MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Establishment of Provincial Growth Fund Ltd

Date:	16 October 2018	**Report No:**	1379 18-19
		File Number:	SH-11-1-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to the establishment of Provincial Growth Fund Ltd (PGF Ltd)	
Minister for Regional Economic Development (Hon Shane Jones)	**Agree** to the establishment of Provincial Growth Fund Ltd (PGF Ltd)	
Minister for State Services (Hon Chris Hipkins)	**Note**	

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Isabel Poulson	Manager, Strategy & Policy, PDU, MBIE	Privacy of natural persons [redacted]	✓
Matthew Appleby	Acting Manager, Commercial Performance, Treasury		

Actions for the Minister's Office Staff (if required)

Return the signed report to agencies.

Enclosure: No

Joint Report: Establishment of Provincial Growth Fund Ltd

Executive Summary

The Provincial Development Unit (PDU) and the Treasury were directed to report to the Minister for Regional Economic Development, the Minister of Finance, and the Minister for State Services on the design of a standalone company to hold commercial investments from the Provincial Growth Fund (PGF) (CAB-18-MIN-0347 refers).

This report proposes the establishment of Provincial Growth Fund Ltd (PGF Ltd), a Crown entity company in which the Minister for Regional Economic Development and the Minister of Finance would be Shareholding Ministers.

We have considered two options for the mandate and operating activities of the company:

- option one – a nominee company that holds investments but has no role in providing advice or management for those investments (these activities would be undertaken by the PDU under a management contract), or

- option two – an operational commercial entity that advises, monitors, and manages commercial investments approved by Ministers under the PGF.

Under either option, RED Ministers would continue to approve funding for projects between $1m and $20m, and Cabinet would approve funding for projects over $20m. However, under option two Ministers would only be asked to approve project funding for projects put forward by the company (rather than considering all projects), and there would be changes to the role of SROs and the IAP.

Officials consider that the choice between the options needs to be made within the context of the potential nature, size, and complexity of the pipeline of investments that might be held by PGF Ltd. This is a sense check to ensure the structure of the entity is fit for purpose.

Option one is a lower cost option that could be transitioned into option two over time if it became clear that there was sufficient deal flow and/or the nature of the deals made that desirable. Option two provides a credible and capable commercially focused entity, with enhanced risk management, including reducing Ministerial risk through separation from the ongoing monitoring, management, and administration of investments once they are made. Option two, however, requires a certain scale and complexity to be efficient and represent good value for money. If deal flow proved to be small and straightforward, the cost, time and resource required to establish and maintain a fully operational company under option two may erode the benefits associated with having an arm’s length commercially focused company.

Treasury’s view is that option two could start to provide net benefits from a portfolio size of around $150m with it likely to be preferred to a nominee company as the portfolio grew beyond $200m. The Investment Team within the PDU has estimated that 15-25 quasi-commercial deals (i.e. not grants) of a magnitude greater than

$10 million may occur over the three year lifetime of the PGF but note that the timing, nature and complexity of deals is highly uncertain. Given the significant uncertainty around this forecast, officials' recommendation is for option one, a nominee holding company, with the ability to scale it into option two as needed.

We propose that MBIE review arrangements and report back in 12 months – or sooner should the pipeline of deals or portfolio size require - with an assessment of whether there would be merit in scaling into option two at that time, given how the pipeline has developed.

Additional information on the legal form of the company and administrative steps involved in its establishment are contained in this report. Once you have chosen an option, we will draft a Cabinet paper for you that seeks Cabinet approval to the establishment of the company.

Recommended Action

We recommend that you:

a **Agree** to the establishment of Provincial Growth Fund Ltd, a Crown entity company, in which the Minister for Regional Economic Development and the Minister of Finance would be Shareholding Ministers

Agree/disagree.	*Agree/disagree.*
Minister of Finance	*Minister for Regional Economic Development*

b **Note** officials consider that there is insufficient information on the timing, nature and complexity of deals at this stage to justify Option two, a fully operational holding company

c **Agree** that Provincial Growth Fund Ltd shall be a nominee company with its operational functions undertaken by the PDU through a management contract (Option one)

Agree/disagree.	*Agree/disagree.*
Minister of Finance	*Minister for Regional Economic Development*

d **Direct** the Provincial Development Unit to review arrangements and report back to joint Ministers by October 2019 on whether the transactions are complex enough in nature and of sufficient size to warrant (i.e. complex equity and debt transactions, being not less than $150m-$200m in total) progressing to option two (a fully operational PGF Ltd).

