2014 Ownership Review Report

WAITOMO ENERGY SERVICES CUSTOMER TRUST

This report includes:

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

Your trustees (left to right) Kevin Tregoweth, Peter Kidd, Murray Loewenthal, Bob Kidd, Ivan Haines (Chairman) and Mark Ammon

Waitomo Energy Services Customer Trust

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August 2014

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

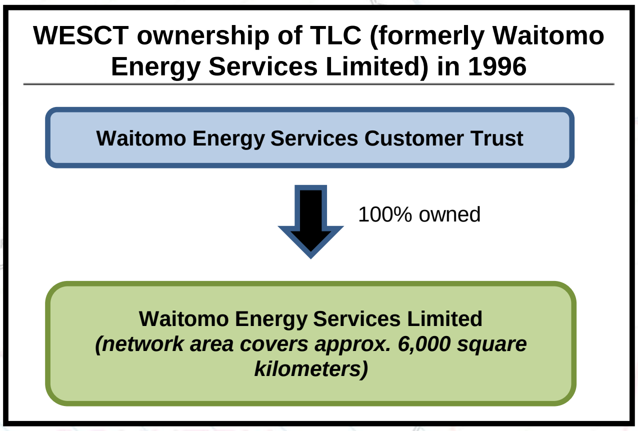
(c) any comments by the Directors of the TLC as to the most appropriate form of ownership of the shares.

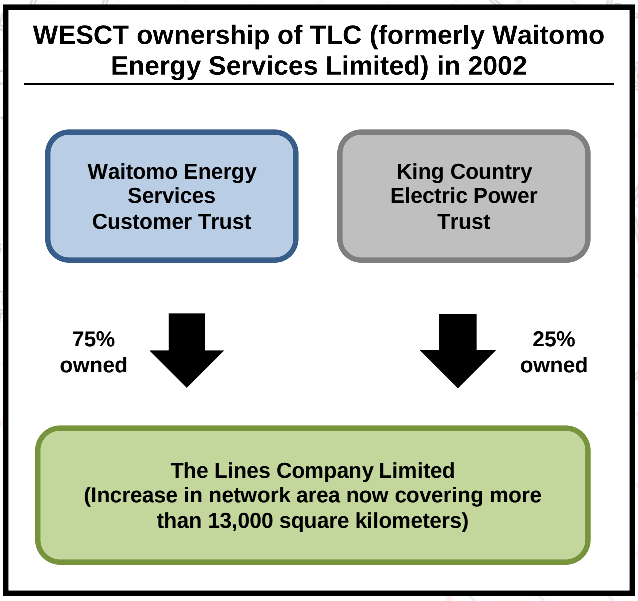
History

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)





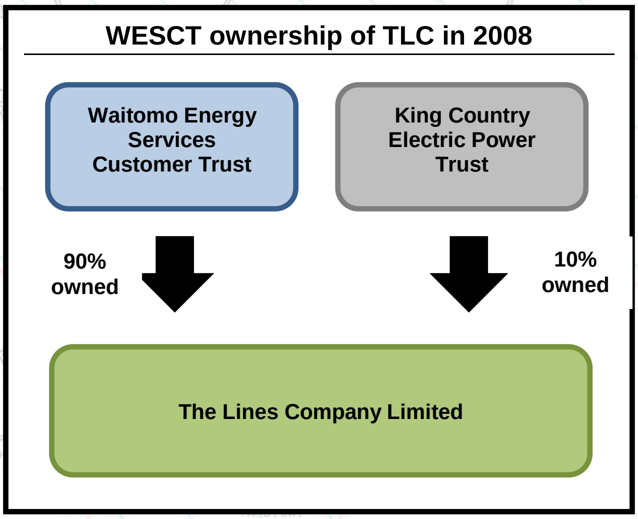
The **second** ownership review then followed six years later, in 2002 with **95.8%** of customers directing the Trust to **retain** the existing **Trust ownership** position. At that time, this Trust was a 75% shareholder in Waitomo Energy Services Limited with the remaining 25% being held by King Country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

