Controller and Auditor-General
Tumuaki o te Mana Arotake

Maintaining a future focus in governing Crown-owned companies

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Auditor-General's overview

The work of my Office has been focused on the theme of *Our future needs: is the public sector ready?* This report focuses on the ability of Crown-owned companies' governance systems to support "future thinking" and to realise and adjust strategies accordingly.

It has been more than 25 years since New Zealand's State-owned enterprise model for governing and delivering certain public services was set up. Since then, other types of Crown-owned companies, such as Crown research institutes and other Crown companies, have been formed, and individual entities have changed. For example, while we were preparing this report, the decision was made to wind up Learning Media Limited and to sell Orcon – Kordia's retail service provider – to private investors.

Crown-owned companies provide strategically significant services, such as electricity infrastructure and assuring meat quality, and have considerable public resources – about $28.3 billion in assets and $5.1 billion in annual revenue.

In this report, I describe how Crown-owned companies are preparing for the future. I set out for Parliament and the public:

- the challenges in maintaining a focus on the future that were described to us; and
- insights and lessons from Board members working within the commercial model.

My staff were told that there are inherent tensions in the governance arrangements for Crown-owned companies, and these tensions can be significant problems for Boards, raising questions such as:

- How is seeking profit balanced with long-term strategic interest and social responsibility?
- What benchmarks are useful to compare the performance of Crown-owned companies against?
- Should one public sector entity compete against another, possibly resulting in duplication of infrastructure or capability?

Managing these inherent tensions is an integral part of being able to focus on the future. Sometimes these tensions can be, and are being, managed at the entity and Board level. There were also examples where these tensions were not being managed as productively as they might. Managing these tensions requires shared understanding between key people inside and outside entities.

Three practices appear fundamental to managing these tensions productively – mutual respect, good information, and a shared understanding by the Board, the Minister, and monitoring agents of the Crown-owned company's purpose, role, and contribution to the public.

My staff found examples where Boards and other agents had productively used these tensions to focus on the future. In my view, the Crown-owned companies that were innovating and communicating with a wide range of stakeholders appeared more likely to be preparing well for the future. My staff saw evidence of:

- better asset planning and condition than the rest of the State sector;
- longer-term thinking, such as MetService taking early advantage of technology to improve services and Scion extending wood-processing technology to help sewage disposal; and
- increases in Crown-owned companies' financial resources, allowing them to better manage uncertainty or invest in the future, such as maintenance and investment programmes at KiwiRail.

The quality and usefulness of planning information reported to Parliament about the performance of Crown-owned companies has also been a long-standing concern for my Office. In my view, planning information would be improved through shared understanding of, and expectations about, that information.

In working to maintain an eye on the future while governing, many Board members we interviewed acknowledged that it was easy to get too focused on details – to manage rather than govern. They told my staff that it took discipline to stay focused on strategy and to take a long-term outlook.

Some of the suggestions made in this report about how to stay focused on the future might seem to be – and are – common sense. Common sense is not always put into practice, but it works when it is. As one person put it: "There are no 'neat tricks' ... [future-focused governance] requires ongoing focus and commitment."

In my view, Boards dealing with the challenge of staying focused on the future within the public sector environment can learn more from each other and so improve their performance.

I thank the governance consulting business that helped with our interviews; the chairpersons, directors, chief executives, and monitoring agents of Crown-owned companies; and those involved in commercial model governance who took the time to share their views.

Lyn Provost
Controller and Auditor-General

5 February 2014

Part 1
Introduction

1.1 It has been more than 25 years since New Zealand set up a commercial model for governing and delivering some public services. Since then, different governance arrangements for entities using this model have evolved. However, all have fundamental features to allow Boards to manage Crown-owned companies for the benefit of all New Zealanders and for shareholding Ministers to be responsible to Parliament for the entity's performance.

1.2 This commercial model sought to transform the organisations that delivered those services into Crown-owned companies that are exposed to market disciplines and governed by boards of directors (Boards) that can focus on their company's future.

1.3 This report has been prepared as part of our work towards our 2012/13 theme, *Our future needs: is the public sector ready?* The future-focused governance of Crown-owned companies is important in helping the public sector to meet our future needs. Although there are many aspects to effective governance, we have focused on the ability of Boards and the governance system to support "future thinking" and to realise and adjust their company's strategy accordingly. This report focuses on examining how people are maximising, and can further maximise, the current legal arrangements and governance conventions.

1.4 The purposes of this report are:

- to set out for Parliament and the public some of the challenges in maintaining a future focus in governance; and
- to share lessons from members of the Boards of Crown-owned companies in dealing with these challenges.

1.5 The Crown-owned companies that we look at in this report – State-owned enterprises (SOEs), Crown research institutes (CRIs), and selected other Crown companies – control a sizeable portion of Crown assets, liabilities, and revenue. Together, these companies have:

- revenue of about $5.1 billion;
- liabilities of about $20 billion; and
- assets of about $28.3 billion.[1]

1 This includes Kiwibank's assets and liabilities– see Crown Ownership Monitoring Unit (2012), *2012 Annual Portfolio Report*, New Zealand Treasury.

1.6 These Crown-owned companies provide strategically significant services. For example, they ensure that:

- scientific expertise is used to increase economic growth;
- there is infrastructure for our electricity consumption; and
- our meat exports are safe.

1.7 In 2012, the workforces of the Crown-owned companies that we discuss in this report ranged from the 11 staff of Animal Control Products to the 7029 staff at New Zealand Post. The first SOEs were set up in 1987 and the first CRIs in 1992. Many of these entities were formed by commercialising previous public sector functions. Since then, new technologies or consolidations and reconfigurations of other functions have resulted in new Crown-owned companies, such as Plant & Food (2008) or Crown Fibre Holdings (2009).

1.8 Further changes are also occurring. For example, while we were preparing this report, decisions were made to wind up Learning Media and to sell Kordia's retail service provider, Orcon, to private investors. In the longer term, New Zealand Post has been considering how best to respond to declining postal use. KiwiRail has grappled with the appropriate classification of its assets. It has separated its public-good assets and the assets that can reasonably be expected to provide a return on investment. Also, some Crown-owned companies have struggled with the global financial crisis, and others have had new threats and new markets emerge.

How we carried out our special study

1.9 To get a range of perspectives for our special study, we considered three types of Crown-owned companies: SOEs, CRIs, and a selection of other Crown companies. We excluded those entities that already have a mixture of public and private shareholders (for example, Air New Zealand) and those that have been identified as suitable for partial sale to private investors (for example, Mighty River Power and Solid Energy). Figure 1 lists the Crown-owned companies covered in this report.

Figure 1
Crown-owned companies covered in this report

State-owned enterprises	Crown research institutes	Other Crown companies
Airways Limited Animal Control Products Limited AsureQuality Limited KiwiRail Limited Kordia Limited Landcorp Limited Learning Media Limited MetService Limited New Zealand Post Limited Quotable Value Limited Transpower Limited	AgResearch Limited Institute of Environmental Science and Research Limited Institute of Geological and Nuclear Sciences Limited Landcare Research New Zealand Limited National Institute of Water and Atmospheric Research Limited New Zealand Institute for Plant & Food Research Limited New Zealand Forest Research Institute Limited (Scion)	Television New Zealand Limited Crown Fibre Holdings Limited

1.10 This study draws on interviews, insights from experts, and analysis of written documents. We conducted 31 interviews. They included the chairpersons of all 20 entities and a selection of directors (experienced and new), chief executives, and monitoring agents.[2] We asked our appointed auditors for their insights, and other people involved in governance gave us their thoughts. We also analysed the financial statements of the Crown-owned companies in this study and the results of our recent audit work.

1.11 Interviewees and others were asked to discuss their experience not only in their entity but also in other companies, in public entities, and internationally. Westlake Governance, a governance consulting business, helped us with interviews and in ensuring that this report was relevant to Board members.

1.12 Our interviews were open. They were shaped by the matters that those we spoke to were willing to share and thought relevant. We sought views on:

- how to govern effectively with a focus on the future;
- what being part of the public sector means for Boards;

2 Monitoring agents (mainly the Crown Company Monitoring Unit within the Treasury and the Ministry of Business, Innovation and Employment) monitor the Government's investment in Crown-owned companies, help with the appointment of directors, and provide performance and governance advice to shareholding Ministers.

- challenges in focusing on the future and solutions to those challenges; and
- managing risks and access to capital with the Crown as shareholder.

1.13 In Part 2, we outline the general governance and accountability arrangements for Crown-owned companies. We also describe our previous reporting on these types of entities.

1.14 In Part 3, we consider what being part of the public sector means for Boards. This includes:

- managing the Government's long-term investments;
- comparing their entity's performance to comparable businesses; and
- having a clear purpose.

1.15 In Part 4, we discuss the feedback from our interviews about focusing on the future, the challenges that Boards commonly face, and suggested solutions to those challenges. This includes:

- the composition of the Board, including:
  – Board members' skill mix and team dynamic; and
  – the turnover of Board members;
- maintaining a future focus, including:
  – understanding the sector, industry, and commercial model; and
  – framing issues as strategic and long term; and
- communications, roles, and expectations, including:
  – the public sector context to the expectations of the Board and of shareholding Ministers;
  – quality information and the flow of information; and
  – creating opportunities to communicate.

