CROWN OWNERSHIP MONITORING UNIT

Treasury Report: Crown asset portfolio: issues and implications arising from the Investment Statement

Date:	3 December 2010	**Report No:**	T2010/2513

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Refer** this report and the attached paper to the Prime Minister, the Minister for State Owned Enterprises (Hon Power) and the Associate Minister of Finance (Hon Joyce).	10 December 2010

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Bryan Dunne	Senior Analyst, Sector Performance & Balance Sheet, COMU	[withheld s9(2)(a)]	[withheld s9(2)(a)]	✓
Nic Blakeley	Manager, Sector Performance & Balance Sheet, COMU	[withheld s9(2)(a)]	[withheld s9(2)(a)]	

Minister of Finance's Office Actions (if required)

Refer a copy of this report and the attached paper to the Prime Minister, the Minister for State Owned Enterprises (Hon Power) and the Associate Minister of Finance (Hon Joyce).

Enclosure: **Yes** (Crown Ownership of Commercial Entities [version sent to MoF]:1959696)

Recommended Action

We recommend that you **refer** this report and the attached paper to the Prime Minister, the Minister for State Owned Enterprises (Hon Power), and the Associate Minister of Finance (Hon Joyce).

Agree/disagree.

Nic Blakeley
Manager, Sector Performance & Balance Sheet, COMU
for Secretary to the Treasury

Hon Bill English
Minister of Finance

3 December 2010

Treasury Report: Crown asset portfolio: issues and implications arising from the Investment Statement

Executive Summary

The release of the Investment Statement offers an opportunity to reconsider current asset management practices, investment intentions and policy settings - including ownership and institutional form.

Attached to this is report is a think-piece we completed earlier this year at the request of Treasury's Executive Leadership Team. The paper examines the arguments and issues related to Crown ownership of commercial entities (i.e. SOEs, Air New Zealand, and regional airports), but the issues are relevant to the broader context of better management of the Crown's balance sheet.

In our view, to meet the Government's overall goals (fund priority public services, rebalance the economy, and rebuild the Crown's balance sheet buffer), the Government should focus on where it has a clear advantage in providing goods and services directly and on doing that well (this includes promoting good quality regulation). This means:

- being more selective about what activities government carries out and why;
- becoming more open to alternative business structures and delivery models for public services;
- being more professional in the way government manages its assets (and liabilities); and
- being more demanding in achieving value from its assets.

While there are other options, we think that reducing Crown ownership of some assets in favour of private ownership/investment would be likely to result in a substantive and sustained shift in performance. We do not see a strong case for trade sales for all or even the majority of candidate assets.

Overall, we think reducing Crown ownership of the commercial portfolio would provide moderate economic gains. But an overall balance sheet strategy needs to be broader than that: big gains could come from introducing and applying additional commercial disciplines to other parts of the balance sheet.

Treasury Report: Crown asset portfolio: issues and implications arising from the Investment Statement

Purpose of Report

1. This report provides our advice on Crown ownership of assets as one lever to help achieve the Government's goals, with a particular focus on the commercial portfolio.

Analysis

The release of the Investment Statement offers the opportunity to revisit current asset management settings and practices across the Crown's balance sheet.

2. The Government will shortly be releasing the first Investment Statement. The release offers an opportunity to reconsider current asset management practices, investment intentions and policy settings in light of the Government's fiscal and economic objectives. This also includes the opportunity to reconsider the ownership and institutional form of a number of Crown assets.

3. The Crown's assets can broadly be classified into portfolios of social assets (such as roads, schools and social housing) which make up around half of total assets, financial assets (around 27 per cent of total assets), and commercial assets (around 23 per cent of total assets).

4. The cost of holding these assets is significant. Using the public sector discount rate, the opportunity cost is approximately $18 billion per year. This is equivalent to about 25 per cent of general Government spending (core Crown expenses) in 2010/11, and is, for example, larger than the annual government spending on Health. This emphasises the need for the Government to use its capital effectively.

5. We have previously reported to you on a set of principles for shaping the balance sheet and the overall high level practical implications of those principles for the social, commercial and financial portfolios [T2010/1668 refers]. A summary table from that report is attached as Annex One to this paper.

