

## Local Authority Governance of Subsidiary Entities

### Controller and Auditor General – March 2001

(The number in the margin is the paragraph number from the Report)

Summary of Recommendations	Project Group's Comments
<p>260 We make a number of recommendations on three subjects:</p> <ul style="list-style-type: none"><li>• Roles and responsibilities;</li><li>• Governance structures; and</li><li>• Monitoring and accountability arrangements.</li></ul>	
<p>261 Our recommendations are indented primarily for local authorities. However, effective governance relies on constructive, well-understood relationships among a number of different parties. In particular, governing bodies and individual board members play an important part in making governance arrangements work. We encourage all parties to consider how our recommendations could usefully be applied to their own circumstances.</p>	
<b>Roles and Responsibilities</b>	
<b>Responsiveness to the Expectations of the Public Owner</b>	
<p>262 A local authority should ensure that a subsidiary entity's board is responsive to its expectations as a public owner, without compromising the board's responsibility as the governing body to direct and control the conduct of the entity's business. In consultation with the board, the local authority should establish:</p>	
<ul style="list-style-type: none"><li>• Director selection and appointment processes which required non-councillor directors to have a sound understanding and acceptance of the wishes, needs and priorities of the public owner, and the needs of the community.</li><li>• A clear statement outlining the council's expectations of the board, including a commitment by the board to "no surprises" on matters likely to cause community concern or have political implications.</li><li>• Periodic forums for discussion between the board and Councillors on strategic business issues and ownership objectives; and</li><li>• Ongoing communication between the council and the board chairperson, and between entity executives and local authority officers, on matters of common interest.</li></ul>	<ul style="list-style-type: none"><li>• Section 9 of the draft Trust Deed sets out the Trustee appointment process including the desirable experience and skills of Trustees.</li><li>• The purpose of the Trust outlined in the Trust Deed. Expectations are included in the Operating Charter, Services and Supply Agreement and Customer Charter.</li><li>• There are no particular references to forums in the documents at present, but could be included.</li><li>• Regular reporting framework outlined in the documents.</li></ul>

**The Accountability of a Non-profit Entity**

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

- A service agreement framework is drawn up within which the entity can be held transparently accountable for the use of ratepayer funds or assets; and
  - Performance monitoring is undertaken at arms-length and with reference to a clear and agreed set of expectations.
- Services and Supply Agreement proposed.
  - The Trust is required to report back to its “owner” Councils.

**Appointing the Governing Board of a Non-profit Entity**

264 A local authority should:

- Document clearly its processes for appointing the governing body of a trust or other non-profit entity; and
  - Consider following processes similar to those used for board appointments to commercial trading enterprises.
- Unit Holder agreement proposed amongst the three Councils.
  - Could be included in the Unit Holder agreement.

**The Role of the Local Authority Chief Executive Officer**

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

- Be kept fully informed of all material matters about the local authority’s subsidiary entities.
  - Take no part in the internal governance of subsidiary entities. In many local authorities this advisory role will be delegated to local authority managers – who also should not, as a rule, sit on the governing bodies of subsidiary entities.
  - Be assigned formal responsibility for reviewing, or commissioning regular reviews of, the local authority’s interests in subsidiary entities and for putting policy options to the council based on those reviews.
- Currently CEOs play active role for existing Trusts. Would expect this to be the same.
  - The draft Trust Deed does not preclude Councillors or Council Officers from being Trustees, but notes ideally this should be resolved before the Deed is finished.
  - Each Council to direct the CEO on what is required regarding the Trust.

**Governance Structures**

**The Role of a Holding Company**

266 to 268 A local authority with a holding company should:

- Not directly relevant as the Trust is not a company.

**Joint Ventures**

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

- Not directly relevant as the Trust is not a joint venture.

**Trusts and Other Non-profit Entities**

270A local authority should:

- Specify key accountability arrangements when setting up a trust or other non-profit entity;
- Draw up a formal service agreement that documents the scope and purpose of the association between the entity and the local authority, defines the services to be provided, and specifies how the entity will be held to account for the delivery of those services.
- Follow an objective process for appointing the governing body, based on a documented set of competencies relevant to the functions and activities of the entity;
- Establish a means (conceivably in the context of its own annual planning process) for the local authority to approve or endorse the entity's philosophy, direction and strategies, planned programmes and activities, financial and non-financial targets, and outcome measures; and
- Put in place an agreed framework for regular reporting against stated measures of performance, in order to provide the local authority with information as to how the entity is meeting the terms of its service agreement and contributing to the achievement of agreed outcomes.