1.16 In Part 5, we set out our analysis of Crown-owned companies' financial statements and the results of recent audits that shed light on the entities' capacity to respond to future needs. This includes:

- trends in managing assets; and
- being able to manage uncertainty, including:
  – the entity's proportion of fixed costs;
  – the entity's ability to meet current liabilities from available resources; and
  – the entity's ability to finance operations and investments (and deliver shareholder returns).

Part 2
Governance arrangements for Crown-owned companies

2.1 In this Part, we describe the governance arrangements for Crown-owned companies and our previous reporting on these arrangements.

2.2 The 1980s reforms that created the first Crown-owned companies were designed to make public entities and the public sector as a whole more effective and efficient. That task included transforming some public entities into Crown-owned companies run by Boards appointed from the private sector.

2.3 In the decades since, it has been increasingly recognised that Crown-owned companies, especially natural monopolies or providers of strategic services, might have "public good" purposes.

Governance arrangements in the commercial model

2.4 Among others, a company includes three groups of people:

- **Shareholders** are the owners of the company. They have the right to hire and dismiss directors, but it is not their job to run the company. If the company is incorporated with limited liability, the shareholders will not usually be liable (beyond the limit of their shareholding) for the company's debts or other obligations – for example, unpaid creditors or breaches of the law.
- **Directors** are legally responsible for running the company. They share ultimate accountability for the company's well-being and, in some instances, may be held personally liable for the company's debts and obligations. Directors collectively form the company's Board. In general, a decision of the Board is a collective decision that all directors are individually accountable for. This might be the case even if a director has disagreed with the decision.
- **Managers** put the decisions of the Board into practice. They follow the directions set by the Board. The chief executive of the company is the only person directly accountable to the Board. All other employees are accountable to the chief executive.[3]

2.5 In considering public sector management and accountability arrangements, it is not uncommon to refer to two parts of the public interest: an ownership interest and a purchase interest.

2.6 An ownership interest is an interest in ensuring that the resources of the entity are used efficiently and that the value of the entity is being maintained in line with the owners' objectives.

2.7 A purchase interest is the interest a purchaser has in the goods or services that an entity provides. The purchaser is concerned with specifying and receiving the desired quantity and quality of goods or services.

3 Westlake, R. (2013), *Guidance for the Directors of Banks*, International Finance Corporation Global Corporate Governance Forum, available at www.ifc.org.

2.8 The commercial model concerns the ownership interest. It can also achieve purchase interest aims. The rationale for public ownership might be in part financial gain and in part operational performance – such as the pursuit of a public policy objective. Public policy objectives include strategic national interest, the need to have public sector capability in a particular part of the economy, or the need to maintain democratic oversight of particular services.

2.9 As the owner of Crown-owned companies on behalf of the public, the Government manages investments for the benefit of all New Zealanders. Shareholding Ministers must account to Parliament for how Crown-owned companies perform and for their spending and use of other resources. Shareholding Ministers need relevant and timely information about these companies' performance to do that.

2.10 Figure 2 sets out governance arrangements and reporting relationships for Crown-owned companies.

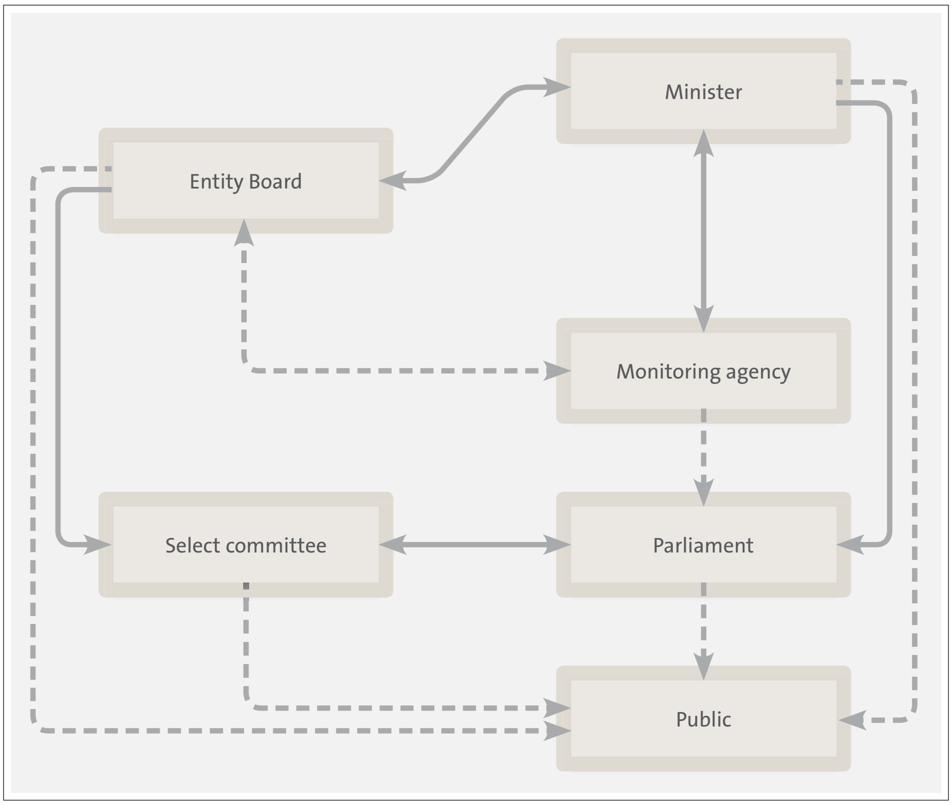
What the commercial model provides

2.11 The commercial model provides two main formal mechanisms to allow shareholding Ministers to hold Crown-owned companies to account and to influence their performance and direction.

2.12 The shareholding Minister appoints Boards, whose members are accountable and responsible for the company's performance and for reporting on that performance to the shareholding Minister.

2.13 The Minister(s) (with varying degrees of regulation, formality, and the involvement of other parties) can comment on, and sometimes direct changes to, the accountability statements of Crown-owned companies. These accountability statements include the statement of corporate intent for SOEs, the statement of corporate intent and statement of core purpose for CRIs, and the statement of intent for other Crown companies (we refer to these statements collectively as "accountability statements").

Figure 2
Formal governance arrangements for Crown-owned companies



Key:
Solid lines: Legislative and Cabinet-mandated governance and reporting relationships.
Dashed lines: Less formal governance and reporting relationships.

2.14 The accountability statements and the annual reports of each Crown-owned company are presented to Parliament and provide information about the company's objectives and performance. These documents are the company's statement to the public about how it has performed and how it intends to manage publicly funded capital investment and, in some instances, revenue.

2.15 The shareholding Minister sends an annual letter of expectation to the chairperson of the Board of each Crown-owned company. The amount of detail about the nature and number of expectations in these letters varies.

Our previous reporting about commercial model governance arrangements

2.16 We first reported on the accountability requirements of the commercial model in a report about SOE accountability statements in 1990.[4] We raised concern that the accountability statements presented to the House did not provide adequate information about SOEs' objectives, scope of activity, performance measures, and reporting obligations.

2.17 Our assessment was that the accountability statements did not provide enough information to meet the legislative requirements and that the SOEs were not meeting their accountability obligations to Parliament and the wider public.

2.18 In 1990, many SOEs expressed dissatisfaction with, and were reluctant to put significant effort into, preparing their accountability statements. Instead, they put effort into preparing their business plans. However, at the same time, several SOEs indicated that the accountability statement was an important document in setting overall operating targets. The business plan, unlike the accountability statement, is not a public document. We observed that the accountability statement should not require significant extra effort to produce because it is mainly a summary of the business plan.

2.19 In 1998, we noted that the requirement to prepare accountability statements had been applied, with slight modifications, to other entities, such as local authority trading enterprises, port companies, energy companies, and CRIs.[5]

2.20 In 1998, we reported that we had reviewed the accountability statements of selected SOEs, local authority trading enterprises, port companies, and energy companies. In doing so, we found a lack of compliance with the relevant legislative requirements. We concluded that not all of these entities were adequately preparing their accountability statements or adequately reporting against them. We considered that this situation reflected weaknesses in the legislative requirements, and poor entity and shareholder performance in preparing and reporting against the accountability statements.

2.21 We noted that the accountability statements are intended to be an important part of the framework for managing the ownership interest. They are intended to provide a public statement of how the Crown-owned company will manage and protect the owners' interest for the medium term, by requiring the entity to explicitly state its objectives and how it will measure its performance against those objectives.

4 Controller and Auditor-General (1990), *Report of the Controller and Auditor-General on Statements of Corporate Intent*, pages 5-6.

5 Controller and Auditor-General (1998), *Third Report for 1998*, pages 101-108.

2.22 The accountability statements provide an opportunity for shareholding Ministers, the public, and other interested parties to see that the Crown-owned company has plans that are consistent with the Minister's expectations as owners. Also, by requiring entities to report in their annual reports against the performance measures and standards set out in the accountability statements, the requirements provide a useful accountability mechanism to judge a Crown-owned company's performance.

