PROVINCIAL DEVELOPMENT UNIT

# BRIEFING

## Advice on managing equity shares taken and loans advanced under the PGF

| | | | |
|---|---|---|---|
| **Date:** | 28 May 2018 | **Priority:** | High |
| **Security classification:** | In Confidence | **Tracking number:** | 3567 17-18 |



**Action sought**

| | Action sought | Deadline |
|---|---|---|
| Hon Shane Jones<br>**Minister for Regional Economic Development** | **Agree** to one of the three options presented for a Crown owned company to hold equity and manage loans under the Provincial Growth Fund.<br><br>**Agree** to officials including your preferred option as part of the June Cabinet paper. | 5 June 2018 |

**Contact for telephone discussion (if required)**

| Name | Position | Telephone | 1st contact |
|---|---|---|---|
| Robert Pigou | Acting Head of Investment, Provincial Development Unit | Privacy of natural persons [redacted] | ✓ |
| Andrew Beaufort | Senior Policy Advisor | | |

**The following departments/agencies have been consulted**

N/A

**Minister's office to complete:**

☐ Approved ☐ Declined

☐ Noted ☐ Needs change

☐ Seen ☐ Overtaken by Events

☐ See Minister's Notes ☐ Withdrawn

**Comments**

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| **Date:** | 28 May 2018 | **Priority:** | High |
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## Purpose

This paper outlines joint advice provided by the Provincial Development Unit and Independent Advisory Panel on the best options to hold equity, manage loans under the Provincial Growth Fund (PGF), set up special purpose vehicles (SPVs) for particular projects and leverage co-investment from the private sector. It seeks your approval for one of three options to be included in the June Cabinet paper.

## Recommended action

The Ministry of Business, Innovation and Employment recommends that you:

a **Agree** to one of the three options presented for a Crown owned company to hold equity and manage loans under the Provincial Growth Fund.

*Agree / Disagree*

b **Agree** to officials including your preferred option as part of the June Cabinet paper.

*Agree / Disagree*

Privacy of natural persons

Robert Pigou
**Acting Head of Investment**
Provincial Development Unit, MBIE

28 / 5 / 18

Hon Shane Jones
**Minister for Regional Economic Development**

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## Background

1. Ministers have asked for officials to present advice to Cabinet seeking approval for establishing a Crown owned company to hold equity, manage loans under the PGF, set up special purpose vehicles (SPVs) for particular projects and leverage co-investment from the private sector.

2. Officials, in conjunction with the PGF Independent Advisory Panel (IAP), have written an options paper (attached as Annex One) with three options for either a Crown entity company or a Schedule 4A company.

3. We are seeking your approval for one of the three options to be included in the June Cabinet paper.

## Overview

4. Provincial Development Unit officials and the IAP have developed three options for either a Crown entity company or a Schedule 4A company:

   - Option One – Passive Shell Company

   - Option Two – Active company with a mandate to originate and manage subset of PGF projects

   - Option Three – Transfer the whole PDU into a CEC or Schedule 4A company

5. If Ministers main priority is just to create a vehicle to hold equity, manage loans and set up SPVs then we recommend Option 1.

6. If Ministers see leveraging co-investment from the private sector for joint projects as important, and/or enhancing commercial credibility with those partners and other commercially focussed stakeholders as important, then we would recommend Option 2. This option is strongly favoured by the Independent Advisory Panel (IAP) and reflects both their experience and discussions with private sector senior management.

7. We expect that the operational expenses of either option would be covered by income generated and capital returned with additional income being reinvested in new projects.

## Next steps

8. Upon selection of your preferred option, we will prepare a Cabinet paper with the recommended option to be submitted to the June Cabinet meeting. This paper would be shared with the Minister of Finance and Minister of Transport before going to the Cabinet office.

