WAITOMO ENERGY SERVICES CUSTOMER TRUST

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3rd August 2020

To all the beneficiaries of the Waitomo Energy Services Customer Trust (WESCT),

Re: 2020 Ownership Review Poll

Background:

1. The WESCT journey of owning 100% of The Lines Company (TLC) was started in 1993 by forward-looking leaders of our community. They wanted to ensure "security of electricity supply and service quality within our district **that could be for the benefit of the people in our community,** in a business environment that strives for maximising shareholder value".

2. WESCT completes an **Ownership Review Poll of the WESCT beneficiaries every six years** regarding their opinion on whether the existing trust ownership structure should remain in place. This process is a requirement in the Trust Deed.

3. Previous polls conducted in 1996, 2002, 2008, and 2014 voted overwhelmingly in favour of retaining the current ownership structure.

4. Similar to previous polls, WESCT commissioned an independent report, and the TLC Board has provided a report. Full copies of these reports follow this letter and are available on the WESCT website – www.wesct.org.nz

Report Conclusions:

1. **Utility Consultants Ltd completed the independent report**. The summary statement in this report is:

   "The overarching conclusion of this report is that continued **100% ownership if The Lines Company by the Waitomo Energy Services Customer Trust is the best way to continue** the existing arrangement of possible community benefits (line charges lower than allowable by law, income distributions, and local jobs for local people)."

2. The **recommendation of the TLC board** was:

   "From a commercial perspective, **we believe WESCT should for the foreseeable future continue to hold TLC shares** with a long-term view and continue to be cognisant of the concept of intergenerational equity".

WESCT Trustee Recommendation:

1. The Trustees agree with the conclusions of the reports and respectively **recommend that the beneficial customers retain the current ownership structure.**

2. The Trustees believe **the current ownership structure provides the best option to continue to obtain benefits** from:

    i. Local control of vitally important infrastructure for both our family homes and local business development **(e.g. local people as Trustees that help set the direction of the business through the annual Statement of Corporate Intent process).**

    ii. TLC being able to charge lower than the maximum allowable line charges (e.g. in the nine years to 31st of March 2019, in recognition of affordability, **TLC charged customers over $30m less than was allowed by the Commerce Commission** which may not have occurred otherwise under a non-beneficial (non Trust) ownership structure).

    iii. The distribution of profit, derived from the network business, back into our local community **(which has seen over another $30 million in discounts and dividends passed back to beneficiaries over the last six years)**.

    iv. A significant local business providing locally based training and job opportunities and career paths for all people in the community – but especially our young people **(e.g. trainee line mechanics, and 118 people who work for TLC live on the network)**.

    v. A locally owned business that can recognise and act on assisting with the specific needs of our community as they may arise from time to time **(e.g. the COVID-19 response of reduced charges in April 2020, and the continued response of helping to make homes more energy-efficient through the Maru Trust).**

With all that in mind, we encourage you to **have your say and vote in the Ownership Review Poll.**

Yours faithfully

The 2020 WESCT Trustees:

Cathy Prendergast, William Oliver, Peter Keeling (Chair), Erin Gray, Nigel Chetty, and Janette Osborne.

WAITOMO ENERGY SERVICES CUSTOMER TRUST

(“WESCT”)

2020 Ownership Review:

1. **Formation and history of WESCT.**
2. **Independent ownership review report – Utility Consultants Ltd.**
3. **TLC Board of Directors recommendation.**

August 2020

History of the Trust

Origin of the Trust

The Waitomo Electric Power Board was a body corporate duly constituted under the Electric Power Boards Act of 1925. Government reforms of the electricity industry resulted in the Board incorporating Waitomo Energy Services Limited (the Company). Under Section 27 of the Energy Companies Act 1992, the Minister of Energy approved an establishment plan under the Energy Companies Act 1992. This plan provided for the allocation of shares to be held by Trustees.

Established in 1993 from Government Corporatisation, Waitomo Energy Services Customer Trust (WESCT) was issued 16,000,000 shares to be held by the Trustees on behalf of the customers in the District. The purpose of creating a Trust entity owning 100% of the shares in Waitomo Energy Services Limited eliminated the possibility of the fragmented ownership that would have resulted, were the shares issued directly to customers.

Transactions involving changes in shareholding

1. The original shareholding in 1993 was 16,000,000 shares held by WESCT. In September 1996, beneficial customers approved a share sell-back to the Company. WESCT redeemed 2,836,882 shares that resulted in the total shareholding reducing to 13,163,118. The distribution of $8,000,007 of surplus capital funds, held by WESCT from this transaction to beneficial customers took place in December 1996.

