

Dr Cullen
ORIGINAL

Treasury Report: Briefing On Issues Regarding Shareholder Support for *e3p*

Date:	5 May 2004	Treasury Priority:	High
Security Level:	Commercial In Confidence	Report No:	T2004/758

Action Sought

	Action Sought	Deadline
Minister of Finance	note recommendations (a-e, g-h) agree that officials work with Genesis on the merits of a risk sharing mechanism with the Crown regarding <i>e3p</i> refer a copy of this report to the Minister of Energy	By 5pm, 6 May 2004
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Associate Minister of Finance (Hon David Cunliffe)	note recommendations (a-e, g-h) agree that officials work with Genesis on the merits of a risk sharing mechanism with the Crown regarding <i>e3p</i>	By 5pm, 6 May 2004
Minister for State-Owned Enterprises	note recommendations (a-e, g-h) agree that officials work with Genesis on the merits of a risk sharing mechanism with the Crown regarding <i>e3p</i>	By 5pm, 6 May 2004

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Michael Moore	Sector Manager – Energy, Land & Environment, CCMAU		
David Taylor	Manager, Commercial Investments		✓

Enclosure: Yes

10 MAY 2004

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Treasury:627996v1

Sgd. Hon Dr Michael Cullen

5 May 2004

SE-2-7-1

Treasury Report: Briefing On Issues Regarding Shareholder Support for e3p

Executive Summary and Purpose of Report

- In the attached letter of 26 April 2004, the Chairman of Genesis Power Limited (Genesis) has requested that shareholding Ministers consider a risk sharing mechanism for Genesis' proposed nominal 400MW combined cycle gas turbine (CCGT) power station, known as **e3p**.
- In order to ensure that **e3p** is commissioned by December 2006 Genesis must irrevocably commit to **e3p**'s contractors by 15 August 2004. Any risk-sharing arrangement with the Crown must also be implemented by this date.
- Ministers are meeting with Genesis on 6 May 2004 to discuss issues relevant to the upcoming 2004/05 business planning round. It is expected that Genesis will raise the issue of **e3p** risk sharing at that meeting.
- Ministers will recall that Genesis and officials engaged in similar **e3p** risk sharing discussions in mid-2003 at which time Ministers decided that the risk to the Crown of the proposal outweighed the benefits to security of supply¹. The reason for Genesis re-approaching Ministers is unchanged from last year. As in 2003, Genesis' Board and *s. 9(2)(b)(ii)* *s. 9(2)(ba)(i)* *s. 9(2)(j)* are unwilling to take on the full burden of **e3p**'s financial risk, and as a result Genesis' Board have approached Ministers asking them to consider agreeing to a mechanism that would see at least some of the financial risk associated with fuel risk assumed by the Crown.
- Gas supply comprises the two key components of physical contracted quantities of gas and deliverability of gas to the proposed station. Since last year circumstances have moved on considerably regarding Maui gas, Pohokura gas, Kupe gas and some gas currently being utilised at Methanex, with increasing clarity expected over the next three months regarding quantities of contracted gas. However, it is not clear how this may have impacted on the financiers' risk appetites.
- This report does not consider the merits of a risk-sharing proposal, nor recommends that Ministers make an immediate decision on supporting a mechanism. The report sets out the key issues that will need to be considered when considering a mechanism. The report also suggests a process for officials to work through the relevant issues with Genesis so that Ministers are well placed to make a decision based on all necessary information.

¹ Ministers were interested in looking at assisting proposals that would secure supply but were too risky for the market to deliver. However, the deal sought by the Company meant that it did not face any gas risk associated with the proposal, whereas Ministers sought a way to share risk so as to maintain strong incentives on the Board to manage the risks. Furthermore, at the time it was still not clear whether **e3p** was critical to securing New Zealand's base load generation capacity by 2006.

