What Works?

A report for Wellington City Council on getting the best from council-controlled organisations
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August 2012
Acknowledgements

Appreciation is extended to the more than thirty people in local and central government in New Zealand, who are involved in the governance of arm's-length entities and who have shared their thoughts and experiences. The discussions with these people have assisted significantly with the development of this report.

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## Glossary

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<td><strong>Arm's-length</strong></td>
<td>Where governance is exercised by a separate board of directors or trustees.</td>
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<td><strong>Council-controlled organisation (CCO)</strong></td>
<td>A trust or company on which a council controls more than 50% of the shareholding or the right to appoint trustees/directors.</td>
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<td><strong>Council-controlled trading organisation (CCTO)</strong></td>
<td>A CCO that trades and was established to make a profit.</td>
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<tr>
<td><strong>Council organisation (CO)</strong></td>
<td>A trust or company in which a council owns or controls less than 50 percent of the shareholding or right to appoint directors/trustees.</td>
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<tr>
<td><strong>Crown Ownership Monitoring Unit (COMU)</strong></td>
<td>Treasury's Crown Ownership Monitoring Unit monitors the government's investment in companies/entities owned by the Crown, assists with the appointment of directors, and provides performance and governance advice to Ministers.</td>
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<td><strong>Crown entity</strong></td>
<td>A Crown entity (from the Commonwealth term 'Crown') is an organisation that forms part of New Zealand's state sector established under the Crown Entities Act 2004, a unique umbrella governance and accountability statute. They do not include SOEs.</td>
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<td><strong>Local Authority Trading Enterprise (LATE)</strong></td>
<td>The statutory precursors to CCOs.</td>
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<td><strong>Long-term plan (LTP)</strong></td>
<td>Each council has to prepare a long-term plan every three years, covering at least the next ten years.</td>
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<td><strong>State-owned enterprise (SOE)</strong></td>
<td>State-owned enterprises (SOEs) in New Zealand are registered companies listed under Schedules 1 and 2 of the State-Owned Enterprises Act 1986. Most SOEs are former government departments or agencies. The function of SOEs is to operate successfully as a business, as profitable as those not owned by the Crown.</td>
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<tr>
<td><strong>Statement of intent (SOI)</strong></td>
<td>A document produced by a CCO or Crown entity annually, to be agreed by the shareholder.</td>
</tr>
<tr>
<td><strong>State Services Commission (SSC)</strong></td>
<td>In addition to its general role regarding the performance of the public sector, the Commission has a role in providing information on the appointment, governance and monitoring of Crown entities and other government boards and bodies</td>
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Executive Summary

1. A review of arm's-length models used in local government in New Zealand and at central government in New Zealand and overseas has identified a number of consistent and straightforward findings about getting the best from arm's-length entities. In local government, this is about getting the best from council-controlled organisations (CCOs), while in central government these include Crown entities and state-owned enterprises (SOEs).

2. A key point to start with is that there is no single "right" way to get the best from arm's-length entities such as CCOs. However, the same messages have come through repeatedly. Getting the best from arm's-length entities is about the following factors:
   - Clarity about the organisation's purpose and strategic direction.
   - Clarity around the organisations' roles and behaviours.
   - Getting the right people, in the governance and management roles.
   - Building and maintaining transparent and accountable processes.
   - Building and maintaining effective relationships.

3. If these factors are in place from the beginning, and there are review cycles in place to rethink the context in which arm's-length entities are operating, there is a much stronger likelihood of success. When the levers and tools that support these factors are used consistently, there is also a stronger trust relationship in place. It is important to understand that the same or similar activities as performed by an entity can perform well or badly within a parent organisation too, and success 'in-house' will benefit from similar attention to these factors.

4. It is also important for all parties to remember that the entity is operating in a public and therefore a political environment, and that the owners will probably be expecting more than just a financial return. The owner will often also be funding or purchasing services from the CCO and will therefore have a significant interest in service performance. These factors all add complexity to the relationship between the owner and the entity, and mean that the ways an entity approaches its objectives and the manner in which it will be held to account will differ to a privately owned entity.

Why will these key conditions get the best from a CCO?

5. **Clear purpose and strategic direction.** Having a clear and commonly understood direction is critical to the right things being done. If the owner does not or cannot articulate what its overall and specific objectives are for the entity, the entity will seek to fill the gap itself. In doing so, the entity will make decisions best for the entity, rather than for the owner or necessarily for the wider community. It is also highly likely that in these circumstances, a divergence of purpose or activity can occur and the owner will start to be disgruntled that the entity is not well aligned with it, nor meeting possibly unspecified expectations. This is the space where dissatisfaction with the arm's-length model often occurs.
6 Clarity around the respective roles (ownership, governance, purchase, performance monitoring) that each entity will have. A common understanding of these roles, both between and within the parent and arm's-length organisations, is a key component. Without common understanding, expectations cannot be achieved and the council and the CCO may start to move (albeit unintentionally) along divergent paths. Likewise, the different relationships such as owner and purchaser need to be overtly articulated and distinctly managed, rather than bundled together. Avoiding duplication of roles between the owner and the entity is also important. There is no point in both entities operating in the same space. All parties need to understand that the council remains accountable to the ratepayers for the funding and performance of these entities, and there needs to be transparency in the decision-making and the reporting to enable this.

7 The right people in the right roles. The directors/trustees and the CEO of a CCO or other arm's-length entity should have the right skills and expertise for that organisation and for the "age" of the organisation. Appointing directors or trustees is one of the key responsibilities of the council, and having robust processes in place to appoint the right people is important; as is thinking carefully about the option to remove them (usually an action of last resort). Having a skills matrix specific to the entity is important, as appointing a director who is skilled at governing a mature or a large organisation may not be appropriate for a small start-up entity, for example. By bringing in directors or trustees for arm's-length entities, additional passions and expertise can be tapped from people that might otherwise not stand for elected office.

8 Transparent and accountable processes. This is about not just doing it right, but letting others see that you are doing it right. Not everyone will always agree with specific decisions or results from arm's-length entities, but there is often less concern when the decision-making processes are transparent. The transparency underpins the accountability by allowing others to see the journey that is being travelled.

9 Effective relationships. There need to be effective formal and informal relationships in place. It has come through clearly that the 'soft' relationships (the interactions outside of the standard performance reporting) are often what create trust and make the overall relationships work. In a local government context, this can be regular meetings between the Mayor and CCO Chairs and regular meetings at CEO level, as well as regular reporting to council committees etc. If these relationships are not managed at the senior level, the cultures of the both organisations are more difficult to influence. When a CCO or other entity is performing at or above expectation, there is likely to be a stronger level of independence for the entity (perhaps demonstrated by less regular meeting cycles). However, it is to the benefit of all the parties involved to maintain an appropriately close relationship, as that trusted independence can easily disappear when the operating environment changes or a key performance area is not met. This is a two-way responsibility.

10 In many respects, the relationships between organisations are like the relationships between people. The terms 'parent' organisation and sub-entity or 'child' are useful in thinking about the relationships between organisations. When a new entity is established, there are likely to be teething problems as the roles and relationships are understood. The boundaries are likely to be tested as the 'teenager' grows up, and a 'mature' relationship between parent and 'adult' child, whilst on a more even keel, will require a review of their respective roles from time to
time. Thinking about where specific council/CCO relationships are placed along this continuum can sometimes assist with problem solving. It may help to identify actions that can get the relationship through difficult patches more quickly. A review may require going well back through some of the basic aspects of the relationship and the expectations set (or not so well set), to reconsider where the relationships are presently and what will improve expected performance going forward.

What about when it goes wrong?

11 The report outlines various ways to systematically support the formal and informal components of the relationships. One thing that has come through repeatedly is that while it is necessary to scale some of this activity according to the size or strategic nature of the arm's-length entity involved, the less attention that is paid to the integrity of the factors identified above, the more likely there will be a deviation in performance. Where directors are not appointed on merit, for example, governance is likely to be less effective; and when the objectives are not well aligned with the 'parent's' expectations, the entity will doubtless define its own priorities and act accordingly.

12 When a CCO is not performing to expectations, a good place to start is reviewing whether the conditions above are appropriately in place before moving to formal interventions. A key question is whether the CCO itself is not performing, or has the context in which it is operating changed significantly?

13 If it is about individual performance, like other 'owners', Councils have a set of formal interventions. These formal interventions include cutting funding where there is a purchase arrangement in place, replacing directors or trustees (either when their terms expire or earlier), or in more extreme circumstances disposing of an entity or bringing the activity back in-house. It is more than likely that there will be disadvantages from these latter courses of action, unique to the specific circumstances, which also need to be understood. Depending on the nature of the problems at hand, working back through the factors above – with the CCO or other entity – may achieve the changes necessary.

14 The environment and operating circumstances do change over time, and the improvement in performance that might have initially been achieved will not necessarily be maintained. International observers comment that there are cycles of governance that seem to occur, not unlike the cycles that are observed within organisations. Building in a regular review cycle to reassess current requirements and relative alignment with the council's strategic direction will enhance the owner's overall confidence in performance.

Consistency of approach

15 This report identifies that there has been a lot of effort, both now and over the last two to three decades, to seek to improve the overall outcomes that can be delivered for citizens using arm's-length entities.
What is clear is that there is no single ‘right’ way of delivering different services. The individual context, the outcomes sought, the level of public interest or consumer interest, and whether the activity is entering a dynamic or mature phase of operation will all influence a decision. Another point is that delivery in-house or at arm’s-length will not of itself guarantees satisfaction with the performance of an activity; as dissatisfaction can occur with in-house delivery too.

There are, however, real similarities in the conversations in New Zealand and internationally about what increases the likelihood of success. Where there are clear purposes and commonly understood roles, the right people and effective relationships, and consistently applied and transparent processes, getting high performing and aligned CCOs is much more likely. Similarly, the more there is deviation from such recommended practice, the more likely it is that there will be dissatisfaction with the entity’s performance.
Introduction

Wellington City Council (WCC) has commissioned advice on the ways in which it can get the best from its council-controlled organisations (CCOs).

In New Zealand, councils can deliver activities directly, by contract through private providers, or through various arm's-length entities (CCOs, council-controlled trading organisations (CCTOs) or council organisations (COs) – which may be trusts or companies etc). Likewise, central government delivers many of its activities through arm's-length entities in the wider state sector, in the form of state-owned enterprises (SOEs) and Crown entities.

The current framework for CCOs began with the accountability and transparency provisions introduced for local authority trading enterprises (LATEs) in 1989. These were enhanced to cover both commercial and non-commercial entities in 2002. The discussion in this report generally relates to CCOs, but the points are usually applicable to CCTOs and to COs.

Wellington City Council wants to identify from current practice in local and central government "what works?" when it comes to councils' ownership, governance, purchase and monitoring roles regarding their council-controlled organisations. The Council wants to be sure that its own approach is as good as it can be, to help achieve its objectives for Wellington.

While the Council operates and is most interested in the local government model, much of the thinking that has been undertaken on arm's-length models has been focused at the national level – be it in New Zealand or internationally. However, whether they operate at the national or the local level, and whether they are large or small, commercial or non-commercial, they are all underpinned by similar ownership, governance and monitoring issues.

This report discusses the lessons from central and local government models, based on an extensive literature review of New Zealand and international practice and a range of interviews with officials in councils and departments responsible for supporting shareholders' interests in a variety of arm's-length entities.

A variety of ownership, purchase and monitoring practices has been identified. While there are differences in current practice, there is also an increasingly common understanding about what it takes to make the model work better and the levers that can make a difference – albeit scaled according to the individual circumstances of the entity.

The report looks at the various aspects of the arm's-length model, from factors to take into account when considering if it may be appropriate to establish them, through the direction-setting process, and the annual and review cycles. It seeks to identify key factors which, in combination, should be able to deliver an effective operating model where owners can have confidence their entities are meeting their communities' needs.
Context

Wellington City

Wellington City Council has eight Council Controlled Organisations (CCOs) that have been established over the last 25 years. These organisations have been set up to deliver significant council services, manage council facilities and/or undertake developments on behalf of the Wellington community – activities as diverse as joint water supply (Capacity), the Zoo and Positively Wellington Tourism, and the management of the art gallery and the Carter observatory.

The CCOs were established individually, in response to specific needs or circumstances that arose over time. They were not established within a deliberate framework; the Council does not have a policy on when it will or will not use arm's-length entities. Many factors have altered in the period since some of these entities were established, both with the environments within which each CCO operates and the environment for the Council. There is also a desire within the Council that the entities could be better aligned with the Council's objectives and with each other. In addition, the Council has recently adopted for Wellington a new strategy – Towards 2040: Smart Capital (and long-term plan) and it needs the support of its CCOs to become a connected city, an eco-city, a people-centred city, with a dynamic central city.

These factors are Wellington specific, but have triggered the Council to commission a review of its CCOs, including:

- a review of current practice in New Zealand and overseas (in establishing, aligning, performance monitoring, etc) arm's-length entities,
- a comparative analysis of Council's current practice and recommendations for a deliberate framework for future CCOs, and
- an overall review of the effectiveness and general efficiency of the Council's current model of CCOs and identifying options for improving the organisational model (if appropriate).

This report addresses the first aspect of this review, the current practice in New Zealand and overseas.

The broader context

There are other factors too that indicate it is an appropriate time to consider the approach the Council takes to managing its CCOs.

New Zealand, like many other countries, first introduced arm's-length entities in the 1980s as part of public sector management reforms. However, as with any organisational change, expectations of improved performance continue. Communities expect better service levels and preferably not for increased cost.

In 2002, and taking into account the report of the Office of the Auditor-General (OAG) Local Authority Governance of Subsidiary Entities 2001, the legislation regarding local authority trading enterprises (LATEs) was updated to provide for council organisations (COs) and council-
controlled organisations, including trading organisations (CCOs and CCTOs). This accountability and transparency regime requires statements of intent (SOIs) and regular reporting cycles for each entity.

33 In 2004, the OECD identified that reforms for efficiency were not enough, and that more focus was required in the areas of governance, strategy, risk management, the ability to adapt to change, collaborative action, and the need to understand the impact of actions within communities for initial benefits from these changes to be sustainable. This has underpinned an ongoing focus on progressively enhancing public sector governance models.

34 In response to this, the Crown Entities Act 2004 provided a consistent framework for the establishment, governance, and operation of Crown entities. It clarified accountability relationships between Crown entities, their board members, their responsible Ministers on behalf of the Crown and the House of Representatives. This regime introduced enduring letters of expectation, and made clear the collective responsibility of the board to act in the spirit of service to the public as well as to deliver on SOI and output agreement expectations (where they exist). In June this year, the government released decisions on changes to this framework aimed at expanding the collective responsibilities of boards, the more deliberate use of existing tools and levers, enhancements such as formalising an annual strategic engagement between the boards and the responsible ministers, and simplifying the SOI requirements (streamlining reporting requirements, and moving to 3-yearly SOIs).

35 With the establishment of the Auckland Council and its substantive CCOs in 2009, the government also outlined a series of expectations in the legislation about how these entities should operate. The Auckland Council has placed a significant emphasis on getting the expectations and relationships on track. New measures introduced with the Auckland legislation included:

- Significant services to be delivered through CCOs.
- No councillors to be on CCO boards.
- CCOs to consult with local boards too on draft SOIs.
- Some CCO meetings to be held in public.

36 Underpinning these changes for Auckland, the government had identified a set of principles – that there should be a common purpose and identity, a focus on effectiveness and efficiency (particularly in improving the value to ratepayers), transparency and accountability, and responsiveness.

