2008 Ownership Review Report

WAITOMO ENERGY SERVICES CUSTOMER TRUST

Includes:

1. Trustees Report to Beneficial Customers
2. Independent Advice: Giffney & Jones
3. The Lines Company Limited: Board of Directors

Waitomo Energy Services Customer Trust

July 2008

Trustees's Report on Ownership Review of Waitomo Energy Services Customer Trust (WESCT)

WESCT has been operating now for 15 years and has recently moved from owning 75% of The Lines Company Limited to 90%. This is a great achievement by the Trust because:-

- It has enhanced shareholder value to the absolute maximum that is possible at the present time.
- It provides the ability to increase returns to beneficial owners.
- It gives WESCT control.

The beneficial owners of WESCT are the account holders located in the old Waitomo Electric Power Board area. It is now entering into its third ownership review period, having previously undertaken reviews in 1996 and 2002. The outcome from the previous reviews has been an overwhelming desire to remain with the status quo, 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 the Company. 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

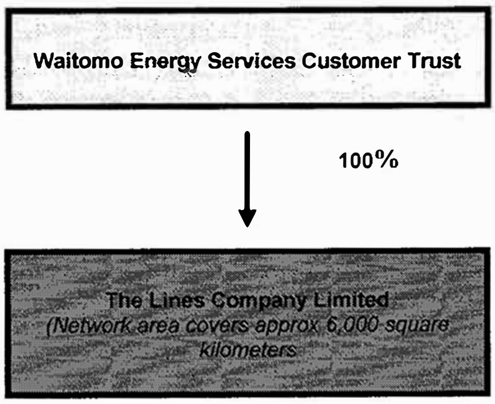
(c) any comments by the Directors of the Company as to the most appropriate form of ownership of the shares.

History

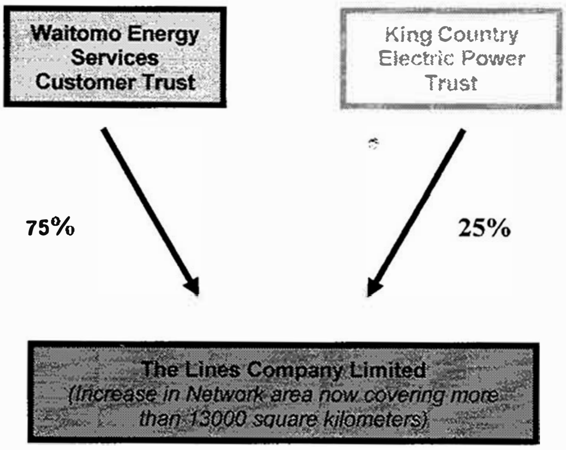
The establishment of this Trust in 1993 resulted from corporatisation in 1993. At that time, by creating a trust entity to own the shares in the Company, then named Waitomo Energy Services Limited, this eliminated the possibility of fragmented ownership that could have resulted had the shares been issued directly to customers. A Trust ownership structure has led to the benefits of customers by creating a monitoring control system to strive for maximization 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 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



WESCT ownership of TLC in 2002

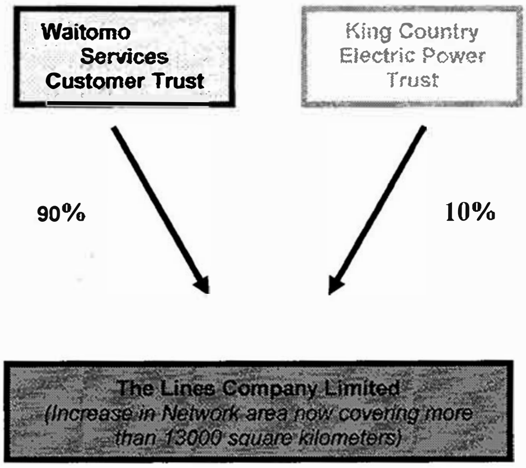


The second ownership review then followed six years later, in 2002, with 95.8% of customers directing the Trust to retain the existing trust ownership position. At that time this Trust was a 75% shareholder in Waitomo Energy Services Limited with the remaining 25% being held by King Country Electric Consumer Trust (KCEPT). The change in shareholding resulted from government enforced reforms in 1998. The company changed its name from Waitomo Energy Services Limited to The Lines Company Limited (TLC).

