Corporate Governance in New Zealand Government-owned Companies: A Stock-Take.

Preamble

The writer was invited to conduct a review of the corporate governance in the utilisation of the company model used in New Zealand for a range of government operations, services and commercial activities. Except where issues have been attributed, the views are those of the writer and should not be attributed to The Boardroom Practice Limited. As with the comments, the writer also takes responsibility for errors or misinterpretations.

Introduction

The adoption of the company model by the New Zealand Government for its trading enterprises was major development in the way in which government services and commercial operations were previously managed. It was also a significant change in the role and functions of Ministers as the model changed them from day-to-day decision-makers into the equivalent of owners. Although the company model had received modest attention by governments and had existed in the private sector for decades, the formation of boards for government operations led to a new and stronger focus on what came to be known as "corporate governance". This paper attempts to address how corporate governance evolved in the years following the formation of State Owned Enterprises in the New Zealand government trading environment.

Background

Prior to 1984 the Government owned a large range of what were essentially commercial trading activities (including coal mining, petrochemicals, banks, insurance companies, plantation forests and an airline). Before there were State Owned Enterprises. Crown Research Institutes and Crown Health Enterprises, there were state-run organisations with boards. For example the New Zealand Railways Corporation had a board but a review of the board's powers and functions demonstrated that the Minister of Railways retained the authority to take major decisions. To varying degrees, this practice applied to other government-owned commercial entities. However, there were many commercial and trading functions inside the departments and Ministries. Departments and Ministries were also tasked with delivering social and regulatory functions. And, even with periodic increases in delegations of authority, many issues had to be referred to Ministers or to Cabinet for decision. A few agencies were formed into companies – the Rural Banking and Finance Corporation, PetroCorp and the Shipping Corporation, for example – but, as Duncan and Bollard observed, they "were heavily constrained in their trading operations". (p.7 *Corporatisation and Privatisation* – Ian Duncan and Alan Bollard, 1992)

Responsibility and accountability were confused and there was a near absence of incentives to do better. From the late 1970s, thanks in part to a report by the Controller and Auditor-General, there was an attempt to place the cost of inputs against the costs of producing services. "User pays" was a catchphrase of the day. However, many of the costs of production were not known. As Duncan and Bollard commented, because the performance of government trading activities was less than satisfactory, it was appropriate to look at other ways of managing the entities.

In the early 1980s the New Zealand Economy was in severe difficulty. In 1984 the Treasury produced a comprehensive analysis of New Zealand's economic situation and found, *inter alia,* that the performance of the Crown's commercial trading activities was a substantial contributor to New Zealand's economic difficulty. In summary, they were found to be poorly governed, consuming large amounts of capital and other resources, and producing low-to-negative returns. *Economic Management* (The Treasury, 1984) was a benchmark document in the development of policies aimed at better utilising the State owned trading activities. It is not necessary to refer to the detailed analysis in this document but it is worth observing that that some of the reasons for the poor performance of the State owned trading enterprises including

> "(a) their lack of clear, non-conflicting objectives;
> (b) their operating environment ie the special assistance they receive and restraints on competition;
> (c) the incentives arising from existing arrangements form monitoring performance."

The Treasury also referred to "a plethora on non-commercial objectives". (p.279) Interestingly, no mention was made of forming the departmental enterprises into a company form.

Although there were government commercial structures in place before 1987, when the first State Owned Enterprises (SOEs) were formed, there was little or no reference to corporate governance issues as a specialist field of enquiry. Certainly, where there were companies, board members were governed by the Companies Act 1955 but there was little or no public debate or wide-spread institutional interest in the quality of governance. The debate on corporate governance gained little or no momentum until there were a significant number of government-owned companies, an environment that encouraged a performance focus, and reliable financial information enabling performance to be measured.

The limited liability company (versus the alternatives of state corporations or non limited liability models which characterised other government-based forms) was selected as the most effective vehicle for the management of the government commercial and trading operations. The decision was taken to treat commercial management and risk the same way the private sector did. The SOEs' market was deregulated along with special assistance which had been provided when the trading operations were within government agencies.

The single-tier board was and is the preferred model, with no executive directors appointed to parent boards and, in the last several years, no managing director. The chair and CEO roles are not held by the same person, in other than very short-term situations.

SOEs operate in an orthodox commercial environment, open to competition by private sector companies. Where they once enjoyed regulatory or structural advantages over private-sector competitors, these were progressively removed (e.g., opening the railway freight-carrying sector to road competition, separating electricity transmission from generation, and making all SOEs subject to general competition law). In many instances the sequencing of reform was critical. Typically, markets were deregulated first then companies incorporated then assets transferred at expected asset values in a deregulated environment. Government agencies were not required to purchase services from SOEs. However, strategic issues required the concurrence of the shareholders through the pre-tabling consultation on each company's Statement of Corporate Intent (SCI). In some cases, this might include pricing decisions (e.g. rural mail, electricity) although there were no legally coercive requirements that they consult.

Boards were appointed from the private sector, essentially on the basis of individual expertise. Civil servants were not appointed – and this remains the case. As with the private sector company model, no director could represent any particular community of interest. This is still the case although the focus on ethnicity appointments has sometimes created an ambiguity in the skills-responsibility for a person appointed in this way. "I'm here for my skills. Not because I am Maori!" more than Maori director as vehemently argued.

Nine SOEs were formed with effect from 1 April 1987. All were formed in terms of the Companies Act 1953 (later, the Companies Act 1993. The attempt was made to emulate private sector tensions in:

- Asset valuation
- Management contracts (for example all staff from public sector renegotiated contracts
- Significant redundancy (as a board decision) of "dead wood"
- All supplier contracts re worked
- All supply relations with the State turned into contracts

The Formation Of The First SOEs.

In addition to certain key Ministers – among them Rt Hon. (Sir) Geoffrey Palmer, Hon (Sir) Roger Douglas, Hon. Richard Prebble and Hon. David Caygill – the prime agency behind the formation process was The Treasury. This is not to diminish the role of the State Services Commission (the agency responsible for civil service employment issues) – in regard to manpower issues – and the (then) Ministry of Commerce in regard to commercial and competitive issue – but The Treasury was, effectively, the lead agency.

The (then) Hon Roger Douglas (Minister of Finance) and the Hon Richard Prebble (Minister for State Owned Enterprises) played major parts in the policy of forming companies. The SOE Act 1986 provided for two shareholding Ministers, with the latter being the "executive" shareholder for day-to-day overview.

It would be true to say that, within the concerned government agencies when the first SOEs were formed, there was only a modest understanding of the relevance and components of corporate governance. The comments in this discussion paper demonstrate how this deficiency was addressed.

