Mighty River Power Limited
Statement of Corporate Intent 2012-2014
MIGHTY RIVER POWER

This Statement is submitted by the Board of Directors of Mighty River Power Limited, in accordance with Section 14 of the State-Owned Enterprises Act 1986. It sets out the Board's overall intentions and objectives for Mighty River Power Limited and its subsidiaries (the Group) to 30 June 2014.

# Statement of Corporate Intent[1] 2012-2014

**1 GENERAL STATEMENT OF PURPOSE**

Mighty River Power invests in, develops and produces electricity from renewable and other energy resources and sells energy and energy-related services and products to retail and wholesale customers.

**2 SCOPE OF THE BUSINESSES**

**2.1 Core Business**

- Securing fuel (to meet long-term energy needs).
- Developing new power plants and energy conversion facilities.
- Preserving access and managing fuel reservoirs to maximise fuel value over time.
- Conversion of fuel into higher value energy forms, particularly electricity.
- Leveraging skills and experience to add value to our business.
- Trading fuel, electricity and related financial products to maximise value and reduce risk.
- Retailing of energy to customers.

**2.2 Complementary Business**

- Providing metering options and energy management services to consumers and energy retailers.
- The Group will pursue the development of related business activities that add value to the core business and are consistent with its business plan and the prudent management of its business risks.

**3 OBJECTIVES**

The principal objective of the Group is to operate as a successful business and to be:

1. As profitable and efficient as comparable businesses that are not owned by the Crown.
2. A good employer that has policies and practices that provide for the fair and proper treatment of employees in all aspects of their employment.
3. An organisation that exhibits an informed sense of social responsibility by having regard to the interests of the communities in which the Group operates and by supporting these where appropriate.
4. A leader in achieving sustainable development for the communities in which the Group operates through world's best management of hydro, geothermal and other fuel resources.

In pursuing these objectives, the Group will take a medium to long-term view appropriate to the nature of the business and its assets. The Group's approach to corporate responsibility is that our values are fully integrated into our business operations. This approach to socially, financially and environmentally responsible business is embedded in the Business Principles and Code of Ethics that the Group has adopted. The Group intends to:

1. Achieve ongoing competitive advantage through superior performance across the industry value chain including development and management of fuel resources, creation of electricity and meeting customer needs.
2. Achieve returns to the shareholder over the medium term that exceeds the Company's cost of capital.
3. Pursue activities designed to ensure the safe and efficient utilisation of its existing capital assets, energy sources and human resources.
4. Continue to meet our electricity generation capacity growth targets, providing economic returns and helping meet New Zealand's energy needs; and in particular to develop, in conjunction with our partners, New Zealand's geothermal resources.
5. Leverage our geothermal development expertise in a planned program of international geothermal development investment activities.
6. Attract and retain high quality people with the right knowledge, skills and attitude to contribute to the success of the business.
7. Maintain and develop a level of engagement and transparency about our performance consistent with our stakeholder's expectations.
8. Continue to build and maintain productive and mutually beneficial relationships with iwi/hapu and Maori landowners as business partners.
9. Maintain a high level of service to our customers.
10. Continue to support customers in improving their energy efficiency, both through provision of information, and through our wider innovation and technology programme.

**4 PERFORMANCE TARGETS**

The Financial Targets below represent Mighty River Power's current reasonable estimates based on Mighty River Power's current business and its current expectations as to the future. Not all of the objectives listed in Section 3 lend themselves to precise measurability. The success of some of the objectives will only be demonstrable over the longer-term. However, there are some indicators that are measurable, and against which the Group will assess its performance on an ongoing annual basis. These targets are tracked to better monitor financial performance, environmental impact, customer satisfaction and compliance. *A description of how each target relates to company performance is provided in Appendix 3.*

**5 INDUSTRY ISSUES & RISKS**

There are a number of issues that have the potential to affect the company and the wider energy sector. These can be grouped into three main categories, namely market related factors, regulatory changes and company specific factors. These factors are discussed in greater detail below:

**Market Related Factors**

Mighty River Power will continue to operate in a dynamic and challenging environment. A number of market related factors will make achieving financial targets more difficult during this time.

- Demand growth remains subdued with almost no increase over the last three years. Forecasts of national demand growth over the planning period remain below historical levels of 2% pa.
- New investment in generation capacity has exceeded demand growth since 2007, widening supply reserves and increasing downward pressure on wholesale prices.
- These factors, along with regulatory changes have spurred retail competition and churn, increasing retention costs and tempering retail price levels.

**Regulatory**

Ongoing regulatory reform continues to impact both the wholesale and retail markets. Regulatory change is occurring through both legislative changes and Electricity Authority code changes.

- The Electricity Industry Act introduces a number of initiatives e.g. scarcity pricing regimes, retail compensation schemes which will have market impacts.
- Transmission pricing reviews, particularly in regard to HVDC pricing, have the potential to significantly change the revenue recovery mechanism for grid assets.
- Policy changes at a central or local government level could reduce the Company's access to Waikato River flows above Karapiro and Lake Taupo storage.
- The Emission Trading Scheme (ETS) is currently being reviewed. It is unclear whether the Government will retain the ETS in its current form or amend the existing arrangements. Changes to the ETS will impact wholesale and retail pricing and may impact future investment proposals.

