

**HAWKE'S BAY REGIONAL COUNCIL**  
**STRATEGIC PLANNING AND FINANCE COMMITTEE**

**Wednesday 19 May 2010**

**SUBJECT: PROPOSED ESTABLISHMENT OF HOLDING COMPANY**

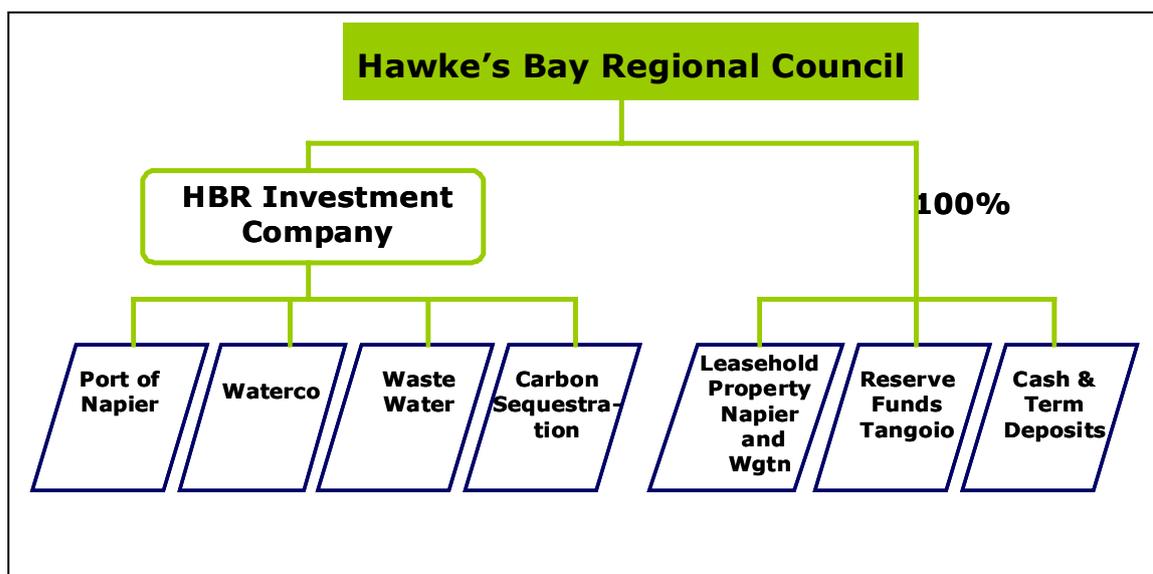
**REASON FOR REPORT**

1. This report records the principles proposed to be adopted for the implementation of Hawke's Bay Regional Investment Company Limited ("HBRIC").
2. These principles have been developed from researching and evaluating financial, investment, accounting, taxation and governance issues about investment structures appropriate for the Council's objectives, consultation with other Councils with similar objectives and structures, examples being Environment Bay of Plenty, Greater Wellington Regional Council, and expert advisers, feedback from Councillors and the Committee, and discussions within the Council and with McDermott Miller.
3. These principles are described in the following sections of this memorandum and are recommended for adoption by the Council.

**PROPOSED STRUCTURE OF HBRIC**

4. The original proposal for establishment of HBRIC envisaged all the current investment portfolio assets (after the sale of Wellington and Napier leasehold property) would be transferred to HBRIC on formation of the company.
5. Further consideration of appropriate decision-making and control elements of the proposal, in particular the desirability of retaining strategic investment decision-making at Council level has led to refinement of the originally proposed structure.
6. Moreover, while initial advice received from PWC is that the original proposal does not change the tax position of the Council in respect to its "corporate" investments (for example Port of Napier Limited), it could do so in respect non-corporate investments (such as term deposits and directly held 100% owned assets such as leasehold property). This is because the net income from rents and interest would become a taxable receipt to HBRIC whereas this income is currently non-taxable to the Council.
7. As noted earlier, the original proposal was to retain the leasehold properties as directly owned by the Council until their sale and conversion to cash, so the PWC advice does not change the concept for these property assets, but its advice is that cash and term deposits be retained and directly invested in similar assets by the Council until required for specific investment opportunities in HBRIC.
8. Focus on the Council role in strategic investment decision making coupled with implementing the PWC tax advice can be accommodated in the proposed refinement of the original proposal to that now shown in the following **Figure 1**.

Figure 1: Council-HBRIC Proposed Refined Structure



## Rationale

9. This refined structure has the advantages of:
  - 9.1. The Council retaining control of strategic decision making about investments requiring Council funding because the Council will decide whether to provide additional equity to HBRIC (from its cash or other investments), or approve new debt, for each new deal;
  - 9.2. Facilitating investment to achieve strategic development objectives for the Hawke's Bay Region;
  - 9.3. Retaining currently non-taxable assets in direct Council ownership to:
    - 9.3.1. Preserve Council control of strategic investment issues; and,
    - 9.3.2. Maximise tax paid returns to the council from those assets.
10. While still achieving the objectives of:
  - 10.1. Improved returns from the investment portfolio as a whole;
  - 10.2. Providing an effective platform for engaging with other public and private sector investors in future development projects;
  - 10.3. Ring-fencing particular investment risks;
  - 10.4. Facilitating exits from "corporatised" investments, whether to realise profits, introduce other shareholders or dispose of underperforming investments;
  - 10.5. Securing greater commercial focus in Council investment decision-making by formally accessing commercial experience from within the region and elsewhere in New Zealand through the appointment of external people to the HBRIC Board; and,
  - 10.6. Ensuring the Council's corporate tax-paying entities, (for example Port of Napier Limited), are moved to a more efficient tax structure of the holding company and improve financial returns as a result.
11. HBRIC is proposed to be a limited liability company which is a structure that facilitates and protects investment involving greater commercial risk than continuing to invest in short term bank deposits and property as the Council does now. This can be done in a number of ways such as:
  - 11.1. By joining, and sharing risk, and returns, with other partners in an investment.

- 11.2. Paying tax on profitable investments but ensuring deductibility of costs and losses for tax purposes on those that are not.
- 11.3. Recovering costs previously incurred by Council for investment assessment, implementation and management in a tax efficient manner.

