The Governance, Management and Accountability of Arms'-length Entities

A report prepared by McKinlay Douglas Ltd with the support of Local Government Victoria, the Victorian Local Governance Association, the Department of Internal Affairs and the Waipa and Rotorua Lakes District Councils

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Introduction

Preparation of this report was initiated by McKinlay Douglas Ltd (MDL) recognising there was a substantial international interest in the governance, management and accountability of local government controlled arms'-length entities so that it was timely to provide an overview of practice in different jurisdictions.
This was especially the case as at least two jurisdictions, the state of Victoria, and New Zealand, were at different stages in rewriting aspects of their legislation governing the use of arms'-length entities:

- In Victoria that state's Local Government Act was under review with the stated objective to "ensure that our new Local Government Act reflects modern business practices and actively promotes collaborative arrangements." MDL understood this included an assessment of whether the current arrangements in place for the use of arms'-length entities in local government were still fit for purpose.

- MDL was aware The Victorian Local Governance Association had a general interest "in learning about the nature and scope of arms'-length entities, different business models… and other measures to share, learn and transition to a new business environment for local governments." reflecting a view Victorian councils would need to be more proactive in looking at different options for raising revenue and/or reducing costs in order to respond to the recently introduced rate capping regime.

- New Zealand's Department of Internal Affairs as the lead agency in the implementation of the New Zealand Government's Better Local Services initiative was known to be interested in how to encourage greater collaboration amongst councils especially through the use of Council Controlled Organisations (CCOs), (the New Zealand term for arms'-length entities in local government).

- MDL was working closely with two New Zealand councils, the Waipa and Rotorua Lakes District Councils, both of which are actively involved with CCOs. They both had an interest in the nature of good practice in the governance of CCOs, especially in how to ensure that the governance of multi-council CCOs gives due weight to the unique circumstances and local requirements of individual councils.

MDL developed a proposal which was discussed with each of these five entities with a request that they provide support for the project which resulted in the production of this report. Each agreed to do so and MDL records its appreciation for that. MDL also records that the opinions expressed in this report including any judgements or recommendations are solely the responsibility of the author and should not in any way be regarded as reflecting the views of any of the five parties who supported this project.

The report begins with a summary of the key themes identified in its discussion of the different elements involved in developing policy and practice in the use of arm's-length entities, briefly describes methodology and then moves into the main body of the report which is the provision of an overview of each of the main elements understanding of which is seen as important for developing both policy and practice in the use of arms'-length entities (ALEs). They are:

- The nature of ALEs and the range of activities which councils in different jurisdictions have undertaken through ALEs.
- Considering the use of an arm's-length entity: process and arguments in support. Some examples.
- International practice - what have different jurisdictions done and why - options to consider.
- If councils are to be able to establish arms'-length entities, what provision, if any, should be made for post-establishment governance - options include 'do nothing', conditions precedent to establishment, ministerial or other consent and a statutory regime.
- What are the accountabilities involved, and how should they be addressed?
- Are additional provisions required for multi-council arms'-length entities?
- Are different provisions required for different categories of arms'-length entity - for example for-profit trading entities, not-for-profit entities established to provide more efficient service delivery, entities in the nature of a social enterprise, for example a trust established to run a library service and tap into community and other support not available to a council as such?

The report concludes with some comments on next steps for project partners.

Summary of key themes

This section summarises the key themes identified in this report and set out in more detail in the next steps section at the end of the report.

- Arguments for the use of arms'-length entities cover two separate but over-lapping situations: improving the performance of an existing council service including attracting requisite skills and other resources not directly available to the council, and building partnerships with the council's communities for service delivery especially in public good activities.
- International experience shows a very wide range of approaches on the part of higher tiers of government. Differences are in part a function of the extent to which individual governments take an enabling or interventionist approach to local government.
- A risk-averse approach to enabling the use of arms'-length entities can have the unintended consequence of undermining the innovative capacity of councils themselves.

- Post-establishment governance will become increasingly important as councils face growing pressure to 'do more with less' and find new revenue sources.

- The 'do nothing' option for post-establishment governance is less attractive than others including setting conditions precedent to establishment, relying on conditions in an approval process, or the use of a statutory framework such as that applied in New Zealand. Factors in choosing an approach will include the flexibility to respond to a changing risk environment, the capability of public officials, and the signals which government wants to send local government regarding the balance between innovation and compliance.

- Arms'-length entities raise complex questions of accountability, including how elected members, and members of an entity's governing body, understand their respective roles and the associated public expectations including the importance of 'public value'.

- There is a strong case for developing a means of capturing and disseminating good practice in the use of arms'-length entities. On balance it makes sense this should be done by the local government sector, in all likelihood a peak body.

- Multi-council arms' length entities raise the question of how an individual council can ensure, in the establishment process, there are arrangements which will protect interests which are important to its communities. A shareholders' committee is a useful but not sufficient tool and should be complemented by a shareholders' agreement which is specific on the matters involved, and on issues such as dispute resolution.

- Much of the interest in arms'-length entities is focused on companies limited by share capital. As financial constraints increase, there will be increasing interest in the potential of not-for-profit entities for purposes such as building partnerships with the community (co-design, co-production) and the encouragement of social enterprise.

Methodology

The methodology employed in the preparation of this report included:

- Review of a range of existing research on the use of arm's-length entities drawing in part on publications authored by Peter McKinlay, in part on a limited search of international journals and in part on Internet searching undertaken to identify relevant experience and reports from experienced advisors and/or monitors (for example New Zealand's Office of the Auditor-General).

- Exchanges with international colleagues on experience within their jurisdictions.

- Telephone or face-to-face interviews with executives from a number of New Zealand local authorities with responsibility, within their own councils, for managing the relationship between the council and its CCOs.

- Exchanges with peak local government organisations in New Zealand and Victoria.

- A series of discussions in Melbourne organised respectively by Local Government Victoria and the Victorian Local Governance Association based on an extensive issues paper prepared to provide background and involving a range of officials from the Victorian Government, and both elected members and officials from a number of Victorian councils.

- With the assistance of the Department of Internal Affairs, reviewing the history of New Zealand local government's involvement with arm's-length entities since the legislative and economic reforms of the late 1980s.

- Peer review by a senior New Zealand company director with experience on the boards of substantial companies in New Zealand and Australia and as a director of CCOs.

Nature of Arms'-Length Entities

The term 'arms'-length entities' is more a term of art than of science and covers quite a wide set of different arrangements. The entity which most often features in public discussion seems to be the company limited by share capital. Reasons could include the fact that council owned companies can often be quite substantial in scale and that at least in some jurisdictions transferring a council activity into a council owned company can be seen as a first step towards privatisation.

However, as well as companies limited by share capital, councils have made use of companies limited by guarantee (in jurisdictions where that option is available), trusts, incorporated societies, industrial and provident societies, partnerships (both limited and unlimited) and some special creatures of statute such as Victoria's regional libraries or South Australia's council subsidiaries.

From the commercial to the public good

The activities for which ALEs have been used range widely from the almost totally commercial to the purely public good, from relying on full-time professional staff to relying almost totally on volunteers from within the council's community.

Recent years have seen a stronger emphasis on social enterprise, including creating arms'-length entities to undertake activity which would previously have been seen as 'core council' and quite inappropriate for outsourcing to an arms'-length entity. The increasing use in England of companies to deliver social care services is just one example of this change.

Governmental interest in 'efficiency'

At the same time, a number of jurisdictions have also seen higher tiers of government placing a stronger emphasis on what they believe is the contribution which the use of the ALE option can make to improving resource use within the local government sector. In England the Localism Act 2011 gave councils the power to undertake trading activities outside their own district (enabling councils to achieve

benefits of scale and specialisation) but required that, in order to do so, they must form a Local Authority Trading Company.

In New Zealand the government has recently introduced an amendment to the Local Government Act one purpose of which is to encourage the formation of multi-council CCOs, notably for water services (in New Zealand local authorities are responsible for the provision of water services) and transport. The explanatory note which accompanied the Bill is explicit that it "implements a set of reforms to enable improved service delivery and infrastructure provision arrangements at the local government level. The Bill contributes to the delivery of key government priorities to deliver better public services and build a more productive and competitive economy."

The problem of disincentives

The Victorian Government recently released a discussion paper[1] on the rewriting of its Local Government Act. The paper notes problems with existing entrepreneurial powers (section 193) including restricting commercial opportunities and creating disincentives for collaborative arrangements. Instead it proposes replacing that provision with revised powers to allow councils to participate in the formation and operation of an entity (such as a corporation, trust, partnership or other body) in collaboration with other councils, organisations or in their own right for the delivery of any activity consistent with the revised role of a council under the Act.

Within this diversity, common characteristics shared by virtually all ALEs are that their governance is ultimately in the hands of one or more councils, they undertake an activity which was previously undertaken by a council and their accountability for performance, both financial and non-financial, is to one or more councils.

Considering the use of an arm's-length entity: process and arguments in support: some examples

Governments: enabling or risk-averse?

A number of different approaches have been taken, in different jurisdictions, to whether and how to empower councils to form arms'-length entities. One major distinction is between jurisdictions where a higher tier of government has had a strong public policy interest in encouraging the use of arms'-length entities and jurisdictions where a higher tier of government has been more concerned with restricting councils' use of ALEs primarily because of a concern councils may not be able adequately to manage the risks involved.

These approaches have focused primarily on the use of companies limited by share capital as this is the area where the greatest potential risk has been seen.

Concerns over the use of arms'-length entities other than companies limited by share capital have varied even more widely and with little apparent rationale, at least when jurisdictions are compared one against another (compare for example NSW where councils may establish any form of arms'-length entity other than a company limited

[1] *Act for the Future: Directions for a New Local Government Act* available at: http://www.yourcouncilyourcommunity.vic.gov.au/DirectionsPaper

by share capital without the need for any third party authorisation with Victoria where formation of any arms'-length entity investment in which exceeds defined thresholds requires ministerial consent).

A common theme, regardless of whether a jurisdiction is inherently enabling, enabling but with requirements regarding post-establishment governance, or enabling but subject to an approval process, is a focus on the better use of resources typically in the context of a higher tier of government policy objective of improving efficiency within the public sector.

