

The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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Reference: T2022/2068

Date: 16 September 2022

To: Minister of Finance
(Hon Grant Robertson)

Deadline: None
(if any)

Aide Memoire: Financial performance in selected industries

Purpose

1. Officials have recently provided an Aide Memoire with further information relating to the financial performance of individual large New Zealand businesses and industries they operate in since 2019.

We have previously advised you about the change in profitability of individual firms

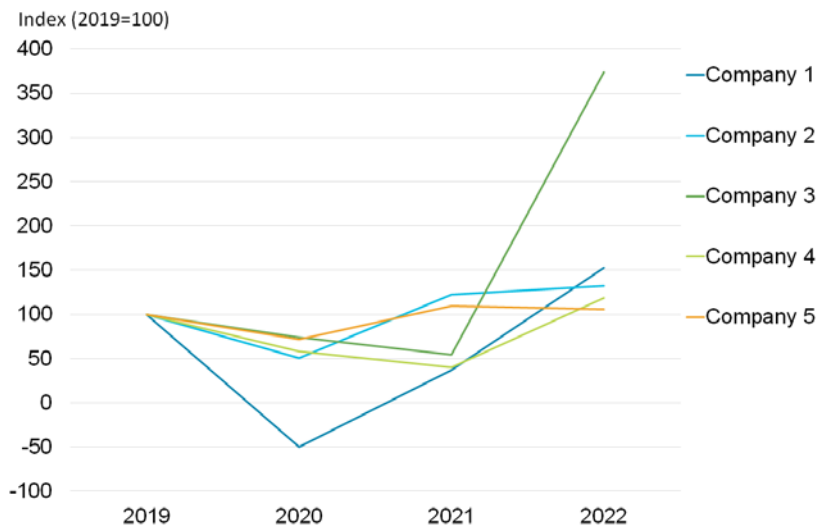
2. Our previous Aide Memoire provided a high-level analysis of the change in profitability of selected companies in banking, energy, retail, construction and aged care, with 2019 as the benchmark year.
3. Our previous Aide Memoire noted that there is some evidence of increased profits across industries, compared to 2019, although this increase varies widely across and within industries. Furthermore, many companies have yet to publish figures for the past year (including those that publish for the annual year rather than the year to June), which means the data is too limited to draw any definitive conclusions at this stage.
4. Our previous Aide Memoire also noted that there is a possibility that some of the firms that received considerable support during the COVID-19 lockdowns are now experiencing high profits. However, it was not feasible to draw a causal relationship between these two events.

You have asked for more information on the reasons for change in profitability in the sectors experiencing higher profits in the 2022 year

Energy sector

5. As noted in the previous Aide Memoire, total before-tax profits in the energy sector companies included in our data grew by 41% in 2022 compared to 2019.
6. One particular company drove a significant amount of this growth. When excluding this company, profits for the energy sector group grew 27% - still higher than nominal GDP growth of 16% over the same period, but less significant.
7. Figure 1 demonstrates how much of an outlier this company was (Company 3), with 2022 profits 274% higher than 2019. Further investigation suggests that this significant increase was the result of:
 - a. unusually low profits in 2019 (43% below the average of the previous 5 years) which persisted in 2020 and 2021, as shown in Figure 1.
 - b. changes to the fair value of electricity swap contracts¹, driven by volatility in wholesale electricity prices.
8. As noted in previous advice, household energy costs and energy company profits have not risen to the same extent as seen in other countries. In the year ended June 2022, CPI household energy prices were up 2.2% compared to the year ended June 2019.

Figure 1: Before-tax profits of selected energy companies



¹ Electricity swaps are financial contracts that enable holders to pay a fixed price for underlying electricity, regardless of the floating wholesale electricity price, or vice versa, over the contract period. Wholesale electricity prices are much more volatile than retail prices, increasing 68% between the year ended March 2020 and the March 2022 year.

Construction sector

9. As noted in the previous Aide Memoire, total before-tax profits in the construction sector companies that we looked at grew by 36% in 2022 compared to 2019.
10. There are variances within the industry with regards to the growth in before-tax profits. Although there are some businesses that saw large increases in before-tax profits since 2019, there were also businesses that reported a decrease in their before-tax profits compared to 2019.
11. Most construction businesses derive their revenue from several divisions. Some of these divisions are sale of building products and materials, development and sale of residential projects, construction of building and infrastructure projects and maintenance service contracts.
12. The key external factors for the increase in profits in the construction industry are a strong housing market and building boom since 2019, and construction companies saw a significant rise in revenue from the development and sale of residential property. Meanwhile, earnings from other business areas (such as the sale of building products) has actually fallen since 2019 due to higher costs.
13. Although construction companies experienced increases in costs as a result of COVID-19 related supply chain issues, the increases were not significant enough to offset the rise in property prices over this period.
14. The New Zealand housing market has experienced a decline in property prices recently. Given that this decline is expected to continue into 2023, it is possible that construction companies could see decreases in profits from the development and sale of residential properties in the current financial year.

Aged-care and retirement villages sector

15. As noted in the previous Aide Memoire, total before-tax profits in the aged-care and retirement villages sector companies that we looked at grew by 88% in 2022 compared to 2019.
16. The median number of beds in care facilities has been increasing year on year, indicating a growing demand for aged residential care facilities.
17. The largest increase in income receipts for businesses in this sector related to the fair-value movement of investment properties. For example, one of the businesses in the pool of samples saw a 154% increase in the fair-value movement of their investment properties.
18. Fair-value movement of investment properties has dramatically increased since 2019 due to the steep rise in New Zealand property prices. This does not generally or automatically translate to significant increases in taxable profits.

Robert O'Hara, Analyst, Tax Strategy, [39]

Stephen Bond, Manager, Tax Strategy, [39]