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Ministry for Primary Industries
Manatū Ahu Matua



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Institutional Arrangements for Crown Irrigation Investment Company

Purpose:

To seek agreement on key institutional arrangements for the Crown Irrigation Investment Company (CIIC) and for the shareholding Ministers to give initial guidance to the company about their expectations of returns.

Minister	Action Required:	Ministers' Deadline
Minister of Finance Minister for Primary Industries	Agree to the recommendations in paragraph 24.	By 12 April 2013. Note that the CIIC Establishment Board may provide some comments to Ministers following its first meeting on 22 March 2013.
Cc: Associate Minister for Primary Industries		

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Contact for telephone discussion (if required)

	Name	Position	Work	After Hours
Responsible Manager	Karen Adair	Acting Director, Sector Policy	04 819 4467	021 409993
Principal Author	Damian Diack	Project Manager	04 894 0123	

Key Messages

Background and introduction

1. Cabinet has agreed to support Crown investment in irrigation schemes, has set aside \$80 million for 2013-2014 for this purpose and signalled a willingness to invest up to \$400 million [EGI Min (12) 29/5 refers]. Cabinet agreed that a Crown-owned company should be established to manage investments in irrigation. Crown Irrigation Investment Company (CIIC) is a working name for the company.
2. This paper is long. We have tried to keep it as concise as possible. This briefing covers several critical areas under the broad area of institutional arrangements for CIIC. We thought it best to present all the arguments and advice in one place rather than across several separate briefings.
3. An Establishment Board for CIIC has been appointed, and the company will be formed on 1 July 2013. This paper has been provided to the Establishment Board for their reference, however the recommendations are for Ministers as its shareholders. The Establishment Board is likely to write to you with their views on the proposed institutional arrangements, in accordance with their Terms of Reference.
4. There is an established division of responsibilities between Ministers (as shareholders) and Crown-owned companies. The Shareholders' role is primarily to set the framework in which the company will operate and monitor performance against this. The company operates within this framework, including making day-to-day decisions, and is, therefore described as operating "at arm's length". Consistent with this, many of CIIC's investment decisions will not require shareholder approval unless approval is required under the Crown Entities Act 2004 or the Companies Act 1993. This approach makes clear responsibility for individual investments lies with CIIC and avoids perceptions of political interference.

Institutional arrangements

5. There are a number of choices about institutional arrangements for CIIC. These relate to:
 - a. type of Crown-owned company;
 - b. Crown Entities Act 2004 (CEA) exemptions;
 - c. constitutional purpose and nature;
 - d. initial funding mechanism; and
 - e. monitoring agency.
6. This paper also proposes some initial guidance for shareholders to give to CIIC about their expectations of returns.

Type of Crown-owned company

7. CIIC should be established as a Crown entity company (CEC) as opposed to a State Owned Enterprise or Public Finance Act company because it will:
- not seek to maximise profits in line with a comparable private business as a State Owned Enterprise must. It will invest without necessarily expecting a commercial rate of return; and
 - be fully Crown-owned at least in the first instance which is a requirement for CECs. The Minister of Finance and Minister for Primary Industries will be full and equal shareholders. Public Finance Act companies provide for mixed ownership, but this is not necessary for CIIC.

Crown Entities Act exemptions

8. CECs are established as standard companies under the Companies Act 1993 and then listed, by Order in Council, on Schedule 2 of the CEA, which imposes certain obligations. The Order in Council specifies whether they are subject to, or exempt from, sections 161-164 of the CEA which restrict: acquisition of securities, borrowing, giving of guarantees and indemnities, and derivatives to circumstances prescribed by regulation, or with an approval from the Minister of Finance. The table below describes our recommendations for CEA exemptions:

Table 1: Crown Entities Act exemptions

Restriction	Exemption?	Comment
Acquisition of securities	Yes	CIIC will acquire securities when making investments. This may be periodic and frequent. Requiring shareholder approval would be cumbersome and erode the "arm's length" relationship.
Borrowing	No	Ministers should control the level of funding available to CIIC to invest, as they are best placed to assess opportunity cost. If CIIC borrows without Ministerial approval it essentially increases the funding it has available to invest.
Giving guarantees and indemnities	No	In some circumstances CIIC may use guarantees and indemnities as a substitute for investment in irrigation schemes. If it were to do so this may involve potential financial exposure beyond the level of funding provided by shareholders. Ministerial approval is therefore appropriate.
Derivatives	No	The use of derivatives may help CIIC to achieve its policy objectives, and to manage risks associated with specific investments. Derivatives are likely to be used in its investment structures. Shareholders should approve CIIC's risk

		<p>management policies and the associated use of derivatives that 1) contribute to its business needs, and ability to achieve its policy objectives and 2) of which CIIC is able to demonstrate its appropriate risk management.</p> <p>This set-up would allow for CIIC to operate at “arm’s-length” from Ministers, but would restrict their use of derivatives to an initial framework that has been agreed by Ministers.</p>
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9. MPI recommends that you agree to expedite the Cabinet Committee process and submit the proposed exemptions to the Crown Entities Act directly to Cabinet Legislation Committee (LEG) rather than taking the proposal to both the Cabinet Economic Growth and Infrastructure Committee (EGI) and LEG. This process has Parliamentary Counsel support. They have advised us that the combination of EGI approval of 12 December 2012 and Ministerial decision (as in this paper) is sufficient for them to commence drafting the proposed Order-in-Council.