2. In July 1998 the Electricity Industry Reform Act came into force and required all energy companies to separate their lines businesses from electricity generation and retailing. Shareholders of lines companies were prohibited under the Act to own more than a 10% shareholding in any electricity generation and retailing company.

   To comply with the above legislation, beneficial customers approved a merger between the Company and King Country Energy Limited as both these companies were in the business of lines distribution and electricity generation and retailing. The merger resulted in the Company selling its electricity generation and retailing business to King Country Energy Limited. The Company then purchased the network (lines) business from King Country Energy Limited.

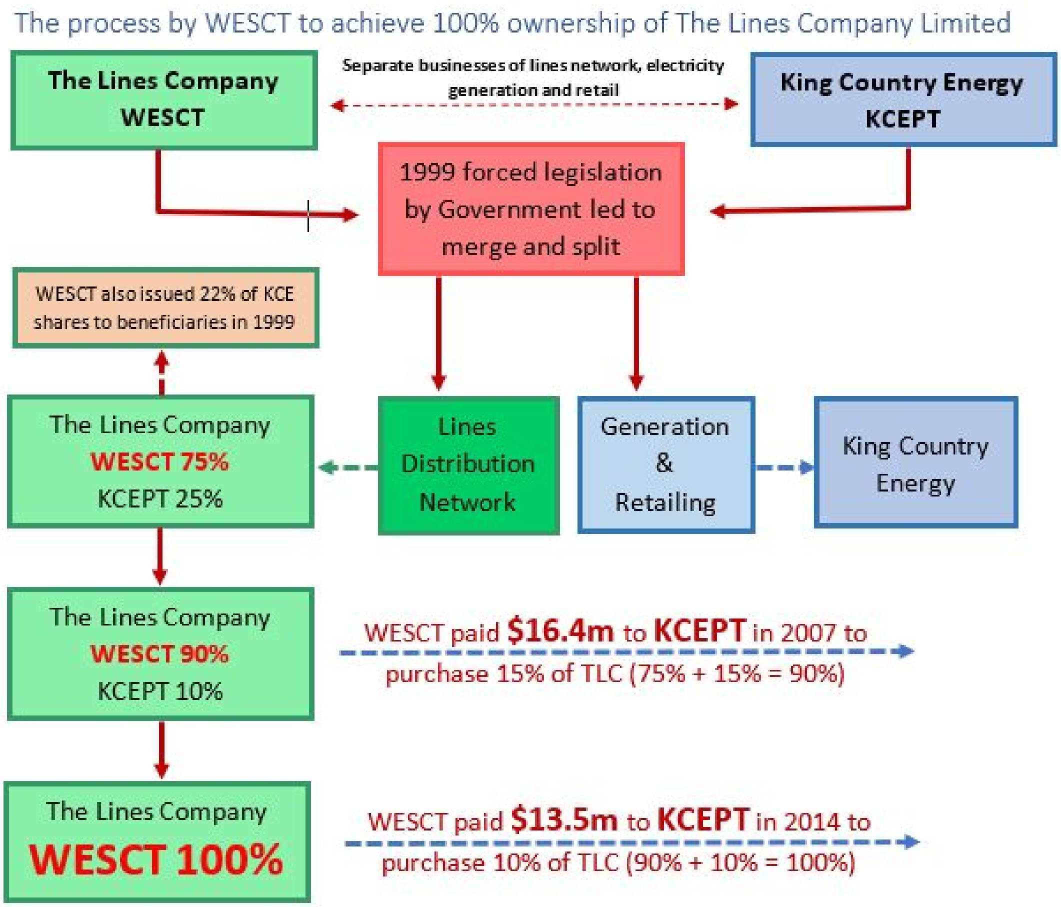
   This merger transaction resulted in the Company being in the core business of a lines distribution network. The Company's geographical area of the lines network approximately doubled in size after this transaction. The two areas are commonly referred to as the northern and southern areas. The Company was now 75% owned by WESCT and 25% owned by King Country Electric Power Trust (KCEPT) and WESCT held 9,872,340 shares.

3. On the other side of this merger transaction, King Country Energy Limited took over the business of electricity generation and retailing. To avoid breaching the legislation of owning no more than a 10% shareholding in any electricity generation and retailing Company, WESCT distributed its excess shares held in King Country Energy Limited to its beneficial customers in 1999. WESCT retained 1,503,514 shares in King Country Energy Limited which was under the 10% legislative threshold.

The above merger transaction resulted in the Company focusing its expertise in the lines distribution network. A name change then followed from "Waitomo Energy Services Limited" to "The Lines Company Limited" (the Company) in 1999. The Company structured itself to become experts in three business function areas; lines network, metering and contracting.