Now entering into our third ownership review, WESCT currently owns 90% of TLC, with the remaining 10% being held by KCEPT. This transaction took place in May 2007 whereby customers approved WESCT selling its shareholding in King Country Energy Limited and purchasing 15% of the TLC shares from KCEPT.

WESCT receives 90% of the dividends from TLC, based on the entire network area, and passes this back to its beneficial customers through a capital distribution credited to their power accounts.

WESCT ownership of TLC in 2008



Since WESCT was established in 1993, it has distributed $8million in surplus capital and approximately $8million in King Country Energy Limited shares to its beneficial customers.

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 the ability of the company to increase its 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 WESCT, as shareholders.

While TLC operates within a commercial and competitive environment (apart from the network division) which allows WESCT to comparatively measure performance against like companies, trust ownership does suitably provide the mechanism for TLC to return dividends back to its shareholders, WESCT. This Trust then returns funds back to its beneficial customers by way of capital distributions based on demand rates. Historically, this was done through special discounts.

Role of the Trustees

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

- To appoint the Directors of TLC
- To monitor the performance of TLC
- To ensure TLC strives to meet an objective of being a successful business in a commercial environment
- To review and approve the Statement of Corporate Intent
- To undertake poll of customers to vote on decisions involving shares, ownership review and election of trustees.
- To encourage TLC to provide an efficient and reliable electricity distribution system
- To hold an Annual General Meetings

The trustees are not involved in the day to day running of 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 being made.

The trustees continue to have a good working relationship with the board of directors and the company executives.

The Trustees continue with their feelings that given the present government regulated environment for lines companies, as well as the decline in the economy, security of supply is still an imperative element to survival.

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. The full report is attached which further explains the points identified below. There have been 5 realistic alternatives identified by the Board:

(a) **Status Quo**

- Increase in service (reliability) since the last ownership review
- Still a moderate increase in the value of the company despite being in a price controlled environment
- Expectation of significant increase in value projected by the company over the next six years
- Probable exemption from price control if TLC remains trust owned
- Does not lock the shareholders into long term ownership; next review 2012.

(b) **Distribution of the shares to customers**

- KCEPT would become the major shareholder resulting in their ability/or a cornerstone shareholder, to control the board.
- Exemption to price control would be lost leading to a probable reduction in the value of TLC.

(c) **Sale of the shares**

- Exemption to price control would be lost leading to a probable reduction in the value of TLC.
- Price increases likely in the Waitomo area.
- Difficulty to identify the optimum time to sell

(d) **Sale of Assets**

- Maximum value can be gained by selling assets rather than selling shares resulting from taxation.

(e) **Mergers**

- The potential effect of achieving savings within 5% of TLC's total costs.
- Ability to employ specialist staff in a larger company
- Continues to be investigated regardless of the ownership review

The Board of Directors have concluded that the **most appropriate options** to consider are the **status quo, total asset sale** or a **merger** with another rural lines company.

However, in terms of the sale option, caution has been highlighted by the Board that maximum price under a sale option is not likely to be gained until conclusion of the renewal programme and the government price control, projected for 2010 at the earliest.

2. Independent Advisers: Giffney & Jones

The trustees also sought the opinion of Colin Giffney, an active consultant within the electricity industry and a member of the NZX, to review the ownership structure of the WESCT. The full report is attached. 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
- WESCT has been an effective advocate in respect to reliable supply at a fair price

(b) **Trust Performance as an investor**

- WESCT optimised its one off opportunity to sell its 8% King Country Energy shareholding thereby avoiding the possibility of being left with a worthless holding.
- Compound growth of approximately 10%pa in the value of WESCT investment in TLC.
- WESCT beneficiaries have had the benefit of a substantial discount on their electricity bills.

(c) **Trust Performance for its stakeholders**

- Significant returns to customers historically in the form of discounts, and recently in the form of capital distribution
- Reinvestment in new activities and the diversification of the earnings base is expected to produce future dividends.

(d) **Advantages and disadvantages of continued Trust ownership**

- The current beneficial customers have no more right to the assets than the preceding generations or the 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 three 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 bodies.

Mr Giffney concludes stating the following:-

- 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 which can be expressed in the poll that the Trust must adopt.
- WESCT has retained ownership of a significant asset on behalf of its customer beneficiaries.
- WESCT has invested wisely. The decision to sell its shares in King Country Energy and to buy back 15% of the shares in TLC was timely.
- 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 the Company.
- WESCT remain at status quo.