The Minister for State Owned Enterprises took the unusual step of forming two groups to advise him, in addition to the usual advice stream from The Treasury. One was the SOE Unit, reporting directly to him as a part of his office; the second was the formation of the SOE Steering Committee. The SOE Unit was formed to provide complementary but contestable advice to the Minister – he respected the capabilities of The Treasury but did not want to be dependant on the agency for his sole source of advice. In addition to managing policy advice, the Unit took the responsibility for advising the shareholding Ministers on board appointments.

The SOE Steering Committee was made up of highly experienced company directors, chaired by Sir Ron Trotter KB and later, by Mr Malcolm McCaw, supported by the *ex officio* membership of the head of the SOE Unit and the relevant Treasury Deputy Secretary. The contribution to both policy and to the evolution of corporate governance in government companies by this committee cannot be understated. Not only was it a commercially - oriented test-bed for the evaluation of proposed SOE policy, it provided both the Minister and his SOE Unit with informed advice on governance and board appointment issues.

It may be noted that, immediately prior to the incorporation of the SOE boards, there were establishment "boards". These had no legal standing and were formed to prepare the first business plans, the first contracts, the draft Statement of Corporate Intent (SCI) and the appointment the CEO-elect. The establishment board also developed the draft company constitution and the sale and purchase agreement for the transfer of assets from the parent agency to the new company. These "boards" also developed their own valuations of the businesses they were being asked to form. These were compared against those made for The Treasury and the differences negotiated in the context of the "sale and purchase" agreement. Some of the negotiations were protracted beyond the incorporation date.

These "boards", in shaping the future of the businesses, had the task of identifying which of the departmental staff would be taken into the new business. This was a shattering time for the state services. Redundancies were many and the State Services Commission had the task of managing the process. Some staff were relocated to other agencies but many were made redundant. It is not the writer's purpose to comment on the social impacts of this but it was major. As Duncan and Bollard noted (p56), "some establishment boards were able to shed staff at government expense before becoming state enterprises. For those that did not, redundancy costs .. have been considerable." Some departments and Ministries had been the repositories for "hidden unemployment" and it was in these that some of the heaviest levels of redundancy took place. Incorporation was not the end of staff-shedding. As the boards and management refined the corporatised businesses, more staff were dispensed with.

The first SOE boards were interesting. Thanks to the mood for State sector reform and the intended deregulation of the many of the policy constraints exercised by previous governments, the business sector provided strong support for the government's incorporation intentions. Business people with strong commercial and entrepreneurial reputations willingly accepted appointments to the establishment and company boards. This was probably one of the major factors for the drive for commerciality to succeed. Naturally, because of the manner in which government appointments are made, the shareholding Ministers also appointed people of lesser commercial experience, such as trade union leaders, to the boards. Although it did not then have the focus it received in subsequent years, gender and ethnic "representation" was taken into account.

Directors were appointed for up to three years and could, subject to their performance and continued skills relevance, expect a second term. Unlike today's boards, there was no formal board or director evaluation and reappointments were generally made if the chairperson and the director supported this action. At times, of course, the shareholding Ministers might reappoint under-performers for in-house political reasons.

Although the shareholding Ministers were formally empowered to make board appointments, in political reality they were – and are - required to gain the approval of their colleagues in the Cabinet (preceded by Cabinet Committee consideration) and the party caucus. There were costs and benefits to this – one of the costs which continues to the present was that the shareholders' recommendations on the make-up of demanding commercial boards were subject to the opinions of MPs who sometimes had little or no comprehension of board skills balance and commercial reality. The appointment environment called upon the persuasive skills of the appointing Ministers. Political reality meant that they sometimes had to make trade-offs.

What Did It Mean To Be A Crown Company Director?

In the early period, the need to be aware of the Crown's different expectations took some directors by surprise. Not that Crown companies had to adhere to non-commercial disciplines but some directors were not, initially, comfortable with ensuring that the Minister should be kept aware of contentious issues. The "no surprises rule", as it came to be known. But it was not all negative. Boards were pleasantly surprised to find that their Minister was fully supportive of business approaches to, for example, restructuring and to the letting of contracts. The writer was present at one meeting when the then Minister said, "I will manage the politics, you manage the business!" on an occasion when the board alerted the Minister to their approving a contract to a company based in a country not then in favour with the New Zealand Government.

The SOE Steering Committee was extremely useful to inculcating government understanding into the new boards, and to ensuring that Ministers had access to robust commercially-oriented advice when required. The chair, Sir Ron Trotter, commanded considerable personal and business respect and this, combined with the power of his personality, helped convey Ministerial governance concerns. By the same token he and his committee, provided the Minister with the comfort of commercial judgement.

Not all boards concurred unanimously with the Government's policies. In one significant issue – that of potential privatisation – boards were told that they should be managing their companies "as though they were to be sold tomorrow: There were negative commercial implications for investment programmes in this and at least one chair was heavily criticised for speaking out against the policy. It was another case in which the SOE Steering Committee chair had the mission of "advising" the "offending" chair on the Government's policies. On another occasion, the writer was instructed, in the capacity of Head of the SOE Unit, to seek a chair's resignation for his board making decisions on company remuneration not consistent with the Government's wages policy. Such decisions were the board's prerogative but it was indicative of the settling-down of the shareholder/board relationship.

Because it led to the formation of the Crown Company Monitoring Advisory Unit (CCMAU), it should be observed that the Steering Committee complemented Treasury's ownership monitoring of the SOEs. CCMAU, of which more will be said below, is the ownership monitoring agency which supports the Ministers for SOEs, Crown Research Institutes and other shareholding Ministers in their formal ownership role. It also has the key function of managing the board appointment process.

It would also be fair to say that many of the new directors were surprised at the extent to which officials took an interest in the operations of the company but this diminished as the model matured, and both the boards and the officials evolved the monitoring protocols and relationships.

But there were other issues which took some commercial directors by surprise. One was that the companies were subject to the Official Information Act and to the Ombudsman. To directors not used to having to respond to community, consumer or media requests for information, enquiries made under either vehicle were sometimes an unwelcome shock. The other surprise was that Parliamentary Select Committees were empowered to question the companies – usually the chair and CEO – on the company's performance against the Statement of Corporate Intent (SCI) for the previous year. Had this been confined to using the publicly available annual and biannual accounts, this may have been easily tolerated. However, as Parliamentary Committees are wont, MPs engaged in "fishing expeditions" for information to use to discredit the government of the day in the House. The SOE Unit found it useful to conduct seminars for the new SOE chairs to assist them in engaging with Select Committees. It is fair to say that one or two remained gun-shy. The then CEO of ECNZ Ltd offered the writer the view that boards should seize the chance to appear before Select Committees – they were platforms to display the positive side of the company. This view has since been expressed to directors on a number of occasions – though to what effect one wonders.

