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State-owned enterprises: Results of the 2012/13 audits





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State-owned enterprises: Results of the 2012/13 audits

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Auditor-General's overview

State-owned enterprises (SOEs) are an important and financially significant part of the public sector. I am the statutory auditor of SOEs and listed companies that are majority owned by the Crown.

This report provides an analysis of what our audit work and audited financial statements can tell us about the financial health of SOEs and the listed companies. We do not provide a definitive judgement on the companies' financial health and their vulnerability to uncertainty. Instead, our analysis provides "indicators" that should prompt further questions by Parliament and the public.

I also report on the results of follow-up work we did to see how Transpower has responded to recommendations we made in 2011. Transpower has made good progress in addressing our 2011 recommendations. It has been proactive in its efforts to improve grid asset and risk management.

My Office has received questions about the accountability of the companies subject to the Government's partial share offers. In this report, I set out my role in the public share offers and reinforce my continued role as the auditor of these companies. They are still public entities, and their accountability requirements are similar to the requirements they had as SOEs.

This report complements other work my Office has done on Crown-owned companies, including a report we published in February 2014, *Maintaining a future focus in governing Crown-owned companies*.

I trust the analysis in this report will be useful for Parliamentarians and others.



Lyn Provost
Controller and Auditor-General

25 July 2014

1

Introduction

- 1.1 This report sets out the results from our 2012/13 audits of State-owned enterprises (SOEs) and two listed companies that are majority owned by the Crown (see Appendix 1).¹ In this report, we refer to these 18 entities as “the companies”.

Background

- 1.2 New Zealand’s SOEs generate significant revenue and are responsible for managing major assets and infrastructure. SOEs are established under the State-Owned Enterprises Act 1986, registered as companies, and bound by the provisions of the Companies Act 1993.²
- 1.3 The principal objective of an SOE is to operate as a successful business and to be as profitable and efficient as comparable businesses that are not owned by the Crown. SOEs are also required to be good employers and to show a sense of social responsibility.
- 1.4 The Auditor-General is the statutory auditor of all SOEs and their New Zealand subsidiaries. In this role, she is responsible for the annual audit and other aspects of the Auditor-General’s mandate provided for by the Public Audit Act 2001.
- 1.5 As at 30 June 2013, the companies managed combined assets of \$52.5 billion (book value) and generated revenue of \$16.37 billion. On a group basis, they represented total shareholder equity of \$20.2 billion.³

Structure of this report

- 1.6 Part 2 sets out the results from our annual audits of the companies.
- 1.7 Part 3 discusses what the companies’ audited financial statements can tell us about their financial health. We do not provide a definitive judgement on the companies’ financial health and their vulnerability to uncertainty. Instead, our analysis provides “indicators” that should prompt further questions by the companies, shareholders, and auditors.
- 1.8 Part 4 sets out the results of follow-up work we did to see how Transpower has responded to recommendations we made in 2011. Our 2011 report, *Transpower New Zealand Limited: Managing risks to transmission assets*, is available at www.oag.govt.nz.

1 We count Meridian Energy Limited and Genesis Energy Limited as SOEs because they were publicly listed after 30 June 2013.

2 The New Zealand Railways Corporation is a statutory corporation established by the New Zealand Railways Corporation Act 1981. It is an SOE but not a company, so is not bound by the provisions of the Companies Act 1993.

3 In accounting terms, shareholder equity is a company’s total assets minus its total liabilities. The remaining interest in the assets is spread between the shareholders of the company. For the companies, shareholder equity includes government and minority interest.

- 1.9 Part 5 outlines:
- the Auditor-General’s role in the public share offer for Mighty River Power Limited, Genesis Energy Limited, and Meridian Energy Limited; and
 - the public accountability requirements for these companies.
- 1.10 Appendix 1 lists the companies and briefly describes what they do. Appendix 2 provides financial data to supplement the analysis in Part 3.

2

Results of our annual audits

- 2.1 In this Part, we set out the results of our annual audits of the companies. For 2012/13, we issued unmodified audit opinions for all 18 of the companies' parent and group accounts.
- 2.2 We did not audit the companies' overseas subsidiaries because they are not public entities and, therefore, are not within the Auditor-General's audit responsibilities. For example, although we audited the company and group accounts of Kordia, we did not audit the foreign subsidiary companies that constitute a significant proportion of Kordia's business activity.
- 2.3 Solid Energy New Zealand Limited, Electricity Corporation of New Zealand Limited, and Learning Media Limited received non-standard audit reports. For these entities, our audit report included "emphasis of matter" paragraphs.
- 2.4 For Solid Energy, we drew readers' attention to the use of the "going concern assumption" in the financial statements. Although the financial statements were prepared under the assumption that Solid Energy is a going concern, there remained uncertainty about capital restructuring, future coal prices, and assumptions used in the cash-flow projections for the Stockton mine.
- 2.5 Electricity Corporation is winding up its operations. We drew attention to disclosures that refer to the financial statements being appropriately prepared on a "realisation basis".
- 2.6 The emphasis of matter paragraph in our audit report for Learning Media noted that the financial statements were appropriately prepared on a realisation basis because of the decision to wind up the company and group.
- 2.7 We issued a modified audit opinion for New Zealand Post Recycled Centre Limited, a subsidiary of New Zealand Post Limited. Limitations in the controls over the subsidiary's revenue meant that we could provide limited assurance about the completeness of the reported revenue.
- 2.8 The audit reports for five subsidiaries of Solid Energy included emphasis of matter paragraphs that mainly concerned the points noted in paragraph 2.4.

Environment, systems, and controls

- 2.9 In annual audits, we consider the management control environment as well as the financial information systems and controls that support the managing and reporting of financial information.
- 2.10 During audits, our appointed auditors assess strengths and deficiencies. Auditors recommend specific improvements to identified deficiencies.

- 2.11 The companies report a range of information in their annual reports, including reporting against their statement of corporate intent. The companies also provide information on corporate social responsibility and sustainability matters, some of which is reported against international frameworks. The State-Owned Enterprises Act 1986 does not require this additional information to be audited. However, auditors are required to consider the information reported against the statement of corporate intent (in particular, the performance measures and targets) to ensure that it is consistent with other information disclosed in the annual report.
- 2.12 Our auditors also provide independent assurance about some of the reported information on corporate responsibility and sustainability. This is done at the company's request.

Management control environment

- 2.13 Comments about a company's controls are based on our observations of many elements. These include:
- clarity of strategic planning;
 - organisational structure;
 - how ethical values are communicated and applied;
 - commitment to competence;
 - involvement of those in governance roles;
 - management philosophy and operating style;
 - assignment of authority and responsibility;
 - human resource policy and practices;
 - risk assessment and management;
 - policies and procedures that provide controls over business processes and monitoring, self-review, and internal audit practices; and
 - arrangements to help ensure that the public entity complies with legislation.
- 2.14 Figure 1 sets out the grades that we assigned to 16 companies in 2012/13.⁴

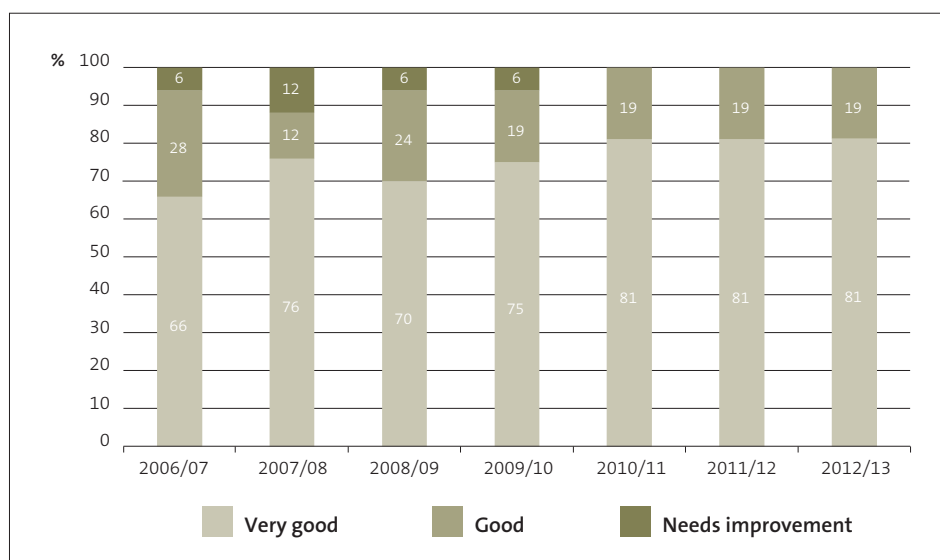
Figure 1
Summary of management control environment grades, 2012/13

Number of companies graded	Management control environment			
	Very good	Good	Needs improvement	Poor
16	13	3	0	0

4 We did not grade Electricity Corporation and Learning Media because they were being wound up.

- 2.15 Figure 1 shows that we made recommendations for improvements to the management control environment for three of the 16 companies graded.⁵ The management control environments for these three companies received “good” grades. This means that we considered that the suggested improvements were not necessary for maintaining a sound management control environment but would be beneficial.
- 2.16 Figure 2 shows changes in management control environment grades between 2006/07 and 2012/13.

Figure 2
Management control environment grades, 2006/07 to 2012/13



Note: There were 18 companies in 2006/07, 17 in 2007/08 and 2008/09, and 16 from 2009/10 on.

- 2.17 The most notable feature of Figure 2 is the increase in the percentage of companies receiving a “very good” grade between 2006/07 and 2010/11. In general, grades improved during this four-year period. The percentages have remained stable since 2010/11.

Financial information systems and controls

- 2.18 Comments and grades for financial information systems and controls are based on our observations of the appropriateness and presentation of financial information, the reliability of financial information systems, and control and monitoring activity.

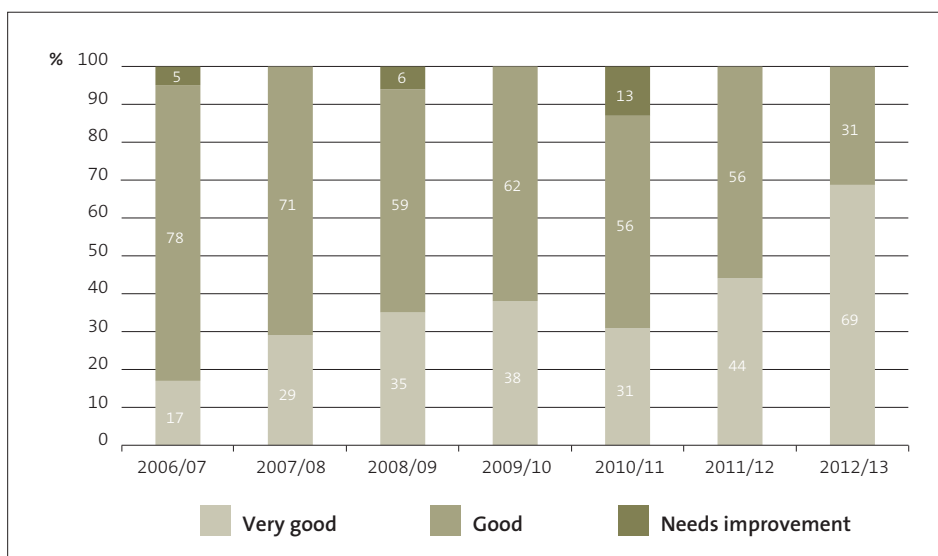
2.19 Figure 3 sets out the grades we assigned to 16 companies in 2012/13.

Figure 3
Summary of financial information systems and controls grades, 2012/13

Number of companies graded	Financial information systems and controls			
	Very good	Good	Needs improvement	Poor
16	11	5	0	0

2.20 As Figure 4 shows, the percentage of companies receiving a “very good” grade for their financial information systems and controls increased between 2006/07 and 2012/13. After intermittent years in which some companies were assigned “needs improvement” grades, all 16 companies have received either “good” or “very good” grades for the last two years.

Figure 4
Financial information systems and controls grades, 2006/07 to 2012/13



Note: There were 18 companies in 2006/07, 17 in 2007/08 and 2008/09, and 16 from 2009/10 on.