Constitutional statement on purpose and nature of the company

10. CECs have constitutions. These provide an opportunity to state the purpose and nature of the company, and give guidance to the Board of the company who must comply with the constitution. Most provisions are standard and a full draft constitution for CIIC will be provided to shareholders at a later time.
11. Our proposal for the purpose and nature section of the company is included in the boxed text below. This has been developed between the Ministry for Primary Industries (MPI), the Treasury and the State Services Commission.

Purpose of the company

The purpose of the company is to implement government policy by co-investing in off-farm irrigation schemes which would not otherwise be established and are expected to be commercially viable in the long term; and to seek to exit those investments once they become commercially viable.

In doing so the company will:

- manage investments using best practice investment management approaches; and
- not seek a controlling interest in irrigation schemes.

Nature of the company

In doing so CIIC:

- will seek to maximise returns to its shareholders to the extent that this is consistent with achieving its purpose;
- will seek to minimise the amount and term of its investment in individual schemes, subject to the achievement of its purpose; and
- must operate in a financially responsible and fiscally efficient manner.

Initial funding mechanism for CIIC

12. We recommend uncalled capital as the most appropriate mechanism to provide the initial \$80 million of funding to CIIC, to fund both its initial operating expenses and investments. Uncalled capital is a way for shareholders to commit to providing capital without providing cash up front. Shares are issued to shareholders who commit to pay for them when their capital is "called". The terms under which a call could be made would be specified in a subscription agreement to be agreed between CIIC and shareholding Ministers.
13. Funding through uncalled capital means that:
 - a. shareholders set the overall level of funding available to CIIC, but CIIC is able to determine when and in what schemes it invests; and
 - b. CIIC has access to funding when it needs it, but does not have to manage surplus funds.

Monitoring agency

14. We recommend that the Crown Ownership Monitoring Unit (COMU) be responsible for monitoring CIIC. COMU monitors most Crown-owned companies, and has the systems, processes and specialist resources to do this effectively. COMU, and MPI as the policy lead for irrigation investment, will work together during the establishment phase to ensure clarity of the respective responsibilities of our agencies.
15. COMU has commenced consideration of the appropriate monitoring regime for CIIC and how it should be funded, and will provide further advice to you as shareholding Ministers.

Returns to shareholders

16. The standard monitoring arrangements for Crown-owned companies include an ongoing discussion between shareholders, their representatives and companies about the expectations of returns to shareholders. It would be useful for shareholders to set out their expectations about returns before CIIC is established, as these may frame the development of its investment and business models.

Returns from divestment to be provided to shareholders

17. Over time, irrigation schemes are expected to become commercially viable, CIIC will begin to exit investments and the case for further investment in irrigation will decrease as more schemes are developed. When CIIC divests from schemes, it will receive returns of capital.

18. A key decision for shareholders therefore, will be to set expectations about returns in the medium term when CIIC divests. This would provide greater clarity to the Establishment Board. There are two broad options for returns that CIIC receives from divestment:
- a. that CIIC should return any capital divested from schemes directly to the Crown. This approach would:
 - limit the investment in irrigation schemes to the amount that Cabinet has signalled it is willing to invest (up to \$400 million), less any CIIC operating costs which will also be funded from the \$400 million, and
 - enable Cabinet to explicitly take decisions on increasing investment in irrigation schemes beyond the maximum \$400 million, and to weigh up irrigation priorities against competing priorities across Government; or
 - b. that CIIC should use returns from divestment to reinvest in subsequent irrigation schemes until shareholding Ministers state otherwise. This approach could enable CIIC to continue to invest beyond the amount Cabinet has signalled it is willing to invest as equity (up to \$400 million).
19. We recommend that shareholders indicate an 'in principle' expectation that CIIC should return all returns from divestment to the Crown unless otherwise indicated by shareholders.

No expectation of short term returns to shareholders

20. Shareholders should acknowledge that a cash surplus is unlikely to arise in CIIC's initial period of operations and is therefore unlikely to provide returns.
21. In its initial period of operations CIIC:
- a. will invest in schemes that will not be immediately commercially viable;
 - b. is expected to forecast greater investment outflows than forecast returns; and
 - c. is likely to receive cash injections called from shareholders.
22. If shareholders did indicate an expectation of returns either:
- a. CIIC would only be able to invest in schemes where it believes it will generate the level of returns required to meet expectations, which may constrain achievement of its policy objectives; or
 - b. CIIC would need to account for the need for returns when requesting additional funds from the Crown. This is a 'zero-sum' game, and is not a genuine return.

CIIC to use earnings to fund operational costs

23. CIIC may receive earnings from the investments that it makes in irrigation schemes such as cash dividends, or interest payments on loans. CIIC should use these earnings to cover or contribute to operating expenses. Operating expenses would otherwise be funded from capital contributions from shareholders, decreasing the capital able to be invested in irrigation schemes. Funding operational costs through earnings provides CIIC with the opportunity to utilise a revenue stream that is independent from shareholder contributions, to support its financial sustainability. In the event that earnings are greater than CIIC's operational costs, the excess should be returned to shareholders. The details of this approach are covered by a dividend policy.