Another major point of difference in the government domain was that board chairs were appointed by the shareholders, not boards. Although this sometimes led to concerns over chair performance issues, the practice ensured that each board was led by a chair in whom the shareholders could derive comfort that the board's programmes would remain generally consistent with government expectations. This was not a question of political comfort but one of stability in company operations.

It should not be thought that the boards were fully independent of the shareholders. In addition to the power to appoint and dismiss directors, the shareholders had power and influence of the business of the company. In S13 of the SOE Act 1986, Ministers had the power to direct boards to make changes to the company's Statement of Corporate Intent which had, effectively, to require the company to change a particular course of action. It was not a power used without much consideration; such directions had to be tabled in the House (and, therefore, subject to debate) and, under new legislation, gazetted. Instances occurred where a board might consider the Ministers' wishes to be not in the best interests of the business. The board was protected from otherwise failing to meet its duty to be profitable by receiving a direction. It is interesting that recent legislation has carried this to non-company government boards.

Ministers' ability to procure social services they might require from SOEs was enshrined in S 7 of the SOE Act 1986, whereby the Government could require the provision of services which a board did not deem to be commercial, but on the basis that the Government would reimburse the company for the costs of this on an arms'-length basis. It is a little-used provision. However, this is not to say that directors are oblivious to the value to be derived through the company sponsoring "good works" (e.g., branding and advertising). These might extend to sponsoring opera through to community groups.

With the change in government in 1990 it might have been expected that the incoming administration would have initiated wholesale changes in board membership. In fact, this was not the case and it was the beginning of stability in board membership that largely prevails today.

The Wider Utilisation Of The Company Model

The company model was deemed to so successful that it was applied to other commercial and trading operations in agencies. State radio and television were cases in point. Other examples included the management of the State's housing stock and mortgage portfolio, weather forecasting and airports. Local government adopted the same model for electricity generation and transmission.

But there were two major sectors which took the use of the company model beyond the commercial and trading sectors and into service sectors.

The structural reforms in State trading functions were deemed to have been so effective, the then Government looked at the health-provider (hospitals), and the science and technology sectors.

A feature of the extension into the two sectors was the utilisation of the purchase/provider split.

In the case of forming companies to run State television and radio, the government retained the all-important purchase function. Utilising annual appropriations, the government formed entities to purchase radio and television programmes. New Zealand on Air had a governing board, tasked with leading the purchase functions from State and private sector sources. A feature of the reforms was the opening-up of State trading functions to full competition from the private sector.

This model was adapted to the health and science & technology sectors. For the former, 23 companies were formed in terms of both their particular legislation and the Companies Act. For the latter, ten (later, reduced to nine) Crown Research companies were incorporated.

Hospital and health services were "purchased" via the Regional Health Funding Authorities, later merged into one Health Funding Authority. It too had a governing board. With the CRIs, the Foundation for Research, Science and Technology (FORST) was the "purchasing" agency. The CRIs had to tender for funds on a project basis.

Concurrent with the extension of the company model into these sectors, there was general agreement that setting up three distinct monitoring organisations was not cost-effective. In July 1993, the Crown Company Monitoring Advisory Unit (CCMAU) was formed. In addition to placing the monitoring functions under one Unit – a semi-autonomous agency whose head was appointed by the Secretary to the Treasury – the appointments and governance policy functions were assigned to the Unit.

Board Membership

For the first SOEs, the search for directors saw the emphasis on appointees having business skills. Initially, there were only modest concerns over industry knowledge. There was, however, a growing desire to appoint more Maori and women to boards and it would be true to say that the government boards led the private sector in actively seeking and appointing women to boards. A major constraint was the then limited number of women in senior levels of business. Indeed, the women in the comparatively small group were inundated with invitations to join boards.

(a) Crown Health Enterprises/Hospital and Health Services Companies

The health-provider companies formed in 1993 – initially known as Crown Health Enterprises (CHEs) and later, Hospital and Health Services (HHS) - were intended to introduce business-like strategies and discplines into the organisations but, unlike the SOEs, their function was to provide efficient and effective health services and not to be “as profitable as comparable companies in the private sector”. Directors appointed to the boards included those with business backgrounds but some also with health and community backgrounds. Because of the issues surrounding Maori health, we strove to identify Maori with the time and capacity to become directors for these boards. As with women in the community (in the early company days) and certain skills areas, the number of Maori with company experience was limited. How this was addressed will be referred to later. Initially, it was difficult to find clinicians prepared to join the boards. Those familiar with health providers will be aware that clinicians to not readily accept constraints on their resources and there was considerable antagonism over the health reforms by this group. In some cases, clinicians also saw potential conflict between their being company directors and their Hippocratic Oath. As the reforms bedded-in, clinicians came to the view that it was better to work inside the reforms and, hopefully influence them, than be outside. Towards the end of the company period, finding clinicians proved to be less difficult. Sadly, in the writer’s view, the change of government in 2000 lead to the termination of the company model and to the institution of District Health Boards, seven of the eleven directors being elected by the local community.

For the first time, the shareholding Ministers (Minister of Finance and Minister for Crown Health Enterprises) – through CCMAU – placed observers on each board. The observers had multiple roles - but had to be careful to avoid becoming deemed directors, and thus subject to any litigation that may have been brought against the board. Their roles included being a conduit for policy explanations between the Government and the board and to supplement the monitoring regime in place with CCMAU. Many became integral members of the company strategic and business planning processes at board level but still avoiding direct influence on board decision-making. Informally, the observers also monitored the performance of the board and individual directors. The observer programme lasted for about two years. It was discontinued because there was a view that the role of the board could be undermined by the board’s perception that the observer was speaking for the shareholder and could have an inappropriate influence on the deliberations. Interestingly, it has been used in other jurisdictions, notably in Fiji. In the writer’s view, the practice is fraught with the potential for misunderstanding in among both the boards and the owners.

Whereas most SOE directors tended to be comparatively remote from the company’s customer base, most CHE/HHS directors were appointed from the community the health company served. Although this assisted directors in knowing the issues that concerned the community, it also meant that they were exposed – individually and collectively – to lobbying and criticism at home and in their social organisations. The health reforms were badly explained to the community and an under-informed public heaped concerns and complaints on the boards. The members of each board are to be commended for the constructive manner they met their governance responsibilities. However, it could equally be appreciated why some people opted not to be a part of the process!

Susceptibility to local pressure working against the board's deliberations led to another practice, that of appointing directors from outside the company's client district. This had the merit of "regional" neutrality in board decisions while also sharing, say, restructuring solutions from one board to another. Afterall, why solve the same issue 23 times?

