STATES OF JERSEY

THE STATES AS SHAREHOLDER: JERSEY TELECOM

Presented to the States on 24th July 2014
by the Comptroller and Auditor General

STATES GREFFE

Comptroller & Auditor General

The States as Shareholder – Jersey Telecom

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JERSEY AUDIT OFFICE

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Introduction

1.1 In 2003 the operational activities of the former Telecommunications Board were incorporated and Jersey Telecom commenced operations as a company wholly owned by the States. In 2013 the JT Group Ltd (JT) had an annual turnover of £151.4 million and a profit before tax of £10.8 million. The States' interest in the JT Group was valued at £183.5 million at 31 December 2013. In Jersey, JT operates under a licence granted by the Channel Islands Competition Regulatory Authority, the independent regulator of telecommunications under the Telecommunications (Jersey) Law 2002.

1.2 Since incorporation, JT has changed significantly. The traditional fixed line business forms a smaller proportion of its activity. Expansion and acquisitions, such as the acquisition of Worldstone (a global provider of managed services), mean that there is greater diversity of activity and a growing proportion of the business is outside Jersey. In 2013, for the first time, the majority of revenue arose outside Jersey.

1.3 The States have the challenge of allowing the management of Jersey Telecom to run the business whilst at the same time effectively protecting their interests as the sole shareholder.

Objectives and scope of this review

2.1 This review:

- reports on the adequacy of the States governance arrangements to discharge their responsibilities as a shareholder; and

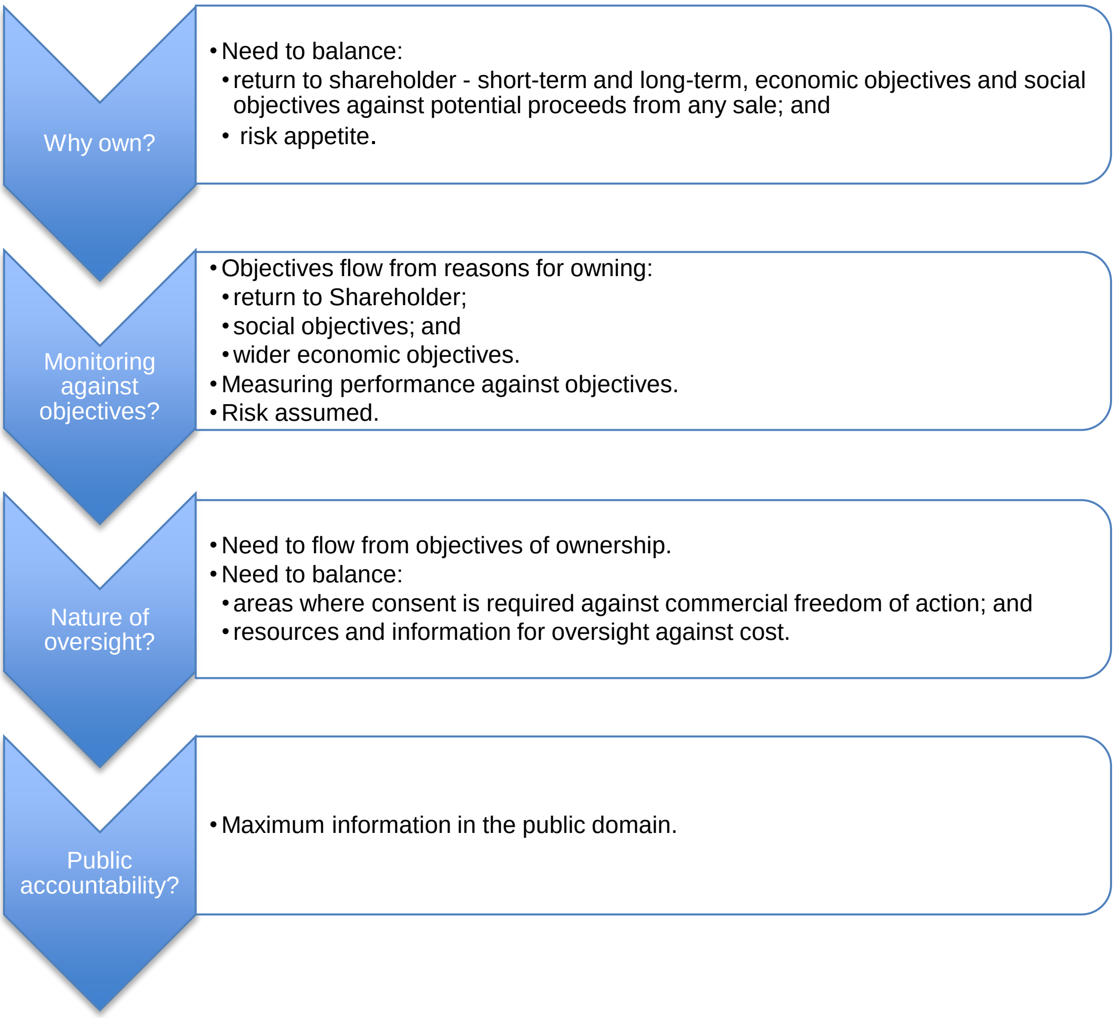
- makes recommendations for improvement.