3

Analysing the audited financial statements

- 3.1 In this Part, we discuss what the audited financial statements can tell us about the financial health of the companies.
- 3.2 This is the first time we have published analytical results about risk and return for the companies. In this Part, we consider:
- the overall size of the SOEs and listed companies portfolio;
 - the returns made on that portfolio; and
 - some aspects of the risks that the companies face in generating their returns.
- 3.3 Analysis of financial statements can produce “indicators” that should prompt further questions. This analysis does not provide a definitive judgement on the companies’ financial health and their vulnerability to uncertainty. However, if used carefully and as a prompt for further testing and inquiry, annual reports can provide early warning of potential financial difficulty.
- 3.4 The companies operate in a wide range of disparate industries. This limits the comparability of financial indicators between the companies.⁶ Companies may also adopt different accounting policies, which may mean that the companies measure and report some items differently. This also limits the comparability of results and other indicators.
- 3.5 Bearing this limited comparability in mind, our analysis places a few companies at the riskier end of several risk indicators. This suggests that they might warrant attention. Our analysis highlights the financial difficulty of two companies in particular – Learning Media and Solid Energy. Our analysis also suggests that a closer look should be taken at the liquidity situation for about half of the companies.
- 3.6 There are many ways to analyse company financial statements. The Treasury, through its Commercial Operations unit (formerly the Crown Ownership Monitoring Unit – COMU), produces an annual portfolio report. In our view, the annual portfolio reports are a valuable resource for anyone wishing to examine the companies’ performance.⁷ The annual portfolio reports use a different and wider set of indicators than we do in this Part. They draw financial data from internal government sources. We have based most of our analysis on the numbers available to Parliament and the public through the audited financial statements of the companies.

⁶ For example, the “normal” range for a financial ratio often differs by industry group.

⁷ Annual portfolio reports are available at www.treasury.govt.nz.

Group and parent financial statements

- 3.7 For our analysis of the size of the SOEs and listed companies portfolio, we used the group financial results reported in the Financial Statements of the Government. This is because the group financial statements provide a better picture of the total resources owned by the Government and the total income earned. In the Financial Statements of the Government, KiwiRail Holdings and New Zealand Railways Corporation are reported as separate companies.
- 3.8 For our analysis of individual companies' performance and risk, we used the financial statements of the parent company in most instances. This allows our analysis to focus on, in most instances, the one dominant business.
- 3.9 Although our analysis of individual companies focused on the parent company's financial statements, we made exceptions for KiwiRail and Kordia. Because KiwiRail was split into KiwiRail Holdings and New Zealand Railways Corporation during 2012/13, we have used the combined group financial statements for comparability between years (KiwiRail Group). These financial statements show what the financial results would have been for the group if the two companies had remained combined for 2012/13. Accordingly, these financial statements have not been audited. We have also used the group results for Kordia because all its business operations are carried out through its subsidiaries.
- 3.10 It should be noted that financial indicators, including financial ratios, derived from the parent company's financial statements might differ significantly from those derived from group financial statements.

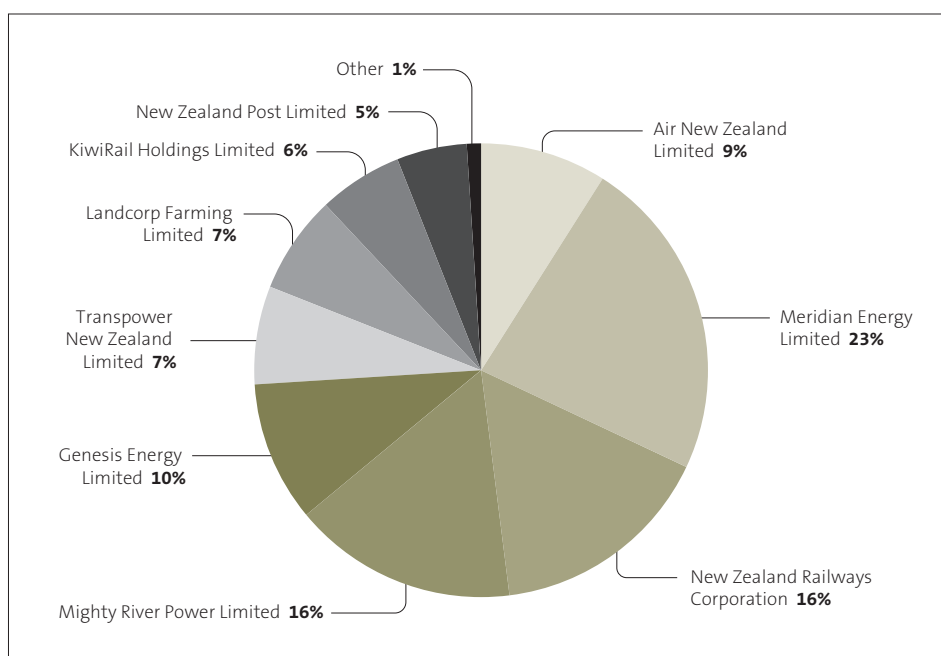
The size of the portfolio

- 3.11 As at 30 June 2013, total shareholder equity in the companies on a group basis was \$20.2 billion. The companies managed assets of \$52.5 billion (book value) and generated revenue of \$16.37 billion.⁸
- 3.12 Figure 5 shows the proportionate sizes of the companies (on a group basis) by shareholder equity. The largest companies by shareholder equity are:
- Meridian Energy Limited (23% of the portfolio);
 - New Zealand Railways Corporation (16%);
 - Mighty River Power Limited (16%);
 - Genesis Energy Limited (10%); and
 - Air New Zealand Limited (9%).

⁸ *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2013*, pages 178-179.

3.13 Together, these five companies account for 74% of the SOEs and listed companies portfolio by equity. As at 30 June 2013, the Crown owned 55.01% of the shares in Mighty River Power and 72.85% of the shares in Air New Zealand.⁹

Figure 5
Companies by shareholder equity, as at 30 June 2013



3.14 Figure 6 shows the largest companies by total assets. The five largest companies (on a group basis) by total assets are:

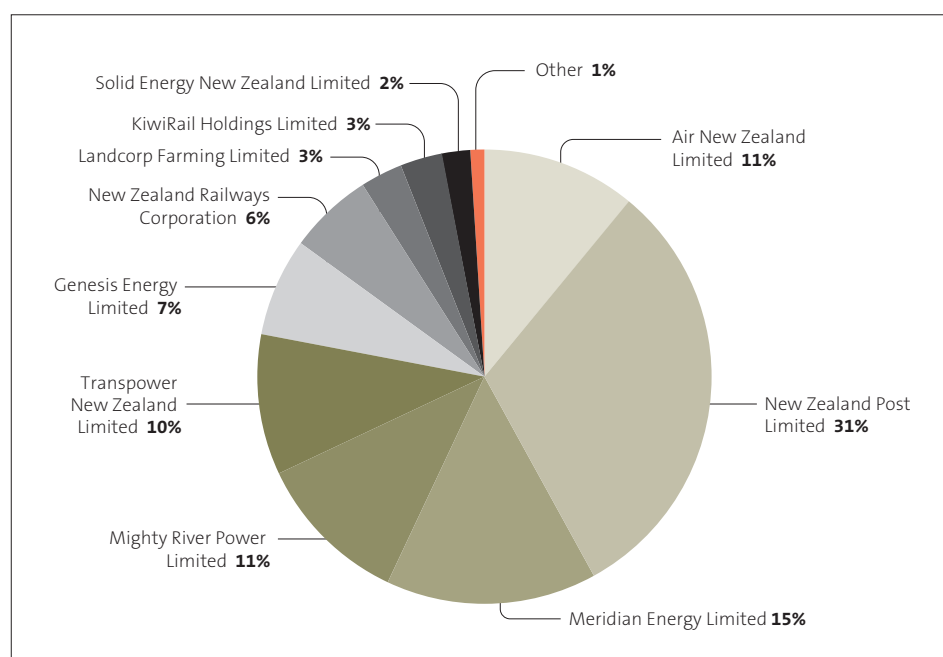
- New Zealand Post (31%);
- Meridian Energy (15%);
- Mighty River Power (11%);
- Air New Zealand (11%); and
- Transpower New Zealand Limited (10%).

3.15 Together, these five companies make up 78% of the total assets (by book value). Although New Zealand Post represents only 5% of the portfolio by equity, it holds 31% of the total assets. Kiwibank's banking assets make up more than 90% of New Zealand Post's total assets.¹⁰

⁹ *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2013*, page 177.

¹⁰ *New Zealand Post Group (2014), Annual Review – Supporting Information 2013*, page 8.

Figure 6
Companies by total assets, as at 30 June 2013



- 3.16 Four of the five largest companies by total assets are also the biggest revenue earners. Air New Zealand, Meridian Energy, New Zealand Post, Genesis Energy, and Mighty River Power accounted for 79% of the revenue that this portfolio of companies generated in 2012/13. Together, the companies employed more than 32,000 full-time equivalent staff in 2012/13.¹¹

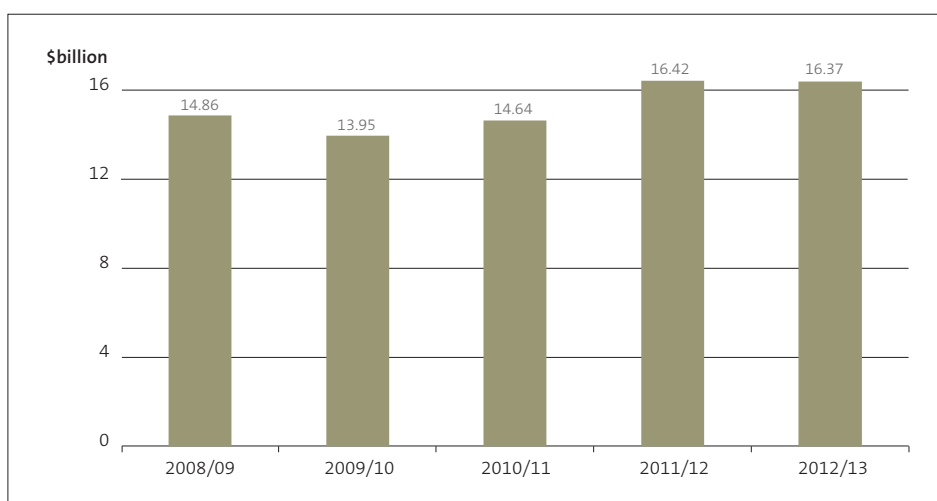
Return on investment

Portfolio return

- 3.17 Figure 7 shows the overall revenue of the companies for each of the years from 2008/09 to 2012/13. The results are presented on a group basis. The overall revenue of companies in 2012/13 was \$16.37 billion (down from \$16.42 billion in 2011/12). Between 2008/09 and 2012/13, the yearly revenue these companies generated increased by 10%.

¹¹ The data on full-time equivalent staff come from Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, page 102, except for the New Zealand Post data, which come from New Zealand Post, *Annual Review 2013*, page 17.

Figure 7
Overall revenue, 2008/09 to 2012/13



Source: The Financial Statements of the Government.

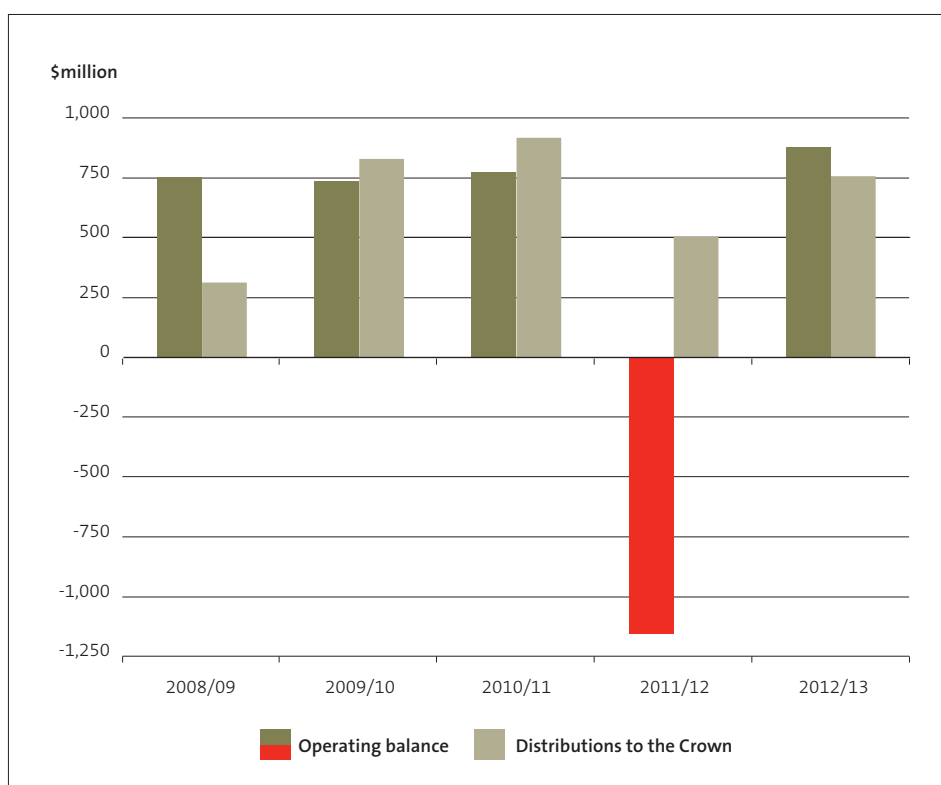
Note: Revenue excludes gains. The results present gross revenue and return. They include both the Government's share and the minority interest share. Inter-company transactions and balances are eliminated on consolidation.

