

The Treasury

Strategic Issues and Shareholder Expectations Letters Information Release

Release Document

April 2015

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- [1] 9(2)(a) - to protect the privacy of natural persons, including deceased people
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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.



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26 February 2015

Hon. Bill English
Minister of Finance
Parliament Buildings
WELLINGTON

Hon. Todd McClay
Minister for State Owned Enterprises
Parliament Buildings
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Dear Ministers

New Zealand Post Group - Key Strategic Issues 2015

In your letter dated 19 December 2014, you outlined your expectations of the New Zealand Post Group (the Group) and requested a response on the key strategic issues that the Group is facing. This letter presents the Group's response. Our thinking will be further developed and reflected in the draft Statement of Corporate Intent and the draft Group Business Plan, which will be provided to you no later than 1 May 2015.

The Group consists primarily of two clusters of business that deliver the following products and services to New Zealand consumers and businesses:

- Mail and Logistics services including:
 - the design, production and delivery of addressed and unaddressed items (with the balance increasingly shifting to parcels);
 - managed warehouse services; and
- Financial services including personal and business banking, insurance, Kiwisaver and investment management.

These business clusters are supported by our physical and digital channels to market.

While the overall strategy remains appropriate, and progress in executing against that strategy is encouraging, we continue to operate in a very challenging and competitive environment and in markets that are rapidly changing.

Where is the Group today?

In November 2013, the Group announced a refresh of its business and operating strategy, the outcome of which is to ensure the businesses remain relevant to the markets within which they operate, are self-sufficient in terms of capital independence and ultimately create sustainable value for the shareholder and key stakeholders alike.

We see on-going transformation as 'business as usual' in order to address the challenges we face and to capture the opportunities presented by changing market conditions. The following strategies are well advanced across the Group, and sit within three key programme themes:

- Growing and adding value for the shareholder:
 - Capturing volume growth opportunities by optimising parcels and logistics operations across the Group to provide a unified value proposition to customers;
 - Increasing the profitability of our financial services business, in particular by increasing the number of customers who use Kiwibank as their main bank, and diversifying revenue streams across key business sectors and service offerings;
- Innovate and Serve:
 - Implementing new modes of physical delivery to reflect our changing product mix, reducing duplication of routes between courier and postal networks, and providing cost effective means of servicing low density areas;
 - Innovations in our mail processing capabilities involving automation to further extract operational efficiencies;
 - In tandem with innovations in processing, we seek to position digital services as an enabler and driver of business elsewhere in to our network and as a trusted facilitator of information and document flow between sender and receiver;
 - Transitioning the store network into distribution channels that reflect the specific needs of Kiwibank customers and one which will provide the product lodgement function appropriate for the mail and logistics business; and
- Lower Cost
 - Reducing costs across our corporate and support services, through the removal of duplication and simplification of processes;
 - Implementing delivery frequency changes for standard mail from July 2015; and
 - Mail processing optimisation; completing the transition process to three primary mail processing centres This project aims to retain scale and drive greater efficiency in mail processing.

Strategic challenges faced across the Group

Business environmental conditions are no less challenging than they have been in the past, and continue to provide the impetus to deliver on our strategic plans across the Group. As in 2014, there are issues, challenges and opportunities which overlap the core businesses and some that are relatively unique to each main cluster – key aspects of these are described below:

Store Network

The store network provides a sales and service touch-point for Kiwibank, while also offering a physical drop-point for lodgement of postal product. Our physical distribution requirements for the postal business are, however, heavily influenced by digital substitution (see below).

The distribution requirements of the Group's two businesses are, therefore, increasingly divergent. With changing customer needs it has become clear that the current network is neither fit for purpose nor sustainable from a cost perspective for either of the core businesses.

For the mail and logistics business to remain commercially viable, a more variable cost model is needed. With the aim of removing approximately [2] of annual operating costs, this is likely to involve more hosted arrangements with other businesses in convenient, high-traffic locations such as service stations or supermarkets and a greater emphasis on self-service options. Meanwhile the focus of the Financial Services requirements is on sales and service with a retail network that delivers high-value interactions, provides brand reach and meets the regulatory requirements of the respective products offered.

