

Treasury Report: Improving the Effectiveness of COMU's Monitoring

Date:	16 September 2010	Report No:	T2010/1751
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Confirm the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister for Economic Development (Hon Gerry Brownlee)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister for State Owned Enterprises Minister of Justice (Hon Simon Power)	Confirm the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Thursday 16 September 2010
Minister of Health (Hon Tony Ryall)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister of Education (Hon Anne Tolley)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister of Agriculture (Hon David Carter)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister of Foreign Affairs (Hon Murray McCully)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister of Research Science and Technology (Hon Dr Wayne Mapp)	Confirm the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Associate Minister of Finance (Hon Steven Joyce)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010

Minister of Broadcasting (Hon Dr Jonathan Coleman)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010
Minister of Internal Affairs (Hon Nathan Guy)	Note the changes COMU is making to its commercial monitoring approach to drive performance improvements across the portfolio.	Tuesday 21 September 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
John Crawford	General Manager, Crown Ownership & State Sector Performance	917 6251	021 578 412	✓

Minister of Finance's Office Actions (if required)

None.

Enclosure: Yes (attached)

Treasury Report: Improving the Effectiveness of COMU's Monitoring

Executive Summary

Over the past few months, Treasury's Crown Ownership Monitoring Unit (COMU) has been looking at ways to improve the effectiveness of its monitoring activities while at the same time ensuring that the relative roles and responsibilities of COMU and the boards in monitoring performance are clear and support the accountability of each of the boards. This is in response both to Ministers¹ requests and the 2009 Treasury Leadership review.

Our starting premise is that the commercial framework arises from the State Owned Enterprises Act 1986 and the Companies Act 1993. Under this framework, boards are responsible and accountable for the individual company performance, are the primary monitor of performance and are the main mechanism that Ministers have in holding the company to account. COMU's role as "contracted" by its three vote Ministers is to act as both a representative of the shareholders and an advisor to the shareholders.

Boards at the centre of the monitoring approach

To support the boards' accountability and monitoring roles, COMU intends to:

- place the boards at the centre of its monitoring model;
- move away from an assist relationship with entities² executives to an assess relationship with the boards: and
- move key interactions on performance away from the executive to the board level.

These shifts support a stronger commercial decision making environment for boards.

How COMU will achieve the shift

There are several key components to this:

Role clarity

- greater formality around key interactions between the entity and COMU as the shareholders' representative; and
- COMU prioritising its monitoring efforts based on the entity's size, complexity and difficulty of current issues.

¹ For the purposes of this report "Minister" is used to cover both shareholding Ministers in relation to companies and responsible Ministers for the other entities that COMU has been charged with monitoring.

² For the purposes of this report, the word "entity" is being used to cover the different types of bodies monitored by COMU i.e. SOEs, CRIs, statutory Crown entities, Crown-owned companies, agencies on the Public Finance Act 4th schedule, other companies in which the Crown owns shares, other statutory entities, and bodies set up by international treaty.

Focus on performance

- quarterly reporting on historic performance to also include a forward view of key results;
- boards providing shareholders with information on the outcomes of past investment decisions;
- COMU undertaking the benchmarking of key companies against peers; and
- COMU having a much greater focus on the portfolio performance, and the commercial value and total shareholder returns of each entity.

Increased public information

- increasing the amount of information on both entity and portfolio performance being made available to the public on COMU's re-designed website.

While the new approach does not affect how COMU undertakes its board appointment function, the information that these changes generate will assist with COMU's advice to Ministers on board performance and board appointments.

We believe this model can be applied across all the entities COMU monitor. Subject to a successful implementation, the principles of the approach could be used by other Government monitoring agencies.

We see significant benefits for shareholding Ministers...

The benefits for Ministers of the approach are:

- an enhanced commercial decision making environment will be put in place;
- the role of boards will be made clearer vis-à-vis the role of COMU;
- performance of key boards and entities will be subject to a higher level of scrutiny by COMU, leading to better advice to Ministers; and
- increased transparency should lead to more public scrutiny and commentary which in turn can have a positive impact on board and company performance.

Combined, these improvements have the potential to enhance the Ministerial engagement with boards and, in relation to the state-owned enterprises (SOEs), lead to better shareholder returns including improved dividends.

...but will require trade-offs in some respects

This approach will require Ministers' sustained support. It will mean lower levels of service in some areas and for some entities, and it does present some risks, however we believe these risks are manageable. In particular:

- differing levels of focus from COMU based on the priority an entity is assigned by COMU;
- with entity performance information and COMU analysis and commentary being made publicly available, Ministers are likely to come under to pressure to be drawn into public debate on both COMU's monitoring and individual entity's performance; and
- a short-term delivery risk as COMU changes its business model to support this approach.