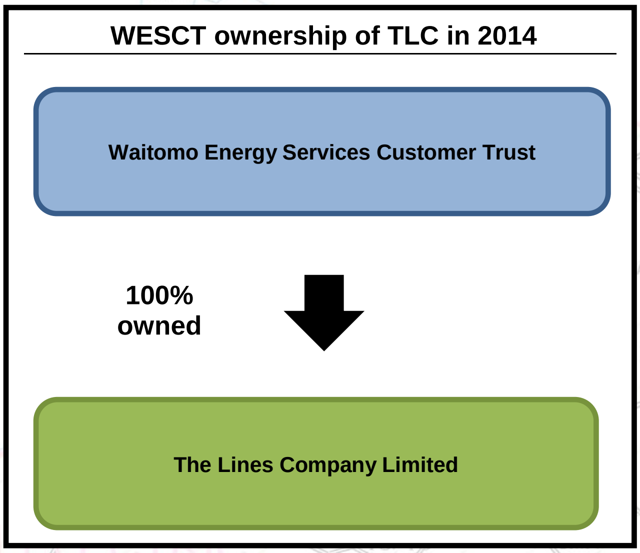
The change in shareholding resulted from Government reforms in 1998. The Company changed its name from Waitomo Energy Services Limited to The Lines Company Limited (TLC)

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.





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 remains 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 diversity, 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.

Report to the Trustees of the Waitomo Energy Services Consumer Trust

for the

Six Yearly Review of Ownership

Giffney & Jones

July 2014

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. This is that report.

Information reviewed

Giffney & Jones have reviewed the following material:

1. The WESCT provided a copy of their annual report to March 2013. The 2014 report will not be prepared until August 2014.
2. The Lines Company Annual Reports 2008 – 2013 and a draft 2014 report.
3. The Lines Company Asset Management Plan 2014
4. The Lines Company Limited Pricing Methodology 2014 - 1 April 2014
5. The Lines Company Compliance Statements 2008 – 2014
6. 2013-14 Statement of Corporate Intent

Major developments within the Group

The core business of The Lines Company is the distribution network. Older annual reports point to the network being "the oldest" in New Zealand requiring a major renewal. Even in the 2013 Statement of Corporate Intent the following statement forewarned that there is still considerable work to do. "*An expenditure of $116m over the next 15 years however is still required to bring the network back to standard and minimise hazards.*"

In late 2006 the Company made the decision "*to invest in exploring alternative business opportunities in order to deliver appropriate returns to shareholders*." In its 2007 Statement of Corporate Intent the Company expressed its wish 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 provided financial capacity to diversify.

Changes in the Company

Following the decision to diversify, in early 2007 $500,000 was allocated to build a generation team. Since that time, The Lines Company has made the following investments:

- Acquired the 1.6MW Mangapehi Scheme in mid 2007. ($1.1m)
- On 1 April 2008 TLC purchased the local electrical contracting company John Deere Electrical. ($1.9m)
- Commenced operations on the 1.6MW Mangapehi Scheme in April 2009.
- Commissioned the Matawai 2MW in September 2009.
- Commissioned the 2MW Speedy's Road in June 2011

The allocation of funds as a result of this strategy of diversification is depicted below:

Net book value of Property, plant and equipment

	2007	**2014**
Lines	101.8	192.4
Generation	0.3	19.6
Other	5.4	6.1
Meters & Relays	8.5	7.4
Total plant & equipment	**116.0**	**225.5**

In 2007 the network assets were 88% of total assets. In 2014 the network assets were 85% of total assets.

The increase in assets includes a revaluation of network assets in 2012 of a net $35.2m. In 2009 there was a revaluation of a net $4.7m. The total increase in Network assets by revaluation since March 2007 has been $40m.

Table: TLC investments $m v contribution to overheads

Description	2014 Asset Value $m	% of portfolio	2014 EBITDA Pre tax Return %	2014 EBIT Pre tax Return %
Network	192.4	**85%**	11.6%	7.9%
Other	6.1	**3%**	35.6%	23.9%
Metering	7.4	**3%**	42.9%	15.7%
Generation	19.6	**9%**	-1.3%	-4.8%
Total	**225.5**	**100%**	**12.2%**	**7.4%**

Changes in shareholding

Perhaps the most significant event since the last review is that the Trust acquired the remaining 10% of The Lines Company held by King Country Electric Power Trust. It paid $13.5m for the shares. The transaction was effective 17 January 2014.

As a result of these transactions WESCT now holds

- 100% of The Lines Company as its principal asset, and
- Owes The Lines Company $13.5m.
- Some cash

Commentary on the investment changes

Diversification strategy

In 2007 the investment in other activities outside the network was $14.2m. This represented 12% of total assets. By 2014 the net book value of investments in other assets had increased to $33m or 15% of assets. The impact of the diversification strategy has been reduced by the revaluation of the Network assets. However, even excluding those revaluations, other investment in activities outside the network would have risen to just 17.8% as a percentage of total funds.