2.23 In 1998, we reported that the accountability statements should:

- as a **public document**, inform the public of the activities and intentions of the Crown-owned company – as ultimate owner of these companies, it is critical that the public should be informed about the direction of these companies;
- as part of the **accountability process**, specify the objectives and related performance measures and standards against which the Crown-owned company can provide a public account in its annual report;
- as a **planning document** in its draft form, provide a valuable means for the Crown-owned company to get input from the shareholding Ministers into the direction of its business – especially when the company's business is required to take account of non-commercial objectives that the shareholding Ministers might be responsible for; and
- as a **relationship management document**, play an important role in providing assurance that the Crown-owned company will be directed in line with the expectations of the shareholding Ministers, and that the Board and management know the criteria that the shareholding Ministers will evaluate their performance with.

2.24 In a 2007 performance audit of 54 public entities, we found improved compliance with legislative requirements for performance reporting. These 54 entities covered CRIs and SOEs, as well as energy and port companies.[6]

2.25 However, we were still concerned that only a little more than one-third of the entities linked their performance reporting to their stated objectives. We were also concerned about how useful and understandable the performance reporting was. For example, although SOEs are required by law to be good employers and to exhibit social responsibility, there was no performance information about these objectives. One-third of the sample had at least some performance targets that could not be measured. Several entities used internal deliverables, such as producing business plans, as measures or targets. The accountability statements of 45% of the entities were unlikely to be easily understood.

6 Controller and Auditor-General (2007), *Statements of corporate intent: Legislative compliance and performance reporting*.

2.26 In March 2013, we drew attention to the new performance framework for CRIs, including the new statement of core purpose. We also drew attention to new requirements for CRIs to report their performance against that statement.[7]

2.27 Overall, we found that the reported performance in CRIs' annual reports is not strongly linked to the outcomes in their statements of core purpose. CRIs receive core funding to allow them to address the outcomes sought in their accountability statements. Each CRI's Board is responsible for deciding how to invest that core funding. The Board is also accountable for the CRI's success in fulfilling its core purpose, carrying out strategy, and achieving accountability statement outcomes. We noted that this is an essential part of CRIs' accountability to the Government and stakeholders.

7 Controller and Auditor-General (2013), *Crown research institutes: Results of the 2011/12 audits*.

Part 3
The commercial model and public interest

3.1 In this Part, we consider what being part of the public sector means for Boards. We describe three elements of the relationship between the commercial model, the public interest, and the Board's focus on the future. Based on these related perspectives, we observe matters that various people in the Crown-owned company governance system might need to consider further. We focus on the implications for maintaining a future focus, but some of the observations are also applicable to other aspects of governance.

3.2 In summary, there can be tension between the needs of an individual Crown-owned company and the public interest. These tensions include:

- balancing profit-seeking with long-term strategic interest and social responsibility;
- different information requirements than those in the private sector; and
- ensuring that the company's performance is compared to the right benchmarks.

3.3 We also found that being clear about the entity's purpose and how that purpose fits in the wider public sector context helped Boards, monitoring agents, and companies navigate their way through these tensions.

3.4 Creating single-purpose companies with profit-seeking aims and exposure to market forces was intended to make these companies and the public sector as a whole more effective and efficient.

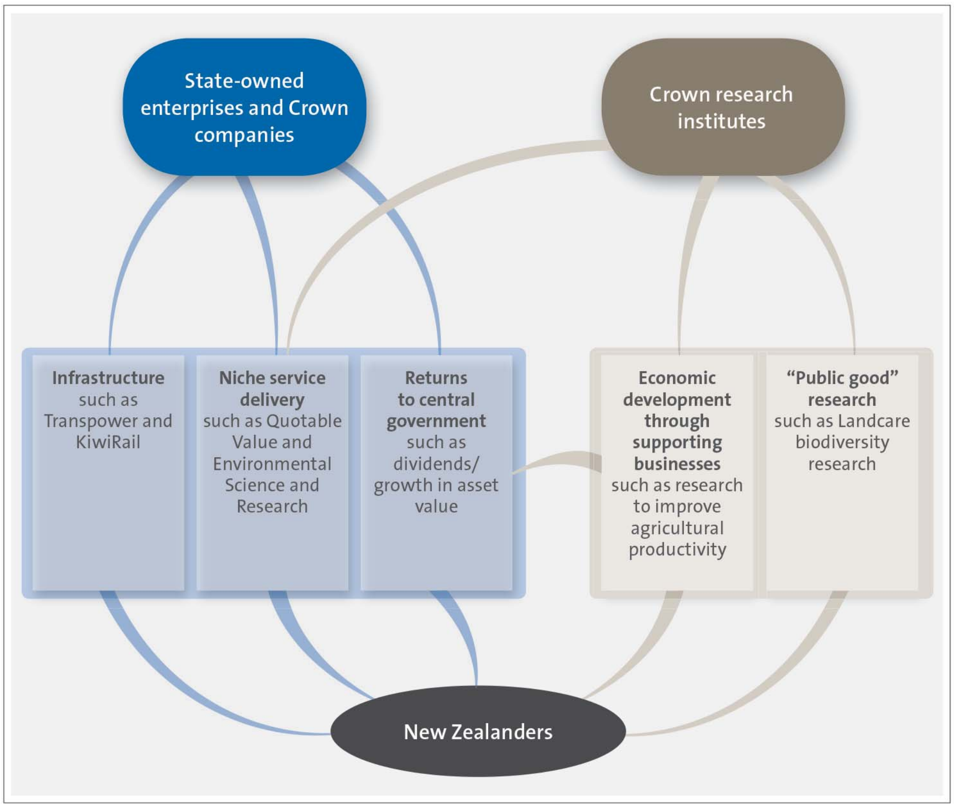
What we heard about the commercial model and its effect on future focus

3.5 Interviewees interpreted how the commercial model's principles should be applied when thinking about the future in two main ways, which reflected different understandings of their purpose and role in the public sector. The two ways of discussing the future were:

- creating value for the Crown-owned company's future (most interviewees had this perspective); and
- creating value for New Zealand's future (a view largely, but not exclusively, held by interviewees at CRIs).

3.6 As Figure 3 shows, the SOEs and other Crown companies in this study predominantly described their purposes in terms of infrastructure, niche service delivery, and returns to central government. A very small number of SOEs identified spill-over benefits of their work or capabilities that were available for "whole of government" use. CRIs predominantly identified their purposes in terms of economic development by supporting business and some public good research.

Figure 3
Main purposes of State-owned enterprises, Crown research institutes, and other Crown companies in this study



Managing the Government's long-term investments

What we were heard about balancing short- and long-term interests

3.7 A former Secretary to the Treasury, Graham Scott, has remarked that, in the 1980s, any tensions inherent in the commercial model were deemed inconsequential because commercial models were a "half-way" house to prepare entities for sale to private investors.[8] However, by 1997, it had become clear that the benefits of the model, and the strategic significance of some of the assets, meant that Crown-owned companies could be a permanent part of the public sector.

8 Scott, G. (1997), "Continuity and Change in Public Management: Second Generation Issues in Roles, Responsibilities and Relationships", in *Future Issues in Public Management* (State Services Commission seminar proceedings) .

3.8 Today, these tensions are being managed between the individual companies, monitoring agents, and shareholding Ministers. Interviewees described three main ways that these tensions affect them:

- Some chairpersons noted that the model expected companies to be commercially driven. However, mixed objectives, with profit and public interest motivations, had been introduced, sometimes without an appreciation of the effect on dividends and complications in demonstrating the value of this to shareholding Ministers, the public, and other interested parties and in accountability statements.
- The competitive environment sometimes induced Crown-owned companies and other Crown entities or departments to compete. Although the purpose of the model is to expose Crown-owned companies to competition and to ensure that they face the consequences of poor performance or obsolescence, it is also necessary to ensure that the public sector is not wasting resources or unnecessarily duplicating infrastructure or capability. Some interviewees expressed concern that acting in the best interests of the business, as required by relevant legislation, might not be the same as acting in the best interests of the public sector overall.
- Some interviewees asked whether the "one size fits all" approach to Crown-owned companies was appropriate because of differences in their roles, funding models, scale, growth potential, and activities.

Managing assets for public and profit purposes

KiwiRail realised that it had "public good" asset holdings (land under the rail corridor) and assets that could reasonably be expected to make a return on investment. Therefore, KiwiRail separated its public-good assets into a public benefit entity and retained other assets within the parts of the business that could, and should, be operated within the market disciplines of a commercial model.

Sharing expertise

Landcorp identified its practical experience in the farming industry as a strength that the Government used for international meetings and delegation visits to New Zealand. Landcorp was in the process of quantifying that contribution and determining the best way to show the value from these "whole-of-government" contributions.

Our observations on the inherent challenges for governing in the commercial model

3.9 As the owner of these Crown-owned companies on behalf of the public, the Government manages investments for the benefit of all New Zealanders. Along with their commercial incentives, many Crown-owned companies have strategic functions that the public sector and the public rely on.

3.10 There are questions about the extent to which Crown-owned companies should have public sector rights and responsibilities. The tensions include:

- constraints on seeking profit because of social and public responsibilities;
- different information requirements than the private sector; and
- difficulties choosing the right comparator to judge how commercial entities perform.

