



OFFICE OF
THE CONTROLLER AND AUDITOR-GENERAL
Te Mana Arotake

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Mr Griff Page
Steering Group Member
C/- South Wairarapa District Council
P O Box 6
MARTINBOROUGH

By e-mail to: griff@swdc.govt.nz

Dear Mr Page

**GOVERNANCE ISSUES ASSOCIATED WITH OPTIONS FOR THE DELIVERY OF
RAIL SERVICES IN THE WELLINGTON REGION**

As requested, we have reviewed the governance aspects of the proposed options for the future delivery of rail services in the Wellington region. We have drawn on:

- a compendium of draft documents supplied by the Wellington Regional Council (WRC), including a summary of the proposed public/private partnership model, and a draft Community Charter, Heads of Agreement, Shareholders Agreement and Company Constitution;
- a meeting with the Steering Group, and Booz Allen and Hamilton, held on 19 September 2001;
- a final report "Delivery and Governance Options for Wellington's Urban Railway" (the report) dated 26 September 2001; and
- the Wellington Regional Council Regional Land Transport Strategy 1999-2004.

We would note that there are other documents of a preliminary nature which we have not reviewed. Instead, we have focused on the governance options in the above key documents. Within the limited timeframe sought for our comments, we have not been able to examine in detail the range of considerations giving rise to the options presently being assessed.

We did not review any governance and ownership documents for Wellington Regional Council Holdings Limited (WRC Holdings Ltd.) as the governance principles are well established for this entity and have been in operation for a number of years.

Focus of Our Review

We have focused on the following sets of governance issues:

1. Ownership and governance of rail assets and operations.
2. Board composition and share allocation of Wellington Regional Rail Limited (WRRL).
3. Board composition of WRC Holdings Ltd.
4. The roles of the proposed Mayoral Community Monitoring Group (the Mayoral Group).
5. WRRL Board casting vote.
6. "C" share provisions.
7. Management of potential conflicts of interest.
8. Information flows.
9. Exclusion of existing public transport operators.

We have also drawn on the best practice principles outlined in our recently published report "Local Authority Governance of Subsidiary Entities." That report discusses governance arrangements for a variety of local authority structures, including collaborative groupings such as joint ventures (an example is the Canterbury Landfill) and multiple local authority shareholder models (an example is Watercare Services Limited).

Finally, we have considered governance options with regard to the guidance contained in our 1998 report "Papakura District Council: Water and Wastewater Franchise", which discusses best practice with regard to the franchising of critical infrastructure assets.

There are a number of other aspects, not directly related to the issue of governance, that the Steering Group may wish to refer to in the report on Papakura District Council. In particular, the sections of the report dealing with consultation and asset management plans.

1. Ownership and Governance of Rail Assets and Operations

- 1.1 The report on page 4 states "Wellington urban rail services were part of the integrated rail freight and passenger business sold to Tranz Rail Ltd in 1993". The assets within Wellington's geographical area consist *inter alia* of the following:
 - Rollingstock, stations, buildings, railway tracks and signalling equipment; and
 - Corridor land that was leased by Tranz Rail Ltd from the Crown for a period of 40 years with a right of renewal for a further 40 years.
- 1.2 We note the intention that WRC or WRC Holdings Ltd. retain ownership of infrastructure assets acquired through a sale and purchase agreement with Tranz Rail Ltd. Clause 6.2 of the Shareholders Agreement states that, should WRRL as part of the sale and purchase agreement acquire the rail infrastructure network (including tracks, signals, bridges and tunnels) and right of use, WRRL must dispose of those assets to the Council or a Council-owned company.

1.3 The report contains little discussion of what types of assets would be disposed to the holding company and what types would be retained by the operating company. Consideration will need to be given to this issue as the proposal evolves.

2. Board Composition and Share Allocation of WRRL

2.1 We note from the proposal there will be three classes of shares:

- A Shares – subscribed by WRC Holdings Ltd;
- B Shares – subscribed by the Private Partner; and
- One C Share – subscribed by WRC (refer section 6 below).

2.2 The Board of WRRL will ordinarily comprise six Directors. In those circumstances when the owner of the C Share invokes the powers set out in Clause 2 of Schedule Eight to the proposed Constitution, the Board number will be capped at seven.

2.3 The intention is that no member of a local authority may be appointed to the Board of WRRL. We would see this director appointment policy as consistent with the commercial focus of the WRRL and the necessary arms-length relationship with WRC Holdings Ltd.

2.4 The Council should put in place a consistent and transparent process for the appointment of directors to the board of WRRL, drawing on skills-based criteria.

3. Board Composition of WRC Holdings Ltd.

3.1 We understand that WRC currently appoints five Directors to the board of WRC Holdings Ltd., three of whom are Councillors. Given the role of WRC Holdings Ltd., this constitutes, in our view, an appropriate representation of Councillors on the board of the Council holding company subsidiary.