### **Ring-Fencing Investment for Regional Purposes Only**

12. Given the Council's responsibilities for the Hawke's Bay Region as a whole, and acting consistently with the Council's Investment Policy expressed in its LTCCP 2009-2019, HBRIC must adhere to the Council's requirement that its investments be made at all times for the benefit of the Regional Council purposes and functions as defined in statute, the LTCCP and other formal documents. In other words, investments, whether within Hawke's Bay Region, or outside it, can only be made by HBRIC if they generate financial, economic, environmental, social or cultural benefits for the Hawke's Bay Region over the long term.
13. This requirement will be embedded in HBRIC's company constitution and in the Statement of Intent between the Council and HBRIC.
14. The classification of HBRIC as a "strategic asset" under the Local Government Act 2002, coupled with the provisions of the Investment Policy contained in the Council's LTCCP 2009-2019 and proposed elements in the HBRIC Constitution reinforces the contribution the Investment Company makes to Regional Council purposes.

### **IMPLEMENTATION OF HBRIC**

15. Implementation of HBRIC is proposed to be a two-phase process.
  - 15.1. **Phase I:** Will be the initial implementation of the new structure effective from 1 July 2010. This involves:
    - 15.1.1. Formation of the holding company;
    - 15.1.2. Appointing its Board of Directors and management;
    - 15.1.3. Concluding its Statement of Intent once HBRIC is established and its Board of Directors appointed;
    - 15.1.4. Transferring assets from the Council to HBRIC; and,
    - 15.1.5. Establishing all administrative, accounting and control procedures.
  - 15.2. **Phase II:** Will include the ongoing management and development of HBRIC as it makes new investments utilising its own financial resources and further funding provided by the Council on an investment by investment basis.
16. The following outlines the features of Phases I and II.
17. **Phase I - Proposed Initial Implementation on 1 July 2010**

Key elements of Phase I are:

#### **17.1. Appointment of the Board of Directors of HBRIC:**

We have previously referred to the desirability of the Council keeping formal Board and management control of HBRIC as well as owning the issued share capital of the company.

In conformity with this objective, while achieving access to wider commercial expertise than currently available, we recommend:

- 17.1.1. The Board consists of seven directors, four of whom will be elected members, one of whom will be appointed the Chairperson, and another appointed Deputy Chairperson, and three others will be external independent persons having appropriate commercial experience.

- 17.1.2. Each member of the Board will have a single vote on all matters, except for the Chairperson, who will have an additional casting vote to be exercised where voting is otherwise deadlocked.
- 17.1.3. A quorum of directors for the purposes of a validly constituted Board Meeting shall be four directors including not less than three councillor-directors.
- 17.1.4. The Chief Executive of HBRIC will be the Chief Executive of the Council who will have day to day responsibility for the management of HBRIC assisted by his Executive Team and other staff as required.

17.2. **Assets to be Transferred to HBRIC on 1 July 2010:**

Subject to consistency with the LTCCP, Annual Plan consultation processes and Council's decisions, certain investment assets will be transferred from the Council to HBRIC with effect from 1 July 2010. On this date, almost all "corporate" assets, ie investments that benefit from being in a company structure, (for example Port of Napier Limited), will be transferred to HBRIC. Other assets (for example, Napier leasehold land), will be retained by the Council until such time as benefits lie in moving these assets or cash realised from them, to HBRIC.

The assets proposed to be transferred to HBRIC and the assets proposed to be retained directly by the Council initially are listed below.

17.2.1. *Existing Assets to be allocated to HBRIC:*

- 100% of Port of Napier Limited shareholding
- 100% of Waterco Limited shareholding
- Central Hawke's Bay Wastewater project
- Mahia Wastewater project
- Carbon sequestration (Tangoio) land and forestry project
- Lake Tutira Forestry cutting rights
- Joint venture forestry right agreements
- Any other corporate investment made up to 30 June 2010 (eg, "Wastewaterco").

17.2.2. *Existing Assets to be retained by Council:*

- Leasehold land Napier
- Leasehold land Wellington
- Reserve Funds (eg Tangoio)
- Cash and term deposits
- Government and other stock
- Public listed equities
- Community loans

17.3. **Establishing New Subsidiary Companies:**

HBRIC will establish new subsidiary companies as required on commencement of its operations, or in later periods when investments are to be made through them, on the following basis:

- 17.3.1. All subsidiary and monitored companies will be required to submit annual Statements of Intent to HBRIC, which will evaluate them and suggest changes as considered necessary, before finalisation by the company concerned.
- 17.3.2. Appointments to Boards of subsidiary companies designated as “strategic assets” in terms of Section 97 of the Local Government Act 2002,(such as the Port of Napier Limited), will be recommended by HBRIC to Council for approval.
- 17.3.3. Appointments to Boards of subsidiary companies not designated as strategic assets will be made by HBRIC and reported to Council. Where such appointments include councillors or council officers, Council shall be required to approve them.
- 17.3.4. HBRIC will appoint the Chief Executives or principal officers of all subsidiaries from time to time, other than for the Port of Napier Limited whose Board will make the appointment of a Chief Executive as required.
- 17.3.5. HBRIC will require Boards and management of subsidiary companies to meet with HBRIC at least twice annually to discuss their company’s strategic direction, financial performance and position and other matters as required by HBRIC.
- 17.3.6. Subsidiary companies will also provide HBRIC with all information required under Section 10 of the Council’s Investment Policy adopted for the Council’s LTCCP 2009-2019.

**18. PHASE II: Subsequent Development of HBRIC**

Once HBRIC is in full operation, it will manage, develop and expand its investment portfolio over time consistent with the terms of the agreed Statement of Intent between the Council and HBRIC. This will involve:

**18.1. Management of Investment Operations:**

HBRIC will manage the investments it holds to achieve its objectives. The Council may also assign the management of investment assets retained in its direct ownership to HBRIC.

**18.2. Making New Investments:**

HBRIC may borrow funds on its own account and use them to make new investments, or to repay any loans received from the Council.

**18.3. Over time, HBRIC may utilise free cash made available by the Council (from the Council’s realisation of funds from its leasehold land properties and other sources), to build up its investment portfolio:**

18.3.1. In these instances an investment case for each proposed investment will be made to Council by HBRIC, which will approve (or not) each such new investment and, where approved, allocate cash to HBRIC to make the investment.

18.3.2. Cash transferred to HBRIC for such investments should be as a loan or capital subscription as appropriate, but in default of any decision then as an interest bearing loan.

**18.4. Disposing of Investments:**

18.4.1. Except where the Council has designated investments as “strategic” in terms of the Local Government Act 2002 (such as Port of Napier Limited), HBRIC may sell or otherwise transfer ownership of its investments for the benefit of HBRIC from time to time.

