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**State Owned Corporations:
A Review**

by

Stewart Smith

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by

Stewart Smith

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EXECUTIVE SUMMARY

It has been over 10 years since the *State Owned Corporations Act 1989* was introduced into Parliament, and five years since major amendments were introduced by the Carr Government in 1995.

A useful definition of corporatisation is: a structural reform process for nominated government entities that (page 1):

- (a) changes the conditions and (where required) the structure under which the entities operate so that they operate, as far as practicable, on a commercial basis and in a competitive environment; and
- (b) provides for the continued public ownership of the entities as part of the process; and
- (c) allows the State, as owner on behalf of the people...to provide strategic direction to the entities by setting financial and non-financial performance targets and community service obligations.

The five principles of corporatisation have been identified as (page 2):

- 1/ ensuring there were clear and non-conflicting objectives so managers could focus on the 'bottom line' of commercial performance, leaving 'social service' and other functions to be dealt with separately.
- 2/ assignment of management responsibility and authority to enable action to achieve stated objectives;
- 3/ independent, external monitoring of performance against agreed targets;
- 4/ rewards and sanctions commensurate with performance according to results;
- 5/ competitive neutrality – 'the level playing field' – so that performance was not distorted by privileges or handicaps arising from government ownership, and so that wider market distortions harmful to economic efficiency did not occur.

'Umbrella' or 'template' State owned corporation legislation was passed in New South Wales in 1989 (page 2). During the Coalition's term of office only six agencies were brought under the State Owned Corporations Act – the Government Insurance Office; State Bank; Hunter Water Corporation; Graincorp; Department of Water Resources Irrigation Schemes; and the Sydney Water Board. With the election of the Carr Government in 1995, the *State Owned Corporations Amendment Act 1995* provided for the establishment of *statutory* State owned corporations as a different model of corporatisation from that provided for under the original 1989 Act. A statutory State owned corporation is not registered under the *Corporations Law*. The amendments also introduced the concept of company State owned corporations which are incorporated or registered under the *Corporations Law* (pages 2-4).

This paper then analyses the differences between the two types of State owned corporations (pages 4 – 13) and, using case studies, looks at the operation of some corporations and the effectiveness of the relevant legislation (pages 13 – 22).

1.0 INTRODUCTION

It is over ten years since the *State Owned Corporations Act 1989* was introduced into Parliament by the Greiner Government, and five years since major amendments were passed by the Carr Government in 1995.¹ With the Government recently splitting electricity corporations into two separate entities, announcing the privatisation of the rail freight corporation, and the accountability and management of other State owned corporations attracting media attention, it is an interesting time to examine the impact of corporatisation in general.

Corporatisation has been defined as:²

- a structural reform process for nominated government entities that
 - (a) changes the conditions and (where required) the structure under which the entities operate so that they operate, as far as practicable, on a commercial basis and in a competitive environment; and
 - (b) provides for the continued public ownership of the entities as part of the process; and
 - (c) allows the State, as owner on behalf of the people...to provide strategic direction to the entities by setting financial and non-financial performance targets and community service obligations.

According to Martin Painter, in New South Wales the road towards corporatisation of public sector enterprises began with Labor during the 1980s. When the Greiner Government took office in 1988, the need for reform was not a matter of political controversy, nor was it being imposed on an unprepared public sector.³

Painter continues that Greiner, under the auspices of the head of the Cabinet Office Gary Sturgess, developed what was labelled as the five principles of corporatisation. These were:⁴

¹ The State Owned Corporations Amendment Act 1995 amended the legislation to provide for a new form of a State Owned Corporation.

² See section 16 of the *Government Owned Corporations Act 1993* (Qld)

³ Painter, M. "Microeconomic Reform and the Public Sector" in Laffin M & Painter M (Ed) *Reform and Reversal. Lessons from the Coalition Government in New South Wales 1988-1995*, 1995, at 92.

⁴ Painter, M. "Microeconomic Reform and the Public Sector" in Laffin M & Painter M (Ed) *Reform and Reversal. Lessons from the Coalition Government in New South Wales 1988-1995*, 1995, at 92.

- 1/ ensuring there were clear and non-conflicting objectives so managers could focus on the 'bottom line' of commercial performance, leaving 'social service' and other functions to be dealt with separately.
- 2/ assignment of management responsibility and authority to enable action to achieve stated objectives;
- 3/ independent, external monitoring of performance against agreed targets;
- 4/ rewards and sanctions commensurate with performance according to results;
- 5/ competitive neutrality – 'the level playing field' – so that performance was not distorted by privileges or handicaps arising from government ownership, and so that wider market distortions harmful to economic efficiency did not occur.

'Umbrella' or 'template' State owned corporation legislation was passed in 1989. In the Second Reading Speech to the State Owned Corporations Bill 1989, Greiner stated:⁵

The main purpose of this bill is to establish a framework for the corporatisation of selected government business enterprises. Corporatisation is a strategy aimed at improving the level of efficiency and accountability in government business enterprises for the benefit of consumers and taxpayers. ...

State owned corporations will be under the same regulatory regime as companies in the private sector. This will include federal trade practices and the State fair trading legislation. Also, State-owned corporations will have their performance measured in the same way as companies in the private sector. ... This will impose on State-owned corporations the same incentives and sanctions which apply to companies in the private sector.

It was further stated that the State Owned Corporations Bill 1989 aimed to provide for a level playing field by putting State owned corporations 'in the same position as their private sector competitors.'⁶ For this reason it was stated that State owned corporations were to be free of certain regulatory schemes such as the *Public Sector Management Act 1988*, the *Freedom of Information Act 1989* and the *Anti-Discrimination Act 1977*.⁷

Whilst the passage of the legislation was relatively uncontroversial, the process of implementation was more problematic. During the Coalition term of office only six agencies were brought under the State Owned Corporations Act – the Government Insurance Office; State Bank; Hunter Water Corporation; Graincorp; Department of Water Resources Irrigation

⁵ NSWPD, 2/8/89, p 9139.

