

The Treasury

Shareholder Expectations Letters Information Release

Release Document

May 2017

<http://www.treasury.govt.nz/statesector/commercial/reporting/strategic>

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
- [2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information
- [3] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [4] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [2] appearing where information has been withheld in a release document refers to section 9(2)(b)(ii).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.



Office of Hon Todd McClay

MP for Rotorua

Minister of Trade

Minister for State Owned Enterprises

Associate Minister of Foreign Affairs

14 DEC 2016

Mr Tony Ryall
Chair
Transpower New Zealand Ltd
PO Box 1021
WELLINGTON 6140

Dear Mr Ryall

2017/18 SHAREHOLDER EXPECTATIONS OF TRANSPOWER NEW ZEALAND LTD

I am writing on behalf of shareholding Ministers to outline the matters we expect the Board of Transpower New Zealand Ltd (Transpower) to address in the business planning process for the 2017/18 financial year.

The Government remains committed to driving the shift towards more active management of its shareholding in commercial assets (the Crown's Commercial Portfolio). We will continue to engage with Boards on how to best maximise the value of the Crown's commercial businesses through improved performance and effective capital management in line with the expectations set out in this letter.

This letter contains the following information:

- Ministers' specific expectations for Transpower;
- General expectations for the Crown's Commercial Portfolio; and
- The timetable for the business planning process this year (refer to Annex 1) and analysis of the Crown's Commercial Portfolio (refer to Annex 2).

Entity specific expectations

Safety

Improving workplace safety is one of the Government's areas of focus. Given the relatively high risk industry Transpower works within, we endorse your objective of promoting a high standard of safety and anticipate your delivery of improved workplace injury metrics.

Prudent management of debt levels

Transpower undertook a review of its capital structure in the 2015/16 year in light of the changing dynamics within the wider New Zealand electricity sector. That review recommended a modest and gradual reduction in long term debt over several years to bring Transpower's gearing comparable to its international peers and manage its credit risk exposure.

Ministers expect Transpower will continue to undertake this modest and gradual reduction in debt without unduly impacting on dividend payments forecast to the Crown. We also expect Transpower will report at regular intervals to the Treasury on its progress in this regard and in relation to its credit rating.

Continued engagement with regulatory authorities and the broader sector

The Electricity Authority is continuing its review of the Transmission Pricing Methodology (TPM). We expect Transpower will continue to keep Ministers and officials updated on the progress and implications for Transpower of this review.

The Commerce Commission is also reviewing the Input Methodologies (IM) that governs its regulation of entities such as Transpower. Whilst this review is nearing completion, we expect that Transpower will continue to engage with the Commission and the wider industry on this review, and keep shareholding Ministers advised of any changes and risks from this review as they emerge.

Continued monitoring of technological developments and the impact to the company

Ministers commend Transpower on its Transmission Tomorrow strategic document and its effort to develop a view of the future in order to implement strategies and plans to address the impact of technological developments on New Zealand's energy sector and Transpower. We expect that Transpower will continue to monitor developments in this area, proactively engage with the industry's regulators on how new technologies will be treated in the regulatory framework, and keep shareholding ministers advised of any changes and the risks and opportunities as they emerge.

General expectations for the Crown's Commercial Portfolio

Transpower is part of the Crown's Commercial Portfolio. We set out general expectations of all entities that form the Commercial Portfolio below.

Dividends

Ministers expect positive business performance to result in dividend payments, and that an appropriate balance is maintained between dividends and reinvestment. Our preference is for dividends over new investment in noncore business activities, or if investment in Transpower's core business can be deferred or avoided without compromising the transmission grid's reliability and operation.

A statement of the principles adopted by the Board in determining the annual dividend is required to be disclosed in the Statement of Corporate Intent (SCI). Further guidance on dividend policy is provided in section 7.6.2 of the Owner's Expectations Manual (OEM).

Investment

Since 2007, the Crown has made significant capital investment in the Commercial Portfolio. However, the impact to the earnings of the portfolio is not clear. The Treasury is looking to place a greater focus on capital investment over the next financial year. Analysis of the capital investment for the Commercial Portfolio since 2007 is included in Annex 2.

Ministers are focussed on maximising returns from capital invested across the Commercial Portfolio. Accordingly, there is a high threshold for Ministers' support for significant new investment.

In light of this, we expect you to engage with Ministers and the Treasury on initiatives that require a meaningful investment of capital. We expect investments to be value enhancing and supported by robust business cases, which: (i) evaluate options thoroughly, (ii) are based on reasonable assumptions, (iii) take into consideration all material risks, and (iv) apply the appropriate risk-adjusted cost of capital.

Investment in Information Technology

Information Technology (IT) investments are becoming increasingly important to businesses' operations. Ministers expect Boards to ensure any IT investments are justified, meet entity needs, and that risks are managed. Boards may wish to consult the Government's Chief Information Officer when considering significant IT investments.