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Recommendations

24. MPI recommends that you:

Crown-owned company

- a. **Note** that Cabinet has agreed to setup a Crown-owned irrigation investment company (CIIC);

Noted

- b. **Agree** that Ministers should not have a role in approving individual company investments in off-farm irrigation schemes beyond those set out in legislation;

Agreed/Not agreed

- c. **Agree** that CIIC should be established as a Crown Entity Company, listed on schedule 2 of the Crown Entities Act 2004;

Agreed/Not agreed

Crown Entities Act exemptions

- d. **Agree** that CIIC should be exempt from section 161 of the Crown Entities Act 2004 which restrict the acquisition of securities;

Agreed/Not agreed

- e. **Agree** that CIIC be subject to section 162 of the Crown Entities Act which restricts borrowing;

Agreed/Not agreed

- f. **Agree** that CIIC should be subject to section 163 of the Crown Entities Act which restricts the giving of guarantees and indemnities;

Agreed/Not agreed

- g. **Agree** in principle that CIIC should be able to use such derivatives approved by the shareholders to structure the investments that it makes to achieve policy objectives;

Agreed/Not agreed

- h. **Agree** that CIIC should be subject to section 164 of the Crown Entities Act which restricts the use of derivatives;

Agreed/Not agreed

- i. **Note** that to give effect to recommendation (g) above approval from the shareholding Ministers will be sought for CIIC's risk management policies and a standing approval of the associated use of derivatives for CIIC to achieve its objectives;

Noted

Constitutional statement on purpose and nature

- j. **Agree** that CIIC's constitution should include the following statement regarding the purpose and nature of the company:

Purpose of the company

The purpose of the company is to implement government policy by co-investing in off-farm irrigation schemes which would not otherwise be established and are expected to be commercially viable in the long term; and to seek to exit those investments once they become commercially viable.

In doing so the company will:

- manage investments using best practice investment management approaches; and*
- not seek a controlling interest in irrigation schemes.*

Nature of the company

In doing so the company:

- will seek to maximise returns to its shareholders to the extent that this is consistent with achieving its purpose;*
- will seek to minimise the amount and term of its investment in individual schemes, subject to the achievement of its purpose; and*
- must operate in a financially responsible and fiscally efficient manner.*

Agreed/Not agreed

Funding arrangements

- k. **Agree** that initial funding for CIIC should be provided as uncalled capital;

Agreed/Not agreed

- l. **Note** that the subscription agreement for uncalled capital will include criteria for the circumstances in which capital can be called;

Noted

Monitoring agency

- m. **Agree** to recommend to Cabinet that the Crown Ownership Monitoring Unit (COMU) be responsible for monitoring CIIC;

Agreed/Not agreed

- n. **Note** that COMU will provide advice to shareholding Ministers on the monitoring plan for CIIC;

Noted

Returns to shareholders

- o. **Agree** to indicate to CIIC an expectation that it will provide returns to shareholders when it receives them from divestment (rather than reinvesting or using them to cover operating expenses);

Agreed/Not agreed

- p. **Note** that CIIC is unlikely to provide returns to shareholders in the short term;

Noted

- q. **Agree** that CIIC should fund operating expenses from any earnings it receives from investments;

Agreed/Not agreed

Next steps

- r. **Note** that Cabinet has authorised the shareholding Ministers to approve CIIC's business plan, including its constitution and operating guidelines; and

Noted

- s. **Agree** to take the Order-in-Council seeking Crown Entities Act exemptions direct to Cabinet Legislation Committee, bypassing Cabinet Economic Growth and Infrastructure Committee.

Agreed/Not agreed

Karen Adair
Acting Director
Sector Policy

Hon Bill English
Minister of Finance
/ / 2013

Hon Nathan Guy
Minister for Primary Industries
/ / 2013

Background

25. Water storage and off-farm irrigation infrastructure has the potential to enhance land productivity and significantly increase returns to the agricultural sector and the New Zealand economy. The government has announced its intention to invest in off-farm irrigation schemes.
26. Cabinet has set aside \$80 million as a commitment against the 2013 Budget Capital Allowance, and signalled that it may invest up to \$400 million.
27. Cabinet agreed to form a Crown-owned company under the Companies Act 1993 to manage the Crown’s investment in irrigation infrastructure. Crown Irrigation Investment Company (CIIC) is a working name. Cabinet chose to establish CIIC:
 - because of the complexity of the decisions required, due to the size and the commercial nature of investments and the impacts on regional and national development; and
 - to remove any perception of decisions being influenced by political considerations.
28. The Minister of Finance and the Minister for Primary Industries are to be full and equal shareholders of the company. In this paper we describe these Ministers as “shareholders”.
29. CIIC will be established on 1 July 2013. In the meantime, an Establishment Board has been appointed to begin planning for CIIC’s business operations.

The Crown-owned company model

30. Establishing a Crown-owned company implies a certain division of responsibilities between shareholders and the company. The role of shareholder is to set the framework in which the company will operate, and monitor performance against that framework. The company works within that framework, and makes day-to-day decisions. The company is therefore described as operating “at arm’s length”.
31. More detail about the roles that are generally held by shareholders, and the company, are set out in the table below.

Table 1: The Crown-owned company model

Role for shareholders (Ministers)	Role for Company (as governed by its Board of Directors)
Appoint or dismiss directors	Directors are responsible for the governance of the company, and appoint employees as management Management is responsible for the day-to-day operations of the business
Approve (and alter) the company constitution	Act consistently with the constitution

Role for shareholders (Ministers)	Role for Company (as governed by its Board of Directors)
Review draft Statements of Intent provided by the company, and propose any amendments	Prepare a Statement of Intent
Provide the company with an annual letter of expectations (including any expectations about returns to shareholders)	Act in accordance with the letter of expectations (including meeting any expectations about returns to shareholders)
Receive an Annual Report from the company	Prepare an Annual Report
Receive quarterly reports from the company	Prepare quarterly reports for shareholders
Provide the company with funding through the acquisition of shares	Operate within the funding provided by shareholders (and any additionally sourced revenue) Advise shareholders of any request for additional funding
Approve major transactions	Make recommendations to shareholders about major transactions Take decisions about other transactions without seeking approval from shareholders

Implications for shareholders in investment decision making

32. The monitoring process for a Crown-owned company (including Statements of Intent and quarterly reporting) will allow shareholders to engage with CIIC about its overall investment strategy. However, an important implication of the Crown-owned company model is that shareholders' formal role in approving investments in irrigation schemes is limited to circumstances prescribed by legislation. These are:

- under the Companies Act, any transaction that is valued at more than half the asset base of a company is deemed a "major transaction" and needs to be approved by shareholders; and
- under the Crown Entities Act 2004, many Crown-owned companies are required to seek shareholder approval to acquire subsidiaries.

