27 October 2023

# Contact Energy Limited (CEN)

The company will hold its Annual Shareholders Meeting at **9.30am Wednesday 15 November 2023.**

The location is **The Grand Space Rydges Wellington 75 Featherston Street Wellington.**

You can also join the meeting online at this link.

***Company Overview***

The company is the second largest energy supplier in the country delivering 19% of the country's electricity generation. It also offers broadband services. It operates 5 geothermal, 2 hydro and 3 thermal power stations producing 7.6TWh of energy, 93% renewable. The company has 1,242 employees and 589,000 customers.

Vic Crone, who has served on the Board since 2015, will retire at the ASM.

***Current Strategy***

The Contact26 strategy was developed in the second half of FY21 and sets out the company's plan of action for the five years until 2026. There are four key themes at its core: Growing Demand, Grow renewable development, Decarbonise the portfolio and Creating an outstanding customer experience.

| | | | | |
|---|---|---|---|---|
| Strategic theme | Grow demand | Grow renewable development | Decarbonise our portfolio | Create outstanding customer experiences |
| Objective | Attract new industrial demand with globally competitive renewables | Build renewable generation and flexibility on the back of new demand | Lead an orderly transition to renewables | Create New Zealand's leading sustainable energy brand that will support renewable development ambitions |

Their latest Annual Report is structured around the Contact26 strategic themes and enablers. It also uses the Global Reporting Initiative (GRI) standards and the International Integrated Reporting Council Framework to report on material environmental, social and governance activities, and to provide a balanced view of performance.

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***Key***

The following sections calculate an objective rating against criteria contained within NZSA policies.

| Colour | Meaning |
|---|---|
| G | Strong adherence to NZSA policies |
| A | Part adherence or a lack of disclosure as to adherence with NZSA policies |
| R | A clear gap in expectations compared with NZSA policies |
| n/a | Not applicable for the company |

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***Governance***

NZSA assessment against its key policy criteria is summarised below:

| Policy Theme | Assessment | Notes |
|---|---|---|
| Directors Fees | A | See below. |
| Director share ownership | G | See below. |
| Executive Remuneration | A | See below. |
| Golden parachutes/handshakes | A | See below. |
| Director Independence | G | All Directors are independent |
| Board Composition | A | See below. |
| Director Tenure | G | See below. |
| ASM Format | G | Hybrid meeting. |
| Independent Advice for the Board and Risk Management | G | See below. |

*Directors Fees:* NZSA notes there is no disclosure as to whether other benefits are available for Directors, such as share options or retirement benefits, and the conditions under which they are paid.

The table of payments in the Annual Report includes $3,000 described as *"Ad hoc committee fee related to major projects"*. We note that the Constitution allows payment of special remuneration *"if it is fair to the company*", a clause which may be open to significant interpretation. NZSA prefers a 'tighter' wording that better defines when ad-hoc fees can be paid.

*Director Share Ownership:* The Board Charter encourages Directors to accumulate 20,000 shares over their first three years. We appreciate the change made to the Charter over the past year to remove the 'compulsion' element to director share ownership.

*Executive Remuneration:* The CEO is paid a base salary, a short-term incentive (STI) and a long-term incentive (LTI).

NZSA encourages fulsome disclosure in relation to any incentive payments made to the CEO, including disclosure of measures (or measure 'groups'), weightings, targets, and the level of achievement versus target for each component associated with any awards.

Contact provides thorough disclosure for both STI and LTI awards, according to the NZSA preferred methodology described above – excepting that the level of achievement vs each measure group is not disclosed.

The STI potential is 50% of the base salary in cash and 30% of the base in share options. The LTI potential is 35% of the base. Therefore, the potential STI is 74% of total incentives. NZSA prefers a weighting towards LTI to ensure alignment with the long-term interests of shareholders.

We note that overall, a potential 56% of the total maximum incentive opportunity can be paid by way of performance or deferred share rights. Contact is clear about the dilutionary impact of options in its financial statements.

We appreciate the disclosure of the ratio of CEO remuneration to that of the median employee (24:1) as well as pay-equity disclosures.

*Golden parachutes/handshakes:* In the interests of transparency, NZSA believes there should be explicit disclosure around the severance terms associated with the CEO, including whether specific termination payments are offered in addition to whether any sign-on, retention or payments for loss of benefits from a previous employer are offered.

*Board Composition:* The company provides a 'collective' skills matrix in the Annual Report, although does not break this down to attribute the skill sets of individual Directors to provide assurance for shareholders. In mitigation, we note that the Board skills were independently reviewed by Korn Ferry during 2021, a best-in-class practice for an NZX company.

The company does not participate in the IoD's "Future Director" programme (or similar) to develop and mentor the next generation of Directors. NZSA expect NZX50 companies to participate as part of a responsibility to develop and mentor the next generation of Directors.

The nature of the company's board indicates a commitment to thought, experiential and social diversity, with relevant experience for Contact. We note the wording in section 6 of their Board Charter that places a minimum threshold for male and female directors.