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 prices charged on electricity networks and the constraints on capital expenditure.
- The ultimate owners of TLC are the customers.
- Trust ownership does not prevent the company from growing; diversification and merger opportunities are continually at the forefront.
- TLC continues to meet or exceed its controlled targets.
- Another set of eyes are on decisions made by TLC.
- All major decisions are taken to TLC's ultimate owners for approval; the customers.
- There is one 90% ownership voice that monitors performance and growth of the company 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.
- WESCT 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 Electricity Network Association (ENA) which represents the interests of electricity lines companies. This unity is crucial in the present regulated environment.
- A means of keeping the directors aware of any major concerns from customers.
- A voice between the customer and the company as a last a last resort.
- Monitors customer perceptions of levels of quality, value and service and continues to work on improving basic qualities.
- Possibility of exemption from price control if TLC remains trust owned.

Dated this 31st day of July 2008

....	....
Ivan C Haines (Chairman)	Mark S Ammon (Trustee)
....	....
Richard L Harford (Trustee)	Robert (Bob) A Kidd (Trustee)
....	....
R Andra Neeley (Trustee)	Kevin O Tregoweth (Trustee)

Report to the Trustees of the Waitomo Energy Services Consumer Trust

for the

Six Yearly Review of Ownership

Giffney & Jones

July 2008

Introduction

The Trust Deed of Waitomo Energy Services Customer Trust ('WESCT') requires that it conduct a poll every six years to determine the future of the Trust.

> *Clause 4.3*
>
> *The Trustees shall during September of 1996 and every 6 years thereafter, and may at any other time, conduct a poll in accordance with Clause 4.5 to determine whether any customers voting on the Poll wish Shares to continue to be held by Trust or be transferred to Customers or to be transferred to Local Authorities or in accordance with any additional proposal of the Trustees pursuant to Clause 4.2.*

Preparatory to that Poll the Trustees are required to prepare and publish a report

> *Clause 4.4*
>
> *At least one month prior to the conducting of the Poll the Trustees shall 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 Company as to the most appropriate form of ownership of the Shares.*

The Trustees have requested that Giffney & Jones prepare that report which is attached.

Information reviewed

Giffney & Jones have reviewed the following material:

1. The WESCT provided a copy of their annual report to March 2007.& 2008
2. The Lines Company Annual Reports 2005 – 2007 and a draft 2008 report.
3. The Lines Company Asset Management Plan 2007
4. The Lines Company Threshold Compliance Reports 2005 – 2008

Background

Since 1999 when the Waitomo and King Country Lines companies merged the WESCT has retained the following major assets:

- 75% of The Lines Company
- 8% of King Country Energy
- A debenture to The Lines Company of $1m.
- Varying amounts of cash ($1.7m at March 2007; $250,000 at March 2008).

As a result of that merger the King Country Energy Trust has held the 25% balance of the shares in The Lines Company.

In July 2007 WESCT

- Sold its holding in King Country Energy for $7.7m to the King Country Energy Trust.
- Acquired 15% of the capital of The Lines Company for $16.4m from the King Country Energy Trust
- To settle the purchase the WESCT received a net dividend of $7.3m from The Lines Company and used $1.5m of its own cash.

As a result of these transactions WESCT now holds

- 90% of The Lines Company as its principal asset, and
- A debenture to The Lines Company of $1m.
- Some cash

Notwithstanding the sale of the interest in King Country Energy, the performance of the WESCT has always been and remains dependent on the performance of The Lines Company.

Performance of the WESCT

Trust performance as a shareholder in The Lines Company

Based on enquiry of the Chairman of the Board, the WESCT has been a supportive yet suitably demanding shareholder of The Lines Company. It has supported the Company in seeking appropriate skills for board members and in its investment endeavours. It has been persistent in demanding appropriate levels of performance as an investment. It has also been an effective advocate to meet the wider expectations of its electricity consumer stakeholders with respect to reliable supply at a fair price.

Trust performance as an investor

King Country Energy

As an investor, the major decision the WESCT has made since the merger with King Country in 1999 was to sell its shares in King Country Energy in July last year.