33. In practice, this means that shareholders are likely to be required to approve CIIC's initial investments in irrigation schemes. They are likely to be major transactions because they will represent more than half of CIIC's asset base. However, it is likely that as CIIC grows and its asset base increases it will make investments without formal approval from shareholders.

34. There are opportunities to vary the standard Crown-owned company model and provide a larger role for shareholders. For example CIIC’s constitution could provide for shareholder approval of all investments in irrigation schemes. However, we do not consider that this is appropriate because:

- this would be inconsistent with Cabinet decisions. In the December 2012 Cabinet paper the Minister for Primary Industries wrote: “I am proposing that all investment decisions and management of the Crown’s investments be delegated to an independent Board of a Crown-owned company established specifically for this purpose”;
- CIIC’s Board will be appointed by shareholders with a view to ensuring relevant skills and experience to make sound investment decisions;
- the Board’s decisions will be framed by their obligation to act in their shareholders’ interests; and
- there may be a perception that investment decisions are politically motivated, if approved by shareholders.

35. In the institutional arrangements proposed in this paper we have not sought to extend the role for shareholders to approve individual investments beyond those described in legislation. This will insulate Ministers from responsibility for individual investments and avoid perceptions of political interference.

Decisions about institutional arrangements

36. Cabinet has agreed that CIIC should be established as a Crown-owned company. There are a number of decisions that need to be taken about the detail of institutional arrangements that will frame CIIC’s operation. The following key questions are considered in this paper:

- What sort of Crown-owned company should CIIC be?
- What Crown Entities Act exemptions should be provided to CIIC?
- What should CIIC’s constitution say about its purpose and nature?
- How should CIIC receive its initial funding?
- Which government agency should be responsible for monitoring CIIC on behalf of its shareholders?

Criteria for decision making

37. In seeking to answer key questions about CIIC’s institutional arrangements we have considered three criteria which are set out in the table below.

Table 2: Criteria for decision making re institutional arrangements for CIIC

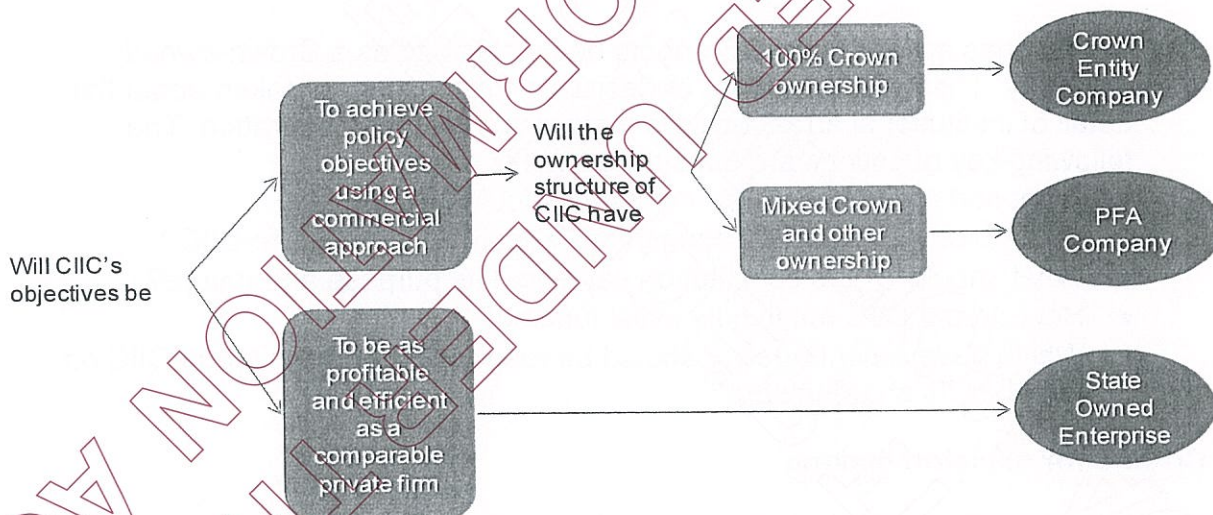
Criteria	Comment
Recognition of appropriate roles for shareholders and the company’s board	<p>There is an established division of roles between shareholders and a Crown-owned company, as set out in Table 1 above.</p> <p>We understand that this division of roles was a key reason for establishing CIIC <i>as a company</i> and have sought to maintain it in proposing institutional arrangements.</p>

Criteria	Comment
Consistency with the Cabinet agreed investment principles	Cabinet agreed a set of investment principles for CIIC. These set out expectations about its operations, including in what circumstances it will invest, and how it will manage investments. Taken together the principles also give a clear indication of CIIC's purpose and objectives. We have sought to recognise, and provide for the application of, the investment principles in proposing institutional arrangements.
Adoption of best practice Crown-owned company design	We have sought to reflect best practice Crown-owned company design in proposing institutional arrangements for CIIC for example ensuring consistency with legislation and seeking to appropriately address risk to the Crown.