To this end, operational control of our stores which are company owned passed to Kiwibank in mid-2014, with a view to accelerating the bank-specific distribution strategy. As customer needs and technology continue to change rapidly, the role and mix of the Bank's sales and service channels will also need to change to continue to meet customers' needs. This will result in a further reduction in the number of stores which are company owned and a change in their focus, with an emphasis on digital enhancement in locations where that makes sense. Across both businesses, we continue to develop more online, mobile and self-service options for our customers.

An additional component of the current store network configuration and offering is the provision of Bill Pay services - acceptance of payments on behalf of third party agencies such as power companies, local councils, insurance and telephone companies and the New Zealand Transport Agency. These companies increasingly encourage their customers to move to online alternatives and offer substantial discounts to incentivise this behaviour. As this trend continues, we will need to actively monitor and review the future of our bill pay business and right size it accordingly to meet the financial and operating objectives.

Digital substitution

The entrenched, generational move away from physical forms of communication is nothing new, and has been well signalled to you over recent years. Our letter volumes continue to decline close to the anticipated rate of approximately 8% per annum, which equates to a reduction of over 60 million items each year. Re-engineering our processing and delivery business in response is a significant focus for the Group, and requires investment in smarter technologies and new ways of delivering services to maximise efficiency and reduce operating costs.

Strategic issues specific to our mail and logistics business cluster

While dynamic market trends impact all of our activities, there are a number of issues that are unique to our letters, parcels and logistics activities. This part of the Group continues to face challenges arising from:

- Volume decline in the postal network is being addressed by our strategic programme, Network of the Future, which has redesigned processing and delivery networks with a view to economic sustainability while still meeting our customers' needs and our Universal Service Obligations as set out in the revised Deed of Understanding. Key initiatives to address this include mail centre optimisation and developing an integrated delivery agent model;
- The parcels market is undergoing dynamic change, driven primarily through the continued development of e-commerce. While the parcels market is growing, particularly through international sources, evidence suggests this does not automatically flow through to an increased volume for delivery companies. We are observing a form of substitution from business-to-business activity to business-to-consumer driven volumes. The highly competitive (with low barriers to entry) nature of the domestic courier market has created an environment where we will need to continue to invest in enhancing our product and service offering to ensure our customer service is aligned with customer expectations for both senders and receivers;
- We have embarked upon, and will continue changes to management and support structures to reflect the changing business model outlined above, and move closer to an integrated Group network. This will likely result in further reductions in staffing levels and lower overhead costs; and
- The cost to the mail and logistics business of the current configuration of the store network is uneconomic and unsustainable when measured against the declining volumes of mail entering the postal network via this channel. Although Kiwibank now has operational control of company owned stores, current pricing arrangements and service offerings mean the store network is both unaffordable today and unfit for the postal services presence we envisage for the future.

Strategic issues specific to our financial services businesses

Kiwibank continues to focus on profitability and improving its competitive position through providing good value to customers. Kiwibank's long term vision of being a strategically important bank for New Zealand is at the centre of our plans to deliver sustainable, profitable growth and value. As the business approaches a position of capital self-sufficiency, the operating environment remains extremely competitive with a number of strategic challenges to be faced by Kiwibank including:

- Large increases in regulatory and compliance activities for Financial Institutions have increased Kiwibank's cost base. We continue to manage operating costs to ensure that the Bank achieves over time an appropriate cost to income ratio which is comparable for like businesses;
- Refining the look and nature of Kiwibank's national presence is part of a new digitally-focused distribution blueprint. This will require careful management and execution to ensure the appropriate level of sales and service continues to be provided across the country;
- Managing the growth and retention of customers in an economic environment in which competition remains high and new providers of financial services continue to enter the market; and
- Delivery of a new core banking system to replace the current IT system is well underway, albeit in the initial stages of a multi-year programme of work. Whilst the new system will drive both efficiency benefits and mitigate operational risk in transaction processing it requires significant capital as well as internal resources [2]

[2] Kiwibank has recently launched a new operating model which has been developed to ensure the Bank achieves its financial and strategic aims by taking a pan-customer approach to its internal team functions. As previously advised, this resulted in a number of personnel changes and will now require a period of bedding in before the full cost and business benefits are realised.