- In addition, this report comments on Genesis' exploration plans for the Cardiff-2 field, and possible agreements with Todd Energy and Shell for significant Gas Sale Agreements (GSAs). Ministers will be consulted separately on the Todd and Shell transactions as together they qualify as a major transaction under section 129 of the Companies Act 1993. Officials will report when the details on the transactions are available.
- Despite Ministers declining the risk-sharing proposal last year, officials consider there to be sufficient merit in reconsidering a proposal given the change in circumstances over the past year. The outlook for security of supply, the new institutional arrangements now in place for delivering security of supply, and the prospects for future gas supply are all factors that have changed significantly in the past year in favour of **e3p**. In addition, we understand from initial discussions with the Company that it is willing to take on a far larger proportion of the risk involved.
- If Ministers are agreeable, officials will put in place a work programme to deliver to Ministers advice on the relevant energy security and commercial issues in time to meet Genesis' timetable, and any consultation processes that Ministers will need to undertake with your colleagues.
- Officials consider that the main reason Ministers should consider providing support to **e3p**, if justifiable, is on energy policy grounds. By doing so Ministers would likely conclude that security of supply would otherwise be imperilled in the absence of **e3p**, and that there are no better alternatives for guaranteeing the adequacy of electricity supply security at least cost. In normal circumstances, shareholding Ministers would typically not support a generation project that is not bankable.
- Officials consider that the key commercial issues that need consideration before Ministers can make a decision on whether to provide Genesis support include:
 - the potential size of any support sufficient to meet the requirements of Genesis' financiers;
 - the time frame of exposure;
 - consequential likely implications on incentives of that support; and
 - the likelihood of a call on shareholders for support, which in turn depends on the certainty of gas supply;
- Security of supply and commercial issues are interrelated because if in the event **e3p**'s fuel supply turns out to be inadequate, **e3p** would be a stranded asset. In this scenario there would be a security of supply problem as well as a financial problem in the absence of long-term gas contracts with appropriate remedies for non-performance.

Consultation

The Ministry of Economic Development was consulted in preparing this report.

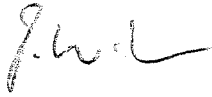
Recommended Action

It is recommended that shareholding Ministers:

- a **note** that Genesis is meeting with Ministers on 6 May 2004 to discuss, among other issues, a proposal for Ministers to consider a mechanism to share the financial exposure to **e3p**'s fuel risk;
- b. **note** that Genesis must irrevocably commit to constructing **e3p** by 15 August 2004 in order to guarantee commissioning by December 2006, and that any risk-sharing mechanism with the Crown must be implemented by that date;
- c **note** that the Genesis Board and *s. 9(2)(b)(ii), s. 9(2)(ba)(i), s. 9(2)(j)* are unwilling to take on **e3p**'s full financial risk in the absence of shareholder support that would, in effect, underwrite a portion of the financial risk associated with future gas supply;
- d **note** that last year Ministers declined a similar request from Genesis because the arrangement Genesis sought exposed the Crown to excessive risk compared to the benefits to security of supply;
- e **note** that new information since last year provides greater certainty around the gas supply, and we understand from initial discussions that Genesis is willing to take on a far larger proportion of the risk than before;
- f **agree** that officials work with Genesis to negotiate a risk sharing mechanism on **e3p** for Ministerial consideration that is just sufficient to meet the requirements of Genesis' Board and *s. 9(2)(b)(ii), s. 9(2)(ba)(i), s. 9(2)(j)* and assess whether **e3p** represents the most secure, least risk option to ensure security of electricity supply;

<i>s. 9(2)(b)(ii)</i>	<i>s. 9(2)(ba)(i)</i>	<i>s. 9(2)(j)</i>
<i>99(2)(j)</i>		
<i>Agreed/declined</i>	<i>Agreed/declined</i>	<i>Agreed/declined</i>
- g **note** that Genesis is spending \$15 million in 2004/05 on funding the drilling of Cardiff-2 well in return for a significant ownership share of any of its output, as well as securing the right to purchase its output;

- h **note** that Genesis is negotiating with Todd Energy and Shell for a long-term Gas Sale Agreements, and that shareholding Ministers will be separately consulted and advised on these transactions; and
- i Minister of Finance **refer** a copy of this report to the Minister of Energy.