6. In addition, Cabinet has recently agreed a set of government investment intentions: rebuilding resilience, reducing risk exposures, sharpening incentives to use existing capital well, introducing private sector capital and disciplines where appropriate, and prioritising capital to its highest value use [CAB Min (10) 43/8 refers].[1]

To meet the Government's overall goals, changes to balance sheet settings will be required.

7. You have been reported in the media as seeking more active management of asset portfolios, including sales, as a way to free up capital for reinvestment in more productive assets.[2] You have also indicated that you wish to fund all new capital investment through freeing up dormant capital and/or by more actively reprioritising the capital that is allocated by entities on the Crown's balance sheet.

[1] Where highest value is (in order of priority) ensuring social services and national infrastructure can be delivered; liquid investments that can be employed when shocks occur; and, illiquid investments.
[2] Media references to your speech to the Cullen Employment Law Firm breakfast function. See for example, Otago Daily Times, 19 November 2010.

8. Attached to this report is a think-piece we completed earlier this year for Treasury's Executive Leadership Team. The paper examines the arguments and issues related to Crown ownership of assets. The scope of the paper is limited to the commercial portfolio of companies (i.e. SOEs, Air New Zealand, and regional airports), but the issues are relevant to the broader context of better management of the Crown's balance sheet.

9. The broader context is the Government's fiscal and economic objectives, particularly the pressing need to rebuild the Crown's balance sheet buffer and to actively reprioritise Crown capital to its highest value use in support of raising New Zealand's potential growth rate.

10. In our view, to meet the Government's overall goals (fund priority public services, rebalance the economy, and rebuild the Crown's balance sheet buffer), the Government should focus on where it has a clear advantage in providing goods and services directly and on doing that well (this includes including promoting good quality regulation). This means:

- being more selective about what activities government carries out and why;
- becoming more open to alternative business structures and delivery models for public services;
- being more professional in the way government manages its assets (and liabilities); and
- being more demanding in achieving value from its assets, including from (but not limited only to) the commercial portfolio.[3]

The commercial portfolio is an obvious candidate for revisiting current settings.

11. The commercial portfolio is comprised largely of entities operating in openly competitive environments where they compete with private sector entities in the supply of goods and services.[4] The composition of the portfolio is the result of broader policy choices rather than a deliberate choice to meet specified commercial investment goals – such as maximising return and/or reducing risk – as would normally be the case for a portfolio of investments.

12. Unless the Government is getting a truly commercial return (greater than the weighted average cost of capital), the Crown should own commercial assets only where there is a strong economic justification, given:

- it crowds out public expenditure on other areas (eg education, superannuation) and private investment in key economic assets and infrastructure; and
- efficiency/performance is likely to be lower than it would be in a market model. The commercial disciplines that come from investors risking their own money are difficult to replicate in the public sector.

13. Further, growing this portfolio is not a priority for the Government in the future, and there are limited grounds for further public financing of growth, which will constrain the future performance of these entities.

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[3] The UK Government has introduced a policy framework, based on these principles, to guide decisions on how government activities will be delivered. See HM Government, *Operational Efficiency Programme: Asset Portfolio*, 2009.

[4] A minority occupy certain niche/monopoly positions in the economy and are not subject to competition. In these cases if there are price or access issues they are subject to regulatory control.

14. In terms of the principles outlined above, the commercial portfolio offers clear opportunities for the Crown to be more selective about the activities it carries out – particularly where it is in competition with private providers; to use different institutional forms (depending on its overall ownership goals) and to derive greater value from its assets by more actively reprioritising Crown capital to its highest value use.

Overall, we think reducing Crown ownership of the commercial portfolio would provide moderate economic gains…

15. The main conclusions of the attached paper are that:

- we do not find any of the main arguments in favour of Crown ownership particularly strong (i.e. monopoly rents, to fulfil 'strategic' objectives of some sort, or to prevent 'hollowing out');

- we think all of the main arguments against continued Crown ownership have merit and point to moderate gains from reducing Crown ownership (i.e. improve economic efficiency, improve the fiscal position, and develop capital markets).