2.2 The review focuses on overall arrangements for discharging the responsibility as shareholder but does not extend to the internal governance arrangements of the JT Group.

Overall governance arrangements

3.1 The States face key questions in their role as owners of a commercial enterprise (see Exhibit 1).

Exhibit 1: Key questions for the States as owners of JT



Why own JT?

3.2 The first question relates to the decision whether the States should continue to own JT in whole or in part. The States have previously considered whether to sell their interest in JT and decided not to do so. A decision on whole or partial sale involves balancing on the one hand the advantages of ownership - financial return to the States and the ability through ownership to pursue social or economic objectives other than those relating to financial return - against the potential proceeds from any sale and on the other hand the risks (both the financial risk to the value of ownership and reputational risk) of continued shareholding. The expansion of JT outside Jersey and outside its traditional activities increases the risk. ‘Risk appetite’ - the willingness of the States to assume risk - is a key factor to take into account in determining whether to continue to own JT in whole or part.

Recommendations

R1 Reconsider whether the States wish to continue to own JT in whole or in part and, if so, articulate clearly all the objectives of ownership.

R2 Schedule periodic reviews of the States' continued ownership of JT and associated objectives.

Monitoring against objectives

3.3 The States' relationship with JT as sole shareholder is governed by a Memorandum of Understanding (MoU) entered into in 2006. This sets out the objectives of JT:

1. to be as profitable and efficient as comparable telecommunications businesses that are not owned by the States;

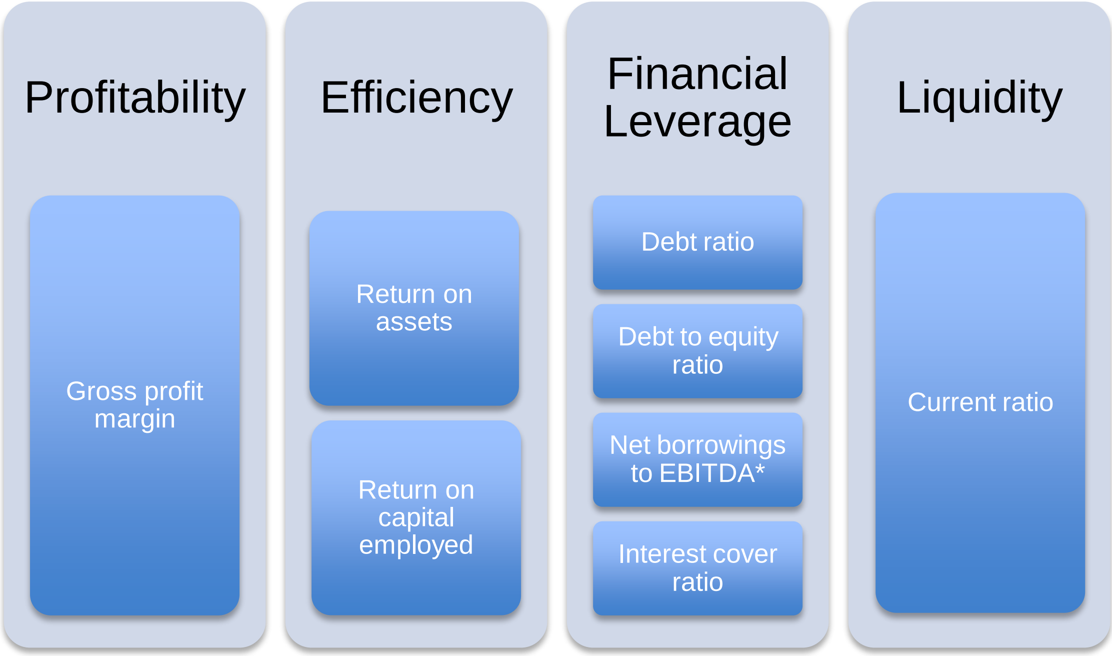
2. to enhance the long term value of the shareholder's investment in the company and deliver sustainable returns comparable to telecommunications businesses that are not owned by the States;

3. to be a good employer; and

4. to be responsive to the wider interests of Jersey's community within the framework of the licence within which it operates, recognising that the interests of customers will be closely aligned to the prosperity and well-being of the island.