## Annexes

Annex One: Advice on Holding Companies

## Annex One: Advice on Holding Companies

PROVINCIAL DEVELOPMENT UNIT

**PREPARED BY:**
RODGER FINLAY
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In Confidence

# Advice on Holding Companies

## Options for managing investments under the PGF

# Advice on Holding Companies

## Executive summary

Ministers have asked for officials to present advice to Cabinet seeking approval for establishing a Crown owned company to hold equity, manage loans under the PGF, set up special purpose vehicles (SPVs) for particular projects and leverage co investment from the private sector.

We have developed three options for either a Crown entity company or a Schedule 4A company:

- Option 1 – Passive Shell Company
- Option 2 – Active company with a mandate to originate and manage subset of PGF projects
- Option 3 – Transfer the whole PDU into a CEC or Schedule 4A company

If Ministers main priority is just to create a vehicle to hold equity, manage loans and set up SPVs then we recommend Option 1.

If Ministers see leveraging co investment from the private sector for joint projects as important, and/or enhancing commercial credibility with those partners and other commercially focussed stakeholders as important, then we would recommend Option 2. This option is strongly favoured by the Independent Advisory Panel (IAP) and reflects both their experience and discussions with private sector senior management.

We expect that the operational expenses of either option would be covered by income generated and capital returned with additional income being reinvested in new projects.

## Background

Ministers have asked officials to provide advice on options establishing an entity to hold equity under the PGF, manage loans that have been advanced, set up SPVs and generate private sector investment. Previously, MBIE and Treasury officials have provided general advice on the principles of when to use certain investments and what possible models may look like.

With Ministers signalling they wish for officials to set up a holding company, we intend to go to Cabinet in June to seek approval for their desired entity.

## Previous advice outlined two broad options – either departmental management, or holding company – we think the second option is now more appropriate

The initial MBIE joint advice, with Treasury, outlined two broad options – either departmental management, or some form of holding company. At that point in time, we were uncertain about what projects were in the pipeline that might be suitable for equity and loans, therefore we recommended departmental management in the short term.

However, we are now aware of a number of large private sector firms who are looking to partner with central government to deliver projects under the PGF. They have discussed ideas with officials and members of the IAP that are of a significant scale and complexity, with potential value up lift. If these ideas are to be progressed further to the proposal stage and beyond, we think it would warrant having some form of entity to shape those proposals and manage those investments. We also note that it is more likely now that the PGF will use debt and equity instruments, strengthening the case for using a company.

## Key considerations

There are a number of factors that Ministers and officials should consider when making a decision on the shape of the required entity. Broadly these are:

1. Ministerial influence – the extent to which Ministers can influence investment decisions and ongoing investment management.
2. Sending credible signals to the market about central government desire to partner with the private sector to deliver projects and operating in a manner that the private sector is familiar with.
3. Timeframes and costs – how long it takes to establish and the costs incurred in doing so.
4. Duration – the need to hold and administer long-term debt, underwrites and shares following the expiry of the fund and the need for ongoing operational funding.

## A holding company may be perceived as reducing Ministerial influence compared to departmental management but Ministers can still exert effective influence through other mechanisms

By interposing a board of directors, the assumption is that Ministers will have less direct influence over specific projects than if using departmental management. However, there are a number of options to give Ministers the desired level of influence (and which can be ratcheted up and down in different circumstances).

Ministers can influence programme direction through the appointment of the holding company board and that board's ongoing accountability to Ministers, but also by setting the mandate of the holding company and the obligations of its board through its constitution and statement of intent, and by reserving rights to the Ministers through the company's constitution or other agreements between the Crown and the company. These options have been used before in the context of other Crown owned companies.

The advantage of using a company is that the desired level of Ministerial influence can be achieved as well as establishing a model that will be perceived as "commercial" to interested third parties (which will assist in leveraging private sector investment).

## An active holding company has greater start-up costs, but can provide efficiencies

Setting up a Crown-owned company is expected to take at least three months to get the required approvals, establish a constitution, appoint directors and capitalise, and will incur establishment costs.

