

Best Practice Principles of Corporate Governance for Crown Corporations

Report for the Commission of Inquiry
Respecting the Muskrat Falls Project

February 25, 2019

Professor Guy Holburn
Ivey Business School, University of Western Ontario
Director, Ivey Energy Policy and Management Centre

Scope of report

This report has been commissioned by the Commission of Inquiry Respecting the Muskrat Falls Project to provide an overview of best practice principles of corporate governance for Crown corporations.

The report summarizes insights from more than 30 reports and studies on corporate governance of Crown and government-owned corporations.

Agenda

1. Background on Crown Corporations
2. The Role of Corporate Governance
3. Best Practice Principles of Corporate Governance
 - i. Corporate Purpose and Mandate
 - ii. Board Selection and Appointment Process
 - iii. Board Functioning and Independence
 - iv. Board Committee Structures and Responsibilities
 - v. Board Relationship with Corporation's Executive
 - vi. Monitoring and Reporting
4. Conclusions

Background on Crown Corporations

- Government-owned corporations with mixed commercial and policy objectives. Arms-length relationship with government to enable operational and strategic autonomy.
- Federal and provincial Crown corporations are active in a wide range of industries and sectors
 - Canada Post, Export Development Canada, CBC, Via Rail, Canada Council
 - Liquor Control Board of Ontario, BC Hydro, Alberta Investment Management Corp.
 - (Petro-Canada, Potash Corp, Air Canada, Nova Scotia Power)
- Crown corporations account for a non-trivial share of economic activity in Canada
 - 47 federal and ~180 provincial Crown corporations
 - ~3.5% GDP, 195,000 jobs, \$220bn net assets

Agenda

1. Background on Crown Corporations
2. The Role of Corporate Governance
3. Best Practice Principles of Corporate Governance
 - i. Corporate Purpose and Mandate
 - ii. Board Selection and Appointment Process
 - iii. Board Functioning and Independence
 - iv. Board Committee Structures and Responsibilities
 - v. Board Relationship with Corporation's Executive
 - vi. Monitoring and Reporting
4. Conclusions

Ownership and Control Issues in Private and Crown Corporations

- The risk that managerial and shareholder interests will diverge is a challenge for all corporations where there is separation of ownership and control rights and where monitoring is imperfect (often referred to as 'principal-agent' costs).
- There are several sources of potential divergence:
 1. **Moral hazard** – managerial shirking, perquisites
 2. **Earnings retention** – managerial usage of retained earnings for growth or diversification opportunities rather than returning funds to shareholders
 3. **Time horizon conflicts** – managerial prioritization of short-term over long-term performance
 4. **Risk aversion** – shareholders (who can diversify portfolios) can be more tolerant of risk than management

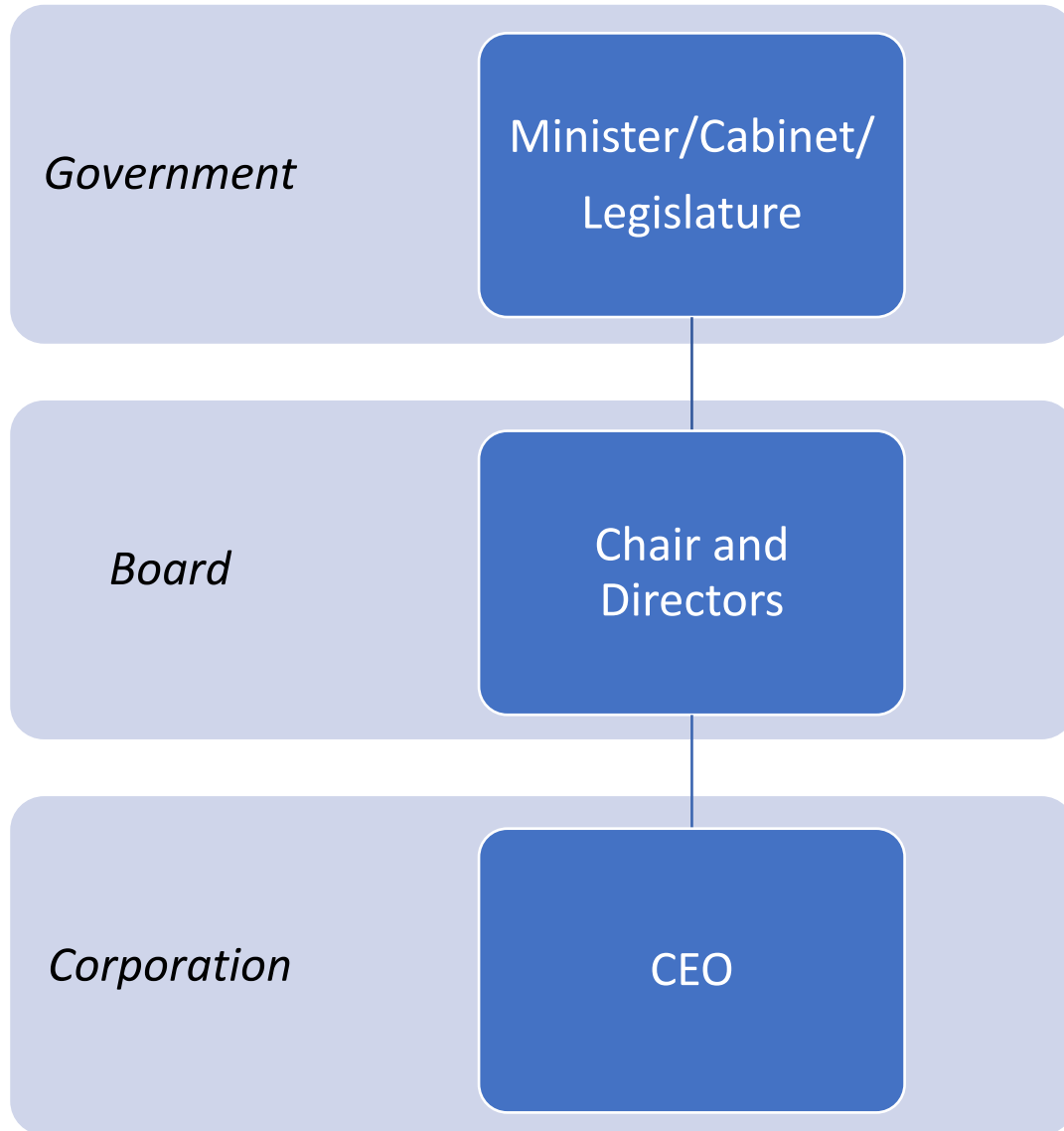
Aligning Incentives in Private Corporations