3.4 The MoU requires the preparation of Key Performance Indicators (KPIs) and inclusion of those within the half-year and full-year reporting to the States. There are no KPIs described as such in the strategic business plan or in the reporting to the States. There are, however, forecasts and actual figures for key financial ratios (see Exhibit 2) that relate to the profitability and long-term value objectives in the MoU.

Exhibit 2: Financial ratios for JT



* EBITDA: Earnings before Interest, Taxes, Depreciation and Amortisation

3.5 In respect of the good employer and wider interests objectives, there is some limited specification of objectives outside of the MoU and associated monitoring:

- the Ministerial Decision for the provision of financial support for investment in Gigabit Jersey imposed a condition that JT agree to establish an unspecified number of apprenticeships, bursaries and job placements to support getting local people back into work. JT reports the number of such positions to the States Treasury on a quarterly basis;
- JT continues to provide low cost landline services to pensioners in accordance with a resolution of the States Assembly.

3.6 The absence of clear specification of KPIs, linked to the objectives specified for JT, impedes effective monitoring of performance.

3.7 In addition, the absence of an explicit objective or associated KPI reflecting the risk that the States is prepared to accept as shareholder - its risk appetite - means that there is an increased risk that JT assumes greater risks than the States would wish to assume as a shareholder.

3.8 In response to recent proposals for the development of a Long Term Incentive Plan for JT's senior management, the States has commenced work on the specification of objectives for JT.

Recommendations

R3 Adopt and monitor performance against Key Performance Indicators that are directly linked to all the ownership objectives in the MoU.

R4 Adopt a specific objective to reflect the States' risk appetite as shareholder and associated Key Performance Indicators.

Nature of oversight

3.9 In common with the other utility companies in which the States have a controlling interest, the shareholder function rests with the Treasury and Resources Minister, supported by the States Treasurer and a dedicated member of staff within the Treasury and Resources Department.

3.10 The MoU:

- specifies the information to be provided to the Treasury and Resources Department;
- requires JT to adhere to the 'Combined Code' incorporated into the listing rules of the UK Listing Authority[1];
- requires JT to seek the consent of the Treasury and Resources Minister for certain 'important management decisions'; and
- specifies the frequency with which meetings should take place between the Treasury and Resources Minister and JT.

3.11 In 2010 the States engaged the accountants Deloitte to advise on the implementation of a 'best practice' shareholder model to enable Treasury and Resources to exercise proper oversight of the States' investments in the four utilities, Jersey Electricity, Jersey Post, Jersey Telecom and Jersey Water. In framing their recommendations, Deloitte drew upon recognised 'best practice' drawn from both the public and private sectors including:

- Guidelines on Corporate Governance of State Owned Entities developed by the Organisation for Economic Development and Co-operation (OECD);
- The Code in respect of responsibilities of institutional investors issued by the UK Institutional Shareholders' Committee; and

[1] https://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

- The working practices of the UK Government's Shareholder Executive and UK Financial Investments Limited.

3.12 Deloitte's report made extensive recommendations for the development of a shareholder function within the Treasury and Resources Department. Subsequently, the Treasury and Resources Department has developed its shareholder function, but not fully adopted all of the recommendations made by Deloitte, as it believes that the benefits of doing so would not be justified by the costs. However, the increased complexity of JT's business increases the information required to undertake the shareholder function, the complexity of doing so and the expertise required.

3.13 More recently in 2013 the Treasury has undertaken a comparison of the requirements of the MoU with the disclosure requirements of the UK Listing Authority. Whilst the disclosure requirements are framed in a different context - companies with shares traded on a recognised stock exchange - they provide a useful benchmark and highlight areas where the existing MoU might not require disclosure of information that is relevant to the exercise of the shareholder function.

3.14 My meetings with the Board of JT, the Treasury and Resources Minister and the States Treasurer indicated broad satisfaction with the operation of the MoU. My testing also identified substantial compliance with the requirements of the MoU.

3.15 However, the MoU is now eight years old. Much has changed in that time and a review is overdue both as a result of experience of the operation of the MoU and as a result of changes in circumstances (see Exhibit 3).