**Company Specific Factors**

Further generation development and hydro plant life-cycle maintenance and capital works are expected during the planning period. Investments in international geothermal developments involve different market, political and regulatory risks to the domestic business. Capital to fund the domestic and international investments will be required, which will, in the short term, increase gearing and lower credit metrics.

**Other Factors**

The proposed mixed ownership model (MOM) is a key risk and opportunity for the Company. Successful management by all parties is required to protect Company reputation. Company initiatives will need to be adequately resourced and managed to avoid unacceptable diversion on the MOM process should it proceed. If it proceeds, the Company will also need to adapt its processes to manage and communicate effectively with a new group of stakeholders.

| Performance Targets[2] | FY2012 | FY2013 | FY2014 |
|---|---|---|---|
| **Financial** | | | |
| Return on equity employed (%) | 14.1 | 13.8 | 14.9 |
| Return on total capital employed (%) | 11.1 | 10.9 | 12.0 |
| Total equity/total assets (%) | 52.5 | 52.8 | 54.5 |
| Total shareholder return (%) | 10.1 | 10.1 | 10.1 |
| Free funds from operations/interest expense (x) | 4.2 | 4.2 | 4.7 |
| Free funds from operations/average debt (%) | 23.5 | 24.2 | 32.3 |
| **Non Financial** | | | |
| Retail market share (%) | 19.1 | 19.2 | 19.5 |
| Level of customer dissatisfaction lower than industry average | Yes | Yes | Yes |
| Retain a ranking in the top two of the five major energy retailers in the Consumer New Zealand survey of electrical suppliers' performance | Yes | Yes | Yes |
| Comply fully with Electricity Commission Guidelines for medically dependent and vulnerable customers | Yes | Yes | Yes |
| Compliance orders by regulatory authorities | None | None | None |
| Optimisation of power plant reliability | | | |
| Plant availability | 88.8 | 88.1 | 92.3 |
| Forced outage factor | <2.0 | <2.1 | <2.1 |
| Maintain the Group's Enviro-Mark Diamond status | Yes | Yes | Yes |
| Lost time accidents – frequency rate per 100,000 hours worked | <0.4 | <0.4 | <0.4 |

*A table showing the performance targets for the past three years is included in Appendix 4.*
*A table showing shareholder financial metrics is included in Appendix 5.*

[2] No allowance has been made for any costs associated with any potential mixed ownership process or any impact resulting from any potential change in shareholding of the company.

[1] The Mighty River Power Limited Statement of Corporate Intent for 2012 – 2014 ("the SCI") is provided pursuant to section 14of the State Owned Enterprises Act 1986. Neither Mighty River Power nor its directors, officers or employees have any liabilitywhatsoever with respect to the use of or reliance on any information contained in the SCI by any person.

## 6 INFORMATION TO BE PROVIDED TO THE SHAREHOLDING MINISTERS

An annual report will be submitted to the shareholding Ministers in accordance with Section 15 of the State-Owned Enterprises Act 1986.

The annual report will contain sufficient information to enable an informed assessment to be made of the operations of the Group and will include a comparison of the performance of the Group with this Statement of Corporate Intent.

The interim report will include unaudited financial statements and such details as are necessary to permit an informed assessment of the Group's performance during the reporting period. Quarterly reports will be submitted to the shareholding Ministers providing provisional financial results.

A summary of the Group's business plan and a draft Statement of Corporate Intent will be made available to the shareholding Ministers for discussion in accordance with shareholding Ministers' expectations. The Company will consult shareholding Ministers on significant proposed investments. The Group will provide any other information requested by the shareholding Ministers pursuant to Section 18 of the State-Owned Enterprises Act 1986.

In 2011 the company held a successful Annual Public Meeting at Karapiro and complied with its filing obligations under the Continuous Disclosure regime for State Owned Entities. The company sees further areas for continuous improvement in transparency that go beyond these compliance requirements and the Company commits to holding a Public Meeting annually.

## 7 FORECAST CAPITAL EXPENDITURE

| Forecast capital expenditure ($M) | Current Year Forecast | Last Year's SCI Forecast |
|---|---|---|
| FY2012 | 483.3 | 559.1 |
| FY2013 | 232.9 | 202.5 |
| FY2014 | 104.8 | |

Capital expenditure includes both reinvestment and new development activities. Reinvestment expenditure is required for major component upgrades on existing hydro, geothermal and thermal stations, expenditure on information systems and the completion of the smart meter roll-out. Major life-cycle replacements are occurring on some of the Waikato River stations and are driving increasing operating and capital costs after a decade of much lower levels of refurbishment spending. Development expenditure relates to the ongoing generation development programme; including expenditure on a new geothermal station at Ngatamariki, a number of international geothermal opportunities and other early stage geothermal and wind activities.

## 8 CAPITAL STRUCTURE

| Forecast capital expenditure ($M) | Total Liabilities | Shareholders' Equity | Total Assets |
|---|---|---|---|
| 30 June 2012 | 2,722 | 3,003 | 5,725 |
| 30 June 2013 | 2,742 | 3,068 | 5,810 |
| 30 June 2014 | 2,617 | 3,136 | 5,753 |

The estimated Group capital structure for the next three years is shown above. The terms used are:

- "Shareholders' Equity" which may include share capital, equity bonds as defined in the State-Owned Enterprises Act 1986 and reserves.
- "Total Assets" comprise tangible and intangible assets, including current assets, goodwill, derivative financial instruments, investments and fixed assets.
- "Total Liabilities" comprise current and term liabilities, including all short and long-term borrowings including finance leases (if any), derivative financial instruments, tax liabilities and other short-term liabilities.

