21 December 2022

Jan Dawson
Chair
Ports of Auckland Limited

By email

Tēnā koe Jan

Letter of Expectation for Ports of Auckland Limited 2023-2026 Statement of Corporate Intent

This letter of expectation sets out Auckland Council's priorities and expectations, as shareholder, to inform the finalisation of the Ports of Auckland Limited (**POAL**) draft Statement of Corporate Intent (**SCI**) for 2023-2026.

Council's expectations build on the workshop of the Governing Body held on 30 November 2022 and discussions with you as POAL's Board Chair and with Chief Executive Roger Gray.

The content of this letter was approved by the Governing Body on 15 December 2022, with delegation to myself and the Deputy Mayor to finalise and issue this letter of expectation.

Deadlines and process for adoption of POAL's Statement of Corporate Intent 2023-2026

Under the Port Companies Act 1988 a port must produce a draft SCI by 1 August each year for that financial year and at least the coming two years, the shareholder may comment on this by 1 September, and the port must deliver the final SCI by 1 October.

This year, Council wishes to do better than that. POAL should provide Council with a draft SCI for 2023-2026 by **1 April 2023** so that Council may consider its shareholder feedback at the CCO Direction and Oversight Committee meeting of 13 April 2023 or 11 May 2023.

Council will comment on the draft SCI to POAL by 31 May 2023 and expects the SCI to be adopted by 30 June 2023.

Key expectations of POAL

In summary, Council's key expectations of POAL are:

1. Continue to actively focus on improvement in worker health, safety and wellbeing.
2. Improve financial performance against specified financial measures.
3. Deliver free cash flows and dividends to Auckland Council as shareholder
4. Support Council-led process to provide certainty on future of Port land, including a plan to return waterfront land to people of Auckland.
5. Move container freight to rail.

1. Focus on improvement in worker health, safety and wellbeing

The new board and management team have reported excellent progress in implementing the CHASNZ recommendations and POAL's new Safety and Wellbeing Strategic Plan. This reported progress is strongly valued and appreciated by the Governing Body of Auckland Council as shareholder and by the Maritime Union of New Zealand, as the key representative of your workforce.

The Council requires POAL to continue to actively focus on improvement in worker health, safety and wellbeing. The target of zero fatalities and serious work-related illnesses or injuries should remain the key health, safety and wellbeing target. Council requests that POAL consult with Council's CCO Governance and External Partnerships and Health, Safety and Wellbeing staff to review the existing targets and consider additional targets for inclusion in the draft SCI.

2. Improve financial performance against specified financial measures

Recently, POAL has delivered a deteriorating financial performance with poor public shareholder returns. I acknowledge the work underway to turn this around.

Particularly since 2014, POAL has exhibited a reduced earnings profile and loss of profitability.

POAL's operating margins (profit) have declined and are now at the bottom end of the New Zealand port sector. POAL's debt leverage (its debt relative to earnings) is the highest in the New Zealand port sector – an unenviably indebted position driven by declining earnings and arguable capital over-spend on the failed automation project and construction of the muti-storey car handling building on Bledisloe Wharf.

POAL's shareholder returns to Council are also weak – POAL's return on equity and return on assets is at the bottom end of the New Zealand port sector. Dividends paid to the Council in recent years have been much lower than historic levels.

By international measures POAL is also seriously underperforming. The World Bank Container Port Performance index (**CPPI**) is an index that reflects a port's productivity and congestion. In 2021 the CPPI index included analysis of 370 ports around the world. Of 18 ports in Oceania, POAL achieved the lowest CPPI ranking at 351 overall.[1] That is, POAL is the least efficient container port in Oceania.

POAL must improve its financial performance and hold itself accountable to the people of Auckland for this performance.

Council expects POAL's <u>SCI 2023-2026 to include a focus on improving its Return on Assets</u>.

- **Return on Assets** (**ROA**) (EBIT / total assets as %)
  - This financial ratio that indicates how much profit a port earns given its total assets. A higher ROA means the port is more efficient and productive in using its assets to earn profits, while a lower ROA indicates there is room for improvement.
  - POAL's ROA performance over recent years has been declining, and it is now around 3%, in the bottom quarter of NZ and Australian ports.
  - Council intends to use ROA to measure what POAL is earning for Aucklanders from the assets it controls, including valuable waterfront space. ROA is a more important measure to council than the Return on Equity.
  - Given the particular importance of measuring the return on the use of Auckland's waterfront space, POAL's SCI must clearly identify the value of the waterfront land and coastal consents / permits it holds (with maps), and the method used to value it. Any changes to valuation or method of valuation should be clearly identified.

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[1] Source: https://thedocs.worldbank.org/en/doc/66e3aa5c3be4647addd01845ce353992-0190062022/original/Container-Port-Performance-Index-2021.pdf

- Council expects POAL to plan to deliver a ROA of at least 10% in the short term.
- In meeting this requirement, council expect POAL to continue to review all assets and investments, with a focus on reducing debt and improving ROA. One way to improve ROA is to reduce the amount of assets on POAL balance sheet while maintaining returns.

In addition, Council expects POAL's SCI 2023-2026 to include the following performance measures

- **Sales Growth** (year on year sales increase %)
  - This metric measures the increase/decrease in the port's revenue from sales in one year compared to the prior year. It indicates how the port's sales are increasing over time and whether it is gaining or losing market share to competitors.
  - POAL's sales growth was 17% last year, which was good.
  - Council expects that POAL plan to consistently maintain 10% sales growth year on year.