37 In 2010, changes to the Local Government Act 2002 included a requirement for the council to periodically assess the expected returns to the council from investing in, or undertaking, a commercial activity and to satisfy itself that the expected returns are likely to outweigh the risks inherent in the investment or activity.

38 The Larsen report on Dunedin City Council’s CCOs in 2011, while focussed specifically on Dunedin City Holdings and its subsidiaries and the relationships between those entities and the parent council, identifies some key lessons for councils and CCOs generally, namely:
For the initial change period, no elected members or officers are to be on the CCO boards (reviewable); and directors are not to be on more than one board.

Revised reporting process and schedules are to be implemented, to improve appropriate information flows through to the elected members – using a system of scrutiny through the holding company and summary reporting to council.

Clear dividend policy is to be set.

It is timely to look at the entire range of Dunedin City Council’s activities, to consider if any activities should instead be delivered in-house or if other activities should be delivered at arm’s-length.

The Government announced this year a programme of work on Better Public Services across the states services, which includes its Crown entities. It noted that as our economic, political and technological space changes, the role of the state needs to be progressively redefined and reshaped. The Better Public Services report also reflected on the importance of the public service ethic and the need to sustain impartial and accountable public institutions. The report also questioned the “clutter” or fragmentation of agencies, ministries and departments, SOE and Crown entities, etc, that there currently are; and whether they all have an adequate critical mass. While the report did not cover local authorities, it noted that interaction with them and with communities underpinned many of its recommendations. In particular, the report identified that:

- There should be a new *modus operandi* for state agencies – where sectors mobilise around specified results, deliberately tackling complex issues.
- There is a proliferation of government agencies in New Zealand, with consequences for diseconomies of scale, higher overhead and transaction costs, and protracted decision-making. Over time, consolidating and disestablishing some public service and state sector entities and reducing their overall number would better support a results focus; reduce fragmentation, duplication, and transaction costs; and capture economies of scale.
- Executive agencies would make sense in relatively well-defined sectors with a clear lead Ministry. These agencies would sit within the Crown under the leadership of a larger department (so are closer to Ministers than Crown entities), but held to account for their own operational responsibilities. They would work to the strategy, policy and funding arrangements determined by the lead agency.
- In some cases, regional and/or local government play a critical role in delivering results (eg in transport or fresh water management), as do non-government organisations or firms.
- The Treasury and the State Services Commission need to ensure the interpretation or letter of the foundational pieces of legislation that govern the state services (Public Finance Act 1989, State Sector Act 1988 and Crown Entities Act 2004) do not impose unnecessary constraints on different parties working together.

Directly following this, Better Local Government was also launched. This has resulted in a proposed change to the statutory purpose of local government “to meet the current and future needs of communities for good quality local infrastructure, public services and performance of regulatory functions in a way that is most cost effective for households and businesses”. Here the emphasis is on ‘local’ to differentiate from services better provided by central government,
on 'public' to clarify that councils should not try to replace services provided by the private sector, and 'most cost effective' to emphasize the need for efficiency. These requirements are likely to require councils to look at their COs (as well as in-house activities) and reconsider what they expect of them and where they are delivering services to the community or using council funds, how to be satisfied that this is being delivered cost-effectively.

41 Both Wellington City Council and Greater Wellington/Porirua City Council (the Wellington Review Panel) have initiated community conversations about options for the structure of local government in the Wellington region going forward, and what this might mean for the delivery of services and activities. Both WCC and the Wellington Review Panel have identified the use of shared services and CCOs as options. The factors identified by each for guiding consideration were:

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<tr>
<th>Wellington City Council (when considering options)</th>
<th>Wellington Review Panel (characteristics of good local government)</th>
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<tr>
<td>• Cost, efficiency and rates</td>
<td>• Strategic</td>
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<tr>
<td>• Effectiveness</td>
<td>• Ensures engagement and decisions are made at the right levels</td>
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<td>• Local identity</td>
<td>• Integrated and coordinated (eg regional networks)</td>
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<td>• Democracy and representation</td>
<td>• Resilient and adaptive</td>
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<tr>
<td>• Layers of local government</td>
<td>• Representative and responsive</td>
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<tr>
<td>• Viability</td>
<td>• Transparent and accountable</td>
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<td></td>
<td>• Financially sustainable</td>
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<td></td>
<td>• Effective and efficient</td>
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42 Together these initiatives all indicate it is timely to think about the way public services are organised and delivered, and how to get the best from CCOs and other arm's-length entities.
Arm's-length entities - What? And Why?

What are arm’s-length entities?

43 Arm’s-length entities are diverse in their nature. There is no single model of entity, nor do similar owners have a consistent entity model for a particular activity. If you take a service like local libraries in New Zealand, this may be delivered in-house by a council, through a council organisation, or under a joint committee arrangement.

44 Entities may have a company or incorporated status, be a statutory board or agency, or a charitable or other trust. They operate in commercial and non-commercial environments and across a very wide range of activities. For the most part they exist to provide services to clients (this could involve delivering services to the door such as water, or being a facility people visit like a stadium or zoo), although some (such as Auckland Council Investments Limited) do just operate as investment companies. Some generate their own revenues and are self-funding, while others rely on public funds through operating grants.

45 What they have in common is that they are publicly owned, wholly or partly, be that by local or central government. They have usually been established as part of a drive for improved efficiencies and better client focus, and following an assessment that incorporating private sector practices should help to achieve this.

46 In New Zealand, the arm’s-length entities of councils are in the form of council organisations (including council-controlled organisations (CCOs) and council-controlled trading organisations (CCTOs)). Central government has state-owned enterprises (SOEs) which are expected to operate as successful businesses and generate a profit, and Crown entities that range from statutory entities and Crown entity companies through school boards of trustees and tertiary institutes. Crown entities have a wide range of roles and responsibilities, and differing degrees of autonomy. Together, these Crown entities deliver many of our public health, education, transport and housing services.

Council-controlled organisations

47 Local authorities have had LATEs since 1989. Alongside a general requirement for councils to be more transparent and accountable themselves, councils were also able to use LATEs to deliver services – similar to central government having access to SOEs (introduced in 1986). This was one of several activities aimed at unbundling numerous public roles (policy maker, regulator, owner, provider, purchaser, monitor, and evaluator) and reducing the potential for conflicts of interest. In addition to being able to establish companies, councils were also able to establish trusts and enter into other arrangements to undertake activities such as recreational, cultural or community activities, or to encourage enterprise boards, museums and art galleries. For some activities, such as roading, corporatising the activity or contracting out the service delivery was compulsory.

48 The Local Government Act 2002 set out the governance and accountability requirements for council-controlled trading organisations (CCOs which are expected to generate a profit), and
extended them to council-controlled organisations (entities where the council or joint councils have more than 50% ownership or the right to appoint board members) and council organisations (entities where one or more councils have an interest, but that interest is not a controlling interest). There are statutory exemptions to the CCO provisions (e.g., port companies, electricity companies or trusts, energy companies), and there are certain circumstances in which organisations can be exempted from being defined as a CCO. A CCO can be a company, a trust, an incorporated society, an incorporated charitable trust, or a joint venture, and the laws relating to each of those different legal entities apply as well as the Local Government Act requirements.

49 Some CCOs will have a profit-making objective and others will not. That profit-making motive of itself is not a determinant of whether or not an entity is a council organisation or a council-controlled organisation. However, it will be a determinant of whether or not it is a council-controlled trading organisation (a CCTO).

50 The Act clarified the consultation process required to establish new CCOs and the reporting requirements that should apply for CCOs and CCTOs. For most of these entities, the council will have an ownership interest that will be reflected in its appointment of directors or trustees, and the statement of intent process. For many, the council will also have a purchase interest as it makes a grant to the entity or directly purchases services.

51 A study of CCOs commissioned by the Department of Internal Affairs in 2009 identified that as at 30 June 2007:

- There were 257 CO, CCOs and CCTOs in 69 of the 85 councils. Half of the 257 were trading companies, trusts comprised just over a quarter and the remainder were largely joint ventures and holding companies.
- The authors surmised that the value of CO assets at 30 June 2007 to be $6 billion, or 8% of the value of total council assets; and CO liabilities were estimated at $3 billion or 56% of council liabilities (around 90% of CO assets and liabilities were concentrated in 10 councils).
- They were primarily operating in 15 activities, and principally in economic development (21%), transportation (17%), recreation and culture (17%) and corporate functions (12%).

52 Irrespective of what the purpose of an individual CCO might be, the Local Government Act 2002 specifies that the principal objective of any council-controlled organisation is to:

- Achieve the objectives of its shareholders, both commercial and non-commercial, as specified in the statement of intent; and
- Be a good employer; and
- Exhibit a sense of social and environmental responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so; and
- If it is a CCTO, to conduct its affairs in accordance with sound business practices (a provision similar to one that applies to state-owned enterprises).
With this principal objective in mind, the role of the director of a CCO is to "assist the organisation to meet its objectives and any other requirements in its statement of intent".

Together, these provisions are intended to ensure that, while the operations of the entity are at arm's-length from the parent organisation, they are not completely independent of the parent organisation – in this instance, the council or councils. This is part of the underlying philosophy of the Local Government Act 2002, that local authorities, and by extension their CCOs, are part of a system of local governance "rather than a collection of assets and services".

Why have arm's-length entities?

The move to arm's-length entities generally over the last 30 years has reflected attempts to get greater efficiency and effectiveness in achieving outcomes. With its origins in the New Public Management movement, characteristics include the creation of 'task specific' organisations and some form of performance target setting, monitoring and reporting. There was an expectation that adopting private sector business models would help achieve this.

A look across the models operating in New Zealand, the United Kingdom, Australia, and Canada, and a review of OECD's extensive research in this area shows that the overall model is widely adopted. There has also been a widespread adoption of many private sector management principles and practices within councils and government departments, and a greater movement of people between the public and the private sector. Consequently, some of the 'low lying fruit' has been picked. However, there are now even higher expectations of performance, opportunities available with new technologies, and (in the current economic climate) an expectation to deliver more and better public service for less – from the shareholders and the public.

An initial concern for increased efficiency is being supplanted by a focus on governance, strategy, risk management, ability to adapt to change, collaborative action and the need to understand the impact of policies on society. Alongside this is a growing understanding that arm's-length entities need to be seen as a part of a wider governance system, and that broader public sector values also have a role to play, as the services delivered in this way are still a part of an integrated response to public issues. Generally, after an initial period of allowing high levels of independence, most national jurisdictions have begun to develop stronger controls over the set up, governance, monitoring and accountability of their arm's-length entities; and this is being seen at the local level too.

Despite this, there are still a number of generally held benefits for adopting arm's-length entities (although not all of these benefits will occur in every situation). At the highest level, the reasons for creating these bodies have been to make the system of delivery more efficient and effective, or (depending on the type of body) to legitimise decision-making by providing some independence from direct political intervention.

Drawing on the work of the Royal Commission on Auckland, COMU and the State Services Commission, plus the OECD, the benefits of arm's-length entities are considered to include:
• **Providing independence and legitimacy**, ie separation from political direction (this is particularly the case for some regulatory functions of local or central government; or statutory entities).

• **Business specific objectives rather than multifaceted political objectives.** Enabling a focus of decision-making and resources on delivering effectiveness and efficiencies in a specific area through a constrained set of business objectives can enhance governance, strategy, risk management and ultimately improve outcomes; rather than having the multi-faceted and often competing objectives facing councils and central government.

• **Professional and specifically experienced governance.** By appointing directors or trustees based on merit, decision-making in those specific areas can be enhanced.

• **Attracting new skills and innovation.** There are many people who have key skills and who are interested in being appointed to a board or working for an arm's-length entity but who would not stand for elected office nor wish to work in a 'bureaucracy'. Neither would they be attracted to a role as a third or fourth tier manager within a large and diverse organisation, but they may be attracted to a CEO or senior manager role in a smaller and focused organisation.

• **Joint or regional activities.** A separate entity can be an effective way to form partnerships with other political entities (eg Capacity between Wellington City Council and Hutt City Council, or Christchurch International Airport between Christchurch City Council and the government); or with the private sector to jointly deliver services (the alternative being a joint committee which may operate more slowly – needing to seek decisions from the individual councils and having to work though sometimes conflicting political expectations).

• **Retaining public control over natural monopolies.** With some activities such as water and wastewater services, there may be significant benefit and efficiencies through applying commercial practices; but as significant community developed assets and with no competitors, continued public ownership might be important.

• **Empowering community-based organisations.** A trust, for example, can have support from an organisation such as a council but still encourage donations, sponsorship and other support, which might not be available if the activity was delivered in-house. The Council recently had such conversations regarding Zealandia, and in 2003 about the Zoo.

• **Maximising profit.** This can be important where the activity is primarily financial and generates revenue through the sale of goods and services. Councils and governments sometimes look to this revenue as a way to reduce the impact of other costs (such as rates or taxes) on their communities. A factor for councils to consider carefully here, too, is the tax implications of different models.

• **Critical mass and economies of scale.** An arm's-length entity can bring together similar activities, and thereby achieve economies of scale.

• **Ring-fencing resources**, both financial and other resources. This can reduce or remove the risk of the activity being diminished or not prioritised in the future. This can be a way to protect resourcing for an activity, for the future, especially if it has been under-resourced in the past.
• **Ring-fencing costs and risks.** The parent can ensure that the costs it faces are contained when the responsibility for delivery a service sits with a separate entity, as the entity may also have access to other sources of funding. Funding arrangements should be separated from ownership interests.

• **Increased transparency and accountability.** When the right performance measures are in place, separate reporting and scrutiny through better and more specific financial information can result in better outcomes for the community. There is often more thought put into the design of an arm's-length body than there is to a new function within an existing organisation. Purchase or output agreement can be put in place formally or informally to hold the entity to account; and elected members are able to focus on the scrutiny of overall performance and delegate the management of the risks. Elected members sometimes consider that they have the ability to scrutinise arm's-length entities better than in-house services.

60 The decisions on Auckland Council were based largely on a similar list of benefits. The Royal Commission's view was:

“For the Auckland Council to plan and deliver the infrastructure and services to meet its requirements, it will need access to the best commercial and engineering expertise and resources. CCO structures and boards of directors can bring these required skills and expertise.”

61 The Auckland Transition Authority considered that these disciplines and expertise would supplement what is available within the council. The ATA report noted:

• Using these skills, CCO boards would add value to CCOs and help them to better achieve their objectives and the council's long-term strategies.

• In contrast to councils, CCOs are focussed on achieving a "constrained" set of business objectives. This brings a unifying focus to the organisation along with efficiencies through a corresponding drive to align resources with the required outcomes. As opposed to the multifaceted nature of councils, efficiency gains can be made in CCOs through the alignment of systems and processes to the specific needs of the business.

• In the same way, integrating multiple existing CCOs into a single entity will mean that further efficiencies are possible through the rationalisation of common support functions.

• The formation of partnerships and alliances is a further strength of the CCO model. CCOs are often able to collaborate more effectively, especially with the private sector.

• From a council perspective, CCOs are a mechanism by which operations can be managed efficiently, allowing council to focus on other matters such as strategy, policy or regulatory functions. This is particularly important given the primary role of Auckland Council to develop policies, strategies, spatial and other plans to drive Auckland forward.

