

The Treasury

Mixed Ownership Model for Crown Commercial Entities: Treasury Advice Information Release

4 September 2012

Release Document

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
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Treasury Report: Mixed Ownership Model Companies - Response to Questions Over Asset Sales by Energy Companies

Date:	27 March 2012	Report No:	T2012/559
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Consider paper	Thursday 29 March 2012
Associate Minister of Finance (Hon Steven Joyce)	Consider paper	Thursday 29 March 2012
Minister for State Owned Enterprises (Hon Tony Ryall)	Consider paper	Thursday 29 March 2012

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Chris White	Manager, Commercial Transactions Group	[1]	✓
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Minister of Finance's Office Actions (if required)

None.

Enclosure: No

Treasury Report: Mixed ownership model companies -- response to questions over asset sales by energy companies

Executive Summary

There have recently been questions in the House and the media as to whether the Crown will be able to prevent mixed ownership model companies (**MOMs**) from selling generation assets such as dams, windfarms and geothermal stations.

In our view, this is primarily a communications issue. We do not consider that the concerns expressed require a regulatory or policy response. Our reasoning for this is as follows:

- It is unlikely that the hypothetical transactions put forward by various commentators would occur as they do not make commercial sense. The electricity industry in New Zealand consists almost entirely of vertically integrated businesses as this structure reduces risks and increases returns. The MOM companies' electricity generating assets are generally more valuable as integrated parts of their businesses than what any third party would value them at.
- In addition, hydro generating assets are usually part of a chain of power stations along a river. There are significant strategic, operational and commercial incentives to maintaining ownership of a chain of hydro stations indicating that the MOM companies are unlikely to be willing to sell a single hydro station. Also, power stations are unlikely to have strategic value for a foreign investor, unlike, say, agricultural land. As a result, a foreign investor is unlikely to make an offer for a power station that is above its commercial value.
- The Government does have some control over transactions of the nature proposed. Under the Overseas Investment Act (**OIA**) there are likely to be significant hurdles in the way of a foreign investor buying assets such as power stations. To be more certain of this analysis, we would need to review closely the assets themselves.
- The Companies Act and Listing Rules provide little control. While the Crown would be able to vote on major transactions (essentially, those disposing of over 50% of company assets) or transactions changing the essential nature of the business, that will make little difference, as most generation assets are under 20% and only one (Manapouri) tops 30%.
- Strengthened Government control, beyond that provided by the Companies Act and the Overseas Investment Act, could be expected to have material impacts on the attractiveness of the MOM companies to investors and the proceeds that the Government receives. It could also increase the cost of debt paid by MOM companies, if debt holders become concerned at their ability to access company assets as security against their loans.
- More broadly, placing restrictions on the ability of the companies to dispose of their assets (whether this is likely to happen or not) would signal to the market a further step away from a standard commercial operating model. Again, we consider that will affect demand for the shares, and thus the return to the Crown.

Given that the transactions are unlikely, and any potential actions to control them would shift the companies further away from being 'standard listed companies,' and would likely prove costly, we recommend that no policy response is necessary.

Communications

Concerns around sales of sensitive assets to overseas investors are unlikely to reduce during the Select Committee hearings. We will develop some key messages for Ministers around this matter. Those messages are likely to focus on the unlikelihood of these transactions taking place, the controls via the Overseas Investment Act already available to the Crown as a regulator, and the fact that whoever the owner of the assets is, they will remain subject to the general regulatory framework (for instance, the Resource Management Act). We envisage that we will need to discuss this with Select Committee; we will provide a further note to you before doing so.

Recommended Action

We recommend that you:

- a **note and consider** this paper

Agree/disagree
Minister of Finance

Agree/disagree
Associate Minister of Finance

Agree/disagree
Minister for State Owned ` Enterprises

- b **invite** officials to discuss it with you

Agree/disagree
Minister of Finance

Agree/disagree
Associate Minister of Finance

Agree/disagree
Minister for State Owned ` Enterprises

Chris White
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Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Tony Ryall
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Treasury Report: Mixed ownership model companies -- response to questions over asset sales by energy companies

Purpose of Report

1. This report provides Treasury advice on:
 - a. why sales of generation assets are unlikely;
 - b. existing controls available to the Government; and
 - c. the potentially negative consequences of increasing Government controls.
2. This report is aimed largely at transactions where a foreign investor is the buyer. Of course, the provisions of the OIA would have no effect where the buyer is not a foreign investor. [4]