*Director Tenure:* NZSA looks for evidence of ongoing succession or 'staggered' appointment dates that reduce the risks associated with effective knowledge transfer in the event of succession. We also prefer a term maximum of 9-12 years, unless there are exceptional circumstances that may apply.

Directors' appointment dates range from 2015 to 2021.

*Independent Advice for the Board & Risk Management:* NZSA looks for evidence, through disclosures, that a Board has access to appropriate internal and external expertise to support board assurance activities. We also look for evidence that Boards are across their risk management responsibilities.

The Board Charter states that Directors are entitled to seek independent external advice at Contact's expense, with the prior approval of the Chair. Board members are also able to access internal staff as required. The Board Charter also notes that the General Counsel / Company Secretary has unfettered access to the Board.

Contact offers comprehensive disclosure of the key strategic, climate-related business and financial risks that impact the business, and their mitigations. There is also good disclosure of risk management and governance processes.

***Audit***

NZSA assessment against its key policy criteria is summarised below:

| Policy Theme | Assessment | Notes |
|---|---|---|
| Audit independence | G | Good disclosure. |
| Audit rotation | G | See below. |

*Audit Rotation:* the company ensures the Lead Audit Partner is rotated at 5 years as required by the NZX Listing Rules. In August 2022, the company announced EY had been appointed external auditor to replace KPMG who had been the external auditor since 2005.

The company also announced its rotation policy would be 15 years. While NZSA policy is that rotation should be 10 years, we accept the limitations caused by the lack of Audit Firms and suitably qualified Auditors and appreciate Contact's approach as one of the few on the NZX to offer a specific rotation policy in relation to audit firm tenure.

***Environmental Sustainability***

NZSA assessment against its key policy criteria is summarised below:

| Policy Theme | Assessment |
|---|---|
| Approach | G |
| Sustainability Governance | G |
| Strategy and Impacts | G |
| Risk and Opportunity | A |
| Metrics and Targets | G |
| Assurance | A |

*Overall approach:* Contact Energy have been preparing their Annual Reports within the <IR> Integrated Reporting Framework since 2020 and providing sustainability disclosures since 2015. They note their ESG framework enabled them and others to assess their business practices and performance on sustainability and ethical issues.

As a result, Contact Energy achieved the second-highest ranking of any NZ company in the Dow Jones Sustainability™ Asia Pacific Index and was graded "A" in the inaugural Forsyth Barr Carbon & ESG Ratings for New Zealand companies.

*Sustainability Governance:* Contact Energy disclose a director skills matrix that show the number of directors with primary or secondary expertise in 10 skill areas, including capital markets, investment, community and ESG. Environmental sustainability matters are the responsibility of the Health, Safety and Environment Committee while climate-related issues are the responsibility of the Safety and Sustainability Committee.

*Strategy and Impact:* Contact Energy's sustainability future is embedded within its strategy, noting that "*leading decarbonisation means cutting greenhouse gas (GHG) emissions from our own operations and helping our customers to cut theirs*". They also disclose a clear understanding of the financial implications of climate-related risk on their business as a result of having undertaken detailed analysis in FY22 and describe the social and environmental impacts they have in New Zealand.

*Risk and Opportunity:* Contact Energy provides good disclosure of their climate-related and other external risks and opportunities over the short to long term. However, NZSA would appreciate the same level of detail around their mitigation strategies.

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*Metrics and Targets:* In their separate Greenhouse gas (GHG) Inventory report, Contact disclose their Scope 1 to 3 emissions with comparative data from the previous FY and baseline year (2018), against which they appear to be making steady progress towards reducing. They also disclose a number of environmental targets as well as targets in the areas of Social and Governance performance.

*Assurance:* In their Auditor's Report, EY disclose having provided limited assurance for specific elements of Contact Energy's Global Reporting Initiative (GRI) disclosures and unless otherwise stated, does not provide any assurance on other information not referred to. We would look for a review of all sustainability claims made within Contact's reporting.

***Ethical and Social***

NZSA assessment against its key policy criteria is summarised below:

| **Policy Theme** | **Assessment** | **Notes** |
|---|---|---|
| Whistleblowing | G | Good disclosure. |
| Political donations | A | Not disclosed if donations were made. |

*Political donations*: NZSA expects clarity on the status of political donations, even where none have been made.