Capital Structure

I acknowledge that Transpower undertook a review of its capital structure in the 2015/16 year. Nevertheless, Ministers still expect that the Board will periodically review the capital structure of the entity to ensure that it is: (i) appropriate for the entity, and (ii) any borrowing is maintained at a prudent level.

Should you undertake any borrowing, ensure that all lenders are specifically made aware that the borrowing does not represent Crown debt, and accordingly is not guaranteed by the Crown.

Entities are expected to return any surplus capital to the Crown so that it may be used to fund other Crown priorities.

Early notification of any material change in forecast financial performance

Robust fiscal management continues to be a key priority for the Government. It is therefore important that entities advise the Treasury on a timely basis of any risk to achieving financial forecasts.

Post-investment reviews

Ministers expect entities to undertake post investment reviews of all significant investments. These reviews should be useful in enabling Boards to better assess whether the benefits expected to be obtained from capital expenditure and/or new investments were realised in practice. Financial thresholds have been established, over which a post-investment review is required to be sent to the Treasury (refer to section 5.7.3 of the OEM). Consistent with prior years, we request copies of any post-investment reviews over the defined threshold.

Strategic reviews

Ministers are focused on maximising the value of the Crown's investment in the entities that form the Commercial Portfolio. As such, the programme of strategic reviews of commercial entities is continuing. Strategic reviews are intended to provide closer alignment on strategy between the Board, management and the shareholder. We request that you work closely with the Treasury, if your entity is subject to a strategic review.

Commercial valuations

Section 14(3) of the SOE Act requires the SCI to disclose the Board's estimate of the SOE's commercial value. Ministers place significant reliance on the Board's estimate of the SOE's commercial value. We therefore expect these valuations to be robust, and either prepared or reviewed independently, where appropriate.

Specific guidance on the preparation and disclosure of the Board's estimate of the SOE's commercial value is provided in Annex 2 of the OEM.

CFISnet Submissions

CFISnet is the means by which entities provide monthly and quarterly financial information to the Treasury which is used for reporting and analysis prepared for Ministers. We request that you encourage Transpower's management to ensure that any information filed is appropriately reviewed prior to submission.

Engagement

The Treasury is working to engage more closely with entities to gain a better understanding of the strategic issues, risks and influences on entities' financial performance. In light of this closer engagement, I would like the Board to meet with the Treasury to discuss this letter of expectations at an appropriate time in the New Year.

Your Treasury relationship managers will be in contact shortly after you receive this letter to discuss Ministers' expectations in more detail. If you have any questions please contact James Forsberg (on [1]) or Aaron Gill (on [1]). Alternatively, please contact Angela Graham (Manager, Commercial Advice on [1]).

Yours sincerely



Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Ms Alison Andrew, CEO, Transpower Ltd

Annex 1

Timetable for the Business Planning Process for 2017/18

| <i>Due Date</i> | <i>Key Action</i> |
|---------------------------|---|
| 28 February | Board sends strategic issues letter to Ministers |
| 28 February | Board provides details of post investment reviews to Treasury |
| February/March | The Treasury to discuss the letter of expectations with the Board |
| 5 May | Board submits draft SCI and business plan |
| 30 June | Board delivers final SCI to shareholding Ministers |
| Within 12 days of receipt | Minister to present SCI to the House of Representatives |

All entities are expected to provide shareholding Ministers with a strategic issues letter, by **28 February 2017**, setting out the key strategic issues facing the entity. Should your company wish to engage with shareholding Ministers to seek clarification around their expectations, we would ask that you advise the Treasury as early as possible of such intentions.

All SOEs are expected to provide shareholding Ministers with a draft SCI and Business Plan, consistent with the expectations as detailed in this letter, by **1 May 2017**.

The final SCI should be delivered to shareholding Ministers on or before **30 June 2017**.

Shareholding Ministers should be alerted as soon as possible if any of these deadlines cannot be met.

Further guidance on the timetable is contained in section 5.6.4 of the OEM. The OEM is available from the Treasury's website at:

<http://www.treasury.govt.nz/commercial/publications/guidance/owners-expectations-manual>.