The diversification strategy has not developed far.

The Generation Strategy

The net investment in generation has been $19m over the review period. The EBIT return on funds invested was -4.8% in 2014.

Management perceived the opportunity was to develop medium sized, low impact, high head generation schemes. It was considered that private investors were constructing schemes of this size as they were below the threshold that attracted most large generators. The benefit that low impact high head schemes had was that, if they are well engineered, they were comparatively low risk. There were no large dams and ponds, thus reducing exposure to significant cost over-runs caused by geo-technical problems. Resource consents were considered easier to obtain, as the effect on the environment is minimal.

The generation model was based on the use of second hand equipment for schemes. This equipment was expected to be less efficient than new equipment but compensated by cost.

We understand from management that:

- To reach the standards TLC demanded (as opposed to the standards private investors seemed to apply) the resource consent process was not simpler or less costly.
- The strategy of using second hand equipment proved more difficult and more time consuming than expected.
- The number of opportunities for low impact high head schemes proved to be limited.
- The management requirement proved to be higher than anticipated.
- The droughts in the last two years have left water flows significantly below normal.
- Most importantly the EnergyLink price path, widely used in the industry, did not foresee the 25% collapse in wholesale electricity prices, after the investment decisions had been made. This has had a significant effect on current profitability against planned.

The auditors have tested the valuation of the generation assets in the 2014 accounts. While the Company has not made much money on its investments neither has it lost any. At just 8.5% of the total assets, the investment in generation is barely significant.

Commentary on the shareholding changes

Effective 17 January 2014 the Trust acquired the 10% of The Lines Company held by King Country Electric Power Trust for $13.5m.

The decision by the KCEPT to offer its shareholding for sale was not surprising. The KCEPT had no board representation at TLC. It is an advocate for King Country consumers but the Trust does not need the shareholding to be that advocate. The shareholding gave no real leverage. Since the electricity reforms KCEPT has been an investor in generation and retail, not distribution.

Because of the restrictions contained in the Shareholders Agreement between WESCT and KCEPT, WESCT was the logical buyer although an open sales process was conducted.

The critical metrics of the purchase are these:

1. The transaction placed a value on TLC of $135m. Based on 2014 accounts, TLC's net tangible assets were $142.6m. The purchase translates to a small discount over regulated NTA of ~5%.

- ⇒ In deriving this net tangible asset calculation a deferred tax liability of $44.1m has been deducted. Management believe it is unlikely that this liability will ever be crystallised. If that proved to be the case, NTA would effectively be $186.7.
- ⇒ Two revaluations of network assets since 2008 to regulated values increased assets of the network by $40m. The next tariff reset is set for 2015. It is likely this will produce another increase in NTA and potentially make the acquisition of these shares even more attractive when measured against the regulated value of the assets.
- ⇒ There have been few recent and comparable transactions.
  - In 2010 Marlborough Lines made a rather odd launch on the NZX for what became 13.9% of the capital of Horizon Energy. It paid $4.15 per share. This compared with the March 2011 NTA per share of $2.16.
  - In July 2013 it was reported that AMP Capital had entered into an agreement to acquire 42 per cent of Powerco NZ Holdings Limited, from Brookfield Infrastructure for NZ$525 million. Filed 2013 accounts reveal a highly leveraged entity. The price paid for the shares represented a very substantial premium to published NTA but the leverage magnifies the result. Taken against the asset base as a whole there was still a premium to asset value but relatively small.
- ⇒ Historically all transactions for 100% of the shares of other network companies have produced considerable premia to net asset backing.
- ⇒ Professionals regularly debate why electricity distribution companies sell at figures higher than their regulated shareholders funds. There are many reasons. Regardless of that argument, on all comparisons it seems that WESCT paid at worst a fair price for the 10% interest.

2. In the event WESCT ever wanted to sell its shares the potential difficulty a 10% shareholder, with various rights enshrined in the shareholder agreement, could have caused has been eliminated. WESCT is now 100% in control of TLC.
3. Dividends.
   ⇒ In 2014 TLC paid a fully imputed dividend of $4.95m as dividend to it's shareholders. At the purchase price of $13.5m this represents a return of 5.1% before tax. The purchase should be more or less cash neutral.
4. Notwithstanding that WESCT can easily carry the debt - about 10% of its asset base, a short to medium term aspiration should be for the company to make a special distribution to WESCT to remove this debt obligation.

