

Department of Treasury and Finance

Tasmanian Government Businesses

Director Information Session

“Governance and Performance”

D W Challen

Secretary, Department of Treasury and Finance, Tasmania

Friday 10 September 2010

Thank you Treasurer.

I too am very pleased to see so many Directors here today.

I can see some very experienced faces in the crowd, as well as some who are fairly new to public sector Boards. This day has been developed to provide something for everyone.

The Treasurer has already provided a good summary of the value of Tasmanian Government businesses to the Tasmanian economy.

Our 15 GBEs and SoCs span a wide range of markets – ports, rail, electricity, forestry, financial services and racing among others – and many are responsible for the provision of essential services and infrastructure that are critical to the Tasmanian community, the economy and future investment in Tasmania.

Government businesses are often involved in the provision of essential services to the community in fields where commercial entities cannot effectively operate due to conflicts between the need to generate profit and the need to supply essential services at an affordable price. Such businesses may need to make long term investment decisions that offer limited short term returns.

Government businesses allow the Government to provide services when the private sector is unable to. A recent example was the Government's decision to enter into rail freight operations when Pacific National decided to withdraw its services. In cases like these, the community expects the Government to step in.

The State has substantial equity involved in its businesses and there is therefore a quite reasonable expectation that the businesses act commercially and return dividends to the Tasmanian community. In cases where the Government chooses to use businesses to assist in meeting its policy objectives, any non-commercial activities can be funded by the Government in accordance with the Community Service Obligation framework.

It is generally accepted that privately owned companies outperform state-owned ones, and there are some commentators who advocate that shifting commercial entities to the private sector makes a lot of sense.

I do not intend to go there today, but I do want to focus on some of the contributing factors to the apparent difference in performance.

Those of you that have been on Government Boards for some time will have an appreciation of the governance framework under which you operate and how it differs from the private corporate world.

It is worth looking at what those differences are and how they may impact on performance and expectations.

Firstly, let me look briefly at the legislative framework within which you operate.

As you no doubt know, government businesses are established under their own Portfolio Act and operate under either the Corporations Act or the Government Business Enterprises Act and associated Treasurer's Instructions and Guidelines.

Through this legislation, Parliament has clearly set out the objectives and structure of each business. The Government sets its expectations in relation to performance and direction, and the policies it requires its businesses to adopt in areas such as accounting, internal governance and reporting.

In principle, government should be able to be a business owner through shareholdings in a Corporations Law company, GBE or similar vehicle and induce behaviour in themselves, their board and the business no different to that which applies to listed companies.

The practice though is different.

These differences in behaviour arise in two broad ways.

First, the formal governance arrangements for government-owned businesses typically involve departures from the standard Corporations Law arrangements.

Legislation establishing state-owned businesses usually adopts the Corporations Law by general inclusion but with specific exclusion. The exclusions cover some matters of machinery – such as the appointment of an auditor, to ensure the Auditor-General is the auditor for state-owned businesses.

Also excluded, though, are significant provisions of the Corporations Law which have material impacts on the behaviour of boards and senior management.

Most significant are the corporate takeover and compulsory acquisition provisions, provisions relating to funding activities including offers, issue and sale of shares, the appointment and removal of directors and the continuous disclosure regime.

There are good reasons for excluding each of these provisions of the Corporations Law because they are not consistent with the state-owned businesses governance model.

But in the process, quite significant changes are made to the incentives under which state-owned businesses operate. The threat of takeover in the private sector, for instance, provides powerful incentives for enterprise-value maximising behaviour. There is no equivalent incentive in the public sector.

Similarly, the fact that there is no trading in shares and consequently no quoted share price makes the daily market scrutiny of a listed company impossible in the case of a state-owned business.

Publication of annual financial statements is a very poor substitute.

In the private sector, poor returns are a signal that the business should be divested, restructured or is ripe for take over. In the public sector, these threats do not exist.

The fact that state-owned businesses don't have the normal access to the equity and debt markets also creates a very different set of incentives. Most state-owned businesses are capital constrained because their owners manage the overall level of public sector debt, which has the potential to lead to sub-optimal funding decisions and limitations on the decision-making of the businesses.

Unlike the Boards of publicly listed companies, the Boards of Government businesses are not able to freely make decisions on divestment, acquisitions and diversification. Such decisions require the approval at least of the shareholders, and, in many cases, of Parliament.

The process for removing an under-performing director, or indeed an entire board, is a rather simple process in a listed company – and, for the shareholders at least, quite painless.

By comparison, a similar process for a state-owned business can present difficulties for the shareholders.

You might reasonably ask why this is. The mechanics are no different for a state-owned business from a listed company. The problem lies in the nature of the decision-makers (and here I am talking generally, rather than specifically of the Tasmanian situation).