18.4.2. "Strategic" investments may only be disposed of in whole or in part, with the specific consent of the Council and after completion of appropriate consultation processes.

18.4.3. "Controlled" investments may only be disposed of in whole or in part with the approval of the Council.

#### **VALUATION OF ASSETS TO BE TRANSFERRED TO HBRIC ON 1 JULY 2010**

19. Transfer of assets from the Council to HBRIC on 1 July 2010 is proposed to be carried out at valuations shown below:

<b>Asset</b>	<b>Valuation Basis</b>
Port of Napier Ltd:	At the value recorded in the financial statements of the Hawke's Bay Regional Council on 30 June 2010. Indicative value as at 30 June 2010 is \$119.8 million.
Waterco Limited:	At a value equal to the accumulated net expenditure incurred by and on behalf of the Ruataniwha Water Harvesting project up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. Indicative value as at 30 June 2010 is expected to be around \$0.8 million.
Forestry Assets:	
(a) Central Hawke's Bay Wastewater:	At a value equal to the accumulated net expenditure incurred on behalf of Central Hawke's Bay Wastewater up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. In the absence of any information at present, value is nominally set at \$0.1 million.
(b) Mahia Wastewater:	At a value equal to the accumulated net expenditure incurred on behalf of the Mahia Wastewater projects up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. In the absence of any information at present, value is nominally set at \$0.
(c) Carbon Sequestration project (Tangoio) - forestry:	At a value equal to the accumulated net expenditure incurred on behalf of the Carbon Sequestration project up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. In the absence of any further information at present, value is nominally set at the figure of \$0.258 million applicable on 30 June 2009.
(d) Carbon Sequestration project (Tangoio) - land:	At a value equal to the accumulated net expenditure incurred by purchasing and developing the land involved up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. In the absence of more recent information we have assumed the value to be the \$1.3 million including land purchased in July 2009.
(e) Lake Tutira Forestry rights:	At a value equal to the accumulated net expenditure incurred by and on behalf of the Lake Tutira forestry project up to 30 June 2010 as recorded in the financial statements of Hawke's Bay Regional Council as at 30 June 2010. In the absence of more recent information we have assumed the value to be the \$0.576 million applicable on 30 June 2009.

<b>Asset</b>	<b>Valuation Basis</b>
“Wastewaterco” or any other corporate asset transferred:	At values equal to the accumulated net expenditure incurred by the particular project to be transferred up to 30 June 2010 as recorded in the financial statements of the Hawke’s Bay Regional Council as at 30 June 2010.

The estimated effect of these transfers will be to establish HBRIC with around \$122.8 million gross assets on 1 July 2010.

### OPENING BALANCE SHEET OF HBRIC AND ITS INITIAL FUNDING

20. Applying the transfer valuations proposed above will result in an indicative balance sheet for HBRIC parent company itself at 1 July 2010 shown in **Table 1** below:

**Table 1: HBRIC: Parent Company: Indicative Opening Balance Sheet on 1 July 2010**

<b>ASSETS</b>	<b>INDICATIVE VALUE at 30-Jun-10 \$'000</b>
Port of Napier Limited	119800
Waterco Limited	800
Central Hawkes Bay Wastewater	100
Mahia Wastewater	0
Carbon Sequestration (Tangoio)	
- forestry	258
- land	1300
Lake Tutira Forestry rights	576
Joint Venture Forestry Agreements	2
<b>TOTAL ASSETS</b>	<b>122836</b>
<b>LIABILITIES</b>	
Loan from HBRC	100000
<b>EQUITY</b>	
Shares held by HBRC	22836
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>122836</b>

Sources: Hawke’s Bay Regional Council Financial Statements for Year ended 30 June 2009 adjusted by information contained in Council press releases since 1 July 2009.  
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The figures contained in **Table 1** are indicative only. Final values will be determined during the course of preparation of the Council’s Financial Statements for the year ending 30 June 2010.

Based on these figures, this means HBRIC will pay the Council \$122.836 million (or whatever the final valuation figures are) for the assets listed in the balance sheet above. This sum will be funded by Council:

- 20.1. Subscribing capital in HBRIC of \$22.836 million; and,
- 20.2. Lending HBRIC \$100 million, by way of a subordinated loan, repayable to the Council on demand. Interest would also be payable on demand.

This funding structure will:

- 20.3. Enable the Council to draw funds from HBRIC simply by requiring part of its loan to be repaid. For example, HBRIC may raise debt to improve its own balance sheet efficiency, some part of which could be channelled back to the Council as a repayment of loan. This is the simplest means of providing a channel for funds to move between the Council and HBRIC and avoids other more complex and time consuming methods of moving money such as HBRIC repurchasing its shares.

- 20.4. At the same time the Council can, if necessary, increase HBRIC's capital simply by converting part of its loan to shares in HBRIC.
- 20.5. Interest is proposed to be payable by HBRIC on demand. In other words if the Council doesn't demand interest be paid to it on this loan then no interest payment will be made.
- 20.6. This gives the Council and HBRIC flexibility to plan and manage cash flows between them to meet the changing circumstances and needs of each party over time.

## COUNCIL RETAINED ASSETS

- 21. As noted above the Council will continue to retain assets in its direct ownership. These assets are estimated to amount to around \$158.5million as at 30 June 2010, as shown in the following **Table 2**.

**Table 2: Council: Estimated continuing directly owned assets as at 1 July 2010**

<b>ASSETS</b>	<b>INDICATIVE VALUE at 30-Jun-10 \$'000</b>
Napier leasehold land	85500
Investment properties - Wellington	11200
Community Loans	86
Fixed term bank deposits	53728
Cash & current bank accounts	3128
Tangoio Reserve Forestry	513
Government & Other Stock	3505
Publicly listed equities	808
<b>TOTAL ASSETS</b>	<b>158468</b>

Sources: Hawke's Bay Regional Council Financial Statements for Year ended 30 June 2009 adjusted by information contained in Council press releases since 1 July 2009.  
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- 22. The figures contained in **Table 2** are indicative only. Final values will be determined during the course of preparation of the Council's Financial Statements for the year ending 30 June 2010.

## TOTAL INVESTMENT PORTFOLIO

- 23. On completion of the transfer of assets to HBRIC, the Council's total investment portfolio is estimated to amount to around \$280 million as at 30 June 2010. This portfolio will be allocated between the Council's new wholly owned investment holding company (as shown in **Table 1** above) and its directly held investments (as shown in **Table 2** above) as illustrated in **Table 3** below.