3.18 Operating balance is a measure of profitability (similar to net profit). It is operating revenue less operating expenses, which includes gains and losses reported as part of comprehensive income.¹² Figure 8 shows that the total of the companies' operating balances has fluctuated between 2008/09 and 2012/13. The decline in 2011/12 is almost entirely the result of the write-down of the New Zealand Railway Corporation's rail assets before they were transferred to KiwiRail Holdings. Considering movement over the medium term, the operating balance for 2012/13 was 17% higher than that for 2008/09.

¹² *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2013*, page 183.

Comprehensive income is operating balance plus valuation gains and losses on assets and liabilities.

Figure 8
Operating balance and distributions to the Crown, 2008/09 to 2012/13



- 3.19 The profit that the companies returned to the Crown in the form of dividends totalled \$757 million in 2012/13. This was more than the \$314 million returned in 2008/09, but less than the \$918 million returned in 2010/11 (see Appendix 2).
- 3.20 In 2012/13, the companies generated a return on total assets¹³ of 1.7% and a return on total equity¹⁴ of 4.4%. The Treasury states that overall performance of Crown-owned companies has been modest and, with some notable exceptions, mediocre.¹⁵
- 3.21 When adjusted for the minority interest investment in Air New Zealand and Mighty River Power, the amount distributed in the form of dividends to the Crown in 2012/13 was 4.1% of the Crown's equity interest.

13 Aggregate operating balances as a percentage of aggregate total assets.

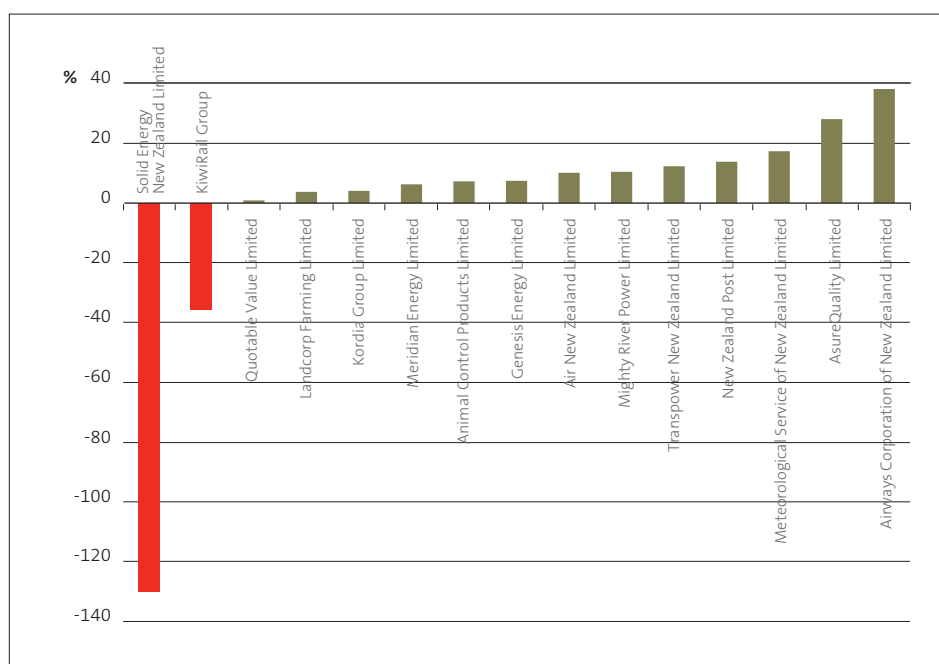
14 Aggregate operating balances as a percentage of aggregate equity.

15 Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, pages 4 and 6.

Returns from individual companies

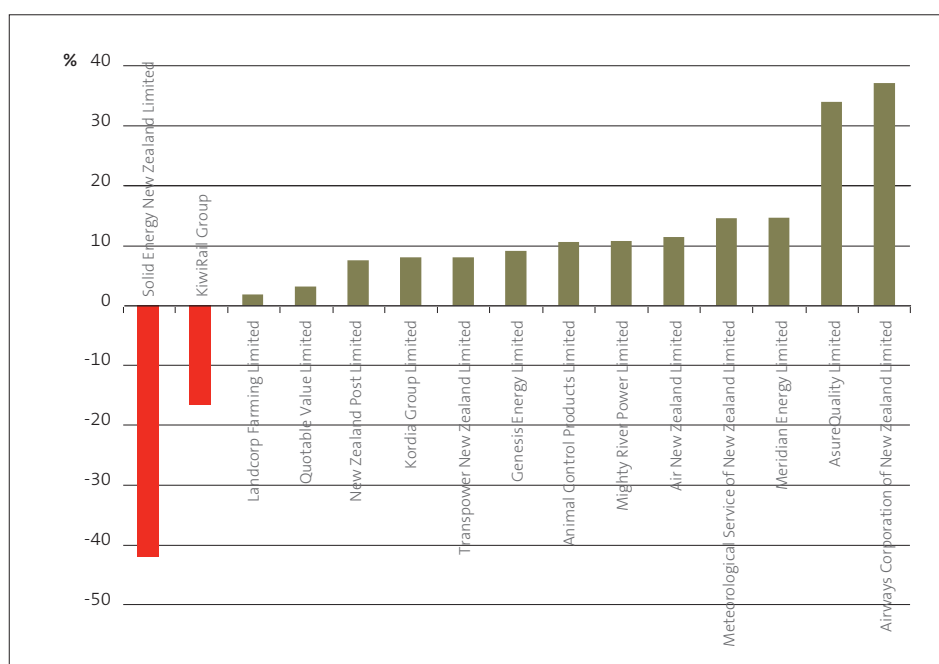
- 3.22 From this point on, our analysis is mainly derived from the parent company's financial statements (except for Kordia and the combined accounts of New Zealand Railways Corporation and KiwiRail Holdings, as explained in paragraph 3.9).
- 3.23 Common measures of return, profitability, or operating efficiency include:
- return on equity;
 - return on capital employed;
 - return on total assets;
 - earnings per share;
 - dividend per share or dividend yield;
 - total shareholder return; and
 - operating margin – a net income-to-revenue measure, often characterised as the percentage of earnings before interest, tax, depreciation, amortisation, and fair value adjustments (EBITDAF) to revenue.
- 3.24 Figure 9 shows the return on equity for 15 companies for 2012/13.¹⁶ These figures are based on the disclosures in each company's annual report (unlike the "portfolio return" discussed in paragraphs 3.17 to 3.21, which is based on the consolidated results in the Financial Statements of the Government). We have excluded Electricity Corporation because it is winding up its operations and Learning Media because it had negative equity at 30 June 2013.

Figure 9
Return on equity, 2012/13



- 3.25 As a performance indicator, return on equity takes an investor perspective. It provides an indicator of the profit (or return) the investor makes on their investment dollar. In 2012/13, the companies with higher reported ratios were Airways Corporation of New Zealand Limited, AsureQuality Limited, Meteorological Service of New Zealand Limited (Met Service), New Zealand Post, and Transpower.
- 3.26 Return on capital employed is also a profitability indicator. It measures how much profit the company generates from all of the financial capital at its disposal (its debt funding as well as its shareholder equity funding). Figure 10 shows that Airways Corporation and AsureQuality lead this indicator, with Meridian Energy, Met Service, and Air New Zealand in the next three places.

Figure 10
Return on capital employed, 2012/13

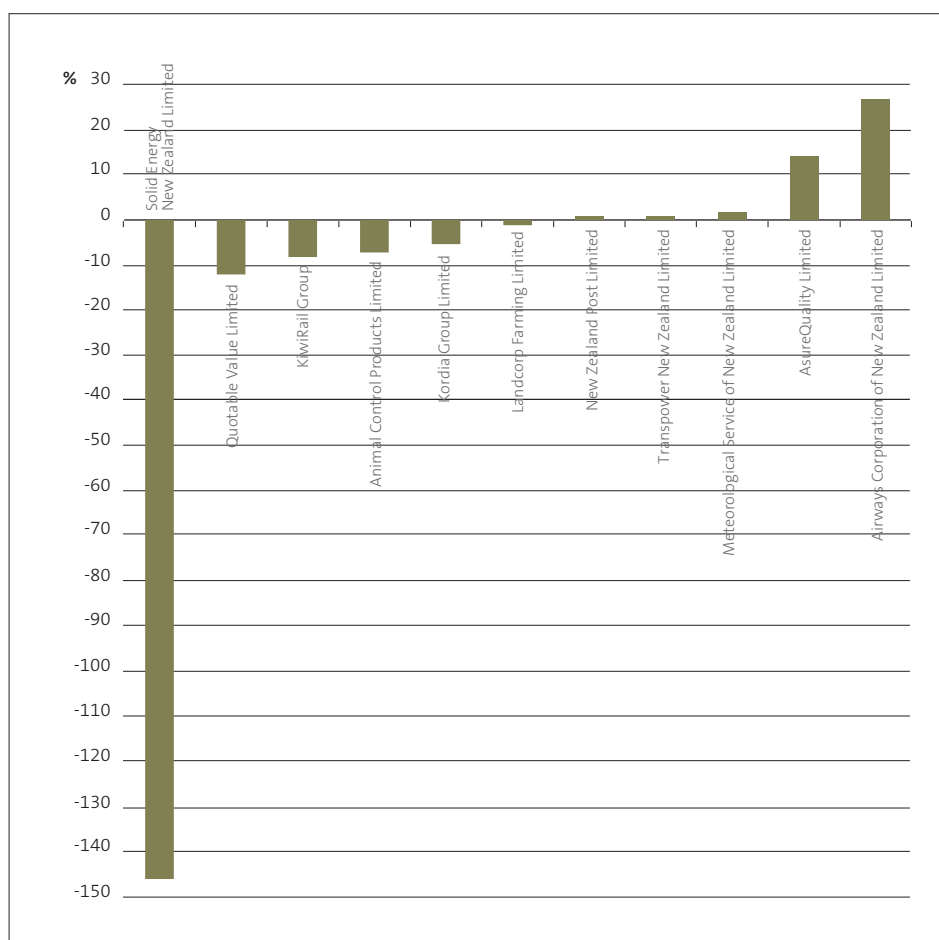


- 3.27 Short-term measures, such as for one financial year, show a small part of the picture. The companies represent long-term investments. As such, a better picture will always be gained by looking at the data for each company over time, as well as a range of operating performance measures.
- 3.28 We recommend reading the Treasury's annual portfolio reports, which report many measures of company return, profitability, and efficiency.
- 3.29 Another important part of looking at the profitability of these companies is to look at the portfolio as a whole, which is best done by looking at the Financial Statements of the Government (see paragraphs 3.17 to 3.21). The diversity of the companies can help to reduce the Government's investment risk.
- 3.30 The remainder of this Part considers some of the risks the companies face in generating their returns, as well as related risk indicators.