Comparing performance with similar businesses

What we heard

3.11 Many interviewees noted that Crown-owned companies are often compared to publicly listed companies, for which there is readily available financial information. When monitoring and judging performance, the choice of comparator is crucial in providing useful and relevant feedback for making decisions about the future.

3.12 However, forms of ownership, risk profiles, and shareholder expectations in the private sector are diverse and are not always comparable with Crown-owned companies. For example, SOEs', CRIs', and other Crown companies' different access to capital should affect expectations about their dividends and strategies (see paragraphs 5.19-5.24).

Our observations on understanding and comparing Crown-owned company performance

3.13 A range of comparators, benchmarks, and types of analysis could be useful in understanding how well companies perform and are governed. Although a lot of performance information about large publicly listed companies is readily available, this might not always be the best or only basis for comparison. Boards, monitoring agents, and shareholding Ministers need to be transparent about what they use to compare performance. Transparency is particularly important in showing why and how a comparator is relevant to the company. Transparency will ensure that Parliament, the public, and those involved in the governance of Crown-owned companies can understand descriptions of the companies' performance.

3.14 In paragraphs 2.16-2.27, we set out our previous work reviewing the accountability statements presented to Parliament and entities' reporting against these. The quality and usefulness of information has been a long-standing concern.

3.15 Reinforcing past reporting concerns, we urge members of the Boards of Crown-owned companies and those in monitoring positions to ensure that:

- they fully understand governance and ownership arrangements in the public sector; and
- the information provided through the shareholding Minister to Parliament is a clear account of the company's strategic direction and is supported by relevant performance information that is drawn from the company's current internal management information.

Having a clear purpose

What we heard about purpose and direction

3.16 Most interviewees were clear about the purpose of their Crown-owned company. Further, chairpersons, directors, and chief executives in the same Crown-owned company were consistent about purpose and direction. There was also consistency between the planning horizons[9] that interviewees discussed and those recorded in the accountability documents. For example, if interviewees discussed the future mainly in terms of expected events taking place in the next year, then their accountability statements focused mainly on the next year too.

3.17 There was less consistency between the interviewees' comments and the purpose and strategic direction in the accountability statements. Some interviewees stated explicitly that their company's accountability statements did not reflect their own views on the strategic direction of the company.

3.18 Interviewees told us that, at times, the Government's budgeting, planning, and election time frames were shorter than those of their entity – for example, when they were looking to enter new offshore markets. Many interviewees from CRIs remarked that the report of the Crown Research Institute Taskforce (the Taskforce) in February 2010 helped them develop a clearer purpose for their companies within the context of the wider public sector.[10] The Taskforce process enabled them to see their strategic contribution in the context of other CRIs, in the context of other government-funded entities, and with the aim of contributing to economic growth.

3.19 By contrast, a portfolio approach was not evident within SOEs, and only infrequent, informal collaboration took place. This was true even when they had shared challenges, such as applying effective governance techniques or managing the public sector aspects of Crown-owned companies.

9 A planning horizon is the time frame for a plan – for example, one year or 10 years into the future.

10 In October 2009, the Government set up the Crown Research Institute Taskforce to work out how New Zealand could get the greatest benefit from CRIs. Crown Research Institute Taskforce (2010), *How to enhance the value of New Zealand's investment in Crown Research Institutes*, available at www.msi.govt.nz.

Our observations about clear purpose

3.20 Crown-owned companies that were clear about how their purpose fits within the wider public sector context appeared to be better positioned to consider New Zealand's future needs. They were more confident that they could contribute to those needs while leading profitable companies. This was particularly observable in CRIs but also in some of the other companies.

3.21 To achieve this confidence, some companies appeared to benefit from considering and being familiar with the context of the Government as a whole, including financial position and risks, when creating and communicating strategy.

3.22 Some interviewees did not appear to have long-term strategies. Although the different purposes and circumstances of Crown-owned companies mean that various planning horizons can be appropriate, we question whether enough attention was always paid to periods beyond immediate projects and challenges.

Part 4
Finding solutions to governance challenges

4.1 In this Part, we outline the challenges in maintaining a focus on the future that interviewees commonly identified and that we observed.

4.2 Many of these challenges arise from the inherent tensions in the commercial model and, especially, differing expectations of how the model is supposed to work. Some Crown-owned companies had identified positive ways of addressing these tensions and of ensuring that they focused on the future. We outline some of these.

4.3 In summary, we observed that successfully focusing on the future seems to be built on good information flows supported by shared understanding and mutual respect. A shared understanding of performance should be the foundation of information flows so that monitoring and reporting does not become a compliance burden.

The challenges

4.4 Most interviewees mentioned two main challenges: the composition of Boards and finding ways to ensure that governance was focused on the future. Some interviewees identified other challenges in communications, roles, and expectations. Those who had addressed this latter group of challenges had more success in influencing government processes than those who had not.

4.5 Figure 4 shows the percentage of interviewees who mentioned each challenge during the 31 interviews that we carried out.

Figure 4
Challenges to future-focused governance that interviewees raised

Categories of challenges	Percentage of interviewees who mentioned the challenge
Board composition	93
Practices of future-focus governance	73
The right skill and personality mix	70
Communication, roles, and expectations	50
Expectations of Board and shareholders	41
Sector, company, and industry understanding	37
Maintaining a future focus	37
Board turnover	37
Quality information	13
Making use of communication opportunities	13
Information flow	10

Board composition

What we heard about Board composition

4.6 Interviewees recognised that Ministerial accountability meant that Boards must hold the trust and confidence of their shareholding Ministers. Two main factors about the composition of Boards were important to our interviewees:

- the right skill mix and team dynamic; and
- turnover – having the flexibility to ensure an appropriate amount of Board turnover while retaining institutional memory within the company and throughout the monitoring arrangements.

Board member skill awareness

One prospective Board member researched what skills government Boards needed through publicly available information and through personal contacts. She then matched her existing skills, personality, and development goals to the needs of a particular Board and waited for an opportunity to apply to join it. She was successful.

Skill mix

4.7 Many interviewees told us that processes for appointing Board members had improved over time and were generally better at taking account of skills and relevant experience than in the past. However, some interviewees were concerned that there was not enough attention paid to the appointee's fit with the current Board culture and team dynamic.

4.8 Some interviewees told us that they had made opportunities to discuss with their monitoring agents and shareholding Ministers the particular skills and working styles they needed to achieve their strategy. Those who had done so reported success in securing the skills they sought for their Board. Others said that they were powerless in this and other accountability processes (see paragraphs 4.26 and 4.36).

4.9 In one instance, two interviewees from the same entity were concerned that, although a recent Board appointee had significant expertise in the public sector and Crown-owned company knowledge, they did not bring the strategic IT skills that had earlier been identified as lacking in members of this particular Board. (The limited availability of people with strategic IT skills was a concern shared by members of several Boards.)

4.10 The interviewees were not aware that the appointment reflected the entity's need for the new appointee's public sector skills. This example shows the importance of recognising what and when particular skills are needed, and having a shared understanding of future needs.

Turnover of Board members

4.11 Turnover of Board members was raised as a concern by 37% of interviewees. Changes in Board members, executives, monitoring staff, and shareholding Ministers created a significant risk to institutional memory not only within Boards but also in other parts of the governance system. This is because high turnover means people are in "new learning" mode and are not always able to draw on past experience when making decisions about the future.

Learning more about commercial entities in practical environments

Several CRI chairpersons told us that, collectively, their Boards visited each other's research sites to discuss issues and ideas with frontline staff and each other. They did this to remain focused on the future and connected to the issues.

4.12 Many interviewees argued that, for Boards of more complex Crown-owned companies, there was merit in allowing directors to serve longer than the perceived norm of two terms (six years). A few interviewees also felt that a Board member leaving the Board earlier than the norm was seen as a reflection of poor performance, rather than making room for changing skill needs.

4.13 One appointed auditor we heard from also noted that uncertainty about Board appointments, including extensions to appointments, distracted people from focusing on the future. Some interviewees suggested that this problem could be dealt with by staggering the appointment process more, so that there is an overlap between new and experienced members, rather than replacing several members at the same time or in quick succession.

Our observations about the composition of Boards

4.14 Appointing Board members is one of the main ways that shareholding Ministers ensure that Crown-owned companies perform in keeping with the public sector context.

4.15 Board members of Crown-owned companies that had well set out accountability statements reported more success in securing the skill mix and team dynamic that they thought they needed for the Board. We concluded that these Crown-owned companies are proactive in communicating, whether through accountability statements, through appointment processes, or by creating communication opportunities. Because they could convincingly and consistently show how and why they needed particular skills, they were in a better position to influence appointment processes and other considerations.

4.16 In our work for this study, we found no evidence of a "right term" for Board members. We found a consistently emphasised principle that being able to contribute in the entity's current context should determine the term of appointment. Not paying enough attention to Board turnover could have a significant effect. This is especially so if changing Board membership is considered in isolation, rather than within the context of the turnover of monitoring agents and Ministerial portfolios as well.