4. In July 2007 WESCT purchased 15% of KCEPT's shareholding in the Company, being 1,974,468 shares for $16,400,000. This purchase increased WESCT's shareholding to 11,846,808 shares in the Company. At the same time, WESCT also disposed of its 1,503,514 shares held in King Country Energy Limited.

5. In January 2014 WESCT became the 100% shareholder of the Company.



Trust Ownership & Returns to Beneficiaries

WESCT receives discounts from the Company that are now distributed by way of five-month then seven-month discount credit to a beneficial customer's account. For the year ending the 31st of March 2019, the Trust delivered a discount of $6.4 million including GST as a return to the beneficial customers.

The Trust reviews its ownership structure every six years; therefore, reviews were carried out in 1996, 2002, 2008 and 2014. Each review requires a poll of all beneficial customers, and the outcome continues to report more than 90% of customers supporting the retention of Trust ownership. Under the terms of the Trust Deed, the next review is due to be undertaken in September 2020.

Trustees

The Trust is administered by six Trustees, apart from the years ended 2009 and 2010 where there were only five Trustees. For recognition as a wholly-owned Trust, customers must have elected all Trustees, and there was a conflict between the Trust Deed and the 2008 amendments to the Commerce Act. The Trust resolved not to appoint an "appointed trustee" to avoid breaching the legislation. An investigation, however, concluded that due to the election process of the "B" Trustees, WESCT was not recognised as being wholly-owned (under the Commerce Act) in any event. In April 2010, therefore, WESCT resolved to continue to appoint an "appointed trustee" to the Board.

The trustee election process is as follows:-

(a) **Three (3) "A" Trustees**
These three Trustees are elected by postal vote of beneficial customers. The position expires after three years which will be the 30th of September 2020. The "A" Trustees are Nigel Chetty of Ōtorohanga, Erin Gray of Te Kūiti and William Oliver of Te Kūiti.

(b) **One (1) "Appointed" Trustee**
The elected "A" Trustees jointly appoint the Trustee to this position. The current "appointed" Trustee is Janette Osborne of Waitomo. This position expires on the 30th of September 2020.

(c) **Two (2) "B" Trustees**
Major beneficial customers elect these two Trustees. The position expires after three years. Cathy Prendergast of Arohena and Peter Keeling of Te Kūiti, currently hold these positions which expire on the 31st of March 2022.

WESCT and The Lines Company Limited

The Trustees monitor Company performance by way of an annually agreed Statement of Corporate Intent.

The Trustees appoint the Directors of the Company and monitors their performance through annual reviews. Directors are required to retire by rotation and may offer themselves for re-appointment. The Board of Directors is responsible for the day to day management and operations of the Company, which is not the responsibility of the Trust.

The Trust expects the Company to strive for maximisation of beneficiary benefit and ensuring quality of supply. In their decision-making role, the Trustees are continually mindful of their vision "Growing and enhancing our community asset for the sustainable benefit of the Trust beneficiaries, now and in the future".

The Trust Deed contains specific requirements regarding the functions and operations of the Trust, a copy of which is available to the beneficial customers.

Visit the website www.thelinescompany.co.nz for further information on The Lines Company Limited.

Report to assist ownership review

Prepared for the WESCT

by Utility Consultants Ltd

www.utilityconsultants.co.nz

July 2020

0. Summary at a glance

The over-arching conclusion of this report is that <u>continued 100% ownership</u> of The Lines Company by the Waitomo Energy Services Customer Trust is the best way to continue the existing arrangement of possible community benefits (line charges lower than allowable by law, income distributions, and local jobs for local people).

0.1 The Trust and the Company

- The Lines Company owns and manages the electricity distribution network in the Waitomo[1] and King Country areas of the central North Island, which supplies 18,548 electricity customers through 23,948 network connection points[2] across some of New Zealand's most challenging terrain including the slopes of Mount Ruapehu.

- The Lines Company is owned by the Waitomo Energy Services Customer Trust, similar to how your house or farm might be owned by a trust.

- The Waitomo Energy Services Customer Trust is governed by trustees who are elected by connected electricity customers throughout the Waitomo areas.

- The trustees' responsibilities and obligations are set out in the Trust Deed.

- One of those obligations is to regularly review the Trust's ownership of The Lines Company, which is what this report is about.

0.2 The Ownership Review

- This report has been prepared to assist the Waitomo Energy Services Customer Trust with its Ownership Review.

- In addition to addressing the requirements of the Trust Deed, this report identifies the significant benefits of trust ownership which sees (i) lower line charges than what otherwise might occur, and (ii) the value of those lower line charges retained within the community.

0.3 Key conclusions of this report

The high-level conclusions of this report include…

[1] "Waitomo" is used throughout this report to conveniently describe the former Waitomo Electric Power Board supply area, which includes virtually all of the Waitomo and Otorohanga Districts, and parts of the Taupo District (Mangakino, Whakamaru and Tirohanga).