- Internal and external governance mechanisms can ameliorate principal-agent problems – narrowing the gap between managers' and shareholders' interests, and improving corporate performance:
 1. **Competition for corporation's products/services** – competitive market pressures and risk of bankruptcy discipline management
 2. **Market for corporate control** – takeover of poorly performing management to transfer control to more efficient team
 3. **Executive stock options and long-term incentive plans** – align incentives of managers through stock price-based compensation contracts
 4. **Institutional investors** – skill, time, and incentive to monitor management (versus small, atomistic shareholders). Representation on board too.
 5. **Managerial share ownership** – strengthens incentives but also risk of entrenchment
 6. **Debt financing** – creates commitment for managers to pay out future cash flows (unlike with dividends), brings external capital market monitoring of performance
 7. **Boards** – chosen by shareholders, position depends on achieving shareholders' objectives

Aligning Incentives in Crown Corporations

- Monitoring and control issues are more challenging for Crown corporations than private corps
 - Harder to assess and measure performance due to multiple corporate objectives (commercial and policy), which may change over time
 - Citizens (ultimate shareholders) are separated from Crown corporations by layer of government
 - Risk of bankruptcy absent
 - Limited set of mechanisms to align managerial incentives
 - No market for citizens to buy/sell ownership rights; hostile takeover not possible
 - Strong incentive-based compensation for senior executives often not politically acceptable
 - No institutional equity investor monitoring and oversight
- The Board of Directors is a crucial element of governance for Crown corporations

Structure of Corporate Governance for Crown Corporations



- Establish performance objectives, priorities and targets
 - Approve corporate plans and budgets
 - Appoint board directors and Chair
 - (Appoint the CEO)
-
- Establish the corporation's strategic direction
 - Safeguard the corporation's resources
 - Monitor corporate performance
 - Report to government
-
- Manage corporate operations to achieve performance objectives

Agenda

1. Background on Crown Corporations
2. The Role of Corporate Governance
3. Best Practice Principles of Corporate Governance
 - i. Corporate Purpose and Mandate
 - ii. Board Selection and Appointment Process
 - iii. Board Functioning and Independence
 - iv. Board Committee Structures and Responsibilities
 - v. Board Relationship with Corporation's Executive
 - vi. Monitoring and Reporting
4. Conclusions

Corporate Purpose and Mandate

- 1. The purpose of the Crown corporation should be clearly stated in enabling legislation**
- 2. Government should clearly state performance expectations for Crown corporations – e.g. through mandate letters, communications protocols**
- 3. Crown corporation mandates should be regularly reviewed and updated**
- 4. A central government agency should provide advice on governance arrangements for Crown corporations**
- 5. Crown corporation boards should ensure that strategic plans are consistent with corporate mandates**

Corporate Purpose and Mandate: BC Hydro mandate letter (2016)

Provide reliable, affordable, clean electricity throughout British Columbia, safely. To achieve this mandate, BC Hydro is directed to take the following strategic actions:

- Continue to implement the 10-Year Plan to keep electricity rates low and predictable by optimizing resources and advancing its Revenue Requirements and Rate Design Applications.
- Deliver your overall capital plan portfolio on time and on budget to maintain the reliability of the system, support British Columbia's economic growth and meet the needs of customers.
- Deliver the Site C project on time and on budget and ensure First Nations and local communities have the ability to participate in economic development opportunities arising from the construction of the project.
- Work with Clean Energy BC to identify further opportunities for clean energy producers in British Columbia.
- Improve customer satisfaction by providing timely and responsive service and exploring innovative energy conservation solutions such as load curtailment rates.
- Implement the five-year safety plan to ensure the safety of your workforce and the public.