Maintaining a focus on the future

What we heard about maintaining a focus on the future

Knowledge of the public sector, industry, and commercial model

4.17 All interviewees mentioned the need for Board members to have appropriate knowledge and training. Lack of institutional knowledge and knowledge gaps were recognised as risks for all Boards. Improving the knowledge of Board members is vital to managing these risks. However, 61% of interviewees raising this issue knew of Board members who were not using professional development budgets and Board members who did not always combine practical learning opportunities with paper-based reviews of the industry or entity.

4.18 More than 40% of interviewees said that, as well as focusing on the needs of individual Board members, development budgets should address the needs of the Board and the Crown-owned company. Some took a "whole of government" perspective, noting that Boards could co-ordinate needs and use collective budgets to create learning opportunities targeted at several Crown-owned companies.

4.19 Although few interviewees wanted more training programmes, they said that directors and the Board as a whole needed practical help. Several interviewees suggested a need for more sources of practical information and advice from experienced Board members, as well as opportunities for learning from others.

4.20 At present, informal networking fills this need. Many interviewees thought that more formal arrangements could help. Introductory courses and events held by the Treasury's Crown Company Monitoring Unit (COMU), the Institute of Directors, and the New Zealand Institute of Chartered Accountants provide some opportunities. Internet-based learning, including blogs (such as www.boardsrus.net), is another source. However, the interviewees said there was limited opportunity to access experienced experts who could provide the targeted, succinct, and timely help that Boards need.

Dedicated strategy thinking time

Airways, NIWA, Crown Fibre Holdings, and others noted that strategy thinking time was used effectively when it was early in a meeting and when members had prepared for the discussion. This discussion often included setting aside dedicated time to ask what value the Board had added to the company. This was an opportunity to focus on whether the Board had improved the company's ability to contribute to New Zealand's future, whether the formal strategy was being achieved, and whether the company was in a better financial position because of the Board's actions.

Taking a long-term view through forecasting

Transpower's long-term forecast to 2040 has transformed the way the Board considers asset management practices. The same forecast is also made available to other industry entities to ensure that they co-ordinate in the long term.

Framing issues as strategic and long term

4.21 For Boards to focus enough on the future, defining success is important. This definition is unique to each organisation. However, it needs to be generated within the context of the public sector commercial model. As a result, achieving clarity and full buy-in from all Board members and other people in the governance system can be a more complex task for a Crown-owned company than for a listed or privately owned company.

4.22 Thirty-seven percent of interviewees noted it is easy to lose sight of the "big picture", particularly if a matter is being debated in a high-pressure environment, such as in the media or during an inquiry. All Crown-owned companies recognised some uncertainty in their operating environment. The challenge, as one interviewee put it, is to "learn to manage through uncertainty". Interviewees suggested various ways to ensure that the Board remained focused on the future.

Board reviews and other formal and informal reviews

Board reviews are an opportunity to reinforce a culture of future-thinking, if the review considers the achievement of future-focused goals.

Many long-serving chairpersons, Board members, and chief executives noted that the formal Board review process was taken more seriously in recent years and that valuable changes took place in Boards as a result.

For example, AgResearch and Crown Fibre Holdings used their annual Board reviews and Board paper reviews to improve the quality of debate through better information.

Our observations about maintaining a focus on the future

4.23 Some of our interviewees' suggestions for building knowledge and staying focused on the future were practical, simple, and common sense. Despite this, we found that simple and practical steps are not always put into practice. We observed that Crown-owned companies that were highly focused on the future usually had particularly uncertain environments, whether in their operating environment or because of a crisis in their organisation. These companies had thought about their purpose and how best to achieve their goals. They had analysed what the future might hold. New Zealand Post and KiwiRail, for example, stood out because they had used a major threat or crisis to stimulate positive change, rather than ignoring it.

Setting goals and expectations

Transpower, MetService, Scion, New Zealand Post, Airways, Crown Fibre Holdings, and other Crown-owned companies set Board goals or a charter to ensure that they remain focused on the strategic issues and consider the future implications of operational matters.

4.24 There are also "quiet achievers" that have been experimenting with innovation to ensure that their people and assets are best placed to respond to new opportunities, regardless of any significant threat – for example, MetService, Scion, AsureQuality, Plant & Food, and Geological and Nuclear Science.

4.25 This innovation has been recognised in case studies in internationally recognised journals. One of these described the technological innovation at MetService, New Zealand Post (Kiwibank), and Quotable Value.[11]

4.26 Fundamental to Board members being able to anticipate future needs is developing appropriate business and public sector knowledge. Interviewees who had tried to get exposure to practical industry and public sector contexts were better able to articulate and communicate their future needs (and had more success in influencing other parts of government, see paragraphs 4.8 and 4.36).

Making a new technology part of business as usual

To improve the accessibility of current weather information, MetService adopted social media early. Weather forecasts are available through social media when and where people and organisations need them. MetService has more than 11,000 followers on Twitter and about 19,000 Facebook "likes" – see our 2013 report, *Learning from public entities' use of social media*.

4.27 Crown-owned companies that made a conscious effort to reframe a matter in terms of strategic needs or long-term goals appeared to have considerable success in addressing immediate issues in a way that led to enduring solutions. Those experimenting and innovating to ensure that their people and assets were best placed to respond to new opportunities appeared to be those most likely to identify and use those opportunities.

Building capable managers

The Airways Corporation's succession planning programme includes employing people at the senior level who are capable of doing their manager's job and then training them to do so. This is part of the MANA (Making A New Airways) project.

Communications, roles, and expectations

What we heard about communications, roles, and expectations

4.28 For Boards and shareholding Ministers to make good decisions and for monitoring agents to provide support for decision-making, interviewees identified three interrelated building blocks: clear expectations, good information, and communication.

The public sector context in relation to the expectations of Boards and shareholding Ministers

4.29 About half of the interviewees told us that it was important for Boards to understand the expectations of their shareholding Ministers. They also said that it was important for Boards to provide those Ministers with their perspective on the major initiatives, concerns, and risks their company is dealing with. The formal process for communicating expectations includes the letter of expectations that shareholding Ministers send to Crown-owned companies each year, and a manual that outlines shareholding Ministers' expectations of the companies fully or jointly owned by the Crown.

11 Kearins, K., Luke, B., and Verreynne, M-L. (2010), "Innovative and entrepreneurial activity in the public sector: the changing face of public sector institutions" in *Innovation Management, Policy & Practice*, 12(2), pages 138-153.

4.30 Some interviewees said that they had sought and created other opportunities to better understand the context in which shareholding Ministers, monitoring agents, and the other main stakeholders worked. Those who sought to understand these contexts were better placed when tensions arose within the Crown-owned company, within the industry, or more widely.

4.31 Monitoring agents and Crown-owned companies told us that they were able to manage tensions and difficult situations constructively when the company, the shareholding Ministers, and the monitoring agents shared an understanding of the Board's performance and capability, and of the company's role. More effective communication occurred when Boards, Crown-owned companies, monitoring agents, and shareholding Ministers had a consistent understanding of context, processes, and expectations.

Sharing the narrative of the Crown-owned company's strategy

The chairperson of Plant & Food uses his consultancy techniques to help the Board and managers use the same language and shared understanding of team work.

At the direction of the chairperson of the Institute of Environmental Science and Research, the Board spent time "learning the language" of the main stakeholders.

4.32 Pressured situations or those with high media exposure can complicate this clarity. Interviewees described circumstances where shareholding Ministers interacted directly with chief executives to obtain real-time information. When the Board meets less frequently, measures need to be in place to ensure that all parties understand the expectations and roles in changing circumstances.

Quality information

4.33 All interviewees told us that good information was essential to success. Several interviewees told us that good information relies on Crown-owned companies collecting and analysing information about strategy, performance, risk, and opportunities.

4.34 Many interviewees also said that they had seen a general improvement in Board papers over time. These interviewees said that Boards had to improve managers' understanding of the Board's role and responsibilities so that the Board received relevant information in a better format.

Creating opportunities to communicate

Because the shareholding Minister(s) is the only shareholder in a Crown-owned company, annual general meetings might not always be a priority for the Minister(s) because they can communicate at any time. As a result, some Crown-owned companies have turned annual general meetings into wider stakeholder meetings.

The stakeholder event helps shareholding Ministers to prioritise attendance, so that the Minister can hear what other stakeholders want from the company as well as discussing their own expectations with the company.

4.35 Board papers improved when companies had considered and debated the information that the Board might find useful for monitoring operations and assessing the achievement and development of the company's strategy.

Companies that had improved the quality of information had focused on effectively condensing a lot of information. This included using summary financial information and visual aids that highlight trends and variations in results.

Experimenting with integrated reporting

New Zealand Post released its first annual report using the integrated reporting framework in October 2013. Interviewees told us that feedback on the new reporting format has been very positive from a range of stakeholders.

The report won the 2013 NZICA Best Sustainability Reporting Award.

New Zealand Post will continue to work with the integrated reporting concepts, specifically the six capitals, throughout the year and assess the benefits of the framework.

Information flow

4.36 Some interviewees described a sense of powerlessness when working in the public sector context and especially when communicating with monitoring agents (see paragraphs 4.8 and 4.26). These interviewees perceived that monitoring agencies did not always use company information as much as they could when advising the shareholding Minister. They perceived that information flows "one way". We noticed that, in some instances, companies did not know that their understanding of governance arrangements and expectations differed from that of monitoring agents.