⁶ Ibid, pp 9140-9141.

⁷ Ibid, p 9141.

Schemes; and the Sydney Water Board. According to Painter, the Government soon discovered that ensuring ‘competitive neutrality’ raised numerous complex difficulties – such as identifying community service obligation payments and ensuring effective price controls over monopoly corporations.⁸

With the election of the Carr Government in 1995, the *State Owned Corporations Amendment Act 1995* provided for the establishment of *statutory* State owned corporations as a different model of corporatisation from that provided for under the original 1989 Act. The structure of the then existing class of State owned corporations, which at that time included the Hunter Water Corporation Limited and the Sydney Water Corporation Limited, was maintained. This class of State owned corporation became known as a *company* State owned corporation.

The 1995 amendments to the *State Owned Corporation Act* created a legislative scheme which established a dual class scheme of corporatisation with company and statutory Government owned corporations. A statutory Government owned corporation is established as a body corporate under an Act and is not registered under the *Corporations Law*; a company Government owned corporation is incorporated or registered under the *Corporations Law*.

Across Australia numerous government entities have gone through the corporatisation process. These include: various port authorities; electricity generators, distributors and retailers; railways; and water entities. Whilst there are a variety of models of corporatisation across Australia, the principles of corporatisation tend to be the same. These identified principles include:⁹

- Clarity of objectives;
- Competitive neutrality;
- Management autonomy and authority;
- Strict accountability for performance.

Whilst the process of corporatisation attempts to mimic private sector conditions in a public sector ‘company’, it is widely accepted that the two are very different entities. It could be argued that there is a greater complexity in terms of corporate governance in the public sector, mainly due to the possible ‘conflicts’ that a director may face. These ‘conflicts’ may include:¹⁰

⁸ Painter, M. “Microeconomic Reform and the Public Sector” in Laffin M & Painter M (Ed) *Reform and Reversal. Lessons from the Coalition Government in New South Wales 1988-1995*, 1995, at 94.

⁹ Reynolds, A and von Nessen, P, “The Government Owned Corporations and State Owned Corporations Statutes” in Collier, B and Pitkin, S (Ed) *Corporatisation and Privatisation in Australia. A collection of papers examining legal, economic and policy issues*. CCH Australia, 1999, at 118.

¹⁰ Australian Institute of Company Directors, *Checklist for Directors of Government Boards*, AICD, Sydney 1994, as quoted in Audit Office of NSW, *Performance Audit Report: Corporate Governance*. Volume 2, June 1997, at 10.

- who the shareholder is and how the shareholder is represented;
- whether they should fulfil a commercial or a social purpose;
- maintaining confidentiality versus being responsible to government;
- applying market pricing versus fulfilling community service obligations;
- being independent of government versus applying Ministerial policy;
- the priorities of customers, employees and the shareholder;
- whether action which is legal for the entity exposes directors to liability under common law or statute law; and
- whether the legal structure is necessarily a protection against political responsibility.

This paper reviews the operation of the *State Owned Corporations Act*, presents some findings of the NSW Audit Office in relation to corporate governance of State owned corporations, and provides some case studies of State owned corporations.

2.0 A BRIEF REVIEW OF THE STATE OWNED CORPORATIONS ACT 1989 (NSW, AS AMENDED)

Section 3A of the Act provides for two classes of State owned corporations. These are company and statutory State owned corporations.

2.1 Company State Owned Corporations

A company limited by shares becomes a company State owned corporation by the insertion of its name in Schedule 1 of the Act by an Act of Parliament. The company cannot be removed from Schedule 1 except by an Act of Parliament. Currently, there are no company State owned corporations listed in Schedule 1. As explained in section 4.1, the two water company State owned have since become statutory corporations.

Section 7 of the Act enables the transfer of assets, rights and liabilities of the State or an authority of the State to a company State owned corporation in exchange for the issue of shares or on any other basis.

Section 8 outlines the principal objective of a company State owned corporation to be a successful business and, to this end:

- (a(i)) to operate at least as efficiently as any comparable businesses; and
- (a(ii)) to maximise the net worth of the State's investment in the corporation;
and
- (b) to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates; and
- (c) where its activities affect the environment, to conduct its operations in

compliance with the principles of ecologically sustainable development contained in section 6(2) of the Protection of the Environment Administration Act 1991; and

- (d) to exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates.

Each of the principal objectives of a company State owned corporation is of equal importance.

The status of a State owned corporation or any of its subsidiaries is outlined in section 9, so that a State owned corporation:

- (a) is not and does not represent the State except by express agreement with the voting shareholders of the corporation; and
- (b) is not exempt from any rate, tax, duty or other impost imposed by or under any law of the State merely because it is a State owned corporation; and
- (c) cannot render the State liable for any debts, liabilities or obligations of the corporation or any of its subsidiaries, unless this or any other Act otherwise expressly provides.

Section 10 provides for the appointment of directors of a company State owned corporation. The board of directors is accountable to the voting shareholders (defined as the Treasurer and one of the other eligible Ministers).

A Minister may, with the approval of the Treasurer, direct a company State owned corporation with respect to the performance of activities that may not be in the commercial interests of the corporation. The corporation is subsequently entitled to be reimbursed.