Agree/disagree.	*Agree/disagree.*
Minister of Finance	*Minister for Regional Economic Development*

Matthew Appleby
Acting Manager, Commercial Performance
Treasury

AJ Millward
General Manager, Governance and Strategy
Provincial Development Unit

Hon Grant Robertson
Minister of Finance

Hon Shane Jones
Minister for Regional Economic Development

Joint Report: Establishment of Provincial Growth Fund Ltd

Purpose

1. This report proposes the establishment of Provincial Growth Fund Limited (PGF Ltd), a Crown entity company that would hold investments as part of the Provincial Growth Fund (PGF). Two options for the mandate and operating activities of the company are presented.

Background

2. The PGF aims to lift productivity potential in the regions. It was established as a three tiered fund, with different policy objectives / strategies for each tier:

   - *Regional Projects and Capability:* to support regional development through investment in a range of smaller economic development projects and feasibility studies for potential projects, initiatives to build skills, capability, and capacity in the regions.

   - *Sector Investments:* to drive regional development through investment in priority and/or high value sectors that will make a significant contribution to a region's future growth potential in areas of comparative, or potential comparative, advantage. This tier also includes funding for the Government's One Billion Trees program.

   - *Enabling Infrastructure Projects:* to invest in regional projects identified both centrally and regionally that enable regions to be well connected from an economic and social perspective, including rail, road and communications.

3. The PGF has a number of options for how to fund or contribute to projects. These range from grants and loans through to underwriting or part ownership in a project, including equity shares. In some instances funding arrangements may involve a mix of investment mechanisms, adding layers of complexity to how funding allocations are administered.

4. In the past, funding for regional economic development has generally been in the form of grants. It has become clear, however, that there are a number of entities who are looking to partner with central government to deliver projects under the PGF that are of significant scale and complexity with potential value up-lift for the Crown. Ministers therefore directed officials to consider the corporate forms that would be most suitable as holding vehicles for significant PGF investments in order to better facilitate effective partnership with the private sector.

5. Accordingly, on 23 July 2018, Cabinet directed the PDU and Treasury to undertake the necessary design work on a standalone Crown-owned company, and to report back to the Minister for Regional Economic Development, the Minister of Finance, and the Minister for State Services. This report responds to that direction. Subsequently, the Minister for Regional Economic Development and the Minister of Finance are invited to report back to DEV by

the end of October seeking agreement to the establishment of the company. (CAB-18-MIN-0347 refers)

PGF Objectives and Options for PGF Ltd

6. The PGF aims to lift productivity in the provinces. Its priorities are to enhance economic development opportunities, create sustainable jobs, enable Māori to reach their full potential, boost social inclusion and participation, build resilient communities, and help meet New Zealand's climate change targets.

7. Commercial projects to be potentially managed by PGF Ltd will still need to meet these broader public policy objectives in addition to consideration of their commercial viability. This mix of public good outcomes and commercial objectives implies a role for Ministers and officials in considering the policy merit of proposals, aligned with capable commercial analysis of each project. The goal is to match roles to the expertise and core functions of the entities involved.

8. The existing allocation of decision making responsibility for PGF investments is as follows.

Party	Decision- making responsibility
Cabinet	Responsible for final review and sign-off of projects over $20m
Regional Economic Development (RED) Ministers	Delegated authority by Cabinet to review and sign-off projects over $1m but less than $20m
Senior Regional Officials	Delegated authority by Cabinet to review and sign-off projects less than $1m
Independent Advisory Panel	Provide advice on any proposals referred to it by RED Ministers and/or the PDU
PDU	Entry point for the Fund – can decline applications that do not meet the criteria of the Fund

9. We are not proposing changes to Ministerial decision making responsibility for approving funding investments in projects. However, under option two below Ministers would only be asked to approve funding for projects put forward by the company, rather than considering all projects, and there would be changes to the role of SROs and the IAP.