All such terms are more specifically defined in the NZ Framework issued by the New Zealand Institute of Chartered Accountants. Values are affected by accounting revaluations which occur periodically.

## 9 COMMERCIAL VALUE OF THE CROWN'S INVESTMENT

The Board's current estimate of the commercial value of the Crown's investment in the Mighty River Power Group (100% of the shares in the company) based on an independent valuation undertaken by PricewaterhouseCoopers (PwC) is $3,719 million.

Key factors taken into consideration in this valuation were:

- The valuation was undertaken independently by PwC and a number of valuation scenarios were calculated as at 30 June 2011.
- An after-tax discounted cash flow analysis (DCF) was performed on all currently operating generation assets, the Mercury Energy retail business including all major energy contracts and the company's metering business (Metrix). Expenditure on projects yet to be completed is recognised at carrying value. No additional value was assigned to future development projects or any other growth options under consideration.
- The DCF is based on nominal (i.e. including inflation) after-tax future free cash flows projections until 2030. The cash flow projections include:
  - The forecast revenue, cost and capital expenditures contained within Mighty River Power Group's FY2012-FY2016 business plan
  - Generation long-term asset lifecycle plans including associated operating and capital expenditures
  - A nominal wholesale electricity forward price path developed by PwC, taking into account other publicly available wholesale price path views.
  - A perpetuity growth rate of 2% resulting in a terminal value of $1,041m to account for the residual cash flows post the discrete cash flow modelling period.
- PwC has estimated a weighted average cost of capital range for the purposes of this valuation of between 8.5%-9.0%.

The valuation compares with a commercial value as at 30 June 2010 of $3,425 million. The key reasons for the change in commercial value are:

- Rising nominal wholesale and retail electricity prices. While the forward price projections are similar to last year and predict prices to rise over time, the change in the modelling period (moved forward by one year) means prices are higher in all periods in the cash flow model.
- Reduction in operating expense and ongoing capital expenditure on geothermal fields due to improved reservoir operating conditions.
- Increase in the value of work in progress and other investments of $110million, mainly in international geothermal and the Ngatamariki geothermal project, currently held at carrying value (assessed as a proxy for the fair market value of these projects).

## 10 DISTRIBUTION POLICY

In recommending dividends payable to shareholders, the Group will follow the procedures laid down in the Companies Act 1993 and those generally adopted by directors of publicly listed companies and in accordance with Sections 13 and 15 of the State-Owned Enterprises Act 1986. The actual dividend payments are subject to review and approval by the Directors of Mighty River Power.

The dividends declared will be determined by reference to:

- The Group's working capital requirements and the medium term asset investment programme.
- A sustainable financial structure for the Group having regard to the risks from predicted short and medium-term economic, market, and hydrological conditions, and estimated financial performance.
- The Group's maintenance of a stand-alone investment grade credit rating in the BBB range, reflected by credit ratios (forecast not less than one year ahead) of:
  - A minimum free funds from operation (FFO) to debt ratio of not less than 20%
  - A minimum FFO interest coverage ratio of greater than 3.5x.

Providing these conditions are met, the dividend payout ratio will be set at 75 percent of net profit after tax after adjusting for the impact of NZ IFRS fair value movements net of tax each year. Dividend payments will be split into an interim dividend paid in March, based on the six months results to 31 December, and a final dividend paid in September, based on the results for the second six months of the financial year.

### 11 PROCEDURES FOR SALE AND PURCHASE OF SHARES OR ASSETS

The Board will consult the shareholding Ministers before the Group:

- Acquires shares, assets or an equity interest in a business that is outside the core business of the Group outlined in this Statement of Corporate Intent.
- Acquires shares, assets or an equity interest in a business that is material in the context of the Group.

The procedure for the establishment and management of subsidiary companies and the disposal of shares and assets is set out in Appendix 1.

### 12 ACTIVITIES FOR WHICH COMPENSATION MAY BE SOUGHT

Under section 6 of the State Owned Enterprises Act 1986, where the Government wishes the Group to undertake activities or assume obligations that will result in a reduction of the Group's profits or shareholder value, the Board will seek compensation sufficient to allow the Group's position to be restored. No requests for compensation are currently under consideration.

The Group will also be entitled to compensation or other recompense in certain circumstances under the agreements relating to the formation of the Group and the purchase of assets and liabilities from Electricity Corporation of New Zealand Limited (ECNZ).

### 13 ACCOUNTING POLICIES

The consolidated financial statements of the Company set out in the Annual Report, which contain the accounting policies of the Company, are prepared in accordance with the Financial Reporting Act 1993, the Companies Act 1993 and New Zealand Generally Accepted Accounting Practice (NZ GAAP). They comply with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) as appropriate for profit-oriented entities. They also comply with International Financial Reporting Standards (IFRS). *The accounting policies of the Company are set out in full in Appendix 2.*

**JOAN WITHERS**
Chair
30 August 2011

# Subsidiary and associated companies

The terms: "share", "Ministers", and "subsidiary" have the same meanings as in Section 2 of the State-Owned Enterprises Act 1986.