[2] Numbers of customers and connection points provided by The Lines Company.

- That the existing 100% trust ownership arrangement has resulted in The Lines Company charging its customers over $30m less than allowed by law over the period 1st April 2010 to 31st March 2019, improving the competitiveness of local businesses and the well-being of households. This is in addition to the annual distribution from the Company of about $5m per year. Both of these returns of value to the community would be unlikely to occur under the other ownership arrangements considered.

- Keeping a corporate office within the network area and ensuring that services are provided from within the network area. This ensures that local knowledge is retained locally, and that professional career paths are available within the community.

- The Waitomo Energy Services Customer Trust's total expenses are slightly higher than the other 2 comparable trusts (Waitaki and West Coast), but certainly not to an unacceptable level. Those total expenses of about $200,000 to $250,000 per year should be considered in the context of keeping about $8.4m of value per year in the community[3] ie. a payback of about 13x.

- An advantage of continued 100% trust ownership is avoiding the inherent tension between investing in supply reliability for the benefit of customers, and paying dividends to an owner. Under the 100% trust ownership model, many customers are also owners so they benefit either way.

- The option that is most likely to provide stable, long-term ownership and continued return of value to customers and the wider community is continued 100% trust ownership.

[3] This approximately $8.4m has occurred in recent years. The third default price-quality path (DPP3) which started on 1st April 2020 may reduce this annual benefit.

Contents

1. Introduction

1.1 Context for this report

The context for this report is the ownership review of the Waitomo Energy Services Customer Trust (the "Trust") of its 100% shareholding in The Lines Company (the "Company"), as required by the Trust's Deed[4,5] (the "Deed"). A key theme of this report is the customer and wider community benefits that stem from 100% Trust ownership which would almost certainly be lost under the alternative ownership arrangements.

1.2 Ownership review requirements

Clause 4 of the Deed addresses the issue of distribution of shares in the Company, with clauses 4.4(a) and 4.4(b) setting out the following specific requirements for a report to be published by the Trust, viz…

- 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.

- 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.

This report addresses the above requirements, and also examines in detail the wider customer and community benefits of the current 100% trust ownership which would almost certainly be lost under the alternative ownership arrangements.

1.3 Electricity distribution regulatory framework

The regulatory framework for electricity distribution is set out in Part 4 of the Commerce Act 1986[6], which includes *inter alia*…

- Subpart 3, which sets out the specific regulations to be compiled by the Commerce Commission (commonly known as the Input Methodologies).

- Subpart 4, which provides for certain industries to be subject to an information disclosure regime. This requires specified electric transmission and distribution companies, gas pipeline companies and airports to annually compile and disclose a wide range of both historical and forecast information.

- Subpart 6, which sets out the default price-quality regulation that The Lines Company is subject to. At the time of writing (March 2020) The Lines Company is subject to the second default price-

[4] Deed reference 2008_06_WESCT Trust Deed including all variations Jun 2008 (provided by the Trust).

[5] Failure to perform an Ownership Review in accordance with the Deed could mean that the Trustees have failed in their duties.

[6] http://www.legislation.govt.nz/act/public/1986/0005/latest/DLM87623.html

quality path (DPP2)[7] compiled pursuant to s52P of the Act[8], and will be subject to DPP3[9] from 1st April 2020 until 31st March 2025.

- Subpart 9, which sets out specific regulations for electricity distribution.

[7] https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-default-price-quality-path/2015-2020-default-price-quality-path

[8] http://www.legislation.govt.nz/act/public/1986/0005/latest/DLM1685621.html

[9] https://comcom.govt.nz/regulated-industries/electricity-lines/projects/2020-2025-default-price-quality-path?target=documents&root=91370

2. Advantages and disadvantages of Trust ownership

The benefits to customers of 100% trust ownership include…

- A single shareholder is likely to result in a Board that is more united, and therefore more able to focus on improving company performance rather than reconciling potentially competing shareholder interests.

- The discounts, dividends and lower line charges attribute to the connected customers rather than to a third party who would be focused solely on financial returns.

- Over the period 1st April 2010 to 31st March 2019 The Lines Company has charged its customers over $30m less than allowed by the default price-quality path, which would be unlikely to occur under the alternative ownership models examined.

- The dividends paid by the Company are more likely to remain in the local communities than under the alternative ownership models examined.

- The alternative ownership models would be less likely to retain a full head office and executive team within the local community[10].

- The alternative ownership models could see some locations or functions of the Company's business serviced from other areas such as Te Awamutu or Taupo eg. Otorohanga faults serviced from Te Awamutu.