CCMAU was in its own learning curve in its management of governance issues and the health companies broke much ground in this process. The removal of under-performing or out-of-step chairs was a case in point. Instead of using the powers endowed on the shareholding Ministers by the Companies Act 1993, the "exit with dignity" approach was generally recommended. In general, this worked well although, in latter years, there were cases when boards were dismissed en-masse. Another aspect was "stakeholder relations". It was not called this now generally used term then but the boards quickly found that they faced many demanding and distracting challenges if they did not keep the community well-informed. Some boards did it better than others and the then Minister urged boards to adopt the "Taranaki Model" by which formal community groups were formed for consultation and communication purposes. The writer suspects that this would be unremarkable in these days of "corporate social responsibility".

Another approach to help defuse community concern was the politically expedient appointment of "community representatives" to each health board. These were not universally welcomed by the boards as there were concerns that inexperienced directors could increase personal and collective risk. The term itself was misnomer of course as, in terms of the Companies Act, no director could represent any particular community or other interest. This came as a shock to some of the appointees.

Before leaving the health companies, it is worth noting that a few directors resigned or opted against reappointment because they could not operate as directors would in the commercial environment. They saw the Government as too soft. The writer thought they were wrong to refuse appointments or to resign as their skills could have further enhanced the governance of the health companies.

(b) Crown Research Institutes

These were formed from the parts of a number of government departments with science and technology functions. It coincided with a period when there was a growing concern that resources allocated to these functions be better accounted for. Again, a steering group resolved that the company model had the capacity to lead to the better utilisation of resources.

The CRI companies also did not have a profit expectation but were required to be commercially viable. This influenced the makeup of each board. It might also be noted that the initially main source of revenue was from the government's Foundation for Science and Technology (FORST). However, there was an expectation that all nine companies (the 10^{th} was wound up) would source revenue from commercial ventures and this is how the model evolved.

The restructuring of the sector, as with the State's trading operations, led to significant redundancies where the boards saw no commercial and science advantage in retaining some functions. As would be expected, the reforms were not universally welcomed in the science sector.

Once again, business experience formed the nucleus of each board, with scientists, technology experts and relevant academics making up the balance. This paper will touch on conflict of interest management below but the CRIs were difficult to place non-commercial directors on as university-sourced directors were, for example, faculty members of competing research organisations. The same conflict could arise where commercial directors were drawn from companies where research was pivotal to their business. And being on the board of a CRI could give a director access to the strategic intentions of a rival company if the latter sourced major research outcomes from the CRI. But the population of appropriately expert directors in some science and technology sector was so small that appointments were weighed as being more important than the demands of conflict management.

The CRIs introduced another element to government company governance – the appointment of directors from outside New Zealand. This may not seem too remarkable in other jurisdictions – especially in Europe – but it is not something that sits easy with governments in New Zealand. In addition to the drive by the then Ministers of Finance and CRIs – Hon Bill English and Hon Simon Upton – the increasing complexity of the CRI business environment, together with the growth in off-shore alliances (e.g. universities) sometimes made it difficult to identify the appropriate level of skills and experience inside New Zealand. The Ministers were able to persuade their Cabinet and Caucus colleagues of the merits of such appointments and three were made before their administration left office at the end of 1999. Initial explorations to develop a pool of Australian-based New Zealand-born directors for consideration for New Zealand government boards died at the same time.

Board Performance Issues

Although there are now a number of companies and institutions involved with advising organisations on corporate governance, initially the New Zealand Institute of Directors (IoD) was the prime one for both conducting training programmes and for issuing “Best Practice” guidelines. New government directors were normally encouraged to attend the IoD programmes. Many also became members of the Institute.

CCMAU and, before it, the SOE Unit worked closely with the Institute particularly in regard to identifying director candidates. Increasingly, the Unit looked for vehicles which would enhance the quality of governance in the government’s boards. One such was the board, chair and director evaluation regime.

It would be fair to say that, although performance issues were important to a director’s reappointment, the initial approach was somewhat informal. To the Unit’s knowledge, little was undertaken in the private sector although a small ground-swell had commenced. Calling upon a director with experience in the issue to develop a template in 1996 the shareholding Ministers, through the Unit, issued an instruction that each board was expected to carry out such reviews at least annually. Although such reviews might be confidential in the private sector, the Minister required that they be copied to the Unit for use in its advising Ministers on board appointments and reappointments. The “request” was grudgingly received by many boards for this was at a time when directors might expect performance evaluations to be normal for management but for themselves to be evaluated was considered to be an intrusion and an imposition!

The initial template was a “top-down” form of evaluation and a later review, also carried out for the Unit by experienced directors, saw a comprehensive set of templates designed. The basis of these was, for the individual director, self evaluation, supported by mentoring by the chair. The revised templates – one each for the board, the director and the chair – were based upon the competencies required of each director. The competencies reflected those developed by the Institute of Directors in its Best Practice Guidelines programme. The distinction was made that there a set of competencies all directors must have but that the range of skills among each board of directors would differ. Competencies made the director; skills ensured that the director contributed to the company’s business.

Board, chair and director evaluation is now an accepted practice and the expectation that these will be carried out are contained in each director's letter of appointment.

But the question might be asked, how were under-performing directors treated? It is a fair question given that the boards are undertaking the fiduciary duties on behalf of the public.

The writer has previously referred to a director (or chair) being asked to "exit with dignity". One reason for this is it may not be the director's fault that they are not performing; it could well be that they have been appointed to a board for which their experience is not compatible. Remember that a director's most important asset is his or her professional reputation. This should not be carelessly destroyed.

The shareholders have two other options – one is not reappointing a director when a term expires. However, the duration of the balance of the appointment may render a board dysfunctional as it tries to work with a poor director. The other option is to seek immediate resignation – usually through the chair – or to use the powers in the Companies Act 1993 to dismiss the director. There have been cases of whole boards, as well as individual directors being either asked to resign or actually arbitrarily dismissed.

But the government appointment process has created an area of ambiguity in regard to under-performing or outright incompetent chairs. As has been said, chairs are appointed by the shareholders, not elected by the board. Instances have occurred when it is the board who has identified the unsatisfactory performance of the chair – either through the annual evaluation process or by observation. Boards have tended to lack direction in regard to the steps they can take. There is the obvious one of counselling the chair to resign; the second option is to report to shareholder – preferably through the Deputy Chair – of the unsatisfactory situation. Both can be effective but it has been the writer's view that the government boards adopt the private sector practice of casting a confidence vote at the first board meeting after the AGM. A chair who receives a vote of no-confidence should resign and, if they do not, the board should be empowered by the shareholding Ministers to report on the resolution to the shareholders. Before leaving CCMAU, the writer proposed that the shareholders be recommended to adopt this convention.