Section 14 deals with the issue of dividends. The board of a company State owned corporation and the voting shareholders *may* agree that dividends will be applied in the purchase of shares by shareholders in the corporation, which effectively permits such dividends to be retained by the corporation, while increasing the value of the shareholdings. Such payments may bypass the Consolidated Fund by being appropriated for the purpose of the purchase of shares. Otherwise dividends are to be paid to the Treasurer for payment into the Consolidated Fund.

Sections 15 and 17 deal with the tax liabilities of a company State owned corporation. The corporation must from time to time pay the Treasurer for payment into the Consolidated Fund amounts to be equivalent if it were liable to pay taxes under the law of the Commonwealth. This ensures that State owned corporations are on a 'level playing field' compared to private companies that must pay company tax.

Section 16 enables the board and the voting shareholders to agree that certain obligations of

a company State owned corporation are to be guaranteed by the Government. Any liabilities arising out of such a guarantee are to be met out of the Consolidated Fund.

Section 19 deals with the ability of a company State owned corporation to acquire and dispose of assets. Section 20 prevents the sale of the main undertakings of a company State owned corporation except with the prior written approval of the voting shareholders.

2.2 Statutory State Owned Corporations

The main defining factor between statutory State owned corporations and company State owned corporations is that company corporations are governed by the *Corporations Law* and statutory ones are not (except as expressly provided for by legislation). A further difference lies with ministerial directions. A portfolio Minister is able to direct a statutory State owned corporation in the public interest, whereas this power is not available to direct a company State owned corporation.

Section 20A provides for the establishment of a statutory State owned corporation, by insertion in Schedule 5 of the Act by an Act of Parliament. A statutory State owned corporation cannot be removed from the Schedule except by an Act of Parliament. Currently Schedule 5 includes the following corporations, as shown in Table 1.

TABLE 1: CURRENT STATUTORY STATE OWNED CORPORATIONS

Advance Energy
 Australian Inland Energy
 Delta Electricity
 EnergyAustralia
 Eraring Energy
 Freight Rail Corporation
 Great Southern Energy
 Hunter Water Corporation
 Integral Energy Australia
 Macquarie Generation
 New South Wales Lotteries Corporation
 Newcastle Port Corporation
 NorthPower
 Port Kembla Port Corporation
 Rail Access Corporation
 Rail Services Australia
 Superannuation Administration Corporation
 Sydney Ports Corporation
 Sydney Water Corporation
 TransGrid

A statutory State owned corporation has the same features as described above for a company

State owned corporation. However, an important difference between the two is that a statutory State owned corporation is an exempt public authority for the purposes of the *Corporations Law*, except as expressly provided by or under the *State Owned Corporations Act* or any other Act.

A statutory State owned corporation has only two shareholders (the Treasurer and another Minister nominated by the Premier).

A statutory State owned corporation can also be directed by the Minister to act in a non-commercial manner, in the same way, and the same reimbursement conditions, as a company State owned corporation.

An important difference in relation to a statutory State owned corporation is the power of the 'portfolio Minister' to notify the board of a public sector policy that is to apply to the State owned corporation if the Minister is satisfied that it is necessary in the public interest (section 20O).

The portfolio Minister is the Minister who has the duty to administer the foundation charter of a statutory State owned corporation. 'Foundation charter' is defined in the Act to mean the Act or Regulations by which the name of the State owned corporation is inserted in Schedule 5, or some other Act or instrument specified by an Act as its foundation charter.

The portfolio Minister is also able to, with the approval of the Treasurer, give the board of a statutory State owned corporation a written direction in relation to the State owned corporation and its subsidiaries if the portfolio Minister is satisfied that, because of exceptional circumstances, it is necessary to give the direction in the public interest (section 20P). The portfolio Minister must first consult with the Board and request the Board to advise the Minister whether, in its opinion, complying with the direction would not be in the best interests of the corporation or any of its subsidiaries. Within one month of the portfolio Minister giving a direction under this section, the Minister is required to publish in the Gazette the reasons why a direction was given under this section and why it is in the public interest that the direction be given.

Both sections 20O and 20P provide for the reimbursement to the State owned corporation of the estimated net cost of complying with such a notification or direction.

Section 20S provides for dividend payments from a statutory State owned corporation. It has the same arrangements as discussed above for company State owned corporations, with one addition. Under section 59B of the *Public Finance and Audit Act 1983*, the Treasurer may require a statutory State owned corporation to pay into the Consolidated Fund by way of dividend an amount determined by the Treasurer. If the Treasurer directs the statutory State owned corporation to pay a dividend under this section, then a notice must be published in the Gazette setting out the amount of dividend to be paid and the reasons for requiring the payment to be made under this section rather than pursuant to the share dividend scheme under the *State Owned Corporations Act 1989*.

Section 20T provides for tax-equivalent payments from a statutory State owned corporation,

which are basically the same as for company State owned corporations.

Section 20Y prevents the sale of the main undertakings of a statutory State owned corporation except with the prior written approval of the voting shareholders.

Part 4 (sections 21-30) of the *State Owned Corporations Act* deals with the accountability of a State owned corporation. In particular, section 22 outlines the required contents of a statement of corporate intent which includes the objectives of the corporation, the main undertakings, the nature and scope of the activities, the accounting policies to be applied in the accounts and performance targets.

Sections 23 and 24 deal with the requirements to deliver to the voting shareholders half-yearly reports and annual reports and accounts. Under section 24, a company State owned corporation must present financial statements, audited by the Auditor-General, that conform to the requirements of the *Companies (New South Wales) Code*. In contrast, a statutory State owned corporation must comply with the *Public Finance and Audit Act 1983* and the *Annual Reports (Statutory Bodies) Act 1984*. The Auditor-General is able to make a special report regarding any matter arising from an audit, which is to be presented to the Legislative Assembly.

