

The Treasury

Strategic Issues and Shareholder Expectations Letters Information Release

Release Document

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Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
- [2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information
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- [4] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [5] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [6] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [7] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

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



Office of Hon Todd McClay

MP for Rotorua

Minister of Revenue

Minister for State Owned Enterprises

Associate Minister of Foreign Affairs

Associate Minister of Trade

19 DEC 2014

Ms Sarah Smith
Chair
Meteorological Service of New Zealand Ltd
PO Box 722
WELLINGTON 6140

Dear Ms Smith

2015/16 SHAREHOLDER EXPECTATIONS OF STATE OWNED ENTERPRISES

I am writing on behalf of shareholding Ministers to set out our expectations and timetable for the business planning process within the 2015/16 financial year. The Government remains committed to driving the shift towards more active management of its shareholding in commercial assets. We will continue to engage with Boards on how to maximise the value of its business through improved performance and effective capital management in line with the expectations set out in this letter.

The timetable for this year's business planning process can be found in Annex 1 to this letter.

Entity specific expectations

[4,7]

Strategic reviews

A programme of strategic reviews commenced last year, with five entities being the subject of jointly-commissioned strategic reviews in 2013/14. The reviews will occur on a rolling cycle, and are intended to provide closer alignment on company strategy between the Board and senior management, and the shareholders. Accordingly, SOEs can now expect to undergo a strategic review every three or four years.

We expect to engage with you soon to initiate MetService's first strategic review, commencing in early 2015. To ensure the most value is obtained from the process, we expect the review to involve the MetService Board, senior management and applicable staff. An appropriate level of information disclosure will be required from MetService in order for the review to be completed.

Dividends

Ministers expect positive business performance to result in dividend payments, and that an appropriate balance is maintained between dividends and reinvestment. Our preference is for dividends over new reinvestment and any alternative capital allocation would require a suitably strong business case.

[2]

I expect you to engage with Treasury officials at an early stage in the business planning process to agree an appropriate dividend policy.

Capital allocation

We expect you to engage with Ministers and officials on MetService's strategic initiatives as they develop, particularly those that involve a meaningful allocation of capital. We expect investments (such as the purchase of MetOcean) to be value enhancing and supported by robust business cases, which: evaluate options thoroughly, are based on reasonable assumptions, take into consideration all risks and apply the appropriate risk-adjusted cost of capital.

In terms of MetService, this involves the right balance between allocating capital to invest in future growth, modify the level of gearing and pay dividends. To allow Ministers to understand the appropriate balance, we expect that you will provide Treasury officials with a deeper understanding and update on current and future growth initiatives. This will enable an understanding of the current approach to managing investment in future growth and how future opportunities are evaluated.

Your Treasury relationship managers, [1] will be seeking to engage with you to further understand your strategy and investment decision making process. I look forward to your cooperation in this regard.

Generic expectations

Early notification of any material change in Statement of Corporate Intent (SCI) forecast

As achieving a budget surplus and reducing debt continues to be a priority for the Government, it is important that state owned enterprises (SOEs) advise the Crown of any risk to forecast performance. Therefore, we expect that SOEs will quantify any risk and advise officials on a timely basis if below-forecast performance is expected.

Update on post-investment reviews

A system of post-investment reviews has been in place for Treasury monitored entities since 2011. Financial thresholds have been established, over which a post-investment review is required by Treasury (thresholds are detailed in pg. 28 of the Owner's Expectations Manual, via the Treasury Commercial Operations website). These documents have been very useful in enabling Boards and shareholding Ministers to better assess whether the benefits expected to be obtained from capital expenditure and/or new investments were realised in practice. Consistent with prior years, we request copies of any post-investment reviews over the defined threshold.

Non-Crown debt assurance

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

Capital injections

There is a high threshold for the Crown to approve any new capital injections.

Independent valuations

As part of our ongoing focus towards more active management of the Crown's portfolio of commercial assets, we expect to make continued use of company valuations.

Annexes

Annex 1 to this letter provides the 2015/16 business planning timetable; and *Annex 2* provides the Commercial Valuation Model Disclosure Statement to be used when providing the commercial value of the SOE in the SCI.

Engagement

Your Treasury relationship managers will be in contact shortly after you receive this letter to discuss shareholding Ministers' expectations in more detail. If you have any questions please contact [1]

[1] Alternatively, please contact Fiona Chan (Manager, Governance and Performance on 04 917 6103).

My office will be in touch in due course to arrange meetings with Chairs, to occur at a later date (toward the middle of the year).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Todd McClay', written in a cursive style.

Hon Todd McClay

Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Peter Lennox, CEO, Meteorological Service of New Zealand Ltd

Annex 1

Timeline

Below is the normal business planning timetable with the final SCI due to be received on or before 1 July 2015.

Key dates for 2015/16

| <i>Due date</i> | <i>Key Action</i> |
|---------------------------|---|
| 27 February | Board sends strategic issues letter to Ministers |
| 27 February | Board provides details of post investment reviews to Treasury |
| 1 May | Board submits draft SCI and business plan |
| 30 June | Board delivers final SCI to shareholding Ministers |
| Within 12 days of receipt | Minister to present SCI to the House of Representatives |

All SOEs are expected to provide shareholding Ministers with a *strategic issues letter*, by **27 February 2015**, setting out the key strategic issues facing the company. Should your company wish to engage with shareholding Ministers to seek clarification around Ministers' expectations, we would ask that you advise Treasury as early as possible of such intentions.

All SOEs are expected to provide shareholding Ministers with a draft SCI and Business Plan, consistent with shareholding Ministers' expectations as detailed in this letter, by **1 May 2015**.

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

Further guidance can be found in the Owner's Expectations Manual, via the Treasury Commercial Operations website. Here is a link to the site:

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

Annex 2

Commercial Valuation Model Disclosure Statement (for use in SCI)

Example

The Board’s estimate of the current commercial value of the Crown’s investment in the Company / Group is [\$X million].

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

- The valuation was calculated as at [30 June 2015].
- The Discounted Cash Flow (DCF) methodology was used to calculate a Net Present Value (NPV) of the entire SOE 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 Group’s 3-year business plan, with forward projections then also made about years 4 to 10, and a terminal value of [\$X 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 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 [\$X billion] (often referred to as the equity value) was calculated by taking the enterprise value of [\$X billion] and deducting net debt of [\$X 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 2014 of \$X million]. 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....., and
- 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.

Please engage with your Treasury relationship manager if you have any questions or wish to apply a different methodology, before engaging external support for this analysis.