David Taylor
Manager Commercial Investments
for Secretary to the Treasury

Minister of Energy



Michael Moore
Sector Manager – Energy, Land & Environment
Crown Company Monitoring Advisory Unit

Referred: Yes/No



Hon Dr Michael Cullen
Minister of Finance

Hon Mark Burton
Minister for
State-Owned Enterprises

Hon David Cunliffe
Associate Minister of Finance

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Analysis

Process

1. There are two streams of analysis required for Ministers to be able to fully consider the implications of the proposal:
 - the link between e3p and energy policy, to be led by the Ministry of Economic Development (MED); and
 - commercial and fiscal issues, to be led by Treasury/CCMAU in consultation with Genesis.
2. Treasury/CCMAU will engage with Genesis to set out in detail the nature of the risk-sharing mechanism required to satisfy its Board and bankers, as well as to provide an assessment of the magnitude and likelihood of the risk to the Crown of a call on the Crown under the mechanism. The process will result in a recommendation to Ministers on the feasibility of a risk-sharing mechanism. Assuming a mechanism is feasible, officials will also recommend a specific mechanism should Ministers choose to support e3p ahead of other possible energy policy options.

Timeline

3. Given that a mechanism needs to be implemented no later than 15 August 2004, and that the final legal documentation will need to be finalised following any shareholder decision (including any Cabinet involvement), officials will need to report to Ministers by the end of June. This allows approximately six-seven weeks to negotiate a draft mechanism, consider the relevant energy policy issues and assess the gas supply situation.

Energy Policy Issues

4. In the recent draft Treasury report "Draft Review of Electricity Policy" (T2004/695 refers), e3p was identified as being crucial to the adequacy of capacity from 2006/07 onwards. If e3p is not commissioned, then only 52 MW of new capacity is likely to be built in 2006 and 2007. MED estimates that 300 MW will be required over this same period to meet the growth in national demand.
5. There is little question that New Zealand will need more power stations in the near future. The issue is whether the Government should support e3p to fulfil this need, or leave these issues to the new industry governance regime to resolve. To make this assessment, the Government needs to be able to compare e3p against the cost and level of security provided by other options. Such other options would also include doing nothing, thereby concluding that other generators can fill the generation gap should e3p not go ahead. A key issue will be an assessment of likely gas available to meet e3p's and existing users' needs (substituting e3p for other gas fired stations is of no security of supply benefit). This is also central to the assessment of e3p's commercial risk.

Commercial issues

Background

6. In 2001 when **e3p** was first proposed, Ministers agreed that Genesis could proceed with its development plans if certain conditions were met. These conditions included securing an adequate long-term gas supply contract, and reconfirming with Ministers that the net financial returns of the project were still expected to be positive in the event it was significantly delayed.
7. With the downwards re-determination of the Maui field and delays in the development of the Pohokura field, Genesis has been unable to date to finalise contracts to cover all its future gas requirements. A shortfall of gas could potentially strand **e3p**, whether it be for a relatively short length of time while gas is secured, or longer-term if serious ongoing supply issues dominate the industry. Genesis intends financing **e3p** entirely through commercial debt. Any significant downtime through fuel shortage would make debt servicing on **e3p** very difficult to manage. For this reason, in the absence of a long-term gas supply with appropriate remedies for non-delivery, Crown support may be a requirement of bank support to finance **e3p**.

Fuel Security

8. In December 2003 shareholding Ministers approved Genesis' plans to develop the Kupe field. Genesis plans to commence taking delivery of Kupe gas by October 2007. Supply from Kupe is dependent on construction of onshore facilities including obtaining resource consents. Prior to the commissioning of the Kupe field, Genesis must source adequate levels of gas from other fields to satisfy its existing demand profile. In addition to this, Genesis must consider how to satisfy the additional gas load of **e3p**.
9. Genesis has nearly concluded negotiating Heads of Agreement with Todd Energy Limited (Todd) and Shell for separate and significant long-term GSAs covering approximately [] PJs and [] PJs of gas respectively. The transactions have gross values of approximately [] million and [] million respectively and as such will each qualify as a major transaction under the Companies Act 1993². Following Board approvals, Genesis is expected to approach shareholding Ministers during the week commencing 10 May 2004 to seek urgent shareholder approval for the deals. A separate report outlining the proposed transactions will be drafted for Ministers' consideration.