**Table 3: Hawke's Bay Regional Council: Proposed Allocation of Total Investment Portfolio as at 30 June 2010**

<b>ASSETS</b>	<b>INDICATIVE</b>	
	<b>VALUE at 30-Jun-10 \$'000</b>	<b>SHARE %</b>
HBRIC	122836	43.7%
Retained Directly by Council	158468	56.3%
<b>TOTAL PORTFOLIO</b>	<b>281304</b>	<b>100.0%</b>

Sources: Hawke's Bay Regional Council Financial Statements for Year ended 30 June 2009 adjusted by information contained in Council press releases since 1 July 2009.

Notes: The figures contained in this table are the combination of the total's contained in Tables 1 and 2.  
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## DEVELOPMENT PROJECTS

24. Where HBRIC has invested in development projects (for example Waterco):
  - 24.1. All payments (including purchases of land, plant and equipment, specialist advisory fees, personnel and material costs incurred in running the project) in respect of each project; together with,
  - 24.2. A capital charge, at rate to be determined by HBRIC and the Council from time to time, on all accumulated payments made in respect of each project. For the year ending 30 June 2011, the rate of capital charge will be 7%, will be capitalised to each project.
25. The capital charge will be debited to each individual project where it applies and credited to the revenue account of HBRIC at the end of each financial year.
26. If necessary, the Council will advance funds during the course of each financial year to finance further investment in HBRIC's development projects. These advances will include sufficient funding to ensure the capital charges on HBRIC's projects may be paid to the Council in cash.

## ESTIMATED OPERATING COSTS OF HBRIC

27. The following **Table 4** summarises an operating budget of \$225,050 (excluding GST) proposed to be adopted for HBRIC, and \$172,000 (excluding GST) proposed to be adopted for Waterco for the 2010-2011 financial year.

**Table 4: HBRIC and Waterco: Proposed Operating Budget 2010-2011 Financial Year**

EXPENDITURE TYPE	PROPOSED OPERATING BUDGET 2010-2011		
	HBRIC \$	WATERCO \$	TOTAL \$
<b>Governance</b>	65000	81000	146000
<b>Secretarial</b>	4450	6500	10950
<b>Accounting</b>	72100	43000	115100
<b>Professional Advice</b>	23500	11500	35000
<b>Management</b>	60000	30000	90000
<b>BUDGET TOTAL</b>	<b>225050</b>	<b>172000</b>	<b>397050</b>

Source: Hawke's Bay Regional Council

Notes: "Governance" includes director's fees paid to external directors.  
 "Secretarial" services include Board meeting secretary, and fulfilling legal and formal functions.  
 "Accounting" services include ongoing accounting services provided by the Council as well as audit fees and external taxation advice commissioned by HBRIC or Waterco as required.  
 "Professional Advice" is external professional advice commissioned by HBRIC as required.  
 "Management" is an hourly based estimate of cost of Council's Executive team involved in HBRIC and Waterco

All figures exclude GST

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28. The gross budget of \$397,050 (excluding GST) shown in **Table 4** includes payments that will be made to the Council for services it provides to HBRIC.
29. These services include secretarial, accounting (excluding audit) and management services estimated to result in payment of \$184,750 (excluding GST) from the budget shown in **Table 4** to the Council which will show as a receipt against the Council's own expenses under these categories. This means net payments by HBRIC and Waterco to external parties in 2010-2011 are estimated to amount to \$212,300 (excluding GST).
30. The net payments are less than the provisions made in the LTCCP 2009-2019.

## REPORTING

31. HBRIC will report to Council from time to time in accordance with the requirements of Section 10 of the Council's Investment Policy contained in its LTCCP 2009-2019.

32. HBRIC will ensure the Council is fully informed of all major developments affecting HBRIC, while recognising that commercial sensitivity may preclude certain information from being made public. Within this constraint, HBRIC will inform the Council of its affairs through the following reports:
33. An annual Statement of Intent in accordance with Section 64(1) of the Local Government Act 2002 and any other information the directors of HBRIC consider appropriate (such as revisions to financial forecasts).
34. An Annual Report, including audited financial statements, director's report and such other information to enable the Council and other stakeholders make an informed assessment of HBRIC's financial performance and position during the financial year and as required under the Companies Act 2003 and the Financial Reporting Act 2003.
35. Half yearly reports on the financial performance, financial position and operating results of the HBRIC "Group" against budgets and including guidance on the ensuing full year result;
36. Briefings to Council, no less than twice annually, on its operations, performance and progress against HBRIC's strategic plan objectives.
37. Budgeted financial performance and financial position for the current full year and the ensuing two years;
38. Such other information and reports as the Council may require from time to time in accordance with the requirements of Section 10 of the Council's Investment Policy adopted in its LTCCP2009-2019.

## PEER REVIEW

39. In accordance with the resolution passed by the Committee on 24 March 2010, the Council commissioned Martin Turner, Senior Fellow of the School of Accounting and Commercial Law, Victoria University of Wellington, to undertake a Peer Review of "the proposed establishment of a holding company structure to hold and manage part of the Hawke's Bay Regional Council's investment portfolio". His terms of reference, as approved by the Committee were to:
  - 39.1. Confirm or otherwise that the proposed structure is capable of meeting the objectives and serving the purposes it is designed for as set out in various papers but most particularly in the presentations to the Council dated 27 May 2009 and 24 March 2010;
  - 39.2. Identify any element of the structure which has not been addressed in the internal assessments and papers submitted to the Council in the course of designing and evaluating the proposed structure; and,
  - 39.3. Comment on their materiality and risk to achievement of the objectives of the proposed structure.
  - 39.4. The proposed Peer Review is intended to be a desktop review of the documentation and assessments made during the course of this process of establishing the holding company structure. It is not intended to consider detailed accounting and administrative issues that flow from implementing the structure but rather the effectiveness and workability of the structure in principle.
40. Mr Turner reported on 28 April 2010 as follows:
  - 40.1. ***Recommendation:***

***I confirm that in my opinion the proposed structure is capable of meeting the objectives and serving the purposes of the Council as set out in Section 1 above.*** [Mr Turner's bolding]

*I do not consider there is a material element of the structure which has not been addressed in the internal assessments and papers submitted to the Council in*