1. The Group will ensure at all times that:
– control of the affairs of every subsidiary of Mighty River Power Limited (the Company) is exercised by a majority of directors appointed by the Company; and;
– a majority of the directors of every subsidiary of the Company are persons who are also directors or employees of the Company, or who have been approved by the shareholding Ministers for appointment as directors of the subsidiary.

2. The Company will, in relation with any single or connected series of transactions, consult with shareholding Ministers on items having a material impact on the Company's financial position not contemplated in the business plan, including;
– any substantial capital investment in activities within the scope of its core business;
– any substantial expansion of activities outside the scope of its core business into new business areas;
– subscriptions for, or sale of, shares in any company or equity interests in any other organisations which are material, involve a significant overseas equity investment, or are outside other company's scope of business;
– the sale or other disposal of the whole or any substantial part of the business or undertaking
– of the Company; and
– where the Company holds 20 percent or more of the shares in any company or other body corporate (not being a subsidiary of the Company), the sale or disposal of any shares in that company.

The Company will also consult on specific items included in the Business Plan as agreed between the Company and shareholding Ministers from time to time.





# Accounting policies

**SIGNIFICANT ACCOUNTING POLICIES**

**a) Basis of consolidation**
*Subsidiaries*
Subsidiaries are those entities in which the Group holds a controlling interest either directly, indirectly or beneficially in the entity.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of the acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are initially measured at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of the acquisition is less than the fair value of the identifiable net assets of the subsidiary acquired, the difference is recognised in the income statement.

All material inter-company transactions, balances and unrealised profits and losses arising from transactions between Group companies are eliminated on consolidation.

*Associates*
Associates are those entities in which the Company holds an equity interest and over which the Company has the capacity to significantly affect but not unilaterally determine the operating and/or financial policy decisions. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investments in associates include goodwill identified on acquisition.

The Group and Company's share of its associates' post acquisition profits or losses is recognised in the income statement, and its share of post acquisition movements in reserves is recognised in reserves. The cumulative post acquisition movements are adjusted against the carrying amount of the investment.

Provision is made for any impairment in the value of investments in associates where the estimated recoverable amount is less than the carrying value.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

*Jointly controlled assets*
Jointly controlled assets are joint arrangements in which the Group jointly controls or owns one or more assets and is consequently entitled to a share of the future economic benefit through its share of the jointly controlled asset. The Group's interests in jointly controlled assets are accounted for by recognising its share of the jointly controlled assets, liabilities incurred jointly, income and expenses in the consolidated financial statements.

Where an entity becomes or ceases to be a Group entity during the year, the results of that entity are included in the net profit of the Group from the date of acquisition or up to the date of disposal.

**b) Property, plant and equipment**
*Owned assets*
Generation assets, which include freehold land and buildings and generation plant and equipment, are measured at fair value based on periodical valuations by third party valuation experts, less accumulated depreciation and less any impairment recognised after the date of the revaluation. The underlying assumptions are reviewed for reasonableness on an annual basis to ensure that recorded value is not materially different to fair value.

Costs incurred in obtaining resource consent are capitalised and recognised as a non-current asset where it is probable they will give rise to future economic benefit. These costs are amortised over the life of the consent on a straight-line basis.

Office land and buildings are measured at fair value based on periodical valuations as determined by third party valuation experts, less accumulated depreciation on buildings and less any impairment losses since the last revaluation.

Any surplus on revaluation of an individual item of property, plant and equipment is transferred directly to the asset revaluation reserve unless it offsets a previous decrease in value recognised in the income statement, in which case it is recognised in the income statement. A deficit on revaluation of an individual item of property, plant and equipment is recognised in the income statement in the period it arises where it exceeds any surplus previously transferred to the asset revaluation reserve. Any accumulated depreciation at the date of the revaluation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset. Additions to property, plant and equipment stated at valuation subsequent to the most recent valuation are recorded at cost.

All other items of property, plant and equipment are recorded at cost.

The cost of property, plant and equipment purchased comprises the consideration given to acquire the assets plus other directly attributable costs incurred in bringing the assets to the location and condition necessary for their intended service.

The cost of property, plant and

equipment constructed by the Group, including capital work in progress, includes the cost of all materials used in construction, direct labour specifically associated and an appropriate proportion of variable and fixed overheads. Financing costs attributable to a project are capitalised at the Group's specific project finance interest rate, where these meet certain time and monetary materiality limits. Costs cease to be capitalised as soon as an asset is ready for productive use.

Where appropriate, the cost of property, plant and equipment includes site preparation costs, installation costs, and the cost of obtaining resource consents. Provision is made for any impairment in the value of property, plant and equipment where the estimated recoverable amount is less than the carrying value.

Where property, plant and equipment are disposed of, the gain or loss recognised in the income statement is calculated as the difference between the sale price and the carrying value of the property, plant and equipment.

*Development of exploration assets*
Development costs of successful efforts are capitalised and amortised on a units of production basis over the estimated life of the field commencing from the first year of commercial production. Any subsequent impairment in the value of unamortised development costs is charged to the income statement.

*Depreciation*
Depreciation is provided on a straight-line basis on all property, plant and equipment other than freehold land, capital work in progress and exploration and evaluation assets, so as to write down the assets to their estimated residual value over their expected useful lives.