S.9(2)(b)(ii)
(9(2)(b)(i))
10. In addition to Kupe, and the Todd and Shell deals, Genesis is seeking additional long-term gas supplies. Given the current upstream gas squeeze, Genesis considers it needs to be further involved in gas exploration. To this end, Genesis is partnering with Austral-Pacific Energy Limited (Austral) to fund the drilling programme and to share in any field output from the Cardiff-2 well. Exploratory drilling will commence in August 2004. While the field looks promising, it is technically challenging because of its depth and flow characteristics. Genesis expects to fund around \$15 million in drilling expenses in return for:
 - a 40% equity stake in the field;

] S.9(2)(b)(ii)
] S.9(2)(b)(i)

] s.9(2)(b)(ii)
 s.9(2)(b)(i)
 s.9(2)(c)

11. Genesis considers the Cardiff-2 opportunity offers better chances of short-term success than the drilling fund promoted by Contact Energy and Mighty River Power. Exercising the Cardiff-2 option, however, does not preclude Genesis from also entering the drilling fund at some later date. Genesis was not required to formally consult with Ministers before committing to Cardiff-2. Officials consider that Genesis' commitment to Cardiff-2 is consistent with the recent Kupe transaction that Ministers approved, and could provide much needed longer-term gas supply for Genesis. If Genesis is successful in discovering considerable quantities of gas, we would expect that Genesis would revert to Ministers to consult on any significant development contracts.
12. On 29 April 2004 Genesis and Austral released a joint press statement announcing their agreement to drill Cardiff-2 which attracted some minor media interest.

Transmission

13. As its gas position becomes clearer Genesis has increasingly emphasised the importance of access to the Maui pipeline to its security of supply. Genesis is of the view that any significant additional gas load will have to be transported through the Maui pipeline, as the existing NGC high-pressure pipeline system does not have the capacity to handle the increased load. Maui pipeline access is the subject of current regulatory proposals by the Minister of Energy, which could resolve the issue within Genesis' required timeframe

Comment

14. As a strictly commercial investment, **e3p**'s fuel uncertainty could result in Genesis not proceeding with its construction. However, the outlook for the electricity industry may be such that **e3p** could be deemed so important to security of supply that the Government would be prepared to review its earlier conditions, and potentially to take a share of the commercial risk of building **e3p**.
15. Moreover, compared to last year when Genesis unsuccessfully attempted to seek shareholder support, there have been some favourable developments in the wider gas market improving the prospects of a surer gas supply³. This raises the prospect of Genesis being willing and capable of diminishing the size and scope of support, thus reducing the size of the financial risk faced by the Crown. Indeed, we understand from initial discussions with the Company that it is willing to take on a far larger proportion of the risk involved. Nonetheless, the key commercial issues remain unchanged from last year and need to be analysed carefully. These issues include:
- limiting the scope of the risk sharing mechanism such that it is just sufficient to encourage the bank's to finance the project;
 - simplicity in form and avoid on-going involvement by the Crown unless the mechanism is to be called⁴;

³ Specifically the Kupe development and the current Todd Energy and Shell proposals.

⁴ In the case of a guarantee, once called the Crown becomes an unsecured creditor of the company for the level of support.

- risk sharing such that Genesis should bear a reasonable proportion of the risk of the project and incur reasonable expense before calling on the risk sharing mechanism⁵ to minimise any perverse incentives created for Genesis to overpay or under-contract for gas;
 - estimating the likely fiscal cost (i.e. size and likelihood of a call against the Crown); and
 - flexibility in achieving the form of the risk sharing mechanism within these principles.
16. As part of any advice on a preferred risk sharing mechanism, we would expect Genesis to demonstrate that **e3p** remains NPV positive. It has been almost three years since Ministers gave their conditional approval to **e3p** proceeding. Since that time industry dynamics have altered significantly, with the electricity and gas pricing paths showing particular variation. Officials consider it important that **e3p** remains a commercially attractive opportunity should the impact of fuel-risk be netted from the economics. Officials intend engaging with Genesis to confirm this as part of the discussion on risk-sharing.

⁵ Guarantees are preferred over uncalled capital provisions to avoid arranging in advance appropriations for unlikely events.

26 April 2004

Hon Mark Burton
Minister for State Owned Enterprises
Parliament Building
WELLINGTON

Hon Michael Cullen
Minister of Finance
Parliament Building
WELLINGTON

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Dear Ministers

We write to update Ministers on the current status of our project to commission a new nominal 400MW Combined Cycle Gas Turbine ("CCGT") at the Huntly Power Station site ("Huntly e3p").