*the course of designing and evaluating the proposed structure. I do note, however, that there remains to be completed aspects of the way in which HBRIC holds and manages its investments (such as, for example, its investment strategy and structures, such as possibly limited partnerships, in which it may hold future investments) which will not be determined by HBRIC until after it is established. Thus my Peer Review is limited to a consideration of the proposed structure and does not extend to issues yet to be resolved and decided by HBRIC.”*

- 40.2. A number of recommendations included by Mr Turner in his report have been used to make changes in the proposed Holding Company structure. The main adjustments are:
- 40.2.1. The freedom for HBRIC to be able to dispose of its investments as it sees fit, has now been amended to include in the Statement of Corporate Intent that the disposal of strategic investments are subject to Council approval and special consultation as required by the Act and controlled investments, which constitute the remainder of the investments transferred by the Council to the Holding Company are to be disposed of only on the approval of Council.
- 40.2.2. The performance targets for “net debt plus equity” has been changed from “40%” to “<40%”.
- 40.2.3. Distributions to shareholders by way of dividends from the Holding Company now include a level of cash distributions that are required by Council as a minimum dividend on each of the first two years.
- 40.2.4. Valuation of HBRIC – changes have been made to ensure that HBRIC will provide the Council with an independent assessment of the market value of the HBRIC group. The first such valuation should be undertaken as at 30 June 2012 and thereafter on 30 June at three yearly intervals.

The full Peer Review report from Mr Turner is **attached** as **Attachment 1**.

## TIMETABLE

41. The following **Table 5** summarises the proposed timetable from 26 February 2010 through to commencement of HBRIC operations on 1 July 2010.
42. **Table 5: Proposed Timetable for Implementation of HBRIC**

COMPLETE BY	TASK	ACTION
Completed	I	Identification of broad principles needing to be resolved
Completed	II	Appointment of specialist tax adviser
Completed	III	Draft SOI and business plan
Completed	II	Stage I report on tax issues from PWC
Completed	III	Complete draft SOI
Completed	VI	Review meeting with Chairman, CEO and Group Manager Corporate Services
Completed	VI	Refine papers for Council as necessary in light of results of review meeting
Completed	VII	Papers to Council (SOI, Business plan, tax issues, implementation principles)
Completed		Refinement of structure in the light of council inputs
Completed	V	Appointment of party to undertake Peer Review
Completed	V	Peer Review Report
12-May-10	VI	Refinement of structure in the light of council inputs and peer review
12-May-10	VII	Papers to Strategic Planning & Finance Committee
19-May-10	VII	<b>STRATEGIC PLANNING &amp; FINANCE COMMITTEE MEETING</b>
19-May-10	VII	Papers to Council (peer review, modifications to design, advertising for directors)
21-May-10	IV	Brief Port of Napier Limited and other relevant stakeholders as required
21-May-10	III	Finalise design, tax and other issues.
26-May-10	VII	<b>COUNCIL MEETING</b>
27-May-10	VIII	Initial public advertisement for independent directors of holding company
28-May-10	II	Appointment of legal adviser
31-May-10	IV	Briefing meeting with CCHL
10-Jun-10	VIII	Applications for positions of independent directors close
18-Jun-10	VIII	Interviews with candidates for independent director positions finish
18-Jun-10	VIII	Documentation of all procedures and policies and establish administration systems
23-Jun-10	VIII	Completion of legal documentation, financing and other arrangements
24-Jun-10		Papers to Council (contractual arrangements, formal documents, directors,etc)
30-Jun-10	VIII	<b>COUNCIL MEETING (to receive final report, make final decisions, select and appoint directors, confirm management and authorise execution of documents)</b>
1-Jul-10	VIII	<b>Commencement of operations</b>

©McDermott Miller, 4 May 2010 - Please note this timetable is subject to independent external inputs and decisions that may change the targeted completion dates.

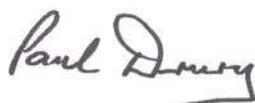
## DECISION MAKING PROCESS

43. As part of the 10 Year Plan 2009/10 Council consulted on the intention to consider the establishment of a Holding Company for the purposes of managing Council's investment portfolio.
44. The review was to be undertaken to establish a Holding Company for Council's investments and is set out in the Investment Policy which was consulted on and included in the final 10 Year Plan 2009-19.
45. Accordingly, the consultation on the Holding Company establishment has been carried out by the Council.

## RECOMMENDATIONS

That the Council Strategic Planning and Finance Committee:

1. Note that the decisions to be made in this paper are part of the process of establishing a Holding Company for Council's Investment portfolio, the establishment of the Holding Company being consulted on as part of the 10 Year Plan 2009-19.
2. Note the Peer Review Report made by Mr Turner, Senior Fellow of the School of Accounting and Commercial Law, Victoria University of Wellington.
3. Approve in principle, the structure and continuing implementation process proposed for HBRIC in this paper.
4. Note that final approval of the holding company structure will be considered by the Council at its meeting on 30 June 2010.



**PAUL DRURY**  
**GROUP MANAGER CORPORATE SERVICES**



**ANDREW NEWMAN**  
**CHIEF EXECUTIVE**

### Attachment:

1. **Peer Review of Proposed Structure – Prepared by Martin Turner, Senior Fellow, Victoria University of Wellington**

**HAWKE'S BAY REGIONAL COUNCIL**

**ESTABLISHMENT OF HOLDING COMPANY**

**FOR MANAGEMENT OF INVESTMENT PORTFOLIO**

**PEER REVIEW OF PROPOSED STRUCTURE**

Prepared by

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28 April 2010

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## INTRODUCTION

On 19 April 2010, the Hawke's Bay Regional Council appointed me to complete a Peer Review of the proposed establishment of a holding company structure to hold and manage the Hawke's Bay Regional Council's investment portfolio ('Peer Review'). The purpose of this Peer Review is to:

- Confirm or otherwise that the proposed structure is capable of meeting the objectives and serving the purposes it is designed for as set out in various papers but most particularly in the presentations to the Council dated 27 May 2009 and 24 March 2010;
- Identify any element of the structure which has not been addressed in the internal assessments and papers submitted to the Council in the course of designing and evaluating the proposed structure; and,
- Comment on their materiality and risk to achievement of the objectives of the proposed structure.

