Board Paper

November 2017

To: Line Trust South Canterbury

From: Board of Directors, Alpine Energy Ltd

Subject: Line Trust South Canterbury Ownership Review 2017

Recommendation

The Directors of Alpine Energy Ltd recommend Line Trust South Canterbury retain its current 40% shareholding in Alpine Energy Limited.

Introduction

In a letter dated 26 June 2017 to Alpine Energy Limited (AEL) Line Trust South Canterbury (LTSC) Trustees initiated a review of LTSC's continued ownership of shares in AEL. This review was initiated under LTSC's Deed of Trust clause 4.1 which in summary requires the Directors of AEL to report to LTSC in a manner prescribed by the Deed of Trust. A summary of the requirements is appended to this report (appendix 1).

1.1 Industry Overview

The electricity industry is essentially made up of five sectors being:

1.	Generation	:	Production of electricity in power generating schemes
2.	Transmission	:	Long distance transport of electricity on the National Grid
3.	Distribution	:	Local transport by regional Line businesses
4.	Retailing	:	Regional billing and customer services
5.	Regulation	:	Watchdog(s) for Price, Quality, and Market Compliance

AEL is in the distribution sector.

1.2 Alpine Energy Ltd and its Shareholders

AEL is the regional electricity distribution business for South Canterbury covering the traditional area except for the Hakataramea which is supplied by Network Waitaki through Kurow, and the upper Rangitata which is supplied by Electricity Ashburton through Mayfield.

AEL has four shareholders being:

- Line Trust South Canterbury 40.0%
- Timaru District Holdings Ltd 47.5%

- Waimate District Council 7.54%
- Mackenzie District Council 4.96%

The initial Trust, established in 1993 to hold shares on behalf of all consumers on the network, was resettled in 2002 to provide perpetuity period of eighty years from 19 July 1993.

Performance Analysis

There are three key measures of performance for an electricity lines business; being reliability of services, price of services, and regulatory profit.

2.1 Reliability

The Regulator[1] has devised several reliability measures, some related to length, type or voltage of lines, and others related to customer service. The need for any business to focus on customer service is paramount and the electricity regulator assesses reliability of AEL's overall performance to its customer through SAIDI, being the System Average Interruption Duration Index. This gives outages in terms of minutes per year.

We breached the quality standards in 2016 following extreme weather events in 2014 and 2016. The breach is not indicative of poor performance or a deteriorating network rather the impact that extreme weather events can have on electricity networks no matter how well built and maintained.

2.2 Price of Services

AEL has increased its lines charges by CPI +11% since 2013. The price increases are prescribed by the Commerce Commission under the default price-quality path (DPP), which encourages AEL to earn a normal return. AEL had in the prior years under recovered on its investment because the previous framework did not take account of the investment in the network. The DPP will be reset on 1 April 2020 price increases are likely to be flatter at CPI – 0%.

2.3 Profitability

The profitability of the AEL is assessed over two sets of accounts, namely:

1. Regulatory accounts and in particular return on investment, and
2. Statutory accounting – Group profit on shareholder funds

[1] The Regulator for New Zealand Electricity Lines Companies is the Commerce Commission

As previously mentioned AEL's regulatory return on investment ranks as one of the lowest against its peers. This is methodically being corrected through the regulator's default price path resets.

Group profitability remains solid and shareholder funds continue to accrue satisfactorily from one year to the next.

In addition AEL is undertaking strategic initiatives of increasing shareholder returns and value through its subsidiary and joint venture interests, namely:

- NETcon Ltd (100% wholly owned),
- Infratech Ltd (100% wholly owned subsidiary of NETcon),
- Rockgas Timaru (50/50 joint venture with Contact Energys subsidiary Rockgas Limited) and;
- On-Metering Ltd (50/50 joint venture with Network Tasman).

2.4 Conclusion

AEL consistently meets high standards of operational and financial performance; both regulatory and non-regulatory.

Continued Trust Ownership

3.1 Strategic Ownership Issues

AEL remains a strong business entity and puts the sustainable interests of the company and its shareholders ahead of specific agenda and sectional interests. South Canterbury has few companies with the financial strength and commitment to invest and therefore makes a real economic difference to the region as a whole.

AEL has chosen to retain ownership and management of the electricity infrastructure assets, and its subsidiary contracting company NETcon. NETcon operates as a separate, stand-alone company, at arm's length from its parent.

Being part of the Community is one of AEL's core values and through its ownership structure AEL is able to distribute proceeds from operations to the community through its shareholders.

