

The Treasury

2014 Briefings to Incoming Ministers Information Release

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Briefing to the Incoming Minister of Finance and Minister for State Owned Enterprises



THE TREASURY
Kaitohutohu Kaupapa Rawa

Commercial Operations Group, The Treasury

Introduction

This document has been prepared for the purposes of briefing the incoming Minister of Finance and Minister for State Owned Enterprises (SOEs) on the work of Treasury's Commercial Operations Group and the issues and decisions it expects to engage on over the near term. It is structured as follows:

- ▶ Section I provides background and context to the SOE framework and SOE performance.
- ▶ Section II provides an overview of Commercial Operations.
- ▶ Section III discusses recent developments and advancements in Treasury's monitoring practices.
- ▶ Section IV sets out details of Ministerial decisions required for the period to February 2015 and beyond.

Responsible and shareholding Ministers advised by Commercial Operations are set out at Annex A and upcoming appointments activity is in Annex B. We do not have any current plans to publish this document.

I. SOE Framework

A key foundation of the SOE legal and accountability framework is its being embedded in the standard corporate law that applies to all New Zealand companies. This includes company law and other regulation that applies to companies, including on competition, securities markets, health & safety, employment, financial reporting and industry specific legislation. Having a basis in corporate law imports a standard and well-established framework for entity governance and accountability, including provisions around:

- company formation, administration, amalgamation and liquidation
- constitution, capacity and powers
- shares and shareholders' rights and obligations
- directors' powers and duties, and
- disclosure and financial accountability.

The corporate legal framework is overlaid with the requirements of the SOE Act (and, peripherally, other legislation such as the Public Finance Act, Official Information Act and Public Audit Act), supplemented by a body of practice that has built up over time (largely codified in the "Owner's Expectations Manual").

The strong basis in the standard corporate law framework lays a foundation for SOEs to be managed and governed in much the same way as privately held companies. In particular, the

Companies Act requires directors to act in the best interests of the company. However, SOEs do have some distinguishing characteristics, including:

- Share ownership - all voting shares must be held by the Crown. Implications of this are:
 - With no institutional equity investors and no equity market, there is no serious analyst following. Some SOEs have listed debt but this has not generated an analyst following
 - There is no market for corporate control to exert pressure on company management
 - Share ownership is not available as an element of the remuneration structure for managers or directors
 - Issue or sale of voting shares requires the high hurdle of legislative change
- Board composition
 - All directors are “independent” in that: officials are not appointed to boards, there are no executive directors, directors rarely have the benefit of an indemnity from the Crown for their actions, and individuals are selected from a large pool and rarely are appointed to more than one SOE board at a time
 - Poorly performing directors are rarely replaced ahead of their terms expiring naturally
 - Except in the case of the MOM companies, the board appointment process is managed by The Treasury for Ministers, in consultation with the board
 - Chairs and Deputy Chairs are explicitly appointed by Ministers, rather than being determined by the board itself
- Directors’ duties - SOEs’ constitutions have not included the provision allowed by company law for directors of a wholly owned company to act in the best interests of the parent
- Objectives and strategy - legislation prescribes a formal annual process of communication between the Crown and each SOE, culminating in annual publication of a Statement of Corporate Intent by each SOE, and
- Political environment - sensitivity to the potential for value-compromising political intervention has resulted in a relatively arms-length relationship between SOE boards and Shareholding Ministers (and officials).

The best interests of the company, which directors are legally obliged to pursue, will not necessarily align with the Crown’s best interests as owner. Even under business-as-usual, agency conflicts -- including moral hazard, excess earnings retention, different time horizons and managerial risk appetites -- can lead to management behaviour that diverges from maximising shareholder returns.

In the private sector, such divergence in interests might be addressed in various ways, ranging from the constitution providing for the directors to act in the parent’s best interests, through setting clear owner expectations and close monitoring by the owner, and ultimately to the shareholder divesting their interests to another owner. For a range of reasons, shareholding ministers could not, or chose not to, use active tools like these, or only did so when failure was imminent.