The annual depreciation rates are as follows:

| | 2011 | 2010 |
|---|---|---|
| Office land and buildings | 1-20% | 1-20% |
| Generation assets:<br>• Hydro and Co-generation<br>• Other generation | <br>1-15%<br>5-10% | <br>1-15%<br>5-10% |
| Meters | 3-33% | 3-33% |
| Computer hardware and tangible software | 15-33% | 15-33% |
| Other plant and equipment | 4-33% | 4-33% |
| Motor vehicles | 20-33% | 20-33% |

*Distinction between capital and revenue expenditure*
Capital expenditure is defined as all expenditure on the purchase or creation of a new asset, and any expenditure that results in a significant improvement to the original functionality of an existing asset.

Revenue expenditure is defined as expenditure that restores an asset to its original operating capability and all expenditure incurred in maintaining and operating the business.

**c) Exploration and evaluation expenditure**
Exploration and evaluation expenditure incurred by the Group is accounted for using the successful effort method.

Exploration expenditure, which includes geological, geochemical and geophysical costs, is recognised in the income statement in the period incurred except where future benefits are expected to exceed such expenditure in which case it is included in capital work in progress.

Land access rights for exploration activities are amortised over the life of the right.

Exploratory drilling costs are initially deferred and are subject to regular review to confirm the ability to develop or otherwise extract value from expenditure. If an exploratory field is appraised as unsuccessful, such costs are charged to the income statement.

**d) Rehabilitation costs**
Estimations are made for the expected cost of environmental rehabilitation of commercial sites that require some level of reinstatement resulting from present operations.

Any liability is recognised when an exposure is identified and the rehabilitation costs can be reasonably estimated. Any changes in the estimated liability are accounted for in accordance with NZ IFRIC 1.

**e) Insurance**
The Group's property, plant and equipment are predominantly concentrated at power station locations which have the potential to sustain major losses through damage to plant and resultant consequential costs.

To minimise the financial impact of such exposures, the major portion of the assessed risk is transferred to insurance companies by taking out insurance policies with appropriate counterparties. Any uninsured loss is expensed to the income statement in the year in which the loss is incurred.



**f) Intangible assets**
*Goodwill*
Goodwill on acquisition is initially measured at cost being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill on acquisitions of subsidiaries is included in intangible assets. Goodwill on acquisitions of associates is included in investments in associates. Goodwill is tested annually for impairment.

*Software*
Acquired computer software licenses are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised over their estimated useful lives of 2010: between 2.5-5 years (2009: between 2.5-5 years). As these assets are deemed to have a finite life, impairment testing will only be performed when there is an indication that the intangible asset may be impaired.

*Rights*
Rights, including land access rights acquired to further the Group's development programme, are stated at cost less accumulated amortisation and any accumulated impairment losses. Rights, which have a finite life, are amortised over the life of the rights 2010: between 3 and 11 years (2009: between 3 and 11 years). Testing for impairment will only arise when there is an indication that the asset may be impaired.

**g) Impairment**
Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment. Other assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Evaluation and exploration assets are assessed for impairment when there is an indication that the carrying amount of the asset may exceed its recoverable amount.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are largely independent cash inflows (cash generating units).

Non-financial assets, other than goodwill, that suffered an impairment are tested for possible reversal of the impairment whenever events or changes in circumstances indicate that the impairment may have been reversed.

**h) Inventories**
Inventories are stated at the lower of cost or net realisable value. Cost is determined on a weighted average basis and includes expenditure incurred in acquiring the inventories and bringing them to their existing condition and location.

**i) Cash flow statement**
The following are the definitions of the terms used in the cash flow statement:

- Cash includes cash on hand and bank current accounts.
- Investing activities are those activities relating to the acquisition, holding and disposal of property, plant and equipment and of investments. Investments can include securities not falling within the definition of cash.
- Financing activities are those activities that result in changes in the size and composition of the equity structure of the Group. This includes both equity and debt not falling within the definition of cash. Dividends paid in relation to equity structure are included in financing activities.
- Operating activities include all transactions and other events that are not investing or financing activities.

The cash flow statement includes net cash flows from loan advances as the rollover of loans and deposits is covered by an arranged finance facility.

**j) Financial instruments**
Financial instruments are recognised in the financial statements when the Group has become party to the contract. They include cash balances, receivables, payables, investments and loans. In addition members of the Group are party to financial instruments to meet future financing needs and to reduce exposure to fluctuations in foreign currency exchange rates and energy prices. These financial instruments include cross-guarantees of related entities guaranteed indebtedness, swaps, options, foreign currency forward exchange contracts and energy contracts.

*Cash and cash equivalents*
Cash and cash equivalents comprise cash at bank and in hand and short term deposits with an original maturity of three months or less that are readily converted to known amounts of cash and which are subject to an insignificant risk of changes in value.

Interest income on cash and cash equivalent balances is recognised as interest accrues using the effective interest method.

*Receivables and payables*
Receivables and payables are initially recorded at fair value and subsequently carried at amortised cost using the effective interest method, less (in the case of trade receivables) any provision for impairment (doubtful debts).

A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of receivables. Financial difficulties of the debtor, default payments or overdue debts are considered objective evidence of impairment.