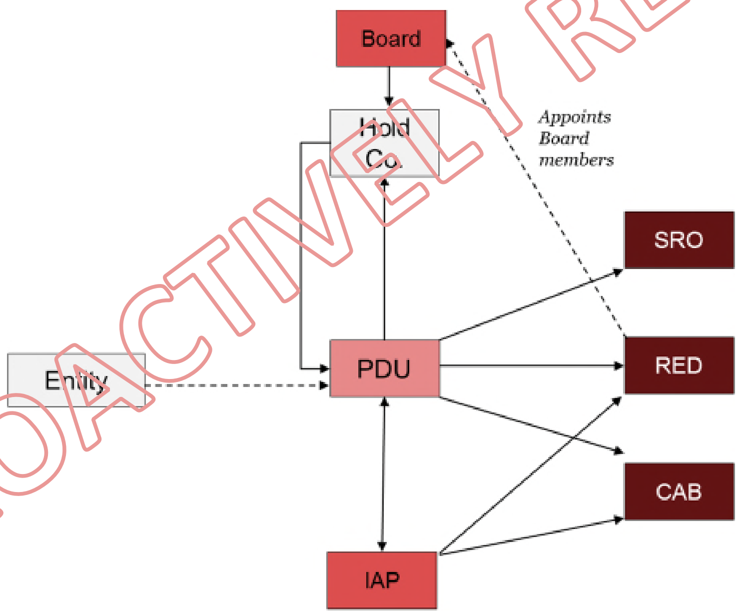
PGF Ltd Options

10. We have explored two structural options for PGF Ltd. The development of these options has been informed by Ministerial objectives for a commercial entity and the direction that the current decision-making framework for approving projects for funding should remain unchanged (though we note that option two does propose some minor modifications to decision making processes).

Option one – Nominee Company PGF Ltd

11. Under option one, PGF Ltd (Hold Co in the diagram below) is established as a nominee company – its role is to hold legal title to the loan or investment assets and to administer funding for the projects. PGF Ltd would have no operational role in analysing or providing advice on project applications, or for managing investments (after Ministerial decisions have been made). As the Crown would remain beneficial owner of the loan or investment assets all gains and any losses on the investments would continue to be for its account.

12. PGF Ltd would have a Board (likely comprising of 1 to 3 directors) who would perform a largely administrative role. A management contract between PGF Ltd and the PDU would transfer the operational responsibilities associated with analysing and providing advice on project applications, and managing and exiting investments, to the PDU. The PDU would maintain its status quo operational role applying PGF criteria and commercial disciplines to analyse and provide advice on applications. However, PGF Ltd is the vehicle funding goes through, and the vehicle that holds the investments.



13. The IAP would continue its current role in providing independent advice to RED Ministers and Cabinet. The decision-making responsibilities of the SRO, RED Ministers and Cabinet would remain unchanged. However, Ministers would have a responsibility to appoint members to PGF Ltd's Board.