Board Remuneration

This was a function assigned to CCMAU, which carried it out on behalf of the shareholding Ministers, who were empowered to approve the fees annually. It has generally been a contentious issue, especially among directors also on private sector boards.

Initially, it was assumed that a director contributed about two or three days a month to board responsibilities; the chair would contribute about one to two days a week. Informal surveys periodically carried out by the writer tended to confirm that this estimate was approximately right during routine times. In government companies, the time demands on directors could fluctuate wildly and nowhere was this more the case than with the health providers. Chairs in particular might contribute most of a week on occasions, managing senior management and clinician issues with the CEO and attending many community meetings to keep stakeholders informed. Many of the directors undertook an additional load on behalf of the board and, in the formation days, the estimate referred to above was significantly inaccurate. The unit rate used to calculate the fees came to bear little relation to the fees paid to directors on private sector boards. Increasingly, directors referred to the opportunity cost of being a government director although fees, on their own, seldom resulted in resignations. As many said, they did join the boards for the fees but, in assisting the governments, they did not expect to be demeaned by the level of fees.

Methodologies developed for CCMAU by PriceWaterhouseCoopers and Sheffields both related workloads, risk, responsibility, business boundaries and other relevant factors in both government and private sector boards. The intention of both methodologies was to achieve internal and external comparability. Some generations of Ministers were receptive to the concepts but others, mainly those in administrations less aware of the business sector, had difficulty with the difference between directors' responsibilities and motivations with those of full-time officials. CCMAU's arguments were not assisted by the agency responsible for advising on State sector remuneration being under-aware of the differences. In the end, the lag between government board fees and private sector board fees became such that the percentage increases required to regain comparability would have been such that it would have been politically difficult to justify it to a critical public. Today, directors still do not join the boards as a source of income.

Board Appointments Process

Successive governments became convinced that they were seeing the "same old names" being recommended for appointment. In fact, this was not the case but all those recommended tended to be persons with a profile in business and/or in the companies' respective sectors of operation. Emphasis was placed on identifying new candidates and, in particular, women and ethnic minorities.

The convention that all appointments being best-qualified and skills based remained but diversity in appointments was sought.

CCMAU led government agencies in codifying the appointment process and focussed on the determination of board skills requirements as a preamble to appointments and new appointments. The concern was that a board make-up should consist of business disciplines as well as industry-oriented skills. At least one director should have expertise in corporate finance in complex and/or large organisations. Many boards also required legal expertise. It should be noted that all directors held equal responsibilities for all aspects of governance although it was natural for specialist-skilled directors to add thrust to relevant deliberations. If a board decided it needed, say, legal advice this came from the management or external resources. And not from the legally-qualified director.

Persons interested in being considered for appointment were encouraged to submit expressions of interest to CCMAU, members of which subsequently met and evaluated the candidates. In addition, shareholding Ministers invited their Caucus colleagues to submit nominations. By the time the writer left CCMAU, the director-candidates numbered about 3500.

Other key sources of nomination included Te Puni Kokiri (The Ministry of Maori Development), the Ministry of Pacific Island Affairs, the Ministry of Women's Affairs and other ethnic minority agencies. All used the detailed skills profiles prepared by CCMAU but, it would be fair to say, often took an over-generous view of their candidates' matching the profiles.

Notwithstanding CCMAU's robust search for "minority" candidates, Ministerial criticism resulted in two reviews of the diversity in appointments being carried out by Dr Brent Wheeler.

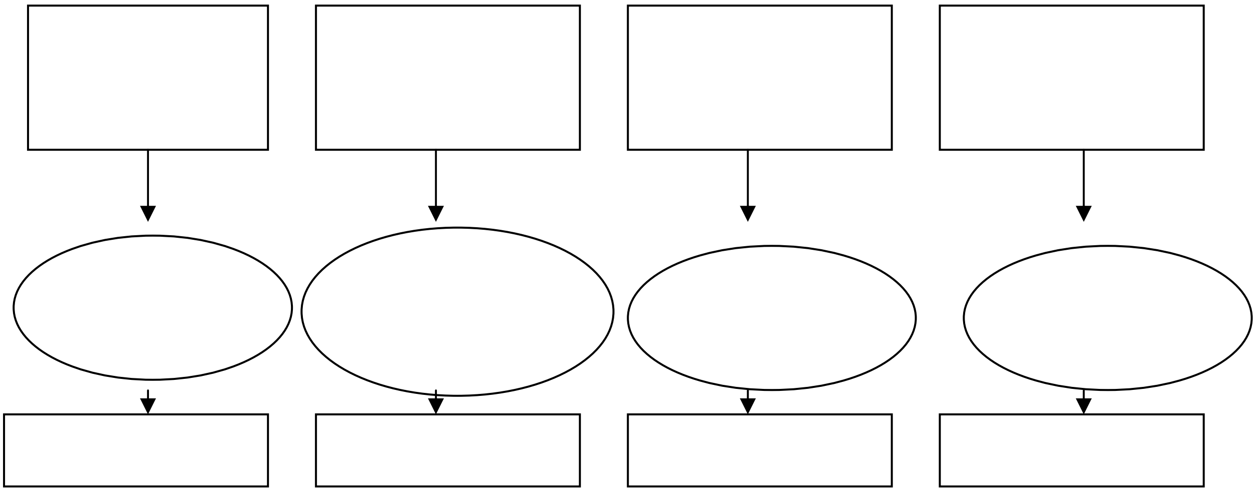
In addition to finding strengths and weaknesses in the candidate identification process, Dr Wheeler also identified flaws in the understanding of those making the appointments. Dr Wheeler's reviews encompassed non-company agencies, known as Crown Entities, as well as the companies. His comments are pertinent to an assessment of the Ministerial and Caucus involvement and understanding of the appointment process.

"Crown Entities are distinct legal bodies, with boards appointed by portfolio Ministers but accountable for the running of the organisations in a manner similar to companies. Degree and effectiveness of performance monitoring varied but was generally deemed to be less than for companies.

The scope of the functions undertaken by boards and board-like structures is very broad. Responsibilities differ, accountability regimes differ, time-scales for delivery differ, legislation under which these arrangements operate differs, effectiveness differs…"

The range of Crown entity boards is "best outlined by the following diagram, which sets out a picture of the functional character of the main groups, the principal to whom boards are accountable and the ultimate market or arena into which services are delivered or where functions are performed[1].

Functional split of government activity outside of the Civil Service



The point is simply that while these institutional arrangements may share the common feature of involving boards or board-like structures which are legitimated through the Executive in one form or another and, with the exception of situations where voting arrangements are used, all appointments are made either by a Minister(s) or Cabinet, these are far from a homogeneous group.

