

Waitomo Energy Services Customer Trust

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Trustee's Report on the Ownership Review of Waitomo Energy Services Customer Trust ("WESCT" & "Trust").

To our beneficiaries

WESCT has been operating now for 23 years. The Trustees are delighted to announce that ownership moved from 90% to 100% ownership of The Lines Company Limited (TLC) in January 2014. Being 100% owns means:-

- Maximisation of shareholder value
- Ability to increase returns to beneficial owners
- WESCT has full control

The beneficial owners of WESCT are the account holders located in the old Waitomo Electric Power Board area. The Trust is now entering into its fourth ownership review period, having previously undertaken reviews in 1996, 2002 and 2008. The outcome from the previous reviews has been an overwhelming desire to remain with the status quo, in trust ownership, by in excess of 90% of the customers' votes received.

Trust Deed

The Trust Deed requires the Trust to review its ownership structure every six years by investigating all realistic options and giving the beneficial owners the decision making power to direct the Trustees as to their preferred ownership of TLC. Under the terms of the Deed, customers are to vote separately on:-

- (a) the question of whether the shares currently held by the Trust should continue to be held by the Trust; and
- (b) if the shares are to be sold or distributed by the Trust, whether the shares (or the proceeds of their sale) should be distributed to customers, or to local authorities or to any particular customer nominated by the Trustees.

Further, under the terms of the Deed the Trustees are required to prepare and publish a report containing:-

- (a) an analysis of the performance of the Trust to the date of the report together with a discussion of the advantages and disadvantages of continued trust ownership of the shares.
- (b) a discussion of the advantages and disadvantages of a transfer of the shares to customers or to local authorities or a sale of the shares and a transfer of the proceeds to customers or to local authorities, and
- (c) any comments by the Directors of the TLC as to the most appropriate form of ownership of the shares.

History

The establishment of this Trust in 1993 result from corporatisation in 1993. At that time, by creating a Trust entity to own the shares in TLC, then named Waitomo Energy Services Limited, this eliminated the possibility of fragmented ownership that could have resulted had the shares been issued directly to customers. A Trust ownership structure has led to the benefit of customers by creating a monitoring control system to strive for maximisation of shareholder value, security of supply and quality service to customers within the district. If the shares had been distributed to customers, or allocated elsewhere, focus may have been lost in securing a successful mechanism of control for the benefit of the customers.

The **first** ownership review was undertaken in 1996 resulting in **96.5%** of customers wishing to **retain Trust ownership**.

At that time this Trust was the 100% shareholder/owner of Waitomo Energy Services **Limited** (now known as The Lines Company Limited)

WESCT ownership of TLC (formerly Waitomo Energy Services Limited) in 1996

Waitomo Energy Services Customer Trust

100% owned

Waitomo Energy Services Limited
(network area covers approx. 6,000 square kilometers)

WESCT ownership of TLC (formerly Waitomo Energy Services Limited) in 2002

Waitomo Energy Services Customer Trust

King Country Electric Power Trust

75% owned

25% owned

The Lines Company Limited
(Increase in network area now covering more than 13,000 square kilometers)

The **second** ownership review then followed six years later, in 2002 with **95.8%** of customers directing the Trust to **retain** the existing **Trust ownership** position. At that time, this Trust was a 75% shareholder in Waitomo Energy Services Limited with the remaining 25% being held by King Country Electric Consumer Trust (KCEPT).

The change in shareholding resulted from Government reforms in 1998. The Company changed its name from Waitomo Energy Services Limited to The Lines Company Limited (TLC)

The **third** ownership review in 2008 resulted in **92.5%** of customers requiring **retention of Trust ownership**.

At that time this Trust was a 90% shareholder of TLC with the remaining 10% being held by KCEPT.

The 90% ownership resulted from this Trust selling its shareholding in King Country Energy Limited and purchasing 15% of the TLC shares from KCEPT.