The decision by WESCT to sell its holding was not really significant in the context of the trust's total investments. However, King Country Energy had a complicated shareholding structure with Todd effectively controlling the company with its 35% share holding. WESCT was probably only going to ever get one opportunity to sell its 8% shareholding and it optimised that opportunity at the time it was made. While a sort out of the King Country Energy shareholding situation may still happen and, at that time the price WESCT received may or may not be good with the benefit of hindsight, WESCT has avoided the possibility of being left with a worthless holding.

The Lines Company

The price for The Lines Company shares transacted with the King Country Trust may not represent the price that could be achieved if WESCT decided to sell 100% of the assets or shares. However, it is a good benchmark to assess the performance of the holding over time.

After the King Country merger in 1999 the shares in The Lines Company were valued at $42.3m. The King Country Energy shares then held had a value of approximately $3m. The purchase of the shareholding from the King Country Energy Trust implied a value of about $110m for The Lines Company. Adjusted for the subsequent dividend payment this value should become about $103m. This represents a compound growth of about 10% per annum in the value of the WESCT's investments.

In addition WESCT beneficiaries have had the benefit of a substantial discount on their electricity bills.

Looking to the future several factors will determine value of The Lines Company:

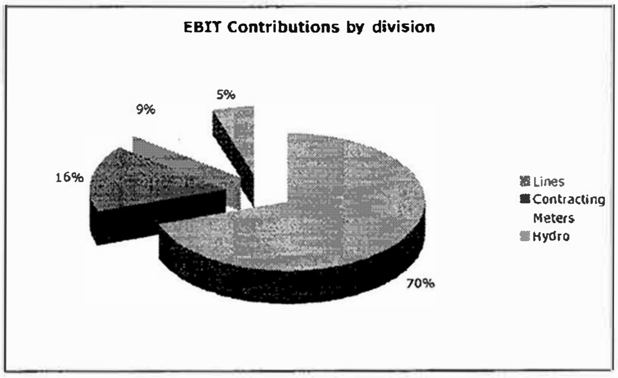
1. Regulation. Lines companies remain subject to regulatory control on profit and performance. Assessment of the impact of regulation has fluctuated over the last few years with a series of challenges to the Commerce Commission regime. Uncertainty has reigned. While the current view is that regulation has relaxed

compared to where it was perceived to be a couple of years ago and will be more certain, everyone accepts regulation will continue.

2. Growth prospects in the electricity lines business. For electricity lines businesses regulation will effectively constrain future growth to either subdivisions for holiday homes and associated commercial development, or by the plans of major customers. Growth at The Lines Company is likely to be relatively slow but steady.

3. Growth from diversification. The Lines Company identified a diversification strategy in its 2007 Statement of Corporate Intent. It wished to double its size over the next 5 years. It identified its under leveraged balance sheet and aimed to increase debt as a % of assets to a maximum of 50% (28.9% at March 2008) which certainly gives it financial capacity to diversify. EBIT in the lines business in 2008 was $11.0m.

   - In the year to March 2008 contracting showed earnings before interest and tax (EBIT) of $1.7m. Subsequent to balance date the Group acquired a 100% interest in John Deere Electrical Limited. With the latest acquisition, in a full year the contracting division should contribute an EBIT of about $2.3m.
   - .The Company has a significant investment in meter assets. In 2008 this business had an EBIT of $1.5m.
   - The first investment in hydro generation should be operational in August 2008. The Company plans "to open one new scheme every year" and sees plenty of scope. Commissioning of the Matawai scheme is targeted for March 2009 and Mangapehi for the last quarter of 2008. In full production these two schemes are forecast to produce EBIT of $0.8m on a total investment of $7m.
   - The Company has successfully developed earnings from businesses other than 'electricity lines' to about 30% of EBIT. None of the new businesses appear to have high organic growth prospects but as a portfolio of businesses should provide good average contributions.



   - The criteria identified in the Statement of Intent for new businesses and existing lines businesses will be difficult to achieve but if they are achieved, then the value of The Lines Company will continue to grow.

4. Prospects for amalgamation or rationalisation. With the uncertainty of regulation merger and acquisition activity has dramatically slowed over the last few years. Until the sale of Vector's Wellington network earlier in this year there have been

few transactions since 2002 – 2003 when The Power Company acquired Otago Power. With more certainty in the regulatory regime it is possible that interest in mergers and acquisitions will increase. With most lines companies now very efficient rationalisation benefits to shareholders are unlikely to be meaningful and so the focus is likely be on softer factors such as geographic spread, size (to deal with regulators and technology) and liquidity for shareholders.