The Peer Review is a desktop review of the documentation and assessments made in the course of establishing the holding company structure of Hawke's Bay Regional Investment Company ("HBRIC"). It is a review of the commercial and financial aspects and I do not comment on the technical taxation and legal issues. These have been the subject of separate specialist advice. There have also been necessarily limitations in the depth and scope of this review due to the requirement to complete the Peer Review over a relatively short period of time. Essentially, the Peer Review process involves the application of a 'fresh pair of eyes' to review what is being proposed to ensure, as far as possible, that the commercial and financial implications have been thoroughly considered prior to establishment of the new structure. There are also a range of specific matters that will need to be determined by the Board of HBRIC immediately after its establishment, such as the development of the investment strategy of HBRIC. There will also be issues of appropriate vehicles to hold new investments of HBRIC. As these have not yet been determined they are outside the scope of this Peer Review.

The terms of reference for the Peer Review are included as Appendix 1.

I am a Senior Fellow in Accounting at Victoria University of Wellington. I have extensive experience in investment banking, funds management and private equity in New Zealand and Australia. This has included establishing and leading AMP Capital Investors' private equity business in New Zealand. Information on my background is included as Appendix 2.

I understand the purposes and objectives of the proposed structure to be as set out on pages 2-3 in the *Establishment of Holding Company, Report to Council Strategic Planning & Finance Committee* by McDermott Miller Limited: Note considered by Council Strategic Planning & Finance Committee on 24 March 2010, namely:

- The council retaining control of strategic decision making about investments requiring council funding because the council will decide whether to provide additional equity to HBRIC (from its cash or other investments) or approve new debt, for each new deal;
- Facilitating investment to achieve strategic economic development objectives for the Hawke's Bay Region;
- Retaining currently non-taxable assets in direct Council ownership to:
  - Preserve Council control of strategic investment issues; and,
  - Maximise tax-paid returns to the council from those assets.
- While still achieving the objectives of:
  - Improved returns from the investment portfolio a whole;
  - Providing an effective platform for engaging with other public and private sector investors in future development projects;
  - Ring-fencing particular investment risks;
  - Facilitating exits from "corporatized" investments, whether to realise profits, introduce other shareholders or dispose of underperforming investments;
  - Securing greater commercial focus in Council investment decision-making by formally accessing commercial experience from within the region and elsewhere in New Zealand through the appointment of external people to the HBRIC Board; and
  - Ensuring the Council's corporate tax-paying entities, (for example Port of Napier Limited), are moved to a more efficient tax structure of the holding company and improve financial returns as a result.

A further purpose is to ensure investments are made at all times for the benefit of the Hawke's Bay Region as a whole. It is intended that this requirement will be embedded in HBRIC's company constitution and in the Statement of Intent between the Council and HBRIC.

## 1. MATERIALS REVIEWED

I have completed a desktop review of these materials:

- The following reports and presentations made to the Hawke's Bay Regional Council and its Executive Team:
  - *Hawke's Bay Regional Council Investment Portfolio Mix: Strategic Positioning Review, Final Report to Steering Group* by McDermott Miller Limited dated 30 September 2008.
  - *Hawke's Bay Regional Council, Managing Investments through a Holding Company: Council Presentation* by McDermott Miller Limited dated 27 May 2009.
  - *Hawke's Bay Regional Council, Case for Managing investments Through a Holding Company*, by McDermott Miller Limited: Note considered by Council on 27 May 2009.

- *Establishment of Holding Company, Report to Council Strategic Planning & Finance Committee* by McDermott Miller Limited: Note considered by Council Strategic Planning & Finance Committee on 24 March 2010.
- The Draft Statement of Corporate Intent for the proposed holding company:
  - *Hawke's Bay Regional Council, Establishment of Holding Company Appendix A, Draft Statement of Intent 2009-2011 For Hawke's Bay Regional Investment Company ("HBRIC")*, by McDermott Miller Limited: considered by Council Committee on 24 March 2010.
  - *Hawke's Bay Regional Council, Establishment of Holding Company Appendix A, Draft Statement of Intent 2009-2011 For Hawke's Bay Regional Investment Company ("HBRIC")*, by McDermott Miller Limited: updated as a result of Council Committee meeting decisions on 24 March 2010 and dated 19 April 2010.
- Draft taxation advice received from PricewaterhouseCoopers (PwC) dated 30 November 2009.
- *Draft Ten Year Plan 1 July 2009 – 30 June 2019 Hawke's Bay Regional Council Part 5 Policies: Investment Policy* pages 13 – 23 ("LTCCP 2009-19").

I also had a meeting with Richard Miller, Managing Director, and Robert Philpott, Principal Economist, McDermott Miller Strategies on 20 April 2010. At this meeting I was given a background briefing about the proposed establishment of a holding company structure to hold and manage the Hawke's Bay Regional Council's investment portfolio and was also provided with various materials to review. I have had two further telephone conversations with Robert Philpott to gain further clarification and information about aspects of the proposal.

I have not completed a review of any additional information about the proposal other than the material that has been provided to me and which is outlined above.

## **2. RECOMMENDATION**

**I confirm that in my opinion the proposed structure is capable of meeting the objectives and serving the purposes of Council as set out in Section 1 above.**

I do not consider there is a material element of the structure which has not been addressed in the internal assessments and papers submitted to the Council in the course of designing and evaluating the proposed structure. I do note, however, that there remains to be completed aspects of the way in which HBRIC holds and manages its investments (such as, for example, its investment strategy and structures, such as possibly limited partnerships, in which it may

hold future investments) which will not be determined by HBRIC until after it is established. Thus my Peer Review is limited to a consideration of the proposed structure and does not extend to issues yet to be resolved and decided by HBRIC.

In Section 4 below, I make a number of comments, observations and suggestions for Council to consider when finalising the proposed holding company structure to hold and manage the Hawke's Bay Regional Council's investment portfolio. These may enhance and support the objectives and purposes of Council in setting up HBRIC.