What sort of Crown-owned company should CIIC be?

38. Three forms of Crown-owned company were considered for CIIC:
- Crown Entity Company (CEC);
 - Public Finance Act 1989 Company (PFA); and
 - State Owned Enterprise (SOE).
39. Figure 1 below shows the framework used to determine which is most appropriate for CIIC.

Figure 1: Crown-owned company characteristics



40. This framework reflects that:

- SOEs must seek to be as profitable as comparable private businesses. This is not necessarily the case for CECs and PFA companies; and
- with proposed amendments to the Public Finance Act 1989 this year¹ the only remaining material distinction between CECs and PFA companies will be ownership requirements. CECs must have 100 percent Crown ownership while PFA companies must only be majority Crown-owned.

¹ Previously PFA companies had a more permissive regime than CECs however the Public Finance and State Sector Reform Bill which is currently before Parliament, and expected to be passed in the coming months changes the regime for PFA companies, meaning that the only remaining material distinction between them and CECs is ownership requirements.

41. The most appropriate organisational form for CIIC is a CEC, as CIIC will:
 - not seek to maximise profits in line with comparable private businesses. It will invest without necessarily expecting a commercial rate of return²; and
 - be 100 percent Crown-owned, at least in the first instance.

42. CIIC is not expected to have an enduring role as it will exit investments once they become commercially viable. In the long-term, a partial sell down of Crown ownership could be used as a wind up mechanism for the company. This is not possible for a CEC, but could be provided for by:
 - transferring CIIC from a CEC to a PFA company by legislation; or
 - establishing a new PFA company, transferring CIIC's assets to that new company and then dissolving CIIC; or
 - selling 100 percent of CIIC to another party and then taking a minority interest in that party's company.

Crown Entities Act exemptions

43. CECs are established as standard companies under the Companies Act 1993 and then listed, by Order in Council on Schedule 2 of the CEA. This listing obliges their compliance with certain sections of the CEA (for example the obligation to prepare a Statement of Intent and Annual Report, or to provide information to shareholders when requested to do so).

44. When a company is listed, the Order in Council also specifies whether the company is subject to, or exempt from, sections 161-164 of the CEA. These sections restrict a Crown Entity's ability to acquire securities, borrow, give guarantees and indemnities and use derivatives:
 - in circumstances described in regulations; or
 - with approval from the Minister of Finance (as described in section 160 of the CEA)

45. The application of sections 161-164 can be changed by an Order in Council.

46. The table below considers whether CIIC should be subject to, or exempt from, sections 161 to 164 of the CEA.

Table 3: Crown Entities Act exemptions

Section	Discussion	Recommendation
161 - Securities	Acquisition of securities is likely be a key mechanism for CIIC to make investments. Some investment structures may make regular and periodic use of securities. ³	CIIC be exempt from CEA restrictions on its acquisition of

² Not expecting a commercial rate of return at the time of investment does not preclude CIIC from seeking to maximise return and minimise risk once invested.

³ For example securities may be acquired at different times to stagger the injection of funds.

Section	Discussion	Recommendation
	Requiring approval for acquisition of securities would be cumbersome. It would also provide a <i>de facto</i> ability to shareholders to approve individual investments, undermining the “arm’s length” decision making of CIIC.	securities.
162 – Borrowing	There may be circumstances in which debt is a useful alternative to equity to fund CIIC’s investments (as discussed in the funding section of this paper). However, debt funding should be at the discretion of Ministers as they are best placed to determine the priority of this spending against other competing demands for government funding.	CIIC’s ability to borrow be restricted by the CEA.
163 – Guarantees and Indemnities	<p>CIIC is expected to make investments in irrigation schemes to support their development, however an alternative may be to provide a guarantee or indemnity to a scheme.</p> <p>Providing a guarantee does not require upfront spending, but does create a commitment to expenditure under certain circumstances. Therefore, in giving guarantees or indemnities CIIC could commit to a potential obligation to spend more funding than Ministers have provided to it. It is appropriate that Ministers are involved in assessing whether this is reasonable. This preserves their determination of what overall level of funding they are prepared to commit to irrigation schemes.</p>	CIIC’s use of guarantees and indemnities be restricted by CEA.
164 - Derivatives	<p>A derivative is a contract that creates a right and/or obligation between two or more parties in specific conditions. CIIC may use derivatives as a tool to structure its investments in irrigation schemes, for example:</p> <ul style="list-style-type: none"> • committing to invest differently in a scheme depending on uptake, meaning it only invests where a scheme is not commercially viable in the short term; and <p>being provided with an option to sell its investment in a scheme once a scheme is considered to be commercially viable. The use of derivatives is likely to help CIIC to meet its objectives, and should, in principle, be supported by Ministers. This can be supported by a standing Ministerial approval under section 160 of the CEA that provides approval for use of derivatives that:</p> <ul style="list-style-type: none"> • may help CIIC to achieve its policy objectives and business needs • for which CIIC is able to demonstrate its ability to appropriately manage risk. <p>Providing a standing approval (rather than approving individual transactions) preserves the “arm’s-length” relationship between CIIC and its shareholders, and</p>	CIIC be provided with a standing approval from the Minister of Finance to use derivatives in an agreed way that supports its purpose.