62 Balanced against the expected benefits, a number of criticisms have been levelled at arm's-length entities too, including:

• **There should be direct accountability to the community.** Those directly accountable to the community or the public for the spending of publicly raised funds (be it rates or taxes) would have more direct control if staff in their organisations directly provided the services, and as such the devolution of services to arm's-length entities is undemocratic. If there is
not adequate alignment, owners do not always consider that they have adequate information from the entity to be accountable; although this report identifies later how this can be improved. The counter to this is information over-load, which is even more likely to occur in multi-faceted organisations; it is important to have useful information to enhance understanding and accountability.

- **Lack of responsiveness to owner.** As with out-sourced services generally, arm's-length entities can be slower than a directly controlled council business unit or a department to respond immediately to issues raised by the owner.

- **Fragmentation.** It can result in fragmentation of services. If there are too many smaller entities, they may not have a critical mass. In addition, if there are too many entities the overall picture of how the governance system is functioning can be blurred and coordination compromised, and may result in a loss of ownership or community confidence.

- **Overall cost.** The cost of service delivery may not be less overall, as the overheads of running a separate entity also have to be factored in.

Within these lists of advantages and disadvantages, there are a number of inherent tensions. The list alone cannot determine whether a CCO or Crown entity etc should be put in place, or not. However, these factors need to be considered against the context of the specific service, including whether the activity in question is a start-up, is in a growing and dynamic phase, or is entering a mature or slowing phase.

In the longer term, a number of underlying social trends have also been identified as generally influencing organisational frames. These include:

- The growth in the size of government, including the increased number of transactions involved.

- The greater complexity of the problems government has to address (eg trying to correct social problems, working through Treaty of Waitangi issues, and the costs of infrastructure and of rolling out broadband).

- Taking advantage of emerging technology to improve the efficiency and oversight of the transactions.

- A growing focus on the performance of public services, rather than simply conformity with law.

- With the move towards measuring and controlling output, rather than input and processes, a view that the form of the organisation matters less.

- Higher levels of service required, eg through resource consenting processes; and expected by consumers.

- More individualised services being expected by citizens and, as the services themselves become more complex to deliver, more technical specialisation required.
How to decide when to have them?

There are clearly some inherent tradeoffs between the potential benefits and costs outlined above. However, it is unlikely that the same, or all, of the factors will appear with an equal weighting in similar circumstances. It is therefore necessary to assess each circumstance individually.

Approaches overseas

Many commentators argue that most arm's-length entities have developed in an *ad hoc* manner rather than within a deliberate framework. In looking at cross-country examples, the OECD found that the rationale for establishing bodies at arm's-length would always vary. Its Distributed Governance project was an attempt to look across OECD countries and identify principles for selecting particular types of organisational form - from the delivery of services in-house, through arm's-length to completely independently. This project identified that, no matter the organisational form, the following principles should apply:

- **Form follows function** - First, be clear about the underlying problem, the policy intent, and other options (which may or may not be organisational) to best achieve that intent.
- **Horses for courses** - There is no single top-down rules for organising government. Good organisational design is based on a bottom-up analysis including the critical mission, constraints, culture and incentives.
- **Balance is all** - Getting high performance from government organisations requires the right balance between discretion and rules, autonomy and control, co-ordination and subordination, empowerment and restraint, looseness and tightness.
- **Reform is not a one-time game** - Most of the effect of organisational design on performance will depend on how well the design is implemented, including building in incentives for learning and continuous improvement.

The OECD concluded that an arm's-length approach should be considered when, compared to alternatives, it creates the best probability of success. In addition, structure alone will not deliver the desired benefits - how well reform is implemented and managed are just as important.

At a national level, different governments are taking different approaches. The Canadian Government has a policy outlining when alternative service delivery arrangements should be considered. The primary rationale must be to improve performance and value for money and to provide more seamless and citizen-centred services. A key expectation for all organisations delivering government services and programmes is that they continually seek to improve performance. The current British coalition government's view is that if a public function is needed then it should be undertaken by a body that is democratically accountable at either national or local level. A body should only exist at arm's-length from Government if it meets one of three tests:
- Does it perform a technical function?
- Do its activities require political impartiality?
- Does it need to act independently to establish facts?

69 In Australia, in 2003, the Commonwealth government concluded that completely arm's-length arrangements should only be used if they are given full power to act.

**New Zealand approaches**

70 In New Zealand, advice from OAG and advice provided by the SSC for central government is consistent with the principles articulated by the OECD.

71 OAG has produced a number of reports over the past 10 years that are relevant to local authorities considering delivering services at arm's-length and how they should be set-up, governed, managed and monitored.

72 In its 2001 report *Local Authority Governance of Subsidiary Entities*, OAG described a number of potential governance structures and outlines the risks and benefits of each structure. The structures looked at included holding companies, collectively managing regional investments, trusts and other non-profit entities, and group structures. OAG found that the ability to hold subsidiaries to account, provide strategic direction, attract expertise and innovation, make better commercial decisions, find efficiencies and share risk vary for each type of arrangement, but that all of these factors need to be considered when choosing the structure the best suits the overarching purpose of each entity.

73 In its 2006 report, *Principles to underpin management by public entities of funding to non-government organisations*, OAG identified that the ultimate test for deciding whether services should be delivered at arm's-length is 'do the arrangements provide the best possible public benefit’. The report also noted that:

- In order to satisfy this test, compromises are inevitable between accountability, openness and trust.
- Accepting higher levels of risk may be appropriate, provided the risks are open and transparent.

74 Also in 2006, OAG prepared the report *Achieving public sector outcomes with private sector partners*. This paper elaborates on what should be taken into account when deciding if an approach is providing the best possible public benefit:

- All of the benefits need to be weighed against the costs.
- Benefits are not restricted to financial efficiencies, but include attributes such as the freeing up of public sector staff to concentrate on key service delivery activities, greater asset utilisation, and the scope for innovation (such as business practice and technology application).
- Costs to be considered need to include the costs of establishing new entities and creating and maintaining an alliance culture.
OAG’s report examined a number of case studies including Canterbury’s regional landfill project, whereby six local authorities partnered with a private sector company to build a new landfill to serve the entire region. The reasons for opting for an arm’s-length approach included the economies of scale, the ability for the best site from an environmental perspective to be chosen without political interference, and access to greater technical knowledge and expertise. It concluded that an arm’s-length approach should be considered when, compared to alternatives, it creates the best probability of success.

SSC has overseen a definitional programme for central government and its Crown entities over the past ten years, which has included the introduction of the Crown Entities Act 2004. In 2007, SSC prepared a paper outlining factors to consider when determining which organisational form is best suited to carry out government functions.

Like the OECD research, this paper recognises that organisational form rarely follows a set of abstract design criteria and that context is crucial. It highlights two key considerations in determining the most appropriate form for different functions – (1) the degree of ministerial oversight required and (2) the commercial focus required. SSC pointed out that ministerial influence and independence can be built in to almost any type of entity. In essence, it is the purpose, strategy and relationships that have to be clear, and the form is less important.

The first question will usually be what are the drivers for a change from the status quo? There will often be a series of problems that the proposal seeks to address, or opportunities that it seeks to take advantage of. These will form the basis of consideration of the options. Should the "service" be delivered in the future? Should it be delivered by the council? If yes, should it be governed in-house or at arm’s-length?

The answers to these questions will be influenced by factors such as:

- The level of control required.
- The ‘public good’ or ‘private good’ nature of the activities.
- Whether effectiveness will be increased by attracting skilled board members and key staff who can focus on the activities of the entity.
- Whether an improved commercial focus is important; whether there should be a revenue making or a profit-making motive.
- The benefits of operating a company or entity with a professional board of directors brings diverse and expert knowledge to the table, together with the time to focus specifically on the objectives of an entity rather than general community governance overall.
- The opportunity to access other forms of funding.
- Any ongoing dependence on council expertise.
- The reliance that the council itself will have on the entity, in order to meet its objectives.
- Encouraging and enabling additional funding streams to be accessed, for example, by way of donations that would not be made to council, or through joint venture arrangements.
- The importance of containing financial risk, by using a company or other incorporated structure to limited the liability of the council.
In the central government environment, there is a continuum within which activities operate going from fully commercial state-owned enterprises (with a profit-making motive and a social responsibility), through to Crown entities (which include statutory entities and Crown companies, school boards of trustees and tertiary institutions).

Machinery of government decision making rarely follows a scientific path that leads inexorably to a clear conclusion. As former State Services Commissioner D K Hunn expressed it in 1997:

"Machinery of government changes do not tend to happen merely because of the existence of an abstract set of design criteria. Context is crucial. They tend to occur in response to perceived problems or inadequacies. Criteria may have a significant effect on the ultimate design, but other considerations will also be relevant such as political judgements about the suitability of different organisational forms, or practical considerations about the relative ease with which changes can be made".

The government may have decided it wants a new function, more control over an agency, or better coordination between agencies without changing their form or functions. The advice must fit the context and nature of the issue. An analysis of ‘form follows function’ will provide some of the answer. For example:

- Purely judicial functions belong in the judiciary; non-commercial functions of executive government belong in one of the many other types of agencies in the executive branch of government. However, should the agency be a department or one of the types of Crown entities or other form of agency?
- Commercial functions of executive government should sit in an agency with commercial objectives, but should the agency be a State-owned enterprise, or Crown Entity Company, or other form of company?

After that a variety of factors and the specific context are more influential:

- Is it about strategy and policy, or implementation and customer service?
- Does it need to be subject to political decisions? Or should it be separate from it?
- Does it generate revenue? Is it self-funding or reliant on public funding?
- Is improving efficiency of delivery important?
- Is the activity new? Alternatively, is it well established?
- Is it open to significant technological change or technical expertise?

SSC has articulated many of these factors in guidance for ministers and departments considering new entities.

These considerations have been summarised in the following table.
## CENTRAL GOVERNMENT

<table>
<thead>
<tr>
<th>Strong strategic/ public interest</th>
<th>Mixed objectives</th>
<th>Service delivery/ customer focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-commercial</td>
<td>Non-commercial</td>
<td>Non-commercial</td>
</tr>
<tr>
<td>Functions and powers that do not require a high degree of Ministerial control or oversight. The responsible Minister has the power to direct the agency to have regard to the policy of the government of the day.</td>
<td>For reasons of public confidence, functions should be made independently from Ministerial influence.</td>
<td>Context or environment in which a function is to be undertaken is not fully commercial. The agency undertaking a function has mixed objectives.</td>
</tr>
<tr>
<td>Desirable or necessary to have a high degree of Ministerial oversight or control. The responsible Minister has the power to direct the agency to give effect to the policy of the government of the day.</td>
<td>Performance is measured primarily in financial terms. Revenue is generated through the sale of goods and services.</td>
<td></td>
</tr>
</tbody>
</table>

- **An inherent function of the State (e.g. the conduct of foreign policy); exercise coercive powers (e.g. policing; tax collection), or will provide policy advice to government**
  - Complexity difficult to "contract", constitutional conventions indicate a need for close Ministerial oversight (e.g. citizenship), or high public or political expectations associated with the activity or risks to the Crown

- **Carrying out non-commercial executive government functions that (e.g. significant service delivery agencies) Will be sustainable in financial and policy terms, to warrant the establishment of a body corporate that is legally separate from the Crown Should come under the management skills and experience of a governance board Do not constitute inherent functions, exercise significant coercive powers, pose significant strategic or fiscal risks for the Crown, or political risks that should come under closer Ministerial control.**

- **For public confidence, decisions should independent from Ministerial influence**

- **Usually established to further policy objectives (e.g CRIs) Profit objective may be secondary**

- **Unambiguous commercial objectives – to maximise the return to shareholding Ministers over time To operate as an efficient and profitable business Tend to sell in contestable market**

### Department

- **Crown agent**
  - (statutory entity such as ACC and LTNZ)

- **Autonomous Crown entity (ACE) – a statutory Crown entity**
  - Agency listed on the 4th Schedule of the Public Finance Act

- **A ‘statutorily independent function’ in a department, Crown agent, Autonomous Crown entity (ACE), Crown entity company, Independent Crown entity (ICE)**

- **Crown entity company**
  - Company listed under 4th schedule of the PFA

- **SOE**
As a decision-tree this looks like:

86

<table>
<thead>
<tr>
<th>Functions Outside Executive Branch (In Terms of Separation of Powers)</th>
<th>Full commercial environment (while exhibiting sense of social responsibility)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Judicial Functions</td>
<td>State-Owned Enterprise</td>
</tr>
<tr>
<td>Judicial Branch</td>
<td></td>
</tr>
<tr>
<td>Legislative Branch</td>
<td></td>
</tr>
<tr>
<td>Office of Parliament</td>
<td></td>
</tr>
<tr>
<td>Parliamentary Service, Office of the Clerk</td>
<td></td>
</tr>
<tr>
<td>No Political Involvement, or More Objectives</td>
<td>Not Full Commercial Environment, or More Objectives</td>
</tr>
<tr>
<td>Defaults: Ministerial control or oversight, and Depend on Ministerial Influence over Decision making</td>
<td></td>
</tr>
<tr>
<td>Unless: High Degree of Ministerial Influence over Decision making</td>
<td></td>
</tr>
</tbody>
</table>

87 This framework operates in an environment where decisions about the level of political involvement have already been made, often in separate legislation, and the activities involved are often more distinctly about the provision of advice to the government or the provisions of services to individuals.

88 The activities that local government engages often have a greater mix of public and private good aspects, as councils are often using a variety of activities and objectives to enhance a ‘place’. Supporting an initiative such as the World of Wearable Art (WOW), for example, could be seen as contributing to making a community a great place to live (and therefore attracting people to move to and live there), as well as supporting economic development and jobs in that community, and thereby attract other investors and tourists alike.

89 As a consequence, there is not necessarily a straight-forward application of the machinery of government decision-tree to the local government context.

90 However, if the underpinning concepts are translated into the local government context, how might it look? The following table outlines initial considerations for local government.

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So what assists with decisions to determine where an activity will sit along this continuum? The decision on whether or not to have an arm’s-length entity can be considered within a framework, but ultimately the decision will be influenced by the specific problem at hand and by its context. It is not a case of immediately saying that because the activity is, for example, running the parks and gardens which are fully funded by rates, therefore the governance of all parks and gardens should be in-house; nor is it the case that, because Watercare Services is a CCO, all water and wastewater businesses should necessarily be governed at arm’s-length.

Instead there are a variety of factors that need to be taken into account for the specific entity. The following questions are not exhaustive, but rather indicative of the assessments that need to be undertaken in order to determine the best governance for a particular activity -

- What is the nature of the activity? Is it about designing and shaping the space in which the community lives and works? Is it about governing 'place' or about providing services to individuals?
- Is it about the community undertaking an activity for itself and seeking some elements of council support, possibly through grant funding?
- Is there a clear and enduring framework and focus of the activity, or is it subject to political influence? Does it need to be readily responsive to public opinion?
- Is the activity entering a significant change or growth period; or not? This could involve, for example, recovery from under-investment, taking advantage of new technologies or opportunities associated with increased scale or scope. Are there significant efficiencies that can be achieved or performance/services levels increased for the benefit of ratepayers or consumers?
Does the activity run or needs to be run as a business? Will specific commercial or technical expertise assist with managing risk and growth opportunities, and governance decisions which need to be made?

Is the activity generally funded through rates, or are there other options for funding? Will alternative funding options be likely to be more successful if the resourcing of the activity is ring-fenced to avoid cross-subsidisation?

As these questions indicate, the answers will vary according to the nature of the activity and the performance expectations that a council has of it. Generally it is possible to place the answers to the questions on a continuum that would indicate whether in-house or arm's-length governance would be most effective.