3.2 Advantages of Continued Trust Ownership

LTSC is a single purpose organisation, directly elected by all consumers and representing no specific consumer segment. It is in a unique position to be focused on the Company, its sustainability and performance. While it is possible for a small vocal group to catch the Trustees attention, the Trustee responsibilities imposed by the Deed of Trust, and the 3 yearly election process for Trustees ensures they remain accountable to all consumers, and the needs of the community at large.

The Trustees therefore have a unique opportunity to develop a vision for the future of AEL that will benefit the whole South Canterbury region and ultimately the consumers. Should LTSC shareholding be distributed it would be more difficult for many individual shareholders to exert such influence over the District Council shareholders who are perhaps more focussed on a vision for their specific district and ratepayers.

LTSC as a single entity is therefore a strong and influential shareholder able to negotiate equally with the District Council shareholders.

The consequential advantage to the company of continued ownership is that 32,000+ beneficial interests in the LTSC are co-ordinated by the Trustees into a single strategic vision, rather than many thousands of shareholders having a diverse range of views.

An early share distribution would likely see widespread cashing up by consumers and dissipation of the community wealth accumulated by the Company and LTSC. This would be likely to result in Timaru District Holdings Limited having over 50% of the shares, and thus having control of the Company.

Also, should the 32,000+ consumers hold the shares, individual shareholders would have minimal influence on the operation of the Company.

The potential costs to the company should the 32,000+ consumers hold the shares, is significant. This would include the servicing of the shareholders with interim reports, dividends, the annual report, the election or appointment of the two directors LTSC presently appoints and the costs of the annual meeting and extraordinary meetings.

3.3 The Disadvantages of Continued Trust Ownership

There is a risk that the 3 yearly LTSC elections might focus on populist issues and circumvent the genuine legal and commercial responsibilities of the Company, as these are much too complex to be represented and comprehended in a public debate. This could create the opportunity for political capture of the legitimate commercial responsibilities of Trustees and the potential for conflict between Directors and Trustees.

Some would consider that rather than a common vision, there is a strong case for widespread shareholding and diversified views as this will bring a broader partnership between individual investors and collective bodies such as District Councils. Continuation of the Trust as a single holder of 40% of Alpine Energy's shares prevents this opportunity from arising.

Continued LTSC ownership deprives the individual beneficiaries of the LTSC of control and access to their assets. It assumes the individuals in the community cannot manage their personal affairs in a responsible manner.

3.4 Options Arising From This Review

After considering the content in this review paper, the Trustees will have a number of options. In particular these include:

- Commence a process of share sale or distribution involving consultation with the public.
- Continue to hold the shares and distribute the dividend proceeds each year.

LTSC in reaching its decision on the preferred option will need to consider the issues outlined above and in addition, a number of further issues including:

1. The ongoing change in the regulatory environment for line businesses makes sustainable decision making uncertain if the best interests of the consumers are to be preserved.
2. Local Government Reform is requiring Local Bodies such as District Councils to operate their commercial investments in an increasingly transparent manner. This places the wish of individual Councillors to meet social goals through the pricing of electricity line services in conflict with the corporate responsibility of Councils to avoid cross subsidies.
3. The possible amalgamation of Councils such as has occurred in Auckland.
4. The high level of misunderstanding in the wider community about the intent and form of regulatory reforms makes it difficult for consumers to make informed decisions on their personal options.
5. AEL, which under the requirements of the Energy Companies Act 1992 operates as a successful business, is well equipped and positioned to make informed commercial decisions on expansion and development investments, and brings to those decisions a financial ability to ensure they proceed.
6. While Timaru District Council no longer includes a target to increase its shareholding in AEL in its Annual Plan, a distribution of shares by LTSC would easily enable the Council to achieve control of the Company by purchasing freely traded shares.
7. Successive Local Government Reforms, and the spectrum of views on commercial development amongst elected members of the Council would tend to prevent AEL operating as a normal business with a normal commercial risk profile. Local Government demands tend to ensure elected Councillors operate in a risk averse environment.
8. Opportunities to add value to the business by reducing operating and management costs are better investigated and implemented by commercial directors who are able to consult fully with owner representatives who have a detailed knowledge of a very technical and complex industry.
9. If a distribution of LTSC shares occurs it is better to be done as a single event rather than a progressive trickle. This will ensure that any selling shareholders are able to maximise sale price and value through the creation of an active market for resale of shares.
10. The sale of shares as a block may realise a “control” premium which would be reflected in the subsequent cash distribution to shareholders.

11. The share distribution should, if it occurs, follow the following process:
    - Valuation of shares.
    - Identification of and notification to LTSC beneficiaries of their entitlement value.
    - LTSC beneficiaries elect to receive shares or cash.
    - LTSC beneficiaries and existing shareholders can elect to preferentially purchase more shares from the pool created by those electing the cash option.
    - Based on the size of the pool the shareholders should consider whether the company buys the remaining shares or offers them for sale to the market at large.