However, in the context of the PGF, these costs will not be large (we consider it would be much less than the almost $500,000 required to establish Crown Irrigation Investments Limited). There may be administrative efficiencies from owning and managing equity shares, and administering loans, through a holding company. These efficiencies would stem from the above tasks being the company's core business, the company not having the same responsibilities as a government department, and the delegation of operational and administrative decisions to the company's board and management. By contrast, independent legal advice provided to us is that the public sector's framework for delegations from the Ministers to departments, and within departments, will give rise to more administrative complexity if the Ministers hold investment directly.

## There are three different types of Crown-owned companies to choose from – we think either a Crown entity company or Schedule 4A is most appropriate

There are three options for what type of Crown-owned company could be used:

i. A Crown entity company
ii. A Public Finance Act Schedule 4A Company
iii. A State Owned Enterprise

Based on previous advice, our view is that a Crown entity company (CEC) or Schedule 4A company would be best suited to the purpose. Independent legal advice provided to us advised that the material differences between a CEC and a Schedule 4A company are minimal. However, Schedule 4A companies are probably more commonly used in commercial situations or for commercial transactions and offer slightly more flexibility as not all of the Crown Entity Act requirements will apply, or need to be applied, to them.

The State Owned Enterprise (SOE) framework was designed for commercial enterprises, and so is less appropriate for delivering non-commercial or public benefits (as the PGF is). A CEC or Schedule 4A would be better placed to deliver a mixture of commercial and public benefit objectives.

## We've developed three different models

On the basis of these considerations, we have developed three options for the company. These are:

- Option 1 – Passive Shell Company
- Option 2 – Active company with a mandate to originate and manage subset of PGF projects
- Option 3 – Transfer the whole PDU into a CEC or Schedule 4A company

A summary of the options is provided below:

| Option | Legal form | Function/Delivery model |
|---|---|---|
| Option 1 | Crown Entity Company or Schedule 4A company. Shares could be held by the Minister of Finance and the | • Decision-making sits with Ministers / Cabinet, except for deals under $1m.<br>• PDU acts as interface with |

| | | |
|---|---|---|
| | Minister for Regional Economic Development. | sponsors, originates and manages assets, and provides "Ministerial support"<br>• Back-office support from MBIE.<br>• Hold Co. simply holds investment assets as "nominee" for PDU and has no active function, no staff, small board, simple management agreement with PDU/MBIE<br>• All returns are 'recycled'. |
| Option 2 | As per Option 1 | • As per Option 1, with the PDU acting as initial filter.<br>• Projects that meet certain criteria are passed over to "Active Co." once an EOI is received. For example this could be projects over $20m, or more commercial in nature.<br>• "Active Co." originates and manages the investment.<br>• A memorandum of understanding is entered into between Active Co. and the PDU, setting out roles and responsibilities. PDU would continue to be responsible for strategy, broader regional relationships, etc.<br>• Active Co would be established as a targeted lean team to focus on delivering the more complex and commercial projects quickly.<br>• It has a board appointed by Ministers and small group of staff.<br>• Opportunity to have an efficient decision-making model.<br>• All returns are 'recycled'. |
| Option 3 | As per option 1, but PDU migrated into Active Co. | • PDU becomes Active Co.<br>• All returns are 'recycled'.<br>• Requires further scoping work . |

A summary of the pros and cons of the three models are:

### Option 1: Passive Shell Company with a board, but investments managed by PDU

| Pros | Cons |
|---|---|
| • Relatively low set up costs compared to an active company.<br>• If managing debt and equity, setting up SPVs is the only consideration then this model would serve well. | • The PDU may not be an attractive option for the expertise required to close complex deals due to limited ability to pay at commercial rates.<br>• With management arrangements |

| | |
|---|---|
| | sitting in a government department, may not send the right signals to the market and potential investors.<br>• The model could be cumbersome where investments are more sophisticated than simple, one-time investments, and require ongoing active decision making, engagement with other investors or follow-on investments.<br>• Possible perception concerns from market on the ongoing security of funding for investments in event of electoral change.<br>• Not commonly used by agencies. |