Community attitudes

Arguably this is an approach which can suggest to a council's public that services they value are being placed under the control of commercially motivated people not directly accountable to the community and focused on running services at a profit rather than to generate the outcomes the community seeks. Participants at one of the roundtable events MDL took part in for this project commented "Have to wonder whether there is yet an appetite for commercialisation of services in the community? Given the choice, a rate rise may be a community's preferred outcome." A later section of this report will argue that where there is a robust post-establishment governance regime in place, ALEs can in practice be an accountability model, enhancing accountability both to elected members and to a council's community, thus offering a council an opportunity to present an ALE proposal to its community in a much more positive manner.

Process

From MDL's overview of the approach taken within different jurisdictions, the establishment of an ALE is normally treated as a stand-alone undertaking rather than within an overall context of how a council best meets the various needs of the communities it serves. This seems to be the case even in a situation such as that which New Zealand local councils now operate within of a statutory requirement to review services on a regular basis and consider a range of different options including the use of a Council Controlled Organisation.

'Strategic commissioning'

This report suggests an alternative approach drawing in part on recent experience in England with an emphasis on 'strategic commissioning'.

A 2011 report[2] from the London based think tank Localis provides an overview of the development of 'strategic commissioning' within English local government. Its starting point is the recognition that commissioning and procurement are often treated as one and the same thing. The report then goes on to observe:

> …there is now a general recognition that an emphasis on outcomes for citizens and communities should be an integral feature of commissioning. This question is about how to identify and pursue those outcomes for communities. A key barrier to this is understanding and interpreting value –

[2] *Commission Impossible? Shaping Places Through Strategic Commissioning* available at: http://www.localis.org.uk/wp-content/uploads/2011/09/localis_commissioning_report_web_final.pdf

> i.e. what outcomes could and should be valued, and how we might recognise when they are being achieved.

As well it notes: "Commissioning should be provider neutral focusing on local need and the best pathways to deliver services that meet that need."

The choice of whether to establish an ALE is essentially a choice about what set of arrangements is best placed to deliver a particular service in order to achieve the desired outcomes at the least reasonable cost. A 'strategic commissioning' approach based on a recognition that commissioning should be provider neutral sets the scene for choosing that set of arrangements which will best deliver the outcomes desired by the community. As a consequence, whilst efficiency remains important, 'strategic commissioning' shifts the principal focus away from a technocratic emphasis on 'efficiency' to more of a community-based focus on the question, will this best achieve what we are seeking from the council?

London Borough of Barnet

The London Borough of Barnet describes itself as 'the Commissioning Council'. Its approach to this role provides a very useful overview of how best to go about selecting the most appropriate set of arrangements for the delivery of any given service or services.

In his introduction to the Borough's Corporate Plan 2015-2020[3], the leader of the Council explains what it means by being a 'Commissioning Council':

> Barnet is a 'Commissioning Council'. What does that mean? It is quite simple – it means we're open to new ways of doing things and we're not captured by the status quo. Public sector; private sector; voluntary sector; a combination: We are concerned less about the 'who' and the 'how' – who provides a service and how it is provided – than we are about ensuring that each service is necessary; that it meets the needs of residents; and that it provides value for money. This ethos drives our approach. This

How the Borough undertakes its 'strategic commissioning' role was the subject of a 2014 report by Localis[4]. "Strategic commissioning" was part of the One Barnet Programme, a change programme put in place by the Council to help cope with the very significant reduction in funding from central government to local government in place since 2010:

> One Barnet was about looking beyond existing provider arrangements, going back to first principles and asking fundamental questions about local services: Is the service necessary; is it giving customers what they need; and who is best placed to manage and run it?

To do this, the Council adopted what it described as "a staged approach, with each project following a common development path as part of the programme." Diagrammatically this was represented as:

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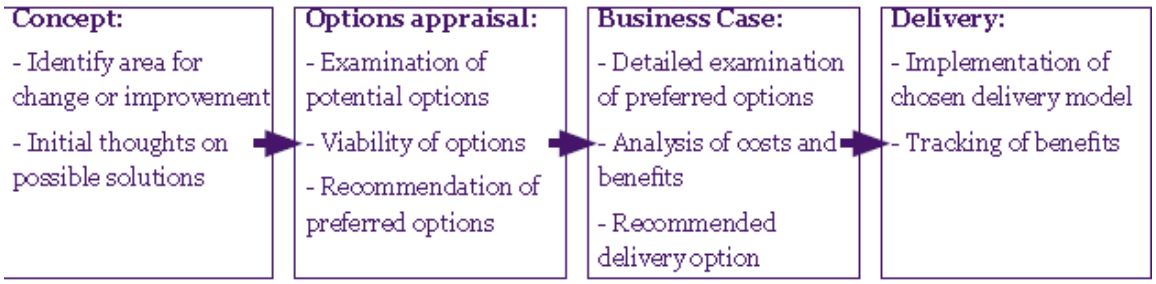
[3] Available at: https://www.barnet.gov.uk/citizen-home/news/Council-publishes-its-strategy-to-2020-.html

[4] *Meeting the Challenge in Barnet: Lessons from becoming the Commissioning Council* available at: http://www.localis.org.uk/research/meeting-the-challenge-in-barnet/



Following this approach, the Borough has:

- Promoted sustainability in the delivery of services for adults with learning disabilities by establishing a local authority trading company with its Arm's Length Management Organisation which has reduced overheads and provided greater choice and control to service users.

- Shared service arrangements with the London Borough of Harrow for public health and legal services.

- Established a charitable trust to provide music services to schools which now employs approximately 60 music teachers previously directly employed by the Borough as part of its education responsibility.

- Established an innovative Joint Venture with Capita to provide planning, regeneration and regulatory services, combining public and private sector expertise to enhance Barnet's built environment. This arrangement will deliver a guaranteed £39.1m in savings and income over ten years, with an aspirational income target of £172m through the provision of services to other councils.

- Created a ground-breaking partnership with Capita for customer and back office services, to transform the customer experience and deliver £125.4m of benefits over ten years.

Adapting the Barnet approach for considering whether to form an ALE

It's an approach which can easily be adapted as the methodology for determining whether or not to establish an ALE, and what form of arm's-length entity to use - company limited by share capital, company limited by guarantee, trust, association…? In each case it is primarily a question of considering the potential for each structural option to support the performance required. If it is intended to be a for-profit commercial operation, then a company limited by share capital is the preferred option. If it is intended to apply commercial disciplines, and commercial governance, to an activity which is nonetheless intended to operate on a not-for-profit basis, then a company limited by guarantee[5] may be preferred. If it's intended to operate as a not for profit and draw in a significant level of community support (an arts, cultural or recreational activity for example) then a trust may be preferred. If it's intended to build a membership organisation, perhaps to underpin council

[5] This option is common in both England and Australia, but not available in New Zealand.

consideration of future options for the development of part of the council area, either an association or a trust may be the preferred option.

Arguments in support

This section of this report considers experience from two jurisdictions, New Zealand and England, together with one example from Victoria, in order to illustrate the principal reasons which will normally underlie a council decision to establish an ALE. Case study examples are included.

New Zealand

Public sector reform and trading activities

During the mid-late 1980s New Zealand went through what was almost certainly the most comprehensive process of reform of both the public sector and the wider economy of any developed country. This reflected a concern held by the newly elected labour led government that distortions in both the public sector and the wider economy were such that unless very comprehensive reform was put in place it would be impossible for the government to meet its social objectives.

One important aspect of the reforms was the restructuring of a number of significant government owned trading activities. The departmental form which had been almost universal was abandoned in favour of government owned companies established under the Companies Act but also regulated by the State Owned Enterprises Act which among other things put in place a comprehensive post-establishment monitoring and accountability regime.

State-owned enterprises were for the most part established in the first term of the labour government. In its second term it turned its attention to local government. The then Minister of Finance, the Hon David Caygill, in a speech, "State Sector Reform: The Future Direction", to the New Zealand Society of Accountants Public Sector Convention in October 1989[6] set out the approach which the government was applying to local authority trading activities and the expectations it had for its reforms saying:

> An area warranting particular attention is the local authority trading enterprises.
>
> The local authority trading enterprises were formally recognised in the Local Government Amendment Act enacted this year.
>
> They are based on the SOE model and have profitability as their principal objective.
>
> Improvements in the performance of these trading enterprises can be expected in much the same way as the formation of SOEs significantly enhanced central government's trading performance.

[6] The speech is not available on the Internet but can be obtained from the Local Government Division of the Department of Internal Affairs.

> The provisions in the Local Government Act relating to local authority trading enterprises apply only where such enterprises take the form of a company.
>
> There may well be merit in extending the principles to other organisational forms, for example joint ventures, partnerships or even divisional units.

The limitation of the legislation to trading enterprises was not in practice a constraint on councils as other provisions in the Local Government Act gave councils the power to take part in the formation of companies, trusts and other entities.

The legislation enabling the establishment of local authority trading enterprises was more enabling than requiring forced corporatisation although in some areas of activity government took other steps to ensure that if councils retained a service delivery role, that had to be corporatised - for example by providing that government subsidy for public transport services would not be paid to councils as such but could be paid to council owned companies.

Evolving government policy

The New Zealand approach has evolved over the past 25 years to a position that councils should be enabled (and ideally obliged) to adopt whatever arrangements for service delivery will yield the best outcomes for their communities. Consistent with this, when New Zealand's Local Government Act was rewritten in 2002, the statutory framework enabling the establishment of arms'-length entities encompassed all council controlled entities regardless of whether they are trading, or non-trading, in company form or some other form.

Recently the government has shifted its focus to measures intended to encourage councils to operate more efficiently with a very strong emphasis on considering the use of arms'-length entities, especially multi-council entities, in the belief that doing so will improve the efficiency of council operations.

Section 17A of the Local Government Act, which came into effect on 8 August 2014, requires councils to review the cost-effectiveness of their current arrangements for meeting community needs for good-quality infrastructure, local public services, and regulatory functions. Councils are to consider options for the governance, funding, and delivery of infrastructure, services, and regulatory functions, including, but not limited to, governance and funding remaining a council function but delivery becoming the responsibility of a Council Controlled Organisation.

On 9 June this year the government introduced a Local Government Amendment Bill intended to implement its Better Local Services strategy. This includes a number of measures intended to encourage the formation of multi-council CCOs, especially in the 'big ticket' areas of water, waste water and transport.

New Zealand case studies

Two New Zealand examples follow. The first is the establishment of a charitable trust by the Horowhenua District Council (a smallish council to the north of Wellington) to take over the operation of the Council's library service with support from the community. The second is various iterations by the Queenstown Lakes District Council to develop an optimal structure for managing certain of its regulatory services.