### 3. FURTHER COMMENTS

I would make the following general comments on some of the key features of the Draft Statement of Intent 2009-2011 for HBRIC dated 19 April 2010:

- **Mix of commercial and 'strategic' objectives:** The objectives of HBRIC require it to consider a mix of both commercial objectives to actively manage its investment portfolio to maximise shareholder value and also 'strategic' objectives. Indeed, to "[h]elp achieve the council's regional strategic economic development objectives ... HBRIC may accept a lower return or slower route to profitability to balance achieving this objective with that of otherwise acceptable returns" (Draft Statement of Intent, page 2). These 'strategic' benefits could be expected to generally be difficult to quantify and will rely on the judgements of Board members and advisers. There will also be difficulties in monitoring the realisation of these anticipated 'strategic' benefits to the region. There are, of course, dangers with a mix of commercial and 'strategic' objectives and the need to balance and trade them off between each other that should be clearly recognised and appreciated at the outset. It is thus important to ensure that in the structure the accountability of HBRIC for the commercial performance of the investments for which it is responsible is not compromised by its ability to also pursue 'strategic' objectives.
- **Wide investment mandate:** HBRIC has a very wide investment mandate. This includes property and infrastructure in New Zealand, equities in listed and unlisted companies, equity (and loans) in joint ventures, fixed interest securities and other financial instruments. It is also able to borrow without any restrictions. I consider this flexibility in the investment mandate of HBRIC to be appropriate. However, the wide investment mandate also underlies the importance of having clear and effective accountability mechanisms between HBRIC and the Council and in particular the importance of HBRIC finalising its Statement of Intent and its investment policy as its first tasks upon establishment.
- **Freedom to dispose of investments:** HBRIC is also able to freely dispose of its investments as it sees fit.

- **Requirement to conform to Council's overarching Investment Policy:** HBRIC is able to set its own investment policy but the investment mandate of HBRIC is limited by the Council's Investment Policy detailed in its LTCCP 2009-19.

I would make the following suggestions concerning the HBRIC proposal:

- **HBRIC Investment Policy:** That an early task of the board of HBRIC be to finalise its investment policy and agree this as part of its first Statement of Intent with the Council. In my opinion, it would be important for the board of HBRIC to place some reasonable limits on its investment policy, most particularly:
  - a. how much it is permitted to borrow as a percentage of its total value of investments. The amount of borrowings of HBRIC could be expressed in terms of 'net debt', namely HBRIC debt less any loans provided by HBRIC to Council.
  - b. A range of relevant restrictions on its investment decision making that makes clear what will be the focus of the investment strategy of HBRIC.

This is an important early task to complete given the wide investment mandate of HBRIC. It would also be an important aspect of the communication between the Board of HBRIC and the Council about the agreed investment strategy and approach of HBRIC.

I understand HBRIC may be a useful vehicle to provide flexibility for funding for the Council more generally. This should be included expressly in the investment policy of HBRIC.

- **HBRIC and Port of Napier Limited ("PONL") Common Directors:** That Council should consider appointing two 'commercial' directors of HBRIC to the PONL board. HBRIC should also ensure it is actively involved in the process of identification and selection of directors of PONL.

Given the strategic importance of the Council's investment in PONL, as an interim measure, it could be considered to appoint one 'commercial' director and also the CEO of Council to PONL (for a period of about 12 months). This could allow the relationship between HBRIC and PONL to be clearly established prior to the CEO of Council stepping down from the PONL board and being replaced by a second 'commercial' director. This arrangement would have the benefit of strengthening and supporting strong informal communications between the PONL and HBRIC boards and establish a supportive commercial relationship between the Council and PONL and also ensure Council's strategic intentions with its investment in PONL are communicated clearly to the PONL board. Given the strategic importance of the PONL investment, this investment should be an important initial focus for HBRIC. Given HBRIC's active investment mandate, it would be important for HBRIC to have an active involvement with PONL strategically (but not, of course, operationally).

- **Council's Investment Policy:** That Council could consider making the following three changes in future to its Investment Policy detailed in Section 9 of its LTCCP 2009-19 (page 22):
  - a. The third responsibility of Council is to 'Approve investments...'. This does not explicitly include 'divestments'. In a future version of the investment policy of Council I would suggest including divestments. This responsibility of Council can be delegated to HBRIC.
  - b. There is an investment management responsibility ('Approve new investments or significant divestments...') where the responsible entity is 'Council and/or Holding Company'. It is thus unclear which responsible entity is in fact responsible for this responsibility. In a future version of the Investment Policy of Council I would suggest making the Council the responsible entity and to include this responsibility as a responsibility that can be delegated in whole or in part to a holding company.
  - c. The fourth responsibility of Council includes the responsibility to appoint directors 'in any holding company' (for example, HBRIC). This responsibility is able to be delegated by Council to a holding company (for example, HBRIC). I suggest in a future version of the Investment Policy of the Council that this ability to delegate the appointment of directors in HBRIC to the board of HBRIC be removed.
- **Performance targets - unadjusted:** That the performance targets for HBRIC be adjusted as follows: 'Net debt to Net Debt plus Equity' Target: ' $\leq 40\%$ ' rather than '40%'.
- **Performance targets – adjusted:** Performance targets for HBRIC "may be adjusted as a result of potentially lower returns as a result of HBRIC being required to assist certain of the council's strategic economic objectives or from council's designation of certain assets as 'strategic' or 'controlled'." (page 3). This will provide a discipline of seeking to quantify the financial opportunity costs of strategic investments, although of course the benefits of these strategic investments will be difficult to quantify.

This use of overall adjusted performance targets is probably appropriate for reporting by HBRIC to Council. However, I strongly recommend that in the internal management of investments by HBRIC that instead of adjusting the overall performance targets of HBRIC as a result of making 'strategic' investments it would be more effective to retain the overall performance targets of HBRIC and instead reduce the targets in relation to individual investments or groups of investments. Thus a specific individual 'strategic' investment (or group of 'strategic' investments) would have a different earnings or capital growth target. Thus in its own internal assessment of its performance, HBRIC would consider its performance results in relation to its investment portfolio without its

'strategic' investments, which would be evaluated against its overall unadjusted performance targets; its 'strategic' investments which would be evaluated against their specific adjusted targets; and the overall performance of the investments of the HBRIC which would be the addition of the performance of its investment portfolio without its 'strategic' investments plus the performance of its 'strategic' investments.

Such an approach by HBRIC to the internal assessment of its performance would help ensure clear delineation of the financial opportunity costs of making particular strategic investments. This would assist in the subsequent evaluation of the net benefit of strategic investments after making subsequent assessments of their strategic economic benefit.

Given the mixture of commercial and 'strategic' factors in the investment mandate of HBRIC, I consider it critical for HBRIC to ensure it carefully monitors each of these two aspects of its mandate separately. It will also be important to clearly identify where the decision to make a particular 'strategic' investment was a decision of HBRIC alone or where it was also a decision of the Council.