The Minister is required to table before each House of Parliament certain documents including the memorandum and articles of association of each State owned corporation, the statement of corporate intent, half-yearly and annual reports, notices, and any written directions given by a Minister under the Act.

Increasing the Parliaments overseeing role of State owned corporations, the Public Accounts Committee, as one of its functions, is to include the examination of the financial statements of the State owned corporations, as well as reports of the Auditor-General laid before the Legislative Assembly under the Act.

Section 29 states that the board of a State owned corporation must provide to the voting shareholders information relating to the affairs of the corporation as requested. Similarly, the Board must supply to the portfolio Minister information relating to the affairs of the State owned corporation as the Minister requests.

Part 5 of the *State owned corporation Act* (sections 31-38) deals with miscellaneous matters. Section 33AA provides that a board of a State owned corporation has an obligation: to ensure that a public sector policy notified to the board is carried out; to ensure that a direction given to a board under section 20P is carried out; and to supply information requested of the Board under section 29. A director of the board of a State owned corporation does not incur any personal liability for the compliance, or purported compliance, in good faith by the board with an obligation as described above.

Section 36 states that for the purposes of the *Independent Commission Against Corruption Act 1988*, State owned corporations and their subsidiaries are public authorities, and directors, officers and employees of a State owned corporation are public officials. However, section 23 of the *ICAC Act* (which enables the Commissioner to enter the premises of a public

authority or public official and inspect the premises and documents for the purposes of an investigation) does not apply to a State owned corporation.

3.0 CORPORATE GOVERNANCE – THE ROLE OF THE STATE OWNED CORPORATION BOARD

In 1997 the NSW Audit Office released its report on corporate governance.¹¹ The Audit Office noted that there were over 600 boards in NSW, including those associated with State owned corporations.¹² The Audit Office found that the role and functions of boards in the NSW public sector are often ambiguous, in that their roles, functions, responsibilities and public accountability are not clearly defined and or may overlap with those of Ministers and the CEO. The existence of Parliament, Cabinet, Ministers and agency CEOs creates an elaborate set of relationships in the public sector. The respective powers and responsibilities of each of these parties tends to create greater complexity in terms of accountability and controls than is found in the private sector.¹³

The Audit Office noted that to achieve full public accountability, boards need to add value and demonstrate that they are cost effective. This requires that boards operate under a model which allows them to be effective and efficient in carrying out their governance functions. A key principle of effective public sector governance emerging from the United Kingdom is that boards should retain full and effective control and monitor executive management and leadership. To achieve this the Audit Office has identified these requirements:

- a clear and appropriate definition of the role and functions of the board;
- consistency in approach to governance in terms of the roles of the board, Government and Parliament regardless of the nature, size, assets or income of the organisation to be governed;
- clarity in and separation of the roles of the Ministers and the board;
- definition in legislation of, the role, powers, responsibilities and accountabilities of the Government, its Ministers and boards;
- legislation to provide boards with the authority to carry out their governance responsibilities; and
- a process to ensure reporting of board achievements and governance practices, including appointments.

The Audit Office notes that if boards are to have powers that match the responsibility of their

¹¹ Audit Office of NSW, *Performance Audit Report: Corporate Governance*. June 1997.

¹² The Audit Office noted that boards can be attached to many different types of organisations, including: universities; regulatory authorities; government businesses; companies; statutory authorities such as area health boards; trusts; and non-statutory authorities.

¹³ Audit Office of NSW, *Performance Audit Report: Corporate Governance*. June 1997, at 17.

statutory duties, then the public will expect boards to be fully and publicly accountable. The Audit Office notes that the Parliament needs to play a key role in the system of accountability for public sector boards and suggest five conditions should be met for boards:

- roles and functions of each board are clearly defined, preferably in legislation;
- expectations as to what boards report upon are clearly defined;
- there is a performance agreement between the board and the Minister/Government;
- boards report achievements against this performance agreement to Parliament through the Minister; and
- the actual need for the board and the performance of boards are regularly reviewed by government.

In developing these themes of governance the Audit Office highlighted two key criteria. These were: the relationship between, and therefore the roles and responsibilities of, the board, Ministers, the CEO and central agencies; and public accountability. The Audit Office further defined these criteria as:

Separation of Powers

- the Minister's ability to issue directions in regard to a board's activities should be subject to clear limits;
- the Minister should not be able to give directions to the board in terms of the exercise of the board's statutory powers and duties;
- any Ministerial Directions to the board in regard to its activities should be in writing and publicly reported;
- there should be clear and agreed provisions for boards to refuse these Ministerial Directions; and
- where Ministerial Directions are imposed, there should be agreed provisions for boards to seek compensation for implementation of Ministerial Directions.

Delineation and Independence in Roles, Functions and Responsibilities of the Board

- roles, functions and responsibilities should be defined in legislation;
- roles, functions and responsibilities should be clarified in guidelines, charters or Memorandum of Understanding;
- roles and responsibilities should be defined with respect to: appointment of board members; appointment of the chair; appointment of the CEO; decision making and control; reporting arrangements; the provision of information by the board to Government.
- the Chair should be appointed by the board;
- the Chair should have a performance agreement with the board;
- the CEO should be appointed by the board; and
- the CEO should have a performance agreement with the board.

In terms of public accountability, boards should be accountable for: their statutory responsibilities; expenditure of public money; and governance practices. The Audit Office proposed the following criteria to assess the degree of public accountability of a board:

- the process of board appointments should be more rigorous;

- there should be a performance agreement (or equivalent) between the board and the Government;
- the board should publicly report its performance;
- the performance of board members should be reviewed and reported upon by the board;
- legislation should provide a clear basis for the removal of board members; and
- legislation should provide for the abolition or redefinition of positions on the board or of the board itself.

