of the Crown's residual claimant interest, is *not* the single dominant interest which the Crown has in ownership entities.[3] As well as the interest in optimising shareholder wealth, it will always have another and, potentially conflicting, interest or interests. The relationship between the latter and the pure ownership interest will be in terms of the latter constituting an overriding interest and a constraint on the optimising of shareholder wealth.

4.5.6 A practical way of illustrating this is to consider what would happen if the Crown received an offer, well in excess of economic value, from (say) a major international health care firm to purchase the Auckland CHE or from an Asian conglomerate to purchase Industrial Research Ltd. It seems certain that such an offer would be declined. The reason would have little or nothing to do with issues of shareholder wealth and everything to do with other and major policy objectives which the Crown believed could only be pursued (protected) through ownership.

4.5.7 The structural and policy implications are non-trivial. In essence, the optimisation objective shifts from being a primary objective to being a performance standard. The focus on structure inherent in the present approach to Crown entities blurs this, even where the structural arrangements import elements of an overriding policy objective. So far as we are able to assess the reasons for this blurring, they are twofold:

* An over emphasis, in ownership monitoring, on shareholder wealth issues.

* Difficulties in the specification and separation of ownership and purchase interests.

4.6 The CRI Example

4.6.1 Crown Research Institutes provide a useful example. Their enabling legislation includes, as ownership stipulations, several provisions which are intended to serve policy objectives other than, and possibly in conflict with, shareholder wealth objectives. Thus, every CRI is required, in fulfilling its purpose, (to undertake research) to operate in accordance with certain principles:

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[3] *This assumes that the entity is one which the Crown intends to own long term, as opposed to one which is being placed on a more commercial footing prior to sale.*

- That research undertaken by a CRI should be undertaken for the benefit of New Zealand.

- That a CRI should promote and facilitate the application of:

  - the results of research;
  - technological developments.

4.6.2 At the same time, every CRI is required to operate in a financially responsible manner so that it maintains its financial viability. According to the Act, a CRI is financially viable if:

- Regardless of whether or not it is required to pay dividends to the Crown, the activities of the CRI generate, on the basis of generally accepted accounting principles, an adequate rate of return on shareholders' funds;

- The CRI is operating as a successful going concern.

4.6.3 The test is a strong one. Over the long term, it is extremely difficult for businesses to earn more than a normal risk adjusted rate of return on equity unless they enjoy some regulatory or other position which allows them to earn excess profits. There is thus little scope for CRIs either to invest significantly in pursuing other principles (benefit of New Zealand etc) or to forego income opportunities for the sake of those principles, unless they are either explicitly compensated for doing so, or able to factor the cost into their pricing for contracted outputs.

4.6.4 We understand that, behind principles such as "benefit of New Zealand", lies a concern that, as taxpayer funded entities, CRIs should not be free simply to sell the results of their research to the highest bidder (the example most commonly cited as illustrating what this requirement is intended to avoid, is the alleged perfidy of certain elements in the kiwi fruit industry who sold plant material offshore thus enabling the establishment of competing industries in Chile, California, Italy, France and elsewhere).

4.6.5 On the face of it, the "benefit of New Zealand" principle would require CRIs, in some way, to give New Zealand interests the first opportunity of exploiting any appropriable intellectual property which might result from CRI research activity. Leaving aside whether such a policy makes economic sense[4], other problems arise:

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[4] *There are strong reasons to doubt that it does; for example the capacity of New Zealand firms to exploit intellectual property with international application may be quite limited through factors such as*

- The requirement is embedded in a structure whose governing principle is financial viability.

- It is probably a purchase interest rather than an ownership interest; the logic is that taxpayer funded research should create benefits for New Zealanders. On the face of it, this is a condition which should attach to the use of taxpayer funding, not an ownership interest as such.

- Expressed as an ownership interest, it results in CRIs bidding for public good science funding on a different basis from other potential bidders such as universities, research associations or the private sector. These parties are all eligible to bid but are not subject to an equivalent "benefit of New Zealand" requirement. They will therefore be able to price research proposals in the expectation that any appropriable intellectual property which results can be exploited internationally forthwith in contrast to the apparent constraint on CRIs.

4.6.6 There is a further set of difficulties which arises from seeking to imbed the Crown's non-shareholder wealth objectives in the legislated constitutional framework of a traditional residual claimant structure. These arise from shifting perceptions of the principal justifications for continuing Crown ownership. There is growing realisation that the by-products of funding research are more important than the direct research results themselves. These by-products include the amassing of globally produced existing knowledge in the relevant area of interest and the expertise of researchers to solve problems in related areas which get thrown up by clients. This argues that the real interest lies in ensuring the preservation and enhancement of the core competencies of the organisation[5] and the desire to preserve a critical mass of scientific expertise.

4.6.7 This is a shift in emphasis from the "benefit of New Zealand" interest which we have argued is clearly a purchase interest. Preservation of a critical mass of scientific expertise, or ensuring that a specific set of core competencies is preserved/enhanced is a somewhat different issue. Theoretically it would be possible to write a purchase contract between a specialist funder (the Foundation for Research Science and Technology) and a CRI requiring it, as a condition of funding, to meet certain objectives in respect of critical mass or core competencies. However doing so would pose a number of problems including:

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lack of access to appropriate distribution channels, capital, and credible test sites as well as issues of reputation and the capacity for effective client service.

[5] *See the seminal work of Gary Hamel and CK Prahalad.*

- Specification of just what it was which was being contracted for; how would the contracting parties decide what the objectives were, determine whether or not they had been achieved, and agree on the penalties which should apply in the event of any shortfall in performance.