When these and other factors are put into a framework, the answers for the specific activity indicate the governance option that might be most appropriate. In the example below, the weighting of the answers to the questions indicates that arm's-length governance is likely to better deliver the activity assessed.

<table>
<thead>
<tr>
<th>In-house</th>
<th>Arm’s-length (CCO/CCTO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flexibility needed</td>
<td></td>
</tr>
<tr>
<td>Responsive</td>
<td>Enduring objectives</td>
</tr>
<tr>
<td>Shorter, one-off</td>
<td>Independence</td>
</tr>
<tr>
<td>Integrated</td>
<td>On-going/business</td>
</tr>
<tr>
<td>Stable</td>
<td>Specific focus</td>
</tr>
<tr>
<td>Single owner</td>
<td>Dynamic</td>
</tr>
<tr>
<td>Less commercial focus</td>
<td>Multiple owners</td>
</tr>
<tr>
<td>Management</td>
<td>More commercial focus</td>
</tr>
<tr>
<td>Similar service level</td>
<td>Leadership</td>
</tr>
<tr>
<td>Not so important</td>
<td>Significant change/innovation</td>
</tr>
<tr>
<td>General measures</td>
<td>Significant change important</td>
</tr>
<tr>
<td>Reliance on ratepayer funding</td>
<td>Increased external funding likely</td>
</tr>
<tr>
<td>No (maybe some fees/charges)</td>
<td>Self funding/profit making</td>
</tr>
</tbody>
</table>

Whatever arm's-length arrangements are put in place, they should be reviewed from time to time to see if they are still fit for purpose.

The following diagram pulls this discussion into a framework for analysis.
Good governance

There are many different, although largely similar, definitions of what good corporate governance is. The OECD has done a lot of work in this area, preparing a set of principles of good governance for state-owned enterprises in 1999, and reviewing these in 2004 to incorporate comments from 70 countries. In its report, it notes good corporate governance:

- Involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.
- Provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.
- Should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.

The concepts underpinning good corporate governance are equally relevant to large and small, corporate and not-for-profit entities. It is a matter of scale. However, there is no single model of good governance. The governance of individual entities will evolve over time – as entities evolve and as their circumstances or the general context changes.

What is common is the expectation of creating value within a framework of appropriate controls. Much of the literature reviewed reflects that while good corporate governance is a system that enables effective direction and management of companies, it relies on consistent and ethical behaviours to support it.

The governance, the goals and the strategy of a business should be compatible, and there should be congruence between the expectations of the various interested parties. In defining best corporate governance practice, this means that:

- There is a common view as to the ethic by which the business is conducted.
- The views of all interested parties are taken into account when deciding the goal.
- Once dissonance in the common goal creeps in, the danger of the standard of corporate governance deteriorating rises steadily.

Good governance in the Crown environment includes:

- Clarifying and understanding the respective powers and responsibilities of Ministers, boards, management and employees.
- Having, and following effective and well-understood accountability processes.
- The modelling of acceptable behaviours.
- Probity in the management of public funds and disclosing and managing conflicts of interest.

Performance failure or the abuse of powers arising from inadequate governance structures and arrangements can have serious consequences, such as:

- Loss of credibility and trust from communities, business and Parliament.
- Reduced ability to carry out policies or delivery of services, because the focus of management is diverted from positive achievement onto the need to 'fight fires'.

103 The distinction between the governance and management roles of boards and chief executives also needs to be clearly understood by all parties. Unless the chief executive or other office holders have specific statutory functions or powers (e.g. the Director of Maritime New Zealand), all decisions about the agency's operation are made by the board, or under its authority. Some legislation provides a partial exception, where a Minister is authorised to direct a board to do or to take account of certain things.23

Governance in the local government context

104 The legislative framework for local government is a representative democracy model, where elected representatives are there to:
- Represent the community.
- Set policy.
- Monitor (regularly) and review (at specified times).

105 These roles are equally relevant as ‘owners’ of CCOs, entities that are often established to own or manage assets that have been developed or acquired over time on behalf of the community. However, just as council management is responsible for decisions about how to implement policy, so CCOs are responsible for running those entities within the agreed framework.

106 Councils are expected to govern themselves in accordance with principles set out in the Local Government Act 2002, by having regard to:
- Clarity in governance roles – to be understood by elected members and the community.
- Effective, open and transparent processes.
- Separation of regulatory and non-regulatory roles.
- Being a good employer.
- Having effective, understood relationships between elected members and management.

107 Just as these principles are about the way the council should behave in its own decision-making processes, they are also relevant to the governance of CCOs.

Principles of Good Governance for CCOs

108 In its 2001 report on Local Authorities Governance of Subsidiary Entities, the Office of the Auditor-General reflected on and updated its 1994 report on Governance of Local Authority Trading Activities. The 2001 report identified five principles of good governance, which influenced the drafting of the Local Government Act 2002, and most people interviewed for this report have referred to similar concepts.

109 The five principles OAG identified are:
- The subsidiary entity should have a clearly defined purpose.
- The subsidiary entity's governing body should be effective.
- The parties involved should be assigned clear roles and responsibilities.
• The local authority should be able to hold the subsidiary entity to account.
• Mechanisms for accountability to the community must be in place.

A key part of providing the right environment for CCOs to succeed is putting in place robust governance arrangements. These principles reinforce the ongoing and cooperative relationship that should exist between a council and its CCO. They guide the interpretation of the processes that direct, control and hold entities to account; their stewardship, openness, programme delivery and leadership.

**The Auckland model**

In establishing the substantive CCOs for Auckland Council, the government stated that the proposals for the establishment of new CCOs should meet good governance principles of being:

• Democratic – including accountable and transparent decision-making, effective leadership, stewardship, ratepayer and citizen redress; and
• Efficient and effective – including vertical alignment of strategic planning, funding, asset management and implementation (integrated decision-making), maximising value for money, alignment of costs and benefits, arrangements to remain effective over time, economies of scale, and decision-makers taking a long-term view in their decision-making.

To meet its obligations, Auckland Council has put in place:

• A draft accountability policy for substantive CCOs, setting out expectations of its CCOs that identify CCOs as partners in the delivery of the Council's objectives and priorities for Auckland. A Shareholder Expectation Guide for CCOs supports this, which outlines expected roles and behaviours, and includes information on SOI development and board processes that should be common across the substantive CCOs.
• The Mayor's letter of expectations specific to each CCO, to guide their strategic direction and assist in the development of each SOI. That letter includes high-level expectations (such as the 'one Council' and 'no surprises' policies, transparency, and fiscal prudence) that define the relationship with the Council and the behaviour required of a public entity, as well as more operational matters and detailed expectations for the SOI. It identifies strategic priorities that support the Mayor's vision for Auckland and a list of key strategic projects relevant to each entity.
• An Accountability and Performance Committee (comprising all councillors) which reviews the performance of CCOs quarterly, and a CCO Strategy Review Sub-committee (chaired by the Mayor) responsible for reviewing and commenting on CCOs' draft SOIs. Both committees operate according to the Council's standing orders and the relevant legislation. They are generally open to the public, although commercial-in-confidence matters are dealt with in public-excluded parts of the meetings.
• A panel for appointing directors to the boards, comprising the Chairperson of the board, two councillors and the chief executive of the Council, which makes recommendations to the CCO Strategy Review Sub-committee.
• One-on-one meetings regularly between the Mayor and the Chairperson and chief executive of each CCO (which can more informally build strategic alignment and discuss business performance and risk), and bi-monthly meetings of all the CCO chairs and chief executives with the Mayor and chief executive of Auckland Council to discuss common matters of strategy and alignment.
In August 2011, the Auditor-General wrote to the chief executives of Auckland Council and Watercare Service Ltd, regarding the governance and accountability arrangements for Watercare and concluded that the arrangements outlined above should meet OAG expectations. The letter also outlined two risks OAG had identified -

“We see two risks:
- That Watercare’s independence from the Council is threatened or circumscribed in some way, particularly if there were general ratepayer dissatisfaction with Watercare’s performance on any matter that gave rise to heightened political concern; and
- The creation of a "compliance burden" through the imposition of informal requirements.

The governance arrangements are clear and seem both efficient and effective. In our view, they should be robust enough to obviate the first risk.

The second risk is that, over time, the Council’s engagement with Watercare on its day-to-day business of providing water services becomes mixed with the Council’s governance of Watercare as a wholly owned subsidiary. Such a confusion of relationships could give rise to requirements for additional reporting by Watercare that go beyond what councillors need to know to discharge their governance role. We consider it important that the Council keeps the "business partner" and governance roles separate.

We note that the governance arrangements for Watercare and the CCOs are only just starting to operate and have yet to be tested. We suggest that the Council periodically review those governance arrangements to ensure that they continue to work as designed”. 

These comments about the Auckland model specifically, re-enforce the general principles that the OAG has been recommending for good governance.
Getting the best from council-controlled organisations

What works

115 Having looked generically at what arm's-length entities are, when they can be effective, and what generally constitutes good governance; the question is how to get the best outcomes when an entity is in place. This section looks at the formal and informal aspects of ownership, governance, purchase and partnering, performance monitoring and reviewing the entity.

116 As with the question of when to use an arm's-length entity, there is not necessarily a single 'right' answer in this space; but if good processes are followed and adhered to, they should create a framework that enhances the likelihood of success. Of course, defining and communicating what success will look like for each circumstance is one of the first critical components, and factors may need to be scaled according to the scope and nature of the entity.

117 Although this section refers to statutory requirements under the Local Government Act 2002 and other acts, it is neither a step-by-step manual for the setting up of a CCO nor a comprehensive legal guide.

Clarity of purpose and strategic direction

118 The interviews and the research undertaken have all emphasised the need for a clear purpose for any entity going forward (including understanding any wider community contribution that the CCO is expected to make). Without adequate steering, arm's-length entities may follow policies that favour their own interests and are not responsive to policy needs.

119 In his 2011 report on Dunedin City Council Holdings, Warren Larsen framed it very simply – there must be a clear and agreed position amongst the key participants as to:

- Why the organisation exists?
- What do we want it to do?

120 Without clarity on these points, and agreement about who is responsible for what, "any governance effort is likely to be largely ineffective".

121 Getting clarity is not a one-off process, as the context and circumstances for arm's-length entities will change over time. However, getting it clear and commonly understood from the beginning is fundamental to early success. The less agreement there is over the expectations at the beginning, the greater is the likelihood that a CCO will consider itself independent of its council and potentially divergent behaviour occurring.

Operating as a public entity

122 One of the first factors that influence the purpose is that these CCOs, CCTOs and other council or government-owned arm's-length entities are not operating in exactly the same space as private trusts and companies. They are operating in a political setting, they have owners who
usually expect more than a financial return on their investment, and owners who are often purchasing services or providing ongoing funding.

For central government entities, SSC guidelines make clear the expectation that all Crown entities will meet the normal corporate governance expectations (eg ethical conduct, integrity in reporting and disclosure, and risk management), but should reflect the ethos of public service (and the impact they have on individuals, business and communities). SSC has also made clear to Crown entity boards that governance in the State sector is about achieving desired results and achieving them in the right way. This becomes very important when thinking about the behaviours that should be demonstrated between the 'parent' and the 'child' organisations, and with the wider community.

For councils and for the state services, this expectation is being specified in legislation too:

- The Local Government Act 2002 operates at a generic level, and states that the principal objective of a council-controlled organisation is to achieve the objectives of its shareholders, both commercial and non-commercial, as specified in the statement of intent.

- The Crown Entities Act 2004 specifies that the board of a statutory entity must ensure that the statutory entity performs its functions efficiently and effectively and in a manner consistent with the spirit of service to the public. That Crown entities are operating in a political environment, in spite of being at arm's-length, is also reflected in the identification of Ministers' powers on matters of strategic direction, targets, funding, performance, reporting and review - as long as the Minister does not interfere with any statutorily independent function. Ministers also remain responsible to Parliament for Crown entities' performance, and entities must report on all aspects of their activities transparently.

- The Local Government (Auckland Council) Act 2009, for the substantive CCOs, states:
  - The Auckland Council may require each CCO to include in its statement of intent a narrative on how the organisation will contribute to the Council's and (where appropriate) the Government's objectives and priorities for Auckland; and to have a 10 year plan that describes how it will (amongst other things) give effect to the Council's strategy, plans, and priorities.
  - The CCO must 'give effect to' the relevant aspects of the Auckland Council's LTP.
  - There is also a requirement that the CCOs hold two meetings each year in public, when approving the SOI and the annual report.

Operating in a political governance setting brings a series of challenges for both the owner and the entity, and both need to understand what factors are going to create the right environment for the arm's-length entity to succeed. In the local government context it is important to remember that individuals will often be at different times a citizen, a ratepayer, a fee payer, and a consumer. If separate entities are making service decisions they should remember that ultimately their separate costs will fall on the same people and take care that a cost saving is really a saving and not just transferring the cost to the same people in a different form.
Clear purpose

126 When an entity is first proposed, it is important to take the time to think carefully about the wider contribution that activity needs to make in the community. This includes:

- What is the problem to be solved or the opportunity to be taken advantage of?
- Is an arm's-length entity the best option for delivering on that purpose?
- What will be the purpose of the arm's-length entity be?
- How will that purpose compare to the purpose of the ‘parent’ organisation and to the purposes of other key stakeholders? Have the strategic expectations of the ‘parent’ been articulated clearly for the CCO or CO?

127 If these things are not clear at the establishment of an entity, it may well be necessary to go back later on and revisit these questions. It behoves the council to put in the effort and get it right from the start, rather than to postpone decisions that might be difficult, for example, as it will improve the relationship overall and save time trying to get this clarity later.

128 The purpose should involve an improvement in some element of performance of the activity (be it by solving a current problem or taking advantage of an opportunity), otherwise, there is not a lot of point in making a change. The expected improvement will not necessarily be a financial benefit or saving. However, where more than one activity or entity is being brought together, the overall benefit achieved should be greater than just the ‘sum of the parts’.

129 Spending time to get a clear purpose is critical before the entity is established, as it should form the basis for the consultation with the community. This means getting agreement on:

- What is the problem or issue that is trying to be solved, or the opportunity at hand?
- What will the purpose of the entity be?
- What are the longer-term expectations?

130 The answers to these questions should be related, but are probably not the same. Instead, the drivers for change often form the basis of the measures of success (indeed some performance measures may be an expression of the reverse of the problem identified).

131 Most CCOs have mixed purposes and most are expected to deliver benefit for the wider community. Therefore, there should be a clear link to the wider objectives of the council and the community, and agreement about the contribution to the wider well-being of the community the entity is expected to make.

At the beginning

132 A council must consult the community (using the special consultative procedure) when it proposes setting up a CCO, including when proposing to deliver a significant activity through a CCO. This is especially important when the establishment of a CCO will involve the transfer of council assets, which are essentially assets that the council holds on behalf of the community. The consultation should inform the community of the:

- Reasons for establishing the CCO.
- Proposed objectives for the new organisations and what it will seek to achieve.
- Nature and scope of activities involved.
- Expected impacts on the council's overall operations.

133 As the entity cannot act outside its deed or constitution (and the SOI cannot require actions outside the scope of the deed or constitution), getting the constitution documentation right is important. While they can be reviewed in the future, it will be more challenging later as the board and its stakeholders will have an interest in any changes.

_Achieving common understanding after establishment_

134 In some instances, especially where the CCOs may have been established some time ago or have been established by another entity altogether, it will be necessary to establish anew that common understanding and clarity.