Ministers, performing the role of shareholders, face the incentives of the political environment. This is quite different to your average shareholders maximising their own wealth, or contemplating the normal scrutiny of the markets through a published share price or a unit price in a trust. Relative to a listed company, the scrutiny and modus operandi of the political environment substantially raises the cost of removing a non-performing director and correspondingly places a premium on making good board appointments. Ministers therefore want to make sure that the director selection process is undertaken with rigour and results in high quality board appointments. In practice, in the past, the reality has not always met this expectation.

The second way in which differences in behaviour arise between listed companies and state-owned businesses is a little more subtle and is probably not widely understood.

The assumption is that, aside from the formal processes, state-owned businesses are pretty much left alone by governments as their owners to get on and run their business in a normal, commercial, enterprise-value maximising way.

However, the reality is that, for good reasons, the formal processes themselves involve a fair amount of shareholder involvement in the operations of the business.

These include formal direction powers in state-owned company constitutions, and something similar in the GBE Act, issuing of shareholders letters of expectations and Ministerial Charters, and shareholder approval or endorsement of corporate plans.

In publicly listed companies, interaction with shareholders is often limited to the annual general meeting and that often does not involve much real interaction.

However, state-owned businesses have much readier access to (and interest from) their Shareholder Ministers, and it is common for the Board (or at least its Chair) to meet frequently with the shareholder ministers. Such meetings are important to keep the Minister informed of issues, but they must not take the place of formal communication to enable appropriate consideration of issues and allow the shareholders to seek expert advice.

Unlike shareholders of listed companies, the shareholders of government businesses are not the owners of the business, and nor do they have a direct financial stake in the company. However, they do have a very high political stake, which tends to lead to a strong desire to be regularly kept informed of the activities and performance of the business.

And, as you are all well aware, while all larger entities are responsive to media comment and public reaction, state-owned businesses need to be much more sensitive to these public affairs considerations and ready for public scrutiny.

State-owned businesses are owned by, and accountable to, the people of Tasmania. This means that they are also subject to the scrutiny of:

- the Auditor-General;
- Parliament, its government business scrutiny hearings and potentially Select Committees;
- the Ombudsman; and
- the Integrity Commission.

But at the same time, state-owned businesses are not subject to the continuous market monitoring associated with publicly listed companies, reporting by analysts and the possibility of takeover.

There may only be two shareholders but each government business has over 500 000 owners, who are, in many cases, also their sole (and maybe captive) customers.

This generally leads to greater public scrutiny and interest in businesses by both the community and the media, particularly when they are not performing well, or make what are seen by some commentators to be unsound decisions.

Some things that are perfectly acceptable in the commercial world may not be appropriate in a public sector context, when you are, in essence, dealing with taxpayers' money and seen to be competing with the funding of the provision of services such as health, public safety and education.

Even if the business is performing well, it may still be open to comment - "as it is obviously charging too much". It is often a no-win situation.

Take electricity, for instance.

The community, especially the business community, expects a high level of reliability and quality of supply from Hydro, Aurora and Transend.

However, electricity users are less keen to contribute, through higher electricity prices, to the investment the electricity supply industry needs in order to maintain its generation and other assets at the very high level of reliability the community expects.

Setting low prices for electricity generation and distribution might well be popular – at least in the short term – but it is not a smart strategy for the medium and longer term.

The consequence of artificially low electricity prices is that operators receive insufficient revenue to meet their operating costs and fund the capital expenditure necessary to maintain the service potential of their assets.

This would lead to increased risk of service failure and erosion in confidence of businesses and the community generally in the reliability of our electricity supply. That would have a severe knock-on consequence for the State's overall economic performance.

On policy grounds, therefore, it is important that the government as owner is pro-active in ensuring that its businesses, which provide essential services to the community, are set up to operate in a sustainable way, with a tight commercial focus, and with prices at levels that cover all costs and provide the revenue needed to fund required investment.

So there are marked differences in the governance framework applying to Government-owned businesses and that which applies in the private sector. These differences need to be fully understood by public sector boards as they give rise to a number of special responsibilities.

Boards of government businesses have a special responsibility to ensure appropriate investment decisions are made. To this end, they need to ensure that any capital expenditure can be adequately justified in terms of its relevance to the business and meeting an appropriate hurdle rate.

This can only be achieved if all investment proposals are put through a rigorous evaluation process.

With adequacy of returns in mind, Boards should also be focused on achieving an appropriate level of gearing for their businesses to effectively deliver their core business objectives and a reasonable return to shareholders.