- Trust Deed, Operating Charter and Customer Charter cover this point.
- Draft Services Agreement included in the project report.
- The Trust Deed and Unit Holder Agreement can achieve this requirement.
- Councils must consult on annual plan, which will include their expenditure.
- Accounts, audit and reporting requirements covered in the Trust Deed.

**Group Structures**

271A A local authority should ensure that it: (comment about investment opportunities)

Not relevant as the Trust is not allowed to deviate from its core activities.

**Monitoring and Accountability Arrangements**

**Information Flows**

272A Local authority should:

- Seek strategic information, as necessary, in order to manage its investments as a diligent and informed investor; and

- Extensive reporting already allowed for through the various documents.

- Where necessary, negotiate arrangements for the supply and handling of commercially sensitive information.

#### **Business Planning and the SCI**

273A A company board should consult its shareholding local authority on the key features of the board's business plan, and brief the authority on the strategic outlook for the company.

274 Drawing on the business plan and strategic outlook, a local authority should:

- Review its interests in light of issues facing the company; and
- Use this information as a framework against which to consider the draft SCI and the local authority's options as an investor.

#### **Disclosing Corporate Governance Practices**

275 A company board should:

- Include in its SCI a corporate governance statement disclosing how the board propose to conduct its business and discharge its obligations; and
- Outline in the company's annual report how those commitments and obligations have been met.

In other parts of the "Local Authority Governance of Subsidiary Entities" the Auditor-General examines the governances and associated issues for Watercare Services Ltd, Infrastructure Auckland, The Canterbury Landfill Joint Venture Project, trusts and other non-profit entities.

Although Watercare Services is a limited liability company and a LATE, there are several issues raised by the Auditor General which are relevant. The following pages comment on these points.

- Not covered at present. However, the Trust could be directed to provide the Unit Holder Group with commercial information if the Councils thought this was appropriate.

- Not entirely relevant as the Councils have a statutory obligation to ensure the water services are provided.

- The Operating Charter is effectively equivalent to a statement of corporate intent.

- Although the entity is a Trust and not a company, the various documents cover this point.

- It is expected the Trust's annual report would cover this issue.

## Watercare Services Ltd

### Conclusions and Recommendations

- 360 Our analysis points to inherent tensions in governance arrangements. Tensions in the relationship between WSL and the local authorities in their dual roles of shareholder and customer arise from:
- Confused roles and responsibilities, leading to competing incentives for the local authorities as shareholders and as customers.
  - Expectations about the manner in which WSL will conduct its operations. WSL is expected to follow a corporate commercial model, applying business disciplines to management of infrastructure, but also to adopt a pricing regime which has regard to a range of public interest considerations.
  - A governance framework which precludes the shareholding local authorities from pursuing the normal interests (value maximisations for potential sale and a dividend stream) of commercial owners.
  - Weak incentives for cost efficiency and limited measures for benchmarking performance given the single supplier status of the company.
- 361 The Act recognises these tensions. It requires the local authorities to exercise their ownership rights in the public interest. At the same time, it preserves a commercial structure (other than the restrictions on dividends and selling out) to the extent that the governing body of WSL has the usual powers and rights of a company board along with significant powers to set prices.
- 362 Structures and ownership throughout the water industry create the potential for similar tensions over pricing and investment issues. We identified a need to manage the competing interests inherent in the current governance arrangements for WSL. To date these arrangements have generated incentives and behaviour that present obstacles to the long-term resolution of these underlying tensions.
- 363 WSL operates under legislation that was intended to be temporary. The previous Government's proposed review of the water industry in New Zealand has not made significant progress. Uncertainty about the future of water and wastewater services in the Auckland region has not promoted effective business planning and strategic decision-making.
- Less confusion with the proposed Trust. It is a cost minimiser with a service delivery function. Its purpose is to carry out the requirements of the councils.
  - The Trust will be commercial, but not profit driven. Pricing is set by the councils not the Trust.
  - The Trust will not pay dividends. Hence value enhancement is not an objective.
  - It is expected the Trust will partake in industry benchmarking initiatives.
  - Powers of the Trust are very restrictive.
  - Councils determine pricing and investment through funding policy and approving Trust requests for funding.
  - Several deficiencies in the local authority legislation and the Wellington Regional Water Board Act have been recognised, but remain a constraint.