Exhibit 3: Operation of the MoU

Requirement	Analysis
Important management decisions: the MoU requires the consent of the Minister to material events e.g. changes in JT's Strategic Business Plan, material changes to the nature of business, material sales, leases and licences. The MoU specifically provides that the term 'material' should be interpreted by the Board.	There is a risk either that JT fails to seek consent for matters that the States believes are material or that additional effort is expended by JT in providing information that the States do not require. Areas of consent are framed in terms of whether the proposed transaction is material rather than in terms of the risk associated with the proposed transaction. Requirements for consent are therefore not linked to the risk appetite of the States.
Important management decisions: the MoU specifically requires consent to sales, leases, licences, mortgages etc. relating to two specified properties (Minden Place and Five Oaks) but not to other parts of the telecommunications infrastructure.	The States may have concerns about potential transactions concerning other assets e.g. any parts of the core telecommunications infrastructure in the context of its wider objectives concerning JT.
On-going communications and accountability: the MoU requires meetings between the Minister and JT on a quarterly basis and specifies that a record of matters discussed at these meetings shall be made.	The MoU does not adequately reflect the current pattern of communication with more emphasis placed on communication with officers in the States Treasury and ad hoc communications. For example, it does not specify the standards of record-keeping required for liaison between JT and the States between formal meetings.
Directors' Remuneration: the MoU requires prior Ministerial approval of non-executive remuneration and of changes to remuneration paid to executive directors.	The provision does not extend to: (i) remuneration of directors of subsidiaries or (ii) remuneration of senior employees who are not members of the Board.

Recommendations

R5 Reconsider the resources devoted to the shareholder function, including in light of the change in the nature of JT's business and the increased risk to the States' investment.

R6 Undertake a thorough review of the MoU.

R7 Provide a clearer definition of proposed transactions for which consent is required, taking into account both the size, context and risk of the proposed transactions.

R8 Consider whether transactions in respect of specific infrastructure should require prior consent.

R9 Review the form and frequency of meetings required in the MoU.

R10 Extend the requirements for Ministerial approval to remuneration of directors of subsidiary companies.

Public accountability

3.16 One of the ways in which those responsible for the stewardship of funds can be held accountable for their stewardship is through the preparation and publication of accounts. The MoU requires JT to prepare an annual report including annual accounts prepared in accordance with UK Generally Accepted Accounting Practice (GAAP). However, under Jersey company law accounts are not in the public domain. The MoU specifically states that the MoU should not be interpreted as requiring the inclusion in the annual report of any information that would be likely unreasonably to prejudice the commercial position of JT. Following a recommendation by my predecessor in 2008, an abbreviated version of the annual accounts is laid before the States. This version excludes all the notes to the accounts, including those detailing, for example, the accounting policies adopted in preparation of the accounts, the composition of fixed assets and its turnover by business lines.

3.17 The decision not to publish the full accounts of JT highlights the inherent tension of seeking to operate a business in a competitive commercial environment and demonstrating accountability for public funds. I understand that disclosure of the information in some of the notes to the accounts might be commercially prejudicial. However, I am concerned by the current exclusion of all notes without there being explicit agreement by the States, on a note by note basis, that disclosure would be prejudicial. In my view, the presumption must be for disclosure unless a compelling case for non-disclosure can be made.

Recommendation

R11 Require the publication of the annual accounts of JT excluding only those notes where the States are satisfied that publication would prejudice its commercial position.

Conclusion

4.1 The States has developed its function as shareholder and there is evidence of substantial satisfaction and compliance with the MoU. However, the telecommunications industry and JT have changed rapidly. After eight years a reconsideration of the reasons for owning JT is needed. Should the States decide to retain ownership in whole or part, the reasons for this decision and the objectives of ownership should be clearly understood.

4.2 If the States retains ownership of JT, it should review how it performs the shareholder function focussing on:

- linking how it monitors JT to its ownership objectives;
- the resources available to perform the shareholder function;
- the MoU that governs the relationship between the States and JT; and
- appropriate public accountability.

Appendix 1 Summary of Recommendations

R1 Reconsider whether the States wish to continue to own JT in whole or in part and, if so, articulate clearly all the objectives of ownership.

R2 Schedule periodic reviews of the States' continued ownership of JT and associated objectives.

R3 Adopt and monitor performance against Key Performance Indicators that are directly linked to all the ownership objectives in the MoU.

R4 Adopt a specific objective to reflect the States' risk appetite as shareholder and associated Key Performance Indicators.

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