**Option 2: Active company with a board, CE, small number of expert staff and mandated to manage PGF projects of complexity and scale – agreement between Active Co. and PDU outlining roles and relationship. Activities of Active Co. are monitored by PDU/MBIE.**

| Pros | Cons |
|---|---|
| • Provides a credible model that private sector investors can engage with.<br>• The ability to attract the right expertise to negotiate complex deals and pay at commercial rates.<br>• Potential administrative efficiencies and some of the returns on investment could be recycled back into Active Co.s operating costs.<br>• Initial assessment suggests establishment does not need to be difficult or time-consuming.<br>• Would address perception concerns around security of funding for investments in advent of political change. | • Perception that Ministers may not have the desired degree of control over investments that they would under departmental management. However, this can be achieved through Active Co. constitution, Ministers appointing the board and other control mechanisms.<br>• There could be concerns around relationship between Active Co. and PDU. However, easy to mitigate with clear purpose statement and utilising seamless model for interacting with all parties.<br>• Higher start-up costs than Option 1, but not that much and possible administrative efficiencies in the longer term.<br>• Need to be sure there is a credible pipeline of projects but can be run lean and mean. |

### Option 3: Transfer the whole PDU into a CEC or Schedule 4A company

| Pros | Cons |
|---|---|
| • Potentially tidier option in respect to having one entity responsible for all PGF projects.<br>• Would also deliver many of the same pros listed in Option 2 | • Could be viewed by partner agencies and parent agency as not very palatable –likely to be political considerations.<br>• Some administrative technicalities to address to transfer staff from department into Active Co.<br>• Would require clear agreements with central government partners outlining roles and responsibilities.<br>• There would need to be a rethink of the governance structures surrounding the PGF – i.e. roles of SROs, etc. |

Of the three options, Option 1 is best suited to our purposes if Ministers only want a vehicle to hold equity, manage loans, or set up special purpose vehicles.

If Ministers want to enable future flexibility, to prioritise leveraging private sector investment, deal effectively with commercial partners, along with having a vehicle to manage equity, managing loans along with establishing SPVs then Option 2 is the preferred model.

There is scope to set up Option 1 and, if we find it is no longer fit for purpose, transform it into Option 2. However, this would incur further costs and would be not be the most efficient approach. We would not recommend this option.

## Income generated and capital returned

Income generated from interest of dividends as well as debt and equity capital returned would be retained within Hold Co. We expect that initially this would be utilised to cover operational costs. However, eventually any additional cash flow over and above operating costs could be redeployed into new proposals to further support regional economic development.

## Tax considerations

Legal advice provided to us advised that relative to the status quo, the tax position for the Crown is:

- Will be unchanged under Option 1 if Hold Co. carries out its activities solely as "nominee" for the PDU because nominees are disregarded for tax purposes.
- For Options 2 and 3, the new entity will have independent tax status. To be "tax exempt", the new entity would have to be a "public authority" for tax purposes – which will also ensure that grants/subsidies that it makes would be excluded income for the recipients (the latter being relevant for Option 3). In order to be a "public authority", the new entity must be an instrument of the Executive Government. This will require the entity to engage with the IRD to confirm that it meets these criteria (we understand other Crown entities have gone through this process with IRD so it's not a new issue).

From the perspective of private sector investors, subject to the above, no other material tax issues should arise due to receiving grants or investments from a Crown-owned entity rather than with a department.

## There are varying start-up costs and times

Option 1 would have the lowest start-up costs and options 2 and 3 would cost more due to the need to hire required staff. All options could be set-up in at least 3 months. Typically, the process to establish a new Crown company includes:

a. Cabinet approvals to the purpose and functions of the company
b. Decisions on the financial powers that can be exercised by the company
c. The drafting of a constitution and the formal incorporation of the company
d. Identification and appointment of directors
e. Capitalisation of the company on incorporation
f. The passing of Order in Council to add the Company to either the Crown Entities Act, the Public Finance Act or State Owned Enterprises Act, and
g. Recruitment and establishment of suitable management and operational team.

## Next Steps

If Minister Jones agrees to the recommendations we will prepare a Cabinet paper with the recommended option to be submitted to the June Cabinet meeting. This paper would be shared with the Minister of Finance and Minister of Transport before going to the Cabinet office.