16. It is worth emphasising that we think the overall gains would be 'moderate' rather than (say) 'substantial' because:

- regulatory and competition reforms and the maintenance of a relatively strong SOE framework has probably enabled New Zealand to generate the substantial majority of potential efficiency gains;

- likely sale proceeds, in a fiscal sense, depend mainly on the entity, the amount sold and the sale process (partial sales, for example, would generate disproportionately lower returns as buyers are likely to apply a discount to reflect the lack of control they will have over the entity); and

- the more important drivers of capital market development are domestic savings and the broader tax and regulatory environment, as identified in the Capital Market Development Taskforce report.

…and within levers to improve company performance, we think reducing Crown ownership is the biggest lever.

17. The attached paper considers the broad economic pros and cons of Crown ownership. Another perspective is how introducing private ownership fits into the spectrum of levers to improve company performance.

18. The Crown company framework has a number of levers, each of which could be altered in ways that may improve performance. Changes can continue to be made within the current framework to improve Board appointments and performance, set higher expectations in terms of dividends and gearing, promote transparency and improve the monitoring of commercial assets (and the other Crown assets). Annex Two to this paper provides a high-level outline of options for changes to settings on the other performance levers.

19. On balance we think that reducing Crown ownership in favour of private ownership/investment is the one option that would be likely to result in a substantive and sustained shift in performance.[5] The gains would come from: better monitoring and feedback to the entity from the private sector investors and their agents, and from

[5] The likely economic benefits are based on a private owner exerting stronger commercial discipline than a public owner. Not all private owners would be equivalent in this regard.

the share price; more public transparency from the entity; and greater constraints on non-commercial influence in the entity from the government. Signalling also matters; ongoing structural reform sends a signal to the international community that New Zealand is serious about its economic agenda.

Such an approach would also support the Government's broader agenda.

20. Introducing private ownership or investment would also support and reinforce a number of policy goals:

- better balance sheet management, by introducing and applying additional commercial disciplines to larger parts of the balance sheet;
- fiscal consolidation, by releasing capital that could be recycled elsewhere in support of protecting priority public services or to rebuild the balance sheet buffer;
- capital market development and saving, by providing investment opportunities for savers (other than residential housing), and deepening domestic capital markets.

Diluting Crown ownership would need to be done judiciously - a pragmatic approach could result in a mixture of ownership models.

21. There are a range of options for introducing greater private ownership or investment and these should be carefully matched to the asset and the overall objective.[6] Options include:

- Trade sale (Sale by Competitive tender): Of all the sale methods, a sale by competitive tender best eliminates risk and maximises price. However, such transactions can involve the sale of assets to offshore buyers. While this can have significant benefits by enlarging the pool of potential buyers and facilitating the introduction of new management expertise and skills, it also can be unpopular domestically. It may also forgo an opportunity to enhance individuals' savings rates or deepen capital markets.[7]
- Initial Public Offers (IPOs) or public share floats: while these generally do not maximise the net proceeds for an asset they can provide an opportunity for New Zealand retail investor participation and may enhance national savings rates; and may also broaden and deepen capital markets to the ultimate benefit of all New Zealand companies (and the economy). Share floats can be in full or in part.
    - Partial Sale: this may allow some of the benefits of a full float to be achieved when full transfer to the private sector is not possible or desirable. While it may help to free up part of the Crown's investment and reduce in part the risks of ownership, the most significant benefit of partial sale is likely to be to protect and enhance managerial autonomy.[8] Partial sale with majority Crown ownership may also mitigate public concerns, such as majority foreign ownership, delisting, and activity moving offshore.

[6] Objectives may include: reducing ownership risk; achieving competitive neutrality; realising fiscal and/or strategic gains; maximising asset value; optimising overall balance sheet; ensuring managerial autonomy and a stronger focus on shareholder value; promoting growth; deepening capital markets; or some combination of these.

[7] There are mechanisms used in other jurisdictions to encourage the retention of certain functions or skills, or to protect the "public interest" in particular firms. For example, the UK has used a "golden share" – a share which is able to outvote all other shares in certain specified circumstances to protect public interest or to allow privatized companies time to adjust to operating in the private sector.