135 In establishing the Auckland Council, for example, the government considered advice that came from the Royal Commission on Auckland Governance and from the Auckland Transition Agency, as well as government officials, when it agreed the statutory framework. This included that significant services should be delivered at arm's-length. The CCOs for Auckland Council were established under statute in advance of the election of the Auckland Council, and therefore also in advance of the adoption of the Auckland Plan. The first SOIs for these CCOs were also adopted in advance of the Auckland Plan and in a time of significant transition for the Auckland Council. Essentially the CCOs commenced their operations without clear expectations being identified by the Auckland Council.

136 Since the substantive CCOs were established, the Auckland Plan has been adopted to guide the growth and development of Auckland. The Auckland Plan is the 30-year strategy to make Auckland the world's most liveable city, by making six transformational shifts – to dramatically accelerate the prospects of Auckland's children and young people; to strongly commit to environmental action and green growth; to move to outstanding public transport within one network; to radically improve the quality of urban living; to substantially raise the living standards for all Aucklanders and focus on those most in need; and to significantly lift Maori social and economic well being.

137 With this plan in mind, the Auckland Council has undertaken a number of actions to create clarity of expectations and common understandings:

- **Implementing the Auckland Plan** - The Auckland Council has conducted workshops with each CCO to work through the contributions that the CCO will make to the success of the Auckland Plan overall (for example, not just the contribution that Auckland Transport will make to the transport needs of Auckland, but how its activities generally can support the whole strategy). From these workshops, agreements reached with the CCOs have been used to inform the Letters of Expectation from the Mayor and to review and revise the SOIs.

- **Council-controlled organisation accountability policy (draft 2012)** – Here Auckland Council has prioritised for each substantive CCO the objectives/priorities from the council's Long-Term Plan that the CCO is expected to contribute to, as well as aligning their activities with their respective objectives.
Shareholder Expectation Guide for Council Controlled Organisations – This was developed after the Council prepared and consulted with the CCOs on a paper that better defined the respective roles of each party, and builds on a similar document that the Government has adopted for its entities. It outlines the six principles of a Good Governance Relationship that the Auckland Council has adopted. In summary these principles make clear:

- **Leadership** - The Auckland Council is responsible for setting the strategic direction and communicating this via the Letter of Expectation, and CCOs should show leadership in their areas of expertise consistent with shareholder expectations.
- **Empowerment** - CCO directors must be fully empowered to fulfil their roles.
- **Accountability** - The accountability of elected members for the use of ratepayer money and stewardship of council owned assets must be ‘transferred’ to the CCOs.
- **Transparency** - A high level of transparency is required especially where CCOs are undertaking a mix of commercial and public-funded activities, to ensure visibility of achieving public good outcomes.
- **Public Service Ethos** - CCO directors must ensure they behave in a manner consistent with the spirit of public service, and require the same from their executives.
- **Trust** - Productive CCO relationships require a culture of cooperation and trust, including a ‘no-surprises’ policy.

These actions fed into the SOI process for 2012, and together with a series of other formal and informal actions discussed later, are resetting the relationship between the Auckland Council and its CCO (and the relationships between the CCOs).

The process that the Auckland Council has used is similar to that which the Ministry of Science and Innovation (MSI) has used with Crown Research Institutes (CRIs). Following the 2010 review of CRIs:

- The government identified that CRIs are part of a national science system, and each one has its own unique role and contribution to make to that system. Each of the eight CRIs is aligned with a productive sector of the economy or a grouping of natural resources.
- To support this, Cabinet has adopted an enduring Statement of Core Purpose (with a 15-year focus) for each CRI, each developed through a high-level dialogue with the CRI and its stakeholders. The statement of core purpose sets out an enduring purpose statement for the entity, identifies the CRI-specific outcomes it will contribute to and the scope of the individual CRI’s operation, and specifies the operating principles (or behaviours) expected of it.
- Annual outlook letters and core funding agreements, which acknowledge the separate ownership and purchase interests of the Crown, support the statements.
- These are used to guide each SOI, which is expected to provide the strategy by which the CRI will meet the obligations in the Statement of Core Purpose and the SOI.
- The performance of the entity is then measured against the outcomes and the operating principles in the Statement of Core Purpose. Both parties understand this clearly – MSI, on behalf of the owner, and the CRI.
**Ongoing strategic alignment**

140 The discussion about purpose and direction between a council and its CCOs should be an ongoing discussion, not a one-off discussion.

141 The SOI process is a formal mechanism that underpins this. Each CCO must prepare annually a SOI that is delivered to the shareholders by 30 June each year and covers the immediate financial year and the following two years. The Auckland Council legislation requires substantive CCOs to prepare a 10-year plan.

142 The SOI documents publicly the activities and intentions of a council-controlled organisation for the year and the objectives its activities will contribute to, provides an opportunity for shareholders to influence the direction of the organisation, and sets out the performance expectations directors are responsible to their shareholders for.

143 A SOI cannot be inconsistent with the constitution of the CCO, but under the Local Government Act must include[^33]:

- The objectives of the entity or entities, a statement of the board’s approach to governance of the group, and the nature and scope of the activities to be undertaken by the group.
- Performance targets and other measures by which the performance of the group may be judged in relation to its objectives, and the kind of information to be provided to the shareholders by the group during the course of those financial years, including the information to be included in each half-yearly report (and, in particular, what prospective financial information is required and how it is to be presented).
- Any other matters that are agreed by the shareholders and the board.

144 However, while the Local Government Act sets out the statutory minimums for the SOI, adherence to that alone is unlikely to achieve either the spirit of the Act or good governance as envisaged in the principles set out by the OAG. OAG has identified[^34] that a SOI should include:

- The nature and scope of the entity’s functions and intended operations.
- The specific impacts, outcomes, or objectives that the entity seeks to achieve or to contribute to through its operations.
- How the entity intends to perform its functions and conduct its operations to achieve those impacts, outcomes, or objectives; and to effectively manage those functions and operations within a changeable operating environment.
- The main measures and targets that the entity intends to use to assess and report on matters relating to its future performance, including the impacts, outcomes, or objectives achieved or contributed to by the entity (including possible unintended impacts or negative outcomes).
- The cost-effectiveness of the interventions that the entity delivers or administers
- The entity’s organisational health and capability to perform its functions and conduct its operations effectively
- Any other matters that are reasonably necessary to achieve an understanding of the entity’s operating intentions and direction; or may be specified by the shareholder/s

145 The SOI is important in helping define the roles, relationship and performance expectations between the council as shareholder/owner and the CCO. This is not a one-way process. The
process is about the shareholder setting expectations and about the entity considering its ability to achieve the expectations. The CCO must prepare a draft SOI and present it to the Council as shareholder for comment, and it does need to be agreed to by both the shareholder and the board but it is not solely an expression of what the board intends to do. Together they need to reach an agreement.

146 An annual Letter of Expectation from the owner to the CCO (before the draft SOI is prepared) is a practice that has been widely adopted in the governance of SOEs and Crown entities, and has usually been adopted by the councils interviewed:

- Wellington City Council – uses a Letter of Expectation to identify general matters for the boards to consider (in 2012 this included a request to the CCO to identify its contribution to the 2040 Strategy, how it can work within its existing funding level or reduce costs, a focus on health and safety) and specific requests such as further details about capital requirements.

- Auckland Council – uses a Letter of Expectations to identify the general expectations of all CCOs and those specific to the entity. For Watercare, the letter states which parts of the draft Annual Plan with which Watercare must act consistently, a list of key strategic projects relevant to Watercare, and identifies strategic priorities that support the Mayor’s vision for Auckland (namely - focusing on demand management, conservation, environmental quality, and sustainability initiatives, including reducing pollution in harbours; reviewing options for wastewater treatment in outlying communities; and “working with people” about unpaid accounts, rather than taking punitive action).

147 The Treasury and other departments representing the Crown’s ownership interest generally use Letters of Expectation (or in the case of MSI – an Outlook Letter) to set similar expectations. The general expectations will reflect the government’s key result areas (KRAs). For SOEs, these letters are likely to focus on the specific financial returns expected; for Crown entities, they are more likely to focus on non-financial matters. These annual Letters of Expectation are in addition to the 2008 Enduring Letter of Expectations to all Crown entities, from the Minister of Finance, which specifies the government’s expectations about value for money, demonstrated performance, and ‘no-surprises’ engagement with ministers and monitoring departments.

### Clarity around the respective roles

148 The owner and the arm’s-length entity each have a number of different roles, and both acknowledging these roles and giving them due attention is necessary for the different expectations to be met. OAG has highlighted the importance of assigning clear roles and responsibilities to the Council as the owner of the entity and as a partner or purchaser in activities, to Council representatives, to the governing body, and to the Council Chief Executive Officer.

149 Lack of attention to and understanding of these different roles will affect expectations and the parties perceptions of success, and the council and the CCO may start to move (albeit unintentionally) along divergent paths.

150 A familiar issue is the bundling of the ‘parent’s’ roles. A public sector owner will often have a purchase or funding arrangement with the arm’s-length entity, as well as the strategic,
appointment and monitoring roles associated with its ownership interest. These different ownership and purchase roles need to be overtly articulated and distinctly managed, rather than bundled together. All parties need to understand, for example, that the council remains accountable to the ratepayers for the funding and performance of these entities. This means there needs to be transparency in the decision-making and the reporting to enable this.

Owner and stewardship

The first role that comes to mind is the roles and responsibilities of the owner. In the case of councils, they are also stewards of assets or entities on behalf of their communities as the activity has usually been developed through ratepayer investment. Whether the asset remains in council ownership or is transferred to the entity, and where there is an operating grant in place, this stewardship will influence the approach that the councils take to their ownership role.

The owner or shareholders need to be clear about the ownership roles and the way that these will be undertaken. This includes:

- Making sure that there is an appropriate and transparent appointment process for appointing members to the board.
- Making clear the performance expectations and the mechanisms and procedures that will be in place to assess and monitor performance.
- Clarifying processes for directly consulting with the community (for example, as a service provider).
- Identifying the expected behaviours (for example, are there circumstances when media communications from the CCO or other entity should be run past the ‘parent’? or policies of the parent that the entity should also comply with?).
- Making clear there should be a ‘no surprises’ policy, and how that will be demonstrated.

These expectations and understandings should also be written down so they can be referred to later, not the subject of a ‘handshake’ between individuals who may no longer be involved with the parties when any issues arise.

COMU has developed a Shareholder Expectation Guide for SOEs, as has SSC for the Crown entities and Auckland Council for its substantive CCOs. These document the expected behaviours and provide some template information – for example, what a SOI is expected to include. The Auckland Council’s guide makes clear the council’s (governing body’s) role as:

“The role of the council as shareholder is to set expectations and monitor the performance of its CCOs under the relevant legislation. Performance is monitored against the SOI and Long-term plan (LTP) measures and targets. The tension between the council and its CCOs is most likely to arise when the council attempts to go beyond this role in monitoring or decision-making. However, the council has further obligations to ensure the wise and transparent use of public money and the protection of public assets managed and owned by CCOs. The council also has a role in ensuring that CCOs do not make decisions that could have significant future funding implications for the council. These obligations can require a level of scrutiny.”
This is supported by a description of the nature of decisions to be taken by the council and by the board. This document differs from the constitution or deed that is developed for individual entities, as it sets out the general parameters of the relationship and applies evenly across all the substantive CCOs. Much of the content could be scaled to apply to smaller entities.

Where the subsidiary entity is a trust or other non-corporate entity, a memorandum of understanding may suffice. The point is not the nature or title of the document but the fact that a document is in place and can be referred to as necessary.

The owner also has obligations in this relationship. As owner, the Council should not be involved in the day-to-day management of the entity or the activity. Instead, once the strategy is clear and good people have been put in as directors, the CCO should have operational autonomy to deliver the expected objectives.

**Partnership**

Both parties have roles, albeit different ones, in the overall governance of their local communities. The owner may have policy and strategy setting roles versus the arm’s-length entity’s service delivery or implementation roles, for example. However, they will both have roles in a sector and in serving a community. There may well be complementary or competing activities too, that both parties deliver, so agreeing how they will respectively operate is important.

While an SOE or self-funded CCTO may operate more independently (thinking of an entity like Orion), they should understand that their behaviours still need to fit with the behaviours expected of a public entity and their actions need to contribute to the well being of the community.

These relationships are about developing ways to work together for the community. Working in an uncooperative or competitive way will not achieve successful outcomes.

**Budget discussions**

Being clear about how and when funding discussions with the council will occur, aligned to the LTP and annual planning cycles, is also important. A good place to articulate these expectations would be in the shareholder expectations guide.

**Purchase and funding arrangements**

One of the things that should be emphasised is where there is a purchase arrangement or a funding flow from the ‘parent’ to the ‘child’; this should be distinct from the ownership interest. A separate purchase agreement, service level agreement, or output agreement should be in place for this; as for other contracts for service. If the roles as owner and purchaser/funder are merged, the expectations will be muddled and often difficult to unpick if dissatisfaction occurs.

The output agreements and memorandums of understanding (MOUs) that departments establish with Crown Entities can provide models for this. An output agreement for a Crown
entity is established where there is funding from the Crown, unless there is another agreement or document such as a MOU that serves the purpose. This might be important where:

- Crown entities receive considerable funding from both Crown and non-Crown sources.
- Ministers want a basis for agreement about what services are to be provided.
- Ministers want a clear basis for setting or assessing the level of fees to be charged by an entity.

The same issues occur for councils and CCOs. Many councils have put purchase or service level agreements (SLA) in place to provide for the accountability for the rates or other public funding it provides to the CCO.

**Monitoring**

Having said that the wider engagement and strategic direction setting processes are not about a compliance relationship, there are compliance roles. The SOI sets out the agreed performance expectations and these have to be monitored. CCOs are required by statute to report to shareholders six monthly and annually. The half-yearly report is due within 2 months of the end of the first half of the financial year, and the annual report within 3 months after the end of the financial year.

The performance measures used for monitoring do have to be relevant and enable the owner to understand if performance is improving and where risks are arising. In 2007, the Office of the Controller and Auditor-General published a report *Statements of Corporate Intent: Legislative compliance and performance reporting*. This found:

- Considerable variation existed in the clarity and "measurability" of performance targets and their linkage with the organisation's objectives.
- Many targets were not easily understood.
- Fifty percent of the CCOs sampled did not have performance targets that addressed all of the entities' stated objectives.
- The CCOs in the audit sample were particularly weak on linking their statutory obligations to be good employers and exhibit a sense of social responsibility with specific performance targets or measurements.
- Statements of service performance, which are part of a council's annual report and where performance against targets are documented and published, are not uniformly used.
- Without a robust annual performance measurement framework, objective assessment of the performance of the board of directors and the chief executive of the CCO in question may be compromised.

This is an area for ongoing focus in central and local government. Getting the performance measures relevant and useful is a challenging task, but needs the appropriate level of attention within the shareholding organisation as well as at the board table, if the wider contribution to the owners’ (and community’s) outcomes are to be successful. An example is that COMU (the Crown Ownership Monitoring Unit at the Treasury) monitors SOEs, which the Government largely hold for getting a financial return. As such, the government expects commercial measures of performance. With this in mind, COMU has been making it clear to all entities that it has been placing a strong emphasis on shareholder returns and on the dividend policy.
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...and these expected returns form the basis of their performance measures. Non-financial as well as financial measures are important. The non-financial measures add the expected impact to the monitoring framework, and thereby assist with greater alignment.