Indicators of ability to operate as planned or forecast

- 3.31 One aspect of a company's performance is the volatility of the commercial environment each company operates in and how well it can manage earnings within that environment. Comparing forecast performance with actual performance is one way of measuring volatility or the stability of earnings. A large difference between forecast and actual performance could reflect management's ability to manage, its budgeting skills, its forecasting ability, or an unpredictable business environment in which accurate forecasts cannot reasonably be expected.
- 3.32 Many measures can be used to indicate a company's ability to operate as planned. We have chosen one measure – the variance in return on equity. Other possible measures include budget versus actual variances for:
- revenue;
 - expenses;
 - earnings before interest, tax, depreciation, and amortisation;
 - net profit after tax;
 - return on capital employed; and
 - the ratio of operating cash flow to total cash flow.
- 3.33 The companies do not publish forecast revenue, expenses, or net earnings variants in their annual reports. However, many report return on equity as a key financial performance indicator. We have been able to obtain target and actual return on equity data from the statements of corporate intent and annual reports of 11 of the 18 companies. We compare target and actual return on equity for those companies in Appendix 2. Figure 11 shows the percentage point variances between target and actual return on equity for the 11 companies.

Figure 11
Percentage point variance between target and actual return on equity, 2012/13



3.34 Figure 11 shows that, even with a relatively small set of 11 companies, there is a wide range of variance between the return on equity forecast for the year and the return on equity achieved. Four companies came within 5 percentage points of their forecast target (Landcorp Farming Limited, New Zealand Post, Transpower, and Met Service). The results of four companies (Solid Energy, Quotable Value Limited, AsureQuality, and Airways Corporation) were more than 10 percentage points away from their forecast target.

3.35 Solid Energy's financial performance reflects a weakened global coal market. As a result, the company has refocused on its core coal mining capability. It has divested operations and assets that are surplus to requirements. This has resulted in substantial impairment to the company's assets, and the company's equity has

decreased significantly. The company never envisaged this amount of impairment, nor the sustained and low price of export coal.

- 3.36 Goodwill impairments, one-off costs and losses, weather disruptions, drought, the performances of major customers, a significant decline in demand, and the loss on sale of a significant subsidiary also contributed to the negative variances shown in Figure 11.¹⁷
- 3.37 Factors contributing to positive variances include shifting to higher-margin business, improved productivity, lower-than-forecast costs, increased volumes, and a one-off event (early termination of a lease).¹⁸
- 3.38 Many factors can contribute to variances between companies' targeted and actual performance. Also, the variances for one financial year provide a limited picture. The companies' variances during the last five years provide a better picture of whether there are persistent or intermittent variances between forecast/target and actual performance.
- 3.39 We reviewed variances for 10 companies for the last five years. For five of these 10 companies, the average variance was more than 5 percentage points. We also observed that the variance for one year in isolation is often not typical of the variances over the medium term.
- 3.40 However, large variances should prompt the question of whether it is reasonable to expect management to have predicted the factors influencing results.

Indicators of liquidity and the ability to manage uncertainty

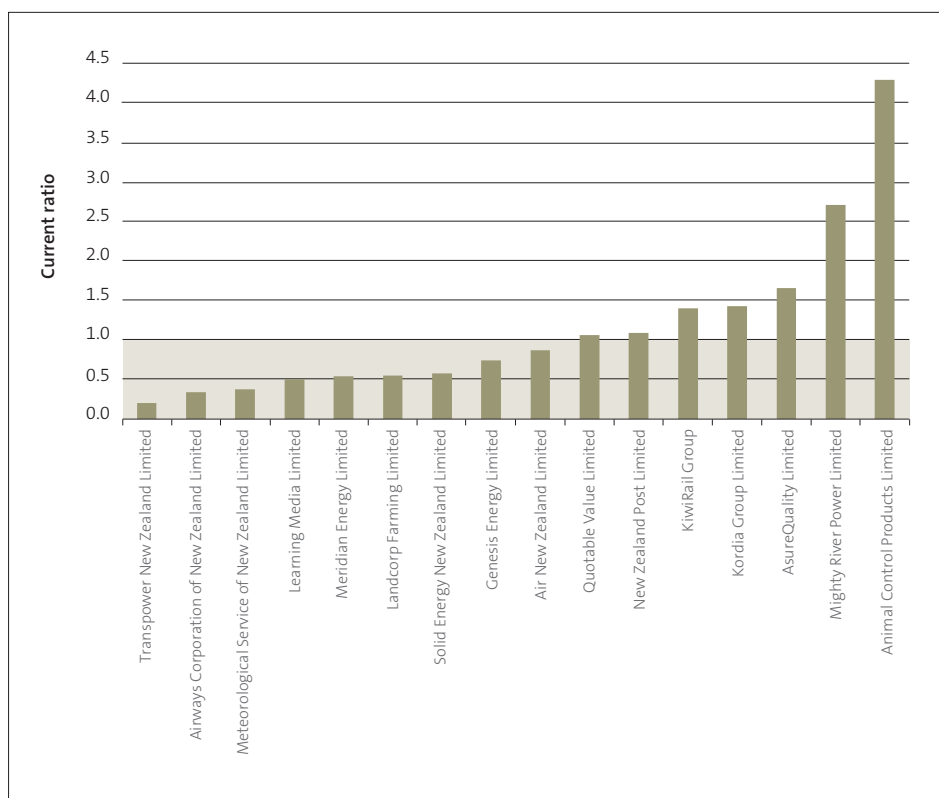
- 3.41 We analyse liquidity and solvency to assess how well a public entity can settle its debts and obligations immediately (liquidity) and over the longer term (solvency). Having enough liquid assets (cash or assets that can be easily and quickly converted to cash) is necessary for day-to-day operations and is important in times of uncertainty.
- 3.42 For the companies, factors such as how dominant the entity is in the marketplace (strong competition or a near-monopoly) and the extent to which its services are essential (certainty of demand) contribute to exposure to liquidity or solvency risks.
- 3.43 Many measures of liquidity have been used to assess how vulnerable a company is to short-to-medium-term disruptions to the flow of "working capital". These measures include the cash ratio, quick ratio, liquid or acid test ratio, and the current (or working capital) ratio.

17 Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, pages 47, 52, 53, and 60.

18 Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, pages 46 and 48.

- 3.44 The current ratio (or working capital ratio) states the value of current assets in relation to the value of current liabilities. It can be expressed as a true ratio (for example, 1.5:1) or as current assets divided by current liabilities (1.5 or 150%). Using current assets over current liabilities, a current ratio of more than 1 suggests that a company will be able to pay its immediate creditors. This presumes that non-cash current assets (such as debtors) can be quickly and easily converted into cash. Because of uncertainties about the ability to quickly liquidate assets, a ratio higher than 1 is usually preferable.
- 3.45 Figure 12 shows the current ratios as at 30 June 2013 for the 16 companies that operated during 2012/13.¹⁹ We have excluded Electricity Corporation and included the combined results for KiwiRail Holdings and New Zealand Railways Corporation as KiwiRail Group.

Figure 12
Current ratios, as at 30 June 2013



Note: Current ratios are current assets divided by current liabilities.

- 3.46 For seven of these companies, current assets exceeded current liabilities at 30 June 2013 (they had a current ratio greater than 1:1). Current assets exceeded current liabilities for Quotable Value, New Zealand Post, KiwiRail Group, Kordia Group, and AsureQuality. At the higher end, current assets exceeded current liabilities by more than 2:1 for Mighty River Power and Animal Control Products Limited. Current liabilities exceeded current assets for Transpower, Airways Corporation, Met Service, Learning Media, Meridian Energy, Landcorp, Solid Energy, Genesis Energy, and Air New Zealand.
- 3.47 There are some limitations with the current ratio, mainly because current assets and current liabilities are defined as rights and obligations that are expected to materialise within the year. Indicators of a more immediate ability to settle debt include ratios of only the most liquid of assets (cash or cash equivalents) to current liabilities.
- 3.48 Working capital can be improved significantly by tighter debtor and creditor management – collecting money from debtors sooner and delaying payment to creditors. However, we expect government-owned entities to pay their creditors within a reasonable time.
- 3.49 Using a range of financial indicators can help readers of financial statements to work out whether a company might be unable to manage its cash flows. To this end, another common measure is the interest cover ratio. This compares earnings generated with the cost of borrowing to indicate how well a company can service loan funding. The conventional measure of interest cover is earnings before interest and tax over interest expense (or EBITDAF over interest expense), derived from figures in the income statement.
- 3.50 An alternative approach is to use cash-flow statement figures to compare net operating cash inflow to interest payments. A cash-based measure of interest costs considers not only the interest that is offset against revenue in the income statement (that is, “expensed” interest) but also interest that is added to the cost of fixed assets (that is, “capitalised” interest). Figure 13 shows the cash-based interest cover indicators for the companies for 2012/13.

Figure 13
Interest cover, 2012/13

Company	Interest cover (based on cash flow)
Animal Control Products Limited	377.3
Quotable Value Limited	21.8
AsureQuality Limited	17.9
Airways Corporation of New Zealand Limited	11.4
Air New Zealand Limited	10.5
Meridian Energy Limited	6.2
KiwiRail Group	6.1
Genesis Energy Limited	3.9
Mighty River Power Limited	3.7
Transpower New Zealand Limited	2.8
New Zealand Post Limited	2.7
Landcorp Farming Limited	2.3
Kordia Group Limited	1.2
Solid Energy New Zealand Limited	0.3
Meteorological Service of New Zealand Limited	(3.9)
Learning Media Limited	(17.5)

Note: Interest cover is net operating cash flow before interest payments divided by interest payments.

- 3.51 Figure 13 shows negative interest cover for Learning Media and Met Service because both companies reported negative operating cash flow for 2012/13. Solid Energy's net operating cash flow before deducting interest payments, although positive, was about one-third of the interest payments, resulting in an interest cover of 0.3. Kordia's interest cover is 1.2.
- 3.52 If we apply the more conventional approach of basing interest cover on the income statement, we find that Met Service's interest cover ratio is 11.9. This means that earnings before interest expense covers the interest expense 11.9 times.²⁰ For Kordia, this approach results in an interest cover indicator of 7.6.²¹
- 3.53 It is clear that interest cover indicators based on cash flow can differ widely from those derived from the income statement. This shows the desirability of considering a range of approaches to deriving risk indicators.

²⁰ Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, page 56.

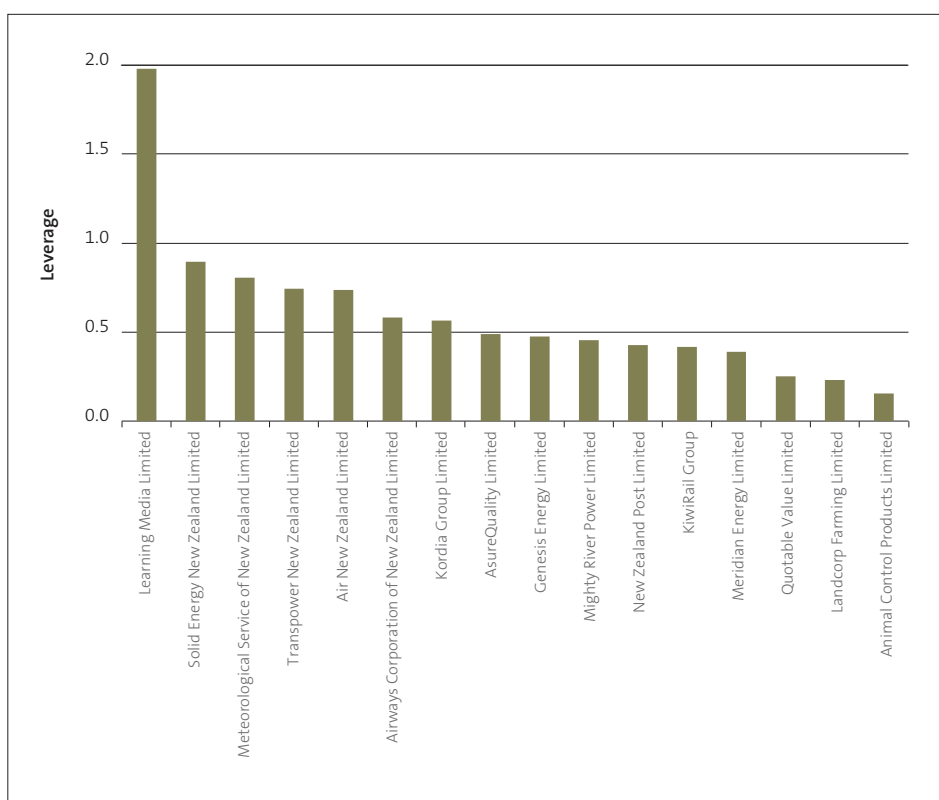
²¹ Crown Ownership Monitoring Unit, *2013 Annual Portfolio Report*, page 53.