Performance of the WESCT

Trust performance as a shareholder in The Lines Company

The Chairman of the Lines Company Board has described the WESCT as supportive yet a suitably demanding shareholder of The Lines Company. It has supported the Company in seeking appropriate skills for board members and in its investment endeavours. He commented that the Trust has found the need to increase tariffs to reach investment returns closer to regulated returns hard to accept given the expectations of its electricity consumer stakeholders. This tension may remain as the Board has indicated that it will implement price increases of 4-5% pa over the next three to four years to narrow the gap between regulatory return and actual tariffs.

The board has maintained continuity but it has been appropriately refreshed from time to time.

Directors	2007	2008	2009	2010	2011	2012	2013	2014
P M R Browne	■	■	■	■	■			
A M Don	■	■	■	■	■	■	■	■
A Muldoon	■	■	■	■	■	■	■	■
J C Lindsay	■	■	■	■	■	■	■	
C M Loewenthal	■							
S Young				■	■	■	■	■
E Rattray				■	■	■	■	
P J Till						■	■	■
A Ball								■
J Rae								■

Trust performance as an investor

Ultimately the Trust depends on the performance of The Lines Company for its own performance as an investor. Performance consists of capital growth and dividends that the Trust distributes to its beneficiaries.

If value can be attributed to growth in shareholder funds then since 2008 these have grown from $73m to $144m. This represents a compound growth of about 11.7% per annum in the value of the WESCT's investments.

In addition the Trust has distributed $23.9m, after tax, in those 6 years. The compound total annual return is about 15.8%pa.

The return to shareholders has been excellent.

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

1. Solar Energy. Solar energy has the potential to be very disruptive to the traditional electricity generation and distribution model. Technology has dramatically reduced the cost of solar energy production. In remote areas the economics are already tempting. Because peak electricity usage remains in the evenings cost effective (battery) storage will be a real warning sign.
2. Alternative transmission. Looking further out and in the more speculative area wireless transmission of energy is a rising technology. If long distance, high efficiency wireless power transmission became possible, reliance on transmission lines to transfer energy over long distances could be severely disrupted.
3. Regulation. The regulatory regime has settled into a more predictable and constant process. It is unlikely to be softened. Populist politics has so far focused on generation but political influence remains a risk as parties thrash around seeking to reduce the cost of energy to households.
4. Growth prospects in the electricity lines business.
    - The industry is currently focused on the likely impact of electric cars. In May the Association for the Promotion of Electric Vehicles looked forward to the number of electric cars rising from 200 to 70,000 cars (2.4% of the nations stock) by 2020. In the short term the resurgence of the economy is likely to have the greatest impact.
    - Within the TLC network the Statement of Corporate Intent 2013-14 noted "*the growth in peak load has declined from 6% pa in the years 2006 to 2008 to a decrease of 0.9 % pa over subsequent years. Energy consumption, which was growing at a rate of 2.0% pa over the 2006 to 2008 years has however continued to grow, but at the lower rate of 1.4%.*" Considering all the competing factors it is hard to see any significant change in that trend over the next few years.
5. Pricing. Currently TLC sets tariffs that produce revenues lower than the regulated level of tariffs. This is a difficult topic in the industry. On the one hand Distributors running such a regime face the prospect of a regulatory freeze and so may inadequately provide for asset maintenance. Similarly running such a regime makes the Company more vulnerable to takeover and then a subsequent ramp of tariffs to "commercial levels" by the new owner. Perhaps the most similar company to observe this phenomenon is Otago Power. If this happens, consumers then lose on the capital value they may receive if the business is sold and tariffs are subsequently lifted. Once the asset has been sold consumers still pay the higher tariffs the original owner could have charged. Consumer Trusts should be able to offset tariff increases with higher dividends.

6. 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). This strategy has not been very successful. While there has been some investment in Generation it still only accounts for 9% of assets. The total investment in "other assets" is just 15%.

7. The May 2014 Statement of Corporate Intent sidelines the diversification strategy but anticipates continuing investment in the network, generation and metering. The return from the network has significantly declined relative to the assets employed and highlights the need to realign tariffs. The lack of return from Generation can in part be attributed to the decline in wholesale electricity prices. However, all other things being equal, generation revenues need to lift from $1.4 in 2014 to nearly $4m to return EBITDA at 10% of assets.