- Unlike a conventional research contract, this type of contract focusing, as it would have to, on the organisation as a whole might well amount to some form of bulk funding. This would be in conflict with the whole purpose of the purchase regime which is to promote the contestable allocation of resources to specific outputs.

4.6.8 Logically, the interest needs to be treated as an ownership interest; maintenance of critical mass or given core competencies is the Crown's reason for retaining ownership. It is assumed that, in the absence of Crown ownership, the private sector would not meet this objective.

4.6.9 The present treatment of the Crown's ownership interest as substantially a residual claimant interest risks overlooking the real nature of that interest, particularly if understandings of it evolve after the structure has been established. Recognising that the Crown's underlying interest in retaining ownership is something different from investment, and putting suitable mechanisms in place for agreeing and safeguarding this, seems essential. It can only be achieved by including within the Crown's monitoring and accountability arrangements a specific responsibility for its policy interests in ownership outside the pure economic/financial set.[6]

4.6.10 Three concerns emerge from this analysis of CRIs as an example of the issues raised by the Crown's ownership interest. They are:

- The failure to distinguish, adequately, between the Crown's purchase interest and its ownership interest has the potential to frustrate attempts to develop competitive markets in the provision of taxpayer funded goods and services.

- Focusing on structural issues, rather than looking directly at the underlying interests of the Crown, may result in significant Crown interests going relatively under recognised. In the CRI instance, monitoring and accountability arrangements focus on the Crown's residual claimant interests rather than on the Crown's underlying policy reasons for retaining ownership.

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[6] *The same issues appear relevant in other groupings of Crown entities, where the value of the assets involved are substantial and there is therefore a focus, by the Crown, on its residual claimant interest. Examples include Crown Health Enterprises and educational institutions.*

* The monitoring and accountability arrangements for Crown entities should include a focus on the underlying policy reasons for retaining ownership. The necessary instrument is already in place, in the form of the statement of corporate intent or statement of intent. It may require, within the core Crown, explicit location of responsibility for ensuring that SCIs/SOIs make proper provision for these matters. A review of a sample of SCI/SOIs carried out for this study (and attached as an appendix) shows little emphasis on the underlying policy reasons for retaining ownership.

4.7 A Footnote on the Crown's Ownership Interest: Is it Always as Residual Claimant?

4.7.1 Categorisation by entity may carry another risk with it; that of over simplification. Treatment of the Crown's ownership interest again provides an example. Use of the limited liability company as the structure through which to reflect this interest carries with it the automatic assumption that the interest is quite explicitly a residual claimant one. In MDL's view, there is at least a prima face case for reviewing this. Residual claimant structures make their best contribution to efficiency when the goods or services which they produce are sold in contestable markets. There is a strong element of circularity when, as is the case with CHEs, the goods and services are sold to an entity which is, itself, under the same ownership. On the economic/financial side disciplines clearly come through demands for improved information flows and through the imposition of purchase requirements rather than through free exchange in a normal market situation. The question of whether or not those entities are "profitable" is a construct rather than a market reality.

4.7.2 On this argument, disciplines on CHEs come not through the fact that they happen to have adopted a particular corporate form but through a complex of policy decisions, contract negotiations and monitoring. On the other hand, the use of the residual claimant form created, in at least some minds, the perception that the Crown intended to privatise CHEs. This perception has been used quite widely as one argument to foment opposition to health sector reforms.

4.7.3 The Crown reacted by stating that it had no intention of privatising CHEs and that any surpluses which they generated would be reinvested in the health sector. This is very close to a statement that the Crown sees its ownership interest in CHEs as being held in trust for health purposes. If that is the Crown's view, then it would make better sense for the CHE structure to reflect it. This might imply, for example, the creation of stand alone institutes (perhaps by generic legislation) whose

assets, on a winding up, would not revert to the Crown for general purposes but be held in trust for equivalent purposes. In practice, the fiscal impact of such a measure would be negligible; the need for ongoing investment in the health sector would probably have the impact that, to the extent resources came available under a trust arrangement, they would substitute for investment which the Crown would otherwise have to fund from a separate source.

4.7.4 The principal issue, though, is not one of how the surplus on a winding up of such an entity might be disposed of; it is how best to promote efficient resource use within present structures. The argument, here, is that where entities are substantially dependent on the Crown, or another Crown entity, as their principal source of funding, then disciplines imposed through contract, rather than artificial constructs through a return on capital approach, are a much more direct and appropriate means of addressing efficiency. If that argument is accepted, then use of a company structure becomes less appropriate, or even inappropriate, purely on efficiency grounds.

4.7.5 Similar arguments could well apply with the CRIs (although the possibility of future staff and/or joint venturer involvement in equity may also be an issue) and in areas such as education.

5.0 SELECTING STRUCTURES

5.1 Process

5.1.1 The process of selecting an appropriate structure appears to be based largely on what we would term a static comparative institutional analysis. The choice, as described, seems to be between an existing departmental structure and a stand alone entity whose only activity is assumed to be the function being transferred. There is a focus on the fact that there will be different governance, monitoring and accountability arrangements, and that these should be efficiency promoting. However, these seem to be viewed primarily as ways of fine tuning the undertaking of the function concerned. There is little apparent recognition that the adoption of a different organisational structure may have impacts going beyond a shift in monitoring and accountability or the conduct of the function itself.

5.1.2 In MDL's view, there are fundamental differences between the management of a function within a department or ministry and the management of the same function within a stand alone agency which can only be properly understood in the context of a dynamic analysis. This conclusion, which will be justified in a moment, is another reason for looking at the interests of the Crown rather than at the structures of Crown entities when considering categories.