- A trust is more likely to seek external advice and more able to afford external advice on either continued ownership or disposing of the shares in the Company, almost certainly more than individual shareholders might.

[10] It is noted that mergers between large electric companies in America are either proposing or being required by regulators to maintain a minimum number of executives in the city of the acquired company.

3. Other options for Company ownership

3.1 Ownership options to be examined

A range of possible ownership options for the Company are shown below…

Decreasing degree of Trust ownership →

Options ↓

	Total	Controlling	Minority	None
Retain full trust ownership.	1(a)			
Transfer shares to customers.		2(b)	2(c)	2(d)
Transfer shares to the local authorities.		3(b)	3(c)	3(d)
Sale of the shares by the Trust, followed by transfer of the sale proceeds to customers.		4(b)	4(c)	4(d)
Sale of the shares by the Trust, followed by transfer of the sale proceeds to the council.		5(b)	5(c)	5(d)

3.2 Analysis of ownership options

The issues associated with each option are considered below…

Option 2 – Transfer shares to customers

- Option 2(b) represents decreasing Trust ownership, albeit with a controlling stake retained. A possible outcome of this option is that at least some of those transferred shares could be on-sold (either to another EDB keen on consolidation, or simply to another investor).
- Options 2(c) and 2(d) represent further deceasing Trust ownership, but without the safeguard of the Trust retaining a controlling stake. Again, it is likely that at least some of those transferred shares would be on-sold.
- The evidence from the transfer of shares to EDB customers[11] in the mid-1990's was that many customers didn't fully appreciate how valuable those shares were, and quickly on-sold them. From an inter-generational perspective, almost 100 years of careful value accumulation began to erode away.
- Options 2(b), 2(c) and 2(d) would incur higher administration costs such as a share register and compliance with the Financial Markets Authority requirements.
- It could be possible to attach some sort of connected customer criteria to the shares, preventing transfer (or making them worthless) to a non-customer owner. This begs the question, however,

11 Or (from memory) to those on the electoral rolls in the case of Thames Valley.

that if the intent is for customers to benefit from stable ownership of the Company then why not continue with 100% Trust ownership ?

Option 3 – Transfer shares to the local authorities

- On the face of it, the local authorities are more likely than individual customers to (i) appreciate the value of the shares, and (ii) take professional advice before selling the shares. In any case, a deed of transfer could specify *inter alia* that the council cannot sell the shares or must undertake a ratepayer poll before selling. However, ownership by more than 1 local authority could also complicate ownership and make 75% decision thresholds difficult to achieve.

- It would be nice to think that council would use the dividends from the shares to fund something a bit special and out of the ordinary for the community beyond what would be funded from council rates, however the emerging picture is that at least some councils treat EDB dividends as an expected income stream (whilst on the whole retaining the capital for a range of purposes including retiring debt or investing in long-life community assets[12]).

- This could also trigger the need for allocating share parcels among more than 1 local authority, which (as noted above) could be difficult[13].

- From a philosophical angle of stable, long-term ownership for the benefit of connected customers, the question is "what might council ownership provide that Trust ownership doesn't". The above analysis suggests "possibly less than continued Trust ownership, or unlikely to be greater but with added transaction costs".

Option 4 - Sale of shares, transfer sale proceeds to customers

- Whilst options 4(b), 4(c) and 4(d) represent a similar transfer of value from the Trust *per se* to the beneficial owners similar to options 2(b), 2(c) and 2(d), the sale price is likely to be greater because the Trust would be required to undertake a more rigorous and disciplined sale process.

- Nonetheless, it would still be expected that at least some individual customers will spend their sale proceeds rather than invest it[14] (the squandering of intergenerational wealth).

Option 5 – Sale of shares, transfer sale proceeds to the council

- Options 5(b), 5(c) and 5(d) are philosophically similar to options 3(b), 3(c) and 3(d) in that there is a transfer of value from the Trust to the council.

- Similar to option 3, it would be nice to think that the council would use the sale proceeds for something a bit special and different that wouldn't ordinarily be funded from council rates (and the evidence is that councils were doing that in the past)[15].

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12 Analysis of how energy company sale proceeds have been spent by councils and trusts, Utility Consultants 2003.

13 The most prominent example of this was the defaulting of the ownership of Egmont Electricity to the South Taranaki District Council (because Egmont's share allocation plan was not approved by the Minister), which was straightforward because the council and the Egmont boundaries coincided. In the case of Waitomo, the shares would need to be allocated between more than 1 council.