Our initial consultation suggests that entities will be generally supportive

The general approach has been discussed with a handful of current and former chairs and chief executives of SOEs who have agreed in principle that this is a sensible direction for COMU's monitoring. Notwithstanding this, there may be some resistance from boards who do not wish to engage more formally and often with COMU. This concern should be addressed as part of an overall package of changes COMU is making to its business model that will see a "back office" group undertaking more in-depth financial analysis and a "front office" comprising a senior relationship manager allocated to each entity.

Recommended Action

We recommend that you:

- a **confirm** the changes COMU is making to its monitoring approach to drive performance improvements across the portfolio;

Confirm/Not confirm
Minister of Finance

Confirm/Not confirm
Minister for State Owned Enterprises

Confirm/Not confirm
Minister of Research Science and Technology

- b **note** the new prioritisation of entities based on their size, complexity and difficulty of current issues, where the priority directly relates to the effort COMU will allocate to the monitoring of each entity;

High level of focus	Moderate level of focus	Low level of focus
Genesis KiwiRail Landcorp Meridian Mighty River Power NZ Post Solid Energy Transpower Public Trust NZ Superannuation Fund Earthquake Commission	Kordia TVNZ Government Superannuation Fund National Provident Fund NZVIF ACC investments* AgResearch Start-up entities – Crown Fibre Holdings – Health Benefits Limited Rugby NZ 2011 Ltd	Air New Zealand Airports – Christchurch – Dunedin – Hawke's Bay – Invercargill Airways Animal Control Products AsureQuality ECNZ Learning Media Lotteries Met Service Pacific Forum Line Quotable Value Radio NZ REANNZ Timberlands ESR GNS Industrial Research Landcare NIWA Plant & Food Scion
11 entities	9 entities	24 entities

* Department of Labour is the monitoring department, not counted in totals of entities.

Confirm/Not confirm
Minister of Finance

Confirm/Not confirm
Minister for State Owned Enterprises

Confirm/Not confirm
Minister of Research Science and Technology

- c **confirm** that COMU will make more analysis and commentary publicly available on COMU's re-designed website;

Confirm/Not confirm
Minister of Finance

Confirm/Not confirm
Minister for State Owned Enterprises

Confirm/Not confirm
Minister of Research Science and Technology

- d **note** the risks associated with this new approach and the mitigation of those risks:

Risks	Mitigation
Increased transparency, while being a driver for improved performance, may give rise to public disagreements with the entities and other commentators e.g. in the media, on blogs, through questions in the House to Ministers.	<ul style="list-style-type: none">• COMU to seek Ministers' agreement to releases of information where COMU believes it is likely to lead to debate;• COMU to provide entities with information it intends to publish in advance to ensure commercial information remains confidential and to ensure the accuracy of data published, although disagreement over assessments will not automatically prevent publication; and• COMU to have staged approach with regard to the releases, gradually increasing the type of information made available.
Boards may not be keen to engage with officials, unless COMU can engage in a credible and informed manner on a range of commercial issues.	<ul style="list-style-type: none">• COMU is changing its business model with a "back office" group undertaking more in-depth financial analysis and a "front office" comprising a senior relationship manager allocated to each entity.
Short-term delivery risk as COMU changes its business model, while trying to fill vacancies.	<ul style="list-style-type: none">• COMU will closely monitor workflow issues and will aim to continue to provide high quality advice and support to Ministers within the changed approach, notwithstanding our staffing issue; and• COMU will be explicit with Ministers and entities on the prioritisation of entities and any consequential changes to expected service levels.

- e **note** that shifting engagements from the executive to the board on performance issues and risk, while strongly supporting board accountability, will require the on-going support of Ministers;

- f **note** that the new approach will support COMU becoming a monitoring centre of expertise and will enable COMU to demonstrate the effectiveness of an alternative monitoring approach to other monitoring agencies; and

- g **note** the attached letter that will be sent by COMU to the chairs of SOEs, and adjusted for other entity chairs, advising them of the new approach.

John Crawford
**General Manager, Crown Ownership & State Sector Performance
for Secretary to the Treasury**

Hon Bill English
Minister of Finance

Hon Gerry Brownlee
Minister for Economic Development

Hon Simon Power
**Minister for State Owned Enterprises
Minister of Justice**

Hon Tony Ryall
Minister of Health

Hon Anne Tolley
Minister of Education

Hon David Carter
Minister of Agriculture

Hon Murray McCully
Minister of Foreign Affairs

Hon Dr Wayne Mapp
**Minister of Research Science and
Technology**

Hon Steven Joyce
Associate Minister of Finance

Hon Dr Jonathan Coleman
Minister of Broadcasting

Hon Nathan Guy
Minister of Internal Affairs

Treasury Report: Improving the Effectiveness of COMU's Monitoring

Purpose of Report

1. This report advises of changes COMU is proposing to improve the effectiveness of its monitoring with the overarching aim of driving further performance improvements across the Crown's commercial portfolio. We seek Ministers agreement and their support to implement these changes.