The Lines Company has been a successful investment for the WESCT and should remain a relatively riskless and predictable investment into the future.

Trust performance for its stakeholders

The beneficiaries of the WESCT are the customers of The Lines Company that reside in the old Waitomo Electric Power Board area - precisely defined in the Trust Deed.

Until the transaction with the King Country Trust last year the customers received a discount on their electricity bill. Because the relativity between the geographic base of the wider group of customers and the shareholdings of the respective trusts has changed with the sale by King Country Energy Trust, in the future WESCT will receive a dividend. The trust will receive the dividend from the company and pay it back to the customer as a capital distribution, in the form of a credit. The distribution is capital; it does not include GST and is not taxable for Income Tax purposes.

Dividends totalling $8.095m have been declared for the year to March 2008.

Historically TLC electricity consumers have received discounts representing about 30% of the total revenue from the electricity lines.

Table: Returns to Waitomo Customers ($000)

	2004	2005	2006	2007	2008
Revenue in lines business	19,556	20,145	21,048	21,372	22,718
Discount provided (Dividend in 2008)	6,000	6,200	6,200	6,200	8,095
% Discount to revenue	30.7%	30.8%	29.5%	29.3%	0.0%

As The Lines Company has grown into other businesses it has retained more profit to invest in new activities.

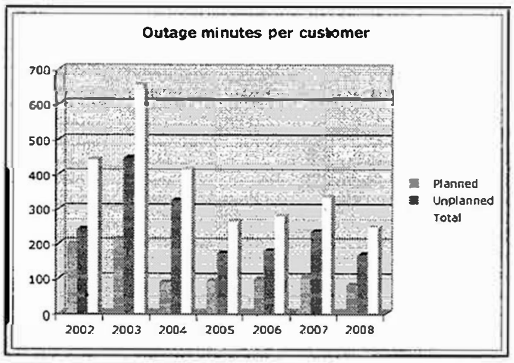
Table: Profits retained in the business ($000)

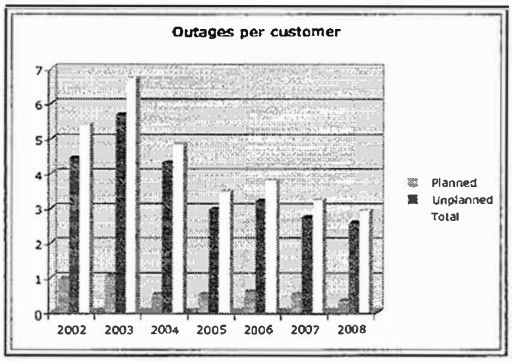
	2004	2005	2006	2007	2008
Reported Net profit after tax	5,041	1,804	1,715	2,940	7,037
After tax effect of discount *	0	4,154	4,154	4,154	0
Net profit after tax adjusted for discount	5,041	5,958	5,869	7,094	7,037
Dividend equivalent to discount	4,020	4,154	4,154	4,154	8,095
Profits retained in business	1,021	1,804	1,715	2,940	(1,058)

This reinvestment in new activities and the diversification of the earnings base is expected to produce future dividends.

The statistics for performance of the electricity network are notoriously difficult to interpret. For any one firm the proportion of the network that is rural, the seasonality of the customer base and the annual incidence of weather events significantly affect results. The same reasons make comparisons between companies very difficult as well.

The charts below show that the incidence of outages in both duration and number has been trending downwards.





The annual Threshold Compliance reports show that The Lines Company has met with its regulatory obligations in terms of revenue, tariffs and performance over the last 5 years to March 2008. [The Company did not comply in 2003 when it made adjustments to its tariff levels.]

Advantages and disadvantages of continued Trust ownership of the Shares

Trust ownership of electricity lines companies was one of the choices of ownership structure in the 1992 deregulation of Power Boards. At the time the majority of companies chose Consumer Trust ownership.