14 The washing machine that I bought with the sale proceeds of my WEL shares back in 1993 has long since gone to the dump…

15 Analysis of how energy company sale proceeds have been spent by councils and trust, Utility Consultants 2003.

4. Analysis of Trust's performance

4.1 Comparators for performance analysis

The Trust has about 13,000 beneficiaries, hence the following comparators have been identified…

- Waitaki Power Trust ("Waitaki") – about 12,900 beneficiaries.
- West Coast Electric Power Trust ("West Coast") – about 13,600 beneficiaries.

4.2 Performance comparisons with Waitaki and West Coast

The following performance comparisons are set out in Appendix 3 for the years ending 31st March 2015, 2016, 2017, 2018 and 2019…

- Trust total expenses.
- Trustee fees.
- Secretarial expenses.
- Election expenses.
- Audit fees.

A key observation is that whilst it costs between $200,000 and $250,000 per year to operate the Trust, that Trust ownership allows line charges to be (on average) about $3.4m per year lower than the default price-quality path allows.

5. Conclusions

5.1 Conclusions on advantages of Trust ownership

- A key advantage of continued 100% Trust ownership is the willingness to accept the Company's recommendation to set line charges lower than the default price-quality path allows, thereby creating about $3.4m per year of customer value. A further advantage of continued 100% Trust ownership is avoiding the inherent tension between investing in supply reliability and paying dividends because the (beneficial) customers are also shareholders.

5.2 Conclusions on other options for Company ownership

- The option that is most likely to provide stable, long-term ownership of the Company value for the benefit of both the beneficial and non-beneficial customers is continued 100% Trust ownership, which is option 1(a). As emphasised throughout this report, the current 100% Trust ownership arrangement has assisted the setting of line charges (on average) about $3.4m per year less than the default price-quality path allows.

- Conversely, the transfer of shares to the beneficial customers is the least likely to provide stable, long-term ownership, and the most likely to see that value frittered away (most likely into ownership models focused on maximising financial returns)

5.3 Conclusions on Trust performance

The Trust's performance over time compares reasonably with the other 2 trust's chosen for comparison, and can be summarised as…

- The Trust's distribution of value on a per-beneficiary basis exceeds (i) those EDB's that are known to charge less than their respective default price-paths allow, and (ii) those 100% trust-owned EDB's in the central North Island.

- Total costs are slightly higher than the other 2 comparable trusts (Waitaki and West Coast), but certainly not to an unacceptable level. It is noted in particular that the Secretarial costs of the 1 comparator for which data was available (West Coast) are much lower because a company employee provides those services.

Appendix 1 - advantages and disadvantages of Trust ownership

This appendix examines the advantages and disadvantages of (continued) trust ownership in detail, and identifies whether each respective advantage or disadvantage is dependent on the Trust holding a 100% stake in the Company. These issues are discussed below…

Issue	Advantage / disadvantage	Comment
Customer benefits		
• Shareholder value remains totally customer owned.	Advantage	Avoids the tension between investing in supply reliability and paying dividends to non-beneficial owners because either way customers benefit.
• All of the Company's earnings attribute to the beneficial customers, of which the majority remains in the area.	Advantage	
• The Trust has "looked after" customers interests through accepting the Company's recommendation that revenue (line charges) be less than the revenue allowed under the default price-quality path.	Advantage	Refer to Appendices 2 and 3 for details.
• Direct ownership by customers allows the distribution to be paid directly by the Company as a pre-tax amount rather than by the Trust as an after-tax amount.	Advantage	Less of the "community wealth" leaks out as tax[16].
• Allocation of benefits such as lower line charges, distributions to customers, location of jobs, awarding of scholarships etc can be targeted towards specific community needs by such mechanisms as eligibility, timing (winter, Christmas etc) etc.	Advantage	Dependent on exactly how the distribution role is struck[17].
• A strong focus on customer ownership by the Trust could lead to worthwhile amalgamation opportunities being ignored or discarded due to a fervent focus on "local ownership".	Disadvantage	

[16] The mechanism of distributing value to beneficial customers through a credit on their electric bill (as distinct from a dividend paid from the Trust) avoids the payment of company tax, effectively adding about 39% additional value (calculation is 1/(1-0.28), assuming the Company's tax rate is 28%).

17 By way of explanation, adoption of a single distribution date could heavily discriminate against a customer who has paid their line charges all year and then moves out of the area the day before the distribution date, and conversely the new occupant of the house pays 1 days' line charges and receives a whole years' distribution. The Auckland Energy Consumers Trust (now Entrust) has tried to avoid this by defining 3 distribution dates and making beneficial customers eligible for 33% of the maximum distribution for each of the 3 dates they were a connected customer of Vector.