Background to COMU's Changed Monitoring Approach

2. Over the past few months, COMU has been investigating ways of improving the effectiveness of its monitoring activities while at the same time ensuring that the relative roles and responsibilities of COMU and the entity boards are clear and support the accountability of the board. This was in response to:
 - the Government's expectation that the public service deliver better services for less; and
 - the 2009 Treasury Leadership review, which stated that one of COMU's objectives is to improve the monitoring of all entities, both through direct monitoring of some entities, and indirect levers (assistance and "monitoring the monitors" assessment) for other entities and better incorporate commercial expertise and capability with other parts of Treasury's business.
3. COMU's self-review was also informed by:
 - Minister English's 9 November 2009 meeting with MAGNet³ where monitors were advised that, among other things, the Government was not getting enough information to judge the performance of boards; Ministers wanted monitoring officials to exercise more judgements in their analysis, and that Ministers did not want officials to focus on maintaining good relationships with entities at the expense of Ministers receiving quality information;
 - Recommendation 8 in the March 2010 *Crown Entity Cost Compliance Review* report in which chairs advised they wanted to see an improvement in the seniority of officials they deal with and in the capability of monitoring departments (T2010/423 refers); and
 - Cabinet's August 2010 direction to Treasury and the State Services Commission in relation to the statutory Crown entity 6-monthly report to investigate ways to standardise and increase the transparency of performance information (CAB Min (10) 29/1A refers).

³ The Monitoring, Appointments & Governance Network (MAGNet) is the community of practice for officials working in these areas.

Benefits of the New Approach for Ministers

4. The benefits for Ministers of the approach COMU intends to implement are that:
 - an enhanced commercial decision making environment will be put in place;
 - the role of boards will be made clearer vis-a-vis the role of COMU;
 - performance of key boards and entities will be subject to a higher level of scrutiny by COMU leading to better advice to Ministers; and
 - increased transparency should lead to greater public scrutiny and commentary, which in turn can have a positive impact on board and company performance.
5. Combined, these improvements have the potential to enhance the Ministerial engagement with boards and, in relation to the SOEs, lead to better shareholder returns including improved dividends.

The Legislative Framework

6. Corporate governance is primarily about agency performance. Owners have many levers to obtain the performance outcomes they require. In the State Sector, corporate governance levers have been systematically incorporated into the various legislative and other frameworks for all entities.
7. The State-Owned Enterprises Act 1986 or other establishing legislation, together with the Companies Act 1993, sets out the ownership, governance and reporting requirements for Crown-owned companies. The principal objective of every State-Owned Enterprise is to operate as a successful business, and to that end, be as profitable and efficient as comparable businesses not owned by the Crown. While the other entities COMU monitors have mixed objectives or a mix of owners, all have commercial imperatives.
8. The roles and responsibilities of the board and Ministers are defined in legislation or other establishing documents. These roles and responsibilities broadly are:
 - Every entity has a board that takes full responsibility for running the business. The board is accountable to the Minister(s) for the entity's performance and reporting on that performance. While legislation does not require the board to hire staff, it does provide for the legal settings if staff are hired. The commercial corporate governance model supports the separation of governance from management, and as such, all boards have chosen to hire an executive team and other staff to assist them in carrying out the functions of the entity.
 - The Ministers are responsible to the House of Representatives for the functions given to them by legislation or other rules. The controls that Ministers have usually include:
 - appointing and removing boards;
 - setting the board's fees;
 - monitoring performance;
 - the ability to require performance information;
 - agreeing to, and presenting to the House, the statement of (corporate) intent; and
 - presenting the annual report.