5.2 Reversing the Objectives/Constraints Set

5.2.1 Of particular importance is the difference between the objectives/constraints set facing a department and that facing a market driven organisation. Common to organisations in both sectors is the fact that they will be seeking to optimise a given objective or set of objectives within the constraints under which they operate. What differs between the public and the private sector is the nature of the objectives on the one hand and the constraints on the other.

5.2.2 Typically, the departmental objective(s) will focus on optimising outputs (whether in terms of quantity, quality, mix or whatever). In pursuing this, it will face resource constraints, primarily human capital and financial. In contrast, the market driven organisation will express its objectives in financial terms and its constraints will lie in the ability to satisfy the output requirements which other parties expect of it in return for providing it with resources (purchasing its outputs). This is

reflected in the common view that the over-riding objective which any chief executive of a private sector organisation should have is optimising shareholder wealth.

5.2.3 Shifting a function from a departmental structure to one which operates under market constraints, carries with it the probability that management's focus will shift from outputs to optimising financial targets. Typically, the shift will not be immediate, especially if the management of the new entity came from the former department. That the shift will take place should, however, be regarded as sufficiently likely that it should be "taken for granted" in designing the arrangements for any entity which is expected to operate on market principles.[7]

5.2.4 This will be reinforced by the fact that one purpose in transferring an activity to a Crown entity is to improve the efficiency with which resources are used. There is a presumption that Crown entities and, in particular, their boards will have considerable flexibility to adapt to reduced budgets, including the flexibility to generate resources from third party income. This is reinforced by the degree of commercial discretion which is (necessarily) left to boards; it is widely recognised that, if you want competent management (including competent directors) then they must have discretion as to how they run the business within the broad objectives set by the owners. Crown entities which commonly have both the incentives and the power (which is much more restricted in the case of departments or ministries) to pursue alternative sources of income.

5.3 Managing Business Risk; the Duties of Directors

5.3.1 In some instances, this may be more than just a matter of incentives. Directors of companies, including Crown owned companies, have an overriding statutory responsibility to act in the best interests of the company. Directors of an entity, involved in the production of goods or services, the great bulk of which are sold to a monopsonist operating under politically determined purchasing criteria, face a major business

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[7] *This statement, as a generalisation, needs some qualification; some departments, such as the Education Review Office, do undertake limited trading activity in the sense of seeking paid assignments from outside its normal client base. Some Crown entities, such as education institutions, lack full commercial powers. Generally speaking, however, Crown entities should have a full set of commercial powers, including powers to borrow, enter into joint ventures and subscribe for capital in other corporates, as well as the ability to retain at least part, if not all, of the additional income they generate. In contrast, departments and ministries lack significant commercial power and will also have difficulty in retaining any of the surplus which they may generate. (This comment should be read in the context of the recommendation that all Crown entities should have a full set of commercial powers unless there is an explicit policy reason for excluding them from trading activities.)*

risk. Arguably, they have a legal obligation to minimise business risk by strategies such as:

* Diversifying so as to minimise their dependence on a single or dominant buyer.

* Seeking to negotiate contract terms which shift the risk back to the buyer.

5.3.2 The same responsibilities extend beyond company boards, to other corporate structures such as incorporated societies or trusts, where they are also involved in the production of goods and services.

5.3.3 There is much uncertainty regarding the exact nature of directors' responsibilities and there is the potential for significant conflict between them and the Crown as owner unless the legal situation is clarified. At the moment, whether a Crown owned company is registered under the 1955 Companies Act or the 1993 Act, a director "when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company".

5.3.4 The question of what the "best interests of the company" actually are has been the subject of litigation in respect of conventional (non-Crown owned) companies. In one case[8] the judge stated "the interests of some particular section or sections of the company cannot be equated with those of the company, and I would accept the interests of both present and future members of the company, as a whole, as being a helpful expression of a human equivalent".

5.3.5 On the other hand, in another case, the court apparently held that "where the company is one of a group, the directors must continue to act in the interests of that company and not look solely to the overall interests of the group".[9]

5.3.6 With a Crown owned company, the Crown can be considered as the equivalent of the present and future shareholders. However, it is also analogous, in a group company situation, to the parent company. Subject to legal opinion, the case law seems to suggest that, even where there is a single owner, directors may still be entitled (bound) to form a different view of the best interests of the company from that held by the single shareholder. Certainly, this view is widely held by directors of publicly owned companies, whether Crown owned or local authority owned, in New Zealand.

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[8] *Gaiman v National Association for Mental Health [1971] ch317, 330*

[9] *Charter Bridge Corporation Ltd v Lloyds Bank [1970] ch63.*

5.3.7 The situation is further complicated by the statutory framework for publicly owned companies. They are required to prepare statements of (corporate) intent. Commonly, the directors have a statutory obligation to abide by the terms of the statement of corporate intent. Thus, "all decisions relating to the operation of a Crown Health Enterprise shall be made by or under the authority of the board of the enterprise in accordance with its statement of intent" (section 39 Health and Disabilities Services Act 1993). There is no equivalent provision in the Crown Research Institutes Act 1992 and no clear reason why CRIs are exempt from that requirement.

5.3.8 It is unclear whether the statutory obligation to operate in accordance with the statement of (corporate) intent is overridden by the director's obligation to act in the best interests of the company if the director concludes that this requires a departure from the terms of the statement. Unless there is clear guidance for directors, based on a definitive legal interpretation of their responsibilities (and possibly a change to legislation), then the Crown should expect directors to continue to act as they would if managing a normal commercial organisation. This means, in particular, managing business risk and, where this is considered necessary, looking for opportunities to diversify.[10] It would certainly be reasonable for directors to take account of their understanding of Government's long term policy objectives in making judgements about the likelihood of Government continuing as a client and the basis on which it would do so. Equally, however, directors may also factor in issues such as the risks associated with a desire for greater contestability in provision or concerns to reduce costs and see these as reasons for reducing dependence on Government as a dominant customer.