Commercial Reality

Transactions, such as those being discussed, are unlikely

3. In our view, transactions involving the sale of power stations or generation assets are unlikely. Such transactions have in theory been possible since at least 1999 (when the separate electricity SOEs were set up) but with one unique exception discussed below, have not happened. This is because such transactions are unlikely to make commercial sense.
4. The electricity industry in New Zealand mostly consists of vertically integrated businesses: companies that own both electricity generating assets and retail units that sell electricity to customers. There are a few stand-alone generating assets and stand-alone retailers, but they tend to be small. This is because there are strong commercial drivers for vertical integration; it reduces risks and increases returns, compared to separate generation and retail businesses. When the electricity industry was de-regulated in the late 1990s and the mixed ownership electricity companies were set up, there was some degree of vertical integration in New Zealand. Because of the commercial imperatives, over the next few years this level of vertical integration significantly increased, as the electricity state-owned enterprises (**SOEs**) grew their retail bases by competing for customers, buying stand-alone electricity retailers, or buying out their customer bases.
5. As a result of these commercial drivers, the MOM companies' electricity generating assets are, most likely, more valuable as integrated parts of their businesses. This means that any third party is likely to put a value on the assets that is less than the value the MOM company boards put on them. So any offer to buy a stand-alone generating asset is unlikely to be commercially attractive.
6. There are two other considerations which make these transactions unlikely. **First**, the hydro generating assets of the mixed ownership companies are usually part of a chain of power stations along a river – i.e. Waitaki, Waikato, Tongariro, or Waikaremoana (the Manapouri Power Station is the one exception).
7. There are significant strategic, operational and commercial incentives to maintaining ownership of a chain of hydro stations. This means that the MOM companies are unlikely to be willing to sell a single hydro station – any offer would need to be for the entire chain.

8. The only sale and purchase of a significant generating asset in New Zealand in recent years was the sale of the Tekapo A and B power stations from Meridian to Genesis Energy. As you will be aware, this sale was directed by the Government for public policy reasons. Without the special legislation that gave the Government the power to direct the companies to enter into the transaction, the sale would not have happened.
[2]
9. **Second**, power stations are unlikely to have strategic value for a foreign investor, unlike, say, agricultural land. This is because electricity generated in New Zealand cannot be exported. As a result, a foreign investor is less likely to make an offer for a power station that is above its commercial value.

Existing Government Controls

1. There are two ways for the Crown to influence MOM company transactions. First, it can do so as a shareholder, under the Companies Act 1993 (**Companies Act**) or the New Zealand Stock Exchange Listing Rules (**Listing Rules**). Second, it can do so as a regulator, using its discretion under the Overseas Investment Act 2005 (**OIA**).

Control as a Shareholder

2. The Companies Act and the Listing Rules offer the Crown as shareholder limited control over transactions. Under both the Companies Act and the Listing Rules, shareholders do not have formal rights of approval of transactions unless they involve assets worth at least 50% of the company's value. The Listing Rules also require shareholder approval if the transaction would change the essential nature of the listed company, which may apply to transactions worth less than 50% of the company's value.
3. These requirements are likely to be of relatively little use to the Government, however, as individual power stations do not constitute 50% of the gross value of each company. The Manapouri power scheme represents only about 31% of Meridian's total asset base; it is the largest single asset held by any of the generator MOM companies. Thus, under existing law, the Crown as owner cannot prevent the sale of any of the generation assets, individually. Even entire clusters of assets – for example the Waitaki system – would not be caught. The one notable exception is the entire Taupo power scheme, which would constitute 61% of Mighty River Power's assets. Further, selling any single power station is unlikely to be seen as changing the essential nature of the business.
4. This limited ability for the shareholder to intervene is quite appropriate. Directors have a duty to act in what they believe to be the best interests of the company and it is appropriate that they are provided with the authority and ability to do this.

Control as a Regulator

10. As you are aware, the OIA is of general application – it applies to all transactions, regardless of the identity of the vendor, where it is proposed to sell significant business assets or sensitive land to overseas investors. The Act and regulations contain threshold provisions below which consent is not needed.
11. Our initial view is that sales of sensitive assets are highly likely to require Ministerial approval under the OIA, because they involve either significant business assets or sensitive land, or both. We have not, however, checked this with the companies themselves.