Horowhenua District Council

In 1997, the council established a council-controlled charitable trust, with trustees appointed from the community, to take over the operation of its libraries. Its main motivation was the belief community control would increase the opportunity of accessing community support for what was an underfunded service. While the trust has been able to increase community support for the libraries, the more important impact has been the benefit from freedom to govern its own activity. The trust's 2012 annual report noted that "the biggest advantage is a different attitude. We now have a more empowered approach to library service – if something is worth doing, we find a way to get it done." In 2013, that something was a major redevelopment of the principal library as a community hub, a redevelopment driven by the community itself.

The Queenstown case study is taken from Governance and Accountability of Council Controlled Organisations[7], a 2015 report by the Office of New Zealand's Auditor-General.

Queenstown Lakes District Council

Queenstown Lakes District Council has tried a range of options for delivering its services since the mid- to late 1990s. These include contracting out to the private sector, the CCO model, and then bringing most activities back in-house. In 1998, the Council took the novel step of contracting out its regulatory services to a private company as part of a general move at the time to contract out many of its core services.* Nine years later, in 2007, the Council decided to end the arrangement with the private company and bring regulatory services one step closer to the Council by buying the private company and forming a new CCO to deliver regulatory services.**Again, this was an unusual arrangement for regulatory services.

In late 2012, the Council commissioned a review of two of its CCOs as part of a wider organisational review of all Council activities.† The review assessed the cost, efficiency, and effectiveness of the CCO model against 13 criteria.†† Other councils reviewing their CCOs might find these criteria useful.

The review recommended that it would be more appropriate for the Council to provide regulatory and recreation and leisure activities than the two CCOs. The primary reasons were to reduce cost, both to the Council and to customers; to reduce fragmentation of activities; to improve integration of policy development and regulatory functions; and to improve management of the tension between commercial and community outcomes.

The Council agreed with the recommendation. In March 2013, it decided to disestablish the two CCOs and to bring their activities back in-house.

[7] available at: http://www.oag.govt.nz/2015/cco-governance/docs/cco-governance.pdf . This report provides a useful overview of current local government practice in New Zealand in respect of CCOs. Additional material can be found in a 1999 OAG report contracting out local authority regulatory functions available at: http://www.oag.govt.nz/1999/contracting-out/docs/colarf.pdf and in a letter from the OAG to the Council entitled *Queenstown Lakes District Council – regulatory and resource management services* and available at: http://www.oag.govt.nz/2007/queenstown-lakes

England

Councils' authority to form companies

The Localism Act 2011 gave councils in England and Wales what is known as a general power of competence. Among other things this meant, subject to any restrictions or prohibitions which might exist in other legislation, councils were free to undertake their activities as they saw fit and either acting directly or through other entities including arms'-length entities of whatever form they regarded as appropriate.

The one area of constraint which remains is the formation of companies which are intended to trade for a profit. The current position is described in a recent publication by Unison[8], a major public sector union, as:

> Local authority trading companies – are also sometimes known – especially in Scotland – as arms'-length external organisations (ALEO). An early decision the council should make is whether it wishes to use the company for commercial trading, or as a vehicle primarily for delivering the council's own services.
>
> In England and Wales, councils have powers under the 2003 Local Government Act to set up companies to trade with a view to making profit in areas relating to any of their existing functions. In England, the General Power of Competence also now allows councils to do anything an individual or company may do, as long as it is not expressly prohibited by other legislation. This means that councils in England can potentially charge or trade in a much wider number of service areas than traditional council functions – for example selling insurance or phone and broadband services. It also means they can trade anywhere in the UK or beyond! However, they cannot trade with individuals where they already have a statutory duty to provide those individuals with that service.

Two perspectives on local government experience: Local Government Information Unit and Grant Thornton

Local Government Information Unit (*LGIU)*

A recent policy briefing from the LGIU provides a snapshot of what has been happening with local authority trading companies. It notes:

> As councils have come under financial pressure, they have considered how to reduce costs, generate income and improve efficiency by developing commercial approaches to their services.
>
> One option gaining widespread support is the formation of Local Authority Trading Companies (LATCs), bodies that are free to operate as commercial companies but

[8] Branch guide to local authority trading companies available at: https://www.unison.org.uk/content/uploads/2013/06/On-line-Catalogue212753.pdf

> remain wholly owned by the parent local authority. As trading bodies, they can provide their services to a much wider market than a council department.

According to the LGIU part of the reason for the growing interest in LATCs is local government's desire to generate income to protect other services. But there are also secondary drivers including:

- the need for certain services to compete in a wider geographical area to be sustainable
- a view that greater commercialisation will drive efficiency
- a view that non-essential services would be better managed separately
- a view that a different statutory and service environment will provide more flexibility and impact, eg housing development, social care.

One specific constraint which councils face in establishing a LATC is that they are required to develop and adopt a business case - clearly imposed as a measure intended to ensure that some consideration is given to risk, and to what will be required to develop a successful business.

Grant Thornton - an advisor's perspective

The business advisory firm, Grant Thornton, in a 2015 report, *Spreading their wings: Building a successful local authority trading company,*[9] provides a very useful overview of council experience with establishing LATCs noting a significant level of innovation, including the emergence of social care companies intended to develop a scale which can only be achieved by serving the districts of more than one council.

At the same time they express some very real concerns which should be seen as relevant for any council contemplating the formation of a significant arms'-length entity, including the importance of a focus on the post-establishment governance regime:

> For most of the LATCs reviewed, councils had thought about what they wanted to achieve, with income generation being the key focus. However, they neither had a particularly clear vision of the future – beyond the general aim of income generation – nor ideas about exactly how the companies would grow. In some cases, the lack of a vision and agreement had resulted in contention around the company's future strategy. At its most extreme it had resulted in LATCs 'going rogue', taking actions councils did not agree with, and being brought back in-house.

Further emphasising the positive, Grant Thornton identify these characteristics of successful Local Authority Trading Companies. They:

- Have a shared understanding of risk with the council.
- Communicate clearly with the council, service users, people and trade unions.
- Use a balanced approach to monitoring performance combined with shared responsibility, rather than a focus on key performance indicators and contractual penalties.

[9] Available at: http://www.grant-thornton.co.uk/Global/spreading-their-wings-LATC-report-2015.pdf

- Have group reporting arrangements that give the council insight into the strategy, finances and risks of the company.

- Have a different risk tolerance, which is understood and managed appropriately to ensure that the council is comfortable with the decisions the company is taking within its commercial environment.

In broad terms, these are characteristics which will apply to all successful arm's-length entities.

The Grant Thornton report contains a number of useful case studies. We have drawn on it for one case study, Norse Group, of interest partly because it has considerable parallels with the Melbourne City Council-owned Citywide.

Case studies of the Norse Group and of Citywide follow.

Norfolk County Council-owned Norse Group

Norse Group is a wholly-owned company of Norfolk County Council. The group brings together NPS (property consultancy), Norse Commercial Services (facilities management) and NorseCare (a social care provider). These companies are wholly-owned subsidiaries of Norse Group. Both NPS and Norse Commercial Services have a significant number of joint venture companies that are partially owned by the companies (80%) and the councils they have entered into partnership with (20%).

Norse Group is by far the largest and most successful LATC in the country and has an annual turnover in excess of £300 million. Collectively, the group's companies employ over 10,000 people nationwide. The group has made significant cost savings and efficiency improvements for the councils involved, providing a clear example of what local authority companies can achieve.

Achieving so much has not been a short-term undertaking and a board member, Peter Hawes, is clear that local authority companies should be seen as long-term ventures, should focus on growth and trade and should not be set up to simply deliver efficiency savings within council services.

Norse is also clear that it is possible for a local authority company to be competitive, to retain an appropriate focus on service and to act as a caring employer. Norse highlights four critical success factors:

- the company needs to stand free of the council and have the ability to set its own direction and make management decisions without referral back to the council. It also needs freedom to provide its own back office services as better information and more timely support services are a key driver of change and the reduced costs are needed to compete commercially
- there needs to be an agreement that the company can transition away from council terms and conditions and move towards commercial terms and conditions that allow it to compete in the market. Norse is clear that this does not mean worse terms and conditions. Rather, the focus is on comparable market terms and conditions that allow it to compete commercially
- the company needs to be in charge of its own finances and have the ability to reinvest in its services and growth. From its inception, Norse has been able to retain 50% of its profits and has used these funds initially as working capital. Over the last few years, the profits have been used increasingly for capital projects as an alternative to borrowing
- the company must be able to bid for other work. The ability to diversify the services provided and to have a greater income base has enabled Norse to increase its service expertise, to benefit from economies of scale and to manage short-term performance issues or market downturns from a secure financial position. Norse considers that the key benefits of an LATC will only be delivered if it is allowed to grow and trade.

Victoria – Melbourne City Council-owned Citywide

Citywide1, formed in 1995, is now a substantial provider of physical services for the public and private sectors in four Australian states.

It was established by Council as part of its Competitive Business Strategy (adopted in May 1994). The strategy foreshadowed that, where in-house providers of services won tenders in an open tendering process, the majority of these activities would be transferred to a trading enterprise owned by Council and incorporated under the Corporations Law (now the Corporations Act 2001 (Cth).

The company, in consultation with its shareholder, has established a Code of Governance Practices to ensure the Board is well equipped to discharge its responsibilities.

This code covers amongst other things the function, composition, nomination, performance and remuneration processes of Directors together with the reporting obligations of the Company and requires the Chairman to review the individual performance of each of the Directors.

The Board consists of six independent non-executive Directors, including the Chairman. The Board consists of Directors who bring a balance of skills, experience and diversity to assist the company to meet its strategic objectives.

Of interest in the Citywide experience is the emphasis placed on the importance of good governance and working with its shareholder.

Summary of experience from selected jurisdictions which enable the formation of council controlled entities

In summary, the position in jurisdictions which do enable the relatively unconstrained formation of council controlled entities (but with requirements, which vary from jurisdiction to jurisdiction, on governance and monitoring requirements) can be summed up as councils should be able to choose that set of arrangements for delivery of any particular service or services which will best meet the needs of their communities. Relevant factors will include:

- The benefits of scale (ownership and management of major infrastructure is an example)
- An efficient means of enabling shared services - replacing multi-council decision making with a single decision-making entity albeit controlled by a group of councils.
- Minimising the impact on the need for timely decision-making of the compliance requirements which councils typically face - seen as especially important in areas where the need to match the efficiency of commercial decision-making is significant.

- The ability to attract people with specific skills and experience who may be reluctant to work within a council environment.