The reasons for this choice can be summarised in the following way:

1. It was considered the best answer to the ownership of "inter-generational" assets. The electricity distribution system had been developed in a co-operative sense by generations of consumers. The argument was that the then owners had no more right to the assets than the preceding generations or the generations to come. This reason is probably still as valid today as it was in 1992.
2. The distribution of electricity was considered a core infrastructure asset, critical to the function of communities and therefore best retained in the hands of the community. That sentiment still permeates New Zealand and to date no Trust on review has decided to change the ownership form.
3. Consumer Trust owned companies would be able (and have been able) to return some profits to consumers to mitigate the impact of expected tariff increases in the transition to full return companies.

4. It was difficult to establish the value of the "power board asset" because of the history of "non-profit" that most power boards had adopted. The performance of the shares of electricity companies since has demonstrated that "share give away" or "sale" as alternatives to trust ownership were poor options.

The regulation of electricity lines companies probably means that the value of lines companies is more easily assessed. In theory, if consumers were to receive the capital value of their shares in their hands, they would receive the present value of future discounts or dividends as the capital sum.

While selling the investment in The Lines Company and giving cash to consumers is a more legitimate option than it may have been in 1992 it may still fail the community's expectations as expressed in points 1-3 above.

Another option is to distribute the shares in The Lines Company held by the Trust to consumers. Historically, such "share give away" options resulted in massive sales and control quickly passing to new corporate shareholders. As only a small proportion of the community are natural share investors this phenomenon would probably occur again. Because this solution would almost certainly result in a change in control it may also fail the community's expectations as expressed in points 1-3 above.

The Trust Deed requires discussion of the merits that the shares in The Lines Company should be sold and the cash proceeds given to local authorities or alternatively give the shares to the same bodies. This was an option in the original 1992 regulation. No community took that option in 1992 and it is hard to see where the logic for such a distribution arises now. The historic connection was that local authorities were a proxy for electricity consumers. Ratepayers and electricity consumers may be the same people but their usages of the services are almost certainly different. When the Trust reaches its defined term (2072) or it holds less than 5% of the capital and is terminated (Clause 16) local body involvement may have some logic but there seems little merit in the suggestion at this stage.

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 which can be expressed in the poll that the Trust must adopt.

Conclusion of the review

As far as the WESCT is concerned:

- It has retained ownership of a significant asset on behalf of its consumer beneficiaries.
- It has invested wisely. The decision to sell its shares in King Country Energy and to buy back 15% of the shares in The Lines Company was timely.
- It has supported the efforts of the The Lines Company to grow and diversify, yet monitored financial performance and electricity distribution performance to the ultimate benefit of all stakeholders.
- It has restricted itself to a governance role in the affairs of the Company.

There seems no reason to change the current ownership structure.

Giffney & Jones

Members NZX

July 6 2008

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JBA

17th June 2008

OWNERSHIP REVIEW

Overview

The Directors of The Lines Company Limited (TLC) have been invited by the Waitomo Energy Services Customer Trust (WESCT) to give their view of the most appropriate ownership form for the shares that the WESCT currently owns in TLC.

The original intent in establishing WESCT was to ensure that local consumers captured the full value of the 1992 energy reforms, which replaced power boards with energy companies. WESCT was therefore a vehicle that allowed for collective ownership of the company's shares while allowing the individual beneficiaries to maintain the major decision making rights that they would have had had the shares been distributed to individuals. Unlike other power trusts established at the time, a poll of beneficiaries was required before the company could undertake a major transaction. Also ownership reviews were subject to poll.

The immediate goal of ensuring that local customers captured full value from the 1992 reforms was achieved. Since formation the trust has distributed $8 million in surplus capital, and approx $8 million of King Country Energy (KCE) shares.

The 1999 reforms saw the Trust end up with 75% of TLC and 8% of KCE. In July 2007 it sold its KCE shares and acquired a further 15% of TLC. The value gap for this transaction was funded by a further special dividend of $8 million from TLC.

When share ownership was last reviewed six years ago, the prevailing market valued network assets at between 1.5 to 2.4 times ODV. Since then

- A new ODV was calculated in 2004. TLC's ODV rose from $65 million in 2002 to $ 94 million in 2004.
- Capital expenditure has since seen the network value rise to $109 million. Most of this investment has been spent in upgrading and replacing core network assets.
- The Commerce Commission introduced new pricing regulations in 2004. TLC's price increases have been constrained since then to CPI less 2%. This limit was designed to put downward pressure on the discounts then being paid out to customers.