168 A key focus needs to be that the measures should be SMART (specific, measurable, accountable, results-oriented, and time-bound). As a rule of thumb, if the measure is very easy to identify, then it pays to think whether that is likely to be the most effective measure.

169 Where within organisations the monitoring roles are undertaken varies between different owners. MSI has a monitoring team, with a senior manager, who is responsible for the relationship with each CRI, as well as for working with each one on their strategic direction and wider contribution to science (and how this will be reflected in the SOI and performance measures). That team liaises regularly with the CRI board Chairs – as it is to the board that the Crown has devolved some of its responsibilities (although there is also a strong relationship with the CEOs). Responsibility for science policy sits with the policy areas of MSI, and the monitoring team liaises closely with them. Ministry of Transport and Department of Labour have similar but smaller teams, and the relationships operate at varying levels through the organisation.

170 The Ministry of Culture and Heritage (MCH) operates matrix models – where advisers responsible for non-financial performance are located in subject areas, and the appointments process and financial monitoring are in a related team. As with Treasury, MCH provides advice on alignment and performance to the relevant Ministers. MCH has an informal monthly reporting system in place where each entity completes a short-form report and MCH summarises all of this to the Minister, to ensure a no-surprises approach. Waiting for a quarterly report will not achieve this, as it is essentially a historic review of what happened, rather than a forward view of performance trends and risks. This matrix model is essentially replicating on a sector basis the dispersed model that central government overall has adopted (with Treasury responsible for the overall financial performance of the Crown's arm's-length entities, and the day-to-day relationship and expectation setting sitting with the relevant department).

171 The WCC has a CCO team within its Finance team, which coordinates quarterly and annual reports to the Council Controlled Organisation Performance Sub-committee (CCOPS), which in turn reports to the Strategy and Performance Committee (a committee of the council as a whole). CCOP's terms of reference is to review quarterly and annual reports, business plans, strategic plans and SOIs for all WCC's COS, CCOs, and CCTOs. CCOPS includes councillors and two independent members. The monitoring team has portfolio advisers assigned to the CCOs, although for some CCOs, such as Capacity, the primary relationship sits with the Infrastructure team because of the technical content.

172 Auckland Council has a CCO monitoring team, which works closely with the Office of the Mayor and with the CCOs on the strategic direction and performance expectations, as well as monitoring and reporting. The monitoring team liaises with other parts of council regarding expectations, and reports to an Accountability and Performance Committee (comprising all...
councillors) that reviews the performance of CCOs quarterly, and a CCO Strategy Review Subcommittee (chaired by the Mayor) responsible for reviewing and commenting on CCOs’ draft Statements of Intent (SOIs). Both committees operate according to the Council’s standing orders and the relevant legislation. They are generally open to the public, although commercial-in-confidence matters are dealt with in public-excluded parts of the meetings.

Depending on the purpose of the CCO (e.g., solely for generating revenue, through to delivering services on behalf of the council), this will also influence where in the council the shareholders primary relationship management role should sit. There will always be key roles around the appointment process, the process of setting expectations and monitoring financial performance, which should probably be located together. However, where there is a strong direct service level expectation, operational funding from the council, or a significant contribution to the wider council or community outcomes, it may be appropriate to locate that responsibility with the appropriate policy setting area of council.

The right people in the right roles

The directors/trustees and the CEO of a CCO or other entity should have the right skills and expertise for that organisation, and for the "age" of the organisation. Appointing directors or trustees is one of the key responsibilities of the council and having robust processes in place to appoint the right people is important; as is thinking carefully about the option to remove them (usually an action of last resort). Appointing as a director someone who is skilled at governing a mature or a large organisation may not be appropriate for a small start-up entity, for example.

Furthermore, as an entity can become a CCO if council appoints more than 50 per cent of the directors or trustees, a council needs to consider carefully the implications of appointing persons to the boards (including community based trusts) which are not yet CCOs, as that appointment process could de facto make it a CCO.

The directors

SSC guidance for Crown entity boards has identified the following behaviours expected of board members, for their role to be effective:

- **Responsibility to the entity.** Members need to recognise and always act consistently with their responsibilities to the entity and to Ministers. They should attend induction training and board members’ professional education to familiarise and update themselves with their governance responsibilities.

- **Strategic perspective.** Members need to be able to think conceptually and see the 'big picture'. They should focus as much as possible, on the strategic goals and overall progress in achieving those rather than on operational detail.

- **Integrity.** Members must demonstrate the highest ethical standards and integrity in their personal and professional dealings. They should also challenge and report unethical behaviour by other board members.

- **Intellectual capacity.** Members require the intellectual capacity to understand the issues put before them and make sound decisions on the entity's plans, priorities and performance.
Independent judgement. Members need to bring to the board objectivity and independent judgement based on sound thought and knowledge. They need to make up their own mind rather than follow the consensus.

Courage. Members must be prepared to ask the tough questions and be willing to risk rapport with fellow board members in order to take a reasoned, independent position.

Respect. Members should engage constructively with fellow board members, entity management and others, in a way that respects and gives a fair hearing to their opinions. In order to foster teamwork and engender trust, members should be willing to reconsider or change their positions after hearing the reasoned viewpoints of others.

Collective responsibility. Members must be willing to act on, and remain collectively accountable for, all decisions even if individual members disagree with them. Board members must be committed to speaking with one voice once decisions are taken on entity strategy and direction.

Participation. Members are expected to be fully prepared, punctual and regularly attend for the full extent of board meetings. Members are expected to enhance the quality of deliberations by actively asking questions and offering comments that add value to the discussion.

Informed views. Members are expected to be informed and knowledgeable about the entity's business and the matters before the board. Members should have read their board papers before meetings and keep themselves informed about the environment in which the entity operates.

Financial literacy. Boards monitor financial performance and thus all members must be financially literate. They should not rely on other members who have financial qualifications and should undertake training to improve their own financial skills where necessary.

Sector knowledge. Members need to make themselves familiar with the activities of the entity and sector. This is likely to include attending induction sessions and ongoing background study.

In setting the expectations of CCO boards, councils should consider articulating similar behaviours.

Appointment of directors

The Local Government Act 2002 specifies that the role of a director of a council-controlled organisation is to assist the organisation to meet its objectives and any other requirements in its statement of intent, and other duties under any other Acts. A subject of much debate is whether elected members or senior managers of a council should be directors on its CCOs or other arm's-length entities, or not. There is no specific prohibition on this, but there are a number of factors that point away from it.

Each council with CCOs –

must adopt a policy that sets out an objective and transparent process for -
(a) the identification and consideration of the skills, knowledge, and experience required of directors of a council organisation; and
(b) the appointment of directors to a council organisation; and
(c) the remuneration of directors of a council organisation.
And may appoint a person to be a director of a council organisation only if the person has, in the opinion of the local authority, the skills, knowledge, or experience to—
(a) guide the organisation, given the nature and scope of its activities; and
(b) contribute to the achievement of the objectives of the organisation.\textsuperscript{36}

180 The appointment of the right people to be board is important because once appointed, the directors and trustees have to act in the best interests of the entity.

181 Board duties are often referred to as directors' 'fiduciary duties'. For CCOs, board members hold positions of trust and the manner in which they undertake their collective and individual responsibility and accountability are fundamental to the integrity of the board. Company directors are obliged to pursue the purposes of the company (according to its constitution), they owe a duty to the shareholders to act in good faith, and not to act for personal or third party gain nor solely in the interests of the shareholder. Similarly, councillors owe a fiduciary duty to ratepayers "in relation to the application of funds contributed by the latter"\textsuperscript{37}.

182 On the whole, most guidance advocates that politicians and senior managers should not be members of governing boards. OAG considers as trustees or governing body members, councillors owe a primary fiduciary duty to the interests of the entity, creating potential conflict with their duty as councillors; and that council representation on a governing body is not a transparent and effective way to hold that body to account and provide assurance to the council and community about its performance. The OECD guidelines on corporate governance of state-owned enterprises states that boards should be composed so that they can exercise objective and independent judgment. This means that when individual board members carry out their duties, they do not act as representatives for different constituencies nor be guided by any political concerns.

183 In Canada, for example, the issue of having politicians as board members has emerged as an issue for a number of transport authorities. A review of Vancouver's Translink\textsuperscript{38} found that board members were focused on the interests of their own municipalities instead of the broader interests of the region and that the board of directors had no ability there to develop the skill-set to understand major, multi-billion projects.

184 In New Zealand, Ministers are not appointed to the boards of Crown entities or SOEs. The most recent local authority – the Auckland Council – has been prohibited by statute from appointing as director of a substantive CCO any person who is a member of the governing body of the Council or a member of a local board of the council. This follows from recommendations from the Royal Commission on Auckland Governance that no elected members or council staff should be able to be appointed to any of the CCO's that it proposed for the Auckland Council. This recommendation was repeated by the Auckland Transition Agency, and implemented by the Government in the Local Government (Auckland Council) Act 2009.

185 A similar approach was taken in the Larsen report on Dunedin City Council's CCOs, which recommended that elected councillors "cannot hold director positions in either the holding company or a subsidiary", that "the CEO and CFO of the Council should attend DCHL board meetings but not hold board positions" and that members of Dunedin City Holdings Ltd (DCHL)
should not also be members of its subsidiaries. Larsen made these recommendations as DCHL has both a strategic and performance monitoring role (so DCHL directors were in effect receiving reports and making judgements on their own performance); although he also noted that this approach did not need to be a long term solution for the Dunedin situation.

186 In both the Auckland and Dunedin instances, a key part of this advice has been that where the same person is in a decision-making and a scrutiny role over an entity, one of these roles will probably be compromised. The Dunedin City Council experience was that where there were common directors on the holding company and on the subsidiaries, the individuals were not asking the hard questions at the point of scrutiny (and therefore with a different "hat" on), as they had already considered the issues from the subsidiaries’ perspective. Therefore, in essence, the hard questions were not asked. At each point, the fiduciary duty is slightly different. As a board member of a subsidiary, it is to the subsidiary. For a company, it is to the group of entities and as set out in its constitution and SOI.

187 At the council table, there is the added obligation not only to act for the well-being of the district or region rather than for the entity, but also there is the obligation on members to consider views presented to it with an "open mind". Again, there can be conflicts of interest that need to be managed, often with members declaring an interest and stepping out of a discussion. With small boards, this can complicate the decision-making, especially if there is more than one elected member on the board.

188 In contrast, elected members constitute half the directors of Christchurch City Holdings Ltd (CCHL), and interviews with staff from the council and the holding company indicated that this provides an additional opportunity for the board to understand the shareholder perspective.

189 OECD guidelines and OAG reports both acknowledge that sometimes public bodies are keen to appoint politicians onto the boards of the arm’s-length bodies they control, as they perceive the benefits outweigh the risks. The main benefit is expected to be greater responsive to the expectations of the owner. The OECD guidelines further note that where politicians and civil servants are appointed to boards, this should only be done if they bring the required skills and knowledge to the board, have the same duties and responsibilities as the other board members and act in the interest of the entity and all its shareholders. This means that politicians would need to participate in the same rigorous selection process as others applicants.

190 The key issue here is balancing the potential for greater information flows between the ‘parent’ and ‘child’ organisations with the potential of conflicting roles occurring (and possibly less than ideal focus on scrutiny) and the underpinning assumption that better decisions will be made by people appointed on merit. If the key object is to have better information flows, there should actually be other ways to achieve this. One elected member on a board has identified that the greater benefit was that the board members got to hear the matters of priority for the council owner, rather than the CEO or staff and that information not getting to the board. If good processes are in place, especially some of the ‘soft’ relationship arrangements (such as regular meetings between the mayor and the chair) then this link at the board table should not be necessary. If a council wishes, the scrutiny can be by the council as a whole, and the soft relationship management processes can include a portfolio leader where these occur.
The newer practice of not appointing elected members seems sensible and avoids risks of conflicts of interest. It also provides better opportunity for scrutiny from the council. If the council considers elected members should be on a board then:

- Limit the elected members to one, as it is not necessary to have more than one member to provide the information flow if that is the objective.
- Ensure that the elected member is actually appointed if they merit the role (ie have the appropriate skills and experience).
- That elected member should not be on any committee charged with scrutiny; if this is a committee of the whole council, they may need to declare a conflict (and this reduces the critical scrutiny input).
- Ensure that the elected member acts as a councillor at the council table (acting in the interests of the wider community), and not as a board member.

**Finding the right people**

As noted above, the council can only appoint as a director a person who has the skills, knowledge or experience to:

- Guide the organisation, given the nature and scope of its activities and
- Contribute to the objectives of the entity.

Based on the interviews conducted, the identification of skills is done in different ways – the Auckland Council (for its substantive CCOs) and COMU (for SOEs) establish a matrix of skills required on each board it appoints to. Some councils ask the chair of the entity to identify the skills that the chair thinks are needed on the board. Where there is a holding company in place, it may advise on or identify the skill requirements.

A skills matrix identified by the council and used to support the appointment process should provide consistency in the quality of the board. To develop the matrix, it is appropriate to ask what are the skills and expertise necessary for this entity to be successful. There is not a lot of value in appointing as directors people experienced in managing large and stable organisations to a small start-up entity or one needing significant change, for example. It is important to consider the nature and maturity of the entity, and its future direction. Also, the NZX has identified for private boards that:

> There is credible research based evidence which suggests that diversity in a variety of forms, and gender diversity in particular, contributes to improved performance at both Board and senior management level. It promotes diversity of thought which stimulates more innovative problem solving and may promote identification and better management of risk.\(^{39}\)

That skills matrix should then be used to inform a discussion between the appointing advisors in council and the chair of the CCO to determine the current skills gaps and how to fill these. Developing a database of potential appointees is useful if the council has a number of boards to appoint to. In addition, the government maintains databases for potential board appointments (especially the COMU and Ministry of Women's Affairs databases). It is quite appropriate to widely canvas for potential appointees (including board specific advertising, searching professional databases, and shoulder-tapping).
Board Induction

196 Board induction needs to be approached consistently to be successful. Approaches to induction vary according to the interviews conducted and the material reviewed.

197 Ensuring that the board understands, is inducted into and ‘buys’ into the purpose for the entity is important. This is likely to be enhanced if the council inducts the board, both the initial board and subsequent members, to facilitate greater alignment and consistency of understanding.

198 Cabinet guidelines for Ministers responsible for Crown entities state:

"Monitoring departments share responsibility for the induction of new board members with Crown entity boards. The monitoring department should give new board members an introductory briefing on the Crown entity environment and the expectations of Ministers. The training for board members from monitoring departments might also cover: the strategic direction for the Crown entity and any areas of sensitivity or high risk; the importance of declaring interests in relation to the entity; the individual duties of board members; the duties of board members for which the whole board is responsible rather than individual members (collective duties); promoting good relationships with key parties such as Ministers, the chief executive, other board members and monitoring departments.

Board chairs should brief members about the board’s specific environment. This briefing could include: information on the Crown entity’s business (including operation site visits where relevant); the structure of the board and its procedures (sub-committees, workload and time demands, governance and management issues); responsibilities to the chair and to board colleagues; relationships with the Minister and Parliament."

199 This approach is equally applicable for CCOs.

Board evaluation

200 Current practice, as promoted by SSC for Crown entities, COMU for SOEs and OAG for councils is that board evaluation is an important component of the overall relationship and as a measure of success. There are essentially two aspects – the first being an evaluation that each chair should take of the board members (which may be used when the chair and the ‘parent’ are discussing members whose terms are up for renewal) and collective evaluations (which are about the overall performance of the board).