Performance

The general issues identified above are reflected in portfolio performance results. There are difficulties associated with assessing performance at a portfolio level. Commercial valuations are generated through discounted cash-flow models rather than market processes, and portfolio results can be dominated by movements in the large companies or sectors that are overly represented. The information that is available, however, illustrates that performance has been relatively poor. Table one below is sourced from the Annual Portfolio Report (APR) published in December 2013.

Table One: Five-Year Performance Metrics

Performance Measure	2009	2010	2011	2012	2013
Total Shareholder Return*	2.0%	19.3%	4.5%	(8.2%)	3.0%
Dividend Yield*	1.6%	4.2%	4.3%	2.5%	6.5%
Dividend Payout	19.9%	45.4%	72.1%	28.4%	46.8%
Adjusted ROE	9.9%	8.8%	8.6%	-17.4%	0.1%
ROCE	6.1%	5.8%	5.6%	-3.3%	1.5%

* KiwiRail is excluded from these metrics because of significant changes in its valuation methodologies over the past few years, including the significant write down in its asset values in 2012. TSR and dividend yield calculation for 2012 have been restated to include Solid Energy following the delayed publication of its 2012 SCI.

The conclusion expressed in the APR regarding portfolio performance for the most recent year was as follows:

While there are some positive indicators in terms of TSR and dividend yield, the overall financial performance for the commercial priority portfolio was poor in 2012/13. Revenue and operating earnings declined, largely as a result of restructuring within Solid Energy. TSR improved from the negative return in 2012 on the back of significant dividend payments by Transpower. However NPAT and associated return on equity was minimal¹.

The clearest indication, however, of poor performance under the SOE framework is the range of performance enhancing activities undertaken by the MOM companies once the prospect of public listing and removal from the SOE framework became apparent. Either immediately before or since being listed the MOM companies:

- ▶ closed or sold unprofitable or marginal operations
 - Mighty River Power restructured its overseas geothermal operations by exiting from the arrangements with GGE and taking direct ownership, and since then has not invested any new capital overseas (in contrast to plans before the IPO process to invest significant amounts). MRP is also trying to sell its Southdown power station, and if it cannot find a buyer, it will restructure its operations

¹ Annual Performance Review, December 2013, page 45.

- Meridian sold its subsidiaries Whispertech, Right House, Meridian Energy USA and Energy for Industry, and is attempting to sell its smart metering subsidiary Arc Innovations (subject to Commerce Commission clearance). All were failures (apart from Energy for Industry) and all were outside Meridian's core business (except arguably Arc Innovations)
- Meridian also restructured its Business Developments internal unit (which was responsible for the subsidiaries) and its Renewable Developments unit (responsible for developing and building windfarms)
- Genesis Energy brought forward the shut down of a unit at Huntly, significantly reduced the capital tied up in its coal stockpile and undertook significant management restructuring
- ▶ stopped any further generation development and exited from existing development options, e.g. by selling land. While the companies may have done this anyway as SOEs, it is unlikely it would have been done as quickly or thoroughly. Similarly, the process of preparation for the IPO of Solid Energy brought to a head significant differences between the shareholder and the company with respect to company strategy and financial performance.
- ▶ [1, 4]
- ▶ increased their dividends to shareholders
 - In 2014/15, Genesis Energy's forecast dividends paid to the Crown, as 51% shareholder, are \$74 million, which is more than the Crown received in 2012/13 as 100% owner, nearly twice as much in dividends than the best year between 2000/01 and 2011/12 when the Crown was a 100% shareholder; and four times the average dividend over this period.
 - In MRP's case, dividends paid to the Crown in 2013/14 as 51% shareholder (\$90 million) were only slightly lower than the average dividends over the previous three years (\$109 million a year), not halved as you might expect.
 - Dividends from Meridian Energy tell a similar story.
- ▶ implemented cost savings initiatives.