Table 2 summarises the key governance issues of company and statutory State owned corporations. Two models of statutory State owned corporations have been identified by the Audit Office. Type one is referred to as the Ports corporatisation model, type two is the energy and rail statutory State owned corporation model. The major differences between the two types are highlighted in the table.

TABLE 2: KEY GOVERNANCE ISSUES OF COMPANY AND STATUTORY STATE OWNED CORPORATIONS.¹⁴

Model	Ministerial Directions and Control	Board Appointments	Chair Appointments	CEO Appointments	Public Accountability	Individual Accountability
Company SOCs	Subject to ministerial directions for non-commercial functions; they must have Treasurers approval and be in writing, entitled to reimbursement	Appointed by voting shareholders	Appointed by voting shareholders	Appointed by board	Annual Report Audit Statement of Corporate Intent Tabled in Parliament	CEO performance agreement with board
Statutory SOCs	Subject to ministerial directions for: (a) non commercial functions (b) public policy and	Type One Appointed by Governor on recommendation of voting share-	Type One Appointed by Governor on recommendation of voting share-	Type One Appointed by Governor on recommendation of portfolio Minister	Annual Report Audit Report Statement of Corporate Intent tabled in	Both types: CEO accountable to board.

¹⁴ From: Audit Office of NSW, *Performance Audit Report: Corporate Governance*. June 1997, at 28.

	(c) public interest issues; must have approval of Treasurer and be in writing, Minister must consult with board re (b) and (c), entitled to reimbursement	holders Type Two Appointed by voting share-holders	holders Type Two Appointed by voting share-holders	Type Two Appointed by board after consultation with voting share-holders	Parliament	
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The Audit Office believes that the company State owned corporation model provides the greatest alignment between the two key criteria identified as responsibilities and powers. It does this by:

- providing for greater clarity and transparency with regard to Ministerial Directions to the board. Such directions can only relate to non-commercial activities and must be in writing; and
- allowing the board to appoint its own CEO.

However, the Audit Office notes that a major difficulty with the company and statutory State owned corporation models is that, in practice, accountabilities to the portfolio Minister and the Voting Shareholders become confused. This is particularly so when a Voting Shareholder (the Treasurer) is also the portfolio Minister (as was the case for energy State owned corporations when the Audit Office report was written). However, this is no longer the case, and the Premier has stated that as a matter of policy, the portfolio minister will not be nominated as a shareholder.¹⁵ The Audit Office continued that statutory State owned corporations have a greater mismatch between responsibilities and powers, and hence have a more limited capacity to add value, because:

- the scope for Ministerial Directions is wider, encompassing non-commercial functions, public policy and public interest issues. The latter two are not defined in legislation; and
- the CEO appointment in the case of the Ports State owned corporation model (type one) is made by the Governor on the recommendation of the Portfolio Minister and the board. In the case of energy and rail State owned corporations (type two) the CEO appointment is made by the board after consultation with the Voting Shareholders.

In regard to public accountability, the Audit Office noted that state owned corporations have

¹⁵ NSWPD, 23 May 1995 at 52.

rigorous reporting requirements which measure the organisation's achievements against standards or targets. Their performance is regularly reviewed by Treasury and reported in the form of a Statement of Corporate Intent, 'signed off' by both the Voting Shareholders and the board. The full statement is required by the *State Owned Corporations Act* to be reported in Parliament.

The comments of the Auditor General in regard to company compared to statutory State owned corporations are interesting because they were made before the Sydney Water contamination incident. As will be discussed in the next section, the status of the Sydney Water Corporation was changed after communication difficulties between the management, Board and Government in relation to drinking water quality incidents.

4.0 CASE STUDIES

One of the major arguments for corporatising a government enterprise is to make it more efficient, accountable and provide a level playing field for the possible entry of competitors. These objectives are to be met through the key principles of: clarity of commercial and non-commercial objectives; management autonomy and authority; strict accountability for performance; and competitive neutrality through being subject to the same rules as any other business.¹⁶ The principal objectives of company and statutory State owned corporations are:

to be a successful business and, to this end:

- (a) (i) to operate at least as efficiently as any comparable businesses; and
- (a) (ii) to maximise the net worth of the State's investment in the corporation; and
- (b) to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates; and
- (c) where its activities affect the environment, to conduct its operations in compliance with the principles of ecologically sustainable development contained in section 6(2) of the *Protection of the Environment Administration Act 1991*; and
- (d) to exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates.

Each of the principal objectives of a company State owned corporation is of equal importance.

Now that NSW has had corporatisation legislation since 1989, it may prove valuable to assess

¹⁶ Jolly, R. "Government owned corporations: Public Ownership, Accountability and the Courts." In *Aial Forum* No 24, 2000, at 16.

whether these objectives have been met, and whether the legislation is meeting current needs. The Sydney Water Corporation will be used as a case study.

4.2 Sydney Water Corporation

As one of the larger State owned corporations, Sydney Water, by its very nature and size, attracts media attention and public scrutiny. The Water Board was corporatised with the passage of the *Water Board Corporatisation Act 1994*, and began trading as the Sydney Water Corporation on 1 January 1995. The corporatisation of the Water Board was done at a time when the Greiner Government held power with the support of independents who were closely involved with the environment movement. Among the issues at stake during the negotiation process, was the inclusion in the corporatisation legislation of environmental objectives of the Water Board's charter. As Aynsley Kellow writes:¹⁷

Clear provisions were insised upon for public scrutiny and transparency in the Board's operating licence, strict and specific performance targets, and in particular areas such as preparation of land management plans. The Board was not only made subject to Corporations Law, the Consumer Claims Tribunal and the Trade Practices Act, but also to the Auditor-General, the Ombudsman, the PAC, the ICAC, the FOI Act, anti-discrimination legislation and the Annual Reports Act. Memoranda of Understanding had to be signed with three principal government regulators, including the EPA. Formal audits of conformity with the operating licence and with customer grievance provisions were also specified.

