

The Treasury

Solid Energy Information Release

March 2013

Release Document

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
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- [3] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
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MINISTERIALS

Hon Simon Power
ORIGINAL



Treasury Report: 2011/12 Expectations Letters for SOEs

Date:	11 November 2010	Report No:	T2010/2209
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Agree recommendation	Friday 19 November 2010
Minister for State Owned Enterprises (Hon Simon Power)	Agree recommendation and sign the attached letters except for [8]	Friday 19 November 2010
Minister of Education (Hon Anne Tolley)	Agree recommendation and sign the attached letter for [8]	Friday 19 November 2010
Minister of Agriculture (Hon David Carter)	Agree recommendation and sign the attached letter for [8]	Friday 19 November 2010
Associate Minister of Finance (Hon Steven Joyce)	For your information	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Bevan Searancke	Senior Advisor, Sector Monitoring	[1]	✓
John Crawford	General Manager, Crown Ownership Monitoring Unit	[1]	
James Cunningham	Manager, Sector Monitoring	[1]	

Ministers' Offices Actions (if required)

Please send signed letters to the Chairs of the respective state-owned enterprises.

Enclosure: Yes (attached)

Letters for TR: 2011/12 Expectations Letters for SOEs (Treasury:1955601v1) [Add to worklist](#)

Treasury Report: 2011/12 Expectations Letters for SOEs

Purpose of Report

1. This report provides shareholding Ministers of state-owned enterprises (SOEs) with the 2011/12 expectations letters for your signature.

Background

2. Shareholding Ministers provide SOE Chairs with a letter each year that sets out their expectations for the year. It also kicks off the annual business planning process.
3. The business planning process provides an opportunity for shareholding Ministers to influence the strategic direction of SOEs, and the content of Statements of Corporate Intent (SCIs). The SCI is one of the key documents for holding boards accountable for performance.
3. The following table provides Ministers with the important dates in the 2011/12 SOE business planning cycle.

Table 1: Key dates for 2011/12 SOE business planning

<i>Due date</i>	<i>Key action</i>
15 November	Ministers send the annual expectations letters to SOE Boards
31 January	Boards send strategic issues letters to Ministers
1 May	Boards submit draft SCIs and business plans
16 June	Ministers send feedback on draft SCIs
1 July ¹	Boards deliver final SCIs to shareholding Ministers

4. As previously discussed with Ministers, COMU intends to engage with SOEs more at the front end of the planning process, and reduce the amount of time we spend on company plans in May and June. We think that this will allow us to have more meaningful engagement with the companies. To assist with this, the date for Ministers sending out the expectations letters is earlier than previous years. We have also brought forward the date that companies send strategic issues letters to Ministers by one month.

Expectations Letter

5. This year's expectations letter is divided into three categories – priority, general and company specific. The first two categories apply across a number of SOEs. The third category is specific to each SOE.
6. The expectations that receive emphasis this year are:

¹ The responsible Minister is then required to table the SCI in the House within 12 sitting days of receiving it.

Financial Returns

- This year the expectations letter places much greater focus on the return that a commercial investor would expect from its investment, relative to the risk inherent in the business. As such, we would expect that on average, the total shareholder return (TSR) from each company should meet or exceed its cost of equity. In circumstances where the TSR is below that cost, we expect the companies to develop a plan to show a path to achieving such a return.
- As part of this expectation, we are asking that each SOE provides us with their assessment of the company's cost of equity by the end of the year, and to engage with COMU should we hold a differing view.

Shareholder Value

- As per prior year expectations, robust and accurate commercial valuations are fundamental to shareholders for understanding the total returns achieved by each SOE. As such, we are maintaining a focus on SOEs producing comprehensive, up to date, and robust commercial valuations, with appropriate disclosures in the SCI.
- We have made some slight amendments to the model disclosure statement that has been sent to SOEs previously (attached to the sample letter). We propose that the revised disclosure statement is sent out with the expectations letter.

Investment Review

- In their dividend decisions each year, boards are making an explicit decision either to return cash flow to the shareholder by way of dividends or to invest. We consider that SOE boards should review major past investment decisions to assure themselves that the benefits claimed when such decisions were made are in fact being realised.
- Our expectation is that such reviews are made available to the shareholders. COMU will engage more specifically with each SOE on this matter.

Joint Ventures

- We have included an expectation that Ministers are informed at an early stage of any joint venture (j.v.) formation, particularly where the j.v. involves another NZ government entity or where it includes a foreign government or sovereign wealth fund.

Dividends

- As highlighted in our report titled Analysis of SOE Dividends (T2010/2071 refers), we think that shareholding Ministers should expect SOEs to pay dividends commensurate with listed peers. This would include that dividends show a degree of consistency across years, and that an appropriate balance between dividends and re-investment in the business is maintained. The letter asks the Board to engage with COMU on an appropriate dividend policy.
- We also consider that the dividends should be related to an agreed proportion of a cash flow measure rather than net profit after tax (NPAT). This is because International Financial Reporting Standards (IFRS) are causing significant volatility in NPAT, primarily as a result of companies having to recognise fair value movements in the income statement. A cash flow measure is also a much cleaner way of calculating dividends, and would provide greater consistency across the SOE portfolio and comparable companies for benchmarking purposes.