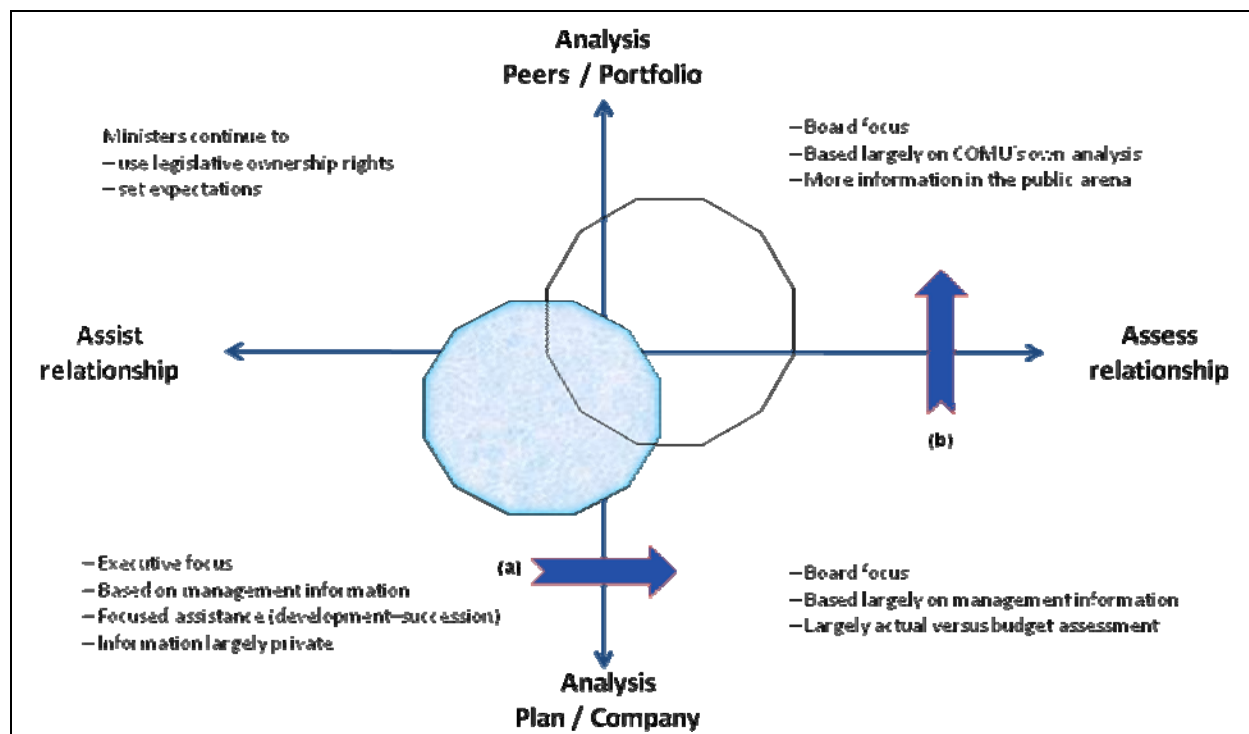
- For SOEs, controls include the ability to issue directions on certain matters in the Statement of Corporate Intent, and on dividend levels. For all companies, shareholders need to be consulted on and approve major transactions.
9. It is clear under this model that boards are accountable for, and therefore the primary monitor of an entity's financial and non-financial performance.
 10. It is also explicit in legislation that one of the levers available to Ministers to gain the performance they require is further monitoring. It is from this lever that COMU derives its mandate from Ministers. For comparable commercial companies not owned by the Crown, there is usually significant public monitoring by the market that increases the pressure on the boards and companies to perform. In the absence of this market analysis, particularly for SOEs, COMU's independent monitoring needs to fulfil the same "market" role for Ministers, while stimulating greater public analysis and comment.

COMU's Current Approach

11. COMU aims to improve the performance and management of the Crown's assets and liabilities through ensuring effective monitoring, risk management and governance occurs. COMU does this through providing assurance to Ministers on the current and future performance of the entity supported by in-depth analysis and advice; providing Ministers with the best advice to frame their decision making to maximise ownership benefits; and challenging the individual board's perspective by applying an external and differing view to aspects of each entity's performance.
12. The 2009 Treasury Leadership Review challenged COMU to lift its monitoring performance. COMU has reviewed its monitoring approach and concluded that, while our overall aim is the right one, COMU's current monitoring can be characterised by a focus on activities that do not provide Ministers with the range of performance information they should have access to. Further, COMU's monitoring approach does not appear to put sufficient pressure on boards to improve performance. Rather COMU's monitoring could be viewed by boards to be micro-monitoring to the detriment of the board's accountability and primary monitor roles. For example, COMU tends to:
 - undertake narrow monitoring of each individual entity's performance by focusing on its recent performance against its annual plan;
 - have a high involvement in issues management, which has drawn COMU into entity specific issues with the consequential risk of acting as an advocate for the entity rather than for the Minister;
 - have relationships based more on assisting the entity meet Ministers' requirements rather than a relationship as an independent monitor of performance of the entity and board;
 - engage mainly with the entity's executive; and
 - provide limited independent public reporting on the performance of the entity and the wider portfolio.

Improving the Effectiveness of COMU's Monitoring

13. To improve the effectiveness of COMU's monitoring we intend to make two fundamental changes to *how* we undertake our role. COMU intends to shift from:
- an assist relationship with the executive to an assess relationship with the board; and
 - a narrow "performance against plan" focus to a broader performance focus supported by benchmarking and increased public scrutiny of performance.
14. These shifts are shown in the diagram below.



15. We intend to apply the model across all the entities that COMU monitors, with appropriate prioritisation, scaling and fit-for purpose-performance tools.
16. While the new approach does not affect how COMU undertakes its board appointment function, the information that these changes generate may assist with COMU's advice to Ministers on board performance and board appointments.