Driving Enhanced Value

The MOM experience provides a clear indication that better returns can be achieved by the Crown's commercial portfolio. Our approach to driving enhanced value from the portfolio is to move towards more active management of the SOE portfolio by:

- increasing our capability and the depth of our understanding of the companies so we can credibly challenge the companies and provide higher quality advice
- introducing outside expertise through an advisory board
- developing proposals for lifting the quality of governance
- engaging early with the company on setting strategic direction, including through the use of periodic strategic reviews

- adopting a sceptical stance towards company proposals to diversify or significantly expand their activities by requiring a high hurdle rate for new investments to reflect the higher incremental risk, and
- providing a clear expression of the Crown’s expectations for each company.

We provide more detail on these matters below. First, we provide information on the Commercial Operations group followed by a discussion on recent enhancements to the monitoring framework.

II. Overview of Commercial Operations

We have been redesigning our commercial advice function in order to accelerate the shift towards more actively managing value within the Government’s commercial assets. Changes to the makeup of the Crown’s portfolio, including the Mixed Ownership Model companies and the increasing prominence of Crown Financial Institutions (CFIs), and a desire to build on the capability developed in the Commercial Transactions Group (CTG) following the completion of the Government Share Offers programme have provided additional impetus to the changes we have made. There are three teams in the Commercial Operations group: Commercial Advice; Governance and Performance; and Strategy and Policy. A summary of these teams’ purposes and primary functions is as follows.

Commercial Operations Group		
<p>Commercial Advice</p> <p>The function of this team is to provide advice and execute commercial transactions on behalf of the Crown. This includes advice and execution on sales processes, purchases, insolvencies, Crown support for distressed firms and PPPs (in economic and social areas).</p>	<p>Governance and Performance</p> <p>The Governance and Performance team is the Treasury lead in the formal relationships between the Crown and the entities. It influences performance by providing advice on governance and board membership, board skill sets and performance, and entity strategy and performance.</p>	<p>Strategy and Policy</p> <p>The Strategy and Policy team leads advice on the portfolio as a whole as well as Crown Financial Institutions. It also supports the Governance and Performance team in work on issues and risks facing specific entities including through periodic strategic reviews.</p>

An additional new feature of the commercial operations function is the establishment of a Commercial Advisory Board. The Advisory Board’s role is to support the Deputy Chief Executive by:

- reviewing and testing the Treasury’s high level strategic advice, where the outcomes could have a material impact on the performance of the commercial portfolio
- providing guidance on the strategic approach and work programme priorities of the Treasury’s commercial operations, and
- giving access to an independent “private sector” perspective, providing the portfolio with well informed advice.

The Advisory Board’s activities include:

- providing input into the scope and nature of Commercial Operations’ strategy and operations, with a view to a more active approach to managing value of these entities and the portfolio overall

- reviewing progress to ensure the commercial work programme is delivering key outcomes
- helping to ensure that the quality of the Treasury's advice is of the highest possible standard by contributing expertise and testing the Treasury's judgements, and
- making recommendations on how to maximise the value of the Crown's commercial portfolio, and providing views on entities' strategy and performance.

The Board is appointed by the Secretary to the Treasury and includes 5 external members and the Treasury Deputy Chief Executive. Current members are Anne Blackburn, Marko Bogoevski, Roger France, Cathy Quinn and Mark Verbiest. The Board meets four times per annum having commenced in July 2014.

III. Recent Developments in Treasury's Monitoring Approach

Integration of Governance and Performance Monitoring

One of the main actions we have taken has been the integration of our governance and appointments work with our monitoring performance functions. We are moving away from a model that divides our work into two streams: "governance and appointments" and "monitoring" to a model with a single stream where all our activities are aimed at achieving the strategic goals which we seek to identify and promote with Boards and Ministers. Given the importance of governance as a key lever for Ministers to influence performance, our judgement is that integration is important to strengthening the way these functions connect in providing the strong focus on engagement with boards, consideration of board performance and board composition, and advice to Ministers to enhance the performance and value of entities.

The scope of entity performance monitoring has been expanded to include not just financial monitoring, but also assessment of board performance. We will be working with boards to design a methodology for regular quality evaluations so that board performance monitoring will be included in entity performance monitoring. This enhanced focus on board performance will necessarily involve a more activist role with respect to decisions around board re-appointments as opposed to automatic rollover of board members to a second term.