8. Prospects for amalgamation or rationalisation. Merger and acquisition activity has dramatically slowed. One consequence of the regulatory regime effectively guaranteeing returns on embedded assets is that there is very little scope to make any significant savings in a "merger" and even more difficulty in making an unsolicited takeover. It seems likely that this trend will continue.

9. TLC funded the purchase of the KCEPT shares.

The Lines Company has been a successful investment for the WESCT and, subject to some emerging macro factors, should remain a relatively riskless and predictable investment into the medium future.

Trust performance for its beneficiaries

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

The table below shows where cash generated in the business ('Net cash from operations') has been invested into the divisions and then distributed to the Trust.

Table: Disposition of operating cash flows

	2007	2008	2009	2010	2011	2012	2013	2014
Net cash from operations	**9.3**	**6.9**	**11.2**	**16.6**	**19.4**	**15.2**	**15.5**	**18.9**
Investment Network	6.3	11.0	8.2	6.9	7.9	8.7	8.2	8.1
Meters	0.8	0.8	0.8	1.0	-0.3	0.6	0.3	1.9
Generation	0.2	3.3	6.0	4.7	4.4	1.1	0.3	-0.6
Contracting & other investment	1.0	2.5	-1.5	0.8	-0.6	0.6	-1.6	0.9
Total investment	**8.2**	**17.6**	**13.5**	**13.5**	**11.4**	**11.0**	**7.2**	**10.3**
Dividends	4.9	4.9	4.9	4.9	4.9	4.9	4.9	5.0
Net cash retained	**-3.9**	**-15.7**	**-7.2**	**-1.9**	**3.0**	**-0.7**	**3.4**	**3.6**

- ⇒ Operating cash flows have steadily risen
- ⇒ Substantial investment in the network has been sustained.
- ⇒ Investment in generation was relatively strong 2008 to 2011 but it has been substantially less since that date.
- ⇒ Dividends have been maintained. Potentially, dividends could have been higher if the diversification programme had not been followed.

This has resulted in the following benefits to WESCT beneficiaries:

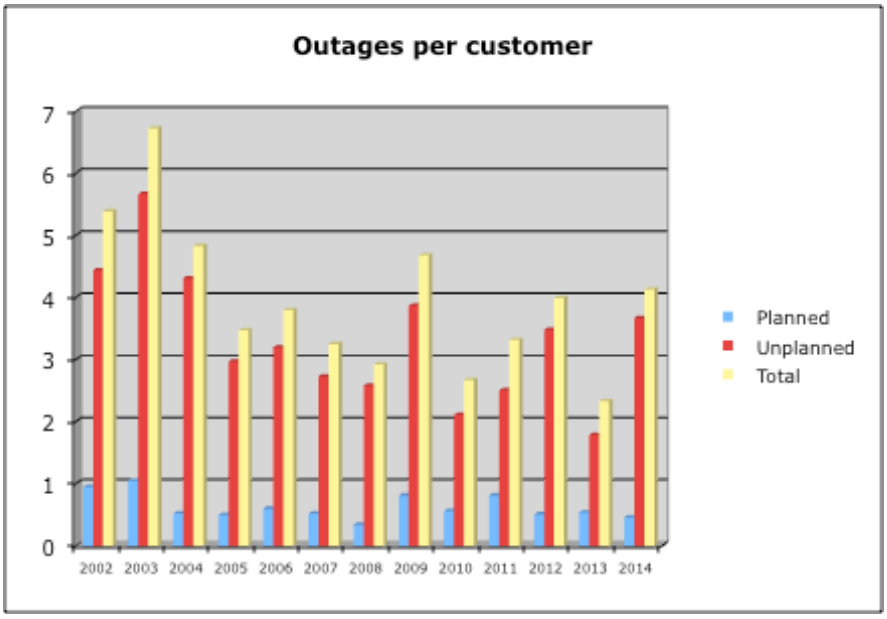
Table: Average Returns to Waitomo Beneficiaries ($000)