- The greater transparency and accountability which can come from placing an activity on a stand-alone basis with its own separate financial and other reporting requirements.

A further set of reasons will often apply where the arms'-length entity is a trust or other form of non-profit. These entities are often used where one of the objectives is to create a form of partnership between a council and interests within its community to encourage community support for an activity which may be under considerable resource pressure. This could be a library where the partnership is based on the council contributing a fixed amount of resourcing and the community through volunteer effort and other means making up any balance (as with the Horowhenua District Council example above). It could be a community hall or other recreational facility where the purpose is to draw on community resources to deal with on-going maintenance and operation. It is a common approach for museums, art galleries and other cultural activities, and also often used for economic development and tourism promotion.

Another common motivation may be using a structure which is eligible for grant funding from grantors which do not fund local government activity as such.

A further consideration is the choice of the legal structure to be used for the arms'-length entity. Different legal structures can evoke very different emotional responses on the part of a council's community, and very different policy responses from grantors, public agencies or private sector or community parties dealing with the entity. If an entity is intended to be profit-making in the sense of earning a return on capital for a council or councils as shareholder, then clearly a company limited by share capital is the obvious option.

However, if its primary purpose is not profit-making but some other perceived advantage, perhaps the benefits of scale, perhaps creating a multi-council entity (a shared service?), perhaps providing a means for implementing what is in practice a council/community partnership, then other structures should be considered. Entities such as a company limited by guarantee, a charitable trust or incorporated society may be much more acceptable and without the need to compromise on quality of governance (a highly qualified individual prepared to serve as the director of a council-owned company limited by share capital is likely also to be prepared to serve as a member of the governing body of a company limited by guarantee or a trust provided that the basic powers and discretions are essentially the same).

International practice - what have different jurisdictions done and why - options to consider

International practice varies significantly in large part reflecting either the constitutional position of local government or jurisdiction specific experience with or concerns about the use of arms'-length entities, especially companies. This section of the report deals only with practice in respect of local authority owned companies although generally councils also have power to form or encourage the formation of other forms of arms'-length entity

Europe

Councils are free to establish companies at their own discretion. Governance etc is regulated by general corporations law with no council-specific provisions. Use of companies is quite extensive - as examples on average large German cities own nearly ninety companies and large Italian cities twenty-five[10].

A more complete although slightly outdated picture can be found in *Local Public Companies in the 25 Countries of the European Union* published in 2005 by Dexia[11] a bank which specialised in financing local government. It is available at: www.lesepl.fr/pdf/carte_EPL_anglais.pdf

Although country legislative provisions are permissive, the operating environment for local authority owned companies in Europe is also affected by the competition policy of the European Union which normally requires contracts to be put out to tender. The European Court of Justice has ruled that a direct contract with a public company[12] could be considered "legal" if the local authority exercises over the company a control which is similar to that they exercise over their own departments and, at the same time, the enterprise must carry out the essential part of its activities with the controlling authorities. The Court stated also that in the case of "in house" contracts, the company must be entirely owned by one or more public authorities[13].

England

The power of councils to establish companies has changed considerably over recent years, reflecting the changing approach which central government has taken to the regulation and monitoring of local government. In the 1980s councils used provisions in the Local Government Act 1972 to create companies for a wide range of purposes. In the late 1980s the then Conservative government established a complex regulatory regime restricting the use of companies based on a combination of the nature of the company and a control test.

The introduction of the 'well-being power' in the Local Government Act 2000, which authorised councils to do anything they believed would promote community well-being, was seen as extending the power of local authorities to create companies, but this was subsequently limited by the Local Government Act 2003 which restricted the power to form companies to those authorities meeting Best Value standards. In essence, the power to form companies became a reward for good performance[14].

The Localism Act 2011 gave councils a general power of competence reflecting the much more 'hands-off' approach which Conservative party led governments since

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[10] Grossi, G. and Reichard, C. (2008), 'Municipal corporatisation in Germany and Italy', *Public Management Review*, Vol. 10 No. 5, 597-617

[11] Dexia was a casualty of the Global Financial Crisis.

[12] This term implies a company owned within the public sector.

[13] See Sbandati, A. (2009), The regulation of local public services in the EU and the Italian case available at: https://www.google.co.nz/search?q=The+regulation+of+local+public+services+in+UE+and+the+Italian+case&ie=utf-8&oe=utf-8&client=firefox-b&gfe_rd=cr&ei=H_9hV8uoLazM8geLw4roDw

[14] Superficially, this could seem an attractive option for a jurisdiction considering moving away from a formal approval process. However, the English Best Value regime involved rigorous supervision of councils by the Audit Commission and, at its peak, an obligation for each council to report against more than 1000 KPIs. The essence of the challenge in rewarding performance is how to measure performance without creating an overly burdensome compliance regime.

2010 have taken towards local government. A number of councils have either established or are involved in establishing local authority trading companies with the objective of reducing costs and/increasing revenue. There is no statutory post-establishment governance regime although councils are required to develop and approve a business case in advance of establishment.

The Local Government Information Unit has observed that "LATCs need appropriate governance, including board chair-ship and composition, and appropriate procedures, protocols and systems to support human resource and risk management and service planning and associated monitoring and reporting arrangements. How these are developed, managed and balanced within the context of a new relationship with the local authority can be fraught with ambiguity, controversy and problems."

In practice governance arrangements have typically included a shareholders' committee, and the appointment of councillors and/or council officers to the board of LATCs. This is a somewhat pragmatic approach which may not always be consistent with the expectation that directors should be responsible for the management of the company.

British Columbia

Councils have a statutory power to establish companies. The provincial government takes an overview approach, providing guidance for councils on how to establish and operate council owned companies, including an interesting guide on the development of company constitutions. This is supported by a specific statutory requirement that a council may only form a corporation other than a society, or acquire shares in a corporation with the approval of the Municipal Inspector (a statutory officer responsible to the Minister of Local Government). Approval typically includes a requirement that the corporation adopt a constitution as approved by the Inspector.

The constitution is required to include a number of provisions which set constraints on the power of directors[15] designed, for the most part, to promote accountability, control risk and provide guidance to councils on matters such as the appointment of directors. In 2006, the Ministry of Community Services which is responsible for local government published *Launching and Maintaining a Local Government Corporation*[16]. The guide covers a very wide range of matters including what must or desirably should be included in the constitution. Interestingly the guide is quite strongly supportive of the appointment of elected members and/or council staff to the board of a local government corporation.

New Zealand

New Zealand practice has evolved into a comprehensive regime encompassing any entity in respect of which one or more councils has the power to appoint 50% or more of the members of the governing body of the entity, or to exercise 50% or more of the votes in any general meeting of the entity.

The regime places a strong emphasis on post-establishment governance (discussed in detail below at page 25 onwards) designed to strike a balance between the role of

[15] A council considering this option should take specialist legal advice to ensure that including constraints on the actions of a company in its constitution did not trigger the ultra vires rule.

[16] Available at: http://www.cscd.gov.bc.ca/lgd/infra/library/Local_Government_Corporations_Guide.pdf

the council on the one hand as representative of and accountable to its communities, and the importance on the other hand of ensuring the governing body of the entity is left free to exercise its judgement in decision-making subject to the terms of what is known as a statement of intent. This is a document developed annually between the entity and the council covering matters such as the activity or activities in which the entity will be engaged, agreed financial and non-financial performance targets, reporting and consultation arrangements and much more (see appendix 1 for the current statutory framework for a statement of intent).

Australia

Practice across Australia varies widely. In Victoria, section 193 of the Local Government Act currently confers entrepreneurial powers on councils enabling them to enter into commercial relationships, including the establishment of companies, but for investments of:

- more than $100,000 or 1% of council revenue, a risk assessment must be considered;
- more than $500,000 or 5% of council revenue, the risk assessment must be accompanied by the minister's approval;
- more than $5 million, the Treasurer's approval must accompany the assessment and the minister's approval.

The Victorian Local Government Act is currently being rewritten. The Victorian Government's just released discussion paper, *Act for the Future: Directions for a New Local Government Act,* foreshadows the possibility of rethinking the approval requirement. The proposed direction is "Remove the entrepreneurial powers in the Act and include revised powers to allow councils to participate in the formation and operation of an entity (such as a corporation, trust, partnership or other body) in collaboration with other councils, organisations or in their own right for the delivery of any activity consistent with the revised role of a council under the Act."

The discussion paper quotes from a submission by the Melbourne City Council, the inclusion of which suggests the Victorian Government accepts section 193 acts as a disincentive:

> Councils need broad powers of investment. While it is appropriate that council investments are not too speculative, the current provisions regarding entrepreneurial powers act as a disincentive to innovation. Section 193 is unwieldy and difficult to interpret, and in practice this provision deters innovation and collaboration…

The New South Wales legislation is more tightly focused with councils having power to participate in the formation of all forms of arms'-length entities other than companies limited by share capital. In respect of these, the minister's approval is required regardless of the size of the investment. As what could be seen as something of an anomaly, councils may form companies limited by guarantee without any requirement for approval despite the fact that, in most situations, a company limited by guarantee may be just as suitable for a council's purposes and raise similar issues of risk as a company limited by share capital. There is some suggestion (based on discussion with New South Wales officials) that the approval requirement could act as a barrier as officials may be reluctant to recommend

approval, or ministers to grant approval, because of concern over who might carry the political responsibility if the company subsequently fails.

In Tasmania councils have full authority to form companies.

In South Australia councils are prohibited from being involved in companies. This is understood to reflect on-going wariness about the use of companies in the public sector because of the enormous cost to the South Australian Government of the 1980s failure of the State Bank of South Australia.

In Western Australia councils are also prohibited from involvement in companies.

In Queensland councils may establish 'beneficial enterprises' which can include companies. The power does include an obligation on councils to satisfy themselves that the entity they are proposing to establish is indeed a beneficial enterprise - failure to do so would leave the council open to judicial review.

If councils are to be able to establish arms'-length entities, what provision, if any, should be made for post-establishment governance?

Five different approaches are considered: 'do nothing', conditions precedent to establishment, ministerial approval, approval by a statutory officer and a statutory framework providing for the controlling council or councils to set the regime within which the arms'-length entity may operate.

'Do nothing'

This is the situation for local government in Europe and reflects the different constitutional position which local government has in European countries as compared with the situation in 'Westminster' tradition countries such as Australia, New Zealand and England. Councils are free to establish companies in exactly the same way as any other legal person.