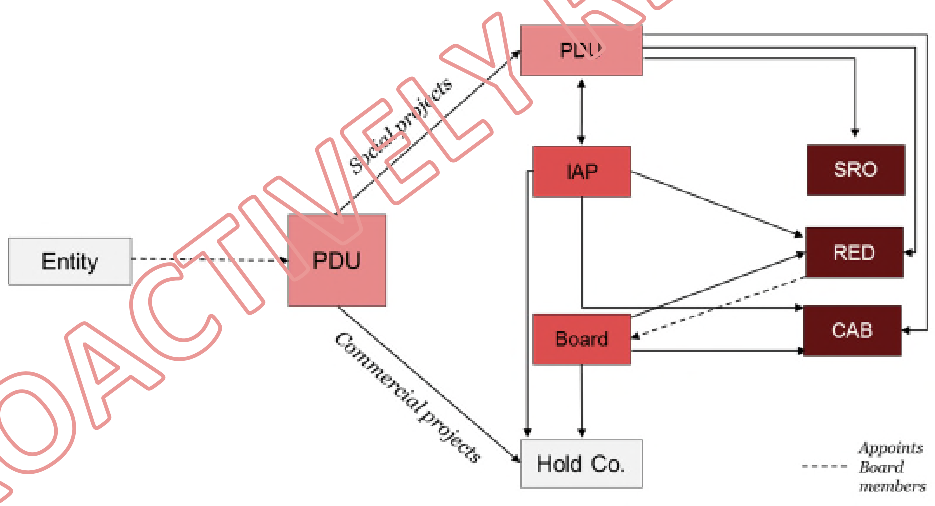
Option two – Commercial Company PGF Ltd

14. Under Option two, PGF Ltd (Hold Co in the diagram below) is established as an independent, commercially focused entity with an operational role. This structure requires the PDU to make an initial classification about whether a project application is likely to lead to ongoing Crown revenue or Crown assets that need to be managed (i.e at least quasi-commercial).

15. For projects where this is not the case (e.g. grants), the PDU would retain its current role undertaking analysis and providing advice to SROs, RED Ministers and/or Cabinet (depending on the size of the application).

16. If a project is deemed at least quasi-commercial it would be sent to PGF Ltd. Under this option PGF Ltd is an operational entity resourced with personnel who have commercial skill sets operating in an entity with a tightly focused mandate, policies and procedures. PGF Ltd would apply commercial disciplines to analyse, to provide advice on applications, and to recommend funding for projects. Once funding was approved by Ministers (subject to such conditions they may wish to impose) the loan or other investment asset would be held on the books of PGF Ltd, with all gains and any losses being for the account of PGF Ltd.

17. PGF Ltd would also be responsible for the on-going management of the investments (after decisions are made). Advice on proposals would be provided, through its Board, to RED Ministers and/or Cabinet (depending on the size of the project).



18. RED Ministers would still make funding decisions on projects between $1m and less than $20m, and Cabinet would still make funding decisions on projects over $20m. However, under option two RED Ministers and Cabinet would only make decisions on the recommended commercial projects that PGF Ltd puts forward for final funding approval following a detailed business case. Currently RED Ministers see all applications that fit the evaluation criteria of the Fund (without rank or prioritisation). This change reflects that PGF Ltd is an independent entity, at arm's length from Ministers, and that it is best placed to undertake the analysis and provide recommendations to Ministers who ultimately agree to provide the necessary funding. While the directors of the company would be formally responsible for the loan and other investments the company takes on, Ministers would continue to exercise considerable influence by determining whether or not a loan or other investment proposal should be funded, and if so, on what conditions.

19. The decision-making responsibility for SROs would change; SROs would only have decision authority over social projects under $1m (rather than all projects

under $1m). SROs' substantive role would not change. They would remain as the champions of their regions and the central government point of contact for their region. The IAP's role would remain unchanged as it would provide advice to Ministers independent of the recommendations of the company board. The IAP would receive information from the company on proposals but would not advise the Board or need to share its advice with the company.

20. As under option one, Ministers would also be responsible for appointing members to PGF Ltd's Board. However unlike option one, PGF Ltd is an operational commercial entity and therefore the skill set and composition of the Board is important for ensuring PGF Ltd is effective in its role. As an operational entity it would be easier to attract highly-skilled potential board members.

21. Once an investment has been made, PGF Ltd would be responsible for monitoring and administering the investment, including decisions such as enforcing its commercial rights when investments perform poorly.

Evaluating the Options

22. In summary, option one provides a vehicle to hold investments and to flow funding through. Option two provides an independent board with a commercially focused company and associated staff.