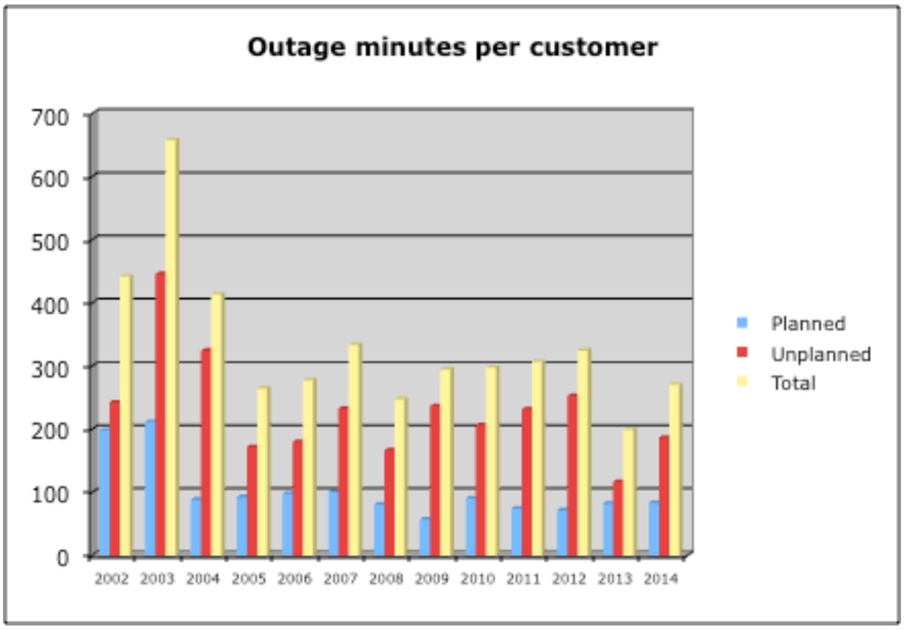
	2004-2008	2008-2014
% Discount to revenue, adjusted for the tax effect of dividends v discounts	31%	21%

Largely due to the combined effect of heavy investment in the network and the diversification policy, the average discount/dividend to total revenue earned in the lines business has declined from 31% to 21% averaged over the relevant periods.

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 affects 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 but progress is not as dramatic as in the previous 6-year review period.





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 6 years to March 2013, except for:

- One of 8 SAIDI[1] reliability assessments in 2013.
- One of the price path notional revenue tests in 2010.
- In all other respects TLC has complied with price path and quality thresholds.

Advantages and disadvantages of continued Trust ownership of the Shares

In the 2008 review the following statement was made. Nothing has changed. "*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 communities 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 communities expectations as expressed in points 1-3 above.

[1] SAIDI (System Average Interruption Duration Index) is a reliability indicator used by the Commerce Commission when regulating electricity lines companies.

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

Conclusion of the review

As far as the WESCT is concerned:

- It has secured 100% ownership of a significant asset on behalf of its consumer beneficiaries.
- It has invested wisely. The decision to buy the shares held by King Country Energy Power Trust was achieved at a fair price, which should enable Waitomo consumers to benefit in the long run through profits from the historic Waitomo and King Country distribution areas.
- It has supported the efforts of 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

July 2014

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20 June 2014

OWNERSHIP REVIEW

Ownership Background

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 WESCT currently owns in TLC.

Since formation the Trust has been successful in ensuring the considerable wealth generated by TLC is captured in the local area. Specifically in the six years since the 2008 ownership review TLC has distributed $21.3 million to WESCT through dividends which are passed on to qualifying customers as capital distributions, and the value of the Company has increased by a factor of close to 2. This has resulted in most qualifying customers not having to pay for up to two months lines charges annually. Any other ownership structure would likely see this benefit disappear. Looking forward the Directors are planning continued dividend streams at a level that aligns with or is greater than the annual amounts paid over the last six years.

The other intrinsic values of having the Company owned and run from the region in addition to the value and return include:

- The employment and training of approximately 10 or more local people at any one time into skilled labor roles.
- The 150 staff employed living in the region and contributing to the success of many local businesses.

As a result of its own ownership review KCEPT decided in 2013 to sell its remaining 10% shareholding in TLC and in January 2014 WESCT acquired that holding to take its ownership to 100%. The purchase was funded by TLC.

TLC's strategic approach is to develop and maintain the Network infrastructure at a sustainable level of investment and provide customers with the ongoing level of service they require.

Business performance since the last ownership review has seen:

- The Network value increase and reliability stabilize at a level with which customers are satisfied.
- Three run of river hydro generation schemes completed and operational.
- The Metering business has expanded and producing strong returns.
- Electrical contracting has produced good returns on TLC's investment and improved profitability.