Kellow continued:

The Act...also imposed internal role conflicts and constraints on commercial freedoms and a heavy burden of conflicting, external monitoring far beyond that to be expected by a private corporation. It was as much a charter for collective environmental rights as for corporate commercial freedoms, a juxtaposition of principles and objectives that was fraught with potential contradictions.

As will be shown in this section, the comments of Kellow in regard to potential contradictions in the Corporation's charter were reiterated by the commission of inquiry in relation to water contamination.

Sydney Water:¹⁸

- delivers water to more than 3.9 million people;
- collects and treats waste water from over 1.5 million properties;
- provides stormwater drainage to 25% of residential customers;
- employs 4,500 people in its core business and its subsidiaries;
- had a 1998-99 total income of \$1,224.7 million, and had a recommended dividend

¹⁷ Kellow,A "The Environment" in Laffin M & Painter M (Ed) *Reform and Reversal. Lessons from the Coalition Government in New South Wales 1988-1995*, 1995, at 266.

¹⁸ Sydney Water, *Sydney Water Annual Report 1999*.

payment to shareholders of \$91.7 million.

Sydney Water operates under a range of regulatory measures, including:

- Operating Licence;
- *Sydney Water Act 1994*;
- *State Owned Corporations Act 1989*;
- NSW Health;
- Portfolio Minister;
- Water Administration Ministerial Corporation;
- NSW Environment Protection Authority.

With the passage of the *State Owned Corporations Amendment Act 1995*, which introduced the categories of company and statutory State owned corporations, the structure of Sydney Water (and Hunter Water) was maintained but became known as company State owned corporations.

As has been widely reported, in late July 1998 Sydney Water was faced with a drinking water contamination event. Both *Cryptosporidium* and *Giardia* were detected in the distribution system. As part of the Government response to the event, an Inquiry chaired by Peter McClellan QC was established. Commissioner McClellan looked at the management of the contamination events by both Sydney Water and NSW Health. He provided both some conclusions on the deficiencies that manifested themselves during the management of the events and some future directions to help ensure that they do not recur.¹⁹ Of particular relevance to this paper are the following conclusions by Commissioner McClellan:²⁰

- loss of public credibility in Sydney Water made it necessary for the Government...to put aside the corporate management structure and adopt the primary management role in the handling of the crisis;
- it is possible that the reporting arrangements and accountabilities prescribed for Sydney Water under the *State Owned Corporations Act 1989*, added to the difficulties in communication between the Managing Director, the Board and the Government.

¹⁹ McClellan, P. *Sydney Water Inquiry. Second Interim Report. Management of the Events.* NSW Premier's Department. September 1998, at 65.

²⁰ McClellan, P. *Sydney Water Inquiry. Second Interim Report. Management of the Events.* NSW Premier's Department. September 1998, at 75.

The Commissioner recommended:²¹

- the Government should review the arrangements relating to corporate control to ensure that the Government has sufficient power to obtain information from the Corporation, and, if circumstances require, give direction to the Corporation which is necessary in the public interest.

The Commissioner also made the following points:²²

- Sydney Water's structure requires it to give equal consideration to its business objectives, protection of the environment and the protection of public health. These objectives may not always be compatible.
- the ability of [the responsible] Minister to provide effective and accurate advice to the public was seriously compromised by the inaccurate advice from Sydney Water.
- there was significant difficulty in the communications between Sydney Water and the operators of the Prospect Treatment Plant, Australian Water Services, probably as a result of their competing commercial objectives. However, an inability for free and effective communication between the operators of the different parts of a water supply system cannot be accepted.

In response to Mr McClellan's comments on 15 October 1998 the then Minister responsible Hon Craig Knowles MP introduced the Water Legislation Amendment (Drinking Water and Corporate Structure) Bill. The Act was assented to on 8 December 1998. Amongst other things, the Act changed the structure of Sydney Water and Hunter Water from corporate to statutory State owned corporations. This provides the portfolio Minister with the power to direct the corporations and access information in the public interest.

In response to this change to a statutory State owned corporation, the Chairman of the Board of Sydney Water made the following comments in Sydney Water's Annual Report:

[this] may appear to be a minor matter to some. However, its impact cannot be underestimated in its alignment of the Corporation to the Government of the day. Sydney Water is now more accountable to its responsible Minister and through this, the Minister is more accountable to the Parliament and people for the actions of the Corporation.²³

²¹ McClellan, P. *Sydney Water Inquiry. Final Report, Vol 2.* NSW Premier's Department. December 1998, at 26.

²² McClellan, P. *Sydney Water Inquiry. Second Interim Report. Management of the Events.* NSW Premier's Department. September 1998, from pages 70-77.

²³ Sydney Water, *Sydney Water Annual Report 1999, 1999*, at 4. Comments of Chairman Gabrielle Kibble.

It is noteworthy comparing the comments of the Auditor-General and those of McLellan. The Auditor-General considered that the company State owned corporation was the most efficient according to the criteria of responsibilities and powers. In contrast, McLellan stated that it was this structure which added to the difficulties in communications between the Managing Director of Sydney Water, the board and the Government.

Whilst the legislative amendments were relatively easy to implement, other responses to McClellan's comments are potentially more problematic. For instance, resolving the following: the potentially incompatible objectives of giving equal consideration to its business objectives, protection of the environment and the protection of public health. Does the legislation ask too much of Sydney Water to be able to resolve these potentially incompatible objectives? Should they be changed so that just one factor is its over-riding objective, such as the protection of public health?