    This process gives preference to ongoing local share ownership in the medium term and ensures the company retains shareholder loyalty through strong performance.

11. The current LTSC dividend distribution policy reflects the level of line charges paid, and therefore the contribution of the various consumer groups to the profit and accumulated value of the company.

It needs to be noted however that the traditional political arguments for community ownership and control are not easily justified as it is considered there is appropriate protection against abuse of the natural monopoly. The traditional arguments that should not be accepted as relevant to the debate on LTSC ownership include:

1. That a share distribution will lead to foreign control and therefore irresponsible management of prices and reliability.
2. Collective ownership with zero profit targets solely in order to avoid taxation is a proper use of community assets.
3. Low prices through low profit will encourage economic development in the region. There is however, a widely held view that low prices generated by business efficiency and reasonable company profits are helpful in assisting economic growth.

4.0 Other Matters

4.1 No external professional advice has been obtained in respect of the preparation of this report.

4.2 AEL directors have given regard to the public consultation undertaken in 2001 that resulted in the resettlement of the South Canterbury Power Trust on Line Trust South Canterbury with a perpetuity period of eighty years from 1993.

4.3 AEL directors have given regard to potential impact of new technologies and currently view this as an opportunity as opposed to an immediate threat. AEL itself is identifying applications for the use of emerging technology and has also invested in Infratec to accelerate its understanding of emerging technologies along with future solutions.

4.4 AEL directors have given regard to the 2017 change in Government and the new Government's intention to undertake a review of the electricity sector. AEL will closely monitor the review and any proposed outcomes to ensure the business is 'best' placed regardless of what changes, if any, are implemented.

5.0 Recommendation

After considering the main outcomes of the above, being:

- AEL's strong performance and efficiency
- The desire of consumers to continue with LTSC ownership
- The vision of current Trustees that ensures AEL contributes to the growth of South Canterbury

AEL Directors have discussed the matter of Line Trust South Canterbury and its ongoing role.

The following recommendation represents the AEL Board's view:

That the Directors of AEL recommend that Line Trust South Canterbury continues with its current shareholding in AEL.

Directors
Alpine Energy Limited

Appendix 1

Line Trust South Canterbury Review Terms of Reference (extract from the Deed of Trust)

The Deed of Trust requires the Directors to prepare a report considering proposals and available options for the future ownership of the shares owned by the Trust.

The Deed of Trust gives the Trustees three (broad) options:

- retain the shares in the Trust; or
- dispose of a portion of the shares and retain the remainder of the Trust; or
- dispose of all of the shares

The report is to contain:

(a) an analysis of the performance of the Company to the date of the report, together with a discussion of the advantages and disadvantages of continued Trust ownership;

(b) if a distribution of shares is recommended, a draft Share Allocation Plan detailing:

- the manner in which and the Consumers to whom the shares (if any) and assets constituting the Trust Fund are to be distributed and such shares and assets may be distributed to a greater or lesser extent to some or all of the Consumers;

- the manner in which and the Consumers to whom the proceeds of the sale of shares (if any) received as a result of a disposal of shares are to be distributed and such proceeds may be distributed to a greater or lesser extent to some or all of the Consumers;

(c) a summary of the professional advice (if any) obtained in respect of the preparation of the report.

(d) a statement as to whether or not the directors have had regard to any views expressed by the public with respect to ownership.

The Trustees shall comment on the report to the Directors and upon completion of their review of the report, the Trustees shall make the report available to the public together with a summary of their comments. [‘available to the public’ means making the information available for inspection at any office of the Trust or any office of the Company or at any other place in the District on normal business hours on any business day, after giving 3 days notice of the place(s) and times in a newspaper].

The Trustees and the Directors shall in respect of the report and no later than 1 month after the date of the report, implement the Special Consultative Procedure set-out in Schedule 2 of the Deed of Trust.

Following completion of the Special Consultative Procedure and not later than 6 months after the report date, the Trustees and the Directors shall meet and, after taking due account of the view expressed by the public and the Directors, the Trustees shall decide whether to:

- retain the shares in the Trust; or
- dispose of a portion of the shares and retain the remainder of the Trust; or
- dispose of all of the shares

If the shares are to be retained by the Trust, the Trustees shall notify the public by making the information available for inspection at any office of the Trust or any office of the Company or at any other place in the District on normal business hours on any business day, after giving 3 days notice of the place(s) and times in a newspaper.

If the shares or any portion of them are to be distributed, the Trustees shall prepare a Share Allocation Plan in terms of Schedule 3 of the Deed of Trust.