201 In 2001, OAG identified evaluations of board performance should be undertaken regularly (preferably annually), against an objective framework and that director peer review is consistent with the self-appraisal principle that professionals should monitor their own performance. This is consistent with advice provided in the UK. COMU has put such a process in place for its boards, as has MSI for the CRIs; and SSC has advice on this available for all Crown entities.

202 The Auckland Council has an initial process in place, but currently is putting a wider review process in place at present so it can have confidence in how the boards are operating as well as how the entities are operating.
At the end of the day, replacing the board for poor performance is an option (albeit rarely used) for the shareholder.

**The CEO**

It is a role of the board of the CCO or other entity to appoint the CEO, and everyone interviewed has commented that getting the right person in this role is also important in order to get successful outcomes. The appointment of the CEO is also one of the most important tasks of the board – if they get it wrong, that can cause difficulty in relationships and performance.

In appointing the CEO, however, the board must have regard to some of the same factors that the owner has regard to when appointing board members – what are the skills this entity needs going forward? Does the entity need strong leadership or effective management? Does this person understand and can it operate in this environment? Although the entity is at arm's-length, again understanding the strategic and political context that the council operates in is fundamental to success.

**Transparent processes**

This is about not just doing it right, but letting others see that you are doing it right. Not everyone will always agree with specific decisions or results from arm's-length entities, but there is likely to be less concern expressed when the decision-making processes are transparent – be that appointment processes, discussions of expectations, performance concerns, or funding arrangements etc. The transparency underpins the accountability.

**Appointment processes**

The process for determining appointments to boards has been discussed above. Where the process is transparent (there is a skills matrix in place, and there is an advertising process followed, etc), there is much less concern able to be expressed that it has been a case of political patronage or "jobs for the boys" or "the same old faces". Without this transparency, the performance debate can start from a base of mistrust, which makes it difficult to identify if there really are performance issues in play or just mistrust creating a lot of noise.

**Scrutiny**

While the responsibility (and some autonomy) for delivering an activity or service has been devolved to an arm’s-length entity, that does not remove accountability that the elected members will have for the expenditure of public funds or the stewardship of public assets. The question becomes what and how much information the elected members require, and how will they receive this, in order to provide that assurance and accountability to the community.

The owner or shareholder needs to have ongoing assurance from the boards regarding performance against the expectations and risks that are identified. OAG recommends that a council (as owner) should seek strategic information appropriate for a diligent and informed investor. This can involve a company board consulting its shareholding council on key features of the board’s business plan and have a process in place for considering commercially sensitive information; and, drawing on the business plan and strategic outlook, a local authority should...
regularly review its interests in light of issues facing the company. Together these actions should inform the development of the SOI and performance measures.

210 In a central government context, the monitoring department works on the Minister’s behalf with the Crown entity to:

- make sure the Crown entity has identified the intended results for New Zealanders along with the Crown’s output and fiscal results;
- monitor performance against expected results and outputs;
- promote coordination of Crown entities within the Minister’s portfolio;
- advise the Minister on the Crown entity’s capability to achieve its results (e.g. by giving advice on major business cases);
- advise the Minister on the merit of Crown entity budget initiatives;
- manage risks, and keep the Minister informed of these risks.

211 There is also a continuous disclosure regime for key SOEs, which mirrors the sort of disclosure expected of publicly listed companies. A range of data and analysis produced or commissioned by Treasury, such as the Annual Portfolio Report that looks at what the Crown owns and how well it is performing and includes reporting across all SOEs on a set of 11 financial measures, has been introduced to make it easier to make direct comparisons, and is published. Independent commercial valuations of selected SOEs are commissioned from external specialists. The COMU website provides easy access to a range of other information about the SOEs and their performance (such as annual reports, Statements of Corporate Intent, summaries of financial information and results). Some SOE boards have also been asked to conduct post-investment reviews to examine how successful their past investment projects have been – and consequently what can be learnt to inform future decisions and projects. Again, these are usually published.

212 Where there is a holding company mechanism in place, the scrutiny role often sits with the holding company. This is the case with both the Christchurch City Holdings Ltd (for its CCTOs) and with Dunedin City Holdings Ltd (for its CCTOs and now for some CCOs such as the Stadium Trust). Here the board of the holding company will set up the reporting requirements and processes. CCHL brings together the chairs of the subsidiaries regularly, and requires each CCO to:

- Do a presentation to CCHL twice a year.
- Have a full discussion at business plan level with CCHL, not just at SOI level (resulting in a better SOI).
- Undertake quarterly reporting to the holding company, with CCHL then reporting six monthly to the Christchurch City Council in summary form.
- Ensuring a ‘no surprises’ for CCHL, so CCHL can give the Council a heads up on key issues.

213 Dunedin City and DCHL have a similar relationship in place for the CCTOs, and more recently the council has also transferred the governance and monitoring function (although not the ownership) for Dunedin Venues Ltd and Dunedin Venues Management Ltd to DCHL, as it
considers that DCHL has better expertise than within the council to focus on improving their performance.

214 Within other councils, the more usual approach is to have a CCO monitoring committee. This ensures that the elected members are able to scrutinize the performance and thereby enhance their ability to be ultimately accountable to their communities.

Public meetings

215 There is an expectation that SOEs will each year hold an Annual General Meeting at which shareholding Ministers can engage with the Board about the results the SOE has achieved. In addition to that AGM, there is also an expectation that each SOE will at least once a year hold a public meeting to give the wider community an opportunity to hear and be heard.

216 This expectation of holding a public meeting is not generally a requirement on CCO. However, the board of each CCO of the Auckland Council must by statute nominate, in its statement of intent for each financial year, two of its meetings during that year to be open to members of the public. Following discussions with the Auckland Council, the CCOs now hold aspects of all meetings open to the public (excluding matters that are commercial-in-confidence).

217 Although the provisions relating to the Auckland Council are more specific that the general requirements in the Local Government Act 2002, it should be possible for all councils to have similar conversations with their CCOs and set similar expectations of them (provided there is nothing to the contrary in the trust deed or constitution of the entity), if they wished.

Graduated interventions

218 Although not currently standard practice, there is also the option of including in the establishment documentation, a process for the council to intervene formally when performance is not meeting expectations. A model currently exists for the government to intervene with statutory management regimes in school boards of trustees, for example, and WCC has introduced such a model in the memorandum of understanding it has established recently with the Guardians of Zealandia.

Review

219 An entity can be around for a long time, and the role that it is expected to play may change over that time. It would be useful to consider if there should be a review period factored in from the beginning, when the role of the entity and the constitution etc, could be reconsidered. This will be particular relevant for entities which have a limited life expectancy; but may be useful for all entities.

220 Just as there are a range of factors that influence a decision to put a CCO in place (how to hold subsidiaries to account, provide strategic direction, attract expertise and innovation, make better commercial decisions, find efficiencies and share risk, etc), so all these factors and their relative weightings will change over time. An international survey of entities and their constitutions showed many of these entities had progressively moved away from their original purpose over time. Although the current activities being undertaken may not necessarily be wrong, there should not be a disparity between the strategic direction set by the ‘parent’ and
the purpose of the CCO; if so, perhaps the entity’s constitution needs reviewing. OAG recommends that these arrangements are reviewed periodically to see if they are still fit for purpose.

221 The 2010 amendments to the Local Government Act will also require some reviews of current entities. Under the financial strategy, the council owners now have to (amongst other things):

- include a statement of the factors that are expected to have a significant impact on the local authority during the consecutive financial years covered by the strategy, including....other significant factors affecting the local authority's ability to maintain existing levels of service and to meet additional demands for services; and
- include a statement of the local authority's.....assessment of its ability to provide and maintain existing levels of service and to meet additional demands for services within those limits; and
- specify the local authority's objectives for holding and managing financial investments and equity securities and its quantified targets for returns on those investments and equity securities.\(^a\)

222 There are two key aspects here – the council needs to be assured that it should be in the business of owning a CCTO, and that it is clear how its expected levels of service will be maintained or achieved. Both sets of requirements require the council to conduct regular reviews of information.

223 It would be most useful to specify a review cycle when an entity is established. In the absence of this, the council should consider the review period that is appropriate for each entity; but maybe something like an 8-year cycle may be appropriate. This would keep the review outside of regular long-term plan and electoral cycles, but frequently enough that it will still be relevant.

**Effective relationships**

224 There need to be effective formal and informal relationships in place as it has come through clearly that the "soft" relationships (the interactions outside of the standard performance reporting) are often what make the relationships overall work. In a local government context this can be regular meetings between the Mayor and CCO Chairs, and regular meetings at CEO level, as well as regular reporting to council committees etc. When a CCO or other entity is performing at or above expectation, there is likely to be a stronger level of independence for the entity (perhaps demonstrated by less regular meeting cycles). However, it is to the benefit of all the parties involved to maintain an appropriately close relationship, as that trusted independence can easily disappear when the operating environment changes or a key performance area is not met.

**Regular dialogue**

225 The greater the level of active engagement in this process, the better the outcome is likely to be. To make the formal SOI process more effective, there are a number of informal and non-statutory actions available and frequently used.
Having a regular dialogue between the shareholder and the entity is important - where sector-wider issues, general performance matters and particular issues can be resolved. For example:

- **Auckland Council** – not only does the Mayor meet one-on-one with each CCO bi-monthly, but every 2-3 months the Mayor convenes a meeting of the Chairs and chief executives of all the CCOs together. Here the discussions are not about individual entity performance, but about the wider governance of Auckland – in which they all have roles, and about issues in common to all CCOs (such as the Auckland Council's expectations regarding common branding of the organisations).

- **Christchurch City Holdings Ltd** (the holding company which owns CCTOs on behalf of Christchurch City Council, and undertakes much of the scrutiny role on that Council's part) - the Chair of CCHL regularly brings together the chairs of the subsidiaries and the chief executive regularly meets with the chief executives to discuss matters in common (such as how to ensure an appropriate 'no surprises' policy is in place for the Christchurch City Council).

- **Ministry of Culture and Heritage** – the Minister meets at least quarterly with most entities, the chief executives meet together monthly, and the Chairs meet together with the MCH chief executive annually to discuss sector-wide issues. This is creating a greater sense of common purpose and an environment where the entities are drawing on each other naturally as issues arise, as part of the wider arts and culture family.

- **Ministry of Transport** – the Minister has annual meetings with each entity to discuss the strategic direction to inform the next SOI and also meets weekly with the Ministry (owner representative) and the New Zealand Transport Authority, and regularly with the other transport entities.

- **Ministry of Science and Innovation** – the Minister has a strategic directions discussion each year with each CRI Chair, and the Chairs collectively meet four time a year with the MSI chief executive to discuss how collectively they can 'double the value of science'.

While these processes require time and effort, they also help to create trust and confidence between a council and its CCO when it is done well. Paying *pro forma* attention to these processes will be unlikely to produce success, nor will leaving it to junior staff. These processes require attention from elected members and senior managers to influence the entity's board and chief executive, especially on matters of direction and performance. This engagement is not just part of a compliance relationship. The informal dialogue will make the subsequent documented processes more successful.

OAG reports are also very clear that building and maintaining good relationships is key to the success of arm's-length entities. OAG makes the point that the structures and processes used to establish, govern and monitor CCOs are important, but the way the parties communicate, the topics they discuss, and their collaborative approach are crucial for achieving alignment. This expectation needs to be clearly set out in the competencies of potential directors, covered in their induction and training, and made explicit in the Statement of Intent. This expectation applies to *both the council and the arm's-length body*. The OECD noted that every organisation, from an assembly line manufacturer to a government office, must rely on informal factors and the sense of joint purpose to be successful. Where performance is more difficult to measure, these informal cultural factors become the prime means of "direction, motivation, co-ordination and control". ⁴³
Not quite a checklist

In essence there is a series of questions that should be tracked through the establishment and the life cycle of a CCO.

Proposal to establish a CCO

- What are the drivers for a change from the status quo? There will often be a series of problems that the proposal seeks to address. These will form the basis of consideration of the options:
  - Should the service or activity be delivered in the future?
  - Should it be delivered by the council?
- If yes, should it be delivered in-house or at arm's-length? This will be influenced by:
  - The level of control required.
  - Is the activity core to the governance role of council?
  - Whether effectiveness will be increased by attracting skilled board members and key staff who can focus on the activities of the entity
  - Whether an improved commercial focus is important; whether there should be a revenue making or a profit-making motive.
  - The benefits of operating a company or entity with professional board of directors brings diverse and expert knowledge to the table, together with the time to focus specifically on this objectives of an entity rather than general community governance overall.
  - The reliance on council funding.
  - Any ongoing dependence on council expertise.
  - The reliance that the council itself will have on the entity, in order to meet its objectives.
  - Encouraging and enabling additional funding streams to be accessed, for example, by way of donations that would not be made to council, or through joint venture arrangements.
  - Ring-fencing financial risk, by using a company or other incorporated structure to limited the liability of the council.
- If it is to be delivered at arm's-length, what should the form be – trust, company, or joint venture, etc? There is a set of legal, tax and other commercial factors, individual to the proposed entity, which will influence that decision.
- Are all the parts of the new entity equal?
  - If the entity is in effect a holding company, the subsidiaries may have different roles, objectives, resources, customers, funding, etc. Understand how this will work together and influence the ability of the new entity to meet its own objectives.
  - Will it influence the legal structure?
- The drivers for change are not usually the same thing as the purpose of the entity going forward. However, these drivers can be used to define some of the performance measures for the entity, and the measures of success.
Initial purpose

- What is the purpose of the entity going forward?
  - There should be a link to the wider objectives of the council and the community.
  - The purpose should involve an improvement in some element of performance. This is not necessarily a financial benefit or savings.
  - Where more than one entity is being brought together, it would be expected that the overall benefit achieved should be greater than just the "sum of the parts".

- Clarity on this purpose is critical before the entity is established. It should form the basis for the consultation with the community, and inform the principal objective in the deed or constitution. As has been noted above, the entity cannot act outside its constitution, nor can the SOI require actions outside the scope of the constitution. So getting it right at the beginning is important. That does not mean that it cannot be reviewed in the future, but it will be more challenging.

- Ensuring that the board understands, is inducted into and 'buys' into the purpose is important. This is likely to be enhanced if the council inducts the board and subsequent members facilitating greater alignment and consistency of understanding.

- Depending on the purpose (eg solely for the purpose of generating revenue, through to delivering services on behalf of the council), will also influence where in the council the shareholders' primary relationship management role should sit. There will always be key roles around the appointment process, the process of setting expectations and monitoring financial performance that should probably be located together. However, where there is a strong direct service level expectation or a significant contribution to the wider council or community outcomes, it may be appropriate to locate that responsibility with the appropriate policy setting area of council.

- What are the roles of the owner/shareholder(s)? What are the roles of the Board?
  - Where the entity has primarily a profit-making motive, setting it up as an independent entity will be appropriate.
  - If there is a funding flow, this should be clear.
  - Most CCOs have mixed purposes and most are expected to deliver benefit for the wider community. The boards should understand what contribution to the wider well-being of the community the entity is expected to make.
  - These roles can be articulated in a Shareholder Expectations document, such as that developed by the Auckland Council.

- Is the entity expected to have a community engagement role?
  - Be clear about which entity will consult or otherwise engage with the community, and whether this is on behalf of the council or with its own customers.