Financial Performance

The Company has reported Net Profit after tax and dividends paid to WESCT over the last six years as follows:

	Net Profit	Dividends
	$000s	
2014	7,315	4,455
2013	5,840	4,438
2012	6,733	3,204
2011	7,744	2,925
2010	6,060	2,700
2009	4,031	3,630

The Company has investments in the following operations:

	Carrying Value	
	$millions	
	31 March 2008	31 March 2014
Network & Field Services	113.0	195.6
Generation	3.8	20.3
Metering	8.5	7.4
Electrical Contracting	-	1.6
Land & Buildings	3.7	3.0
Intangibles	0.8	0.7
Total	129.8	228.6

Since the last ownership review in 2008, the performance of the company has been such that shareholders have had a 124% return when measured by the sum of the equity and cumulative dividends divided by the 2008 equity.

The Net Profit after tax for the 2015 financial year is projected to be $7.8m with a dividend distribution of $5m.

Regulation and Pricing

The Commerce Commission was charged with introducing price control that encouraged commercial investment that would have long term reliability and environmental benefits.

The pricing and quality regulations that TLC is required to comply with consist of a number of inputs which go into a complex economic calculator that determines the prices that can be charged.

TLC's prices are influenced by these regulators' limits, the customers' ability to pay and what work has to be done to keep the Network at sustainable performance levels. At present, TLC is pricing Network services such that it's returns are below the regulated level, which impacts on the value of the business. The Company's focus is on increasing its revenues and thus its returns to the allowable level by 2018, whilst improving the stakeholder value perception.

Other changes that have come through in parallel with pricing regulation include the increasing focus on hazard control coming as a byproduct of the Pike River tragedy and more recently accidents in the forest industry.

Pricing Methodology

The lines into many of the rural areas of the King Country were built with in the main recycled materials using a government subsidy put in place for land development, largely associated with soldiers returning home from the wars. These farms were typically 300 acres. Since that time the economics and technology around farming have changed and today a sheep and beef farm requires around 4000 to 5000 stock units to be economic. This equates to approximately 1000 acres of land meaning that the region has depopulated and in parallel with the changes in farming all subsidies were removed. For much of the Network an historic business model of little renewal or investment was used in an effort to minimize short term prices. More comprehensive hazard control requirements than those of past times meant that a renewal backlog has had to be addressed in recent years. TLC has had to find innovative ways to ensure it has adequate revenue to fund these necessary renewals both now and into the future.

To ensure it has the cash available to buy materials, labour and plant resources to renew the network, TLC has had to put in place pricing methodologies that are cost reflective and eliminate the risk of revenue reducing as energy efficient appliances and solar technologies become more common. The costs of operating a network are not related to the volumes it transports but more demand. If volumes reduce and costs remain the same the only way of compensating for this effect is to increase the amount for each unit of energy volume or KWh transported. This quickly makes technologies' such as solar even more economic and as such creates a downward spiral that over time would see the value of the assets eroded.

Quality

The average number of minutes without supply in a year suffered by TLC customers has been stabilized at a level that consultation with customers in the early 2000's indicated they felt appropriate. That is, across the Network customers thought that on average, 300 minutes a year without power for both faults and repairs and the power going off about 4 times a year would be acceptable. Our performance over the last six years is an average of 280 minutes per customer per annum with the power going off 3.55 times annually.

Matters potentially impacting value

The following are considered the key items which may impact the value of the Network operation in the future:

1. Strengths / Opportunities
   - Increase in revenues to align with regulatory requirements through to 2018.
   - TLC has developed a lot of unique intellectual property that it believes sets it up for the future.
   - TLC has implemented pricing which includes protection against volume reductions.
   - Investment in IT and process change is likely to deliver a reduction in the customer cost to service.
   - TLC has selectively renewed and maintained its network in a way that has ensured it has got the best 'bang for the buck' spent as evidenced when TLC's indices are compared on an apples for apples basis to others in the industry.
   - TLC has implemented a unique modular approach to asset development that minimizes the risk of stranded assets and smooth's investment. For example substations typically cost $1 to $2 million and increment capacity in 5MVA increments.. TLC has been incrementing its capacity in 2MVA bites at a cost of about 30% to 40% of the legacy method by deploying uniquely designed modular substations.
   - TLC has limited exposure to any one large industrial customer. Its customer base is diversified.