Strategic Reviews

A rolling programme of in-depth strategic reviews of SOEs has been initiated. Strategic reviews analyse options for maximising long-term value for the Crown. They seek to identify and agree an enduring strategy for the entity being reviewed, together with a pathway for the entity to deliver that strategy.

They encompass a fundamental review of an entity's business operations, ideally in partnership with the entity. The exact nature of the review will vary depending on our judgement of priorities but can include:

- Relevant sector and market analysis, e.g., market prices, outlook, drivers, benchmarking with competitors
- Analysis of the appropriateness of the entity's strategies and plans
- Review of business structures, taking into account existing strategic plans
- Analysis of financial and operational performance, risks, financing and valuation, and
- Analysis of potential options, future financing requirements and ongoing viability.

Experience to date is that strategic reviews deliver value to the entity concerned by deepening its understanding of its own business and long-term sustainability and by identifying improvements to its underlying business model. The reviews also deepen officials' understanding of the business, allowing rigorous debate of strategic issues with the Board and management. They provide Ministers with the opportunity to be more engaged and informed shareholders, and should result in a shared view on the entity's objectives, accountabilities and strategic direction.

Recent reviews that have been completed or are underway are as follows.

Entity	Last Review	Reviewer
Kordia	2012/13	Deloitte
Quotable Value	2013/14	Cameron Partners
Public Trust	2013/14	KPMG
NZ Post Group	2013/14	Goldman Sachs
Landcorp	2013/14	Deloitte
KiwiRail	Ongoing	Internal (company)

We are in the process of assessing which entities should be reviewed over the next year and will report to you with recommendations once we have completed the process of setting entity expectations outlined below.

Setting Entity Expectations

Over the last two months, officials have been conducting SWOT² analyses to identify the key issues for each entity in the portfolio. We will be raising these issues in discussion with boards in or around Annual General Meetings over the next few weeks, as a prelude to setting formal expectations for each entity via the annual letter of expectations. These expectations should provide Boards with clarity regarding Crown expectations and will be important drivers of how we measure individual board performance and define director appointment briefs.

The approach to setting expectations for the entities in the past was often conducted at the portfolio level. For example, general instructions were issued to all SOEs to pay higher dividends or increase debt to target a BBB debt rating. While these were worthwhile expectations for the portfolio, we consider it will be more effective to have expectations for each entity that are specific to their circumstances and that have been developed through a consultative process with the entities. This recognises that entities in the portfolio face different issues: some are operating in industries experiencing structural decline, some have reasonable incremental investment options available to them, and some are in a steady state. For example, while we adopt a general stance that new investment should meet a higher hurdle before being supported, this is clearly more applicable for companies experiencing structural decline than those where replacement and incremental investment would be sound commercial practice.

² Strengths Weaknesses Opportunities & Threats

[3]

IV. Key Decisions to February 2015 and Beyond

Specific decisions and issues you may be required to consider shortly are discussed below.

Governance Issues

Board Appointment Activity

Treasury administers board appointments for 54 companies and entities across 14 ministerial portfolios, of which 16 sit within the SOE Portfolio. Shareholding Ministers will shortly receive a briefing detailing upcoming appointment activity across the majority of the 16 companies (list of affected positions in Annex B attached). There are a small number of positions which will require

urgent consideration (due to current vacancies and early retirements), and also a further 24 positions due to expire on 30 April, for which the Cabinet-approved appointment process will usually commence around mid-November to ensure the requisite process is completed prior to that date. Note that as they are companies, and therefore subject to the Companies Act, directors cannot stay on the boards past their term end dates as is possible for Crown entities.

[3]

Monitoring Issues

Annual Review Cycle

In a formal sense, the annual review cycle begins in the last quarter of the calendar year with letters to be sent to Chairs of SOEs outlining the Ministers' expectations and priorities for 2015/16. As discussed earlier in this briefing, officials will engage with SOE boards around the upcoming Annual General Meetings to discuss strategic issues prior to drafting suggested letter content for Ministers. Finalised letters will be sent to Ministers for signing once their content meets Ministers' requirements, with the intention that these be sent to the SOEs before Christmas. Strategic issues letters in response from the Chairs are expected by the end of February 2015.