23. We have previously provided criteria for the evaluation of options, as follows:

- Capable – have commercial expertise, resourcing and structure to ensure that it can behave, and be perceived to behave by stakeholders, as commercial.
- Credible – give stakeholders confidence that the government can operate successfully in this space.
- Efficient – operate with minimal overhead.
- Prudent – be able to manage Crown risk and liabilities, balance the need to be commercial in outlook with the wider objectives of the PGF.
- Adaptable – able to adapt over time (e.g. if Ministers wish for the company to have a greater role in originating PGF investments).

24. Our assessment of the two options with respect to these evaluation criteria is as follows.

Criteria	Option One (compared to the status quo)	Option two
Capable	There is no change in capability as PGF Ltd does not have any operational role. Any benefits associated with a commercial structure will not be realised as the management contract between PGF Ltd and the PDU will see the operational activities continue to be undertaken by the PDU.	PGF Ltd has an independent board, operates in a commercial structure, and is staffed with commercial expertise. This will enable the company to behave – and be perceived to behave – as a commercial entity.
Credible	There is no change in credibility from the status quo as PGF Ltd	PGF Ltd should provide a clear signal to market participants that

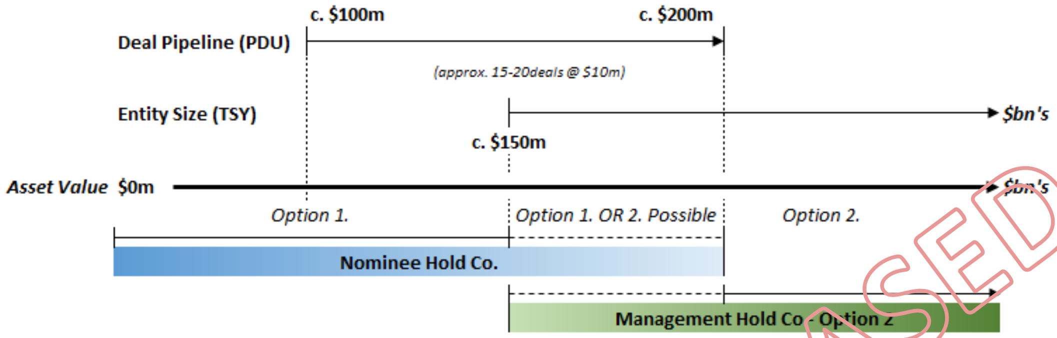
	does not have an operational role.	the Government is serious about successfully operating in this space.
Efficient	Minimal additional overheads are required to establish and maintain PGF Ltd (primarily director fees) as a nominee company. It is likely that the company itself will only require 1 FTE, and the Board comprise 1 to 3 members who undertake largely administrative tasks (e.g. undertake statutory annual filing requirements).	The costs of establishing an operational company, and maintaining it, will be higher than Option one (and higher than the status quo – $0.5m to establish and ongoing operating costs would be $1m to $3m per annum). PGF Ltd is likely to require a Board (estimated at 5 -7members), and staff (Crown Irrigation has 7FTE for comparison) and premises.
Prudent	No additional capability is provided to manage Crown risk and/or liabilities, including the risks that Ministers currently bear from direct involvement in managing commercial investments.	PGF Ltd will be staffed with commercially capable staff who are likely to be able to manage commercial risk and liabilities more effectively than a department. Ministerial risks are reduced as PGF Ltd manages the investments once they are made.
Adaptable	Establishing PGF Ltd as a nominee company will make it comparatively straight-forward to adapt the purpose of the company in the future (e.g. if Ministers wish for PGF Ltd to change its function as being a nominee company and to instead take on an operational role).	It will be more difficult to re-purpose an operational PGF Ltd (compared to a nominee company under Option one). This is because the company will have a Board, staff and constitution in place tasked with analysing, recommending and managing investments.

25. Option one is a low cost option that could be transitioned into option two if it became clear that that was desirable. Option two provides a credible and capable commercially focused entity, with enhanced risk management, including reducing Ministerial risk through separating them from the ongoing monitoring and administration of investments once they are made.