Conditions precedent to establishment

The law regulating the power of English local authorities to establish companies has undergone a number of changes over the past 2-3 decades. The current position is that the general power of competence enables local authorities to establish companies but there are some specific provisions if the purpose is to undertake trading activity, including a requirement that a council must prepare a business case and then form a company:

> The Local Government Act 2003 enables local authorities to establish Local Authority Trading Companies (LATCs) to trade in a wide market. The General Power of Competence under The Localism Act 2011 allows local authorities to expand their trading activities into areas not related to existing functions. It also removes geographical boundaries to local authority activity so that they can set up a trading company that can trade anywhere in the UK or elsewhere. The 2009 Trading Order requires that a business case ('a

comprehensive statement') be prepared and approved before exercising trading powers. (sourced from the LGIU).

Strictly speaking, the regulatory constraints are not on the formation of council controlled companies, but on the way in which councils may undertake trading activities.

English councils have made quite extensive use of LATCs with a number of companies formed to undertake services such as fleet management, cleaning, facilities maintenance and property management. The majority, however, are now being formed to work in the adult care sector delivering services such as residential care and home support.

The council/LATC relationship is commonly managed through means such as the establishment of a shareholder's committee to work with directors, and the appointment of councillors to the board of the LATC.

Not all have been successful. Some have been placed in liquidation. Others have performed well initially but less so as competition has increased.

There does not appear to be any particular interest on the part of central government in whether LATCs succeed or fail (something which would be consistent with the government's current 'arms-length' approach to local government). Rather, the question of what action should be taken if an LATC is getting into difficulty seems to be treated as just another matter which a council is required to manage and for which it will be accountable to its community.

As a check on the nature of oversight of LATC performance, MDL searched the website of the National Audit Office for any reference to LATCs but were unable to find any.

The Grant Thornton report referred to at page 15 above is quite explicit that LATCs can fail, and cites a number of case studies. The following box sets out a general statement from the report on LATC loss-making.

LATCs can make a loss

Common forms of failure arise due to: over optimistic growth assumptions; lack of sensitivity analysis with regard to future council budget assumptions; lack of modelling of revised contract terms, for example from block- to activity-based; and changes in methods of service delivery, for example from direct care to preventative services.

In particular, where LATCs have not diversified services, this can leave them highly exposed. In some instances, councils have needed to liquidate LATCs and bring services back in-house.

Ministerial approval

This approach is followed in both New South Wales and Victoria although the legislative criteria for approval vary significantly between the two jurisdictions. In Victoria approval is required for entering into any commercial relationship involving investment above stated thresholds. Strongly implicit in the legislation is that approval (by the Minister at a first threshold and by the Minister plus the Treasurer at a second threshold) should focus on assessing the financial risks involved and how it is proposed those be managed. Review of three case studies provided by Local Government Victoria suggests that this is indeed the focus of the approval process. As a consequence, the approval process can be extremely transaction cost heavy, as well as begging the question of whether departmental officials are better placed than a council and its advisers to make judgements on commercial risk.

In contrast, in NSW there appear to be relatively few requirements governing what matters a minister should or should not take into account. As an example, a ministerial approval granted some five years or so ago for the establishment of a multi-council owned company to manage a significant recycling facility restricted its conditions to ones which would protect the interest of the workforce with little or no emphasis on issues of commercial risk and prudent management of ratepayer investment. Inquiry at the time suggested that this was typical of the NSW approval process.

In Victoria the rationale for the ministerial approval approach is set out in the Victorian Government's consultation document[17] on the rewrite of the Local Government Act 1989 as:

> Entry into a commercial activity may provide a council with an alternative source of revenue, allowing rates and charges to potentially be reduced. The approval framework attempts to balance this benefit against the fact that, unlike private companies funded by shareholders who agree to assume the risk of investing, council entrepreneurial ventures are funded by the collection of compulsory rates paid for the benefit of the community.
>
> Ministerial oversight cannot remove the risk of commercial ventures failing but provides an external check to ensure that councils have properly considered high risk activities. It is designed to ensure that the council is able to manage the project and any risks prior to entering into the arrangement.

It is an approach which can allow for quite rigorous scrutiny **prior** to the establishment of a council controlled commercial activity, but is less well placed to enable on-going oversight including the ability to ensure that council owners respond appropriately to changing conditions.

As noted at page 21 above it appears that the Victorian Government is now rethinking the need for the section 193 approval process. Although the current discussion paper on rewrite of the Local Government Act does not say so, it seems a reasonable assumption that the Victorian Government will look for alternative means of ensuring council decisions about investment in arms'-length entities or other commercial arrangements with third parties are soundly based.

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[17] Review of the Local Government Act 1989: discussion paper available at: http://www.yourcouncilyourcommunity.vic.gov.au/sector/documents

Approval by a statutory officer

British Columbia's local government legislation empowers councils to establish or take shares in a corporation but subject to the prior approval of the Municipal Inspector, an independent statutory officer. The process which applies is described at page 20 above.

The main interest in this approach is the use of the corporation's constitution (in Australia or New Zealand, the articles of association of the company) as a means of regulating the conduct of the corporation once established. Because the regulatory provisions are included in the corporation's constitution, this approach does not interfere with the directors' statutory right to manage the business of the company. Instead, whatever restrictions are included in the constitution are simply part of the business which the directors are empowered to manage. However as suggested in footnote 15, it would be wise to take specialist legal advice on whether this approach might trigger the ultra vires rule.

It can be seen as an alternative to the New Zealand approach, discussed next, of including a post-establishment governance regime in legislation. Unlike the New Zealand approach, however, the British Columbia approach does appear to be dependent on an approval/oversight process at least if consistency is seen as desirable. It would of course be perfectly possible for individual councils elsewhere to adopt the British Columbia approach in a situation in which they had full legislative freedom to establish arms'-length entities.

A statutory framework enabling a council to establish an operating regime for the entity

In contrast to other jurisdictions which have put their primary emphasis on conditions precedent to a council becoming involved in an arms'-length entity, New Zealand has emphasised establishing an on-going monitoring and accountability framework with the primary responsibility held by the council.

In the beginning: state-owned enterprises

This approach originated with the major public sector reforms which took place in New Zealand in the late 1980s. The then government placed a great deal of emphasis on improving the performance of publicly owned trading enterprises. Its initial focus was on those owned by central government. Legislation was put in place enabling their conversion from (typically) a departmental form into a company form. This included formally recognising these companies as 'state owned enterprises' with their own on-going monitoring and accountability regime. Ministers were very well aware that under general companies (corporations) law they would have very little influence other than the power to appoint and remove directors because of statutory provisions making the directors responsible for the management of the company and for determining the 'best interests' of the company.

To ensure that ministers could continue to influence the on-going governance and management of state owned enterprises (SOEs) legislation included a requirement for the boards of SOEs to develop what is now known as a statement of intent (SOI), and to manage the business in accordance with the SOI once agreed. The SOI covers

a very wide range of matters including the nature of the business or businesses which the SOE will undertake, its financial and non-financial performance measures, reporting arrangements, the measures the SOE will take if acquiring or disposing of a significant asset and any other matters agreed between the board and shareholding ministers.

As well as the formal statutory framework, the government recognised that it needed a set of non-statutory arrangements to assist in managing the on-going relationship between the government and each of its SOEs covering matters such as how government expected the relationship between shareholding ministers and each SOE would be managed (SOEs each have two shareholding ministers, one the Minister for SOEs who has specific portfolio responsibility for government owned companies and the other the Minister holding the portfolio to which the activity of the SOE most closely relates).

The basis for the non-statutory relationship is a document known as the shareholders' expectations manual. It covers a wide range of matters spelling out how the government expects the boards of its companies to act including how they will work with ministers and officials, as well as expectations for how shareholding ministers will work with the SOEs. One of the most important matters covered is a 'no surprises' policy designed to ensure that ministers always have advance notice of any significant decision which an SOE may be going to take.

The relationship is designed around an annual cycle beginning with the development of an SOE's business plan and statement of intent for the forthcoming financial year and concluding with its annual report. The cycle commences with what is known as a letter of expectations from shareholding ministers spelling out what the government expects of the SOE for the following year. In essence this letter sets the basis for the preparation of the SOE's business plan.

Local government: building on the SOE model

When government turned its attention to the reform of local government, it decided to adopt the SOE model for local government noting that local government included a number of significant trading enterprises, as noted at page 11 above, with the belief that "improvements in the performance of these trading enterprises can be expected in much the same way as the formation of SOEs significantly enhanced central government's trading performance".

As already discussed, initially the legislation was limited in its application to activities which were specifically trading enterprises. Councils had separate powers elsewhere in the Local Government Act for the formation of other types of arms'-length entities.

New Zealand's Local Government Act was rewritten in 2002. A major emphasis was placed on improving accountability to the communities which councils served. The consultation document which the government released as part of the review of the act observed:

> Establishing stand-alone council-controlled organisations (CCOs) for council functions has the potential to remove those activities from public scrutiny. It is proposed that elected councillors should be ultimately responsible for ensuring that appropriate governance mechanisms are in place.

Specific accountability requirements for council-controlled organisations [18]will cover all such organisations, irrespective of the nature of the business (commercial or non-commercial). This includes trusts where local authorities effectively have control.

This was an extension of a monitoring and accountability regime which had applied only to trading enterprises which took the form of council owned companies, to any council controlled organisation in whatever form.

As with SOEs, the governing bodies of all CCOs are required to develop a statement of intent annually, in respect of the forthcoming financial year, and to run the business of the entity in accordance with the statement of intent. Appendix 1 sets out the current provision in the New Zealand Local Government Act for the content/coverage of SOIs for council controlled organisations.[19]

Councils with CCOs have generally adopted the shareholders' expectations/annual cycle approach which government had put in place for SOEs but practice varies[20] in terms of matters such as monitoring, appointment of directors (some councils have opted to appoint councillors, others taking a conflict of interest perspective have decided councillors will not be eligible for appointment) and the balance between formal and informal relationship management.

The New Zealand council which has the most extensively developed set of arrangements for managing the relationship between a council and its CCOs is the Auckland Council.[21]

What are the accountabilities involved, and how should they be addressed?

Council controlled arms'-length entities, whether in a company or some other corporate form, raise complex issues of accountability which, unless they are very well understood, may be an active disincentive for the use of arms'-length entities. The various accountabilities include:

- The accountability of the chief executive officer to the council for the management of the affairs of the council including "providing timely advice to the Council" (Victoria) and "providing advice to members of the local authority and to its community boards, if any;" (New Zealand).