Treasury Commercial Operations is also reviewing the form and function of its various reports to Ministers with the objective of making them more commercially useful. For example, the SOEs Quarterly Results Report is to have a new format from the September 2014 quarter and was not produced for the period to June 2014. Similarly, the Annual Portfolio Review which was produced between 2010 and 2012 met the needs of few users and so will not be produced this year. Last updated in 2012, the Owners' Expectations Manual is also likely to undergo modification to reflect current priorities.

[3]

[2, 3]

[2, 3]

Annex A: Shareholding and Responsible Ministers

State-Owned Enterprises	Minister(s)
<ul style="list-style-type: none"> ▶ Airways Corporation of New Zealand (Airways) ▶ AsureQuality Ltd (AsureQuality) ▶ Electricity Corporation of New Zealand (ECNZ) ▶ Kordia Group Ltd (Kordia) ▶ Landcorp Farming Ltd (Landcorp) ▶ Meteorological Service of New Zealand Ltd (MetService) ▶ New Zealand Post Group (NZ Post) ▶ New Zealand Railways Corporation (KiwiRail) ▶ KiwiRail Holdings Ltd ▶ Quotable Value Ltd (Quotable Value) ▶ Solid Energy New Zealand Ltd (Solid Energy) ▶ Transpower New Zealand Ltd (Transpower) ▶ Learning Media Ltd (LML) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister for State Owned Enterprises
<ul style="list-style-type: none"> ▶ Animal Control Products (ACP) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister of Primary Industries
Mixed Ownership Model Companies	
<ul style="list-style-type: none"> ▶ Mighty River Power ▶ Meridian Energy ▶ Genesis Energy 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister for State Owned Enterprises
Crown Research Institutes (from 1/2/2011 joint responsibility with Ministry of Science & Innovation)	
<ul style="list-style-type: none"> ▶ AgResearch Ltd (AgResearch) ▶ Institute of Environmental Science & Research Ltd (ESR) ▶ Institute of Geological & Nuclear Sciences Ltd (GNS Science) ▶ Landcare Research New Zealand Ltd (Landcare Research) ▶ National Institute of Water & Atmospheric Research Ltd (NIWA) ▶ New Zealand Forest Research Institute Ltd (Scion) ▶ The New Zealand Institute for Plant & Food Research Ltd (Plant & Food Research) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister of Science and Innovation
Other Crown Companies	
Crown entity companies	
<ul style="list-style-type: none"> ▶ New Zealand Venture Investment Fund Ltd (NZVIF) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister for Economic Development
<ul style="list-style-type: none"> ▶ Radio New Zealand Ltd (RNZ) ▶ Television New Zealand Ltd (TVNZ) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister of Broadcasting
<ul style="list-style-type: none"> ▶ Crown Irrigation Investments Ltd 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister of Primary Industries
Companies listed in Schedule 4A of the Public Finance Act 1989	
<ul style="list-style-type: none"> ▶ Crown Fibre Holdings Ltd (CFH) ▶ Crown Asset Management Ltd 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister for State Owned Enterprises
<ul style="list-style-type: none"> ▶ Health Benefits Ltd (HBL) 	<ul style="list-style-type: none"> ▶ Minister of Finance and Minister of Health