- As a result of the 2007 change in shareholding the discount payment of $6.2m pre tax for 2007 has now been replaced with dividends of $4m after tax for 2008 ($6.0 with imputation credits).
- The above pricing regulation regime means that the network value is unlikely to be significantly above ODV.
- Over the past six years
    - Ebitda has increased from $12.5 million to $17.7 million
    - Ebit has increased from $9.5 million to $ 11.6 million
    - Pre tax surplus has risen from $8.7million to $9.3 million. The low rate of growth is largely due to the increased depreciation on revalued assets, which has increased depreciation expense by $3.1 million.
- The average number of minutes without supply in a year suffered by TLC customers has fallen from 863 per customer in 1996 to 437 in 2002 to 247 in 2008.
- TLC has invested in growing its contracting business and in commencing a business of developing and operating small hydro schemes.
- WESCT has increased its ownership of TLC from 75% to 90%. The King Country Electric Power Trust (KCEPT) holds the remaining 10%.
- The Commerce Amendment Bill is currently being considered, which if passed would exempt trust owned lines companies from Commerce Commission price controls, unless requested by a company's customers.

Currently TLC's network profitability is too low, and the 5.7% return on the network is below a commercial rate. A report to the Commerce Commission from Meyrick and Associates on the productivity of lines companies concluded that the data of the past 8 years showed that TLC consistently rated as one of the more efficient lines companies. TLC's network costs are therefore reasonable. Instead TLC's network revenue has been squeezed to a non commercial level.

Another adviser to the Commission, Farrier Swier, confirmed that TLC's expenditure in renewing lines needs to increase by more than $2 million per annum. The Government has also announced that the requirement to supply uneconomic installations that existed in 1993 will not expire in 2013 but will be extended indefinitely, confirming that not renewing lines is not an alternative. However replacing an old pole with a new one does not by itself generate any increase in income to pay for the replacement.

The combination of low current returns and the requirement for increased renewal capital expenditure means that it is certain that TLC lines prices will increase in the short-term. The only alternative, since many of the lines nearing the end of their useful lifes are in remote rural areas, is to seek government funding for those lines, since they were originally funded with government subsidies and their retention is in the national interest.

While TLC's revenue as a whole needs to increase, the revenue in the Waitomo area is already at a commercial level, with the revenue in the Ruapehu / Taupo area needing to increase substantially.

With the WESCT owning 90% of TLC there is an incentive to ensure that, to the fullest extent possible, the extra revenue required to fund the increased renewal expenditure either comes from the Ruapehu/ Taupo community where those lines are located, or comes from government subsidy. If the company had a different ownership structure this incentive would not be as strong, and it is likely that prices in the Waitomo community would be increased to a greater extent to subsidise this renewal expenditure.

20% of the TLC's current surplus comes from non-regulated businesses i.e. contracting and metering. TLC has invested in generation, expanded its contracting investments and is exploring other opportunities. These investments are funded from debt and do not impact upon the size of local line charges. We expect these investments to significantly increase TLC's profits, and hence returns to shareholders, in the next six years.

As noted above increases in line charges in the medium term will be spent on replacing old network assets.

Scope

With the exception below, we believe we should be only commenting on how the WESCT's ownership of 90% of TLC impacts on the ability of the company to deliver increased value to its shareholders. We believe that the following issues are more properly the responsibility of the trustees to consider, if they are considered at all:

- Desire for local control
- Impact on local communities

We do, however, note that in the past there has been a strong correlation between the growth in TLC discounts and the growth of its industrial and commercial revenue in the Waitomo area. We believe that the structure of distributing TLC surpluses back to consumers aids local development. This in turn increases the profitability and value of the company. This symbiotic relationship would not necessarily persist with regional or national ownership.

Ownership alternatives

We consider that there are five realistic ownership alternatives:

1. <u>Status quo.</u>

   The results of the past six years have seen a strong increase in service (in terms of reliability). The value of the company has however probably increased only modestly due to the multiples being paid for network companies declining with the Commerce Commission's pricing control regime.

We expect the value of the company to increase significantly over the next six years due to:

- Increasing renewal expenditure increasing the value of the network. It is expected that the network value will grow by approximately $3 million a year during this period.
- Line charges increasing over the next two years, in order to fund the above.
- Rising electricity prices providing good cashflows and returns from our planned generation investments.
- Above average returns from our contracting investments.