- 3.54 Learning Media (now wound up) and Solid Energy (experiencing financial difficulty) scored at the lower end of the range on both of our measures of liquidity and the ability to manage uncertainty.

Indicators of leverage, solvency, and the ability to invest for the future

- 3.55 Gearing and leverage ratios indicate a company's ability to service its debt in the long term. Gearing and leverage measures come in various forms. However, all involve the relationship of shareholder equity (funds owned through shareholding) to liabilities (funds owed to others). They are useful for providing benchmarks of the desired balance between shareholder equity and debt finance.
- 3.56 If leverage is too high, a company can risk breaching its debt covenants with banks and other suppliers of funds. This could restrict future borrowings and affect the company's ability to invest for the future. High leverage can also provide an early warning of possible liquidity problems – the company might have trouble servicing high borrowing costs as leverage increases.
- 3.57 In Figure 14, we present one indicator of leverage for the companies. The indicator we have derived from the annual reports is the relationship of total liabilities to total assets.

Figure 14
Leverage of companies, as at 30 June 2013



Note: A leverage of 1.0 means that total liabilities equal total assets. A leverage of 0.75 equates to a debt/equity ratio of 3:1, meaning that total assets are funded by \$3 of debt to every \$1 of shareholder equity. See Appendix 2 for data.

- 3.58 We expect leverage ratios to differ by industry. Therefore, it is difficult to conclude whether a company's leverage is appropriate without an industry context. The obvious observation from Figure 14 is Learning Media's extreme leverage situation at 30 June 2013, reflecting negative equity. Others at the high end are Solid Energy (90%) and Met Service (81%). The leverage of all the other companies appears to be within normal commercial bounds.
- 3.59 When we consider a company's ability to invest in the future, we are also interested in how well it can maintain and replace productive assets. We expect the companies to have comprehensive and robust asset management plans that help to ensure that their long-term productive assets are maintained and replaced so as to provide continuity of service. It is difficult to draw inferences about this aspect of performance by looking at numbers alone. However, there are several

approaches to analysing annual report data that, like many of the indicators already discussed, might prompt further investigation.

- 3.60 As a starting point, a useful indicator of a company's ability to invest for the future is the relationship between retained earnings and total shareholders' equity or retained earnings and total assets. Companies are generally expected to replace fixed assets from their own funds as part of their financial strategy and therefore need to retain a certain amount of their earnings. Although these ratios do not directly measure whether companies have enough funds to replace fixed assets, the ratios might indirectly reflect the movement in the relationship between available funds and accumulated depreciation (which approximates the value of assets needing to be replaced). An alternative financial strategy to replacing assets from retained earnings could be, of course, to borrow or raise more equity capital.
- 3.61 More generally, retained earnings to equity and retained earnings to total assets can indicate whether the companies will be able to re-invest from their own resources in the future. Observing how these indicators move over the medium term can indicate whether the company's balance sheet is getting stronger or weaker.
- 3.62 Figure 15 shows the companies' ratio of retained earnings to equity for the seven years from 2006/07 to 2012/13.
- 3.63 Figure 16 shows the ratio of retained earnings to total assets for the same time period.

Figure 15
Retained earnings to total shareholders' equity, 2006/07 to 2012/13

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Air New Zealand Limited	(3.11)	(2.30)	(3.11)	(4.68)	(3.12)	(1.61)	(0.97)
Airways Corporation of New Zealand Limited	0.11	0.19	0.17	0.03	0.01	0.01	0.30
Animal Control Products Limited	0.64	0.68	0.71	0.69	0.72	0.71	0.70
AsureQuality Limited	0.06	0.06	0.14	0.17	0.24	0.22	0.27
KiwiRail Group	0.03	0.04	0.06	0.09	0.11	(0.22)	0.75
Genesis Energy Limited	0.39	0.43	0.29	0.30	0.24	0.28	0.27
Kordia Group Limited	0.19	0.12	0.12	0.11	(0.06)	0.07	0.09
Landcorp Farming Limited	0.12	0.16	0.18	0.18	0.18	0.19	0.18
Learning Media Limited	0.79	0.52	0.70	0.78	0.80	0.74	1.27*
Meridian Energy Limited	(0.02)	(0.04)	(0.02)	(0.04)	(0.03)	(0.05)	(0.02)
Meteorological Service of New Zealand Limited	(0.07)	0.21	(1.31)	(4.53)	(1.37)	0.19	0.13
Mighty River Power Limited	0.34	0.29	0.31	0.24	0.22	0.20	0.22
New Zealand Post Limited	0.56	0.56	0.74	0.74	0.73	0.74	0.75
Quotable Value Limited	0.54	0.79	0.79	0.78	0.79	0.81	0.77
Solid Energy New Zealand Limited	0.79	0.82	0.82	0.84	0.84	0.86	0.34
Transpower New Zealand Limited	(0.34)	(0.30)	(0.21)	0.15	0.21	0.24	0.15

* Learning Media reported negative retained earnings and negative shareholders' equity, which resulted in a positive ratio.

Figure 16
Retained earnings to total assets, 2006/07 to 2012/13

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Air New Zealand Limited	(0.46)	(0.39)	(0.43)	(0.51)	(0.42)	(0.31)	(0.25)
Airways Corporation of New Zealand Limited	0.03	0.07	0.06	0.01	0.00	0.00	0.13
Animal Control Products Limited	0.54	0.55	0.57	0.54	0.54	0.58	0.60
AsureQuality Limited	0.02	0.03	0.08	0.09	0.13	0.11	0.14
KiwiRail Group	0.03	0.03	0.06	0.09	0.10	(0.18)	0.44
Genesis Energy Limited	0.23	0.23	0.16	0.17	0.11	0.14	0.14
Kordia Group Limited	0.09	0.05	0.04	0.04	(0.02)	0.03	0.04
Landcorp Farming Limited	0.10	0.13	0.15	0.15	0.15	0.15	0.14
Learning Media Limited	0.26	0.19	0.24	0.34	0.32	0.27	(1.24)
Meridian Energy Limited	(0.01)	(0.02)	(0.01)	(0.02)	(0.02)	(0.03)	(0.01)
Meteorological Service of New Zealand Limited	(0.02)	0.08	(0.14)	(0.17)	(0.10)	0.04	0.02
Mighty River Power Limited	0.20	0.16	0.19	0.13	0.12	0.10	0.12
New Zealand Post Limited	0.35	0.34	0.47	0.48	0.46	0.41	0.43
Quotable Value Limited	0.31	0.57	0.57	0.60	0.65	0.65	0.57
Solid Energy New Zealand Limited	0.45	0.44	0.44	0.37	0.38	0.30	0.04
Transpower New Zealand Limited	(0.07)	(0.08)	(0.05)	0.05	0.08	0.08	0.04

- 3.64 A declining ratio might indicate that a company is distributing more of its earnings to shareholders rather than reinvesting. However, a high ratio might indicate that the company is retaining too much. Either way, retained earnings to equity or total asset ratios will differ by industry and are best compared with industry norms.
- 3.65 AsureQuality has been retaining a steadily increasing proportion of its earnings during the past seven years. New Zealand Post's retained earnings ratios have fluctuated while increasing over the medium term. Kordia and Mighty River Power retained a decreasing proportion of earnings during the period, before a slight upturn in 2012/13. The negative numbers in Air New Zealand's indicators reflect negative retained earnings (also known as a "retained deficit"), which are the result of historical accumulated losses for the parent company. Despite the retained deficit, Air New Zealand's total equity position is positive because the shareholders' capital more than covers the negative retained earnings. Air New Zealand's retained earnings as a proportion of shareholders' equity and total assets have improved between 2010/11 and 2012/13.
- 3.66 The big picture that can be drawn from Figures 15 and 16 is interesting: although the ratios for individual companies fluctuated during the seven years, there is a general trend for the portfolio as a whole. When we compare the ratios for 2006/07 with those for 2012/13, we find that the retained earnings ratios improved for almost every company during those seven years.

Summary of our conclusions

- 3.67 The financial statements within audited annual reports provide information on the past performance of companies. With few exceptions, it is unlikely that clear and unequivocal conclusions about the risks to future performance can be drawn with a high degree of certainty from a handful of ratios based on annual report information. However, financial statement analysis is a valuable starting point. The indicators it produces can provide early warning of potential financial difficulty or, at least, be used to prompt further questions.
- 3.68 The companies operate in a wide range of disparate industries. They may also adopt different accounting policies, leading to different measurement or reporting bases. This needs to be taken into account when comparing the indicators.
- 3.69 The overall return generated from the SOEs and listed companies portfolio, at 1.7% return on assets and 4.4% return on equity, appears to be low. This accords with the Treasury's view that the performance of Crown-owned companies has been modest.

- 3.70 Large variances between forecast and actual performance are prompts for questions about management's ability to predict and/or manage performance. In 2012/13, only a minority of companies came within 5 percentage points of their forecast return on equity. Taking a longer-term average, only about half of the companies reported a variance of less than 5 percentage points.
- 3.71 The ability to manage uncertainty and withstand unfavourable economic conditions in the short term often rests on having enough working capital to pay short-term debts when they fall due. The current ratio (or working capital ratio) shows that more than half of the companies reported current liabilities greater than current assets. Although this indicator does not provide evidence of financial difficulty, it suggests that a closer look should be taken at the companies concerned. When we considered the current ratios with the interest cover indicators based on cash flow, Learning Media, Met Service, and Solid Energy stood out as being at the risky end of the scale. This indicator showed that all of the other companies appeared to have enough interest cover.
- 3.72 To indicate the longer-term sustainability of the companies, we looked at leverage – that is, the extent to which companies' assets were funded by borrowing (as opposed to shareholder equity). We also looked at the companies' ability to reinvest in assets out of retained earnings. Although we expect leverage to differ by industry, Learning Media, Solid Energy, and Met Service clearly have high leverage. Throughout the portfolio, the level of retained earnings as a proportion of assets and equity has improved over the medium term.

4

Following up on our 2011 performance audit of Transpower New Zealand Limited

- 4.1 In September 2011, we published a report entitled *Transpower New Zealand Limited: Managing risks to transmission assets*. The report contained the findings and recommendations of a performance audit we had carried out.
- 4.2 Our 2011 performance audit asked how well Transpower was managing risk to the national electricity grid to reduce the chances of:
- power failure in the short term; and
 - adopting an inadequate or excessive investment strategy for the medium to long term.
- 4.3 The grid is a national network of high voltage electricity assets. It comprises transmission lines, supporting towers and poles, substations and transformers, as well as associated assets. Transpower owns and operates the grid. It is responsible for ensuring that the grid is kept in good condition.
- 4.4 Transpower is also responsible for:
- transmitting electricity from where it is generated to cities and towns and some major industrial users;
 - supplying lines companies that deliver electricity to homes and businesses; and
 - managing New Zealand's power system so that electricity is delivered continuously when and where it is needed.
- 4.5 The first part of our question asked how well Transpower was managing risk to the grid to reduce the chances of power failure in the short term. We found that Transpower:
- was well placed to reduce the likelihood of power failure and to restore supply after a power failure;
 - solved problems well and fixed many day-to-day problems with the grid when they occurred; and
 - had put in place robust project, technical, and commercial governance to oversee complex projects. (These projects were part of the programme to significantly increase investment in grid capacity.)
- 4.6 The second part of our question focused on the risk of Transpower adopting an inadequate or excessive investment strategy for the medium to long term. We found that:
- Transpower lacked asset information available in a way to fully inform an investment strategy for the medium to long term;
 - Transpower had accumulated much data about its assets, but the data had been recorded in different systems and formats;

- it was difficult to form an integrated view of risk throughout the fleet of assets,²² or of a group of assets at a particular site; and
- Transpower did not prioritise risk between asset management plans.

4.7 When we finalised our 2011 report, Transpower had recognised the need to improve how it managed risks to assets. Transpower had already prepared a unified long-term strategy, *Transmission Tomorrow*, describing main strategies to improve grid performance, system performance, and reliability and resilience. We considered that *Transmission Tomorrow* provided a sound basis to guide the grid's future development.