As Sydney Water strives to reduce its costs and increase its productivity, it is using the services of the private sector at an increasing rate. For instance, the private sector has been commissioned to design, construct and operate the upgrade for the Cronulla sewage treatment plant. McClellan's comments about Sydney Water's communication difficulties with the privately operated water filtration plant will thus become increasingly pertinent: "an inability for free and effective communication between the operators of the different parts of a water supply system cannot be accepted."

The fundamental reasons behind these warnings are pertinent to all State owned corporations. How State owned corporations deal with this matter in general will be an increasingly important test of the corporatisation process.

Sydney Water in the Land and Environment Court

On 21 July 2000 Justice Lloyd of the Land and Environment Court delivered his verdict in the case *Environment Protection Authority v Sydney Water (2000) NSWLEC 156*. Sydney Water pleaded guilty to an offence against the *Environmental Offences and Penalties Act 1989* in that it polluted waters with sewage, contrary to the *Clean Waters Act 1970*. The case came about in October 1998 when Helensburgh residents complained about sewage odours, which were subsequently traced to sewage overflowing from an access cover in nearby bushland. The sewage overflow was caused by a 'soft blockage/choke', primarily caused by fats and greases in the sewage collecting on fine roots from trees and plants which had grown into the sewers.

The Helensburgh sewers were classed by Sydney Water as non-critical, and are subject to what the corporation describes as a 'reactive maintenance' strategy. In effect, no maintenance or preventative work is carried out on non-critical sewers and Sydney Water simply reacts to overflows when they occur. When a problem such as an overflow occurs, a 'corrective maintenance' program is implemented.

In its defence before the Court the counsel for Sydney Water submitted a variety of factors, including the following:²⁴

... Sydney Water had virtually no control over its level of resources to be directed to preventative maintenance. It is governed by the State Owned Corporations Act 1989 and the requirement thereunder to produce a dividend to its shareholder, the State Government. Its income is controlled by a pricing structure determined by the Independent Pricing Tribunal.

The Court was scathing of the reactive maintenance approach and other resource issues and made the following comments in its decision:²⁵

In addition to its public responsibilities, Sydney Water is constituted as an independent statutory corporation. It is a commercial enterprise. Whilst it has a highly important public role, Sydney Water cannot be given special exemptions simply because its shareholder, the state government, is not private. It must be responsible for its actions or omissions, at least to the same degree as any other business is subject to the environment protection laws of this State.

The defendant has presented its case on an assumption that the current level of its resources directed at prevention and maintenance is fixed and may not be increased. This situation is purportedly caused by the statutory framework within which 'its hands are tied' – with no means to independently control its income and expenditure.

Sydney Water has failed, however, to address the fact that it is also bound by the environmental protection regime of this State. Sydney Water is required by law to do which is necessary to protect the environment. As the prosecutor has submitted, the clear obligation to comply with the Clean Waters Act sits above any contractual, commercial or other obligations.

Sydney Water clearly has surplus funds. At the same time, the rate of chokes is increasing.

It seems to me that Sydney Water has, to use a colloquial expression, failed to put its money where its mouth is. If Sydney Water was so wholly determined to protect the environment it would allocate any surplus funds to the implementation of preventative measure. At a bare minimum, dividend levels should be significantly reduced until such time as choke rates start to significantly decrease.

In no other sector or industry is such a 'reactive maintenance' strategy considered acceptable. The era of unregulated dumping of industrial wastes

²⁴ Environment Protection Authority v Sydney Water (2000) NSWLEC 156, at 29.

²⁵ Environment Protection Authority v Sydney Water (2000) NSWLEC 156, at 45 to 51.

has long since past. The era of virtually unmitigated overflow of sewage should similarly cease. I accept the fact that there is no practical possibility of zero sewerage overflows. The environmental laws stipulate, however, that pollution must not occur. In the absence of a licence to pollute, Sydney Water must not pollute. It must spend all its available resources on pollution prevention which, in this case, means preventative maintenance. Dividends or profits are inappropriate if they are coming from a corporation that is breaking the law on a routine basis. The priorities of Sydney Water's management and its shareholders must be re-examined.

Sydney Water was subsequently fined \$40,000.

4.3 Other State Owned Corporations

4.3.1 Electricity

With the operations and responsibilities of State owned corporations having such a great impact on our day to day lives, their performance is often the subject of media coverage and public interest. The recent breakup of Pacific Power into two entities,²⁶ together with the impact of a national electricity market, privatisation and competition, has added to the interest in electricity State owned corporations. For instance, it has also been claimed that Pacific Power has suffered losses of up to \$600 million from trading in electricity 'hedge' contracts with the Victorian distributor Powercor.²⁷ The Treasurer, Hon Michael Egan MLC has referred Pacific Power's risk management and trading procedures and processes to the Auditor-General for an inquiry under section 38B of *the Public Finance and Audit Act*.²⁸

It has also been reported that some of the electricity distributors are also losing money, with Integral Energy reportedly losing between \$1 million and \$1.5 million a month from poor electricity trading practices.²⁹

The electricity supply industry has undergone major reform, with competition between generators and distributors now occurring. However, the problem is that all the NSW based competitors are owned by the same entity, that being the government. The former Auditor-General Tony Harris has highlighted this problem, and is reported as saying: "In particular, in a competing market, you expect firms to fail, and it is very difficult under the current structure for the Government to manage its shareholder interests properly." Mr Harris noted that there was no model whereby a single shareholder could foster unfettered competition

²⁶ The State owned corporation Eraring Energy was formed with the electricity generating assets of Pacific Power.