[18] The legislation does contain provision authorising councils to exempt small organisations from the CCO requirements which would otherwise be required to comply with them provided it is not a trading organisation.
[19] The recently introduced Local Government Amendment Bill will change the specific provisions regarding the statement of intent but will not change the basic purpose, or the role of the statement of intent.
[20] For a number of case studies on New Zealand Council practice see McKinlay, P. (2015), Innovation in local government and governance: observations on emerging practice in New Zealand, Asia Pacific Journal of Public Administration Vol 38 No.2 pp128-141

[21] An overview of its approach and access to core documentation is available at: http://www.aucklandcouncil.govt.nz/EN/AboutCouncil/representativesbodies/CCO/Pages/Home.aspx

- The accountability of elected members themselves to the communities they serve, partly in terms of statutory obligations under legislation, and partly in terms of public expectations of the nature of local democracy.

- The accountability of directors in terms of discharging their role in relation to the company.

So long as an activity remains the direct responsibility of a council, matters of accountability are relatively straightforward in the sense that the respective roles of the chief executive officer and elected members are generally well understood, and local government legislation spells out how councils should be held accountable to their communities.

Understanding the role of a member of the governing body of an arms'-length entity

The situation is different when what was formerly a council activity becomes the responsibility of an arms'-length entity so that immediate accountability, in terms of performance of the activity, shifts from council/executive management to the governing body of the arms'-length entity. The difficulty is compounded by what appears to be relatively wide spread lack of understanding of just exactly what the powers of the governing body of an arms'-length entity are, and what councils are able to do to influence the way in which the governing body exercises its powers.

One important issue to consider, especially in respect of companies as arms'-length entities, is how directors understand the expectations of their role as the governing body of a publicly owned entity. Here, informal understandings are at least as important as understandings expressed through statutory means such as the statement of intent. The very reason for the existence of councils is to provide services for their communities, with an emphasis on improving the community's outcomes. This will inevitably influence expectations of arms'-length entities, especially those handling significant activities (and regardless of whether those are trading or non-trading activities).

It is important for directors to understand the 'public value'[22] expectation on councils and manage the business of the arms'-length entity accordingly. Often, if there is conflict between a board and a council or councils, it will be the result of a failure on the part of the council to effectively articulate the role of 'public value' and/or on the part of directors to understand this. One useful means of dealing with this is to ensure that the shareholder's expectations manual does provide a good overview of what it means to be the director (or trustee etc) of a council controlled arms'-length entity. Another is to ensure that the context in which the members of the governing body of a council controlled arms'-length entity function is properly addressed in good practice guidance - which should be targeted not just at elected members and council management but also at the governing bodies and management of arms'-length entities.

[22] 'Public value' refers to the delivery of actual services, the achievement of social outcomes, and maintaining trust in the public agency. See Kelly, G, Mulgan, G and Muers, S., Comments (2002) Creating Public Value - An analytical framework for public service reform, Strategy Unit, Cabinet Office.

The powers of a governing body

There is a useful discussion of the Australian legal situation in respect of the boards of companies[23] in a 2009 essay published by the Melbourne University Centre for Corporate Law Securities Regulation, *Should Australia Replace Section 181 Of the Corporations Act 2001 (Cth) With Wording Similar to Section 172 of the Companies Act 2006 (UK)?*[24]

In respect of directors' duties generally the author observes:

> In most cases the power to manage the company is granted by the company to its directors. This power is derived from both the Corporations Act and the company's constitution. Section 198A of the Corporations Act, a replaceable rule, states that the business of the company is to be managed by or under the direction of the directors. Although section 198A is a replaceable rule, many company constitutions contain a similar provision, delegating authority to manage the business of the company to its directors.
>
> Consequently, absent a specific provision in the company constitution limiting this power, it is up to the directors to determine how and why corporate funds are to be spent. In large companies, this can mean that directors have power over a large amount of assets.
>
> The directors' power to manage the business has been interpreted by courts to be very wide. As stated by the Senate Committee in 1989 'directors are the mind and soul of the corporate sector'. In fact, as was confirmed by the Privy Council in Howard Smith Ltd v Ampol Petroleum Ltd, directors can make decisions against the majority shareholders' wishes.

The position is much the same in New Zealand where section 128 of the Companies Act 1993 states "the business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company."

Section 131 of the New Zealand act provides in part "a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company."

The equivalent Australian section provides "A director…must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose."

The author of the essay referred to above, on this aspect of directors' duties, observes:

> Directors are not bound to only take into account the short term interests of shareholders, directors should consider the interests of future as well as existing shareholders. How such short and long term interest is balanced, is a matter for the directors.

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[23] Although this discussion deals solely with companies, the powers/obligations of the members of other governing bodies such as boards of Trustees are similar.

[24] Available at: http://law.unimelb.edu.au/__data/assets/pdf_file/0003/1709832/60-Should_Austalia_replace_s181_of_the_Corporations_Act3.pdf

> Directors' duties do not only protect the company against misuse of their powers. Equity, contract and tort require directors to discharge their duties with proper care and diligence….
>
> Courts have traditionally been reluctant to interfere with business decisions made by directors. In *Re Smith & Fawcett Ltd [1942] Ch 304.*, Lord Greene M.R. said in relation to the manner in which directors must discharge their duties '*They must exercise their discretion bona fide in what they consider - not what a court may consider - is in the interests of the company, and not for any collateral purpose.* Rather, the courts have traditionally been more concerned that a director's power has been exercised for a proper purpose – i.e. that the directors believed that they were acting in the interests of the company.

Emerging local government practice

With the apparent extent to which the influence of shareholders over the way in which the business of the company is managed is constrained by the powers of directors, it is hardly surprising many councils have been reluctant to use arms'-length entities, especially companies. This may be not just because of the concerns which elected members and/or management might have, but because public perceptions may also be that control has passed from their elected council, to unelected and potentially unaccountable private directors.

At least for arms'-length entities which are partly or wholly dependent on council funding, concerns about whether directors can be required to reflect the wishes of the council owner will be independent of which of two principal means of managing the relationship between a council and an arms'-length entity is used - a contract for services, or the use of a statutory framework/statement of intent approach.

From observation of experience with arms'-length entities, especially New Zealand CCOs, it does seem that concern about the extent of directors' powers, and implications for council influence over the activity of an arms'-length entity has been somewhat overdone. Either a contract for services or a statement of intent can include provisions which may set a quite detailed framework within which the directors are required to manage the business of the company but neither will give a council the power to intervene in the business of the company beyond the explicit terms of the contract or SOI.

Appendix I sets out the statutory framework for the development of a statement of intent between a council and a CCO. The framework sets out what the statement of intent should cover including this very significant provision which in practice enables a council to put in place whatever reasonable requirements it has in respect of accountability either to the council itself or to its community or interests within it:

> Any other matters that are agreed by the shareholders and the board.

Auckland Council, which has a number of what are known as substantive CCOs (CCOs responsible for large-scale and significant activity) has used this provision to set out its expectations of how its major CCOs will engage with the Council's communities. The Council itself is comprised of what is known as the governing body - an elected body representing the entire Auckland region - and a series of 21 local

boards. The statement of intent for each CCO incorporates by reference what is known as the governance manual for CCOs which sets out quite extensive expectations. Crucially for accountability this includes:

> Local boards have an important role in local representation and decision-making. CCOs will proactively build relationships based on transparent communication of their activities. CCOs are required to develop local board engagement plans which provide an overarching framework to guide engagement between local boards and themselves.

The Auckland experience also demonstrates the importance of anticipating what issues could arise between a council and an arm's-length entity.

To give a practical example, the Ports of Auckland Ltd, which is the 100% owner of Auckland's Waitemata and Onehunga ports, and which itself is 100% owned by the Auckland Council's investment CCO, recently sought resource consent to extend one of its major wharves a further 100m into the Waitemata harbour. The proposal resulted in significant public outrage, and the Council itself expressing a view there should be no further extension. The port company's initial reaction was to see this as an unwarranted interference with the business of the company including its obligation to operate as a successful business.

The Council has subsequently recognised this was a matter which could have been dealt with by a provision in the statement of intent for the port company[25] limiting the footprint within which it could operate. The same general solution of using the SOI (or a contract for services) to spell out operational or other limits which a council owner expects an arms'-length entity to observe should ensure the governing body acts within what the council sees as reasonable bounds. Whether this happens depends in part on the extent to which councils and boards of directors understand their respective roles, responsibilities and powers and how effective the council is at monitoring performance.

The New Zealand statutory framework: enhancing accountability to the community

The New Zealand statutory framework setting out the powers and responsibilities of councils in relation to CCOs (arms'-length entities), quite apart from the provision for a statement of intent, has been specifically designed to ensure that accountability to the community itself is enhanced.

Section 56 of New Zealand's Local Government Act provides that "Before a local authority may establish or become a shareholder in a council controlled organisation, the local authority must undertake consultation in accordance with section 82." Section 82 sets out the general principles of consultation which a council must follow including "that persons who are invited or encouraged to present

[25] In strict terms, this would have required the Council to include an appropriate provision in the statement of intent of Auckland City Investments Ltd (ACIL) requiring it, in turn, to include a provision in the statement of intent of Ports of Auckland Ltd (which is a subsidiary of ACIL). The example also illustrates the importance of aligning understandings of requirements included in documents such as SOIs. In this case, the SOIs of both ACIL and the port company included a commitment to 'no surprises' but despite this neither company advised the Council in advance of being granted a resource consent. The experience has resulted in both the Council and its CCOs putting stronger emphasis on regular informal consultation with each other.

their views to the local authority should be given clear information by the local authority concerning the purpose of the consultation and the scope of the decisions to be taken following the consideration of views presented." Effectively, this means that councils are required to develop a quite comprehensive proposal before making the decision to establish a CCO, thus minimising the risk of the type of problems identified by Grant Thornton with Local Authority Trading Companies in England and Wales (see page 15 above).

The use of arms'-length entities is normally promoted as a means of improving efficiency and better enabling the delivery of important services. A point which is often missed is that given the statutory provisions for accountability by a council to its community (consultation prior to establishment, reporting in its public planning documentation) and the post-establishment governance regime, the arms'-length entity approach also becomes a significant accountability mechanism in its own right. Where the statement of intent approach is used, the governing body becomes directly accountable to the elected council. With either the statement of intent approach, or the use of a contract for services, there will be much greater transparency around financial and operating matters as the arms'-length entity will have its own separate financial statements and reporting arrangements (spelt out in the SOI and/or contract for services).