*Investments*

The Group classifies its investments in the following categories:

- financial assets held at fair value through the income statement, held to maturity investments and available for sale financial assets. The classification depends on the purpose for which the investments were acquired. Management determines the initial classification of its investments upon acquisition.
- Realised and unrealised gains and losses on investments classified as financial assets at fair value through the income statement are included in the income statement in the period in which they arise.
- Investments classified as available for sale are held at fair value and any related unrealised gains and losses are recognised in equity. Held to maturity investments are carried at amortised cost.

*Loans*

Loans are initially recorded at fair value net of transaction costs incurred. Loans are subsequently stated at amortised cost; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the loan using the effective interest method. Borrowing costs are expensed to the income statement unless they relate to qualifying assets in which case they are capitalised to capital work in progress.

*Foreign exchange and interest rate derivatives*

The Group enters various financial instruments for the purpose of reducing its exposure to fluctuations in interest rates and foreign exchange rates. These are designated as financial instruments at fair value through the income statement.

Derivative contracts are classified as held for trading and are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured to fair value. The method of recognising the resulting gain or loss depends on whether the derivative is recognised as a hedging instrument, and if so, the type of hedge. The Group designates certain derivatives as either: a) hedges of the fair value of recognised assets and liabilities or a firm commitment (fair value hedge); or b) hedges of highly probable forecast transactions or variable interest cash flows on recognised liabilities (cash flow hedge).

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Ineffectiveness arises where the movement in the fair value of the derivative instrument does not perfectly offset the movement in the fair value or cash flows of the hedged item.

Amounts included in equity are reallocated to the income statement in the periods when the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a liability, the gains and losses previously deferred in equity are transferred and included in the initial measurement of the asset or liability.

Any gains or losses on derivatives that do not qualify for hedge accounting are recognised immediately in the income statement.

*Energy contracts*

The Group has entered into a number of contracts to manage its exposure to price fluctuations on the electricity spot market. These contracts are in the form of power supply agreements, contracts for difference, and option based instruments. They are not undertaken for speculative purposes.

These energy contracts establish the price at which future specified quantities of electricity are purchased, sold or otherwise exchanged. These contracts are designated as financial instruments at fair value through the income statement. Energy contracts are a form of derivative and are accounted for on the same basis as other derivatives described above.

The fair value of energy contracts is based on the net present value of anticipated cash flows from each contract.

**k) Foreign currencies**

Transactions in foreign currencies are recognised in the functional currency of the relevant operating unit.

Foreign currency transactions are translated to the functional currency using the spot rate on the transaction date. At balance date monetary assets and liabilities denominated in foreign currencies are translated at the closing rate.

Exchange variations arising from these translations and the settlement of these items are recognised in the income statement, except when deferred in equity as qualifying cash flow hedges.

The assets and liabilities of independent foreign operations, whose functional currency is not the New Zealand dollar, are translated at the exchange rates ruling at balance date. Revenue and expense items are translated at the spot rate at the transaction date or a rate approximating that rate. Exchange differences are taken to the foreign currency translation reserve.

**l) Employee entitlements**

A liability for employee entitlements is recognised for benefits earned by employees but not yet received at balance date. Where payment is expected to be within twelve months of balance date, the liability is the amount expected to be paid by the Group. Where payment is expected to be longer term the liability is determined by discounting the expected future cash flows at a pre-tax discount rate that reflects current assessments of the time value of money. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

**m) Operating leases**

Operating lease payments are representative of the pattern of benefits derived from the leased assets and accordingly are charged to the income statement in the periods in which they are incurred on a straight line basis over the lease term.

**n) Revenue**

Revenue recognised in the income statement includes the amounts received and receivable for energy and related energy services supplied to customers in the ordinary course of business. Revenue is stated exclusive of:

- Distribution costs paid to lines companies as collected from customers on their behalf, and
- Goods and services tax collected from customers.

Revenue includes the value of units assessed as being recorded on meters as at balance date, but for which invoices have not yet been rendered.

**o) Income tax**

The income tax expense charged to the income statement includes both the current year's provision and the income tax effect of:

- Taxable temporary differences, except those arising from initial recognition of goodwill; and
- Deductible temporary differences to the extent that it is probable that they will be utilised.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of the assets and liabilities and their carrying amounts in the NZ IFRS consolidated financial statements. A deferred tax asset is only recognised to the extent that there will be future taxable profit to utilise the temporary difference. Temporary differences arising from transactions, other than business combinations, affecting neither accounting profit nor taxable profit on initial recognition are not recognised. Deferred tax is not recognised on temporary differences associated with investments in subsidiaries and joint ventures because:

- The parent company is able to control the timing of the reversal of the differences; and
- They are not expected to reverse in the foreseeable future.

**p) Goods and Services Tax**

The income statement and cash flow statement have been prepared so that all components are stated exclusive of GST. All items in the balance sheet are stated net of GST with the exception of receivables and payables which include GST invoiced.

**q) Capital and reserves**

*Cash flow hedge reserve*

The cash flow hedge reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

*Asset revaluation reserve*

The asset revaluation reserve is used to record the increments and decrements in the fair value of property, plant and equipment identified as being carried at valuation.

*Foreign currency translation reserve*

The foreign currency translation reserve is used to record exchange differences arising from the translation of the financial statements of foreign subsidiaries.

*Available for sale investment reserve*

The available for sale investment reserve records movements in the fair value of available for sale financial assets.