WESCT ownership of TLC in 2008

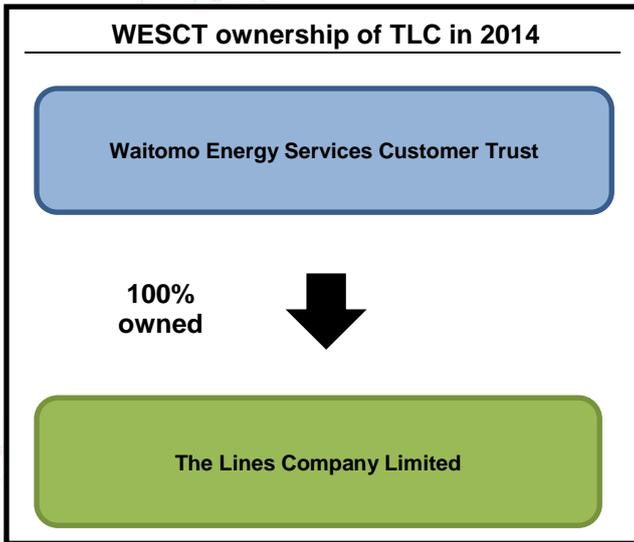
Waitomo Energy Services Customer Trust

King Country Electric Power Trust

90% owned

10% owned

The Lines Company Limited



We are now entering our **fourth** ownership review and the Trust is proud to announce that they are now the 100% owners of TLC on behalf of customer beneficiaries. This transaction took place in January 2014.

The Trusts receives 100% of the dividends from TLC and passes this back to its beneficial customers by way of capital distribution credited to their lines bill.

This ownership review is being undertaken in September 2014

Since the Trust was established in 1993, it has distributed \$27.9m in capital and issued approximately \$8m in King Country Energy Limited shares to its beneficiaries.

The Lines Company Environment

The industry continues to go through changes and as yet has not been able to free itself from Government intervention. While TLC operates in a commercial environment, it remains constrained in its ability to earn profits on the network due to price control measures.

TLC has one of the oldest networks in New Zealand and the price controlled environment has further restricted its ability to increase capital maintenance on the network. In order for TLC to move forward, it has to be able to adapt itself to preserve shareholder value, and to grow to increase shareholder value. This has led to TLC investigating diversification opportunities in order to increase its income to enable dividends to be paid to the Trust, as its shareholders. These dividends received have been paid to beneficial customers by way of capital distribution. Historically, distributions to beneficial customers had been done through special discounts.

While TLC operates within a commercial and competitive environment (apart from the network division as referred to above) which allows WESCT to comparatively measure performance against similar companies, Trust ownership does suitably provide the mechanism for TLC to return dividends back to its shareholders.

Role of the Trustees

The following items have been significant elements to the role of the Trustees:-

- To appoint the Directors of TLC
- To review Director's performance annually
- To review Director's fees
- To ensure TLC strives to meet an objective of being a successful business in a commercial environment
- To annually review Company performance
- To annually review and approve the Statement of Corporate Intent
- To undertake polls of customers to vote on decisions involving shares, ownership reviews and election of trustees
- To encourage TLC to provide an efficient and reliable electricity distribution system
- To hold annual AGM's of beneficiaries

The Trustees are not involved in the day to day running to TLC. This is the role of the Directors.

The Trustees have at all times followed the terms and conditions as set down in the Trust Deed.

The Trustees confirm that they have undertaken their roles with a high level of professionalism, skill and expertise, and have sought advice where necessary to ensure that the best decision is made.

The Trustees continue to have a good working relationship with the TLC Board of Directors and Company employees.

The Trustees continue with their feelings that given the continued Government regulated environment for lines companies, the resurrection of the economy from the global financial crisis, and the natural disaster in Christchurch, security of supply continues to remain an imperative element to survival for its beneficiaries.

Alternative Ownership Options

1. TLC Board of Directors

The Trustees invited the Directors of TLC to provide their views on the alternative options available for ownership. Their full report is attached which further explains the points identified below. TLC have identified five realistic ownership alternatives:-

(a) Status Quo

- Increase has been strong in service and value by TLC
- Strong dividend flow retained within the District
- Customer beneficiaries receive capital distributions credited to their lines bill
- Expected future enhancement of the TLC's value
- The Trust is not locked into long-term ownership, with the next review being in 2020

(b) Distribution of the shares to customers

- Risk that sale of shares by customers to third parties will be less than their true value
- Risk of price increases because investors would be focused on returns only
- Loss of benefit of local ownership

(c) Sale of Shares

- A partial sale resulting in a new shareholder could add future value from skills, direction or capital. However, a partial sale could introduce risk if shareholder interests were not aligned.
- Difficulty in identifying the optimum time to sell

(d) Sale of Assets

- Sale by way of assets sales rather than share sales due to the tax impact
- Assets can be sold under the status quo arrangement

(e) Mergers

- Benefits would mostly be around regulatory, pricing billing and corporate
- Initial merger with another lines company has some potential for savings, but historic trends have shown erosion as the organisation increases in size.
- No obvious scale benefits for TLC
- TLC continues to investigate opportunities that offer enhanced stakeholder value

The Board of Directors has concluded that the most appropriate option to consider is **STATUS QUO**.