5.3.9 The obvious examples of Crown entities with a financial/legal incentive to develop business outside the Crown are CHEs and CRIs. However, virtually every other Crown entity involved in the provision of goods or services faces the same imperative. Thus, many of New Zealand's largest secondary institutions and virtually all of its tertiary institutions are actively diversifying their businesses away from dependence on Crown funded activity. Many other seemingly single purpose entities are following the same approach.

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[10] *One reader of an earlier draft of this report commented that "the Government is not just any customer and while it is acknowledged that policy does change it seems .... that directors may well be entitled to rely on that single customer more than might be prudent for a privately owned firm".*

5.4 The Case for an Informed Owner

5.4.1 This situation poses a particular risk which we believe should be addressed urgently. It is the risk inherent in any organisation which engages in business activity without being properly answerable to an informed owner. In MDL's judgement, many of the initiatives being undertaken by these various entities could well be highly desirable both in their own interests (that is the interests of their developing activities) and in the interests of the Crown. However, at present they lack the essential discipline of an owner playing its proper (but not interfering) part in their business development.

5.4.2 This raises a different aspect of the ownership interest of the Crown; that of setting an appropriate monitoring and accountability framework for the possibility that Crown entities not presently involved, or significantly involved, in marketing of goods and services outside the Crown, or areas of activity agreed with the Crown, do so within a proper framework. Ownership accountability is a critical factor in the system of checks and balances needed for efficient commercial activity.

5.4.3 The available mechanism, at the level of the entity, is the statement of (corporate) intent. Not all of these entities are required, at the moment, to produce statements of (corporate) intent. To impose such a requirement on all entities, not presently required to do so, would be unduly onerous. However, it would make sense to require any entity, not currently subject to an SOI/SCI requirement, to do so if it intends undertaking trading activity with third parties, perhaps beyond an agreed ceiling.

5.5 The Better Focus: Interests Rather than Structures

5.5.1 We conclude that there has been a disproportionate focus on structure as the element on which the Crown should concentrate in managing its interests in Crown entities. Instead, the Crown's focus should remain on defining and safeguarding its interests in the activities which are now, or may in the future be, undertaken by Crown entities.

5.5.2 On this approach, the emphasis shifts from selecting a standard form of organisational structure governed solely by dominant interest considerations to one of isolating, almost on a case by case basis, the specific interests of the Crown which the Government wishes to optimise.

5.5.3 The necessary steps include:

* Careful analysis and specification of the Crown's interests. We have already seen, in discussion of "benefit of New Zealand", how categorising a purchase interest as an ownership interest has the potential to give rise to substantial distortions.

* Separating the Crown's pure ownership interest from the policy reasons which justify continuing ownership.

* Designing the institutional arrangements to match, respectively, the pure ownership interests and the reasons for retaining ownership. In the case of the CRIs, a company structure may be the appropriate vehicle for carrying the Crown's pure ownership interest. The reasons for retaining the interest should be carefully reflected in the "contract" between the Crown and the directors through the statement of (corporate) intent. This will require careful specification of the owner's objectives for matters such as retaining a critical mass and developing the organisation's core competencies and should also be reflected, quite specifically, in the owner's view on matters such as diversification.

5.5.4 This approach may allow the development of a standard set of structures for Crown entities. The matters in respect of which the interest of the Crown require an entity specific approach are not structural so much as contractual. In the case of an ownership entity, the use of a company structure is consistent with this (but note the comments on trustee issues above) so long as there is a careful separation out of purchase and ownership interests of a non-economic/financial type and these are properly reflected in the arrangements between the Crown and the entity. On this basis, the structure can be standardised and the statement of (corporate) intent written to reflect the Crown's specific underlying policy interests.

5.5.5 In practice, the impacts may be more one of a shift of emphasis rather than one of the development of new instruments. At the level of the entity, the necessary instruments already exist. As an example, in respect of Crown owned companies, the instruments comprise:

* The company structure itself
* The statement of (corporate) intent
* The contract(s) between the company and the Crown's purchasing agent.

5.5.6 The company structure would be seen purely as reflecting the Crown's interest as residual claimant. The statement of (corporate) intent would

reflect the Crown's ownership interests other than that as residual claimant, as well as performance objectives, definition of scope of business etc (which are themselves ownership interests) and the contract(s) with the Crown's purchasing agent would deal with the Crown's purchase interest.

5.5.7 The main change which would be required would be to remove, from existing special purpose legislation, requirements such as those found in the Crown Research Institutes Act or the Health and Disability Services Act entrenching elements of the Crown's ownership and/or purchase interests. This could clear the way for a standard Crown Owned Companies Act which authorised the Crown to establish companies for whatever purpose, with the specific ownership and purchase interests (including statutory provisions such as the "benefit of New Zealand" obligation on CRIs or the objectives of Crown Health Enterprises) being dealt with through the statement of (corporate) intent.[11]

5.5.8 The same argument could be applied in respect of other types of entities such as regulatory bodies or purchase agencies, for which shareholder wealth, or the potential to undertake trading activities, is not a major issue. The one caveat which would need to be observed is the constitutional issue of whether the specific interests the Crown wishes to discharge through (say) a regulatory body should be set through legislation or through something akin to a statement of intent. For constitutional reasons, the former approach would almost certainly need to apply.