4.8 Our recommendations to Transpower were in two parts. First, we recommended that Transpower complete its programme for improving how it manages assets and risks by putting in place:

- an integrated system for managing assets;
- a comprehensive, quantitative, risk-based approach to managing assets; and
- long-term targets for what Transpower considers to be the appropriate level of risk at a network level.

4.9 Secondly, we recommended that the Board of Transpower actively monitor progress against *Transmission Tomorrow* and the prioritised work programme.

Following up our 2011 recommendations

4.10 In late 2013 and early 2014, we reviewed the initiatives Transpower has taken to address our 2011 recommendations. This involved discussions with the former Chief Executive and senior personnel in two of Transpower's divisions – grid development and grid performance.

4.11 Grid development is responsible for identifying the future needs of the grid's users, planning the national transmission grid, developing grid upgrade plans, managing the regulatory approval processes, and working with customers to develop their connection points. Grid performance is responsible for operating and maintaining grid assets such as substations and transmission lines.

4.12 We also examined extensive documentation about the initiatives Transpower has taken to improve asset and risk management.

²² In Transpower, "fleet" means a distinct group of assets, rather than vehicle or plant fleets.

What we found

- 4.13 In our view, Transpower has been proactive in its efforts to improve grid asset and risk management.
- 4.14 Transpower has set up a large number of initiatives covering all elements of asset and risk management. Many of the initiatives are still in the early stage of development. However, they are progressing on a measured path that, if continued, will meet best-practice asset management and deliver the long-term outcomes described in *Transmission Tomorrow*.
- 4.15 A particular strength is the asset management framework, including the comprehensive documentation that underpins it.
- 4.16 Transpower has used the asset and risk management initiatives to prioritise future investment proposals, even though it has acknowledged that some initiatives are “interim” measures.

Regulatory framework

- 4.17 Before setting out the detailed findings from our follow-up review, we briefly outline the regulatory framework governing Transpower.
- 4.18 The Commerce Commission regulates Transpower’s transmission service revenue and performance targets under individual price-quality path regulation (as defined by Part 4 of the Commerce Act 1986).²³
- 4.19 At present, Transpower is subject to the individual price-quality path determination covering four years to March 2015. This is known as Regulatory Control Period 1 (RCP1). The second Regulatory Control Period (RCP2) will apply for the five years from 2015 to 2020. Transpower is required to submit a proposal for capital and operational expenditure for RCP2 to the Commerce Commission.
- 4.20 Transpower submitted this proposal to the Commission in December 2013. The Commission is now considering and consulting on it. The Commission is expected to issue a determination setting out base capital and operational expenditure allowances and Transpower’s service performance regime. The Commission will then use this information to set Transpower’s forecast maximum allowable revenue for RCP2.

²³ Price-quality regulation is designed to mimic the effects seen in competitive markets so that consumers benefit in the long term. This includes making sure that businesses have incentives to innovate and invest in their infrastructure, and to deliver services efficiently and reliably at a quality that consumers expect. For a set of businesses (including Transpower) that are not consumer owned, the Commerce Commission sets what are known as “price-quality paths”. The paths either restrict the amount of revenue a regulated business can earn or set the maximum average prices it can charge. The paths also specify the service quality standard each business must meet.

- 4.21 Transpower’s proposal to the Commerce Commission is a substantial document. It mentions initiatives that Transpower has carried out in asset management and risk management. Our comments on Transpower’s initiatives in this Part relate solely to our 2011 recommendations and not to the regulatory review process.

Initiatives to introduce an integrated system for managing assets

- 4.22 In 2011, we recommended that Transpower put in place an integrated system for managing assets. An integrated system would provide one consistent source of information about assets to enable good decision-making.
- 4.23 In our follow-up work, we had expectations about an integrated system for managing assets. We expected that:
- Transpower had developed a comprehensive asset management framework that clearly sets out asset management strategies, plans, and actions;
 - the asset management planning included all elements seen as best practice – asset attribute data (such as description, location, value), asset condition and performance information, management strategies and operational strategies, as well as long-term financial forecasts;
 - there had been solid progress in implementing a new asset management information system; and
 - Transpower had obtained external certification of its asset management systems.
- 4.24 In our view, Transpower has made good progress in developing an integrated approach for managing assets.

Transpower’s asset management framework

- 4.25 We expected Transpower to have prepared a comprehensive asset management framework. Transpower finalised this framework in November 2013. It consists of:
- an asset management policy;
 - an asset management strategy that underpins the asset management policy and states the strategic objectives and approach to managing the grid assets;²⁴
 - “fleet” strategies;²⁵
 - asset management plans, which translate the fleet strategies into projects and budgets;²⁶ and
 - site strategies, which reconfigure the asset plans into work required for specific sites or substations.

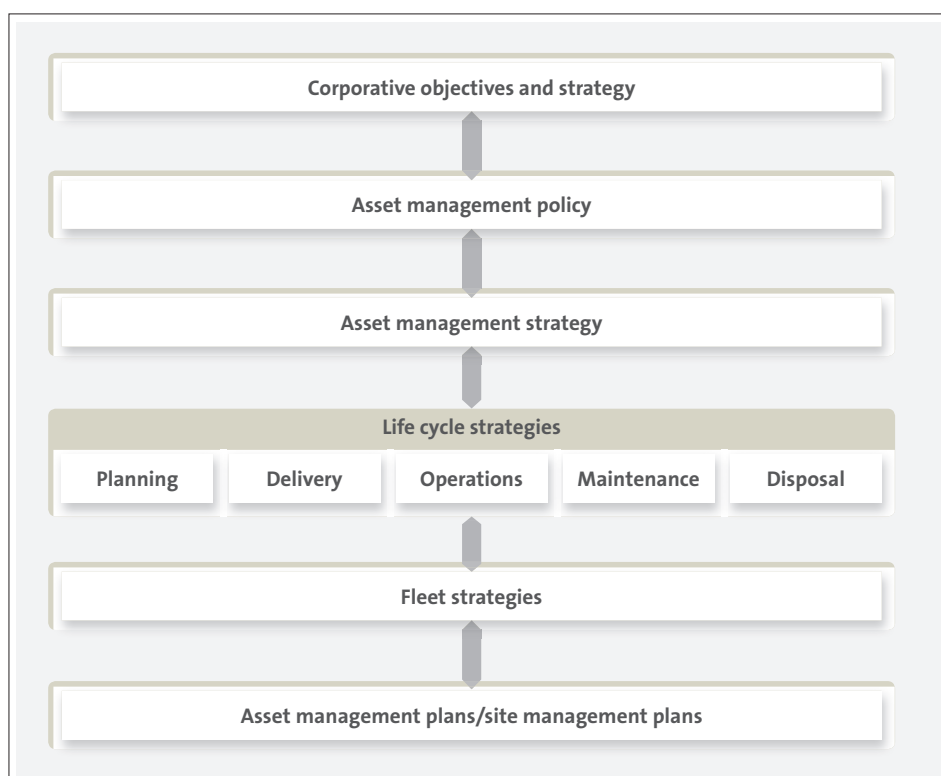
24 The strategy includes five “lifecycle” strategies – planning, delivery, operations, maintenance, and disposal.

25 There are 25 grid asset fleets grouped into 14 fleet strategy documents.

26 The current asset management plans cover the period to June 2020.

- 4.26 Figure 17 shows the suite of documents that make up Transpower’s asset management framework. Each document serves a different purpose, but they complement each other effectively. The framework is consistent with the requirements of the new international standards on asset management.²⁷

Figure 17
Transpower’s asset management framework



Source: Transpower Asset Management Strategy, 2013.

- 4.27 The substantive content of the asset management strategies is contained in the fleet strategies. The fleet strategies include summaries of asset attribute data, asset condition and performance information, management strategies, and operational strategies. Importantly, they also outline issues to be addressed and aspects of asset management that require improvement. Some of the fleet strategies are large and detailed (for example, transformers). Others are briefer. Each fleet strategy’s content is proportionate to the size and importance of that fleet.
- 4.28 By contrast, the asset management plans are essentially operational and capital expenditure budgets that extend to 2020.

27 ISO 55000 Asset management – Overview, principles and terminology; ISO 55001 Asset management – Management systems – requirements; ISO 55002 Asset management – Management systems – Guidelines for the application of ISO 55001. Published by the International Organization for Standardization, January 2014.

- 4.29 Transpower’s asset management policy was approved by the then Chief Executive, but not by the Board. In our view, the Board should specifically approve the policy, which is a short non-technical document (although it could be inferred that the policy has been indirectly approved through the RCP2 submission and other actions). However, a specific approval by the Board would give the policy additional power and status.

Transpower’s asset management information system

- 4.30 We also expected that Transpower had made solid progress in setting up a new asset management information system (AMIS).
- 4.31 At a basic level, an AMIS will record the attribute data of the physical assets (such as description, location, value) and record the condition of assets. At a more advanced level, an AMIS can provide predictive information about maintenance and replacement intervals, workflow management, and performance information. It can also contribute to risk management.
- 4.32 In our 2011 report, we noted that Transpower’s AMIS did not have the capabilities of a modern asset management system. Although extensive data was collected, it was stored in a relatively unstructured way, making it difficult to access. Transpower’s AMIS also did not provide predictive capability.
- 4.33 In June 2013, Transpower implemented the first stage (release 1) of its Maximo asset management information system. The first stage involved capturing existing data from the previous systems. An independent review of the implementation process found that release 1 was well managed.
- 4.34 The next stage of the AMIS development (release 2) began in July 2013. It is expected to be completed by June 2014. This stage will incorporate functionality to improve workflow management, inventory management, health and safety management, and enhanced reporting capability.
- 4.35 The first stage of the AMIS development has progressed smoothly and to established timelines. The more crucial measure of success of the project will be the outcome of release 2, because this begins to bring in the more advanced functionality of an asset management information system. In our view, progress on release 2 is on track.

Certification of Transpower’s asset management systems and practice

- 4.36 In our 2011 report, we noted that Transpower intended to adopt the requirements of PAS 55 as its guide to good asset management practice. PAS 55 stands for Publicly Available Specification 55. It is a United Kingdom “quasi-standard” for asset management practices. It has been widely applied in the United Kingdom and Europe, especially in the energy and utility sectors.

- 4.37 In April 2012 and November 2013, Transpower contracted an external assessor to do a “gap analysis” of Transpower’s asset management practices, to see how they compared with the requirements of PAS 55. The November 2013 assessment noted a considerable improvement in compliance with the provisions of PAS 55 from the April 2012 assessment. The November 2013 assessment showed “79% compliance” with the provisions of PAS 55. The assessment also found that Transpower had made excellent progress in core asset management documentation.
- 4.38 Transpower had planned to complete certification to the requirements of PAS 55 by June 2014. A review by a PAS 55 accreditation agency is under way.
- Other ways Transpower is working to improve how it manages assets**
- 4.39 Transpower has been working on other processes and documentation relevant to asset management. For example:
- Transpower has been building a database of routine maintenance activities carried out during the last 10 years. This is known as the maintenance activity and cost model. An associated project was “data mining” historical maintenance transactions. This was done to identify potential cost savings.
 - Transpower has developed a cost estimation tool known as TEES. This is a price book for individual project elements and unit rates for labour and materials.
 - Transpower has prepared standard maintenance procedures (SMPs). These are documented mandatory procedures for all fieldwork maintenance. SMPs provide two main benefits: a standard approach to tasks and a consistent platform for service pricing. To date, 450 SMPs have been prepared.
 - Transpower has introduced specific categories of maintenance – preventive, corrective, predictive, and proactive. When the categories become embedded into the overall maintenance system, asset interventions will be informed by risk and asset health, rather than being reactive or time based.
- 4.40 Transpower documents record that several aspects in the development of Transpower’s asset management approach were regarded as “out of scope”. These included hardware for running systems that support asset management functions, the network communication system, customer-owned assets at Transpower sites, and generic corporate disaster-recovery processes.
- 4.41 Industry best practice on asset management, as contained in ISO 55000 and guidance from the New Zealand National Asset Management Support Group, strongly emphasises that asset management is a broad and multi-disciplinary approach. It should embrace all relevant systems and organisational efforts. Relevant systems could also embrace those areas that might seem peripheral

to core asset management but that do affect asset management. We consider that Transpower will need to ensure that “out of scope” activities do not slow or hamper the asset management projects now under way.