Finally, and I will expand on this later, boards need to be mindful of their obligations under the accountability framework, including meeting the needs of performance monitoring, the obligation for continuous disclosure of information to the Shareholder Ministers and Treasury, and Parliamentary scrutiny through the tabling of annual reports and participation in the Government Business Scrutiny Committee hearings.

It's important to keep reminding ourselves that the Government's financial position, and hence the wealth of the Tasmanian community, is affected by the financial performance of government businesses and that the Government bears the residual risk of corporate failure.

Let me now turn to the area of monitoring the performance of government businesses.

The absence of active share trading or owners with a personal equity at stake may weaken the incentive of state-owned businesses to maximise enterprise value.

I am sure there are some CEOs and CFOs that think that the current monitoring framework is overly burdensome and that Treasury must have better things to do than analyse quarterly and half yearly reports, corporate and business plans etc. However in the absence of market scrutiny, this is a necessary element of the accountability framework.

Overall, well-intentioned departures from the standard Corporations Law model create significant differences in the incentives facing state-owned businesses which, in my view, make it difficult for state-owned businesses to perform as well as their listed-corporate counterparts.

There is some market evidence in support of this assertion. When state-owned businesses are privatised, a competitive market outcome almost always yields enterprise prices substantially in excess of the present values of the pre-privatisation projected cash flows.

This tells us that the private sector buyers of state-owned businesses have a high degree of confidence that they can run these businesses substantially better, and create substantially more value, than if the state-owned business were to remain in government ownership.

I am not advocating that we privatise government businesses – merely stating that we should be looking at continuous improvement in the governance framework and at what works well in other businesses – be it government-owned, not-for-profit, private or publicly listed.

A good starting point is the ASX Corporate Governance Council's eight corporate governance principles. Though developed with listed companies in mind, they form the basis of good practice, and should be at least considered by Government businesses to help guide their governance regimes.

If nothing more, they provide food for thought – if you are not doing something recommended by the ASX Council, why not? If there is a good reason, then well and good, but if not, then you need, at least, to ask yourselves why.

The first principle relates to laying a solid foundation for management and oversight.

In the case of government businesses, much of this framework is laid out in the legislation, instructions, policies and shareholder expectations detailed in the constitutions, ministerial charters and the like.

The role of the Shareholder Ministers must be recognised and the roles and responsibilities of the Board and senior management clearly identified.

The performance of the Board and the chief executive officer should be regularly reviewed and reported on, and the Chair and CEO must be prepared to attend and respond to questions raised in Parliament in the Government Business Scrutiny Committees.

The second principle, and one which is right at the foundation of the success of any business, is that Boards should be structured to add value and have an effective

skills mix, size and commitment to adequately discharge its responsibilities and duties.

The Board must have the competence to deal with current and emerging issues, exercise independent judgement, encourage enhanced performance and effectively review and challenge the performance of management.

The director selection process is aimed fairly and squarely at addressing this principle. It creates a framework to ensure that we are getting the best possible people to sit on our government Boards and take stewardship of the business.

It provides a process, supporting the Board and the shareholders, to identify and put forward a list of potential candidates that meet the criteria identified by the Board for approval by the shareholders.

Boards play an important part in this process through reviewing the skills and experience of the current board, identifying gaps, undertaking performance reviews of Directors and, most difficult, making hard decisions when Directors are underperforming by not supporting their reappointment and telling them why.

I would also like to see a greater focus at the board level to succession planning. Boards need to work on this in close cooperation with the Director Selection Advisory Panel. Succession planning should be actively considered by boards to manage future retirements of directors from office and – importantly – this needs to be done in conjunction with the changing requirements of the business.

Director succession is a focus area for the Director Selection Advisory Panel and is included in the Board Appointment Guidelines along with the management of directors' terms to ensure adequate board renewal.

Working with the CEO on succession planning at the senior executive level is also a key obligation for any board and another area where I can see the potential for additional effort and improvement by boards.

The third principle – that of promoting ethical and responsible decision making – has already been given fair coverage here today by the Treasurer and I probably need not go into it in any more detail, except to say that this is an ongoing process.

New Directors need to receive induction into the Board's code of conduct and conflict of interest procedures and all Directors should be regularly reminded of their obligations.

Fourthly, there is a need to safeguard the integrity of financial reporting.

Formal mechanisms in place to help achieve this include the requirements to establish audit committees, to adhere to financial reporting policies set out in the Treasurer's Instructions and for Directors to make a declaration or certification in relation to the accuracy of the financial statements.

Most Boards also tend to include at least one Director with financial acumen, but Boards should be careful not to place too much reliance on an individual Board member.

Now we come to principle five – making timely and balanced disclosures.