26. Officials consider that the choice between the options needs to be made within the context of the potential size and complexity of the pipeline of investments that might be held by PGF Ltd. This is a sense check to ensure the structure of the entity is fit for purpose. Option two has the potential to provide advantages, such as being a model that encourages private sector engagement and gives commercial legitimacy to the PGF's investments. This option, however, requires a certain scale to be efficient and represent good value for money. If deal flow proved to be small, the cost, time and resource required to establish and maintain an operational company may erode the benefits associated with having an arm's length commercially focused company.

27. The Investment Team within the PDU has estimated that 15-25 quasi-commercial deals (i.e. not grants) of a magnitude greater than $10 million are likely to occur over the three year lifetime of the PGF but note that the timing, nature, and complexity of deals is highly uncertain. Treasury's view is that

option two could start to provide net benefits from a portfolio size of around $150m with it likely to be preferred to a nominee company as the portfolio grew beyond $200m[1].



28. Given the significant uncertainty around the timing, nature and complexity of deals, officials' recommendation is for option one, a nominee holding company, with the ability to scale it into option two as needed.

Adaptability of Option one over time

29. It would be possible to transition a nominee company (option one) into an operational company (option two). Possible principles for when it would be beneficial to transition from option one to option two could include:

- the size and complexity of the projects in the pipeline - for example if the PDU received multiple projects seeking large equity investments (to date, the PDU has not been required to manage an equity investment)

- when additional safeguards against the current 'hands on' Ministerial approach are seen as more favourable - in practice, this is likely to occur at the time when an investment goes poorly and difficult decisions are required (e.g. whether or not to enforce loan requirements in the event of a default), and

- the $3b funding has all been allocated and there would be benefit in applying commercial disciplines to manage and exit the projects.

30. We propose that the PDU report back in 12 months with an assessment of whether there would be merit in transitioning to option two given how the pipeline has developed in that time.

[1] Assessment of the ranges provided were also benchmarked to both past and current entities, such as: the Green Investment Fund $100m (Schedule 4a), Crown Irrigation Investments Limited $65m (Crown Entity), Venture Investments Fund $245m (Crown Entity), and Crown Asset Management Limited $103m in 2012 (Crown Entity).

31. We have considered two legal forms: a Crown entity company under the Crown Entities Act (CEA) and a schedule 4A company under the Public Finance Act (PFA).

32. Crown entity companies are subject to the Companies Act and the Crown Entities Act and typically have mixed commercial and non-commercial objectives. They must be 100 per cent owned by Shareholding Ministers. They can be created relatively easily as they can be added to the Crown Entities Act by Order in Council. However, they can only be removed from the Crown Entities Act by primary legislation. Crown entity companies can establish subsidiary companies, which do not need to be wholly owned by the Crown, which, under option two, could be used as separate vehicles for investment in specific projects where a joint venture is proposed.

33. PFA Schedule 4A companies are similar to Crown entity companies in most respects. The main exception is that these companies can be less than 100% owned by the Crown (but must be more than 50% owned). Unlike Crown entity companies, the can be removed from the PFA by Order in Council rather than requiring primary legislation.

34. Based on our understanding that PGF Ltd will continue to be 100 per cent owned by the Crown, we propose a Crown entity company.

Risks

35. Crown owned companies will normally operate on an arm's length basis from the Crown. Under the Companies Act the business and affairs of the company are normally required to be managed by or under direction of the company's board. However, the directors of a company board also have duties under the Companies Act. They must (among other things) act in the best interests of the company and they must not agree to the carrying on of the company's business in a manner likely to create substantial risk of serious loss to the company's creditors. As a result, there is a risk that at times Ministers' and directors' views of the role and operations of a company may not be fully aligned.

36. These risks are ameliorated under option one, since the purpose of PGF Ltd in this case is to merely hold legal title to the loan or investment assets and to administer funding for the project. The Crown would remain beneficial owner of the loan or investment assets, so any losses incurred on the investments would not be a threat to PGF Ltd's balance sheet. Dealings with the loan and or investment assets so held could be at the direction of the Crown as beneficial owner of those assets.