Issue	Advantage / disadvantage	Comment
Governance		
• The present Trust Deed requires regular formal reviews of ownership, ensuring that a substantial customer investment is subject to regular scrutiny.	Advantage	
• Resolution of shareholder issues should be easier with a trust than with a widely spread group of potentially conflicting interests.	Advantage	
• Strategic opportunities may be easier to pursue with a united Trust rather than a widely spread group of shareholders.	Advantage	
• If, in the future, the Trust sold a stake in the Company to a minority investor, that minority investor would be less likely to force it's will upon a Trust than upon a widely spread group of shareholders.	Advantage	
• All of the directors are accountable to the same shareholder ie. there should be no factions on the Board representing different shareholders.	Advantage	Even if the trust holds a controlling stake, directors appointed by other shareholders may cause the Board to deviate from the trust's views.
• Absence of conflicting goals amongst different shareholders.	Advantage	Although a trust holding a controlling stake could probably get its way, achieving that could prove more difficult than with a simple 100% trust-owned structure.
• Directors will almost certainly be more accountable to a trust than to a widely spread group of small shareholders.	Advantage	Each director will be accountable to an appointing shareholder[18], which may have different views from the trust.
• The present Trust provides a stable environment for the Board and Management to focus on supply reliability and cost minimisation.	Advantage	
• Present election and appointment arrangement helps maintain the accumulated experience of the Trustees.	Advantage	Maintaining trustee experience is not dependent on the trust's stake, however the influence of those trustees is.
Industry structure, positioning & ownership		
• Provides a more robust defence against unwanted acquisitions of the Company.	Neutral	A trust is more likely to seek sound advice, but then could also reject fair offers.
• A trust would be more likely to carefully evaluate an acquisition bid than small shareholders would, including following the systematic process set out	Advantage	Could also reject fair offers despite trust beneficiaries wanting to sell, noting that the Deed requires the Trustees to conduct a Poll

18 Notwithstanding their primary duty to the Company's best interests under s131 of the Companies Act 1993.

Issue	Advantage / disadvantage	Comment
in the Trust Deed which requires a poll of beneficiaries.		of consumers as part of considering any major transaction.
• Low cost of maintaining the share register and performing other related activities.	Advantage	
• May limit the Company's ability to raise equity for future development, such as acquisitions[19].	Disadvantage	Hasn't proved to be a problem simply for funding routine electricity distribution works.
• Any sale of a large tranche of the Company shares by the Trust would be likely to yield a greater per-share value than if small blocks of shares were "mopped up" by an acquiror directly from the customers[20].	Advantage	A trust would be more likely to take sound advice on whether an offer is fair[21].
• Capital gains due to the performance of the Company or to other industry factors are unlikely to reflect through to the shareholder value as they could if the shares were tradable.	Disadvantage	Difficult to reflect this with an asset re-valuation, but also pointless to go to the expense of listing just to get an accurate market valuation if there is no intention to trade the shares.
Operating costs		
• Existing Trust arrangement incurs election expenses, which are minimal (and lower than those of peer trusts).	Disadvantage	Although this is a disadvantage, it is probably a lower cost option than other ownership models[22]. It must also be viewed in the context of the cost of lower prices and keeping local employment.
• The Trust's decisions represent the majority of customers' wishes, and by default will probably not represent those who would prefer the cash rather than an "on behalf of" stake in the Company.	Disadvantage	A possible advantage is that those individuals who would prefer the cash may be prevented from selling their stakes too cheaply.
Wider community benefits		
• The dividends paid by the Company are more likely to remain in the local communities (and support local businesses) than under the alternative ownership models examined.	Advantage	
• The existing 100% Trust ownership model is more likely to retain a full head office and executive team within the local community.	Advantage	The observation from the last 30 years of NZ electricity distribution consolidation is

[19] Noting that funding could be raised by retaining distributions.

[20] It is noted that this may be less of an issue under the existing Takeovers Code, which requires all shareholders to be paid the same amount.

21 There was plenty of anecdotal evidence from the energy company share give-aways of the mid-1990's that most individual shareholders had little if any understanding of the value of their shares and rapidly on-sold them. Comment at the time was that many electric power board customers owned their shares for as long as it took to walk from the power board offices to the caravans set up by the share brokers.

[22] The analysis in Appendices 2 and 4 indicates that the total cost of operating the Trust of about $250,000 per year allows line charges to be about $3.4m per year less than they otherwise might be.

Issue	Advantage / disadvantage	Comment
		that small towns have lost executive teams and head offices[23].
• The existing 100% Trust ownership model is more likely to see all areas of the Company's business serviced from within the Waitomo and King Country areas.	Advantage	
• Setting a revenue requirement lower than allowed under the default price-quality path may provide a competitive advantage to local energy intensive businesses, with the flow-on effect of retaining jobs in local communities.	Advantage	

[23] A further observation dating back to the late 1990's was the proposed amalgamation of Alpine Energy, Network Waitaki and Otago Power (prior to the acquisition of Otago by the southern consortium). It was proposed that head office would be in Timaru, finance and admin in Balclutha, and engineering and operations in Oamaru. Further analysis revealed that the costs of keeping those 3 offices made the merger virtually pointless.