4. The Roles of the Proposed Mayoral Community Monitoring Group

4.1 We understand that the Mayoral Group is intended to monitor the performance of WRRL from a user perspective, and to engage regional territorial local authorities in the oversight of service quality.

4.2 Any such Mayoral Group will not assume any of the responsibilities currently performed by the WRC through its Passenger Transport Committee. WRC staff are already responsible for monitoring user satisfaction and compliance by the rail operator against terms of the current funding agreement.

4.3 We raise questions about the extent to which such a group might be in a position to undertake a monitoring role in a systematic way. We note the absence of documented expectations for the Mayoral Group to use to measure the performance of WRRL.

We would suggest that any guiding document of this nature should be derived from the expectations, standards and performance measures from the Funding Agreement between WRC and WRRL. It is not clear how the Group would gather and process service information, and hold the company to account for addressing identified concerns.

5. WRRL Board Casting Vote

- 5.1 We note that the Chairperson of WRRL is to be selected by each of the two shareholders every alternate year. The Chairperson does not have a casting vote if the Directors are deadlocked on an issue.
- 5.2 The objectives behind these provisions appear to provide a balance of power within the board, and to provide an incentive for the joint venture partners (through their appointed directors) to reach agreement on matters affecting the company. The provisions appear reasonable in the circumstances.

6. "C" Share Provisions

- 6.1 The proposed Shareholders Agreement (Clause 5.4 Capital Structure) states that WRRL shall have three classes of shares. In Clause 5.4.3 of the proposed Shareholders Agreement, WRC will subscribe for the C Share. Schedule Eight of the proposed Constitution of WRRL states the rights, powers, privileges and restrictions attaching to the C Share.
- 6.2 If the conditions of clause 2 of Schedule Eight of the proposed Constitution are satisfied and the holder of the C Shares appoints a C Share Director then the WRRL Board will number seven.
- 6.3 We note that the C Share belongs to the WRC. The aim of having the acquired monopoly assets and its ownership with WRC Holdings Ltd. is to ensure that the WRC is at arms length from the "operator", while the WRC acts as "funder and purchaser" of transportation services in Wellington.
- 6.4 Given that we would expect this provision to be invoked only in extreme circumstances, this would appear to be a reasonable approach.

7. Management of Potential Conflicts of Interest

- 7.1 The potential for a conflict of interest between the funding and ownership roles of WRC is well documented in the report. Far from seeking to separate these roles, it could be argued that the success of the proposed joint venture option rests on WRC's ability, as joint owner, to link these roles.
- 7.2 In practice, decisions about fares, protection of rail routes, service levels, subsidies, capital investment, infrastructure management, and rates of return, are likely to be closely linked. The relationship between these factors is reflected in the financial reporting requirements (incorporating a price control regime) envisaged under the

proposed Funding Agreement. Separation of interests between WRC as owner and WRC as regulator and funder will need to be carefully managed to ensure transparent decision-making in relation to the operation of the joint venture rail company – WRRL.

- 7.3 In the local government sector we note that issues associated with the separation of funder and provider are not uncommon. We also note that Transfund will have a monitoring role.

8. Information Flows

- 8.1 Information requirements are at the heart of issues concerned with disclosure, WRC control, and public accountability.
- 8.2 We suggest consideration should be given to the nature and extent of information passed from WRRL to WRC Holdings Ltd. (the legal shareholder of WRRL), and from WRC Holdings Ltd. to its parent Council – WRC. Some local authority holding company structures have developed the practice of reserving key controls to the parent Council – such as approval of the Statement of Corporate Intent for all operating subsidiaries of the holding company, and validation of board appointments.
- 8.3 WRC should consider ensuring appropriate means of holding WRRL to account through WRC Holdings Ltd. This may require changes to the Statement of Corporate Intent for WRC Holdings Ltd, and to other accountability documentation between the holding company and its Council parent.

9 Exclusion of Existing Public Transport Operators

- 9.1 The report notes the potential for conflict between the Council's roles as funder of all modes of public transportation and as owner of one company that is a provider of transportation services. Rail services in the Wellington region are protected from competition by bus operators, whereby bus operators cannot directly compete on routes serviced by rail.
- 9.2 We note that Clause 12.1 of the proposed Shareholders Agreement precludes, without prior written consent, any existing public transport operator in the Region from entering the joint venture as the private participant.
- 9.3 This has the potential to exclude existing bus operators from entering the joint venture and therefore this issue needs to be addressed before development of the Request for Proposal.

We trust you find these comments useful as you work through the options.

Yours sincerely

Kevin Brady
Deputy Auditor-General