- 364 However the Auckland region's local authorities are currently carrying out a review of regional water, wastewater, and stormwater services. We suggest that the Government gives careful consideration to its findings, and we recommend that, as soon as practicable, the Government declare its intentions for the structure of the water industry in Auckland. A sound and effective governance structure and long-term certainty need to be provided to both WSL and its shareholding local authorities.
- 365 In the interim, WSL and its shareholders should take every step to improve their relationships. Immediate steps that could be taken are:
- Negotiating long-term contracts between WSL and its customers; and
  - Developing a comprehensive protocol between WSL and its local authority shareholders to define the roles and relationships between the company and its owners and customers.
- 362 We understand that, since the time of our study, discussions have continued on negotiation of contracts and development of a protocol. We encourage the parties in their efforts to put their relationships on a firm business footing.
- Government appears to be considering changes to the water industry, as indicated by a statement from the Minister of the Environment in April 2001.
  - The various governance documents for the Trust specify the roles and relationships between the Trust and the Councils.

## Comments of the Controller and Auditor General

### The Role of Councillors on Governing Bodies (Trusts and Other Non-profit Entities)

649 Views differ in local government on the merits of appointing councillors to be directors or members on the governing bodies of commercial or non-profit entities. Of the four local authorities we reviewed, only one had a practice of appointing councillors to the boards of non-profit entities. We explored the benefits and disadvantages of councillor appointments.

650 Arguments in favour of appointing councillors to governing bodies of non-profit entities include:

- Aligning their activities with the outcomes sought by the local authority;
- Overcoming the difficulty of specifying desired outcomes in contractual terms;
- Lifting the profile of the entity in the community; and
- Reflecting the social and community focus of the entity's activities.

651 Local authority representation can be seen as necessary to:

- Align the direction of the entity with the objectives and priorities of the local authority;
- Secure local authority support for strategic initiatives; and
- Co-ordinate and rationalise the activities on non-profit entities performing complementary functions.

652 Local authority representation can also be seen as a way to provide a mechanism for monitoring performance, to communicate with the local authority, and to be a voice for the interests of the community.

653 Councillor appointments may also have the following significant disadvantages:

- Trustees and members of governing bodies are expected to give priority to the interests of the stand-alone entity, and they have certain legal and professional obligations.
- Councillors face a potential conflict between their roles as trustees or board members and their interests as elected representatives.

- Direct involvement of councillors in the internal governance of the entity may also inhibit the effective operation of an arm's-length accountability relationship with the local authority. This may make it more difficult to hold the governing body to account for its performance. In particular, a strong councillor presence on the governing body has the potential to undermine the operating independence of the stand-alone entity.
- Councillors are unlikely to have the time and resources to analyse and monitor the performance of the governing body objectively. In our view, this monitoring role is best assigned to local authority officers.
- In their role as members of the governing body, councillors may become personally liable for the decisions of the body.

### Selecting and Appointing Councillor Directors (Commercial Trading Enterprises)

- 766 In our 1994 report we commented on the roles of councillor directors on the boards of commercial enterprises. In this study we heard a variety of arguments for and against such appointments.
- 767 The benefits of appointing councillor directors include:
- Providing a local authority voice on the board: and
  - Making the company more sensitive and responsive to community views.
- 768 Concerns about such appointments include:
- Councillor directors may face difficulties in reconciling their dual roles as councillor and company directors; and
  - Local authority representatives may be expected to pass information from the company to the shareholding local authority outside established communication channels, which is inappropriate behaviour.
- 769 Some local authorities have a policy of appointing councillors to the boards of their commercial trading companies. Of the ten companies we reviewed, only three boards did not include a councillor representative.
- 770 Councillor Directors need to have commercial skills, background and experience to make a fully informed contribution to board discussions. A formal process for selecting directors is an effective way to meet this requirement.



771 One holding company periodically sought expressions of interest from councillors wishing to be appointed to the boards of the local authority-owned companies. The skills and experience of those interested can then be assessed against the competencies for appointment to a board. This preserves the transparency of director appointments. It also ensures that all councillor appointees have the necessary competencies to fill director positions and participate fully in governance of the company.