2. Regulatory Risks
   - Increasing disclosure and other requirements that will increase indirect costs.

3. Political Risks
   - Legislation that forces amalgamation or changes the industry structure.

4. Commercial & Other Risks
   - Some form of large natural disaster such as an earthquake or volcanic eruption that destroys a large part of the Network and there is a substantial cost in rebuilding that the balance sheet cannot support.
   - Further erosion of the customer base, particularly in areas of the Network which are already costly to service.
   - IT hacking into meter data and records could lead to difficulties for the industry. (TLC is no more exposed than the entire industry.)
   - Technology Risks i.e. technology advancing and TLC not keeping up with this in a way that allows it to react to customer requests.

Solar for grid connection is economic in the mid 20 cents per unit and solar with battery storage about two to three times this. Both are reducing in cost. The reduction in battery storage costs are closely related to increased availability and economics of electric vehicles including plug-in hybrids. Reduced battery storage costs will improve the economics of people going off the grid.

Other Investments

At about the time of the last review, the decision was taken to identify and invest in activities which would produce returns for the shareholder greater than the regulated returns from the Network business.

Investments were made in electrical contracting, run of river hydro generation and off network metering.

Many of the longer term development strategies will be focused on the Network and investments that will generate long term cash at rates greater than the regulated return from the Network business.

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 and value. The value of the Company has increased substantially to the point where the depreciation is aligned with the ongoing capital expenditure on renewals needed to provide a sustainable network.

   This option means a strong dividend flow to customers which would likely go out of the district if the ownership was transferred to another party. Customers effectively receive two months free lines charges because of the Trust ownership.

   Because TLC still has pricing headroom, work to do in completing the implementation of its capacity based pricing methodology, investment in IT and process redesign, and the maximization of the output of its generation investment implies the Company's value can be further enhanced.

   We note that the status quo does not lock the shareholders in to long-term ownership.

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

   The risks/ likely outcomes if WESCT were to distribute its shares to customers are that customers could sell shares often at less than their true value, and the Company would be captured by investors who would focus on returns only. The customers would quickly lose the benefit of local ownership and the receipt of dividends.

   Nationally this option was actioned in the late 1980's when most companies were valued considerably less than now. These gains were captured by investors not the customers.

3. Sale of the Shares

This could involve either a partial sale or a total sale.

This could add future value to the Company in a partial sale where the new shareholder brings skills, direction or capital requirements not already existing within the structure, governance and management of the Company. However a partial sale would introduce risk if shareholder interests were not aligned.

Should the WESCT wish to pursue a share sale, it is difficult to judge when would be the optimum time for such a sale. What is known is that prices and revenue are at least 10% behind where they could be under price regulation. Once this gap is bridged the value will be closer to the maximum realizable value. Sustainable revenue drives value.

4. Sale of Assets

It is possible to sell some, or all of the assets.

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

There is nothing in the present trust deed that precludes selling assets under the status quo arrangement. This is part of the normal investment portfolio review process that is taking place. Currently the retention of some or all of the generation assets is under review. Similarly the forward strategic plans will include exit plans for all assets including possibly network sectors that are not and are unlikely to ever provide returns that are acceptable to stakeholders or have unacceptable risk profiles.

5. Mergers

The major cost to a network company is the size and condition of the Network. Of TLC's forecast 2014/15 regulated revenues, 66% goes to covering depreciation and capital costs, a further 18% goes to Transpower leaving only 16% to cover controllable costs.

The benefits of any merger would mostly be around regulatory, pricing, billing and corporate. These also tend to move with the size of the organization. Merging with another lines company does have some potential, however what has tended to happen over the years is that there have been initial savings then over time these have eroded as the organisation increases in size. If the industry indices are compared there are no obvious scale benefits other than for the organizations smaller than TLC.

We have been and will continue to be active in investigating suitable merger combinations but at this time no real opportunities have presented themselves such that stakeholder value is enhanced.

Conclusion

The Directors believe that until the Network achieves a return equivalent to that permitted under the current regulations the appropriate option to consider is the status quo. Once the regulated return is achieved and effectively value maximized then a total asset sale, or a merger with another lines company could be considered.

At all times Directors will continue monitoring technological changes such that if at any stage these indicate a possible permanent diminution in value for a network business then they will advise the owner, WESCT, that it may need to re-evaluate its ownership of the Company.

A M Don
Chairman