A comprehensive, quantitative, risk-based approach to managing assets

- 4.42 The second recommendation we made in 2011 was that Transpower should implement a comprehensive, quantitative, risk-based approach to managing assets. This approach should allow for risk to be traded off against the cost of mitigating the risk. We saw this as essential for prioritising investment in the grid.
- 4.43 In our follow-up work, we expected that a comprehensive, quantitative, risk-based approach to managing assets would include:
- a concise, clear policy on asset risk management;
 - the melding of “bottom-up” asset-based risk initiatives with “top-down” or corporate-oriented risk management;
 - measured progress in developing sophisticated, quantitative risk tools;
 - the use of risk in prioritising investments; and
 - appropriate reporting of risk at various management levels.
- 4.44 We were impressed by the progress Transpower has made in developing a comprehensive, quantitative, risk-based approach to managing assets.

Transpower’s asset risk management policy

- 4.45 Transpower has prepared an asset risk management policy. This became effective in December 2013. The policy sets the minimum standard of asset risk management applying to grid business and operations. The policy is part of, but subordinate to, an overarching Transpower risk management policy. The asset risk policy outlines risk management principles, scope, governance and responsibilities, and risk categories.
- 4.46 The following associated documents underpin the asset risk management policy:
- asset risk management process – this describes how the policy should be implemented;²⁸
 - asset health indices – this relates to the remaining life of an asset (see paragraphs 4.50-4.51); and
 - criticality framework – this relates to assets having different degrees of importance and different vulnerabilities (see paragraphs 4.52-4.53).

28 This document was in “pending” status at January 2014.

How Transpower melds “bottom-up” and “top-down” risk activities

- 4.47 In terms of melding “bottom-up” with “top-down” risk activities, the risk policy notes a “lines of defence” concept based on three “lines”. The first line of defence is the specific asset-risk activities in grid management. The second line of defence consists of activities done as part of Transpower’s internal governance. The third line of defence is Transpower’s internal and external audit function.
- 4.48 Transpower has also begun a series of asset-risk workshops to communicate the risk approach. The workshops also aim to gain a greater understanding of risks and potential treatments. It is expected that this will result in a collated revised risk register by mid-2014.

Tools Transpower uses to quantify risks

- 4.49 As part of its risk-based approach to managing assets, Transpower uses a combination matrix of “asset health indices” and “asset criticality”. These approaches are essential building blocks of a comprehensive asset risk management framework that will ultimately include fully quantified risk assessment for the higher criticality and high value asset portfolios.
- 4.50 Asset health indices are an indicator of the estimated remaining life of assets. Remaining life is defined as the estimated time before an intervention might be required in response to increasing asset risk. To date, asset health indices have been developed for three core assets – transmission lines, transformers, and circuit breakers. Indices for other fleet assets will be progressively developed.
- 4.51 Remaining life is based on a number of factors, such as asset condition, degradation projections, failure and outage rates, as well as the actual age of the asset and the life expectancy for the asset class. The remaining life is categorised into five periods: “now due”, 0-2 years, 2-7 years, 7-12 years, and beyond 12 years.
- 4.52 The asset criticality framework recognises that, in terms of the grid, assets have different importance or represent different vulnerabilities. Transpower has assigned criticality at each “point of service”. These are based on the effect of a loss of supply at each specific “point of service”. Point of service criticality reflects the type and scale of load or generation connected to the grid at a point of service. Point of service criticality also reflects the economic effects that interruptions cause. It is assigned into three categories – “high priority”, “important” and “standard”. For example, “high priority” would include a load of national significance.
- 4.53 Transpower has also defined bus and circuit criticality as an indicator of the effect that an outage of a network component (for example, transmission or transformer circuit) has on a point of service. Transpower intends adding a third

element to its framework – individual asset criticality. Asset criticality reflects the effects of individual outages on points of service, such as a circuit breaker or transformer. In addition to the effect on customers, the framework will also be further developed to embrace safety, environment, and financial impacts.

How Transpower uses risks in prioritising investments

- 4.54 During our follow-up work, we saw that Transpower has applied the risk framework (asset health indices and asset criticality) in fleet asset management strategies and forward financial projections. In our view, this enables Transpower to arrive at prioritised investment proposals in the period covered by the asset management plans.

How Transpower reports risks

- 4.55 One of our expectations in the follow-up review was that risks are being reported to appropriate management levels. We found that there are multiple layers of risk reporting, which culminate in the “top ten” risks being reported to the Board each month. A corporate governance external review was done in June 2013. This included a section on how risks are reported to the Board. The report on the review noted a misalignment between how network risks and non-network risks are reported. This appears to have been addressed in the subsequent asset risk policy.

Remaining work for Transpower to complete a fully developed approach to asset risk

- 4.56 Transpower has made good progress towards a fully developed approach to asset risk. It knows what it still has to do. It has planned initiatives to arrive at an integrated risk regime, including the use of fully quantified risk assessment techniques. We encourage Transpower to complete this work by:
- fully developing its asset risk register (which is due shortly);
 - extending asset health indices to the remaining asset fleets;
 - developing safety, environment, and financial dimensions to the asset criticality framework; and
 - developing the criticality framework to include the effect of individual asset outages on customers.

Long-term targets on the appropriate level of risk at a network level

- 4.57 The third of our 2011 recommendations was that Transpower put in place long-term targets for what is considered to be the appropriate level of risk at a network level, as well as the associated network performance and quality measures.

- 4.58 In our follow-up review, we expected that:
- the long lives of many of Transpower’s assets (beyond 40 years in some instances) would be reflected in how risks are identified and assessed;
 - asset and network risk management would be increasingly focused on the performance of assets to meet agreed standards or levels of service; and
 - network quality and performance would be comparable to international peer organisations.

- 4.59 In our view, Transpower is appropriately addressing long-term risks to the grid’s performance.

How Transpower identifies and manages long-term risks to the grid’s performance

- 4.60 In early 2011, Transpower published *Transmission Tomorrow*. This describes three main strategies to improve how the grid performs, improve systems performance, and improve reliability and resilience. *Transmission Tomorrow* included committed initiatives to be completed within five years, potential outcomes within 10 and 20 years, and possible outcomes beyond 20 years.
- 4.61 A December 2013 update report to Transpower’s Network Risk Committee noted initiatives and progress towards meeting *Transmission Tomorrow* strategies. These included initiatives in matters such as future grid planning, reliability risks, and operating risks. Examples of initiatives about reliability risks included:
- a transformer replacement programme (now under way);
 - procurement of a mobile substation so that maintenance can be carried out at smaller substations without turning off the power to communities; and
 - “high impact – low probability” risk reviews completed at four major substations (these detail risks that have a small probability of occurring but that would be significant if an event does occur).
- 4.62 The risk initiatives we noted on asset health and asset criticality (see paragraphs 4.49-4.53) are expected to increasingly bear fruit in the longer term, when they extend to environmental, safety, and financial dimensions.
- 4.63 Transpower has included several grid and asset performance measures in its submission to the Commerce Commission on the RCP2 for the years 2015-20. There are targets for each measure, and Transpower has proposed an incentive regime that would reward or penalise Transpower depending on its performance against the measures and targets.
- 4.64 In its RCP2 submission, Transpower included long-term performance targets beyond 2020. This reflects the view that a five-year period is a short time

compared with the expected lives of most assets. Although changes in operation and maintenance strategies might result in short-term to medium-term performance improvements, longer-term performance improvements will come from improved asset performance (fewer outages and interruptions, and condition-based asset management).

- 4.65 *Transmission Tomorrow* outlined “committed initiatives” in the next five years (from 2011). A review of those initiatives by Transpower’s Network Risk Committee in December 2013 indicates that Transpower is carrying out these initiatives in a methodical manner.

How network performance compares internationally

- 4.66 Transpower participates in an international comparison of performance that covers the operation and maintenance of transmission assets. This is called ITOMS.²⁹ A comparison is done every two years. In our 2011 report, we stated that Transpower’s benchmarking results had shown worsening performance since 2003. The 2011 ITOMS study showed that Transpower’s composite service level had improved significantly. Transpower’s composite service level was around the average of 27 international transmission utilities. However, its composite cost level was still above average.
- 4.67 The results from the 2013 ITOMS study had not been published when we carried out our follow-up work. *Transmission Tomorrow* notes that a potential outcome of the risk and asset management initiatives is “asset performance comparable to that of our international peers”. This potential outcome is timetabled “within 10 years”.

Monitoring by the Board of Transpower

- 4.68 In our 2011 report, we recommended that the Board of Transpower actively monitor progress against *Transmission Tomorrow* and the prioritised work programme on risk and asset management.
- 4.69 In our view, from 2013 Board papers we have seen, the Board has actively monitored the progress against *Transmission Tomorrow*.

Our concluding comments on how Transpower manages risks to assets

- 4.70 In our view, Transpower has been proactive in its efforts to improve grid asset and risk management since we published our 2011 report.
- 4.71 Transpower has set up a large number of initiatives that cover all elements of asset and risk management. Many of the initiatives are still in various stages of development. They are progressing on a measured path that, if continued, will meet best-practice asset management and deliver the long-term outcomes described in *Transmission Tomorrow*.
- 4.72 A particular strength is the asset management framework, including the comprehensive documentation that underpins it.
- 4.73 The asset and risk management initiatives have been used to prioritise future investment proposals, even though some have been acknowledged as “interim” measures.
- 4.74 As part of our follow-up review, we discussed the following matters with Transpower:
- The Board of Transpower should formally approve the asset management policy.
 - Transpower should ensure that all asset management initiatives are progressed on a “broad front”, leaving no areas lagging behind. Because of the interrelationships and interconnectedness between the initiatives, any weak link will imperil the strength of the “asset management chain”.
 - Transpower should continually monitor asset and risk management activities that are currently regarded as “out of scope” to ensure that there is no impediment to, or slowing of, asset and risk-management initiatives.
 - The content of asset management plans, which are presently short-term budgets, should be extended beyond 2020 as and when further reliable information becomes available.
- 4.75 Through our annual audit process, we will continue to maintain an interest in Transpower’s progress with these matters.

Our relationship with mixed ownership model companies and their public accountability

5

- 5.1 This Part outlines the:
- Auditor-General’s role in the public share offers for Mighty River Power Limited, Genesis Energy Limited, and Meridian Energy Limited; and
 - public accountability requirements for these mixed ownership model companies.³⁰
- 5.2 The mixed ownership model companies remain public entities, and their accountability requirements are similar to the requirements they had as SOEs.

Our role in the public share offers of mixed ownership model companies

Background

- 5.3 In 2012, the Government introduced the State-Owned Enterprises Amendment Act 2012 to support its intention to offer the public shares in four SOEs (as defined in the State-Owned Enterprises Act 1986) and to sell part of its ownership in Air New Zealand Limited.³¹
- 5.4 For each of the mixed ownership model companies, the legislation came into force on a different date. The date was appointed by the Governor-General by Order in Council and was before the respective public share offers.
- 5.5 The purpose of the legislation was to remove the mixed ownership model companies from most provisions in the State-Owned Enterprises Act 1986.³² Effectively, the legislation permitted:
- removal of the public entity from the schedule of State enterprises, as listed in the State-Owned Enterprises Act 1986; and
 - incorporation of the public entity into a new Schedule 5 of the Public Finance Act 1989.
- 5.6 The Public Finance Act 1989 now includes provisions that ensure that the Crown owns at least 51% of the shares of the mixed ownership model companies and that no one person owns more than 10% of the shares.³³
- 5.7 The mixed ownership model companies are now subject to the accountability provisions in the Companies Act 1993 and the Financial Markets Conduct Act 2013, rather than the provisions in the State-Owned Enterprises Act 1986.

30 Section 45P(1) of the Public Finance Act 1989 defines “mixed ownership model company”.

31 At first, Solid Energy was to take part in this public share offer, but this did not transpire. The Government sold additional shares in Air New Zealand Limited through a different process. As a result, we do not discuss these two companies in this Part.