In choosing whether to put in place a statutory framework for regulating the relationship between councils and arms'-length entities, or to rely instead on the use of a contract for services, one matter to consider is the merits of a common approach across the local government sector. A statutory framework is more likely to result in a common approach than the alternative of enabling councils to establish arms'-length entities but with the relationship to be managed through a contract for services - especially in the case of arms'-length entities which may generate all or most of their own revenue and so perhaps not be subject to a contract for services at all. The reason is that the statutory framework spells out those matters which, as a minimum, must be addressed (see the requirements for a statement of intent set out in appendix I). This contrasts with a contract for services approach where a council will normally have much greater discretion.

A further matter to consider is whether good practice in managing the relationship between a council and its arms'-length entities should be left entirely to the discretion of individual councils or whether there should be some good practice guidance. The wide variation in performance identified by Grant Thornton in respect of LATCs, and by McKinlay in relation to New Zealand CCOs provides strong support for the argument that there should be some form of sector wide good practice guidance. This could be done either as guidance from government, or as a sector-based initiative. The latter approach would make better sense if there is adequate capability within the local government sector as the former approach inevitably carries with it the risk of shifting from supportive guidance to a compliance based approach.

Are additional provisions required for multi-council arms'-length entities?

Much of the interest in the use of arms'-length entities in both Victoria and New Zealand is in areas such as shared services, or the creation of scale without

amalgamating councils. Possibilities range from sharing back-office services where conventional multi-council approaches, for example in Victoria through the use of Regional Organisations of Councils, have proved somewhat cumbersome, to building scale for the management of significant infrastructure - water and wastewater in New Zealand, roading and related services in Victoria.

Multi-council arms'-length entities could range from trading entities where earning a profit is a significant but not necessarily the only objective (Citywide, childcare centres in Victoria, property development in New Zealand) to explicitly not-for-profit activities where building scale, including the potential for professional development of staff, is seen as important for enhancing the range and quality of service - libraries, art galleries, leisure centres (although these could be seen as for-profit activities) and parks and reserves provide examples.

Protecting council objectives

Often individual councils will have specific objectives which are important for them but might not necessarily have the same importance for other councils, or for the governing body of a multi-council entity. It may be maintaining employment in rural centres, ensuring timely access to skilled staff and machinery to deal with natural disasters, or preserving an individual council's discretion to influence the way a particular activity is undertaken so that it can satisfy interests within its community - in New Zealand this may include influencing decisions in respect of management of water and wastewater in order to meet the concerns of local iwi.

Should any specific measures be taken so that individual councils have the opportunity of influencing a multi-council entity arrangement in order to protect matters of importance for them? Experience suggests if this is not done it may be more difficult to obtain public support for the use of arms'-length entities.

What are possible options? One is simply to rely on a council's rights as a shareholder, if the entity is a company, or on other instruments such as a funding agreement where the entity is a not-for-profit, or a company where the relationship with councils includes a contract for the purchase of services. Relying on a council's rights as a shareholder may not provide adequate protection, in part because shareholders have no power to instruct the governing body of an entity on how it should undertake its activities (apart from any provisions in the statement of intent).

Another possible option, and one which is used quite extensively in England with Local Authority Trading Companies, is the establishment of a shareholders' committee as a vehicle through which individual councils can share their concerns, seek the commitment of other councils in supporting those, and work with the governing body of the entity.

The New Zealand government has recently introduced into Parliament a Local Government Amendment Bill[26] which, among other things, provides for the creation of a shareholders' committee for multiply owned substantive CCOs:[27]

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[26] The bill is available at: http://www.legislation.govt.nz/bill/government/2016/0144/latest/versions.aspx

[27] A substantive CCO is defined in the Bill as: means a council-controlled organisation, other than a council-controlled trading organisation, that is wholly owned, or wholly controlled, by 1 or more local authorities, and that—
(i) owns or manages assets with a value of more than $10 million; or 5
(ii) is a water services council-controlled organisation; or

The shareholders of a multiply owned substantive council-controlled organisation must establish and maintain a joint committee for the purpose of collectively managing their interests in performing or exercising their responsibilities, duties, and powers as shareholders of the council-controlled organisation.

This approach relies either on councils collectively accepting the importance of protecting matters which are significant for one or more councils, or on the terms of reference for the shareholders' committee giving individual councils power to protect interests important to them. It also assumes the governing body of the arms'-length entity will do as requested by the shareholders' committee notwithstanding the committee has no power to direct the governing body on how to manage the business of the entity (except to the extent that is explicitly provided for in the statement of intent).

The use of a shareholders' agreement

A third approach which is commonly used in the private sector when two or more parties collectively control an entity, normally a company, is the use of a shareholders' agreement. The purpose of such an agreement is to spell out explicitly those matters which individual shareholders wish to protect, and how that protection will operate.

An example of a useful overview of what a shareholders' agreement in the private sector might cover comes from the Corporation Law Committee of the Association of the Bar of the City of New York in a paper *The Enforceability and Effectiveness of Typical Shareholders' Agreement Provisions*[28]*.* Among the matters the paper suggests should be included are:

- The appointment, removal and replacement of directors.
- The size of the board (although typically this would be dealt with in the entity's constitution).
- Limiting the powers of the board of directors (under Australian corporations law a company's constitution can place restrictions on the power of the board to manage the business of the company).
- The right for a shareholder to appoint an observer to attend board meetings and receive information provided to directors.
- Corporate opportunities - generally whether or not individual shareholders have the right themselves to pursue opportunities which the entity has identified and could itself exploit.
- The right to influence the selection and removal of key officers of the corporation.
- The right to require that certain decisions may only be taken by the corporation if shareholders generally, or individual shareholders have given their approval.
- Rights to access defined information.

(iii) is a transport services council-controlled organisation; or
(iv) is agreed by all shareholders to be a substantive council-controlled organisation;

[28] Available at: http://www.nycbar.org/pdf/report/uploads/20071830-TheEnforceabilityandEffectivenessofTypicalShareholderAgreementProvisionsforweb.pdf

- Provisions regulating the right of individual shareholders to deal in their shares.
- Dispute resolution processes.
- Provisions regulating the amendment and termination of the shareholders' agreement.

These provisions are designed primarily to meet the needs of investors to protect and enhance the value of their investment in the corporation. Councils involved in a multi-council entity, especially one which itself is a trading entity, are likely to want similar protections. However, they are likely also to want specific provisions covering a number of other matters where there is a particular interest of the council or its community at stake.

As an example, if a multi-council entity is involved in child care, or services for the elderly, individual councils may want to specify minimum standards of care, whether and how individual facilities might be sold or closed down, the approach the entity should take to working with users, including those who might have difficulty in meeting commercial charges, and much more.

Finally, in situations where a council is either required to consult its community on the establishment of an arms'-length entity, or where elected members believe that the establishment of an arms'-length entity could become an election issue, it's very likely that elected members will want to know that they can provide satisfactory answers to their community on the council's ability to protect matters likely to be of concern to all or part of the community. This places an added importance on ensuring that whatever arrangements are in place, they do provide the council with the necessary powers so that although it may only be a minority shareholder (or in respect of entities other than companies limited by share capital, a minority influence over the governing body) it can still protect matters of concern to its community.

Are different provisions required for different categories of arms'-length entity?

From a public policy perspective, the main interest in provisions affecting the different categories of arms'-length entity has been ensuring competitive neutrality. In New Zealand, as an example, councils are prohibited from giving any guarantee or indemnity in respect of a council controlled trading organisation (CCTO), or lending money to a CCTO at a lesser interest rate than the council itself would pay if its borrowing were not secured against rates.

Different approaches for different entities

Arms'-length entities can take a number of different forms and be used for a number of different purposes. Possibilities range from trading activities (including shared services or developing centres of excellence), to not-for-profit entities established as a means of generating additional community support, or accessing sources of funding not available to councils themselves (common in the arts, cultural and recreational area) to the promotion of social enterprises, for example, through supporting the establishment of staff run entities especially in social service or related areas.

Of necessity, different approaches will be taken to the establishment, governance and management of arms'-length entities depending on matters such as the nature and scale of the activity to be undertaken. However, experience also shows that different approaches can result simply from different understandings of what constitutes good governance and accountability. Accordingly, the issue of different provisions for different categories of arms'-length entity needs to distinguish between differences which result from a lack of understanding of good practice, and differences which are inherent in the nature of the entity.

Good practice in the sense of sharing experience of what works and what doesn't will be an important part of the evolution of any significant arms'-length entity activity. The New Zealand experience initially with Local Authority Trading Enterprises and now Council Controlled Organisations provides a useful illustration with the qualification that much (but not all) documented experience has been with companies limited by share capital.

As already noted, local government has looked to central government which developed its own approach to ensuring consistency in the management of the relationship between government (shareholding ministers) on the one hand and state-owned enterprises (and other arms'-length entities) on the other. This included a standard process for the appointment, removal and replacement of directors, and the development of an annual cycle for working with arms'-length entities - a shareholder's expectations manual setting the basic framework and requirements, quarterly reporting, a letter of expectations from shareholding ministers to set the scene for the preparation of the budget for the forthcoming financial year, and informal collaboration between shareholding ministers' advisers and the board of the entity on development of the statement of intent.

Differences in practice

Some councils adopted all or part of the government approach but there was no specific requirement to do so. The result was quite significant differences in practice with, in some instances, significantly adverse outcomes. As examples:

- Individual councils' policies on whether elected members could be appointed to the boards of council owned companies or other entities varied from an outright prohibition, to favouring the appointment of elected members. In practice this represented an inherent conflict of interest as councillor members of the board of a council owned company or a council controlled trust were, as councillors sitting around the council table, tasked with monitoring their own performance. A distinction does, however, need to be made between those instances where the council's primary reason for the use of an arms'-length entity is improving performance and capability, and instances where the council's purpose is more in the nature of building a partnership with all or part of its community in which case appointment of elected members to the governing body may be entirely appropriate.

- Some but not all councils took the view that, if elected members were appointed to the board of a council owned company or other entity, they should be remunerated in the same way as other board members. The result was significant tension within councils which paid director fees with a real sense of resentment on the part of elected members who were not benefiting from this additional source of income.

A sector wide approach to disseminating good practice?