2. Independent Advisers: Giffney & Jones

The Trustees also sought the independent opinion of Colin Giffney, an active consultant with the electricity industry, to review the ownership structure of the Trust. The full report is attached. Brief key points from the report have been extracted as follows:-

(a) Trust performance as a shareholder in TLC

- WESCT has been a supportive, yet demanding shareholder
- WESCT has been persistent in demanding appropriate levels of performance and investment returns
- WESCT has been supportive in considering appropriate skills for Board members

(b) Trust performance as an investor

- Compound growth of about 11.7% per annum in the value of WESCT's investments
- Trust's beneficiaries have had distributions with a compound total annual return of about 15.8% per annum.
- Return to WESCT has been excellent
- Future factors that will determine the value of TLC are solar energy, alternative transmission, regulation, growth prospects, pricing, growth from diversification, prospects for amalgamation or rationalisation.
- TLC has been a successful investment for WESCT

(c) Trust performance for its beneficiaries

- Due to the combined effect of heavy investment in the network and the diversification policy of TLC, the average discount/dividend to total revenue earned in TLC has declined from 31% to 21% averaged over the periods 2004-2008 and 2008-2014

(d) Advantages and Disadvantages of Trust Ownership

- The current beneficial customers have no more right to the assets than the preceding generations or future generations
- The lines network is a core infrastructure asset critical to the function of communities; best to be retained in the hands of the community
- Ability to return profits to consumers to mitigate the impact of price increases
- Low performance of shares from sales or share giveaways in electricity companies

The points above do not support cash to customers from sale of the shares or distribution of the shares. There is little merit to suggest why the sale proceeds or shares should be given to local authorities.

Conclusion of the Giffney Report

- Trust ownership has shown itself to be a durable and appropriate way to hold shares in the local electricity distribution company. There is no evidence that economic, business or community circumstances have changed sufficiently to demand a change in ownership other than the will of the community that can be expressed in the poll that the Trust must adopt.
- WESCT has secured 100% ownership of a significant asset on behalf of its consumer beneficiaries
- WESCT has invested wisely. The decision to buy the shares held by King Country Electric Power Trust was achieved at a fair price, which should enable WESCT's consumer

beneficiaries to benefit in the long run through profits from the historic Waitomo and King Country distribution areas.

- WESCT has supported the efforts of TLC to grow and diversify, yet monitored financial performance and electricity distribution performance to the ultimate benefit of all stakeholders.
- WESCT has restricted itself to a governance role in the affairs of TLC.
- **There seems no reason to change the current ownership structure.**

WESCT recommends that trust ownership is retained, based on the following key points:-

- Trust ownership is the best mechanism to increase shareholder value, particularly in the current regulated regime that underlies the lines charges and the constraints on capital expenditure
- The ultimate owners of TLC are the beneficial customers
- Trust ownership does not prevent TLC from growing; diversification and merger opportunities are continually at its forefront
- TLC continues to meet or exceed its controlled targets
- The Trust is another set of eyes on the decisions made by TLC
- All major decisions are taken to TLC's ultimate owners for approval: beneficial customers
- The Trust is the 100% ownership voice that monitors performance and growth of TLC to ensure maximisation of shareholder value embeds decision-making.
- Security of supply, which was to cease in 2013 has been extended by the Government indefinitely.
- The Trust is a member of the Electricity Trusts of New Zealand (ETNZ) which is a national body that provides support for electricity Trusts. ETNZ works with the Electricity Network Association (ENA) which represents the interests of electricity lines companies. The unity is crucial in the present regulated environment.
- A means of keeping the Directors aware of any major concerns from the community
- A voice between the customer and TLC as a last resort
- Monitors customer perceptions of levels of quality, value and service and continues to work on improving basic qualities.