Section	Discussion	Recommendation
	<p>ensures that approving derivatives does not become a <i>de facto</i> approval of individual transactions.</p> <p>We suggest that once CIIC is established Ministers should provide it with a standing approval for use of derivatives that are likely to support achievement of its purpose.</p>	

Constitutional statement on purpose and nature of company

47. CECs are established as companies under the Companies Act 1993, which provides for company constitutions. The constitution contributes to the overall accountability framework of the company. It must be followed by the company's board. A full constitution for CIIC will be provided to shareholders for review in advance of the formation of CIIC.
48. Constitutional purpose and nature sections make shareholders' expectations clear and provide guidance to a company's board as to what they should do. They are especially useful where the purpose of a company is not to maximise profit, as is the case for CIIC. Defining purpose and nature in a company's constitution also provides some insulation from government policy change.
49. The proposed purpose and nature statement is set out below. MPI, the State Services Commission and the Treasury have all been involved in its development. It is informed by Cabinet decisions, including the investment principles for CIIC. However, it does not replicate the investment principles in full. There will be other opportunities for CIIC to reference them, for example CIIC's Statement of Intent. The rationale behind the different components of the purpose and nature sections is set out as Appendix 1.

Purpose of the company

The purpose of the company is to implement government policy by co-investing in off-farm irrigation schemes which would not otherwise be established and are expected to be commercially viable in the long term; and to seek to exit those investments once they become commercially viable.

In doing so the company will:

- manage investments using best practice investment management approaches; and
- not seek a controlling interest in irrigation schemes.

Nature of the company

In doing so the company:

- will seek to maximise returns to its shareholders to the extent that this is consistent with achieving its purpose;
- will seek to minimise the amount and term of its investment in individual schemes, subject to the achievement of its purpose; and
- must operate in a financially responsible and fiscally efficient manner.

Mechanism to provide funding to CIIC

50. There are a range of funding mechanisms that could be used to make the \$80 million of pre-committed funding available to CIIC. Four potential mechanisms have been considered:
- called capital (called Crown equity);
 - uncalled capital (uncalled Crown equity);
 - Crown debt; and
 - purchase agreements.
51. We suggest that uncalled capital is the most appropriate mechanism to provide initial funding to CIIC. The case for uncalled capital is set out below. Appendix 2 provides an assessment of the other three options considered.

What is uncalled capital?

52. Uncalled capital is a way for shareholders to commit to provide capital without necessarily providing all cash up front. A company issues shares to shareholders. The shares are not fully "paid up" when they are issued. After shares are issued the company can "call" capital (i.e. request that the shareholders provide a certain amount of cash), under circumstances described in a subscription agreement.

Why is uncalled capital appropriate for CIIC?

53. Uncalled capital provides an appropriate balance between shareholder oversight and CIIC independence.
- CIIC has the flexibility to make a series of investments without returning to the shareholder for approval.
 - CIIC retains the freedom to operate as an independent, commercially focused entity and apply commercial disciplines to investment decision-making.
 - This mechanism allows shareholders to make decisions regarding the overall level of funding that the Crown chooses to invest.
54. Uncalled capital promotes fiscal efficiency.
- CIIC has access to capital if and when it needs to make investments in irrigation schemes, or to fund operational costs but does not have to manage additional capital that is surplus to its core requirements.
 - Shareholders provide funds to CIIC in line with its investment profile, which is highly uncertain.
55. Uncalled capital provides CIIC with a committed level of funding to provide certainty to the CIIC board and potential investors.
- CIIC can develop its business model and investment strategy with a degree of certainty in relation to the funding it will need to support this.
 - Potential investment partners can have a degree of certainty that CIIC is able to access funds to co-invest in irrigation schemes.

56. Uncalled capital has been the preferred funding mechanism for a number of other Crown-owned companies, including Crown Fibre Holdings Limited.

Subscription agreement

57. Uncalled capital is “called” under a subscription agreement. This agreement provides an opportunity to enhance the accountability framework for CIIC. It can include objective, transparent and stable rules for calling capital without introducing a *de facto* approval of individual investments by shareholders. For example, only allowing cash to be drawn down if CIIC has cash below a certain threshold in its own accounts. The detail of the subscription agreement can be developed between CIIC and its shareholders.

Monitoring agency

58. Shareholding Ministers of Crown-owned companies are supported by a monitoring agency which provides advice from an ownership perspective. This includes advice about the strategic direction of the company and performance against shareholders’ expectations (including financial performance). We recommend that the Crown Ownership Monitoring Unit (COMU) should be the responsible monitoring agency for CIIC. This is because COMU:

- is responsible for monitoring all Crown-owned companies except for Crown Research Institutes;
- is familiar with monitoring organisations that take a commercial approach to address policy issues;
- has established systems and processes, and specialist resources who focus on Crown-owned company monitoring;
- has a large enough team to leverage economies of scale in company monitoring;
- has established benchmarking and company valuation methodologies that can be extended to CIIC; and
- routinely engages with departments that have a policy interest in the performance of Crown-owned companies (as would be the case for MPI with CIIC).

Institutional arrangements: conclusions

59. The table below provides an overall conclusion to the institutional arrangements proposed for CIIC. It builds on the general model of Crown-owned companies described in Table 1 by providing the specific arrangements for CIIC.

Table 4: Institutional arrangements for CIIC

Role for shareholders (Ministers) of CIIC	Role for Company (as governed by its Board of Directors) of CIIC
Appoint or dismiss directors.	Directors are responsible for the governance of the company, and appoint employees as management.