5.5.9 The major difference between entity types, in terms of our analysis, should lie between those which do or may undertake trading activities and those which do not and will not. On this basis, there is much in common between (say) the Privacy Commissioner, the Lottery Grants Board, the Commerce Commission and New Zealand on Air. Equally, there is much in common between a school board of trustees and a crown research institute; the possibility of each of these, as an example, entering into business relationships with parties from South East Asia is a very real one.

5.5.10 Precise structural forms may differ but, in each case, the same emphasis should be placed on ensuring both that adequate legal powers are in place for the entities to undertake such trading activities as it is reasonable to expect (which, in practical terms, means a broad set of

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[11] *This suggestion raises the question of why not use the State Owned Enterprises Act. The main argument against doing so is the perception that SOE status is a way station on the route to privatisation. The Government has already made it clear that it wishes to use a different statutory structure when (signalling the possible) privatisation of the entity is not seen as appropriate.*

legal powers to avoid problems with ultra vires and interference in the proper role of boards) coupled with monitoring and accountability arrangements which deal effectively, and separately, with the Crown's ownership and other policy interests.

5.5.11 This approach would also allow a focus, important at a policy level, on the inherent differences amongst entity types. Categorising school boards of trustees as a subset of purchase entities does have a certain logic. Effectively the boards of trustees have taken the responsibility for arranging the purchase of educational services, through their particular school, in the same way that RHAs arrange for the purchase of health services (with the difference that, in the case of the schools, the purchase agency has been embedded in the provider structure). However, the categorisation does seem somewhat artificial. The policy issues likely to arise with the Crown are not the normal issues associated with purchase agencies.

5.6 Conclusions on Categorisation

5.6.1 We answer this part of the brief as follows:

* The Crown's policy objective should lie in identifying and categorising the nature of the interests which it has in the activities undertaken by present or future Crown entities, rather than in categorising the structures as such.

* The Crown's primary reason for retaining ownership of a Crown entity will never be ownership, in the residual claimant sense, as such; there will always be a different and, potentially conflicting interest justifying retention of ownership.

* There is a need for a much clearer specification of the different interests which the Crown has in each Crown entity. A clear distinction between purchase and ownership interests is necessary in order to avoid distortions in the market behaviour which the Crown is seeking to encourage. Within the Crown's broad ownership interest, a careful distinction between financial/economic interests on the one hand and remaining policy interests on the other is required. For the most part, this can be reflected through more careful attention to the drafting of statements of corporate intent or statements of intent. This may require that the responsibility for the financial/economic component on the one hand and the remaining policy content on the other should be handled by different elements within the Crown in order to avoid one suppressing the other.

6.0 THE PRINCIPLES FOR ESTABLISHING A CROWN ENTITY

6.1 The Principles

6.1.1 We identify one overriding principle and eight subsidiary principles. The overriding principle is that Crown entities should be single purpose[12] entities, that is, as a general rule, entities should be either regulatory, or policy, or operational rather than the combining two or more of these purposes. This flows from the fact that, in the present environment, the emphasis is on unbundling activities in order to promote clarity of objectives, accountability and monitoring. As a practical example, it is inconceivable that, in today's policy environment, we would create an Accident Rehabilitation and Compensation Insurance Corporation with the range of responsibilities (for example policy and operations) which that corporation has.

6.1.2 The eight subsidiary principles are therefore discussed in the context of selecting the appropriate structure for a single purpose entity. The eight principles, not all of which will apply in each case, are:

- Contractability
- Relevance of market disciplines
- Management of Crown risk
- Independence/objectivity
- Access to specialist expertise
- Co-option of stakeholder resources
- Contestable provision
- Transition and operating costs.

6.1.3 These eight principles are discussed on the assumption that the choice being made is between a Crown entity and a departmental/ministry form. The Crown has the further choice of simply exiting from the function and leaving it either to the market or to the non-Crown public sector. The decision that neither of those options are appropriate is assumed to have been made.

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[12] *(Though the purpose should be construed sufficiently widely to accommodate complementary functions).*

Contractability

6.1.4 Is it possible to specify the required outputs, performance standards etc in a formal "arms length" arrangement or are the desired outputs so difficult to specify that a more informal relationship is required so as to permit of regular fine tuning. The more readily the outputs can be specified in contract form, the more appropriate the function is for transfer to a separate entity. Conversely, if regular and informal fine tuning is required, perhaps on the basis of ongoing involvement with the responsible minister, then a departmental form is more appropriate.

Relevance of Market Disciplines

6.1.5 To what extent is exposure to market disciplines expected to improve the efficiency and effectiveness with which the function is discharged? Most importantly, to what extent will "bottom line accountability" lead to improvement in the performance of the function? If this factor is significant, then a separate entity is indicated. If not, then the case for retention in departmental form is relatively stronger.

Management of Crown Risk

6.1.6 The activities of departments or ministries automatically pledge the credit of the Crown. Although they have no ability to borrow in their own right, the contracting and other activities of departments or ministries do have the potential to incur significant liabilities, for example, as the result of negligent performance. Thus, where Crown activities carry with them the potential for significant liability, a separate legal entity may be indicated (but note: the formal legal exclusion of Crown liability may not equate to the actual avoidance of liability in practice. This will be particularly the case with Crown entities which incur liabilities in other jurisdictions where foreign governments may seek to argue that the Crown should stand behind the entities it owns).

Independence/Objectivity

6.1.7 In a number of instances, the Crown will wish to distance itself from the actual exercise of particular functions, in order to maintain an appearance of objectivity and an absence of political interference. This applies particularly to regulatory agencies and to transfer agencies such as the Lottery Grants Board.