**r) Segment reporting**

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for allocating resources and assessing performance of the operating segments, has been identified as the Chief Executive Officer.

**s) Related parties**

The Group considers its related parties to be key management personnel, its associates and its joint venture partners. Key management personnel are those people with responsibility and authority for planning directing and controlling the activities of the entity.

Key management personnel for the Group are considered to be the Directors and Senior Management.

# Performance

**Market Share; Customer satisfaction; Consumer New Zealand survey**
Retail market share is measured as our share of total combined electricity and gas ICPs nationwide. With the ease with which customers can switch suppliers, customer dissatisfaction is an important performance indicator of our efficiency in net growth in customer numbers. Our internal monthly survey, although not externally verified, measures amongst other things, customer dissatisfaction of Mercury customers compared to non-Mercury customers, by retailer. The monthly survey results are averaged to give an annual dissatisfaction ranking relative to all other retailers. In addition, we also use the Consumer New Zealand electricity industry customer service survey as an external benchmark.

**Compliance orders by regulatory authorities**
Traditionally we have used this target to measure our environmental performance. This is important to us as the generation side of our business relies on using natural resources to generate electricity. However we are subject to regulation by a number of regulators and we take them all seriously, so this year we are extending this target to cover compliance orders by all regulators. Those regulators include: Electricity Commission, Commerce Commission, Electricity and Gas Complaints Commission; Gas Industry Company; and regional and local authorities.

**Optimisation of power plant**
Power plants are expensive to build and operate, and can have a large impact on the environment. It is important that they are well maintained and run efficiently. Plant availability measures the percentage of time the plant is available for use. A high level of availability typically shows that the plant is well maintained and run. There is an economic trade-off between achieving high levels of availability and the cost to do this. Excessive expenditure will be uneconomic. Conversely, a high forced outage rate, showing the amount of time our power stations are required to close for unplanned maintenance, to indicate poor maintenance. In FY2012 the company improved and standardised it's reporting of availability and forced outages across the generation fleet. The company uses a simplified version of the GADS (Generating Availability System) outage coding as prescribed by NERC (North American Reliability Corporation). This change will mean the availability and forced outage statistics before FY2012 will not be directly comparable to those from FY2012 onwards.

**Enviro-Mark status**
As a company that relies on natural resources for a large part of its business, we take our responsibilities to the environment seriously. We apply Enviro-Mark across our whole business as an overall indicator of environmental performance. Enviro-Mark is an environmental management system aimed at achieving health, safety, and environmental legal compliance, reducing environmental risk, increasing resource use efficiency (i.e. water, energy, and raw material) and improving status with stakeholders by demonstrating environmental commitment.

**Lost time accidents**
The health and safety of our employees and on site contractors is a key objective of the company. Lost time accidents, measured per 100,000 hours worked, is the most important of a number of measures used to monitor the effectiveness of our health and safety management programme.

**Accounting Return on Equity; Return on Equity Employed; Return on Total Capital Employed**
Overall financial performance for shareholders can be measured by the return they receive on equity. The usual measure for this is accounting return on equity. This measure is no longer being reported as it is significantly distorted by unrealised or non cash variables being asset revaluations and IFRS fair value movements of derivatives. Two measures that are more closely tied to the actual economic performance of the company are return on total capital employed and return on equity employed.

We measure return on total capital employed as adjusted EBITDAF/ Capital employed (Adjusted EBITDAF = EBITDAF less income tax paid in the period, adjusted for the tax shield on interest. Total Capital Employed = the average of the opening and closing Total Assets less revaluations, capitalised interest, trade payables and accruals plus accumulated depreciation). We measure return on equity employed as EBITDAF less income tax paid in the period less interest paid/ Equity Employed (Equity Employed = Capital employed as defined above, less average debt).

Because we are required to revalue our assets from time to time, we have decided to also include a measure of return on total capital employed for comparative purposes. This provides a measure broadly consistent with the company's post tax weighted average cost of capital (WACC). A subcomponent of the company's WACC is the cost of equity. Return on equity employed is a measure broadly consistent with the company's post tax cost of equity.

**Total Equity to total assets**
This shows the level at which the company's assets are funded by shareholders' equity rather than external debt. While a certain amount of debt is appropriate for any business, too high a level of debt creates risk around ability to service that debt.

**Total Shareholder Return**
This return measures the performance from an investor perspective by calculating the movement in the commercial value of the organisation plus dividends paid to reflect investment growth.

**Free funds from operations to net interest expense**
This is a measure of the amount of cash the business has available to cover its debt servicing costs. Too low a ratio of funds to interest expense could have implications for credit worthiness, which in turn can affect availability and cost of funds. FFO stands for Funds from Operations. Free funds from operations to net interest expense is calculated as cash flow from operations less any changes in working capital plus cash interest paid, all divided by interest expense reported plus capitalised interest.

**Free funds from operations to average debt**
This is a measure of the amount of cash the business has available to cover its debt. Too low a percentage could have implications for credit worthiness, which in turn can affect availability and cost of funds. Free funds from operations to average debt is calculated as cash flow from operations less any changes in working capital, all divided by average debt.