Corporate Purpose and Mandate: BC Hydro mandate letter (2016)

Government is committed to continuing to revitalize the relationship between the Government and PSOs. This strong focus on increased two-way communication supports and ensures a common understanding of Government's expectations. Timely communication of any issues which may affect the business of BC Hydro and/or the interests of Government is critical to building trust and the effective delivery of public services, including information on any risks to achieving financial forecasts and performance targets.

Each Board member is required to acknowledge the direction provided in the Mandate Letter by signing this letter. The Mandate Letter is to be posted publicly on your organization's website and a copy signed by all Board members provided to the ministry and made available to the public upon request.

I look forward to our regular meetings focusing on strategic priorities, performance against the TAP, key results and working together to protect the public interest at all times.

Board Selection and Appointment Process

- 1. Director appointment processes should be open, transparent, and merit-based**
- 2. Crown corporation Boards should prepare a skills matrix outlining the experience and competencies required of individual directors and the Board as a whole**
- 3. Director remuneration should be structured to attract quality applicants and should be commensurate with the nature of public service and time commitment required**
- 4. The size of Crown corporation Boards should be appropriate for the scope of roles and responsibilities**
- 5. Orientation and training programs should be provided to all Board members**
- 6. Appointments should be appropriately staggered to maintain continuity**
- 7. Board vacancies should be filled on a timely basis**

Board Functioning and Independence

- 1. Directors of Crown corporations should be independent**
- 2. The Board should not involve itself in day-to-day management of the corporation**
- 3. There should be separation of the role of Chairperson and CEO**
- 4. There should be limits around the appointment of public servants to Crown corporation Boards**
- 5. The Chair is responsible for facilitating the Board's debate and decision-making process**
- 6. Board decision-making and deliberation should be designed to embrace the challenge function of independent Boards**
- 7. The Board should conduct periodic self-evaluations of performance**

Board Committee Structures and Responsibilities

- 1. The Board should establish committees with specific roles and responsibilities, e.g.**
 - a. Audit
 - b. Corporate Governance
 - c. Human Resources and Compensation
 - d. Health and Safety
- 2. Board committees should have written terms of references**
- 3. Committee members should have relevant skills, qualifications and competencies**
- 4. Boards should constitute an Audit Committee to ensure financial accountability**
- 5. The Board should ensure that an overall risk management process is in place**
- 6. The Board should conduct periodic evaluations of the performance of each committee**

Special Board Committees: Darlington Refurbishment Project

Internal Oversight		
Darlington Refurbishment Committee of OPG's Board of Directors	Project Status and Performance	<ul style="list-style-type: none"> Oversees the Project's execution, which includes monitoring the Project's progress and performance against its schedule and budget, and making recommendations to OPG's Board Has retained an external advisory group* to support its oversight responsibility Receives regular reporting on the status of the Project from OPG senior management.
Refurbishment Construction Review Board	Project Status and Performance	<ul style="list-style-type: none"> Consists of external industry experts with relevant experience with megaprojects to provide assessments of the Project's progress and to advise OPG senior management (including the Chief Executive Officer, Chief Nuclear Officer and Senior Vice President of Nuclear Projects) Provides quarterly reports to OPG senior management (such as the President and the Chief Executive Officer) and provides updates to the OPG's Board of Directors on the status of the Project
OPG's Project Senior Management Team	Project Status and Performance	<ul style="list-style-type: none"> Consists of OPG senior management responsible for the Project (such as the Senior Vice President of Nuclear Projects) Receives regular reporting from OPG Project staff (such as directors and managers who are responsible for overseeing contractors perform Project work)

Board Relationship with Corporation's Executive

- 1. The Board should be involved in the selection and appointment of the CEO**
- 2. The Board should develop clear performance expectations for the CEO**
- 3. The Board should develop with senior management the corporation's strategy and values**
- 4. The Board should hold in camera sessions without the presence of the CEO and senior management on a regular basis**

Monitoring and Reporting

- 1. The Board should publicly report on Crown corporation performance each year**
- 2. The Board should communicate regularly with government**
- 3. The Board should ensure that it receives sufficient performance information on a timely basis**
- 4. The Board should ensure that it receives appropriate financial and accounting information**

Agenda

1. Background on Crown Corporations
2. The Role of Corporate Governance
3. Best Practice Principles of Corporate Governance
 - i. Corporate Purpose and Mandate
 - ii. Board Selection and Appointment Process
 - iii. Board Functioning and Independence
 - iv. Board Committee Structures and Responsibilities
 - v. Board Relationship with Corporation's Executive
 - vi. Monitoring and Reporting
4. Conclusions

Conclusion

- **Clarity of Crown corporation commercial and policy objectives is essential for setting performance expectations and for creating accountability**
- **Governance of Crown corporations presents unique challenges relative to private sector corporations**
- **Boards of directors are a central element of governance for Crown corporations since other oversight mechanisms are often not available**