Recommended Action

7. We recommend that you **agree** that the responsible Minister for each state-owned enterprise (SOE) signs the attached letter(s) to the SOE(s) within his or her responsibility.

Agree/disagree
Minister of Finance

Agree/disagree
Minister for State Owned Enterprises

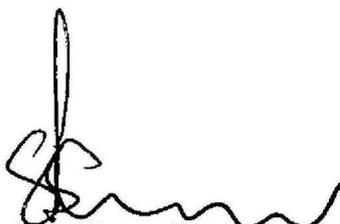
Agree/disagree
Minister of Education

Agree/disagree
Minister of Agriculture



James Cunningham
**Manager, Sector Monitoring
for Secretary to the Treasury**

Hon Bill English
Minister of Finance



Hon Simon Power
**Minister for State
Owned Enterprises**

Hon Anne Tolley
Minister of Education

Hon David Carter
Minister of Agriculture

Hon Steven Joyce
Associate Minister of Finance



Office of Hon Simon Power

MP for Rangitikei

Minister of Justice

Minister for State Owned Enterprises

Minister of Commerce

Minister Responsible for the Law Commission

Associate Minister of Finance

Deputy Leader of the House

15 NOV 2010

Mr John Palmer
Chair
Solid Energy New Zealand Ltd
PO Box 1303
CHRISTCHURCH 8140

Dear Mr Palmer

2011/12 SHAREHOLDER EXPECTATIONS OF STATE OWNED ENTERPRISES

I am writing on behalf of shareholding Ministers to set out the shareholder's expectations for 2011/12. These build on the expectations set out in similar communications for 2010/11. They should be viewed in the context of Ministers seeking a continuous improvement in the performance and governance of the state-owned enterprise (SOE) portfolio.

Our expectations are divided into three categories – priority, general, and company specific. The first two categories apply across a number of SOEs. The third category is specific to your company.

Priority expectations

- *Shareholder Returns:* A prime focus for shareholding Ministers is that commercial entities should, over time, deliver returns that meet or exceed the company's cost of capital. Over the past year, we have been progressing towards better ways to monitor and measure shareholder returns. The Crown has a long term perspective on returns, and acknowledges that returns will vary from year to year, sometimes due to temporary or non-controllable factors. Emphasis will therefore be placed on total shareholder returns (TSR) over periods of up to the past 5 years. In circumstances where the TSR is persistently below the cost of capital, or is not expected to achieve it over the forecast period, we expect the company will develop a plan to take corrective action.
- As part of this expectation, we ask that, no later than the end of the calendar year, your company provides COMU its assessment of its cost of equity. This should include the basis on which it has been calculated and how it has changed (if at all) from prior periods. We will expect this estimate to be maintained and updated as its operations, capital structure and market circumstances vary through time. You should be prepared to engage with COMU on this matter should it hold a differing view.

- *Valuation:* As per prior year expectations, robust and accurate commercial valuations are fundamental to shareholders for understanding the true economic returns achieved by each SOE. As such, we would expect that a comprehensive, up to date, and robust commercial valuation be produced annually. This should be publicly disclosed in the Statement of Corporate Intent (SCI), with any major changes in assumptions from previous valuations being made transparent and justified. There have been some slight amendments to the commercial valuation model disclosure statement we sent you previously. We have attached the revised disclosure statement to this letter, which we expect you to adopt in your SCI.
- *Investment Review:* We expect SOE Boards to review major past investment decisions to assure themselves that the benefits claimed when such decisions were made are in fact being realised. Our expectation is that such reviews are made available to the shareholders. I understand that COMU will engage more specifically with you on this matter.
- *Joint Ventures:* While shareholding Ministers are supportive of SOEs entering into joint venture (j.v.) arrangements as a way of leveraging expertise and capital, we expect to be informed at an early stage of any j.v. formation, particularly where the j.v. involves another New Zealand government entity or where it includes a foreign government or sovereign wealth fund.
- *Dividends:* Shareholders expect SOEs to operate a dividend policy that is commensurate with listed peers. This would include an understanding that dividends show a degree of consistency across years, and that an appropriate balance between dividends and re-investment in the business is maintained. We have asked COMU to work with you to determine an appropriate dividend policy, which in our view should be related to an agreed proportion of a cash flow measure rather than net profit after tax (NPAT). This proportion will, no doubt, reflect the maturity of the business and the investment opportunities the business faces.
- *Capital Retention and Injection:* In general, shareholding Ministers are open to considering either:
 - allowing SOEs to reduce dividends and thus retain capital to fund particular expansion projects, or
 - making further capital injections,
 but only where prospective returns warrant it, and it is the most efficient form of financing available. In either of these situations we expect a fully developed and detailed business case that supports the investment will be provided to COMU.