4.37 Many of the same interviewees suggested that reporting and compliance burdens could be lower and that there were unnecessary compliance costs in the commercial governance model. Interviewees felt, for example, that the extent of Parliamentary scrutiny that they experienced, such as select committee review, varied.

4.38 In contrast, people who knew more about government processes and the public sector context were able to maximise the value gained from information used for accountability requirements. These people recognised that the requirements provided information that allows the company's performance to be scrutinised and were an opportunity to communicate with decision-makers. They used the commercial governance model and other process requirements to maximise the future potential of their company and to shape the understandings that shareholding Ministers and Parliament had of their capability and performance.

Creating opportunities to communicate

4.39 Interviewees told us that focusing on the quality of their information and communication to a wide range of stakeholders helped their companies achieve their strategies and ensure that accountability obligations were met.

4.40 Interviewees told us that, as a result, they had had considerable success dealing with many matters, including Board appointments, accountability statements, and communicating with stakeholders and other parts of government. For example, although some interviewees perceived COMU and the Treasury as a

Clarify expectations and discuss performance proactively and openly

For the Ministry of Business, Innovation and Employment (MBIE), the type of monitoring relationship that would enable it to improve the quality of its advice to Ministers has the following main characteristics:

- good two-way communication; and
- robust discussions of future strategy and proactively sharing information about context, potential challenges, and strategic intentions.

MBIE told us how one such monitoring relationship worked in practice. Using a Crown entity as an example, it described the transformation of a relationship from "difficult" to "very good". The strategies that had changed included being proactive about identifying and discussing concerns. Collectively, MBIE and the entity used the following strategies to improve matters:

- creating opportunities to better understand each other's perspectives, such as frequent engagement with senior management, developing a relationship with the Board (in particular, the Chair), and positive engagement at other stakeholder meetings; and
- MBIE being transparent about how it used information from the entity, its value-adding analysis, and the "whole of government" context in which it advised the Minister.

These strategies had helped the Board, entity, and monitoring agent to understand each other's perspectives, needs, and sources of information. They allowed the entity to test ideas for developing the entity in a safe environment that was closely attuned to shareholders' needs.

"one-way mirror", others told us how well they worked with COMU to ensure that shareholding Ministers were well briefed. They believed that two-way sharing of information, between monitoring agent and/or shareholding Ministers and the Board about the needs of the Crown-owned company and the government, enhanced achievements.

4.41 Interviewees identified that communications strategies are particularly important when two or more Ministers are involved with the portfolio. COMU, the Ministry of Business, Innovation and Employment, and other officials might need to ensure that good communication strategies are in place when two or more Ministers consider the performance of a Crown-owned company. When only one Minister dealt with all matters about, and the policy context for, the company, it was easier for the Minister to see the Crown-owned company from a strategic perspective. When the roles were split, good communication between Ministers, officials, and Crown-owned companies became more important for ensuring that a future focus was maintained.

Our observations about communications, roles, and expectations

4.42 The success of the governance models for Crown-owned companies is built on good information that supports shared understanding and mutual respect.

4.43 Boards are responsible to shareholding Ministers for how their Crown-owned company performs and to shareholding Ministers and the public for reporting on that performance. A Board must try to give the shareholding Minister confidence that it understands the Minister's expectations. Clear and aligned understanding of roles and responsibilities allows Boards to produce concise and well-tailored information to help decision-making.

4.44 Boards, managers, shareholding Ministers, and monitoring agents need shared understanding of the inherent tensions between the public and private sector models and mutual respect for each other's responsibilities. Each Board needs a shared understanding with their shareholding Minister and monitoring agent of:

- the context of the Crown-owned company within the public sector;
- the Crown-owned company's objectives; and
- the Crown-owned company's performance, including the performance and capability of the Board.

4.45 This shared understanding should form the foundation for information flows between all the parties involved in the governance of Crown-owned companies to inform future-focused decision-making and avoid becoming compliance burdens.

4.46 There are reporting and monitoring risks in the commercial model governance arrangements. Mainly, these risks are:

- that a Crown-owned company's independence is threatened or circumscribed in some way – in particular, if there is general public dissatisfaction with the Crown-owned company's performance; and
- creating a "compliance burden" – for example, through overly detailed letters of expectation and other regular and irregular reporting and information requests.

4.47 A compliance burden could arise where processes for company staff to consult, liaise, and report to monitoring staff duplicate or render ineffectual the Board's oversight and governance role.

4.48 Monitoring agencies have been improving their monitoring and ability to engage with Boards. It will be interesting to observe the improvements over time.

Part 5
Future-focused governance in practice

5.1 In this Part, we outline some observations about how Boards are financially preparing for the future. We describe what the financial statements and our survey of asset management tell us about trends in future-focused governance over time and what interviewees told us they experience when trying to earn dividends and raise capital.

5.2 Overall, we found evidence of longer-term thinking, good asset management, and reserves for addressing unexpected events. We also found a more "negotiated" dividend policy than occurs in the private sector (see paragraphs 5.19-5.24). We observed that these differences should be considered when determining expectations of Crown-owned companies.

Being able to achieve future-focused governance

5.3 The way a Crown-owned company's financial resources are organised and managed provides insights into how much emphasis there is on future-focused governance – in particular, the company's capacity to manage uncertainty (or risk) and invest for the future.

Trends in managing assets

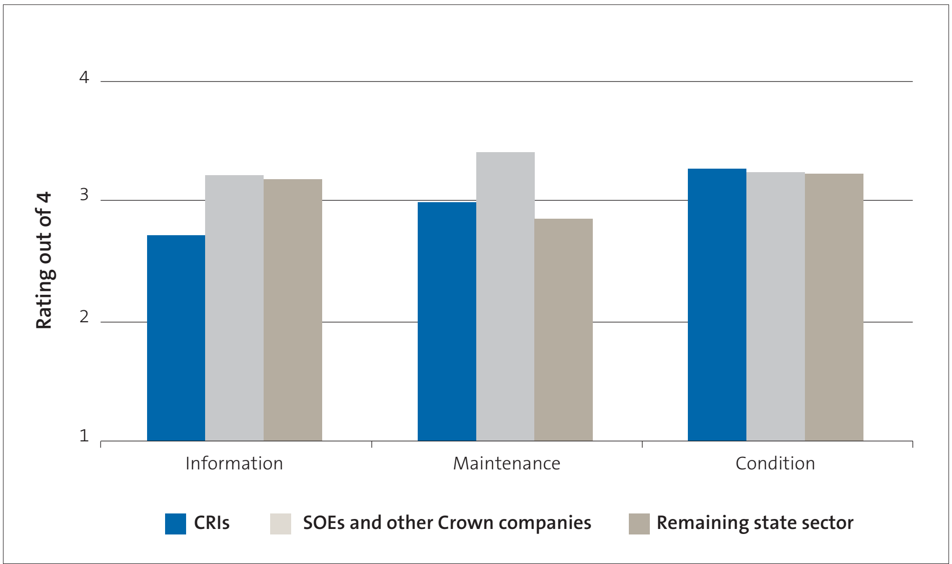
5.4 Asset management plays a significant role in ensuring that resources are able to deliver future services in a resilient and sustainable way. We recently asked the auditors of SOEs, CRIs, and other Crown companies, as well as more than 340 other public entities with physical assets of more than $2 million, to rate how well asset management was practised throughout the public sector.[12] The findings were published in our discussion paper, *Managing public assets*. We asked our auditors to rate the following elements of managing (physical) assets on a scale from one to four:

- the quality of information ("information");
- planned maintenance and renewals ("maintenance"); and
- the current condition of assets ("condition").

5.5 Figure 5 shows some results from *Managing public assets* for SOEs, CRIs, other Crown companies, and the other public entities involved. The higher the score, the better asset management is in practice.

12 Crown Fibre Holdings and Quotable Value were not part of the asset management survey because their physical assets are worth less than $2 million.

Figure 5
Managing public assets – public entities' average ratings for information, maintenance, and condition



Note: For Information, a rating of four means that an entity holds enough information to ensure that all assets that provide services are kept in a condition that supports the continuing delivery of services. A rating of one means that the entity holds no such information. For Maintenance, a rating of four means that maintenance and renewal is in keeping with the plan. A rating of one means that the entity is not following a maintenance and renewal plan at all. For Condition, a rating of four means that the asset is in very good condition. A rating of one means that it is in poor condition.