How These Shifts will be Achieved by COMU

17. COMU will change its monitoring in the following areas. These are:
- Placing the party that is accountable - the board - at the centre of the monitoring approach with the expectation that the boards will formally engage with COMU on key issues. The consequences for the monitoring relationships is shown in the three tables below:

Table 1: Increasing COMU interactions at the board level

Activity	Interaction to cover
Performance reporting	Boards will be asked to include in their quarterly reports to their Minister(s) commentary on what the projected outcomes for the full year will be, how confident the board is that the outcomes can be met, and what the key issues affecting meeting planned performance levels are.
Performance discussions	Initial discussions on performance issues and risk will be, in the first instance, between COMU and the board rather than COMU and the executive. The board may of course choose to invite the executive to those discussions.
Strategic direction	COMU will engage with the board at the front end of the annual business-planning and far less in the final 6 weeks (late April / May). Early engagement will provide greater clarity of shareholder expectations of performance. These discussions will utilise the results of the new analysis COMU will be undertaking i.e. benchmarking, a review of annual investment decisions, and the results of the improved annual performance review. To support these discussions, boards will be expected to provide information on the outcomes of past investment decisions.
Requests for capital or major approvals	COMU expects to discuss any requests for capital or major approvals with the board, rather than with the executive.

Table 2: Interactions between COMU and the entity executive

Activity	Interaction to cover
Official Information Act (OIA) requests	COMU will continue to seek information from and consult with agencies on Ministerial or COMU OIA requests.
Performance discussions	As noted in table 1.

Table 3: New interactions between the board / entity and Ministers' offices

Activity	Interaction to cover
Issues management	To prevent COMU being drawn into issues management where the entity rightly needs to undertake the work, all "no surprises" alerts will be direct between the board / entity and the Ministers' office and copied to COMU on a "no action" basis. COMU will continue to undertake work on a matter when asked to do so by the relevant Minister or where COMU believes it needs to be proactively involved.

- b. COMU's prime performance metric for entities will be the total return the shareholder has derived from both dividends and value growth compared with the risk-adjusted cost of equity for the entity. This requires boards to provide high quality commercial valuations (as Ministers have already directed). For large entities, COMU intends to commission independent valuations to provide a further view on entity value.
- c. COMU will provide Ministers with advice on what performance entities should achieve, and what level of dividends should be expected, as part of a richer set of analyses. COMU believes such expectations should be formally communicated to boards via the annual letter of expectations.
- d. In addition, COMU will place far greater emphasis on different types of performance assessment e.g. comparative analysis of the entity's financial performance versus comparable businesses not owned by the Crown.
- e. COMU will over time make more information available to the public on COMU's re-designed website, which will meet the transparency and accountability objectives Ministers have set. Public releases will exclude commercially sensitive information. The first example of this will be an annual portfolio report, which will be available in early November 2010. COMU intends to put the following additional information on its website:
 - entity performance versus plan;
 - entity performance versus peers (where applicable); and
 - portfolio and individual entity valuations and returns.

Prioritisation of Entities

18. In order to achieve the change in monitoring approach outlined above, COMU must prioritise its monitoring effort in relation to the performance issues and risks within each entity. Although prioritisation will provide reduced monitoring of some entities, the objective is to improve the quality of COMU's advice across the portfolio.
19. Criteria taken into account by COMU when making a judgment on prioritising of entities and the associated monitoring that is required are:
 - entity size;
 - complexity / difficulty of current issues an entity is facing;
 - entities undergoing major change e.g. regulatory reform, in establishment or disestablishment phases;
 - the degree of long or short term risk;
 - financial performance concerns;
 - where major capital expenditure is underway;
 - the strength of the board and/or management;
 - the importance of an entity for government priorities; and
 - whether there is more than one monitoring department.

20. Each quarter COMU will reassess the priority allocated to each entity, as well as on an ad hoc basis as issues arise. COMU will be explicit with Ministers and entities on priority allocation.
21. This prioritisation does not apply to COMU's appointment and governance activities; where a similar effort is typically required for all processes, regardless of the scale, complexity and risk of the entity concerned. Below is a table with the prioritisation as at September 2010.

Table 4: Prioritisation of entities as at September 2010

High level of focus	Moderate level of focus	Low level of focus
Genesis Kiwi Rail Landcorp Meridian Mighty River Power NZ Post Solid Energy Transpower Public Trust NZ Superannuation Fund Earthquake Commission	Kordia TVNZ Government Superannuation Fund National Provident Fund NZVIF ACC investments* AgResearch Start-up entities – Crown Fibre Holdings – Health Benefits Limited Rugby NZ 2011 Ltd	Air New Zealand Airports – Christchurch – Dunedin – Hawke's Bay – Invercargill Airways Animal Control Products AsureQuality ECNZ Learning Media Lotteries Met Service Pacific Forum Line Quotable Value Radio NZ REANNZ Timberlands ESR GNS Industrial Research Landcare NIWA Plant & Food Scion
11 entities	9 entities	24 entities

* Department of Labour is the monitoring department, not counted in totals of entities.

Ministers' Agreement and Support Needed

22. The proposed changes have consequences for the level of service Ministers can expect and how COMU will undertake its monitoring role.
23. Ministers can expect to receive richer monitoring reports on high priority entities which will better support Ministerial and COMU engagements. However, at the other end of the spectrum, Ministers will receive less extensive reporting and analysis on lower priority entities. Across all entities, Ministers can expect to see COMU less involved in issues management, unless explicitly directed by Ministers to undertake this work, or unless COMU believes it needs to be pro-actively involved.
24. Ministers need to understand and agree to COMU placing the board at the centre of the monitoring approach and that COMU intends to move away from an assist relationship with the executive to an assess relationship with the board.