BACKGROUND

The detailed work programme for Huntly e3p commenced in early 2001. Initially a commissioning date of December 2005 was anticipated, but this date slipped due to the unavailability of a long term gas supply for the operation of the CCGT.

Following a tender process Mitsubishi Corporation ("Mitsubishi") was selected as the preferred supplier, and by May 2003 the contract for the design construction and commissioning of Huntly e3p and the contract for the long term maintenance of the CCGT were in an agreed form. The contracts were capable of being executed, by Genesis and Mitsubishi, without further amendment, if certain conditions, namely Genesis entering into gas supply contracts sufficient for the intended operation of the plant and the continuing economic viability of the investment, were satisfied by 16 July 2003.

In its letter to Ministers dated 8 May 2003, Genesis advised Ministers of the level of agreement reached between Genesis and Mitsubishi and the long term gas supply situation. In that letter Genesis also advised Ministers that the Genesis Board of Directors was not able to commit to the project until suitable gas supply contracts were obtained and invited Ministers to consider whether there was any mechanism by which the Crown could provide Genesis' bankers with comfort that the Crown would bear the risk of insufficient gas until suitable arrangements for gas for Huntly e3p were secured.

Working together, Genesis management and Crown officials developed a synthetic gas proposal. However, by letter dated 7 July 2003, the Minister for State Owned Enterprises advised the Chairman that shareholding Ministers did not consider the synthetic gas proposal reflected the appropriate balance of risk between the Crown and Genesis and that they did not therefore wish to support the synthetic gas contract as proposed.

GENESIS ISSUES LIMITED NOTICE TO PROCEED

The Genesis Board of Directors considered the content of the Minister's letter of 7 July 2003, including shareholding Ministers' interest in Huntly e3p being

commissioned by 31 March 2006, and the risk arising from entering into a contract for the supply of a large gas turbine ahead of securing sufficient fuel gas for the operation of the plant. By letter dated 30 July 2003 the Chairman advised shareholding Ministers that Genesis would issue a Limited Notice to Proceed ("LNTP") to Mitsubishi covering the provision of certain preliminary engineering and site work from 15 August 2003 to 15 February 2004, by the end of which period it would be necessary to issue and execute the contract for the full works in order to maintain a 31 March 2006 commissioning date. In that letter Genesis also sought Ministers' support to secure the gas necessary for the commissioning of Huntly e3p through the Crown-Maui Development Limited negotiations that were in progress.

The Hon Dr Michael Cullen, in his letter dated 22 August 2003, on behalf of shareholding Ministers, acknowledged Genesis' decision to issue a LNTP to keep alive the possibility of commissioning Huntly e3p by winter 2006. The Minister also commented on the Crown - Maui Development Ltd discussions which, he advised, were seeking to create an environment that maximises gas recovery from Maui reserves. However, the Minister was not able to provide any Crown guarantee that the flexibility Genesis sought for 2006 gas delivery could be resolved by 15 February 2004.

The value of the LNTP works, now completed, was approximately \$20 million. In addition Genesis proceeded with all necessary site enabling works including the design for bridge strengthening works required to ensure a heavy haulage route is available from the Ports of Auckland to Huntly.

FUEL UNCERTAINTIES PREVENT ISSUE OF FULL NOTICE TO PROCEED IN FEBRUARY 2004

During the course of the LNTP Genesis continued its efforts to secure gas for Huntly e3p. Genesis participated unsuccessfully in Todd Energy's tender for Mangahewa-McKee gas. Genesis proceeded with the sell-down of 50% of its interest in the Kupe field and entered into a long term gas contract for 81% of the gas production from the field, totalling 191PJ delivered over [] years. The consenting and development process for Kupe is expected to be completed by 2007. Genesis also awaited the opportunity to bid for Pohokura gas. The issue of a request for proposals by the Pohokura Joint Venture partners, expected in December 2003, was subsequently received in April 2004.

During that time Genesis also learnt [

s 9(2)(b)(i)
s 9(2)(b)(i)

s 9(2)(b)(i)
s 9(2)(b)(i)
s 9(2)(i)

As a result of these continued uncertainties with regard to gas supply, the Genesis Board of Directors did not authorise the issue of a final notice to proceed ("FNTP") for Huntly e3p in February 2004. Without execution of the contract for the full works or a further significant financial commitment from Genesis, Mitsubishi was no longer able to maintain the commissioning date of 31 March 2006.