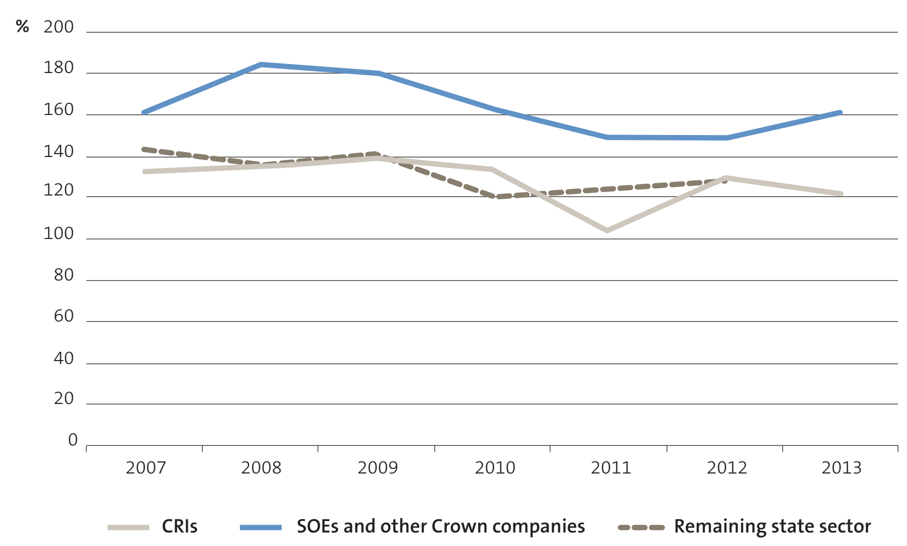
5.6 The CRIs and SOEs and other Crown companies have different kinds and amounts of assets. For example, some companies have strategically significant physical assets, such as Transpower, and others have physical assets with limited monetary value, such as Crown Fibre Holdings. Others are focused on developing intellectual property, such as CRIs. Despite these differences, the commercial model assumes that private sector discipline will improve asset management practices. We noted that the averages for SOEs, CRIs, and other Crown companies were (in most instances) better than the averages for the remaining state sector entities.

5.7 Further evidence of the quality of Crown-owned companies' long-term asset management can be seen by comparing capital asset spending with what an accounting assumption suggests is reasonable (depreciation). We collected this information from the audited financial statements of each entity from 2007 to 2012.[13]

13 Crown Fibre Holdings Limited was set up to manage the Crown's investment in broadband infrastructure in October 2009. Its first full-year financial statements were for the year ended 30 June 2011. We have not included it in these results.

5.8 As Figure 6 shows, from 2007 to 2013, the average annual percentages indicate that all the categories of public entity are investing above the depreciation level.[14] As a group, SOEs and other Crown companies are investing more than CRIs and the remaining state sector entities. The difference reduced between 2007 and 2012 and slightly increased in 2013.[15]

Figure 6
Public entities' capital expenditure compared to depreciation, 2007-2013



Note: Wherever possible, we have endeavoured to include 2013 data. However, there are different reporting dates for different entities. At time of publication, 2013 data for all of the remaining state sector was not available.

14 SOEs and other Crown companies have been grouped as one category because of the small number of other Crown companies in our study.

15 For all of the following graphs, which are based on audited financial statements, we have made judgements in collecting and analysing the data. Our aim is to identify underlying trends, rather than record the diversity of accounting policies and treatments. Therefore, we have included figures as displayed in the headline statements, even if the figures are made up of slightly different components. For example, some entities use depreciation alone in their headline statements, while others include impairments. Also, to isolate general trends, we capped extreme one-off events. For example, a one-off billion dollar cash injection because of a new project in one year of the six would distort the general trend for more usual capital expenditure and depreciation.

Being able to manage uncertainty: Flexibility and buffers against shocks

5.9 Being able to deal with the future and having options for addressing future challenges depends on many factors, including Crown-owned companies being able to reallocate financial resources and manage liabilities as they fall due.

5.10 The information in annual reports provides some evidence of how well Crown-owned companies are able to manage future challenges and uncertainties. To show this, we looked at three aspects of the financial statements:

- the proportion of fixed costs;
- the ability to meet current liabilities from available resources; and
- the ability to finance operations and investments (and deliver shareholder returns).

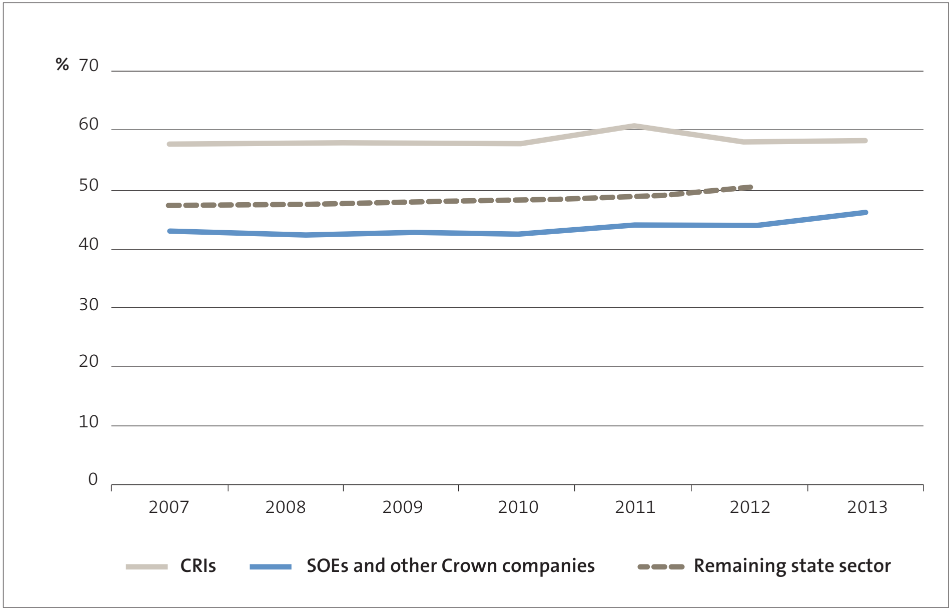
5.11 In general, although we found that most SOEs, CRIs, and other Crown companies have the capacity to manage future uncertainty, SOEs and other Crown companies, as a group, have been better positioned financially for achieving future-focused governance than CRIs.

The proportion of fixed costs

5.12 Fixed costs usually include full-time personnel, interest, and depreciation (as a proxy for renewal capital expenditure). To show the flexibility to respond to changing circumstances in the short term using only one indicator, we compared fixed costs to the entities' operating and investing cash outflows. A proportion of 100% means that all costs are fixed and cannot be easily changed.

5.13 As Figure 7 shows, CRIs have the least flexible cost structures, with fixed costs ranging from 59% to 63% of operating and investing cash outflows. As a group, SOEs and other Crown companies have a relatively more flexible cost structure, with lower fixed costs than the average for the remaining state sector entities.

Figure 7
Public entities' fixed costs as a percentage of operating and investing cash outflows, 2007-2013



Note: Wherever possible, we have endeavoured to include 2013 data. However, there are different reporting dates for different entities. At time of publication, 2013 data for all of the remaining state sector was not available.

Being able to meet current liabilities from available resources

5.14 Being able to manage current liability obligations in times of change allows more freedom to focus on future challenges and opportunities when they arise. To show this capacity, we compared current liabilities with current assets over time. A proportion above 100% means that there are enough current assets to cover current liabilities. This indicates a greater potential to focus on the future.

5.15 From 2007 to 2012, the averages are all about or above 100%, indicating that current liabilities are reasonable and should not unduly limit how well companies respond to future uncertainties. For SOEs and the remaining state sector entities, the proportion is well above 100%. CRIs showed an increase from 97% in 2007 to 120% in 2013.

Being able to pay for operations and investments (and deliver shareholder returns)

5.16 A Crown-owned company's ability to raise finance should affect its strategy, appetite for risk, governance, and shareholders' expectations. As a group, CRIs have little debt financing. They also now have stable core funding. It remains to be seen whether this funding change will help make CRIs better able to manage uncertainty and invest for the future.

5.17 The situation for SOEs and other Crown companies is different. Interviewees had mixed views on their ability, politically and economically, to raise finance from the Government or the private sector. Figure 8 outlines SOEs' debt compared to their assets for each SOE (the square dots) from 2007 to 2013. A proportion of 0% indicates that an SOE has no debt. The range in each year is the difference between the square dots, and the average over time is represented by the dashed line starting in 2007 and ending in 2013.

Figure 8
State-owned enterprises' and other Crown companies' total debt compared to total assets, 2007-2013

5.18 From 2007 to 2013, the average for SOEs and other Crown companies shows debt declining as a percentage of total assets from 21% in 2007 to 17% in 2012, and rising slightly in 2013 to 19%. This profile is different for entities in the private sector, where entities can have debt levels at 40%-60%, depending on their appetite for risk.[16] Although this comparison implies that SOEs could have more debt, current debt may reflect a more risk-averse attitude from Boards or their shareholding Ministers. The Treasury's Long-Term Fiscal Statement advocates for overall government debt levels to be at, or below, 20%.

5.19 Some SOEs understood from their shareholding Minister that their main contribution to the public good was increasing dividends to the Government. However, the Boards of Crown-owned companies have a duty of care to ensure that the entity remains solvent after that dividend has been paid.[17] Therefore,

16 Acceptable proportions of debt to assets are disputed and depend on many things, including how asset-intensive the industry is. For example, see Cecchetti, S., Mohanty, M., and Zampolli F., (2011), "The real effects of debt", in Bank for International Settlements, *Working paper No. 352*, http://www.bis.org/publ/work352.htm.