Arguably, a contributing factor to the variation in practice and performance in the way in which councils dealt with arms'-length entities in company form (or substantial not-for-profit entities) has been the lack of any sector wide understanding of what constitutes good practice. As already noted this suggests that there is quite a strong argument for any jurisdiction where arms'-length entities are a significant part of the local government sector to have some means in place for disseminating good practice. There is a choice to be made, which will depend on understandings of the proper relationship between different tiers of government, as to whether good practice should be 'handed down' from government to local government or whether it should be developed within the local government sector. Note however the preference expressed at page 32 above for disseminating good practice to be undertaken by the local government sector itself (which in all likelihood would mean as an additional function for an existing peak body)

Practice in respect of arms'-length entities in limited liability company form will remain dominated by private sector understandings of the role of directors and the relationship between directors and shareholders in respect of the business of the company. This will not necessarily be the case in respect of other forms of arms'-length entity where quite different considerations often apply, for example, as already noted, the arms'-length entity may be established as the means of implementing a partnership between the council and community interests. In this situation the role of the governing body may be partly that of running the business of the entity but also partly one of developing and managing the partnership between the council and the community in which case it would be entirely appropriate to appoint council representatives to the governing body.

As is increasingly common, the arms'-length entity may have been formed as the basis of a social enterprise intended to take over from the council a service or services currently produced by the council itself. In Victoria childcare is a possibility. Other possibilities exist throughout the arts, cultural and recreational aspects of council activity, as well as in a number of other services - is there a case, for example, for encouraging social enterprises as a means of delivering a number of services currently considered as potential shared services?

Looking to the longer term, there is now a significant body of opinion which believes that local government will become increasingly important as a means of enabling access to significant services on the part of its communities **including** developing means for co-design and co-production. If this does indeed happen, it is likelier than not the typical means of implementing such an approach will be some form of not-for-profit arms'-length entity. This suggests an emphasis in developing good practice not just on how to manage the relationship between a council and an arms'-length entity in company form, but on other forms of arms'-length entity where the expected relationship between the governing body and the council may be quite different, draw much more on a partnership approach and in the longer run potentially be at least as significant as the relationships between a council and council controlled companies.

Next steps

As stated in the introduction to this report, its purpose is "to provide an overview of selected international practice with the use of arms'-length entities in local government in order to inform policy/practice development by the project partners."

Accordingly, this final section of the report, rather than making recommendations, highlights areas which project partners may wish to consider as they further develop their own policy and practice in enabling and/or working with arms'-length entities.

The main themes from the report, for consideration by project partners, include:

- Arguments for the use of arms'-length entities fall into two separate but overlapping groups. The first is their use as a means of improving the efficiency with which councils undertake their activity, including achieving the benefits of scale, being able to access commercial structures, and attract people with related skills and experience, and ideally to improve the effectiveness with which councils use their resources through either or both of reducing the cost of delivering services, and generating additional income for the council (or councils in the case of multi-council entities). The second is the opportunity to build partnerships with the council's community and develop new approaches to enabling service delivery especially in areas where there is a strong arts, cultural, recreational or social service imperative.

- The overview of international experience shows a wide range of different approaches on the part of higher tiers of government to the use of arms'-length entities by local government. In some jurisdictions, especially much of Europe, this is a function of the constitutional position of local government which differs significantly from that in 'Westminster' country jurisdictions. More generally, there appears to be a loose correlation between the freedom which councils have to establish arms'-length entities and the extent to which the higher tier of government takes an interventionist approach towards local government as compared to an enabling approach.

- Jurisdictions which take a risk averse approach towards enabling the use of arms'-length entities by local government could find that in the current climate one unintended consequence may be to undermine the innovative capacity of councils themselves, and make it more difficult for councils to recruit really competent people, especially people with commercial skills which can assist the council make better use of resources (see the comment from the Melbourne City Council at page 21 above).

- Post-establishment governance is likely to become an increasingly important issue as councils face growing pressure to do more with less - austerity in England, rate capping in Victoria (and the conditions which the Essential Services Commission applies to applications for exemptions) and an increasing legislative emphasis on efficiency in New Zealand. In each case, councils face an incentive to apply commercial practices to much of their activity often with an emphasis on generating additional income, or using commercial structures as part of a process of driving down cost. As the English experience with Local Authority Trading Companies in particular demonstrates, this can significantly increase the risk associated with local

government activity at least in the absence of robust post-establishment governance arrangements (see the Grant Thornton report referred to on page 15 above).

- The 'do nothing' option is unlikely to be attractive to higher tiers of government in Australia, especially when the English experience is taken into account. The choice is more likely to be between conditions precedent to establishment (for example a requirement to develop and adopt a business plan, and to consult with the council's community), ministerial or other consent, or the adoption of a statutory framework along the lines of that used in New Zealand. Factors which a higher tier of government may wish to consider include the extent to which the chosen option is sufficiently flexible to encompass management of future risk not yet considered (for example if an arms'-length entity's governing body should decide to move into a different area of business), the relative capabilities of public sector officials to make informed and appropriate judgements on arms'-length entities' proposals put forward for consent, and the signals which different approaches send to local government about the balance between innovation and compliance.

- Arms'-length entities, especially those undertaking substantial activity, raise complex questions of accountability emphasising the importance of developing an understanding of good practice, including how to manage the relationships between a council or councils as shareholders (or otherwise as the parties responsible for appointing the governing body) and the governing body of the entity. This includes not only ensuring councils understand the difference between setting a framework within which an arms-length entity may operate, and seeking to intervene in the business decisions of the governing body but also that members of the governing body itself understand the subtleties of operating in the public sector environment, including the importance of 'public value'.

- In jurisdictions such as New Zealand and Victoria there is a strong case for developing a means of capturing and disseminating good practice in the use of arms'-length entities. This requires that an appropriate body take responsibility for doing so. On balance, it makes sense that this become a function of the local government sector itself (possibly an existing peak organisation) rather than, say, a government agency with responsibility for local government which could carry with it a risk that disseminating good practice became a compliance driven exercise.

- Multi-council arms'-length entities may present additional challenges especially if a council which is a minority party wishes to ensure that it can protect over the longer term matters of importance to its community which have passed from the council to the arms'-length entity. The establishment of a shareholders' committee is a useful tool but councils themselves may decide that to protect their interests effectively they need also to have in place a shareholders' agreement which specifically provides effective means for delivering that protection.

- Much of the discussion of arms'-length entities tends to focus on the use of companies limited by share capital. It is likely that as financial constraints increasingly impact on all tiers of government there will be an increasing

interest in the use of not-for-profit arms' length entities for purposes such as building partnerships between councils and their communities (among other things to enable co-design and co-production) and promoting social enterprises.

Glossary

Arms'-length entity. In local government a separate legal entity controlled by one or more councils but with independent governance and management able to exercise its own discretion in management and decision-making subject to any formal framework established by the controlling council or councils.

Corporation Often a synonym for company but under section 193 of Victoria's Local Government Act a term which encompasses the full range of entities which may be controlled by a council either through ownership or through the power to appoint the governing body of the entity.

Council Controlled Organisation An entity in respect of which one or more local authorities control, directly or indirectly, 50% or more of the votes at any meeting of the members or controlling body of the entity; or have the right, directly or indirectly, to appoint 50% or more of the trustees, directors, or managers (however described) of the entity.

Council subsidiary. Under South Australia's Local Government Act a special purpose entity which may be established by one or more councils with the approval of the Minister of Local Government for a purpose or purposes set out in a charter prepared by the council(s) and approved by the Minister. Subsidiaries are a statutorily provided alternative to the power to establish arms'-length entities.

Post-establishment governance In local government an arrangement whether statutory or otherwise empowering a council to set the framework within which the governance of a council controlled entity may be exercised once that entity has been established.

Regional Library. A special purpose entity which can be established under Victoria's Local Government Act to deliver library services within an area defined by the agreement establishing the regional library.

Social enterprise is not a legal term, but an approach. The phrase is used to describe businesses that exist for a social purpose. You can't register your business legally as a social enterprise. There are various legal forms that are used to incorporate social enterprises. In the end, being a social enterprise is about adopting a set of principles. These include:

- Having a clear social and/or environmental mission (set out in your governing documents)
- Generating the majority of your income through trade
- Reinvesting the majority of your profits to further the social mission

This is regardless of what form the organisation takes. So if you have these in place – you are acting as a social enterprise
(sourced from Start Your Social Enterprise, published by Social Enterprise UK and available at:
http://www.socialenterprise.org.uk/uploads/files/2012/04/start_your_social_enterprise.pdf)

State Owned Enterprise (SOE). In New Zealand, a government owned company limited by share capital and listed in Schedule 1 to the State-Owned Enterprises Act 1986.

Statement of Intent (SOI). An SOI is a statutorily required document intended to regulate the relationship between a council controlled organisation and the controlling council or councils. To the extent that is appropriate given the organisational form of the council-controlled organisation, the SOI must specify for the group comprising the council-controlled organisation and its subsidiaries (if any), and in respect of the financial year immediately following the financial year in which it is required to be delivered and each of the immediately following 2 financial years a range of information specified by statute (see appendix I).

Appendix 1

Required Content for Statements of Intent

A statement of intent must, to the extent that is appropriate given the organisational form of the council-controlled organisation, specify for the group comprising the council-controlled organisation and its subsidiaries (if any), and in respect of the financial year immediately following the financial year in which it is required by clause 3(b) to be delivered and each of the immediately following 2 financial years, the following information:

(a) the objectives of the group; and

(b) a statement of the board's approach to governance of the group; and

(c) the nature and scope of the activities to be undertaken by the group; and

(d) the ratio of consolidated shareholders' funds to total assets, and the definitions of those terms; and

(e) the accounting policies of the group; and

(f) the performance targets and other measures by which the performance of the group may be judged in relation to its objectives; and

(g) an estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to the shareholders; and

(h) the kind of information to be provided to the shareholders by the group during the course of those financial years, including the information to be included in each half-yearly report (and, in particular, what prospective financial information is required and how it is to be presented); and

(i) the procedures to be followed before any member or the group subscribes for, purchases, or otherwise acquires shares in any company or other organisation; and

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

(k) the board's estimate of the commercial value of the shareholders' investment in the group and the manner in which, and the times at which, that value is to be reassessed; and

(l) any other matters that are agreed by the shareholders and the board.

(2) If a council-controlled organisation has undertaken to obtain or has obtained compensation from its shareholders in respect of any activity, this undertaking or the amount of compensation obtained must be recorded in—

(a) the annual report of the council-controlled organisation; and

(b) the annual report of the local authority.

(3) Any financial information, including (but not limited to) forecast financial information, must be prepared in accordance with generally accepted accounting practice.