Annex 2: Commercial Portfolio

Chart 1: Revenue (FY16) % of Commercial Portfolio

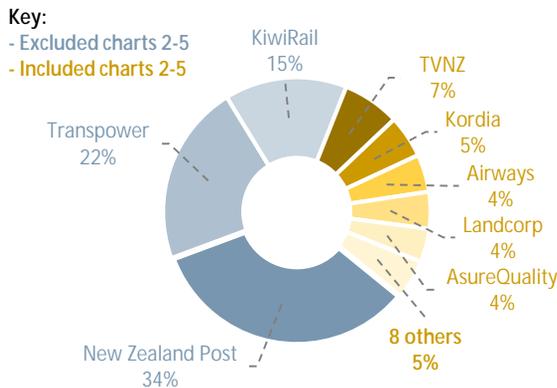


Chart 2: Purchase of fixed assets¹

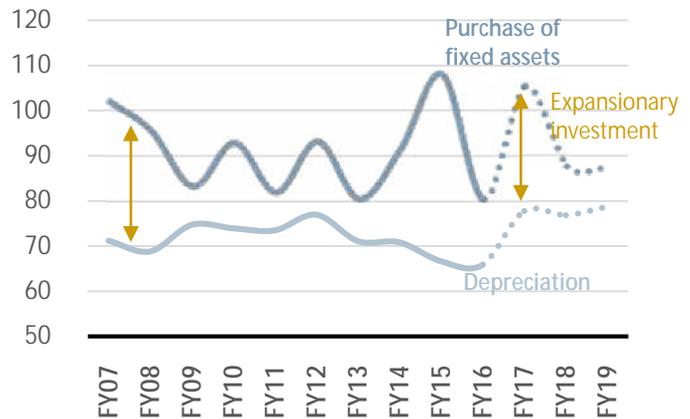


Chart 3: Sources & uses of cash (\$bn, FY07-FY16)²

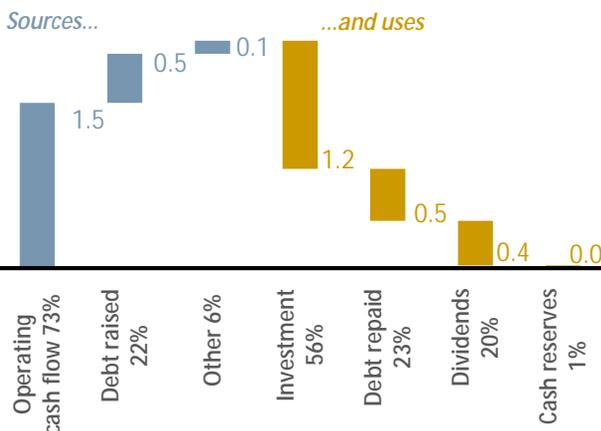


Chart 4: Dividend yield

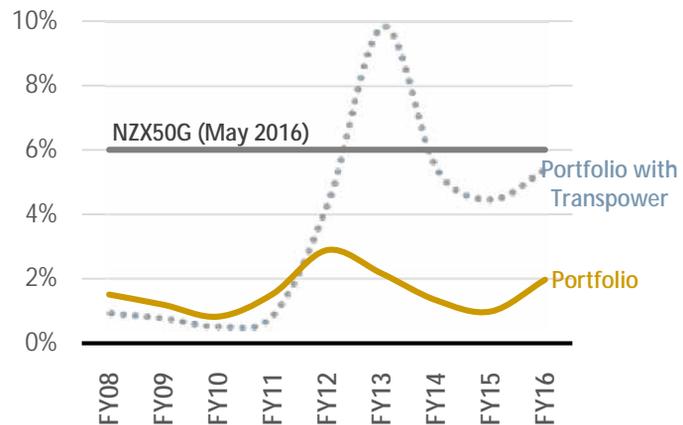
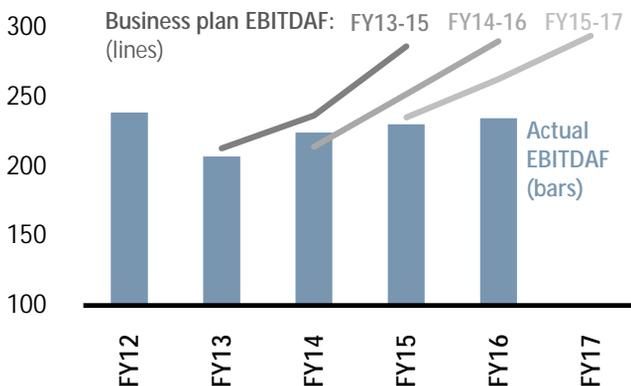


Chart 5: EBITDAF (\$m)



Commentary

The Commercial Portfolio comprises 17 companies with a combined commercial value of \$5.8bn*. 11 are State-owned Enterprises and the remaining six have a primary commercial objective (note MOM companies are not included).

The charts above present the following observations:

- Chart 1: The largest three companies account for 71% of the portfolio's revenue.

Charts 2-5 focus on the remainder of the portfolio*:

- Chart 2: Purchases of fixed assets have been above depreciation levels suggesting expansionary investment
- Chart 3: Over 50 cents per dollar of total cash inflows was applied to investment, and only 20 cents to the payment of dividends
- Chart 4: The outcome is a dividend yield below the market and shareholder expectations (1-3%). Transpower makes the most significant contribution to the portfolio's dividend payments
- Chart 5: Investment performance rarely meets original expectations. Earnings were broadly flat despite recent investment

All data is sourced from ComOps CFISnet

* Charts 2-5 exclude the largest companies; NZ Post, Transpower and KiwiRail. This is done to demonstrate that observations around heavy investment and the adequacy of returns are not just driven by a few larger entities, but are also applicable to the remainder of the portfolio. Including these companies would exacerbate all of our observations except chart 4 (as Transpower lifts the portfolio yield substantially).

¹ Chart 2 excludes Landcorp since many of its fixed asset purchases relate to land development, which is not depreciated. ² Chart 3 excludes Public Trust due to financial institutions having large debt movements.