6.1.8 It is also an important factor in the discharge of purchase functions where the precise specification of what it is that is to be purchased is intended to result from a consultative procedure. Purchase agencies

such as the Foundation for Research Science and Technology and the Regional Health Authorities are both examples of cases where some distancing from the Crown is seen as contributing to factors such as:

* The willingness of other stakeholders to participate in the consultative process

* The potential for, and desirability of, the Crown being able to distance itself from responsibility for particular outcomes.

Access to Specialist Expertise

6.1.9 In some cases, the Crown may wish to have ongoing access to specialist expertise which it would be unable to access in a direct employment relationship but would prefer to access in a more permanent fashion than (say) through a consultancy arrangement. The Law Commission provides one such example. Questions of status and independence, on the part of the key advisors, influence their institutional choice and thus the way the Crown can use their services. The Crown's wish to access their expertise, and to do so within a permanent institutional structure so that it has some access to the accumulated organisational learning, governs its choice.

Co-option of Stakeholder Resources

6.1.10 In some circumstances, the Crown may be seeking to reconcile continuing Crown ownership of a particular activity with a desire for substantial stakeholder input, in cash or in kind. Perhaps the best example is school boards of trustees where both the trustees themselves, and the wider school community, provide substantial financial and non-financial input into the school's operation. The alternative means of seeking such input would be for the Crown to withdraw from ownership and, instead, make its contribution in cash or other resources to the operation of the school by third parties. There is clearly a policy objective, separate from stakeholder involvement, which argues for continuing Crown ownership.

Contestable Provision

6.1.11 The Crown may wish to have the benefit of different approaches, within a common framework, to achieving its desired outcomes. It may be important, for policy reasons, to be able to evaluate the effectiveness and efficiency of particular management or contracting practices against alternatives. This is difficult, if not possible, to achieve within a departmental structure so that the creation of one or more stand alone entities may be necessary. One justification for the creation of four

RHAs is the ability this provides to assess different approaches to contracting for the provision of health care services.

Transition and Operating Costs

6.1.12 The shift from a departmental or Ministry structure, to a stand alone Crown entity, will inevitably involve costs, both one off or establishment costs, and ongoing costs; for example, through monitoring and accountability arrangements and the overheads associated with a board structure. Economies of scale will also be an issue. Establishing functions on a stand alone basis may be an inefficient use of resources, if the entity requires specialist in-house resources which it cannot fully utilise. Alternatively, if the entity is too small to achieve critical mass in a business sense, then it may operate at a sub-optimal level or fail. Proposals to establish Crown entities (or for that matter, separate Ministries) should be assessed both in terms of the additional costs, of economy of scale issues and from an opportunity cost perspective. Will the likely return to the Crown, from the effort and resource which goes into setting up a particular Crown entity, be justified as compared with the potential returns from the alternative uses of those resources? The skills available for organisational restructuring in the public sector are not infinite.

6.2 Comment on Principles

6.2.1 Each of these principles is relatively straight forward in its own terms. From our assessment of the establishment process for Crown Entities, difficulties arise not so much in terms of identifying the specific principles which should apply, as in the practicalities of their implementation. Thus;

* What, in practice, constitutes a single purpose entity? We have argued that this should be considered in terms of regulatory, policy or operational but the same issue can arise in terms of scope, eg, a single versus several regulatory agencies in the transport sector or purchase agencies in health. Clearly, as a matter of principle, complementary functions can reasonably be co-located. In practice, though, determining whether or not specific functions are complementary is as much a matter of judgement as it is of analysis. Debates over the boundaries between the various CRIs provide a good example. Factors such as the nature of the technical or professional skills required, the commonality or otherwise of the client base, economies of scale in the use of equipment and the avoidance of cross subsidy between different activities, will be amongst those which should be taken into account.

* For regulatory agencies, how is the desired degree of independence/objectivity defined and sustained over time? The recent demise of the Public Health Commission is an example of the practical problems associated with this principle.

6.2.2 As well as recognising problems with the application of these various principles, we have identified four other issues which, in our view, need more attention than they seem to have received, so far, in the establishment and operation of Crown Entities. These are:

* Contracting capability
* Risk management
* The incentive impact of establishing Crown Entities
* The legal obligations affecting boards

Contracting Capability

6.2.3 If the Crown is to get the best value out of the separation of purchase and provider functions, it is essential that the contracting capability of purchase agencies (whether Crown Entities themselves, or still Ministries or Departments) is equal to the task. In broad terms, an effective contracting function requires:

* High level technical competence in specifying the outputs the subject of any contract, and in actually writing the contracts themselves.

* Extensive prior experience of commercial negotiations.

6.2.4 The scope of this project has not included the opportunity for a detailed review of the contracting capability of significant purchase agencies. However, we have encountered sufficient indicators to suggest that this is an area which the Crown might wish to review. In particular, we have not found the awareness we would have expected of the extent to which contracting is a pivotal function from the perspective of the provider. We would expect the typical provider to invest heavily in resourcing its contract capability and to ensure that its key staff in this area are not only highly skilled technically but very experienced in commercial negotiation. We have encountered at least something of a suggestion that, at least during the start up phase, some purchase agencies may have seen contracting as simply an extension of the appropriation process.

6.2.5 We want particularly to stress that this is the type of issue which needs to be got right at the point of establishment rather than something

which can be subject to fine tuning as time goes by if the Crown is to get the expected benefits from separating purchase and provision.

Risk Management

6.2.6 We expected to find evidence that Crown Entities had undertaken a proper risk assessment of their operations and developed risk management policies accordingly. The risks which such entities should address include:

* Risks to their own business, including the risk associated with the fact that, in many instances, they face a monopsonist as their principal market.