▶ Research and Education Advanced Network New Zealand Ltd (REANNZ)	▶ Minister of Finance and Minister of Science and Innovation
▶ Education Payroll Ltd	▶ Minister of Finance and Minister Responsible for Novapay
▶ Fairway Resolution Ltd	▶ Minister of Finance and Minister for ACC
▶ Network for Learning	▶ Minister of Finance and Minister of Education
▶ Southern Response Earthquake Services Ltd	Minister of Finance and Minister for Canterbury Earthquake Recovery
▶ Tamaki Redevelopment Corporation	▶ Minister of Finance and Minister of Housing
Other Entities	Minister(s)
Statutory Crown Entities	
▶ Earthquake Commission ³	▶ Minister of Finance
▶ Government Superannuation Fund Authority (GSF) ³	
▶ Accident Compensation Corporation ³	▶ Minister of ACC
▶ Housing New Zealand Corporation	▶ Minister of Finance and Minister of Housing
▶ New Zealand Lotteries Commission (Lotteries)	▶ Minister of Internal Affairs
▶ Guardians of New Zealand Superannuation ³	▶ Minister of Finance
▶ Public Trust (Public Trust)	▶ Minister for Public Trust
Other Statutory Boards	
▶ National Provident Fund (NPF) ³	▶ Minister of Finance
Other Crown Companies in which the Crown holds shares	Minister(s)
▶ Air New Zealand Ltd	▶ Minister of Finance
▶ Christchurch International Airport Ltd (CIAL)	▶ Minister for State Owned Enterprises and Minister of Finance (with responsibility delegated to the Associate Minister of Finance)
▶ Dunedin International Airport Ltd (DIAL)	
▶ Hawke's Bay Airport Ltd (HBAL)	

³ The entities are also collectively known as the Crown Financial Institutions (CFIs). All these entities have specific responsibilities relating to the management and investment of significant Crown financial assets.

Annex B: SOE Portfolio – board positions due for consideration up to 30 April 2015

	<i>Position</i>	<i>Term</i>	<i>Service start</i>	<i>Term End</i>
Airways Corporation of New Zealand Ltd				
Mr Terry Murdoch	Director	Term 2	1/05/2009	30/04/2015
AsureQuality Ltd				
Mr John Ashby	Deputy Chair	Term 2	1/05/2009	30/04/2015
Vacancy (ex-Dean Nikora)				
Christchurch International Airport Ltd				
Vacancy (ex-George Gould, resigning 31/12/14)				
Crown Fibre Holdings Ltd				
Ms Danelle Dinsdale	Director	Term 1	1/05/2012	30/04/2015
Mr Jack Matthews	Director	Term 3	20/11/2009	30/04/2015
Dr Murray Milner	Director	Term 3	20/11/2009	30/04/2015
Mr Keith Tempest	Director	Term 2	20/11/2009	30/04/2015

Electricity Corporation of New Zealand Ltd (The Residual Company)

Mr Victor Wu	Chair	Term 10	1/04/1994	30/04/2015
Ms Jane Meares	Director	Term 2	1/05/2012	30/04/2015

Hawke's Bay Airport Ltd

Mr Jim Scotland	Director	Term 2	1/07/2009	30/04/2015
Vacancy (ex-Stuart Webster, resigning 31/12/14)				

Kiwirail Holdings Ltd

Ms Paula Rebstock	Deputy Chair	Term 2	1/07/2009	30/04/2015
Mr Bob Field	Director	Term 3	1/07/2009	30/04/2015

Kordia Group Ltd

Ms Sheridan Broadbent	Director	Term 1	1/07/2014	30/04/2015
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Landcorp Farming Ltd

Vacancy (Chair – ex-Bill Baylis)				
Mr Chris Day	Director	Term 1	1/05/2012	30/04/2015
Ms Pauline Lockett	Director	Term 1	1/05/2012	30/04/2015
Mr Tony Reilly	Director	Term 1	1/07/2014	30/04/2015

Meteorological Service of New Zealand Ltd

Mrs Sarah Smith	Chair	Term 4	1/11/2007	30/04/2015
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New Zealand Post Ltd

Mrs Carol Campbell	Director	Term 1	1/05/2012	30/04/2015
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Mr Temuera Hall	Director	Term 2	1/05/2009	30/04/2015
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Mr Richard Leggat	Director	Term 1	1/05/2012	30/04/2015
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Quotable Value Ltd

Mr Phil Lough	Chair	Term 2	1/05/2009	30/04/2015
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Mr Gary Traveller	Director	Term 2	1/07/2009	30/04/2015
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Ms Kim Wallace	Director	Term 1	1/05/2012	30/04/2015
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Transpower New Zealand Ltd

Mr Ian Fraser, BE	Deputy Chair	Term 4	1/05/2007	30/04/2015
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Ms Abby Foote	Director	Term 2	1/05/2009	30/04/2015
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Mr Michael Pohio	Director	Term 2	1/07/2009	30/04/2015
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