There are, obviously, legislative requirements around the regular provision of certain financial and non-financial information by government businesses to Shareholder Ministers.

In addition to regular regulated reporting, the ASX Listing Rules require listed companies to continuously disclose share price sensitive information. There is a similar expectation that government businesses will keep Shareholder Ministers informed of all matters that may have a material impact on the business or potentially adverse implications for the Government.

Next - respect the rights of shareholders.

This principle appropriately follows that relating to disclosures.

It involves effective communication, giving shareholders ready access to balanced and understandable information about the business and its intentions. Businesses should ensure that they have due procedures and policies in place to ensure that the information is timely, accurate, and meaningful, and the communication method is appropriate. And again, I refer you back to the comments made by the Treasurer in this regard.

Shareholder ministers generally seek advice from Treasury and the portfolio department who act as market analysts, reviewing and interpreting the information for the benefit shareholders. It is vital that the information provided to these departments is consistent with that provided to the Ministers.

Penultimately, Boards should recognise and manage risk. This needs to be considered in the context of the nature and ownership of government businesses and the Government's low risk appetite. The governance framework requires corporate plans to outline the key financial and operating risks of the business and the strategies approved by the Board to manage those risks, including highlighting any residual risks that cannot be fully mitigated that have the potential to adversely impact on the government as shareholders.

A question every Board should ask is – “How good is our risk management approach?” – do we concentrate primarily on financial risk, or do we seriously consider and monitor non-financial risks in areas such as safety, markets, reputation, infrastructure and the like?

Finally, the ASX principles recommend that boards remunerate fairly and responsibly.

The recent economic crisis has highlighted how board and executive remuneration can lead to serious disincentives and risk taking behaviour, particularly when rewards are given for short term gains at the expense of the long term viability of a company.

In the private sector, shareholders often have difficulty in comprehending the size of some remuneration packages when the value of their investment is declining dramatically. Government has an answer for this, and the parameters around Board remuneration are determined by a government agency (the Department of Premier

and Cabinet), rather than the shareholders on the recommendation of the board. This enables the Government to have control over one of the most contentious aspects of corporate governance in recent years.

Boards, in their turn, should be suitably restrained in the determination of remuneration of the senior executives of the company when times are tough – certainly many public listed companies have gone through some serious belt tightening over the past few years.

As you can see, the Government's corporate governance framework already picks up on each of the ASX principles to some extent. It is up to Boards to consider their own governance arrangements to determine if there are improvements that can be made.

To assist, Treasury has prepared a number of guides and an outline of the Corporate Government Principles in the government business context which are available on the Treasury website.

It's wise to remember that good corporate governance is not chipped into a block of stone and in the set-and-forget category. Rather, it is an evolving process and encompasses more than rules, principles and codes – it's about the sum total of corporate behaviour.

As the Treasurer indicated in his speech, we should all be looking at continuous improvement and adaptation to changing times.

Treasury is no different when it comes to the corporate governance model.

Government businesses currently operate under both the Government Business Enterprises (GBE) model and the State-owned Companies (SoC) model under the Corporations Act.

There were good reasons for this at the time - the *Government Business Enterprises Act 1995* was based on Commonwealth administered company law in existence at the time the Act was developed in the early 1990s.

Substantial changes have since been made to company law, including the enactment of the *Corporations Act 2001*.

Although from time to time amendments have been made to the Government Businesses Enterprises Act, it has been left behind somewhat and would require a major overhaul to bring it back into line with the Corporations Act.

Life must already be pretty hard for those directors who are on the Boards of both a GBE and SoC – where there is different terminology, reporting, governing legislation and other requirements.

Treasury has therefore been considering for some time whether it is still necessary and worthwhile to continue to maintain two government business governance models.

The fact that any new business established since the GBE Act was developed has actually been created as a SoC, and a number of GBEs have been transitioned recently to SoCs, suggest that the day of the GBE may have passed.

We are therefore developing a discussion paper which will be circulated to all businesses. The paper discusses the implications and transition issues were today's GBEs to become tomorrow's SoCs.

Obviously government businesses will be fully consulted as part of the process to progress towards a uniform, more robust and contemporary corporate governance framework for the future.

It is also vital that the transition to any new structure is accomplished with minimal impact on the businesses themselves.

We look forward to your constructive input into this important governance initiative.

In conclusion, there are two messages I want to reinforce:

- firstly, an effective board of directors is a vital element of the corporate governance and accountability regime for Government businesses and is fundamental to achieving good business performance; and
- secondly, governance is much more than rules, regulations, accountabilities, structures and frameworks – it's also about leadership, values and behaviours. It is as much about culture as it is structure, and as much about the example set by Boards and management as it is the rules imposed on them.

Thank you.