²⁷ See 'Bonuses to fat cats despite losses' in *The Sydney Morning Herald* 2 September 2000.

²⁸ *NSWPD*, 6 September 2000 at 23.

²⁹ 'Integral losing \$1m a month' in *The Sydney Morning Herald*, 1 June 2000.

between the companies it owned. The problem, of course, would be solved by the privatisation of the industry.³⁰

4.3.2 Railways

After a series of accidents and mishaps, the operation of the rail transport system has also attracted interest. Three State owned corporations are involved. These are: the Rail Access Corporation, which manages the railway infrastructure; Rail Services Australia, which bids for contracts to maintain railway infrastructure; and Freight Corp, which operates freight trains.³¹ These corporations, together with the State Rail Authority, which operates passenger services, comprise the NSW rail system.

On the 2 December 1999 seven passengers were killed in a railway accident at Glenbrook. The Hon Acting Justice Peter McInerney was appointed Commissioner to inquire into and report on the Glenbrook accident. Highlighting the number of incidents on the rail system, Justice McInerney was also requested to report on the following accidents as well:

- Redfern on 6 April 2000;
- Hornsby on 9 July 1999 and 14 November 1999;
- Olympic Park on 2 September 1999 and 14 November 1999;
- Waverton on 20 December 1999;
- Kerabee on 18 August 1998;
- Bell on 15 October 1998.

Justice McInerney is due to report on 31 December 2000.

It has been reported that the State Coroner has criticised the break up of the State's rail organisations into the above listed entities, saying that it has led to a spate of problems not encountered earlier. The Coroner concluded that the separation of the entities appears to have led to communication difficulties as regards safe working practices.³²

The Productivity Commission has also highlighted some potential costs associated with the structural separation in the rail sector, including:³³

- A lack of coordination between separated rail entities, both in terms of above and below track business and between geographically separated entities;
- The complication of timetabling, train schedule allocation and capacity management;

³⁰ "Left attacks auditor's support for power sale" in *The Sydney Morning Herald*, 4 August 1997.

³¹ The Government has recently announced that it intends to privatise FreightCorp, and this was approved by the Labor caucus in September this year. See 'Left says no to FreightCorp sale' in *The Australian Financial Review*, 1 August 2000.

³² 'Splitting of railways 'led to deaths'', in *The Daily Telegraph* 15 August 2000.

³³ Productivity Commission, *Progress in Rail Reform, Draft Report*, 1999, at 97.

- Loss of some economies of size, scope and density
- High transaction costs of acquiring full information necessary for train operators and track providers to undertake long term investment planning

It is apparent that at least the first of the problems identified by the Productivity Commission has arisen in NSW.

In response to concerns about the reliability of the NSW rail network, on 8 June 2000 the Government appointed Ron Christie to a new position, Coordinator-General of Rail.³⁴ He has been given wide ranging powers to direct and coordinate the State Rail Authority, and the State owned corporations Rail Access Corporation and Rail Services Authority. In relation to the statutory powers of the Coordinator-General giving directions to the State owned corporations, Transport Minister Carl Scully is reported to have said: “I’m entitled to issue directions to the State owned corporations and the State Rail Authority. I have issued a direction that they are to comply with the directions and instructions of Ron Christie.”³⁵

There were some concerns reported about the legality of Mr Christie directing the boards and chief executives of the rail State owned corporations. However, in response to these concerns the Premier was reported to have said: “There’s one priority here – to fix up State Rail. We put Ron Christie in to do the job and will give him whatever powers are required, whatever authority is required and, if he sees it necessary, whatever additional funds are required.”³⁶

An example of the issues facing Mr Christie was the recently reported conflict between the State Rail Authority and the Rail Access Corporation. In this case, the argument was over which organisation was in charge of rail safety. It was reported that Mr Christie wrote to the two organisations in early August ordering an end to the demarcation dispute over a safe working rules review, which had led to two, contradictory, safety documents. Mr Christie was reported to have said that the dispute could lead to confusion and potentially compromise safe working on the network.³⁷

In its submission to the McInerney Inquiry, the Rail, Tram and Bus Union claimed the following: “The Transport Safety Bureau is a poorly resourced agency. Although the NSW Rail Safety Act defines the bureau as the State rail safety regulator, it has been unable to assert this authority and has been overshadowed by the RAC. This is an untenable situation. The open conflict between RAC, SRA and Transport Safety Bureau over power to establish safe working rules is a symptom of the underlying rail policy contradictions in

³⁴ ‘Railways Mr Fix-it’ in *The Daily Telegraph*, 8 June 2000.

³⁵ ‘Rail chief’s new power’ in *The Daily Telegraph*, 2 August 2000.

³⁶ “Rail chief’s legal authority in doubt” in *The Sydney Morning Herald*, 2 August 2000.

³⁷ ‘Rail chiefs fight over safety rules’ in *The Sydney Morning Herald*, 11 August 2000.

NSW and Australia.”³⁸

5.0 CONCLUSION

The accountability and governance of State owned corporations are major issues for New South Wales and Australia. In New South Wales at least, the purest form of corporatisation, ie, the company State owned corporatisation model, has been wound back. Presently, there are no company State owned corporations, and under the present government it is likely that any future corporatisation will involve the statutory model. This has come about because ultimately, governments are responsible for the operation of the State owned corporations, and the statutory model provides the best mechanisms for the Government to have some control over their operation and management.

On a broader level, the question of whether the over-riding objective of a State owned corporation is to operate solely as a private company does, or to be accountable to government, and through it the community, can only be resolved by public debate.

³⁸ As reported in: ‘Rail chiefs fight over safety rules’ in *The Sydney Morning Herald*, 11 August 2000.