- **Operating Margins** (EBIT / sales as %):
  - Operating margin measures how much profit the port makes on a dollar of sales after paying for costs of production (such as wages, raw materials) and making an allowance for asset depreciation but before paying interest or tax. This shows the profitability of the port operations, as distinct from financing decisions and tax planning. It is calculated by dividing the port's operating income by its net sales. Higher ratios generally indicate that the port is efficient in its operations and good at turning sales into profits.
  - Prior to 2019 POAL's operating margin was 33-38%. It is now approximately 19%, just over half. By contrast, the Port of Tauranga sits consistently above 40%.
  - Council expects that in its next SCI POAL plan to achieve an over 40% operating margin.

- **Leverage** (Net Debt/EBITDA)
  - Leverage is a ratio measuring the amount of port income generated and available to pay down debt before covering interest, taxes, depreciation, and amortization expenses. It measures the port's ability to pay off its incurred debt. A high ratio could indicate the port has a too-heavy debt load.
  - The Council wishes to measure POAL's leverage and considers that POAL needs to reduce debt. POAL's leverage in 2015 was around 2x, increased to 5x-7x during the pandemic, and is now at 5x.
  - POAL should not be borrowing for major capex projects without consultation with Council and being signalled in an SCI.
  - Council expects that in its next SCI POAL plan to achieve a leverage ratio of 2x-3x .

- **Free Cash Flow to Sales** ((EBITDA less capex)/sales %)
  - Free cash flow represents the cash that the port generates after cash outflows to support operations and maintain capital assets. Unlike earnings or net income, free cash flow is a measure of profitability that excludes non-cash expenses and includes spending on equipment and assets, as well as changes in working capital. Free cash flow is available to reinvest in the business, make acquisitions, pay down debt or pay dividends. Interest payments are excluded from the definition of free cash flow.
  - POAL's free cash flow prior to 2017 was approximately 13%. It dramatically plunged in 2018-2020 into negative. It is now approximately 20%. Council expects it to improve further.
  - Council expects that in its next SCI POAL plan to achieve free cash flow of 30%.

These new key performance targets benchmarks are to be reported against in POAL's SCI 2023-2026, its quarterly shareholder reports, POAL's 2022/23 and subsequent Annual Reports, in POAL's reporting to the Governing Body generally, and in POAL's ongoing public relations activity.

Council expects POAL to achieve improved financial performance through increased productivity and sales revenue. POAL should look closely at its charges, including the possibility of increasing charges for container handling, wheeled vehicles, breakbulk volumes, cruise ship visits along with more efficient port service to justify those charges. POAL has no mandate to continue a situation where Auckland ratepayers are subsidising importers.

3. Deliver free cash flows and dividends to Auckland Council as shareholder

POAL's contribution to Council's budgetary position must be to immediately improve dividends paid to the Council as its shareholder. As illustrated above, the Council believes that POAL's profitability and dividends have been inadequate, a view that is shared by the POAL's board and senior management. In addition, POAL's activity ignores the true opportunity cost of waterfront land being locked into port operations. As a result, and as acknowledged by your chief executive, Auckland ratepayers have always and continue to subsidise importers.

Council expects this to change and POAL to increase its dividends to the Council from its commercial operations. Dividends are to be funded out of surplus cash achieved through higher profitability and not by increasing borrowings. POAL has promised a $30m dividend in 2023/24. Council expects that POAL's increased profitability will mean it delivers more than that.

In Council's view, it is well within POAL's means to deliver improved profitability and free cash flows with significant productivity and revenue enhancements.

4. Support Council-led process to provide certainty on future of Port land, including a plan to return waterfront land to people of Auckland

The Mayor and council will lead the development of a plan for a phased consolidation of port operations and the return of waterfront land for the use of all Aucklanders. The plan is to be complete by December 2023 and the consolidation should occur in phases over the period 2024 – 2039.

The plan must improve Aucklanders' access to the waterfront, while preserving port activities in Auckland. Improving the safety, operational performance and return on the assets utilised by Ports of Auckland Limited will be principles in the plan.

The plan is necessary to provide certainty to the port, workers, businesses, the Government and Aucklanders. It is a key part of delivering an integrated transport plan for Auckland and will inform Government decision-making on the New Zealand freight and supply chain strategy.

POAL are to cooperate and collaborate on the development of that plan as part of a council-led team. This includes providing council with information about how it will deliver the plan, and information on any contractual obligations that need to be considered and managed.

POAL is not to take actions that could undermine council's plan or the development of it. This includes not publicly campaigning against council directly or indirectly through funding of external organisations. POAL should report in its draft SCI on its planned external memberships and any spending on any organisations involved in public relations, lobbying or campaigns.

As Mayor I would like to see prime waterfront land returned to Aucklanders on an ambitious timescale, which is something I campaigned on.

5. Move container freight to rail

The council expects POAL to work with Council and KiwiRail to move 100% of container freight to rail solution as soon as possible, to reduce Auckland’s congestion and greenhouse-gas emissions.

Council looks forward to receiving a draft of the POAL Statement of Corporate Intent no later than 1 April 2022.

Staff are available to expand aspects of this letter if required. Please contact Alastair Cameron Manager CCO Governance and External Partnerships to discuss.

Ngā mihi

Wayne Brown
MAYOR OF AUCKLAND

Copy to:

Desley Simpson	Deputy Mayor
Councillor Wayne Walker	Chair CCO Direction and Oversight Committee
Councillor Shane Henderson	Deputy Chair CCO Direction and Oversight Committee
Councillor Chris Darby	Ports of Auckland Limited Lead Councillor
Roger Gray	Chief Executive, Ports of Auckland Limited
Alastair Cameron	Manager CCO Governance and Oversight