It should be noted that:

> Types of criteria that are appropriate may differ. Representation may be absolutely critical on a distribution board, but less a concern on a State-Owned Enterprise board.
>
> The weighting lent to criteria may well differ depending on the function of the board in question."

To sum up, in the writer's view, Ministers sometimes appeared to under-value the skills requirements of the company boards and the extent to which recommended candidates met these requirements. There are instances where the appointments have surprised both officials and boards and, among the latter, raised concerns over other directors' personal risk through the appointment on non-relevant (in skills terms) directors.

[1] From report by Dr Brent Wheeler, on appointment processes, to CCMAU, 2003.

Another negative aspect which, reportedly, continues to the present is the poor management of board retirements and reappointments. Notwithstanding the long lead-time in commencing the process, there are many instances of boards not knowing if one or more of their colleagues will be reappointed for a second term right up to where their terms formally end. This uncertainty does little for positive boardroom dynamics when appointments may be extended month-by-month until the shareholding Ministers and their Cabinet colleagues finalise the appointment decisions. In the writer's view, this stems from the lack of understanding of commercial imperatives existing in company boards, and referred to above in the reference to Dr Wheeler's review.

It is not the writer's intention to question whether there has been a politicisation of board appointments. In one sense, all appointments are political. But it is the writer's view that the best-qualified person should be appointed to a board, tempered by diversity considerations where the balance of the board has sufficient strength to carry a new and developing director. It is interesting that, although appointments are a matter of public record, few appointments are challenged by Opposition parties.

Before leaving this point, the writer is strongly of the view that an agency such as the UK's Office of the Commissioner for Public Appointments has the potential to make the overall board appointment process much more robust and less subject to the appointment of lesser-qualified persons. (see www.ocpa.gov.uk)

Director Development Programmes

Because of the desire to appoint first-time directors, CCMAU developed, with the Institute of Directors, a Potential Directors' Seminar aimed at equipping new directors with the basic tools of governance when and if they were appointed to boards. Although company-focussed, the lessons gained stood the participants in good standing for other governance appointments – in the government domain or in the private sector.

Serving directors were and are expected to maintain their skills and competencies through attending development programmes – such as Intellectual Property, Information Technology for boards and "senior" governance programmes. In addition, directors seek out industry relevant situations to ensure they remain current. CCMAU encouraged boards to maintain a provision in the board's annual budget to support director development.

A key component in each director's development is the induction process. Even a governance-competent director needs to be appropriately inducted into the board and the company and the competent board has a structured induction process in place. CCMAU both encourages directors and boards to develop this process and also provides a programme to induct directors into the nuances of being a government director. A regular one-day programme is provided by the Unit for new SOE directors and new CRI directors. In addition to the important relationship issues the programme covers the reasons for and the contents of the performance monitoring regime. The Boardroom Practice Limited also provides board-specific induction programmes for directors and senior management for client organisations.

Managing Conflicts Of Interest

It should not be necessary to discuss this issue – conflict-of-interest management should be fundamental to all boards. However, it is worth observing that all government directors are formally reminded of the need to avoid conflicts in the course of their appointments. Indeed, recent legislation requires candidates and directors to formerly advise appointing Ministers of their interests in the course of the appointments process. In the writer's view, this is over-zealous as boards are in dynamic situations and members, not the shareholders are the best judges of how to manage a conflict. Serious conflicts which would significantly diminish a director's contribution should, of course, be identified prior to appointment and the appointment rejected but a slavish denial of all issues could deny boards the contribution of otherwise sound directors. Sound conflict management is a "must" for all boards – companies, parastatals – indeed, all governing boards.

Boardroom sanctity is an issue which is another “conflict” issue which can affect government boards, as much as it affects those in the private sector. The convention is that only the chair speaks for the board, unless the board as a whole authorises another person to do so. “What goes on in the boardroom, stays in the boardroom!” An issue which concerns boards from time-to-time is the presence of an obviously political (in the party sense) appointee and the discomfort over what may be conveyed to the shareholder through “social” channels. This was one of the reasons why the practice of board observers, as discussed above, was discontinued. To the writer’s knowledge, there have been very few instances when negative outcomes have occurred through this communication and those that have occurred have generally been a reflection of the political naivety of the director than an attempt to undermine the board. Of course, the Ministerial shareholder also needs to adopt the discipline of not encouraging “back-door” information from friends sitting on the board. The writer is strongly of the view that the chair is the sole conduit for communications in regard to board business with the shareholder.

Of course, the distinction needs to be made between boardroom gossip and the performance monitoring information the monitoring agency gathers from management.

Code Of Corporate Governance

Although the writer tried to initiate the adoption of Codes of Corporate Governance across all companies when in CCMAU, no formal programme for these resulted. There was interest in a handful of companies and with the then Minister for SOEs but no comprehensive adoption has taken place. Of course Codes, on their own, carry little weight – the philosophy underpinning the Code also needs to be adopted by each board. In the writer’s view, the Code is a sound tool for the guidance of each director and there have been boards which, had they adopted the tenets of a Code of Corporate Governance, could have avoided a number of governance transgressions. The writer remains committed to their adoption and promotes their use in other governance domains.

Ownership Monitoring

All government companies are 100 percent owned by the government, other than certain airport companies whose shares are owned by district councils and central government. This means that the normal market surveillance that private sector companies are subject to is missing from the government companies. This has resulted in the development of mechanisms to advise the owner about the performance of each company. In New Zealand, the performance monitoring is carried out by the Treasury and the semi-autonomous agency already referred to: the Crown Company Monitoring Advisory Unit (CCMAU). The Treasury is responsible for, *inter alia*, advising on the Crown’s balance sheet and has a fiscal-impact focus on the performance of each company. CCMAU, on the other hand, takes a commercial, ownership perspective seeking to ensure that government’s investment in each company is maximised within the broad expectations of the owner.

It was not always that clear-cut. Several of the early directors felt that they had been appointed to be on independent boards and regarded the tenor of the early attempts at performance monitoring at encroaching on their “independence”. There was some discussion as to whether the monitors should receive copies of all the boards’ board papers. There was resistance to this and, in the end, the monitors received quarterly reports from the companies and these, with the business plans, provided the Ministers and officials with the necessary comfort. The important Statement of Corporate Intent (SCI) (Statement of Intent, for the non-SOE companies) was scrutinised by officials prior to this being recommend for tabling in Parliament by the Ministers. The shareholding Ministers did not – and do not – formally approve the SCI but tabling implicitly means that they concur. Of course, the preparation of the SCI involves discussions and a confirmation that major initiatives are have the Ministers’ concurrence.