GUARANTEED COMMISSIONING DATE

Genesis has however secured a guaranteed commissioning date of 15 December 2006 from Mitsubishi subject to the issue of a FNTF by 15 August 2004. This guarantee is provided on the basis that an incremental fee over and above the agreed contract price and approved escalations, is payable in the event the project proceeds, but not otherwise. Two further options, based on the issue of a FNTF by 15 October 2004 or 15 December 2004, would achieve commissioning dates of 15 February 2007 or 15 April 2007 respectively.

CURRENT GAS SITUATION

Genesis requires 20PJ of gas per annum to operate Huntly e3p. From 2007, at least 75% of this volume should be available from Kupe provided the consenting and development of Kupe proceeds according to plan. In the meantime Genesis does not yet have sufficient contracted gas to fuel Huntly e3p as well as meet its other generation, industrial and retail commitments which require 17 PJ and more going forward, over and above the requirements of Huntly e3p. We attach a graph showing Genesis' current contracted gas supplies and requirements as an appendix to this letter.

Efforts to secure gas for Huntly e3p continue. Genesis is working with NGC to achieve greater certainty of supply for Genesis than that initially proposed by NGC following the Maui redetermination. Genesis is negotiating with Kupe Joint Venture partners NZOG and Mitsui to secure the remaining 19% of the gas production from Kupe. Genesis will also invest in further upstream gas interests.

With the recent decision by the Pohokura Joint Venture partners to market Pohokura gas separately there are now three potential sellers of gas from June 2006. Genesis is already actively engaged in separate sales processes with the Pohokura Joint Venture partners, with the expectation of making final binding bids by June 2004. Genesis is also negotiating with Todd Energy for the supply of Mangahewa and McKee gas from 2005 to 2012.

Subject to reaching contractual agreement on the above alternative gas supplies Genesis will be able to meet existing requirements and the commissioning of Huntly e3p in December 2006 through until 2008 when Kupe gas should be in firm supply. Kupe gas will be supplemented by new gas fields coming on stream and/or LNG over the long term.

MAUI OPEN ACCESS REGIME

Genesis is concerned about access to the Maui pipeline for gas from fields other than Maui. The transport regime in place to transport gas for Huntly e3p will be a key concern for financiers of the project. Genesis believes that the Maui open access regime needs to be operational as soon as possible and before January 2005 in order that Genesis can receive non-Maui gas.

s.9(2)(b)(i)
s.9(2)(b)(i)

POTENTIAL COMMISSIONING OF HUNTLY E3P BY DECEMBER 2006

Genesis remains committed to Huntly e3p. Rising fuel prices internationally and locally make a shift to high efficiency generating plant more economical. Subject to securing satisfactory fuel supplies, Huntly e3p is still economically viable for Genesis and increasingly critical for meeting New Zealand's base load energy requirements.

Despite the delays to the project due to recent fuel uncertainties, Huntly e3p remains capable of being commissioned by December 2006. Huntly e3p is the only significant new generation that can be delivered to the New Zealand market in the next three years. Not only is the site consented and prepared but the form of contract for supply of a high reliability CCGT is agreed and a willing supplier has guaranteed a completion date.

It is Genesis' view that it is again timely for the Crown and Genesis to consider an appropriate risk sharing mechanism by which to allow Huntly e3p to proceed as soon as possible. The extent to which gas supplies are confirmed will dictate the balance of any such risk sharing mechanism. To this end Genesis intends engaging with your officials to discuss possible options for consideration by Ministers leading towards the 15 August 2004 FNTF deadline.

The Chief Executive and Deputy Chairman, Keith Smith, look forward to further discussions on these matters with you at the meeting between Ministers and Genesis scheduled for 5.00 pm on 6 May 2004. As I will be out of the country at the time of the meeting I have asked the Deputy Chairman, who will be Acting Chairman during the month of May, to attend the meeting in my place.

Yours faithfully



Brian Gorban, QSO
Chairman

cc Hon Peter Hodgson
Hon David Cunliffe

5.9(a)(6)(ii), 5.9(a)(6)(i), 5.9(a)(6)

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