To fully meet the needs of Kiwibank's growing and maturing customer base, there is a strong focus on diversification of income, [2]

[2] It is anticipated that the wealth and insurance and business markets [2] will continue to be the most likely sources of diversified growth.

Strategic Review

As part of Treasury's ongoing independent review of Crown entities, Goldman Sachs completed an independent review of the Group's strategies, business models, and options in May 2014.

The review confirmed the direction of the Group's key strategic programmes is soundly based and provided a useful backdrop for dialogue on future state considerations.

Deed of Understanding

In December 2013, New Zealand Post reached agreement with the Crown on changes to the Deed of Understanding. While the revised Deed contemplates that a formal review of the Deed is to be completed no later than 1 November 2018, the timeframe for commencing engagement with Officials is likely to be at the earlier end of the intervening period, based on market conditions and the commercial outcomes required under our governing legislation.

Credit rating

NZ Post holds an A+ credit rating from Standard & Poor's which was re-affirmed at the annual review in September 2014. We continue, however to be held on a 'negative outlook' in terms of the risk of a ratings downgrade, principally dependant upon our ability to execute change programmes whilst delivering satisfactory levels of profitability and cash flow within the mail & logistics business. Complicating the ratings outlook is their perceived risks to the concentration of earnings provided to the Group by Kiwibank being associated with an over-heated Auckland housing market.

We therefore continue to focus on the successful implementation of our strategy, both for the support this lends to the credit rating of Kiwibank but also our own commercial objectives.

Other matters

We welcome continued engagement with officials and shareholding Ministers over the upcoming months as we prepare our FY16-18 Business Plan and Statement of Corporate Intent.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'M. Cullen', with a long horizontal flourish extending to the right.

Hon. Sir Michael Cullen KNZM
Chairman, New Zealand Post Group

cc David Stanley, Treasury

Appendix - Specific matters contained in your letter

Set out below are responses to the matters specifically relating to New Zealand Post Group raised in your letter:

Matter raised	New Zealand Post Group response
Business transformation	We appreciate the Ministers recognition of the transformational nature of the capital requirements within the business. In particular, there are ongoing capital requirements for investment to integrate our delivery agent capabilities and processing innovations to fulfil our strategic plan. We anticipate the benefits to our major programmes of work will continue to emerge over the next 2-3 years
Dividends	We acknowledge the Crown's desire for enhanced financial returns. We reiterate our commitment to a minimum dividend return of \$5m. Additional dividends may be made from surplus funds at the conclusion of each financial year after balancing the needs of the business with those of the shareholder. We will continue to work with Treasury officials in this matter, noting the Minister's linkage to Kiwibank's improving performance.
Capital allocation	We note the Ministers expectations and emphasise our approach to targeted, independent capital allocation between our core clusters of businesses.
[2]	[2] [2]
Strategic Review	We note the Ministers comments. We look forward to updating Treasury officials throughout the year as our strategic initiatives progress.
Engagement with officials	We note and endorse the Ministers comments.
Early notification of any material changes in the SCI forecast	We will provide Ministers and Treasury with regular updates on our core strategic initiatives. At a minimum, we will include these in our quarterly briefings to Treasury and semi-annual updates for shareholding Ministers.
Update on post-investment reviews	We will work with Treasury to provide further information to Ministers as requested. We will also make available other post investment reviews and monitoring of investments to Treasury and Ministers as appropriate and in accordance with the requirements stipulated in the Owner's Expectation Manual.
Capital injections	We note there is a high threshold for the Crown to approve any capital injections.
Non-Crown debt assurance	We note the Ministers comments and confirm that all documentation specifically addresses the issues around Crown guarantees.
Independent valuations	We will provide an updated valuation in the SCI.