Although The Treasury played an active role in the development of the early monitoring regimes, the members of the SOE Steering Committee were allocated companies on whom they would provide a commercial perspective as well as being a conduit between the boards and the SOE Minister. Anecdotally, SOE boards derived considerable comfort from knowing that Ministers were being advised by people who understood business and governance. It should also be acknowledged that officials – including the writer – gained much through working with the SOE Steering Committee.

Today, each company is required to present its business strategy to the shareholding Ministers and receive guidance on any aspect which may be of specific interest to the shareholding Ministers. Importantly, although boards are required to consider Ministers' views they are not required to act on them (unless formally directed to do so, or they are of a specific nature such as a major transaction under the Companies Act where the consent of shareholders is required) and remain reputationally and legally liable for decisions taken by the board. Issues of substance, such as a significant investment in expanding the business, require specific concurrence by the shareholders. Although privatisation is off the agenda, a significant disposal of assets would normally be discussed and guidance given. Fundamentally, although the boards run the companies without political intrusion, boards are expected to abide by the "no surprises" convention in regard to major issues.

The Government does not guarantee company borrowing and would not normally be involved in company borrowing, although the Treasury takes a keen interest in this issue through its role in managing government debt, and the overall state of the Crown's consolidated balance sheet.

CCMAU, with The Treasury, has developed a regime of monitoring instruments which support their monitoring against each company's business plan. The Unit is required to manage good relationships at board and senior management level to supplement their understanding of the financial and non-financial indicators the agencies receive each month.

Expectations Manual And Shareholder Relationships

An extremely useful innovation to guide the boards in their relationships with the shareholders was the production of an owner's expectations manual. This manual provides each board with a succinct explanation of how the shareholder expects the board to behave in regard to ownership interests as the board runs the company. The manual brings together a range of documents and letters into a comprehensive guide. In addition to relationship management it also outlines the monitoring process and timetable for various steps in the monitoring cycle. In this way, all boards have a consistent, clear-cut outline of how to manage the relationships. (This manual is publicly available from CCMAU's website www.ccmau.govt.nz)

Cultural Issues

Although this has a strong influence on board appointments, boards and companies must be mindful of the relevance of the Treaty of Waitangi on company strategy and decision making. The Treaty is an instrument signed by the Crown and representatives of a number of tribes (iwi) in 1840. In essence, in return for ceding sovereignty to the Crown the latter gave Maori certain assurances in regard to lands, flora and fauna. Comparatively ignored for several decades, the Treaty regained significant importance in government/Maori relations from about the mid-1980s. Much legislation requires participants – including the companies – to ensure that the interests and values enshrined in the Treaty are taken account of in business deliberations. The SOE Act 1986 was amended to take account of land claims by recording specified Maori interests on certificates of title in the event of the land being resumed by Maori owners after disputes deliberations. Since the 1980s claims by Maori over various aspects New Zealand's resources have impacted on commercial decisions. Two key examples included delays in the transfer of radio and television assets to the then SOEs, Television New Zealand Ltd and Radio New Zealand Ltd. Treaty settlements also saw the transfer of other companies' land assets back to Maori and subsequent lease-back of the assets to the companies.

Directors undertaking due diligence prior to joining the boards must be comfortable in regard to the potential claims on company assets through Treaty settlements.

Boards of private sector companies do not face the same issue in regard to assets but both public and private sector boards must be increasingly aware of Maori cultural values in their deliberations. For example, in shaping the CRI boards, it is important that directors have a good awareness of Maori interests in regard, for example, the utilisation of land and water resources. To ignore these could be costly as challenges and disputes can readily arise.

New Zealand is a multi-cultural society with many nationalities and ethnicities making up its population. Maori are the prime minority population group but Pacific Island peoples are an increasing influence on business. It is becoming increasingly relevant to take account of the differing perspectives of Pacific Island peoples in boards determining business strategies. The growing number of Asian-sourced residents is likely to lead to similar influences.

Recent Developments

Legislation has recently been enacted that will markedly strengthen governance and accountability in government non-company boards. In many respects, the reforms entailed in the legislation derive from the lessons gained from the many years government-owned companies have been operating. In a sense, the legislation has had only a modest impact on the companies although a new definition has been developed: Crown Entity Companies. A number of non-SOE companies fall within this group, including the nine Crown Research Institutes. The term replaces the original "Crown Owned Company", which was loosely used to categorise companies whose business was not intended to be "as profitable as comparable companies in the private sector". As each such company operates in terms of its own legislation and the over-arching Companies Act 1993, it seems to the writer that the inclusion of the Crown Entity Companies in this legislation was unnecessary. Established appointment and monitoring protocols and regimes have been in place for several years and have proven to be effective. On the other hand, the changes re-categorised three Crown companies as State Owned Enterprises.

Another interesting change is to require SOEs to consult with the State Services Commission in regard to any collective agreements they may determine in terms of industrial relations for their employees. Crown Research Institutes have always had to consult the Commission in regard to, for example, employment contracts for their CEOs and there has been contentious debate on this issue from time-to-time, the companies being concerned that their commercial decisions were being impeded. In terms of SOEs' board independence and arms-length relationship with the Crown, this appears to be a retrograde step. However, how the collective agreement consultation issue will sit with the SOEs in practice remains to be seen

The Status Of The Company Model

The company model is still in place. A number of the early SOEs were privatised and there are still SOEs and Crown Entity Companies in being. The model has, however, been rejected by the present government as the preferred means of managing certain State assets and functions. It has, however, been endorsed for fully commercial functions.

The health-provider companies have been replaced by District Health Boards – a combination of appointed and elected board members. The DHBs retain a broadly similar structure below the board but the board itself has been removed from the aegis of the Companies Act 1993. In the writer's view, there is a distortion of accountabilities in the new structure and the potential for destabilised board dynamics as seven of the board members face re-election every three years. On the other hand, the New Zealand penchant for making things work in spite of impediments appears to overcome much of the tension the election dynamic creates.

The company incorporated to manage the State's housing stock has also been rolled back into a government agency, albeit with a governing board. Similarly, so too has the New Zealand Symphony Orchestra. The comment has been made that the reasons are ideological as against logical but a neutral observer would still see strong elements of corporate governance prevailing in the organisations. As has been seen in the passing of the Crown Entities legislation, it has been necessary to re-invent many of the disciplines provided in the Companies Act 1993 and this does tend to support those who allege the roll-back was merely ideological.

In regard to the several government companies still in being, it would be fair to describe them as functioning well. The government sector continues to attract a large number of people who wish to be directors and, through CCMAU, has well-managed mechanisms to up-skill those candidates lacking in governance knowledge but not lacking in enthusiasm. Both these factors should continue to ensure robust, if not fully commercially-oriented boards.