25. There is a risk for Ministers in relation to the increased transparency of COMU's monitoring activities, which is discussed in the risks section below.

Risks

Possible effect of increased transparency on Ministers

26. Increased transparency and the associated public monitoring that this brings should positively assist in improving entity performance, particularly in relation to SOEs. However, increased transparency may give rise to public disagreements with the entities and other commentators. To mitigate this risk COMU will:
- provide Ministers with advance notification and details of any significant information and analysis COMU intends to publicly release;
 - provide entities with any information it intends to publish in advance to ensure commercial information remains confidential and to ensure the accuracy of data published, although disagreement over assessments will not automatically prevent publication; and
 - implement a staged approach with regard to the releases. Initial releases will be more factual e.g. performance over periods longer than a year, followed by more independent COMU assessments of performance with analysis, commentary and judgments provided. Eventually we would expect to provide links from the website to other public assessments and commentary on an entity's performance.

Boards not wanting to engage with COMU

27. There is some risk that boards will not be keen to engage with officials, unless COMU can engage in a credible and informed manner on a range of commercial issues. To that end, COMU is changing its business model with a "back office" group undertaking more in-depth financial analysis and a "front office" comprising a senior relationship manager allocated to each entity.

Short-term delivery risk by COMU

28. Since the merger into Treasury, COMU has not had a fully staffed sector monitoring team. COMU has 4 FTE sector monitoring positions available, from a team of 13.5 FTEs (this excludes management). Recruitment rounds have failed to secure the skill set we require. In part, this may be due to COMU's current monitoring approach. We believe the change to COMU's business model, combined with the increased transparency of COMU's analysis, will assist COMU in attracting the skilled people it requires. However, given COMU is understaffed and will be implementing the new business model within current staffing levels, there is some short-term delivery risk for Ministers. COMU aims to continue to provide high quality advice and support to Ministers within the changed approach, notwithstanding our staffing issue. Being more explicit with Ministers and entities on the entity prioritisation should also assist.

COMU as a Centre of Expertise

29. A second objective of the 2009 Treasury Leadership Review was that COMU indirectly lift the monitoring capability of other monitoring agencies. The first three initiatives in achieving this are:
- a. **COMU presentation of its new model to other agencies whose monitoring has some commercial emphasis**
30. The underpinning principles at play in COMU's changed approach – board accountability and responsibility, relationships with boards occurring with senior officials, and improved capability of monitors – are all issues that were raised with the Minister of Finance in the *Statutory Crown Entities Cost Compliance Review Report*. COMU intends invite the other agencies whose monitoring has a commercial aspect [Department of Labour (ACC), Department of Building and Housing (Housing Corporation), Tertiary Education Commission (TEIs), Ministry of Health (DHBs), Ministry of Transport (NZTA and with COMU KiwiRail)] to a presentation on COMU's new approach. We note however, that as COMU has a critical mass of entities and therefore associated resource, COMU is better placed than most other agencies to fully implement this approach. We also note that Labour, Housing and Transport are already addressing capability concerns by restructuring their monitoring units and that the newly established National Health Board is now charged with monitoring District Health Boards. We will keep other agencies informed of COMU's progress with this shift in the monitoring approach.
- b. **Advisor working with the monitoring agencies for a set period**
31. Subject to COMU operating with a full complement of staff, we intend to discuss with the key monitoring agencies if the allocation of a COMU advisor for a set period, to be a key contact on financial monitoring would be of assistance. If agreed to, working more closely with counterpart monitors will also challenge and inform COMU's own monitoring.
- c. **COMU supporting the Ministry of Science and Innovation's monitoring of Crown Research Institutes (CRIs)**
32. COMU currently monitors the CRIs. In line with the February 2010 CRI Taskforce proposal, from 1 January 2011 the Ministry of Science and Innovation will be the monitoring department for CRIs, with COMU moving to a second-opinion role in relation to the CRI's financial performance. COMU is working with MoRST to transfer knowledge on how COMU monitors the CRIs and will continue to work with the new monitoring team to share developments in financial monitoring approaches. It is expected that COMU will retain a key role in the board appointments advice, working alongside the Ministry of Science and Innovation.

Evaluation of COMU's Changed Approach

33. We expect to have the new business model in place by late October 2010. As the changes fit within the current aims of Treasury's Statement of Intent and COMU's business plan, assessment of COMU's approach will occur at quarterly intervals. COMU is also working on performance measures as part of the 2011 planning round that will better reflect the new approach.

Financial Implications

34. There may be some re-adjustment of COMU's resourcing and expenditure in relation to these changes. Any increase would be modest and covered within Treasury's overall budget.