- Will the entity have assets transferred to it, or will it manage assets on behalf of the council?
  - Either way, if there are expectations about the way the assets should be managed, retained or otherwise, these should be explicit.
Appointment of directors

- What are the skills and expertise necessary for this entity to be successful?
  - A skills matrix identified by the council and used to support the appointment process should provide consistency in the quality of the board; as will a wide process of canvassing for potential appointees (advertising, searching professional databases, and shoulder-tapping).
  - The Constitution should include matters such as the number and appointment process for directors. If there are any exclusions, such as elected members not being on an arm's-length entity (discussed above), this should be considered here too.

- What is the process for board evaluation?
  - Think here about the role that the shareholder wants in this process. The Chair should conduct an evaluation of board performance annually, and of members. Some of this information may be available to the council to consider when terms are up for renewal.
  - At the end of the day, replacing the board for poor performance is an option (rarely used) for the shareholder/s.

Statement of Intent (SOI)

- Who will prepare the first SOI?
  - The shareholder can directly establish the entity, or use an establishment board. Either way, the council should be actively involved in the preparation of the first SOI.
  - A draft can be prepared for discussion with the new board, and its approval.
  - Preparation of a draft SOI and a shareholder expectation document for the start of an entity should enhance common understand and expectations.

- What should be in the SOI?
  - The Local Government Act 2002 sets out the statutory minimums for the SOI, and adherence only to that is unlikely to achieve either the spirit of the Act or good governance as envisaged in the principles set out by the OAG.
  - The Office of the Controller and Auditor-General recommends the following be included in an SOI:
    - the nature and scope of the entity's functions and intended operations;
    - the specific impacts, outcomes, or objectives that the entity seeks to achieve or to contribute to through its operations;
    - how the entity intends to perform its functions and conduct its operations to achieve those impacts, outcomes, or objectives; and to effectively manage those functions and operations within a changeable operating environment;
    - the main measures and targets that the entity intends to use to assess and report on matters relating to its future performance, including the impacts, outcomes, or objectives achieved or contributed to by the entity (including possible unintended impacts or negative outcomes);
    - the cost-effectiveness of the interventions that the entity delivers or administers;
    - the entity's organisational health and capability to perform its functions and conduct its operations effectively; and
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- any other matters that are reasonably necessary to achieve an understanding of the entity's operating intentions and direction; or may be specified by the shareholder/s.

- What should be the period of the SOI?
  - Legislation generally requires a plan produced annually, to cover a three-year period; but the Auckland Council legislation requires substantive CCOs to prepare a 10-year financial information.
  - As the council's long-term plan has to cover a 10-year period, then requiring the CCOs to also prepare 10-year financial plans would assist the council to better understand its own opportunities and risks, and its funding requirements.

- What development process will ensure commonly agreed objectives, purpose etc?
  - As noted above, there are different approaches, but usually the greater the level of active engagement in this process, the better the outcome.
  - This is not a one-way process.
  - The process is about the shareholder setting expectations and about the entity considering its ability to achieve the expectations. Together they need to reach an agreement.

**Purchase or Funding Agreement**

- Will there be a purchase relationship with the council as well as a governance relationship? Is a separate purchase/funding agreement required?
  - Having a separate purchase arrangement agreement can clarify the purchase expectations from the ownership expectations.
  - The output agreements and MOUs that departments establish with Crown Entities can provide models for this.

**Performance measures**

- What should the performance measures be? Should they be financial or non-financial performance measures?
  - In 2007, the Office of the Controller and Auditor-General published a report *Statements of Corporate Intent: Legislative compliance and performance reporting*. This found:
    - Considerable variation existed in the clarity and “measurability” of performance targets and their linkage with the organisation’s objectives.
    - Many targets were not easily understood.
    - Fifty percent of the CCOs sampled did not have performance targets that addressed all of the entities’ stated objectives.
    - The CCOs in the audit sample were particularly weak on linking their statutory obligations to be good employers and exhibit a sense of social responsibility with specific performance targets or measurements.
    - Statements of service performance, which are part of a council’s annual report and where performance against targets are documented and published, are not uniformly used.
Without a robust annual performance measurement framework, objective assessment of the performance of the board of directors and the chief executive of the CCO in question may be compromised.

Monitoring and Reporting

- Will there be informal monitoring as well as formal monitoring? What will be the frequency of this? Where will responsibility for this sit within council?
  - Formal reporting timing and deliverables, including any presentation dates, should be clearly articulated.
  - Informal reporting and other relationships can enhance the success of the overall relationship and the delivery of the expected outcomes and services. Consider:
    - Will there be regular meetings between the Mayor and Chair?
    - Will there be regular meetings between the CE of the council on behalf of the shareholder, and the CEO of the entity?
    - Will there be regular 'roundtable' discussions with all the entities and the council (this process is used by Auckland Council, Treasury and MCH amongst others, to encourage overall 'sector' performance and alignment to priorities)?
    - How will the role of a scrutiny committee work?
    - What is the information the elected members require, and how will they receive this?

When it goes wrong

230 The last question is what can you do if a CCO or other entity is not performing as expected? As has already been stated, if the steps outlined above have all been followed and effective formal and informal relationships are in place, then performance should be as expected and this circumstance should not arise. An entity may come to the end of it useful or expected life, but that is a different matter. If it does 'go wrong', the council's formal levers are somewhat limited.

231 Where there is a purchase or operational funding arrangement in place, as with any contract for service, there are the options of reducing funding, or ceasing the funding and terminating the arrangement. However if the entity is providing community services, there is likely to be reluctance to take this action, at least initially.

232 There is the option of replacing the directors (either at the conclusion of their terms or, if the circumstance warrant it, part way through their terms). This action has recently been seen, when the government replaced several members of the Accident Compensation Commission (ACC) board, following a number of privacy breaches and significant other public criticisms of ACC over a sustained period. At the time the Minister responsible for ACC stated, when announcing that the chair had agreed it would be timely to appoint a new chair, it was also a need for the corporation to "refocus on rebuilding public trust and confidence" and time to "bring in a new culture to ACC". This is a clear example of these processes being used; but it takes courage and a willingness to wear some political flack in the community too.
Before these actions are contemplated, a better course of action would be to go back through the strategy, performance and behaviour expectation setting processes outlined above; to get the entity back on track. If council intervention actions are also allowed under the establishment or funding documents (ie the constitution, deed, funding or purchase agreements), these can also potentially be used here.
Conclusions

234 There is no single "right" way to get the best from arm's-length entities such as CCOs, but the same messages have come through again and again - getting the best of arm's-length entities is about:

- Clarity about the purpose and strategic direction.
- Clarity around the organisations' roles and behaviours.
- Getting the right people in the governance and management roles.
- Building and maintaining transparent and accountable processes.
- Building and maintaining effective relationships.

235 When these factors are in place, there is a stronger trust relationship in place. Therefore the more emphasis that is placed on getting it right from the beginning, the greater the likelihood of success.

236 So what are the key actions that will help?

- Take time to make sure as owner, the council understands what it wants to achieve, and how it will determine success. What is the contribution expected to the wider council and community? What is the improved performance that is expected? Workshopping this together with the entity might be advantageous. This will inform the Letter of Expectation and the SOI processes.
- Make sure that the council and the CCO are both clear that the CCO will be operating in a public sector environment, which has some political imperatives, and that any expected contribution to the wider community governance or wellbeing is clear and agreed.
- Relate this to the roles that both the council and the CCO will have, and ensure these are clearly articulated in an owners’ expectation manual or similar document (the Auckland Council Owner Expectation Guide and the CRIs’ Statements of Core Purpose provide examples of this).
- If there is a purchase or operational funding flow in place too, this should be specified in separate purchase or output agreements.
- Use a rigorous process to get the best people on the boards, to be right for the specific entity (ensure that the Appointment Policy articulates this clearly).
- Avoid having elected members and senior managers on boards to minimise the potential for conflicts of interest and the need for board members (or councillors when in scrutiny roles) to declare a conflict and step back from a governance role. If the council considers it has to have councillors on boards to ensure a flow of information, this should probably be limited to one member to limit the potential for conflicts.
- There should be a skills matrix specific for each entity (including an appropriate diversity in their membership).
• Ensure that the scrutiny role is managed actively and avoid having an elected member scrutinising the performance of an entity whose board they are on. This leans towards having members on a scrutiny committee who are not also on any boards.

• Be clear within the monitoring organisation where the policy setting and monitoring roles sit, and how they will operate with each other. They need to understand that these are both important roles and should be managed in an integrated way. The commonality or diversity of purposes of arm’s-length entities will affect the monitoring structure. Where this is a finite set of objectives, possibly generally financial measures, there may be a case for having these roles together (as with COMU); where there are mixed objectives, considering an approach such as the MCH’s dispersed model may work better.

• Actively manage the formal and the informal relationships. The ‘soft’ aspects of these relationships significantly improve overall performance - including regular informal dialogues between the council and the CCO to set and maintain the strategic direction, and achieve alignment and risk management. Consider:
  o Using workshops to jointly understand the expected and possible contributions (at least as part of the long-term planning process, but preferably annually),
  o Regular one-on-one meetings between the mayor and chair,
  o Regular meetings of the chairs and CEOs of all CCOs together with the Mayor and CE to encourage a collective approach.

• Identify effective performance measures that will enable performance trends to be monitored (using financial and non-financial measures for all entities) – including appropriate intermediate measures.

• Ensure that regular reporting, eg monthly updates, is future-focused and identifies risks and upcoming opportunities.

• Consider opening meetings of CCOs to public scrutiny.

• Stay as close as possible to good practice, despite being in a political environment.

In many respects, the relationships between organisations are like the relationships between people. The terms ‘parent’ organisation and sub-entity or ‘child’ are useful in thinking about the relationships between organisations. When a new entity is established, there are likely to be teething problems as the roles and relationships are understood. The boundaries are likely to be tested as the ‘teenager’ grows up, and a ‘mature’ relationship between parent and ‘adult child’, whilst on a more even keel, will require a review of their respective roles from time to time. Thinking about where specific council/CCO relationships are placed along this continuum can sometimes assist with problem solving. It may help to identify actions that can get the relationship through difficult patches more quickly. A review may require going well back through the steps to identify and communicate expectations, and the processes and relationships to support performance, in order to reconsider where the relationships are presently and what will improve the performance going forward.
Deciding whether to use an arm's-length model in the first place is usually a complex decision, and the decision-trees that central government uses are not always directly applicable. There are some activities (e.g., profit-making services) that may be a relatively natural fit with an arm's-length model, but for others the specific context of the activity needs to be analysed.

Common sense and remembering the activities or services involved are usually operating within the wider public sector environment will go a long way towards success.
NOTES

1. There are some mechanisms that only work in certain circumstances - such as SOEs and CCTOs which are only suitable when the entity is expected to be making a profit.

2. Crown entities - Government delivers key public services through arm's-length entities, namely most health, education, transport and housing initiatives. As such, many of these entities are part of the "face" of government. The term 'Crown entity' applies to a varied collection of public organisations in New Zealand. Crown entities are neither State-Owned Enterprises nor public service departments. They conduct a broad range of activities including the provision of policy advice to Ministers, provision of services to the public, administration of rules and regulations, occupational regulation and monitoring of other government entities. Crown entities fall into five statutory categories:

   - Statutory entities, which fall into one of three types: Crown agents (eg, the District Health Boards), Autonomous Crown Entities (ACE, eg, the Standards Council), Independent Crown Entities (ICE, eg, the Law Commission).
   - Crown entity companies (trading entities such as the Crown Research Institutes and Television New Zealand).
   - Crown entity subsidiaries, which are companies incorporated under the Companies Act and owned by Crown entities.
   - School Boards of Trustees, constituted under the Education Act 1989.
   - Tertiary Education Institutions, again formed under the Education Act.

   There is a continuum along which the Crown entities sit, eg:

   - Crown Agents – these must "give effect to" policy if directed by the Minister.
   - Autonomous Crown Entities (ACEs) – these must "have regard to" policy if directed by the Minister.
   - Independent Crown Entities (ICEs) – these do not need to have regard to the policy direction of the Minister unless specifically provided for in other legislation.

   Entities that form part of the state sector under the Crown Entities Act 2004 come under the following subtypes: Statutory entities — bodies corporate established under an Act (Crown agents — organisations that give effect to government policy, such as the Accident Compensation Corporation.

   - Autonomous Crown entities (ACE), which must have regard to government policy, such as Te Papa
   - Independent Crown entities (ICE), which are generally independent of government policy, such as the Commerce Commission
   - Crown entity companies — registered companies wholly owned by the Crown, including Crown Research Institutes (CRIs) and a small number of other companies.
   - Crown entity subsidiaries — companies that are subsidiaries of Crown entities.

   - School boards of trustees.
   - Tertiary education institutions, including universities, colleges of education, polytechnics and wānanga.

3. McKinlay Douglas Ltd, A draft guide to the use of Local Authority Trading Enterprises (LATEs) for NZ Department of Internal Affairs (2000), p.8

4. The circumstances and process for exemptions are outlined in section 7(1) and 7(3) of the Local Government Act 2002


6. Local Government Act 2002 section 59(1) (a) to (d).
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7 Local Government Act 2002 section 58(1).
8 KnowHow Guide to Governance under the Local Government Act 2002, p.19
9 OECD Policy Brief: Public Sector Modernisation (October 2003), p.1
10 OECD Policy Brief: Public Sector Modernisation (October 2003), p.1
11 Royal Commission on Auckland Governance Report 2009, paragraph 21.46
12 Auckland Transition Authority discussion document on Council-Controlled Organisations, 2010
21 OECD Principles of Corporate Governance 2004
23 State Services Commission, Board Appointment and Induction Guidelines, updated March 2012
24 Ad hoc Cabinet Committee on Auckland Governance Review, AGR Min (09) 10/2
26 Public Sector Modernisation: Changing Organisational Structures, September 2004
27 Larsen Report, p.6
28 State Services Commission, Board Appointment and Induction Guideline, p. 6
29 Crown Entities Act 2004 , section 50 (and applications to subsidiaries under s.98)
30 Crown Entities Act 2004 , section s.27
31 Local Government (Auckland Council) Act 2009, s.91
32 Crown Research Institute Taskforce report, How to enhance the value of New Zealand's investment in Crown Research Institutes, February 2010
33 The SOI also has to contain:
   • the ratio of consolidated shareholders' funds to total assets, and the definitions of those terms, the accounting policies of the group, and an estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the shareholders;
the procedures to be followed before any member or the group subscribes for, purchases, or otherwise acquires shares in any company or other organisation;

• any activities for which the board seeks compensation from any local authority (whether or not the local authority has agreed to provide the compensation); and

• the board's estimate of the commercial value of the shareholders' investment in the group and the manner in which, and the times at which, that value is to be reassessed.

The full requirements are specified in Schedule 8 of the Local Government Act 2002.

34 Office of the Auditor-General, The Auditor-General's observations on the quality of performance reporting, p.56. These were developed for Crown entities, but are equally relevant here.

35 Office of the Auditor-General, Statements of corporate intent: Legislative compliance and performance reporting, 2007 p.28

36 Local Government Act 2002, ss.57-58


39 NZX Limited – Main Board/Debt Market Consultation Memorandum - March 2012

40 Cabinet Office Circular, CO(o6)5, 2006

41 Office of the Auditor-General, Local authorities governance of subsidiary entities, 2001

42 Local Government Act 2002, section 101A(3)

43 OECD Modernisation Agenda 1, 2003, p5

44 Office of the Auditor-General, The Auditor-General's observations on the quality of performance reporting, p.56. These were developed for Crown entities, but are equally relevant here.

45 Office of the Auditor-General, Statements of corporate intent: Legislative compliance and performance reporting, 2007 p.28