General expectations

Expectations in the Owner's Expectations Manual and the previous two Outlook Letters continue to apply in 2011/12 and the forecast period. Particular regard should be given to the following:

- *Strategic issues letters:* All SOEs are expected to provide Ministers with a letter, by **31 January 2011**, setting out the key strategic issues facing the company. Should your company wish to engage with shareholders to seek direction or clarification (e.g. around equity provision), we would ask that you advise COMU as early as possible of such intentions. Please note that this date is one month earlier than in previous years.
- *Draft Statement of Corporate Intent (SCI)/Business Plan:* All SOEs are expected to provide Ministers with a draft SCI and Business Plan by **1 May 2011**, at the latest.
- *Annual General Meetings (AGMs):* All SOEs are expected to hold an AGM.
- *Continuous disclosure:* Where the Continuous Disclosure Regime applies to SOEs, SOEs are expected to make timely disclosures, including advising the Ministers' offices prior to the public release of disclosures.
- *Public Meetings:* SOEs subject to the Continuous Disclosure Regime are expected to hold a public meeting on an annual basis. We also encourage other SOEs to give consideration to holding a public meeting.
- *OIA requests:* The Office of the Minister for State Owned Enterprises is to be advised by an SOE when it receives a request under the Official Information Act 1982 and of the proposed response.

Company specific expectations

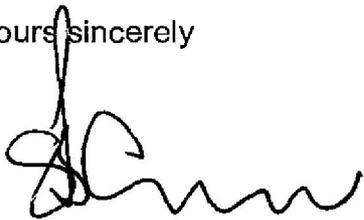
- *Dividend Payments:* We expect Solid Energy to establish an appropriate balance between dividends and capital investment. The current dividend forecast relative to Solid Energy's level of capital investment is below historic levels and significantly lower than all other SOEs, over the forecast period. The proposed dividend also does not show any improvement over the forecast period. We would like Solid Energy to present a business plan with dividends which are consistent with our priority expectations outlined in this letter.
- *Future Resource Development:* We are supportive of SOEs entering into joint venture arrangements as a way of leveraging expertise and capital. We expect to be consulted on significant developments, and receive robust business cases for consideration.

- *Increased Transparency:* Solid Energy has shown leadership with respect to the transparency of reporting the Chief Executive's salary and performance arrangements. There are, however, other areas where Solid Energy could be more transparent in its public reporting. In particular, Solid Energy could separately identify the financial performance of different business activities in its annual report.
- *Commercial Valuation:* Over the last four years, Solid Energy's commercial valuation has shown considerable variation. Shareholders expect that such variation will be adequately explained as part of the annual valuation and that such a valuation has been independently reviewed.

Engagement

Our expectation is that you will engage with officials from COMU shortly after receiving this letter to discuss shareholding Ministers' expectations in more detail. Please make arrangements with your usual contact in COMU, [4] (1) . Alternatively, please contact John Crawford (General Manager, Crown Ownership Monitoring Unit) on [1]

Yours sincerely



Hon Simon Power
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Dr Don Elder, CEO, Solid Energy New Zealand Ltd

Attachment: Commercial Valuation Model Disclosure Statement for use in Statements of Corporate Intent

Example for the SOE Corp Group

The Board's estimate of the current commercial value of the Crown's investment in the SOE Corp Group is [\$1.650 billion].

Key points about the manner in which that value was assessed are:

- The valuation was calculated as at [30 June 2011]
- The discounted cash flow (DCF) methodology was used to calculate a Net Present Value (NPV) of the entire SOE Corp Group, including all subsidiaries, on an after-tax basis
- The DCF / NPV was based on the nominal (i.e. not inflation-adjusted) future cash flows set out in the SOE Corp Group's 3-year business plan, with forward projections then also made about years 4 to 10, and a terminal value of [\$500 million] was included in the terminal year. The growth assumption assumed in the terminal value was [X%]
- A discount rate of [X%] was assumed
- The valuation was prepared [internally by the SOE Corp Group's finance team, and was externally peer reviewed by XYZ Corporate Finance Ltd], prior to approval by the Board
- The current commercial value of the Crown's investment of [\$1.650 billion] (often referred to as the equity value) was calculated by taking the enterprise value of [\$1.950 billion] and deducting net debt of [\$300 million].
- Other material factors that are relevant to the determination of this valuation are [.....]

The valuation compares with a commercial value as at [30 June 2010 of \$1.545 billion]. The key reasons for the [increase] in commercial value are:

- [An increase in year 1 to year 3 cash flows of \$X million due to changed expectations for the future price of x
- A reduction in year 4 to year 10 cash flows of \$X due to.....
- A reduction in the terminal value assumed of \$X million due to.....
- A change in the discount rate assumed from XX% to XX% because.....]

These changes could be represented graphically in a waterfall (or similar type of) diagram.