Role for shareholders (Ministers) of CIIC	Role for Company (as governed by its Board of Directors) of CIIC
	Management is responsible for the day-to-day operations of the business.
Approve (and alter) the company constitution including description of purpose and nature of the company.	Act consistently with the constitution including descriptions of the purpose and nature of the company.
Review draft Statements of Intent provided by the company, and propose any amendments.	Prepare a Statement of Intent.
Provide the company with an annual letter of expectations (including any expectations about returns to shareholders).	Act in accordance with the letter of expectations (including meeting any expectations about returns to shareholders).
Receive an Annual Report from the company.	Prepare an Annual Report.
Receive quarterly reports from the company.	Prepare quarterly reports for shareholders.
Provide the company with funding through the acquisition of shares.	Issue shares to shareholders. Operate within the funding provided by shareholders (and any additionally sourced revenue).
Provide capital funding to CIIC when it is called, consistent with a subscription agreement.	Call funding from shareholders as required, consistent with a subscription agreement.
Approve major transactions, including investments in irrigation schemes that are major transactions.	Make recommendations to shareholders about major transactions. Take decisions about other transactions, including investments in irrigation schemes, without seeking approval from shareholders.
Have no formal role in approving the acquisition of securities (unless as major transactions).	Acquire securities without approval from shareholders.
Consider CIIC's requests for approval to borrow.	Not borrow unless as described in regulation or with approval from the Minister of Finance.
Consider CIIC's requests for approval to give guarantees and indemnities.	Not give guarantees or indemnities unless as described in regulations, or with the approval from the Minister of Finance.

Role for shareholders (Ministers) of CIIC	Role for Company (as governed by its Board of Directors) of CIIC
Provide a standing approval to CIIC to be able to use derivatives to support policy aims.	Seek a standing approval from the Minister of Finance to use derivatives to support policy aims.

Returns to shareholders

60. The standard monitoring arrangements for Crown-owned companies include an ongoing discussion between shareholders and their representatives and companies about the expectations of returns to shareholders. This, and the letters of expectation, would include discussions about use of earnings, and return of capital as well as further capital contributions based on assessments of CIIC's:

- forecast investment opportunities;
- planned divestment profile;
- expected cash dividends from its underlying investments; and
- forecast operating expenditure requirements.

Returns from divestment to be provided to shareholders

61. It is useful for shareholders to provide initial guidance on their expectations of returns, as this may inform CIIC's development of its investment and business models.

62. There are two options for the funds divested from schemes:

- a. that CIIC should return capital divested from schemes directly to the Crown. This approach would:
 - limit the investment in irrigation schemes to the amount Cabinet has signalled that it is willing to invest (up to \$400 million); and
 - enable Cabinet to explicitly take decisions on increasing investment in irrigation schemes beyond the maximum \$400 million, and to weigh up irrigation priorities against competing priorities across Government; or
- b. that CIIC should reinvest divested capital in subsequent irrigation schemes until shareholding Ministers state otherwise. This approach could enable CIIC to continue to invest beyond the amount Cabinet has signalled it is willing to invest (up to \$400 million).

63. We recommend that shareholders indicate an 'in principle' expectation that CIIC should return divested capital to shareholders, rather than reinvesting it.

Returns not expected in the short term

64. It is unlikely that CIIC receive returns from divestment in the initial period of its operations. In the initial period:

- CIIC will be making its first investment in irrigation schemes;
- CIIC will be investing in schemes that private investors do not consider suitably attractive to invest in, due to uncertainty largely relating to demand;
- There is likely to be a significant development and construction period for each scheme which are unlikely to generate returns for CIIC.

65. As a consequence of the above factors CIIC is likely to have greater investment outflows than forecast inflows. In this context if shareholders did indicate an expectation of returns either:

- CIIC would only be able to invest in schemes where it believes it will generate the level of cash returns required to meet expectations, constraining achievement of its policy objectives; or
- CIIC would need to account for the need to provide cash dividends when requesting additional funds from the Crown. This is a 'zero-sum' game, and is not a genuine return.

Returns to shareholders expected in the longer term

66. Over time:

- many of the schemes in which CIIC invests will become commercially viable. CIIC will begin to exit its investments, and receive returns of capital as it divests;
- the case for further CIIC investment in further irrigation schemes is likely to decrease because of the success of those that CIIC has supported; and
- as CIIC's existing and forecast investments decrease its operating costs are also likely to decrease.

67. CIIC may therefore begin to forecast returns to shareholders.

Earnings to be used to fund operating costs

68. CIIC may receive earnings from the investments that it makes in irrigation schemes such as cash dividends, or interest payments on loans. CIIC should use these earnings to cover or contribute to operating expenses.

69. Operating expenses would otherwise be funded from capital contributions from shareholders. This would decrease the capital available to be invested in irrigation schemes. CIIC would need to make estimates about operating expenses over its expected lifetime, and set aside capital equal to these to ensure financial sustainability.

70. Funding operational costs through earnings provides CIIC with the opportunity to utilise a revenue stream that is independent from shareholder contributions, to support its financial sustainability. In the event that earnings are greater than CIIC's operational costs, the excess should be returned to shareholders. The details of this approach are covered by a dividend policy

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APPENDIX 1: Rationale for constitutional purpose and nature sections

This appendix sets out the reasoning for the different elements of the proposed purpose and nature of the company sections for CIIC's constitution.

The purpose of the company is to...