***Financial & Performance***

| **Policy Theme** | **Assessment** | **Notes** |
|---|---|---|
| Capital Management | G | There was no capital raising. Good disclosure around dividend policy and rationale. |
| Takeover or Scheme | n/a | *n/a if no takeover* |

Contact Energy's share price rose from $7.37 to $8.13 (as of 4th October 2023) over the last 12 months – a 10% increase. This compares favourably with the NZX 50 which rose by 1% in the same period. The capitalisation of CEN is $6.4b placing it 8th out of 128 companies on the NZX by size and makes it a large company.

| **Metric** | **2020** | **2021** | **2022** | **2023** | **Change** |
|---|---|---|---|---|---|
| Revenue | $2,073m | $2,573m | $2,387m | $2,118 | -11% |
| EBITDA | $446m | $553m | $537m | $505m | -13% |
| NPAT | $125m | $187m | $182m | $127m | -30% |
| EPS[1] | $0.174 | $0.241 | $0.233 | $0.162 | -31% |
| PE Ratio | 38 | 34 | 31 | 50 | |
| Capitalisation | $4.8b | $6.3b | $5.6b | 6.4b | 11% |
| Current Ratio | 0.66 | 0.89 | 0.73 | 0.76 | 4% |
| Debt Equity | 0.87 | 0.72 | 0.82 | 1.07 | 31% |

| | | | | | |
|---|---|---|---|---|---|
| Operating CF | $341m | $432m | $400m | $395m | -1% |
| Operating CF (cps) | $0.47 | $0.56 | $0.51 | $0.50 | -2% |
| NTA Per Share[1] | $3.08 | $3.18 | $3.07 | $3.00 | -2% |
| Dividend Per Share[1] | $0.39 | $0.35 | $0.35 | $0.35 | n/c |

[1] *per share figures based off actual shares at balance date (not weighted average)*

Most metrics continued to decline for CEN during FY23, now forming a trend since 2021, however the share price increased and outperformed the market index. Share prices are forward-looking, with investors clearly adopting a positive view of CEN's future cashflows.

*Revenues* were down 11% to $2,118m but still slightly ahead of 2020's $2,073m. *EBITDA* was down 13% to $505m and likewise *NPAT* was down 30% to $127m (although we note this was impacted adversely by a negative change in fair value of financial instruments of $63m). This places CEN on a high *PE* of 50, but this is in line with the sector where share prices rely more on net cashflows than EPS to support distribution to shareholders.

*Operating cashflows* are a more useful financial metric for a company such as CEN, and these decreased by 1% on the prior year coming in at $395m. Measured in cents per share this equates to $0.50. These robust operating cash flows enabled CEN to maintain a *dividend* of $0.35. As the dividend is higher than EPS (and thus tax paid), dividends are only partially imputed.

CEN operates a financially sound balance sheet and low levels of debt, with *debt equity* a low 1.07. We note that the company took on an additional $360m of debt after taking on an additional $119m in 2022. Debt is a mix of bank facilities and bonds.

On pages 26-27 of an investor presentation released to market released on 14th August 2023, CEN provide some forward guidance for FY24 on a variety of financial metrics, however do not provide a NPAT range. They expect EBITDAF to be $600m (FY23 $550m)

The company is widely held by a variety of institutions and individuals.

***Resolutions***

**1. To re-elect Rob McDonald as an Independent Director.**

Rob McDonald was appointed to the Board 12 November 2015 and is the Chair. He is a Director of Fletcher Building Limited, Chartered Accountants Australia and New Zealand and was formerly the Chief Financial Officer with Air New Zealand. He is a former board member of the Institute of Finance Professionals New Zealand Inc., and AIA Limited, and the former vice chairman of the IATA Financial Committee.

We will vote undirected proxies **In FAVOUR** of this resolution.

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**2. To re-elect Rukumoana Schaafhausen as an Independent Director**

Rukumoana Schaafhausen was appointed to the Board 1 March 2021. She was recently the Chair of Waikato-Tainui and is currently serving across a number of Iwi, community, private and public organisations in governance roles including Water Governance Board, AgResearch, Miro Berries, Tindall Foundation, and The Princes Trust. Previously, she was a Director at Genesis Energy and has received the Sir Peter Blake Award and the US embassy Wahine Toa Award for Leadership.

We will vote undirected proxies **In FAVOUR** of this resolution.

**3. To re-elect David Smol as an Independent Director.**

David Smol was appointed to the Board 1 October 2018. He was part of the Contact Energy establishment team in 1995–1996 and a member of the team that developed the rules for the New Zealand electricity market. In 2008 David was appointed as chief executive of Ministry of Economic Development and, from 2012–2017 was the inaugural chief executive of the Ministry of Business, Innovation and Employment (MBIE), following the merger of four government departments. David is currently Chair of GNS Science and a board member of The Co-operative Bank Limited and Waka Kotahi.

We will vote undirected proxies **In FAVOUR** of this resolution.

**4. That the Board is authorised to fix the auditor's remuneration for the coming year.**

This is an administrative resolution.

We will vote undirected proxies **IN FAVOUR** of this resolution.

***Proxies***

**You can vote online or appoint a proxy at** [https://vote.linkmarketservices.com/CEN/](https://vote.linkmarketservices.com/CEN/)

Instructions are on the Proxy/voting paper sent to you.

Voting and proxy appointments close **9.30am Monday 13 November 2023.**

**Please note you can appoint the Association as your proxy. We will have a representative attending the meeting.**

**The Team at NZSA**