* Risk to the various interests of the Crown as owner. These include not only potential financial risk but also policy risk if, as an example, the actions of a Crown Entity undermine the credibility of government policy and force additional expenditure as a result.

6.2.7 As can be seen from the analysis of Statements of (Corporate) Intent attached to this paper, there is very little evidence of risk management strategies. In some cases, at least, this may be because they have been spelt out in business plans rather than in Statements of Intent. We do not see this as satisfactory. Risk exposure is a major issue for the Crown as owner and its advisors should insist that each Crown Entity has identified the relevant risks and how they are to be managed. This is an ownership issue both at the level of the business and at the level of the interests of the Crown which could be affected by the business's activity.

Incentives

6.2.8 From the material we have seen, and the discussions we have held, we have inferred that insufficient attention has been paid to the incentive shifts which take place when a function is transferred from a department to a Crown Entity. The shift has normally been seen in terms of the encouragement to efficiency which would flow from placing functions in a more contestable environment.

6.2.9 What is not being properly assessed, in our view, is the changed incentives which the organisation as a whole, and people working within it, will have to act in their own interests as opposed to the interests of the Crown. We have already commented (see page 24 above) on the different nature of the objectives/constraints set facing ministries on the one hand and the private sector on the other. To the extent that Crown Entity structures and incentives mimic those in the private sector, the same difference applies.

6.2.10 When a function shifts from the Crown to a stand alone entity, a new element comes into play. The entity will have a life of its own separate from the function assigned to it. As pressure is placed on it for more efficient performance, for example, through seeking to purchase more for the same funding or providing less for the same outputs, the entity will be encouraged to seek revenue from other sources. Unless the Crown's purchase agent is able to specify contracts with rigour, this may see a displacement of the particular skills the Crown wishes to access away from servicing its contract(s) towards servicing third parties.

6.2.11 The incentive impact on individuals, from the transfer to a Crown entity environment, may be even more important, particularly when they possess skills which may not be readily available elsewhere within the economy. Shifting individuals from what is still the relative security of departmental employment changes, significantly, the context within which those individuals plan their own careers. The shift is one from relative security to one in which continued employment must be seen as rather more uncertain; thus:

* The entity itself is on short term funding (annual contract) with no assurance of renewal, at least on similar terms. This is reinforced by the underlying emphasis on contestability. In many cases, it is at least an implicit justification for the shift to Crown Entity status that the Crown will be looking to buy from other providers.

* Further uncertainty comes from the downward pressure typically placed on contract funding for Crown Entity outputs with the implicit recognition that the entity has the option of generating alternative revenue streams to offset losses.

6.2.12 In themselves, these changes can all be seen as part of the process of creating a more efficient operating environment. However, where the Crown has an interest in retaining scarce skills, the shift creates risks which themselves need to be managed, not only from the entity's perspective but from that of the Crown's interest in maintaining capability.

6.2.13 At the level of individual, each of these changes will impact on career planning. Thus:

* Increased uncertainty in funding, and downward pressure on resources (which may be reflected, for example, in salary restraints) may encourage individuals to explore alternatives.

* Marketing Crown Entity services to third party purchasers, especially where the main asset is human capital, can have the unintended effect of alerting the market to the existence of skilled people who, as individuals, may then be open to attractive offers.

6.2.14 As a general principle, it is one of the responsibilities of the Chief Executive and Board of the Crown Entity to develop policies to encourage staff retention. This is no substitute for the Crown identifying areas where it has a particular interest in maintaining a critical mass of skills. In those cases, we consider that it is insufficient to rely simply on the Chief Executive and Board of the entity to deal with retention. The Crown, as well, should ensure that the operating framework it is establishing for the entity is consistent with its wish to retain a core capability.

Board Member Responsibilities

6.2.15 We have already discussed the change in the incentive environment for the organisation which takes place when a function is shifted from a departmental to a Crown Entity structure. For a number of entities, this is reinforced by the legal obligations which Board members face. We have seen little evidence that this impact has been properly understood and its implications, for the management of Crown Entities, worked through. As discussed above (p.25 - 27), company directors have a formal legal obligation to "act in good faith and in what the director believes to be the best interests of the company". The same legal obligations to act in the best interests of the entity can apply in respect of other corporate forms; as an example, MDL has received a legal opinion from a major law firm to the effect that the duties of and liabilities of the members of the management committee of an incorporated society are broadly the same as those of company directors.

6.2.16 There are very real and practical implications for the management of Crown entities. Many have been established to undertake a single function or set of functions which involve the production of goods or services for sale, under contract, with a Crown purchase agency acting as a monopsonist. In business terms, this is a high risk situation. The entity is overly dependent on one customer and the risks arising from this dependence are magnified by the fact that the relationship is normally a non-market one (the "contract" is not a typical arms length commercial transaction) magnified by the policy risk lying behind the purchase agency's own decisions.

6.2.17 In MDL's view, the present practice of using entities, whose Boards face this type of legal obligation, and expecting them to confine their activities broadly to the functions taken over at their establishment is to

impose an unreasonable burden on Board members. It may also, and we have not explored this issue in depth, raise issues regarding the liability of the Crown if the entity were to fail. There may be an argument that the Crown was a party to the circumstances which saw the directors managing the business in a way which is in breach of their obligations, particularly given the deemed director provisions of the Companies Act.

6.2.18 There is a clear need for a definitive review of the obligations of the Board members of Crown Entities and their implications for government policy, including recommendations on the explicit measures needed to deal with this problem.