Consultation

35. The general approach was discussed with a handful of both current and former chairs and Chief Executives of SOEs who have agreed in principle that this is a sensible direction for COMU's monitoring.
36. COMU also has a wider communications plan as discussed below.

Communications

Advising Chairs

37. COMU intends to send a letter to the respective chairs advising of the changed monitoring environment, seeking their comments and welcoming on-going feedback on the new approach. Attached is the version of that letter developed for the chairs of SOEs. The letter will be adjusted accordingly for other entities.

Advising other departments COMU works with

38. COMU operates across a number of Votes in undertaking its monitoring and appointments role and therefore has some engagements with various other departments as matters arise. These departments are: the Ministry of Transport (KiwiRail), the Ministry of Health (Health Benefits Limited), the Ministry of Culture and Heritage (TVNZ, RNZ), MoRST (CRIs), the Ministry of Justice (Public Trust), the Department of Internal Affairs (New Zealand Lotteries Commission), the Ministry of Foreign Affairs and Trade (Pacific Forum Line), the Ministry of Education (Learning Media), the Ministry of Agriculture (Animal Control Products), the Ministry of Economic Development (NZ VIF and Rugby New Zealand 2011). COMU will advise all these departments of the new approach COMU is taking. In most cases, this will not change anything for these departments.

Informing the public on entity performance – COMU's redesigned website

39. The structure of the current COMU website primarily focuses on COMU itself, which appears to be how other monitors tend to use the internet. COMU is shifting the emphasis to the entities monitored so the front page is likely to have recent continuous disclosure announcements, quick links to the entities in the portfolio and links to relevant financial analysis undertaken by COMU or others. This is in line with how the New Zealand and Australian stock exchanges use their websites. Information on COMU and its monitoring model and approach will still be available. The re-designed website will be operational in time for the annual portfolio report in early November 2010.

Supporting boards, the executive and other entity staff

40. COMU is updating the Owners Expectations Manual to reflect the changed monitoring approach.

Annex One: Draft letter for SOE chairs – needs to be altered for other chairs

Dear [*insert chair name*]

COMU'S MONITORING APPROACH

The purpose of this letter is to advise you that COMU intends to shift its monitoring approach to support your board's role as the shareholders primary monitor of company performance, and to enable us to provide better advice to shareholding Ministers. It also advises you of the consequential changes that this will mean for your board and company.

Over the past few months, I have been looking at ways of improving the effectiveness of COMU's monitoring activities while at the same time ensuring that the relative roles and responsibilities of COMU and the board are both clear and support the accountability and authority of the board. My starting premise is that the commercial framework that arises from the Companies Act 1993 and the State Owned Enterprises Act 1986, defines the roles of shareholder and board. Under this framework, boards are responsible and accountable for the individual company performance and are seen as the primary monitor of performance and the mechanism that the shareholding Ministers have in holding the company to account. COMU's primary acts as both the representative of the shareholders as well as an advisor to the shareholders.

As a result of my internal investigations, coupled with further discussions with shareholding Ministers and some current and existing SOE board members and chief executives, COMU intends to shift its monitoring approach to create a stronger commercial decision making environment. There are several key components arising from such a shift, each of which is discussed in more detail below. In summary, the shift will result in the following changes for boards and COMU:

Role Clarity

- greater formality around key interactions between your company and COMU as the shareholders representative.

Focus on Performance

- quarterly reporting on historic performance to also include a forward view of key results;
- boards providing shareholders with information on the outcomes of past investment decisions;
- COMU undertaking the benchmarking of key companies against peers; and
- COMU having a much greater focus on the portfolio performance, and the commercial value and total returns of each entity.

Increased public information

- increasing amounts of information on both entity and portfolio performance being made available to the public on COMU's re-designed website.

1. Greater formality around key interactions between the company and COMU as the shareholders representative

COMU often interacts with the company executive team, which is appropriate for many of the activities we are asked to undertake on behalf of shareholding Ministers. We believe, however, that there are a number of key interactions that should be with the board, and not the executive; particularly where these interactions are around expectations and/or strategy and formal reporting. As such, we are seeking to have greater formality in the following key interactions.

- (a) *Engagement on strategic planning:* COMU will seek to engage with the board at the front end of the annual planning cycle via the shareholder's annual letter of expectations (previously called the outlook letter) so that the board has greater clarity on the shareholders preferences and expectations prior to the company developing its business plans and Statement of Corporate Intent (SCI). Consequently COMU will look to have far less involvement at the end of the strategic planning process (late April / May), other than advising shareholding Ministers whether the draft SCI meets legislative and information requirements and shareholder expectations. We intend in future to send you the annual letter of expectation within three months of the start of each financial year i.e. by the end of September, but note that this year, this will occur in October.
- (b) *Engagement on company performance:* Ministers view quarterly performance reports as a formal report to shareholders from the board on the board's view of company performance. In the first instance, COMU will seek to engage with the chair on any major issues arising from the quarterly report before engaging with the company's executive.
- (c) *"No surprises" policy in action:* It has been agreed with Ministers that all "no surprises" alerts are to be sent direct to Ministers' offices and copied to COMU on a "no action" basis. COMU will take action if requested to do so by the shareholding Minister or where COMU believes it needs to be pro-actively involved. COMU intends and needs to be involved in issues which potentially affect company value or performance and expects to be engaged early on such issues.