[8] This could be enhanced through using partial sale mechanisms such as employee share ownership plans (ESOPs) or through allowing management buy outs/ins (MBO/MBI).

[withheld s(9)(2)(f)(iv) & s(9)(2)(g)(i)]

- Composite sale (combined trade and IPO)[9]: while this method is more complex and risky than either a trade sale or a 100% IPO (and is probably only justified for larger transactions) it did enjoy broad public support in the case of Contact Energy.

- Asset by asset sell-down: this is applicable essentially only for companies whose asset base can be broken up and sold in parts. (The assets of most companies have some value in combination which would be lost upon breakup). Sell-downs are primarily used for property-owning and financial/lending institutions.
[withheld s9(2)(f)(iv), s9(2)(g)(i), s(2)(i) and s9(2)(b)(ii)]

- Securitisation: this is a variant of an asset by asset sell-down used for disposing of financial assets/liabilities. [withheld - s9(2)(f)(iv) & s9(2)(g)(i)]

- Gifting: Crown assets (or proceeds) could also be gifted for no or limited consideration. (KiwiSaver, for example, may provide a mechanism through which any transfer of asset proceeds could be distributed into long term household savings).

- Licensing or leasing: The Crown already sells licences and leases for a number of assets (though not companies) including for example: fishing quota, radio spectrum rights, mining and exploration licences. A broader range of assets could be transferred into private ownership through a fully contestable process for a specified period of time.
[withheld s9(2)(f)(iv), s9(2)(g)(i), s(2)(i) and s9(2)(b)(ii)]

22. We do not see a strong case for trade sales for all or even the majority of candidate assets. There may be a case for full sale of some of the smaller companies, though the likely benefits are commensurate with the size of the companies. For the remainder, an enhanced status quo could consider use of a holding company and/or outside financing that is short of ordinary equity, such as equity bonds.[10]

23. We see a case for a medium-term strategy that involves a mixture of:

- full sale of companies in competitive markets, where potential gains are high and/or New Zealanders' concerns are low or could be mitigated;
- partial sale where residual concerns remain; and
- full Crown ownership for a subset with high residual risks.

24. As an illustration only, a sequenced approach across a combination of companies, utilising different approaches depending on the primary objective, could look like *[primary objective(s) in brackets]*:

- a (say) 25% partial listing of one or more of the gentailers *[fiscal, capital market]*;
- a (say) 25% partial listing of Solid Energy's core business *[efficiency, fiscal]*;
- issuing equity bonds for Kiwibank to fund its growth *[fiscal]*; and
- full sale of Kordia and minority shares in regional airports *[efficiency]*.

[9] This method was used in the sale of Contact Energy in 1999.
[10] A holding company could be used to manage, as a portfolio, the smaller SOEs.

Releasing dormant capital from the balance sheet does not simply involve asset sales (whether in part or in full)…

25. The toolkit for releasing capital and improving overall asset management is broader than asset sales. Equally, the option of divesting or diluting Crown ownership is not simply confined to commercial assets.[11] We think that, consistent with our advice on asset sales above, the method used should be carefully matched to the asset or portfolio and the overall objective.

26. While the focus of this report has mainly been on the commercial portfolio, the social and financial portfolios have a role to play. For example, options for the social asset portfolio include reconfiguring the service (which may include changing policy settings, demand pressures, entitlements or standards), reconfiguring the asset, or disposing of surplus or redundant stock.

…just as the options for using any capital released are broader than paying off debt.

27. Release of capital from the balance sheet gives the Government choices, such as:

- repaying debt;
- re-investing in other balance sheet items (social and commercial) assets; and/or
- allocating the resource into operating spend.

28. However, consistent with previous advice on balance sheet issues (T2010/1668 refers) we think that re-investing for growth should also include options around financial assets/liabilities as well as physical assets. Growth (and rebuilding the buffer) can come from managing both sides of the balance sheet.[12]

Next Steps

29. We are planning to undertake further work in the following areas:

- [withheld s9(2)(f)(iv) & s9(2)(g)(i)]
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- providing an analysis of New Zealand's experience of the previous tranches of asset sales, focusing on post-sale performance (we hope to report to you on this work by Christmas).