32 Sections 22 to 30 of the State-Owned Enterprises Act 1986 still apply to the mixed ownership model companies.

33 There are some exemptions from the 10% limit for trustee corporations and nominee companies.

Audited information in the prospectus

- 5.8 To sell shares in the mixed ownership model companies, the Crown carried out an initial public offering for each company. The Crown made a public offering for the sale of shares to the general public, on a securities exchange, for the first time.
- 5.9 Details of the public offering were disclosed to potential buyers of shares in the form of a prospectus or offer document. The Securities Regulations 2009 (the Regulations) specify the information that a full prospectus must contain. This includes the requirement to include historical financial information.
- 5.10 Because SOEs are public entities under the Public Audit Act 2001, the historical financial information included in the prospectus had previously been audited. The appointed auditor had expressed an opinion on that information on behalf of the Auditor-General. This audit opinion was included in the prospectus alongside the historical financial information.
- 5.11 Regulation 5(1)(a) and clause 28 of Schedule 1 of the Regulations also require the prospectus to include an auditor's report. The auditor's report is required to state, among other matters:
- whether the financial statements contained or referred to in the prospectus comply with generally accepted accounting practice, and give a true and fair view of the matters to which they relate (if the financial statements did not comply or give a true and fair view, the auditor's report would outline why); and
 - a statement that, in the auditor's view, the prospective financial information has been compiled and calculated based on the accounting policies set out in the prospectus.

Auditor independence

- 5.12 Independence is fundamental for an audit. The independence of the Auditor-General is supported by law. Requirements are placed on appointed auditors and their firms to ensure that they meet the independence standards that the Auditor-General expects.
- 5.13 For the public share offer of mixed ownership model companies, the Auditor-General wrote to the chairpersons of the mixed ownership model companies to reinforce the importance of independence.
- 5.14 We recognised that, in the share offer process, there was a particular need for appointed auditors and their firms to maintain an appropriate distance from decisions that are the responsibility of the mixed ownership model companies.

As a result, we reinforced the respective roles and responsibilities of all parties, especially with the due diligence process.

- 5.15 To protect the independence of the Auditor-General, the Office of the Auditor-General and Audit New Zealand also have internal policies that prohibit certain employees from having financial interests in public entities, including owning shares in mixed ownership model companies.

Accountability for mixed ownership model companies

Primary accountability of shareholding Ministers to Parliament

- 5.16 As shareholding Ministers on behalf of the Crown, the Minister of Finance and the Minister for State Owned Enterprises are accountable to Parliament for the mixed ownership model companies.
- 5.17 The Treasury provides the Ministers with advice about ownership and investments.
- 5.18 Parliament has resolved that Mighty River Power Limited and Meridian Energy Limited are “public organisations” for the purposes of Standing Orders. We understand that Parliament intends to make the same resolution for Genesis Energy Limited. This means that each mixed ownership model company can be called for an annual financial review of its performance and current operations after its annual report is presented to Parliament. Air New Zealand Limited is also a public organisation. It can also be, and has been, called for an annual financial review.

The role of the Auditor-General as auditor in enhancing accountability

- 5.19 The Auditor-General continues to be the auditor of the mixed ownership model companies. They are public entities listed in the Public Audit Act 2001, because they continue to be controlled by the Crown.
- 5.20 For the same reason, the Public Finance Act 1989 specifies that they should be included in the Financial Statements of the Government. However, because some of their net assets are owned by others, the Financial Statements of the Government incorporate 100% of the assets, liabilities, revenue, and expenses of the mixed ownership model companies and also reflect that the residual is attributable to minority interests. The Financial Statements of the Government include a line called “minority interests”, which reduces the total operating

balance and net worth by the amount attributable to minority interests. The *Financial Statements of the Government for the Year Ended 30 June 2013* describe in more detail how the partial sale of shares in Mighty River Power was accounted for.³⁴

- 5.21 New Zealand-based subsidiaries of the mixed ownership model companies are also public entities. However, overseas subsidiaries of public entities are not public entities and are not audited by, or on behalf of, the Auditor-General.
- 5.22 The Auditor-General, through her sector managers, has a long-standing practice of writing each year to the shareholding Ministers of each SOE to summarise the results of the annual audit. This letter also notes any particular matters about the operation or performance of the company that Ministers should be aware of. There are specific procedures to ensure that this communication treats any confidential information appropriately – for example, by providing the letter to the SOE before it is finalised to ensure that it is factually accurate. The practice of writing to shareholding Ministers will continue for mixed ownership model companies.
- 5.23 Because mixed ownership model companies are publicly listed and subject to securities market regulation, there is particular sensitivity about access to inside information (information that, if publicly known, could materially affect market prices of a company's securities). To ensure that Ministers and officials do not unnecessarily or inadvertently receive inside information through these letters, the practice of the company first being given an opportunity to consider the letter for factual accuracy will continue. We will also ask mixed ownership model companies to confirm that the letter does not contain any material price-sensitive information.

Appendix 1: The State-owned enterprises and listed companies

In 2012/13, we audited 16 SOEs and two listed companies that are majority owned by the Crown. We list each of these public entities below.

State-owned enterprises

1. Airways Corporation of New Zealand Limited – commercial provider of air navigation services and associated aviation infrastructure services;
2. Animal Control Products Limited – manufacturer and seller of pest management products;
3. AsureQuality Limited – provider of a wide range of services to the food and primary industries in New Zealand and other countries;
4. Electricity Corporation of New Zealand Limited – no longer operating;
5. Genesis Energy Limited – generator, wholesaler, and retailer of electricity (listed on NZX in April 2014);
6. KiwiRail Holdings Limited – owner and operator of the rail network and Interislander ferry services;
7. Kordia Group Limited – telecommunications and media business, which provides network and technology solutions;
8. Landcorp Farming Limited – pastoral farming, including dairy, sheep, beef, and deer;
9. Learning Media Limited – publisher, producer, marketer, and seller of education materials;
10. Meridian Energy Limited – generator, wholesaler, and retailer of electricity (listed on NZX in October 2013);
11. Meteorological Service of New Zealand Limited – provider of weather information services in the form of forecasting, advice, weather graphics, and data systems;
12. New Zealand Post Limited – postal and courier business, as well as banking services through its Kiwibank subsidiary;
13. New Zealand Railways Corporation – owner of railway land;
14. Quotable Value Limited – valuation and property information company;
15. Solid Energy New Zealand Limited – coal producer; and
16. Transpower New Zealand Limited – plans, builds, maintains, and operates the national grid, which links generators of electricity to distribution companies and major industrial users.

Majority-owned listed companies

1. Air New Zealand Limited – an international and domestic airline group, which provides air passenger and cargo services; and
2. Mighty River Power Limited – generator and retailer of electricity (listed on NZX in May 2013).

Appendix 2: Financial data

This Appendix provides financial data to supplement the analysis in Part 3.

Figure 18
Revenue, operating balance, and distributions to the Crown

	2008/09 \$m	2009/10 \$m	2010/11 \$m	2011/12 \$m	2012/13 \$m
Revenue	14,857	13,948	14,638	16,423	16,373
Operating balance	755	738	777	(1,156)	880
Distributions to the Crown	314	831	918	506	757

Sources: *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2010*, page 170; *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2012*, page 180; *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2013*, page 178.

We have provided return on equity (ROE) and return on capital employed (ROCE) data for 15 companies in Figure 19. Where possible, we have taken the headline ROE and ROCE indicators from published annual reports.

To provide figures for as many companies as possible, if those headline figures are not disclosed in the annual report, we have supplemented the data with data taken from the Treasury's *2013 Annual Portfolio Report*. Although this provides more complete data, it also limits the comparability of the data because the annual portfolio report data might not always correspond to the annual report information.

In addition, the annual portfolio report uses "adjusted ROE" (ROE adjusted for fair value movements and asset revaluations) instead of actual ROE, which also limits the comparability of the ROE data in this Appendix.

Figure 19
Return on equity and return on capital employed, 2012/13

Company	ROE %	ROCE %
Air New Zealand Limited	10.0	11.4*
Airways Corporation of New Zealand Limited	38.0	37.1
Animal Control Products Limited	7.1	10.5
AsureQuality Limited	28.0	34.0
Genesis Energy Limited	7.3*	9.1
KiwiRail Group	(35.7)	(16.6)
Kordia Group Limited	4.0	8.0
Landcorp Farming Limited	3.6	1.8

Company	ROE %	ROCE %
Meridian Energy Limited	6.2	14.6*
Meteorological Service of New Zealand Limited	17.2	14.5
Mighty River Power Limited	10.4*	10.7*
New Zealand Post Limited	13.6	7.5
Quotable Value Limited	0.7	3.1
Solid Energy New Zealand Limited	(130.0)	(42.0)
Transpower New Zealand Limited	12.1	8.0

* Derived from the Treasury's 2013 Annual Portfolio Report.

The ROE numbers in Figure 20 come from information published in the companies' annual reports and/or statements of corporate intent. Not all the companies report ROE as a key performance indicator. As such, target and actual ROE data were not available from some companies for our analysis.

Figure 20
Return on equity: budget versus actual, 2012/13

Company	Actual %	Budget/target %	Variance %
Air New Zealand Limited	n/a	n/a	n/a
Airways Corporation of New Zealand Limited	38.0	11.4	26.6
Animal Control Products Limited	7.1	14.4	(7.3)
AsureQuality Limited	28.0	14.0	14.0
Genesis Energy Limited	n/a	n/a	n/a
KiwiRail Group	(35.7)	(27.4)	(8.3)
Kordia Group Limited	4.0	9.3	(5.3)
Landcorp Farming Limited	3.6	4.8	(1.2)
Learning Media Limited	n/a	n/a	n/a
Meridian Energy Limited	n/a	n/a	n/a
Meteorological Service of New Zealand Limited	17.2	15.5	1.7
Mighty River Power Limited	n/a	n/a	n/a
New Zealand Post Limited	13.6	12.9	0.7
Quotable Value Limited	0.7	12.8	(12.1)
Solid Energy New Zealand Limited	(130.0)	16.0	(146.0)
Transpower New Zealand Limited	12.1	11.3	0.8

Figure 21 provides the data from which the current ratio is derived. The current ratio is the relationship of current assets to current liabilities.

Figure 21
Current assets, current liabilities, and current ratio, as at 30 June 2013

Company	Current assets \$000	Current liabilities \$000	Current ratio
Air New Zealand Limited	1,767,000	2,025,000	0.9
Airways Corporation of New Zealand Limited	21,900	64,448	0.3
Animal Control Products Limited	2,655	618	4.3
AsureQuality Limited	35,510	21,414	1.7
Genesis Energy Limited	487,729	657,133	0.7
KiwiRail Group	210,800	162,700	1.3
Kordia Group Limited	93,355	65,442	1.4
Landcorp Farming Limited	110,361	201,800	0.5
Learning Media Limited	4,584	9,084	0.5
Meridian Energy Limited	343,400	635,300	0.5
Meteorological Service of New Zealand Limited	2,972	7,809	0.4
Mighty River Power Limited	948,533	349,737	2.7
New Zealand Post Limited	356,641	326,824	1.1
Quotable Value Limited	4,933	4,632	1.1
Solid Energy New Zealand Limited	336,500	582,200	0.6
Transpower New Zealand Limited	424,300	2,093,100	0.2

Figure 22
Leverage (total liabilities to total assets), as at 30 June 2013

Company	Leverage
Air New Zealand Limited	0.74
Airways Corporation of New Zealand Limited	0.58
Animal Control Products Limited	0.16
AsureQuality Limited	0.49
Genesis Energy Limited	0.48
KiwiRail Group	0.42
Kordia Group Limited	0.57
Landcorp Farming Limited	0.23
Learning Media Limited	1.98
Meridian Energy Limited	0.39
Meteorological Service of New Zealand Limited	0.81
Mighty River Power Limited	0.46
New Zealand Post Limited	0.43
Quotable Value Limited	0.25
Solid Energy New Zealand Limited	0.90
Transpower New Zealand Limited	0.74

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- Public entities' progress in implementing the Auditor-General's recommendations 2014
- The Auditor-General's strategic intentions 2014/15 to 2017/18
- Annual Plan 2014/15
- Setting up Central Agencies Shared Services
- Watercare Services Limited: Review of service performance
- Local government: Results of the 2012/13 audits
- Inquiry into the Plumbers, Gasfitters, and Drainlayers Board: Follow-up report
- Reflections from our audits: *Our future needs – is the public sector ready?*
- Health sector: Results of the 2012/13 audits
- Schools: Results of the 2012 audits
- Central government: Results of the 2012/13 audits (Volume 2)
- Additional work on Solid Energy New Zealand Limited
- Inquiry into property investments by Delta Utility Services Limited at Luggate and Jacks Point
- The Auditor-General's Auditing Standards 2014

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