The Treasury

Strategic Issues and Shareholder Expectations Letters Information Release

Release Document

April 2015

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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

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

Hon Sir Michael Cullen
Chair
New Zealand Post Ltd
Private Bag 39990
WELLINGTON 5045

Dear Sir Michael

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.

Business transformation

Ministers recognise the progress NZ Post is making in transforming its operations to better position them as self-sustaining businesses in marketplaces undergoing significant technology-driven changes. This required considerable investment in physical, human and financial capital and has not been without its risks. The benefits of actions already taken are beginning to show through. While there are still major initiatives underway, I understand that the high levels of capital investment required and most associated execution risks – for which mitigation strategies are in place – should gradually dissipate over the next two years.

Dividends

Ministers expect that an appropriate balance is maintained between dividends and reinvestment. Our default preference is for distributions over retention for new investments and Board decisions should be weighed in light of the Crown's need to fund its social policy and debt reduction objectives.

NZ Post's current dividend policy was established to recognise the need for business transformation and the inherent execution risks. Ministers expect improved business performance along with funds released by the CouriersPlease sale will prompt review of dividend policy with a shift to one which is tied more closely to post-transformation underlying profitability and prospects. In addition, Ministers expect group dividend policy will closely link distributions to the parent from Kiwibank which should, in turn, recognise its improving performance.

Capital allocation

Ministers expect that the group business plan will include comprehensive updates on previously advised business change programmes and investment initiatives. This should include details on actual progress and how risk management has performed relative to plan along with details on any further significant initiatives the Board plans. Whilst expressly recognising the responsibility of the Board for NZ Post's governance and of management for operational execution, Ministers expect to be kept abreast of strategic initiatives as they develop, particularly those that involve meaningful capital allocations. We expect investments to be supported by robust business cases and to be value enhancing after applying an appropriate risk-adjusted capital cost.

[2]

Strategic reviews

Shareholding Ministers are focused on the value management of entities in the commercial portfolio. Consequently a strategic review programme continues as one mechanism to aid closer alignment of the Board and management, and shareholders', perspectives on company strategy. We intend that reviews will continue on a rolling cycle with each entity being reviewed every three to four years.

The NZ Post strategic review was completed and its recommendations discussed with the company earlier this year. It confirmed the benefit of group initiatives to transform its businesses, better enabling them to withstand the negative impact of declines in traditional mail, to capitalise on new opportunities in core business areas and divest peripheral units.

Ministers recognise that NZ Post already had significant initiatives underway in a number of spheres the strategic review focused on. In particular, we note the developments in the following areas:

- mail processing optimisation now focused on three efficient centres, preparation for changes to delivery frequency from July 2015, and the testing of new delivery options,
- broadening Kiwibank's range of products and services to reduce its reliance on high capital intensity products and lowering the bank's cost ratio, and
- transferring management of the retail network to the bank to aid transparency amid moves to reshape the retail network to match the specific and diverging customer and business needs in the mail and logistics and financial services business clusters.

Ministers look forward to updates on progress in these areas and expect the group's business plan will also include details on continuing efforts to:

- drive the courier business to capture a strong and maintainable share of the growing parcels market and further capitalise on its integration with the mail division,
- manage all options to improve the mail and communications business including implementing the new delivery equipment and processes, as well as further analysis of evolving letter volumes, pricing and price elasticity, and
- drive Kiwibank's operating and financial performance to be more in line with its major competitors.

Engagement with officials

Your Treasury relationship managers, [1] already benefit from the strong relationship that has built up between NZ Post and Treasury over the last five years. Ministers are aware of both groups' continuing engagement so that the relationship managers gain a deeper understanding of your strategy, challenges, opportunities and decision-making processes. I look forward to your ongoing commitment to the success of this arrangement going forward.

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 will request copies of any post-investment reviews over the defined threshold.

Capital injections

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

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.

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

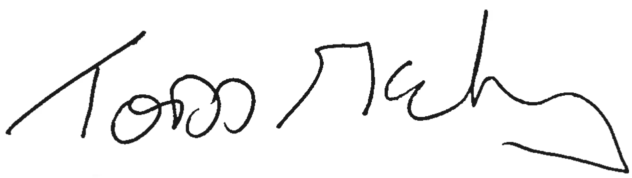
Annex 1 to this letter provides the 2015/16 business planning timetable; and *Annex 2* provides the Commercial Valuation Model Disclosure Statement to be used when providing the commercial value of the SOE in the SCI.

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 (towards the middle of the year).

Yours sincerely,



Hon Todd McClay
Minister for State Owned Enterprises
on behalf of shareholding Ministers

cc: Mr Brian Roche, CEO, NZ Post

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

Due date	*Key Action*
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

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 billion].

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 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……………..,
 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.