Text	Reasoning
...to implement government policy...	<p>This phrase is useful to distinguish CIIC from profit oriented companies; CIIC is being established as a tool of government policy.</p> <p>In addition the implication of this statement is that CIIC's activities should be consistent with government policy without requiring a full statement of (potentially changing) policy in the constitution. Certain elements of government policy that are core to the business of CIIC and considered unlikely to change are explicitly included in the purpose statement as set out in the rest of this table.</p>
...by co-investing in off-farm irrigation schemes that...	<p>Investment in irrigation is CIIC's focus. "Co-investment" makes it clear that CIIC will invest with partners, not alone.</p> <p>"Off-farm" is important because it reflects shared infrastructure, rather than individual farms, which is the policy intent.</p>
...would not otherwise be established...	<p>This is an important limitation on the situations in which CIIC will invest. CIIC should not be investing where private investment alone would see a scheme established.</p>
...but are expected to be commercially viable in the long term...	<p>This is a further limitation on the situations in which CIIC will invest. CIIC is not intending to subsidise schemes in the long run, so the schemes must be expected to be commercially viable themselves in the long term. Commercial viability means a scheme that is able to provide a commercial rate of return to its investors.</p>
...and to seek to exit those investments once they become commercially viable.	<p>CIIC's policy objectives relate to the establishment of irrigation schemes and address uptake risk. CIIC is not intended to be a long term investor in any given scheme. This phrase sets out when CIIC is expected to seek to exit its investments.</p>

In doing so the company will:

Text	Reasoning
<p>...manage investments using best practice investment management approaches.</p>	<p>CIIC has been established to support policy objectives, though it is expected to use commercial disciplines in achieving these. This phrase generates an expectation that CIIC will adopt the best practice investment management approaches that a comparable private firm would take.</p> <p>It also functions as a “catch-all”, avoiding the need to list some of the contents from Cabinet’s investment principles, such as an expectation that CIIC will only invest in entities with sound governance structures. This approach also provides some flexibility, as “best practice investment management approaches” may be different at different stages of CIIC’s business over time.</p> <p>This phrase also implies management of risk and reward, without specifying a particular approach to risk management. CIIC will therefore be required to manage risk in a manner that would be considered “best practice” in investment management.</p>
<p>...not to seek a controlling interest in irrigation schemes.</p>	<p>Cabinet has been clear that it expects CIIC to be a minority investor as the Crown’s intention is not to control or operate irrigation schemes. “Not to seek a controlling interest” matches that intent but:</p> <ul style="list-style-type: none"> • contemplates a wider range of investment models than “minority investor”; and • acknowledges that while CIIC will not seek a controlling interest, circumstances may arise where this is the case.

Nature of the company

In doing so the company will...

Text	Reasoning
<p>...will maximise returns to its shareholders to the extent that this is consistent with achieving its purpose.</p>	<p>This section has two purposes. First it prioritises achievement of CIIC’s purpose over the provision of returns to shareholders. Second, it states that CIIC should maximise returns to its shareholders, within the constraint of achieving its purpose.</p> <p>Because CIIC’s purpose is described as an activity, rather than a specific outcome, there will need to be a conversation between CIIC and its shareholders about what “achieving” its purpose means (and this may change over time). This conversation can be included in the standard monitoring process for the company.</p>

Text	Reasoning
<p>...will seek to minimise the amount and term of its investments in individual schemes to the extent that this is consistent with achieving its purpose.</p>	<p>An investment principle states that the Crown will invest "no more than what is required to make a scheme viable in the short term."</p>
<p>...must operate in a financially responsible and fiscally efficient manner.</p>	<p>This section signals an expectation that CIIC will manage its finances in a responsible and efficient manner.</p> <p>This signals an expectation that CIIC will:</p> <ul style="list-style-type: none"> • not hold cash beyond what is needed for working capital purposes; and • seek to minimise costs needed to achieve its objectives.

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APPENDIX 2: Other options for funding CIIC in the initial period

This appendix sets out the funding mechanisms for CIIC's initial funding that were considered as alternatives to uncalled capital, but discounted.

Mechanism	Reason for not recommending this mechanism
<i>Crown debt</i>	<ul style="list-style-type: none"> It is unlikely CIIC would be able to obtain third party debt funding on commercial terms during the initial period. This is due to the lack of expected cash flow for CIIC. On the basis that the use of Crown debt should be based on the same credit process that a third party debt provider would use, using Crown debt to partially fund CIIC in the initial period would be inappropriate.
<i>Purchase agreement</i>	<ul style="list-style-type: none"> This mechanism may not be appropriate for this type of investment as the outcomes and outputs are not clearly defined, it is therefore difficult to stipulate in a purchase agreement. Limits the perception of separation from the Crown as the contract could constrain CIIC's scope of activities and freedom to identify appropriate schemes to invest in. This therefore, also inhibits CIIC's ability to deliver on its objectives.
<i>Called capital (lump sum)</i>	<ul style="list-style-type: none"> This mechanism is not necessarily fiscally efficient as this method provides upfront capital to CIIC, possibly before funds are required for investments. There is a risk that this mechanism dilutes CIIC's objectives, as it would need to manage investment of any surplus capital. May distort investment incentives, encouraging CIIC to invest because it has surplus cash.
<i>Called capital (as required)</i>	<ul style="list-style-type: none"> Undermines the "arm's length" relationship as Minister's approval of capital as required to fund investments would be a <i>de facto</i> approval of those investments. Could increase the perception of political influence in investment decisions if CIIC is required to request capital for each investment and present a case for doing so. Could undermine the simplicity of the funding model if CIIC is required to submit multiple applications for funding in a short timeframe. This may add further complication if these requests do not align with government budget processes. Restricts CIIC's ability to make long term plans, as there is limited certainty over available funding.

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