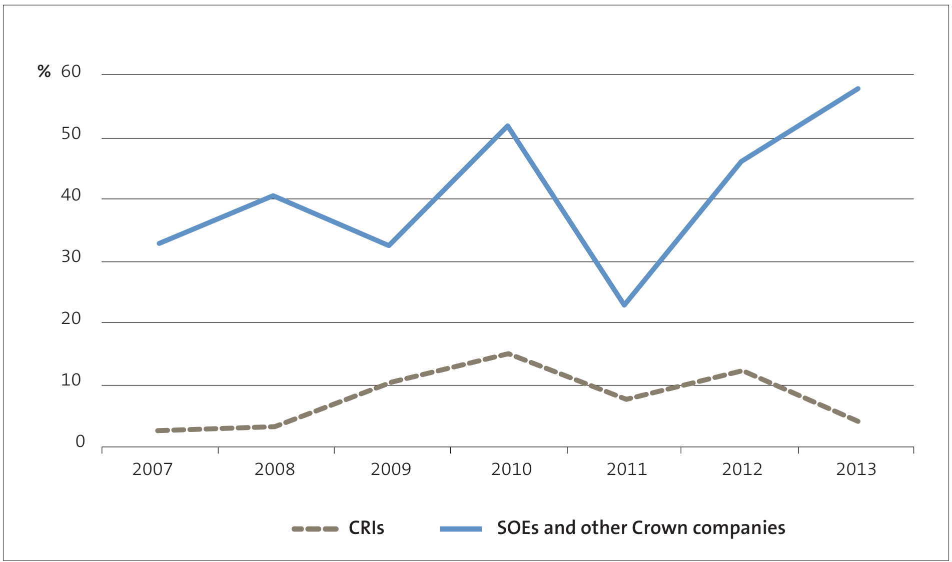
17 As in section 4(1) of the Companies Act 1993.

there is an inevitable trade-off between shareholder return expectations and retaining enough funds to manage future operating and investing decisions.

5.20 Some interviewees perceived that the Government had a mainly short-term focus on dividend expectations. At times, the interviewees considered that this was at the expense of current/future investments. The interviewees perceived that dividend streams were directed by the Government and affected retention of capital for investment. The interviewees thought it difficult for Crown-owned companies to raise new equity capital. Some suggested that there was a need to distinguish between the different funding requirements of mature and growing SOEs, CRIs, and other Crown companies.

5.21 In considering this, we looked at dividends paid as a proportion of the net operating cash flows available from 2007 to 2013. As Figure 9 shows, when SOEs and other Crown companies paid dividends, they were, on average, between about 30% and 60% of net operating cash flows. SOEs and other Crown companies had a higher "payout" proportion than CRIs.

Figure 9
Crown-owned companies' dividends as percentage of net operating cash flows, 2007-2013



5.22 From a future-focused perspective, Figure 12 shows that, when paying dividends, SOEs and other Crown companies retain between about 40% and 70% of their net operating cash flows for their future investing and financing needs. CRIs retain about 90% to 95%. Six of the 12 SOEs and other Crown companies and four of the seven CRIs declared no dividends for three or more of the six years shown. One SOE also reinvested some or all of its declared dividends into the business from 2008 to 2011.

5.23 The variability in dividends and "payout" proportions over time could suggest that, for SOEs, CRIs, and other Crown companies, dividends are more "negotiated" than the dividends of private sector companies. For listed companies, dividends are valued as a relatively stable cash return to shareholders and any equity funding requirement is usually arranged by separately issuing additional shares.[18]

5.24 This could mean that Crown-owned companies and listed companies have different views on how to prepare for the future.

What we observed about Crown-owned companies' financial ability to respond to future needs

5.25 Together, our analysis of the financial statement information and our asset survey shows evidence of longer-term thinking and better asset management in Crown-owned companies than in other state sector entities. It also shows appropriate financial management. It suggests that the commercial model can help Boards to focus on the future and that Crown-owned companies are in a position to deliver future-focused governance.

18 Although the actual relationship between stable returns and company value may be disputed (see Gwilym, O., Morgan, G. and Thomas, S. (2000), "Dividend Stability, Dividend Yield and Stock Returns: UK Evidence", *Journal of Business Finance and Accounting*, 27(3) and (4), pages 261-281), many companies still try to maintain stable cash returns to signal company value and stability to the market.

Appendix
Governance arrangements of Crown research institutes and State-owned enterprises

We outline below some of the specific differences in the governance and funding arrangements of CRIs and SOEs. Every CRI, SOE, and other Crown company (including their subsidiaries) is defined as a public entity for the purposes of the Public Audit Act 2001 and is therefore audited by the Auditor-General.

Governance arrangements for Crown research institutes

CRIs were set up under the Crown Research Institutes Act 1992 to carry out research for the benefit of New Zealand. CRIs provide a range of scientific and advisory services and operate as companies with a particular and distinct science or research purpose.

The governance structure is the same for all CRIs. The shareholding Ministers (the Minister of Finance and the responsible Minister, which is currently the Minister of Science and Innovation) appoint the Board, which is accountable to the shareholding Ministers for the CRI's performance.

Boards of CRIs are required to produce an annual statement of corporate intent, an annual report, and a half-yearly report, all of which the responsible Minister must present to Parliament for scrutiny.

Since 2009, CRIs have been required to hold annual general meetings with the shareholding Ministers or their representative. At these meetings, the Board describes and accounts for the CRI's activities during the past year.

CRIs are required to promote, and help to apply, the results of research and technological advances and to maintain their financial viability.

The report of the Crown Research Institute Taskforce (the Taskforce) in February 2010 led to considerable change for CRIs and for science research funding and policy agencies.[19] The Government's objectives have been to:

- increase the benefits from science-based innovation;
- simplify funding and monitoring; and
- move responsibility and accountability for investment decisions.

The changes included:

- a statement of core purpose setting out the enduring purpose and focus for each CRI;
- balance sheet reviews by the monitoring agent;

19 In October 2009, the Government set up the Crown Research Institute Taskforce to work out how New Zealand could get the greatest benefit from CRIs. Crown Research Institute Taskforce (2010) *How to enhance the value of New Zealand's investment in Crown Research Institutes*, available at www.msi.govt.nz.

- the requirement for each CRI to prepare its statement of corporate intent in close consultation with its sector groups, related businesses, and other end users;
- moving significant funding from funding agencies to CRIs, so that each CRI Board receives core funding (direct Crown funding), with the amount and percentage varying for each CRI;
- CRIs receiving an investment (and accountability) role in strategy and allocating resources;
- a new set of key performance indicators for CRIs that give weight to the financial viability requirement and the requirement to deliver research that benefits New Zealand; and
- moving the main responsibility for monitoring CRIs from the Treasury's Crown Ownership Monitoring Unit (COMU), first to the Ministry of Science and Innovation, then to the Ministry of Business, Innovation and Employment. (COMU retains a role monitoring how CRIs perform financially.)

Governance arrangements for State-owned enterprises

SOEs were set up under the State-Owned Enterprises Act 1986 (the SOE Act). As registered companies, they are bound by the requirements of the Companies Act 1993.

The SOE Act defines an SOE's main purpose to be as profitable and efficient as comparable businesses that are not owned by the Crown. Each SOE is required to be a good employer and to show a sense of social responsibility. Each SOE's accountability statement describes the SOE's specific purpose.

Part 3 of the SOE Act details specific accountability requirements and the information to be provided to shareholding Ministers and Parliament. An SOE is required to present an annual accountability statement and annual and half-yearly reports on the accountability statement to Parliament. The accountability statement:

- is fundamental to a Board's governance responsibilities to the shareholding Minister;
- discloses in advance the SOE's objectives and scope of operations, among other things, for the three-year period;
- discloses the basis on which the Board will be held accountable at the end of the financial year; and

- provides a basis for informed public debate about matters such as:
  - the corporate objectives of each SOE and the nature and scope of activities that they carry out;
  - any non-commercial obligations that the SOE accepts and the manner and amount of compensation; and
  - how profits should be used.

In the past, these information requirements were a significant difference between public sector and private sector companies. However, changes in the disclosure requirements of the Australian Securities Exchange suggest that expectations of the information disclosure by private sector companies are increasing and that the "gap" between public and private sector disclosure requirements is reducing.

An SOE has two shareholding Ministers – the Minister of Finance and a responsible Minister (normally the Minister for SOEs). COMU is the monitoring agent for shareholding Ministers. It provides those Ministers with advice on SOEs' performance. COMU helps in appointing Board members.

In its 2013 report for the Treasury Review of Monitoring of Solid Energy, Deloitte set out the main changes in SOE monitoring arrangements from 2008 to 2013:

- In 2009, shareholding Ministers introduced a regime for larger SOEs to keep the public informed on matters that could have a material effect on an SOE's commercial value. Deloitte reported that this was extended to all SOEs from 2012.
- In 2010, COMU moved its focus from helping executives to more independently assess the Board and a move from a narrow "performance against plan" assessment to a broader performance focus supported by benchmarking and increased public scrutiny of performance.
- In 2010, the Minister's letter of expectations set out a desire for Boards to modify dividend policies to become more commensurate with listed companies and for more consistent and improved payout levels over the years.[20]

20 Deloitte (April 2013), *The Treasury: Review of Monitoring of Solid Energy*, chapter 5, pages 17-31.

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