12. *Significant business assets* are, broadly, assets valued at over \$100 million. The acquisition of a 25% or more ownership or control interest in such assets by a foreign investor would trigger the OIA. New Zealand has recently signed, but has not yet implemented, an agreement to raise the monetary threshold to \$477 million (indexed annually to GDP) for investors that are Australian or have substantive business operations in Australia.
13. If the application involves only sensitive business assets, the test, commonly referred to as the 'investor test', is relatively straightforward, and affords relatively little discretion to Ministers. The foreign investor must (i) have business acumen and experience relevant to the investment; (ii) demonstrate financial commitment to the investment; (iii) be of good character; and (iv) not be a person of a kind referred to in ss. 15 and 16 of the Immigration Act 2009, which lists classes of persons not eligible for visas or entry permits.
14. *Sensitive land* is defined according to type of land and an area threshold, as summarised in the table below. The interests covered include freehold or leasehold interests of 3 years or more, or the acquisition of a 25% or more ownership or control interest in an entity that owns sensitive land.

Land that is or includes this type of land...	...and exceeds
non-urban land	5 hectares
bed of a lake; land on specified islands; land held for conservation purposes; reserve, as a public park, for recreation purposes, or as open space; land subject to a heritage order; or a historic place or area or wahi tapu or wahi tapu area	0.4 hectares
foreshore or seabed; land on other islands (other than North or South Island)	-
Land that adjoins...	...and exceeds
Foreshore	0.2 hectares
bed of a lake; land held for conservation purposes; scientific, scenic, historic, or nature reserve; regional park; reserve, a public park, or other sensitive area; sea or a lake; land subject to a heritage order; or a historic place or area or wahi tapu or wahi tapu area	0.4 hectares

15. If 'sensitive land' is involved, a prospective foreign investor would need to show that the investment will, or is likely to, be of benefit to New Zealand. If the land includes non-urban land of more than 5 hectares, the benefit must be substantial and identifiable. This requires evaluation against 21 economic, social, environmental and other factors. Whether the requisite benefit could be shown would depend on the circumstances of a particular prospective investment and investor and on the exercise of Ministerial judgement in considering and weighing the relevant factors.
16. The benefit test can be quite difficult to meet, particularly if 'substantial and identifiable' benefits must be shown. For example, if the land is already in efficient and effective productive use, it can be difficult to show that the foreign investment will bring additional benefits.

[4]

18. This change lifts the hurdle for foreign investors in situations where a competing bidder for the investment exists. In such circumstances, the relevant counterfactual would be that another person makes the investment and, potentially also, contributes associated economic benefits (the judge acknowledged that the relevant counterfactual could still, in some cases, be the status quo – if there was likely to be no change to the status quo if the investment did not go ahead). To take the Crafar example, the overseas investor will now have to show economic benefits over and above those that would arise if an alternative bidder bought the farms (and, likely, injected their own capital for development, improved production, etc) rather than simply show economic benefits over and above the status quo of farms in receivership and substandard condition.
19. One factor that would likely be relevant is whether the investment assists New Zealand to maintain New Zealand control of the strategically important infrastructure on sensitive land. Although there is some uncertainty about the precise definition of 'strategically important infrastructure', the OIO advises that the interpretation it applies would capture important electricity assets. This factor was considered to weigh against an application to invest in Auckland International Airport.
20. Where sensitive land includes farm land or 'special land' (foreshore, seabed, lakebed or riverbed) there are additional requirements for consent. Farm land must first be offered for sale on the open market. Special land must first be offered to the Crown.
21. In sum, the controls available to the Crown as regulator should give the Crown reasonable control over the sale of generation assets (assuming as we do that the sale of hydro, geothermal and wind generation assets will all involve sensitive land). Moreover, the market has over 25 years' experience with the Act.

[3],[4]

Conclusion

26. By way of conclusion, we note the fundamental issue is the extent to which the Crown as regulator or as shareholder wishes to have greater control over asset sales by the MOM companies, than a 51% shareholder in any other listed company would have. We consider there are significant risks in seeking greater controls. We are, however, available to discuss this further with you, and what policy goals might lie behind further controls, if that would be useful.