2. Board's reporting on historic performance to also include a forward view of key results

Performance reports from companies generally focus on the company's last quarter performance versus the SCI plan, reasons for deviation and remedial actions. We are looking to provide shareholding Ministers with a forward look at performance as well. To that end I will be asking boards to include commentary from the board as to what the projected outcome for the full year will be, how confident the board is that the outcome can be met, and what are the key issues that are impacting on meeting planned performance levels. I will send out a letter with a draft template for the information we require in the next few weeks.

3. Boards providing shareholders with information on the outcomes of past investment decisions

In their dividend decisions each year, boards are making an explicit decision either to return available cashflow to the shareholder by way of dividends or to invest such surplus back into the company. Shareholding Ministers care very much about what value companies are creating from these investment decisions. They require greater visibility as to how successful past investments have been, and whether companies have a track record of making investments that meet the criteria that management have proposed in seeking board approval for such investments. I wish to make it clear that neither shareholders nor COMU expect to be involved in any investment decisions (unless required by law) and also note that

shareholders hold the expectation that a board should be receiving such information in any event, so that this should not be an additional impost on the company. I will include our requirements in respect of this information in the letter mentioned above.

4. COMU undertaking the benchmarking of key companies against peers

The principal objective of SOEs is enshrined in the SOE Act and requires every SOE to operate so as to be as profitable and efficient as comparable businesses not owned by the Crown. COMU will devote an increasing proportion of its resources to understanding and benchmarking the performance of each SOE with its peers. COMU intends to make such information available to the boards as part of discussions on company performance and expectations, and to publish such information in due course. We would expect that, in many cases, boards will have carried out such benchmarking activities themselves and we will be seeking this information from companies to assist in our further analysis.

5. COMU having a much greater focus on the portfolio performance, its value and total returns of each company

COMU is forming a small team dedicated to undertake the type of analysis typically undertaken by external parties interested in company performance. This group will undertake specific exercises for the shareholders such as internal valuations, an annual portfolio performance report as well as the benchmarking activities described above.

6. Increasing amounts of information on both company and portfolio performance being made available to the public on COMU's re-designed website

Shareholding Ministers have made clear their expectations for greater disclosure and an increased amount of performance information to be made available publicly. In line with this call for increased transparency of State sector agencies performance, COMU will be publishing on our website (www.comu.govt.nz), which is currently undergoing re-design, more information on companies and their relative performance. The first example of this will be an annual portfolio report, which will be made available in early November 2010. COMU intends to put the following additional information on this site over time:

- Company performance vs plan;
- Company performance vs peers; and
- Portfolio and individual company valuations and returns

It is our intention to provide companies with any information we intend to publish in advance to ensure commercial information is kept confidential and to ensure the accuracy of data published.

7. COMU prioritising its monitoring efforts based on a company's size, complexity and difficulty of current issues.

COMU is operating within a fixed complement of staff and resources. In order to achieve the change in monitoring approach outlined above, it will need to further prioritise its efforts and engagement with companies based on a number of factors. This may lead to fewer day-to-day interactions with your company.

Other changes

This change in approach requires COMU to implement changes to its internal approach. This may lead to a change in the person allocated to engage with your board and company. Each company will still have a senior relationship manager as your key point of contact within COMU. I will advise you of any personnel changes as they occur.

COMU will also update the Owners Expectations Manual (OEM) to reflect these changes. The updated OEM will now also include a section on expectation for business cases seeking shareholder equity or approvals. If there is any other material you would like to see included in the OEM, please let me know.

COMU's Board Appointment and Governance Function

Please note that your first contact for discussions on board appointments, reappointments, professional development, director remuneration and other governance related matters will continue to be Steve Rich, and the Appointments and Governance team.

Feedback welcome

These changes are all consistent with treating your Crown company as far as possible as a commercial company with a controlling shareholder. The performance information that these changes generate will be taken into account, when COMU is working with chairs and shareholding Ministers to assess board composition and requirements. I believe these changes will support board accountability and improve both shareholding Ministers and COMU's engagements with you on the key issues of company strategy and performance.

I would welcome both any immediate and on-going feedback on this approach. If you wish, I am available to meet face to face with you and/or your board to discuss these changes and their potential impact, or to get any direct feedback from you or your fellow directors. If you would prefer to engage by phone or email, I can be contacted at John.Crawford@treasury.govt.nz or on landline 04 917 6251 or mobile 021 578 412.

I look forward to working with you in implementing this change in approach which should lead to an improved commercial decision making environment for you and your company.

Yours sincerely

John Crawford
General Manager
Crown Ownership Monitoring Unit

cc Chief Executive of each SOE