- **Distributions to Shareholder:** It is noted that the provisions about distributions by HBRIC to Council in 'Section 10 Distributions to Shareholder' will not ensure that the current level of cash distributions to the Council from the investments transferred to HBRIC will be maintained in the future. This is because of the ability HBRIC has to borrow significantly and thus reduce its Net Profit after Tax (NPAT) through the payment of interest on borrowings. Mechanisms would need to be introduced into the annual budgeting processes of Council to ensure levels of cash flow to be provided by HBRIC are agreed between HBRIC and Council each year.
- **Expenses by HBRIC:** The Draft Statement of Intent for HBRIC is silent on the issue of expenses, such as expenses in relation to the use of external advisers. The Council might like to consider what level of control it may want to have over these expenses. For example, it might want HBRIC to include a budget for expenses in its draft Statement of Intent each year; or alternatively, to include a 'cap' on expenses (which it will not exceed without reverting to Council) in its draft Statement of Intent each year. My suggestion would be to include an annual cap on expenses in the Draft Statement of Intent.
- **Appointment of Chief Executive of PONL:** Section 11 Corporate Governance of the Draft Statement of Intent for HBRIC states that "HBRIC will appoint Chief Executive or principal officer of all its subsidiaries." (page 9). This would include PONL as a subsidiary of HBRIC. I would suggest appointment of the Chief Executive of PONL should be by the board of PONL, subject to confirmation by HBRIC. A key function of the board of PONL would be the appointment of the Chief Executive. As 100% shareholder of PONL, involvement in the appointment of a

Chief Executive of PONL should be part of HBRIC's active investment strategy. The appointment of two 'commercial' directors of HBRIC on the PONL board would support the process of appointment of a Chief Executive of PONL. Thus I suggest Section 11 Corporate Governance of the Draft Statement of Intent for HBRIC be adjusted to state that "HBRIC will confirm the appointment of Chief Executive of PONL and appoint Chief Executives or principal officers of all its other subsidiaries." (page 9).

- **Valuation of HBRIC:** I consider it would be appropriate for HBRIC to provide the Council with an independent assessment of the market value of the HBRIC group every three years. However, clearly HBRIC would need to assess its own market value more frequently than every 3 years. This should be done at least annually and preferably six-monthly. This may not require a published independent valuation but should require the Board to consider an assessment of its value using the skills of either the commercial board members, members of its investee companies or external advisers. Given the investment mandate of pursuing both income and capital gains a regular evaluation of capital value is important. A useful way of reporting such a regular review of values might be by way of an internal memorandum of market values which could be provided to council officers say every six months. Any significant movements in value could be reported to Council.
- **Reporting by HBRIC to Council:** Reporting by HBRIC to Council will be an important issue given its wide investment mandate, the need to protect commercially sensitive information from unnecessary or premature public disclosure and the need to ensure commercial and investment decision-making is retained by HBRIC within its delegated authorities while maintaining proper governance and monitoring of HBRIC by the Council.

HBRIC can report on its overall performance without having to give too much detail about individual investments that may be commercially sensitive from time to time. To the extent it provides performance figures and valuations of its total portfolio this would be less likely to disclose commercially sensitive information about any particular investment of HBRIC than valuations and other information specific to individual investments. For example, one issue would be whether HBRIC should provide an annual valuation of PONL. Given the strategic importance to Council of its investment in PONL, I would suggest Council should require this. This would not necessarily need to be a full 'independent valuation' which could be provided every three years but should be the assessment by the directors of HBRIC of its value after taking appropriate advice. Also, investments such as development projects could be usefully valued at cost for a period until the benefits of the projects become more apparent. A determination by HBRIC of its internal valuation processes and valuation approaches would be an early task the board of HBRIC would need to complete.

I also agree that at least twice annual briefings to Council by HBRIC on its performance would be important.

- **Taxation advice:** PwC have provided draft taxation advice dated 30 November 2009. Final taxation advice should be obtained from PwC in relation to the holding company structure now being proposed. They should also be asked to consider the issue of the most appropriate vehicles for holding future investments of HBRIC. This advice should be provided prior to finalising and implementing the holding company structure.

**APPENDIX 1****TERMS OF REFERENCE****Purpose**

The Peer Review of the proposed establishment of a holding company structure to hold and manage the Hawke's Bay Regional Council's investment portfolio is intended to:

- Confirm or otherwise that the proposed structure is capable of meeting the objectives and serving the purposes it is designed for as set out in various papers but most particularly in the presentations to the Council dated 27 May 2009 and 24 March 2010;
- Identify any element of the structure which has not been addressed in the internal assessments and papers submitted to the Council in the course of designing and evaluating the proposed structure; and,
- Comment on their materiality and risk to achievement of the objectives of the proposed structure.

**Review**

The Peer Review is intended to be a desktop review of the documentation and assessments made in the course of establishing the holding company structure.

The Reviewer will need to consider a range of documents for this purpose, including:

- Reports and Presentations made to the Hawke's Bay Regional Council and its Executive Team;
- The Draft Statement of Corporate Intent for the proposed holding company; and,
- Taxation advice received from PricewaterhouseCoopers.

**Schedule**

The Peer Review will commence immediately upon appointment by the Council. The Reviewer's Report will be required by 28 April 2010.

**APPENDIX 2****MARTIN TURNER****BACKGROUND INFORMATION**

Martin Turner is a Senior Fellow in the School of Accounting and Commercial Law at Victoria University of Wellington. He teaches financial statement analysis, introductory accounting and corporate finance to MBA and undergraduate accounting and finance students. He also researches aspects of accounting education, particularly how to support accounting students to develop critical thinking skills. He joined Victoria University in June 2006, after having had an association with the university in a part-time teaching capacity for 18 months. He remains a director of Falcon Private Equity, which he established in 2004 to advise investors in private equity in New Zealand.

In 1998, Martin established and subsequently managed the private equity operations of AMP Capital in New Zealand. Over six years, Martin invested \$220 million into 22 investments in New Zealand private equity. He has served on the boards of a number of New Zealand private companies and investment funds. He also has experience in funds management, institutional and retail marketing, and investment banking. He has a B.Com (Hons 1), LLB and MBA. He was a University Medallist and came top of his combined Commerce/Law degrees at the University of New South Wales in Sydney, Australia. He won the Prize for Finance in his MBA, which he completed at the Australian Graduate School of Management (AGSM).

Martin has both New Zealand and Australian citizenship. He lives in Wellington with his wife and three children.