37. There are more risks inherent if an operational PGF Ltd was used as contemplated under option two. The loan or investment assets would be on the PGF Ltd's balance sheet. If Ministers were to perform the overt role of deciding which loans and investments were to be made by PGF Ltd, and the directors of the company routinely followed Ministerial direction or were obliged to do so pursuit to the company's constitution, then there would be a real risk that Ministers could be deemed to be directors of the company and be subject to

the duties to which the directors are subject under the Companies Act. This could in particular circumstances expose Ministers to liability.[2]

38. However, as mentioned above Ministers would retain a significant degree of influence in making decisions on the funding of specific loan or other investment proposals and the conditions on which such funding is made. Ministers can also influence the directors through a carefully framed statement of intent (on which direction can be taken by Ministers).

39. Furthermore, an option two PGF Ltd will have the benefit of being seen as formally operating at arm's length from Ministers and will have additional commercial capacity and acumen to undertake the analysis and provide recommendations to Ministers for the funding of those investments. A higher quality of candidate for the PGF Ltd board is also likely to be forthcoming, for a company that is seen to be more operational and independent of the Crown.

Establishment Activity

40. It is likely to take at least three months to establish the company. The longest part of the process will be the formal appointment of directors.

41. As previously advised, we have worked through whether an existing Crown company can be repurposed into the PGF company and were not able to identify a suitable existing Crown company. Therefore, once Ministers have confirmed the nature of the company's activities via selecting either option one or option two, we will draft a Cabinet paper for you to seek Cabinet approval to the establishment of PGF Ltd. We propose the following design features and note the associated steps:

i. Name – Provincial Growth Fund Ltd. Once agreed we would reserve the name of the company with the registrar of companies.

ii. Shareholders – Minister of Finance and Minister for Regional Economic Development, 50% each. Shareholding Ministers would consent to form a company under s12(1) of the Companies Act.

iii. Directors – at least one director would be required to consent to acting as a director under s12(1) of the Companies Act. MBIE's appointment unit would undertake its usual process to form a board for the company with Ministers proposing the appointments to APH and Cabinet.

iv. Shareholding Ministers adopt a constitution by special resolution that states the purpose of the company.

[2] See for instance section 126(2) of the Companies Act: "If the constitution of a company confers a power on shareholders which would otherwise fall to be exercised by the board, any shareholder who exercises that power or who takes part in deciding whether to exercise that power is deemed, in relation to the exercise of the power or any consideration concerning its exercise, to be a director for the purposes of sections 131 to 138. Ministers could also be seen as being in breach of section 105 of the Crown Entities Act which provides "A responsible Minister of an independent Crown entity or a Crown entity company may not direct the entity or company to have regard to or to give effect to a government policy unless specifically provided in another Act.

v. The relevant documents are filed with the registrar of companies, the company formed and registered, and a certificate of incorporation issued.

vi. Drafting instructions are provided to Parliamentary Counsel Office (PCO) to draft an Order in Council to add the name of the company to the Crown Entities Act. The Order in Council would need to be submitted to LEG.

vii. On establishment, a Letter of Expectations will be needed from the responsible Minister. This would include specific expectations for PGF Ltd as well as the delivery date for its Statement of Intent and business plan, and general expectations applicable to Crown companies.

viii. Investments already made by the PDU that are of the nature of those to be undertaken by PGF Ltd in future could be transferred to PGF Ltd.

Operational Funding and Monitoring

42. Cabinet has previously agreed that the costs of supporting and administering PGF Ltd will be met out of the funding allocated to the PGF. We are working on the basis that this includes the costs of establishing and operating PGF Ltd. For option one, any financial implications would be minor, primarily comprised of directors' fees. For option two, we estimate that establishment costs would be less than $0.5m and ongoing operating costs would be $1m to $3m per annum. We have based these estimates on the experience of Crown Irrigation Investments Ltd. We will provide detailed financial recommendations in the Cabinet paper once Ministers have selected which option to implement.

43. PGF Ltd will fund its investments through subscribing for equity from Shareholding Ministers. To ensure the financial sustainability of the company its operating funding should be separately provided by the PGF. A new appropriation in Vote Business, Science and Innovation is likely to be required.

44. MBIE would be the monitoring agency for the company.