# Performance Targets 2009-2011

The table below details performance targets set by the company over the period FY2009- FY2011.

| | Year ended 30 June 2009 | | | Year ended 30 June 2010 | | | | Year ended 30 June 2011 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **2009 target as at 1/7/07** | **2009 target as at 1/7/08** | **2009 actual as at 30/6/09** | **2010 target as at 1/7/07** | **2010 target as at 1/7/08** | **2010 target as at 1/7/09** | **2010 actual as at 30/06/10** | **2011 target as at 1/7/08** | **2011 target as at 1/7/09** | **2011 target as at 1/7/10** |
| Return on Average Shareholders' Equity (%) | 6.2 | 5.7 | 6.5 | 6.8 | 5.9 | | | 6.4 | | |
| Total Equity/Total Assets (%) | 55.9 | 56.6 | 59.7 | 52.2 | 55.6 | 54.3 | 54.9 | 55.7 | 52.7 | 53.1 |
| Net Debt/Net Debt Plus Equity (%) | 28.4 | | | 34.9 | | | | | | |
| Free Funds from Operations/Interest Expense (x) | 7.0 | 5.5 | 6.7 | 5.5 | 4.8 | 4.1 | 5.1 | 4.8 | 4.2 | 4.2 |
| Lost time accidents per 100,000 hours worked | <1.25 | <1.0 | 0.32 | <1.25 | <1.0 | <0.4 | 0.47 | <1.0 | <0.4 | <0.4 |
| Compliance orders by regulatory authorities * | None | None | None | None | None | None | None | None | None | None |
| Plant Availability (%) | 93 | 94 | 92.6 | 93.0 | 94.0 | 91.5 | 87.5 | 94 | 91.6 | 91.0 |
| Forced Outage (%) | <1.9 | <1.7 | 1.3 | <1.9 | <1.7 | <1.5 | 2.2 | <1.7 | <1.5 | <1.7 |
| Customer Switching to Industry Standards (%) | 100 | | | 100 | | | | | | |
| Calls to call centres (calls/customer/year) | <2.5 | | | <2.5 | | | | | | |
| Maintain Enviro-Mark Diamond status | | Yes | Yes | | Yes | Yes | Yes | Yes | Yes | Yes |
| Report Greenhouse Gas emissions in accordance with international standards | | Yes | Yes | | Yes | | Yes | Yes | | |
| Percentage of customers rating Mercury Energy at least 8/10 for customer satisfaction | | 60 | 50 | | 60 | | | 60 | | |
| Comply fully with Electricity Commission Guidelines for medically dependent and vulnerable customers | | Yes | Yes | | Yes | Yes | Yes | Yes | Yes | Yes |
| Retain a ranking in upper quartile in Consumer New Zealand survey | | Yes | Yes | | Yes | | | Yes | | |
| Retain a ranking in the top two of the five major energy retailers in the Consumer New Zealand survey of electrical suppliers' performance | | | | | | Yes | Yes | | Yes | Yes |
| Return on Equity Employed (%) | | | | | | 9.6 | 9.7 | | 13.1 | 12.5 |
| Return on Total Capital Employed (%) | | | | | | 8.5 | 8.2 | | 10.4 | 10.2 |
| EBITDAF/GWh ($) | | | | | | 58,700 | 59,826 | | 65,900 | |
| Retail Market Share (%) | | | | | | 19.5 | 21.0 | | 20.2 | 21.0 |
| Level of customer dissatisfaction lower than industry average | | | | | | Yes | Yes | | Yes | Yes |
| Free Funds from Operations/Average Debt | | | | | | | | | | 23.7 |

* In the FY2009 Statements of Corporate Intent this target was worded as no enforcement by regulatory authorities arising from breaches





# Shareholder Financial Metrics 2012-2014

| | FY2012 | FY2013 | FY2014 |
|---|---|---|---|
| **Shareholder Returns** | | | |
| Total Shareholder Return | 10.1% | 10.1% | 10.1% |
| Dividend Yield | 3.2% | 3.4% | 3.2% |
| Dividend Payout (%) | 97.7% | 93.2% | 59.8% |
| Return on Equity^ | 4.9% | 6.5% | 6.4% |
| IFRS Adjusted Return on Equity | 16.2% | 20.9% | 20.4% |
| **Profitability/Efficiency** | | | |
| Return on Capital Employed* | 7.0% | 7.6% | 8.6% |
| Operating Margin | 34.2% | 37.1% | 39.9% |
| Generator Efficiency $/MWh | 68.2 | 76.9 | 80.4 |
| **Leverage/Solvency** | | | |
| Gearing Ratio (net) | 31.9 | 31.5 | 30.1 |
| Interest Cover | 4.6 | 4.9 | 5.4 |
| Solvency | 1.2 | 1.1 | 1.1 |

A detailed description of these financial metrics can be found on the Crown Ownership Monitoring Unit Website http://www.comu.govt.nz/resources/pdfs/fpm-soes.pdf

^ These forecasts do not assume any future asset revaluations. Any future asset revaluation will affect the level of these ratios.

* The Shareholder definition of return on capital employed is different to the return on capital employed performance metric used by Mighty River Power as shown in Section 4. The key difference being the Mighty River Power return on employed capital seeks to calculate a return based on cash invested in the company since inception. The shareholder metric is based on a return calculation using pre-tax earnings (EBIT) and a definition of capital which includes historical accounting revaluations. The difference in measurement between these two capital measures causes a significant variance between the two return metrics.

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