The Commerce Amendment Bill should exempt TLC from Commerce Commission price control while it remains trust owned. This will increase TLC's ability to set its lines prices to cover its costs, and given this ability should remove pricing uncertainty thereby lowering the cost of its capital, leading to lower than otherwise medium term prices.

As noted above ownership by the WESCT will ensure that the incentive to address the Waitomo/ Ruapheu area cross-subsidisation issue remains, again leading to lower than otherwise prices in the medium term.

Our experience of the WESCT trustees is that they are generally strongly focused on the goal of increasing shareholder value, and have where possible encouraged directors in their efforts.

We note that the status quo does not lock the shareholders in to long-term ownership. Any merger or takeover proposal received by the trustees must be taken back to customers for their consideration.

2. <u>Distribution of the shares to customers.</u>

If the shares held by WESCT were distributed to its beneficiaries this would leave the KCEPT as the major shareholder with probably an ability to control the board. Given the large shareholding that the KCEPT has in KCE then this influencing position would probably be a breach of the Electricity Industry Reform Act.

The only way of avoiding such a breach would be to introduce a reasonably large cornerstone shareholder, which would then control the Board. This would produce a similar outcome as the third option, but at a lesser value to existing shareholders as a premium for control is unlikely to have been extracted.

Under this option, the pricing regulation exemption would be lost. This is likely to lower the value of the company.

3. Sale of the shares.

This could involve either a partial sale or a total sale. Under this option, the pricing regulation exemption would be lost. This is likely to lower the value of the company. Also there would be no incentive to pursue either targeted price increases or government subsidies. Across the board price increases are more likely, leading to higher prices in the Waitomo area.

Should the WESCT wish to pursue a share sale, it is difficult to judge when would be the optimum time for such a sale. Asset values will rise once the current asset renewal programme is completed. The declaration by the Commerce Commission of a new price control regime may increase (or decrease) asset values. As the regime will not be finalised until 2010 at the earliest then uncertainty may lower network values in the interim.

4. Sale of Assets

Most past network sales have been by way of asset sales rather than share sales because of the tax impact.

Existing network assets have normally had tax values considerably below their current market values. This meant that depreciation recovered in the sale, which was taxed, was relatively low. The price paid for the assets therefore included a significant capital gain to the vendor, whereas the new owner was able to depreciate the full price for tax purposes.

Maximum value was therefore gained by selling the assets rather than selling shares.

This value gain has been negated somewhat for the purchaser by the Commerce Commission taking into account actual tax paid rather than nominal tax in calculating whether an excess return is being earned. Lowering the amount of tax paid therefore increases the after tax regulated return, which the Commission will want lowered, therefore leading to lower prices.

An asset sale still has a higher benefit than a share sale for WESCT and its beneficiaries as:

- The extra depreciation for tax purposes on assets other than the network, e.g. meters, contracting, generation should lead to a higher selling price
- The extra depreciation for tax purposes on the network assets, while not changing the selling price, should lead to lower lines prices which are a benefit to the trust's beneficiaries.

5. Mergers

The major cost to a network company is the value of the network. Of TLC's current line charge income 62% goes to covering depreciation and capital costs, a further 19% goes to Transpower leaving only 19% to cover controllable costs. The majority of this is engineering cost, which tends to vary according to the size of the network.

Merging with another lines company would therefore have the potential effect of achieving savings within 5% of TLC's total costs. If half of this was saved then this would add approximately $500,000 to the EBIT.

A more significant impact would be on TLC's ability to employ specialist staff. The larger the entity the greater the ability to hire staff that specialise in a specific area, provided that the two entities being combined have similar networks. Merging the King Country and Waitomo networks has meant that a more specialist engineering resource has been employed, and the benefit can be seen in the high standard of asset planning, and the reductions in outages. A further merger with a rural network would enable further specialisation.

We have been active in investigating suitable merger combinations over the years.

Conclusion

The Directors believe that the appropriate options to consider are the status quo, a total asset sale, or a merger with another rural lines company.

We would caution that maximum price under a sale option is not likely to be gained until price levels are increased to a fair value that at least cover the costs of the renewal programme, and the new Commerce Commission pricing control scheme is finalised. This would be 2010 at the earliest.

A M Don
Chairman