The policy shift away from privatisation of SOEs has resulted in the owner and the boards evaluating the implications this has for ownership and investment. This process has resulted in shareholding Ministers having a greater involvement in issues such as core strategy and financial structure, than occurred previously. Known as "long-term hold", it recognised that the "prepare for sale" mode had potentially negative implications for commercial decision-making. And, although company debt is not government-guaranteed, the investment market provided only modest market signals of the companies' performance. In addition, government reluctance to further invest in the companies (with the capital injection into a State generator for power generation development a notable exception) for large-scale developments tended to deter major capital investment decisions. Some directors have also pointed to the propensity for Treasury to become more involved and see that agency has having an agenda for seeking higher dividends and an increased influence over the business strategies of the individual companies. This is in the guise of "portfolio management" though cynics have also compared this to the "former days when civil servants tried to pick the winners".

In earlier days, concerns were expressed in regard to political influence over SOE strategies. See, for example, The Business Roundtable's paper on "The Public Benefit of Private Ownership (1992). "A more direct example of the willingness of governments to succumb to pressures to get involved in the management of state trading enterprises was the recent governmental pressure, culminating in a select committee hearing, that led to a pricing policy backdown by the (then) Electricity Corporation. The prime minister acknowledged that pricing policy was ECNZs responsibility, but he added that he was sure the corporation would not take any step that would defer economic recovery, and that he wanted all decisions to be made consistent with the government's desire to stimulate economic growth. Further to this, ECNZ's two shareholding ministers were publicly reported as telling the corporation that the government would accept a decreased rate of return to accommodate the pricing backdown. The imposition of a clearly non-commercial political objective on an organisation which, by statute, is required to operate as a successful commercial business demonstrates the fragility of the SOE model." Are we past this stance on the part of the owners?

How has this impacted on governance? Critics could argue that the change in approach to ownership has made the boards as risk-averse as the owner. Certainly, while there is a tight dividend policy combined with a reluctance to make further investment in the SOEs, boards could easily adopt a steady-state behaviour. Such new investment by the Government as has happened – particularly in regard to electricity generation – has resulted in Ministers having to be as informed in industry issues as the boards they have appointed. The writer tends to the view that the original concept of corporate governance is being diluted by this environment. Boards are still doing the same things – running the company and developing corporate strategies. But the implementation of major initiatives results in a greater involvement of the shareholder's officials than is desirable as well as a dilution of board responsibility. Worse, it maintains the public belief that Ministers are responsible for company actions – almost as though they are deemed directors. It is a worrying thought that that next step may be to roll the company model back into something more akin to a Ministry. With the consequential diffused accountability that existed in the pre-reform days.

One solution is for the shareholders to reinstate the full nature of the board's role – that of making strategic business decisions with the board being fully accountable for those decisions. In turn, this would drive the shareholding Ministers to ensure that the best-qualified people are appointed to the boards, the appointments not being diluted by non-relevant diversity or "representative" appointments. It may even require the recognition that there is a shortage of skills in New Zealand for some boards and that a multi-national approach is required. Practicality before parochialism!

Finally, the change in attitude requires that the shareholders be appropriately advised on the robustness of their appointments and the competency of the boards. The vehicles exist for this and could be strengthened by presence of experienced market-place advisers either appointed to CCMAU or contracted to that body. Prior to the writer's leaving CCMAU, he recommended the appointment of an Advisory Committee to, inter alia, inject high-level commercial expertise into the nature of the performance and governance advice provided by the Unit. Perhaps this sounds like the re-invention of the SOE Steering Committee? But, it appears to the writer, the best source of practical and strategic advice would come from those whose businesses and personal reputations rests on the ability and experience to lead and manage large and/or complex businesses.

The changes cited would reaffirm the importance of high-quality corporate governance.

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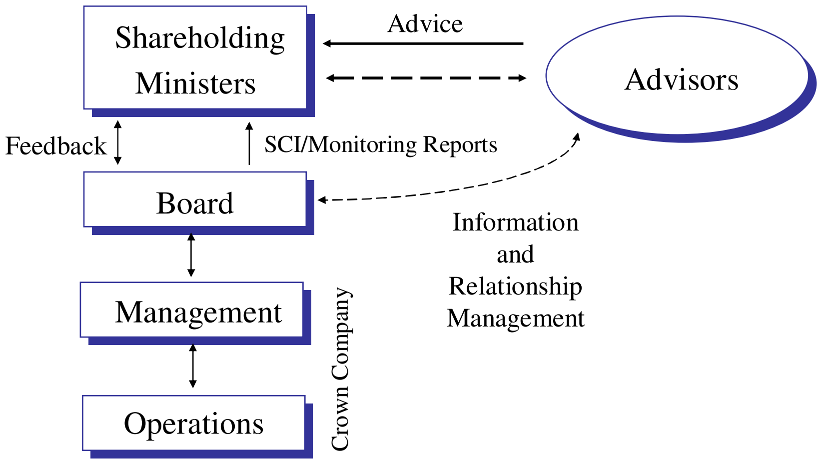
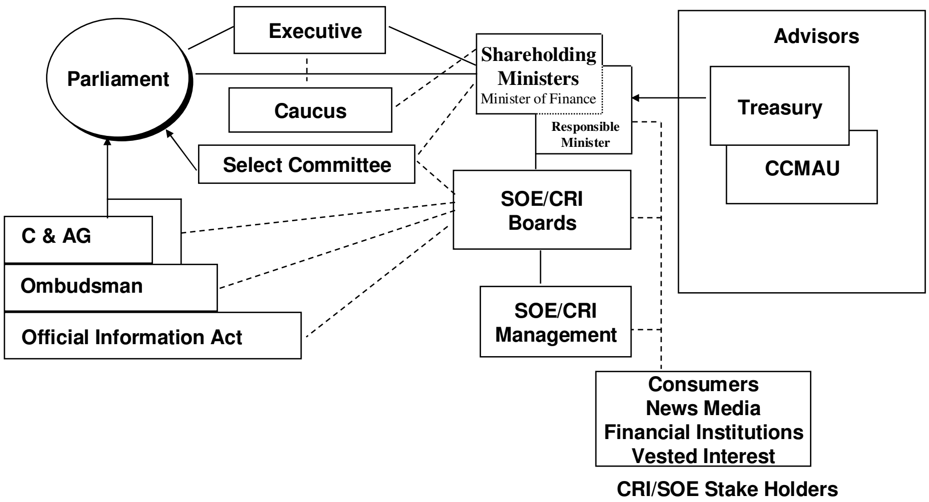
ANNEX

Crown Company Model



Accountability Network



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