30. [withheld s9(2)(f)(iv), s9(2)(g)(i), s(2)(i) and s9(2)(b)(ii)]

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[11] Effective management of the social asset portfolio, for example, should include examining options for service provision where Crown ownership is unnecessary and where risks can be cost-effectively shifted to the private sector (ie depending on future cost and liability if sold). Current work around greater alternative provision of social housing is one example. The Crown provides a number of other core social services without owning the assets (eg early childhood education, aged care).

[withheld s9(2)(f)(iv), s9(2)(g)(i)]

[withheld s9(2)(f)(iv), s9(2)(g)(i), s(2)(i) and s9(2)(b)(ii)]

Annex One: Implications: possible directions of change

(Excerpt from T2010/1668: Balance Sheet Strategy – Initial Thinking)

	What's on the balance sheet (size/composition)	Improving performance/efficiency
Financial assets and liabilities	• *possibly* a growth area over time (accumulate assets through higher debt) [s9(2)(f)(iv), (g)(i)]	• consider merits of single fund manager or back office for the CFIs (amalgamate the current 4) [s9(2)(f)(iv), (g)(i)] [s9(2)(f)(iv), (g)(i)]
Commercial assets and liabilities	• maintain or decrease (if willing to reconsider long-term hold strategy) level of net commercial assets over time • look for private sector investment to allow them to grow (and to enhance performance)	• direct investment of returns to higher performing areas (do not invest in lower performing entities) • stronger commercial disciplines (including gearing and dividend policy), portfolio monitoring and benchmarking • using a holding company structure to manage smaller entities as a portfolio
Social assets and liabilities	[s9(2)(f)(iv), (g)(i)]	• continue looking to increase contestability in service delivery to drive up efficiency/ performance of Crown-owned assets • ensure that institutional settings (eg around depreciation, capital charging) support efficiency and reprioritising capital to highest use • apply more business disciplines to asset/liability management (eg student loans, housing and school property portfolios) • stronger network perspective to asset management (eg hospitals, schools)

Annex Two: Possible performance levers

Lever	Current situation	Possible options				
Ownership (There are various other choices within these 3 options, all of which have the potential to bring increased levels of market monitoring)	100% Crown-owned	Issue non-voting shares / equity bonds, as allowed under the current SOE legislative regime	Partial sale (including management buy-ins, employee share ownership plans)	Full sale		
Institutional form (if long term hold)	Depends on the entity e.g. SOE, Crown entity companies, Crown entities	Change institutional form e.g holding companies	Change institutional form e.g more control, closer to government.			
Shareholder expectations	Based on being as successful as a commercial business, with some other objectives	Removed mixed objectives e.g. remove social objectives , remove the ability of shareholders to contract for non-commercial services	Shareholder target returns (eg returns, dividend yield or gearing) as the only shareholder objective	Increase autonomy of board decision making e,g. board can diversify, expand off shore, sell etc without seeking Ministerial approvals	[withheld s9(2)(g)(i)]	
Board selection	Ministers appoint directors	Change test for appointments from “best qualified” to “would the person be appointment to a listed company board”	Directors select chair / deputy from amongst their ranks	Chair selects directors	Independent appointment body (Note: UK appointments Commission is to close)	Public get to vote for a percentage of the directors
Board incentives	Cabinet fee schedule	Increase the fees to equivalent market fees	Percentage of fees performance based	Share options for directors		

Lever	Current situation	Possible options				
Board performance	Board and Minister review	Advisory board of experts to regularly review board performance	More consequences for poor performance e.g. Remove poor performers in a more timely and public way	Publicly available league tables on boards	Allow failure, which may have reputational repercussions	
Chief Executive	Board set remuneration package, which includes some incentives in the SOE area	Increase incentives e.g. share options, or tag percentage of salary to meeting specified objectives				
Monitoring	COMU and small group of interested business / lobby groups	Contract monitoring to the market (partial or full)	Increase market monitoring via ownership options above	Consequences for monitors (including COMU) where advice found later to be poor		
Transparency	Continuous disclosure, public annual meetings, subject to OIA, annual reports, Statements of Corporate Intent	Make letters of expectation public (subject to commercial considerations)	Make short list of directors public	Allow public to vote for one or more directors		