6.3 The Structure Itself

6.3.1 Once the decision has been made that a Crown entity, rather than a departmental structure, should be used to undertake a particular function, it is then necessary to select and design the particular structure. The choice is between two categories, each of which covers a wide range of possibilities. The categories are:

* Crown owned companies
* Statutory corporations.

Crown Owned Companies

6.3.2 The pure form of company, whether under the Companies Act 1955 or the Companies Act 1993, is a relatively simple structure. However, whether as a privately owned company, or as a Crown owned company, there is an increasing tendency to design corporate structures to meet the very specific needs of the particular business or activity involved and the preferences of owners. Typically, the Crown has sought to impose its specific requirements partly through legislation setting out statutory obligations and partly through the design of the company's constitution.

6.3.3 MDL prefers the use of the statement of (corporate) intent process for imposing particular obligations rather than the use of statutes. However, we would still expect a case by case approach to the design of company structures, if only to reflect the particular governance requirements which the Crown may have in any particular case.

Statutory Corporations

6.3.4 Much the same applies in respect of statutory corporations. These are entities which achieve their separate legal persona by being established

under a specific statute. Regional health authorities are an example; section 32 of the Health and Disabilities Services Act provides "each regional health authority shall be a body corporate with perpetual succession and a common seal and shall have and may exercise all the rights, powers, and privileges, and may incur all the liabilities and obligations, of a natural person of full age and capacity".

6.3.5 For statutory corporations, their enabling legislation is their constitution. There is much greater variation between them than between (say) companies, substantially because of the very different governance arrangements and the widely different discretions which Government has seen fit to give them.

6.3.6 As examples:

* The boards of regional health authorities are appointed by the Minister of Health; school trustees are elected.

* Regional health authorities have very limited powers to borrow or acquire assets; tertiary institutes have quite wide powers to do so.

6.3.7 The process of selecting/designing a structure for a Crown entity, is, in MDL's view, one which is necessarily undertaken on a case by case basis.[13] This is a matter of identifying the separate elements for which separate provisions should be made in an organisational/governance sense, specifying the design criteria in respect of the key components, relationships and activities which emerge from that analysis and then reviewing the characteristics of different organisational forms in order to understand the strengths and weaknesses of each in meeting the organisational/governance needs.

6.3.8 The process is a complex one and should be the subject of a separate study. As an example of what is involved, reference could be made to the paper "Museums and Structure" written for the Museum Directors Federation of Aotearoa/New Zealand and Taonga o Aotearoa National Services of the Museum of New Zealand Committee as part of their project on "The Rationale for Public Funding and Performance Measurement of Museums in New Zealand".

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[13] *This, indeed, seems to have been the practice with Crown entities. Instances where a group of entities have used a common design structure seem confined to cases where those entities have all been intended to undertake the same type of activity as with, for example, Crown Research Institutes, Crown Health Enterprises or school boards of trustees.*

7.0 RECOMMENDATIONS

7.1 We make the following recommendations:

* Government's focus, in dealing with Crown entities, should be on the interests of the Crown rather than on the category or type of entity; if the former are correctly identified, then the appropriate structure should follow naturally. The reverse does not apply.

* Greater precision is required than has typically been the practice in identifying the separate interests of the Crown, in any particular case, and assigning the pursuit of those interests to appropriate instruments. Specifically:

    - Purchase interests should be dealt with through contract and *not* through ownership instruments, whether the statutory directions to boards or non-statutory directions through statements of (corporate) intent.

    - A clear distinction should be drawn between the Crown's ownership interest as residual claimant and its ownership interest as a means of ensuring certain policy outcomes.

* As a means of encouraging efficient resource use, there should be a presumption that all Crown entities may undertake trading activity unless there is a specific policy interest of the Crown to the contrary (for example, Government may conclude that it is undesirable for quasi-judicial entities to undertake trading activity). The constitutions, and the statements of (corporate) intent, of Crown entities should be explicit in this respect and, where trading is contemplated, contain the necessary powers and authorities.

* The monitoring arrangements for Crown entities should be designed to ensure that there is minimum risk of one interest of the Crown being submerged by another. In respect of the Crown's ownership interest, this may mean separate arrangements for monitoring its interest as residual claimant and its policy interest in retaining ownership.

* High priority should be given to clarifying the legal responsibilities of board members of Crown entities as regards acting "in the best interests of the company" (or other entity). Currently, the potential for conflict between the Crown's expectations of certain entities, and the way in which directors may interpret their responsibilities, is considerable.

* In establishing Crown entities, or monitoring their performance after establishment, particular attention should be paid to the potential for changing incentives, both as regards management and staff, as a result of the shift from a departmental to a Crown entity mode. The specific risk, which needs to be managed, is the potential for organisations, or staff with scarce skills, to be more easily competed away from serving the Crown's interest.

* There may be merit in reviewing the capability of the Crown's purchasing agents (both ministerial and Crown entity) vis a vis the Crown entities from whom they purchase services. For Crown entities, substantially dependent on government funding, contracting is their single most important function and will normally be resourced accordingly. There may be a skills and information asymmetry between some entities and the purchasing agents with whom they deal. The amounts at stake are such that capability monitoring, by the Crown, should be a normal part of managing the Crown's fiscal risk.

* The activities of Crown entities pose substantial risks for the Crown. Poor performance in the management of the business can diminish the value of the Crown's residual claimant interest. Serious errors could expose the Crown itself, or the wider public, to major fiscal or other risk. We consider it essential that all Crown entities should have developed risk management policies covering the business and other risks associated with their activities and that these should be detailed in their statement of (corporate) intent. We recommend accordingly.

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