Appendix 2 – lower line charges through Trust ownership

Section 2 of this Report notes that the current Trust ownership arrangement allows the Company to charge less than it is allowed to under the default price-quality path[24], viz…

YE 31st March	2011	2012	2013	2014	2015
Allowable[25]	$25.67m	$27.41m	$29.75m	$33.36m	$38.08m
Actual	$24.46m	$26.65m	$28.97m	$28.98m	$30.57m
Difference	**$1.21**	**$0.76m**	**$1.95m**	**$4.39m**	**$7.51m**

YE 31st March	2016	2017	2018	2019	Total
Allowable[26]	$35.11m	$35.87m	$36.18m	$39.25m	$300.68m
Actual	$31.44m	$31.75m	$32.56m	$35.92m	$270.13m
Difference	**$3.67m**	**$4.12m**	**$3.61m**	**$3.33m**	**$30.55m**

This analysis concludes that over the 9 year period from 1st April 2010 to 31st March 2019, the Company's customers[27] have paid over $30m less in line charges than they otherwise might[28] have done under a non-beneficial ownership arrangement, which averages to about $3.4m per year.

[24] Taken from The Lines Company's price path compliance statements.

[25] The precise terms used to describe the allowable revenue and actual revenue have changed over time, so this report has simply used "allowable" and "actual".

[26] The precise terms used to describe the allowable revenue and actual revenue have changed over time, so this report has simply used "allowable" and "actual".

[27] It is specifically noted that this benefits all customers, not just the beneficial customers. It is further noted from the MBIE quarterly survey included in the 2015 Trust Report that the average line charges are lower in the southern network than in the northern network.

[28] The word "might" is specifically used, because whilst it would seem unlikely that a non-beneficial owner would charge less than the allowable revenue it is possible.

Appendix 3 – comparison with other EDB distributions

A3.1 EDB's compared to the Company

This appendix compares the Company's distributions of benefits with the following two cohorts…

- A cohort comprising non-exempt beneficially owned EDB's that are known to be charging less than the respective default price-quality paths allow.

- A cohort comprising beneficially owned EDB's in the central North Island.

Cohort		Basis for inclusion in cohort
1	• The Lines Company • Top Energy • Centralines • Network Tasman	• Fully trust owned[29]. • At least some beneficial customers[30]. • Subject to a default price-quality path (non-exempt). • Charging less than the DPP allows is a key method of returning value to beneficiaries[31].
2	• The Lines Company • WEL Networks • Waipa Networks • Counties Power • Electra	• Fully trust owned. • Central North Island.

A3.2 Classes of benefits

The following benefits have been identified for this analysis…

Class of benefit	Benefit	Ability to meaningfully compare with other EDB's
Cash direct to beneficiaries	Payment from Trust.	High
Avoided payment by beneficiaries	Credit on bill.	High
	Charging less than DPP allows[32].	High
Wider economic benefits[33]	Trust choosing not to take dividend.	High

[29] Thereby excluding Vector, which is 75.1% trust owned.

[30] Thereby excluding Eastland Network, which does not have any beneficial customers.

[31] Thereby excluding Unison, whose line charges are almost right up to the default price-quality path.

[32] As noted in Appendix 2, charging less than the default price-quality path allows benefits all customers, not just the beneficiaries.

[33] The "Low" categories have been excluded from further analysis.

Class of benefit	Benefit	Ability to meaningfully compare with other EDB's
	Maintaining corporate office.	Low
	Competitiveness of local businesses.	Low
	Spending power retained in community.	Low
	Maintaining capability within network area.	Low

A3.3 Comparisons of value distribution to beneficiaries

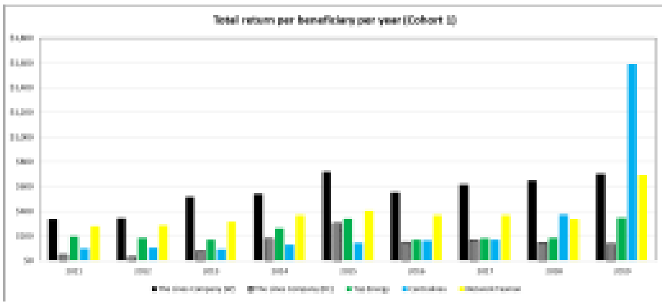
It is understood that each of the comparator EDB's identified in Section A2.1 distributes value to beneficiaries in the following ways…

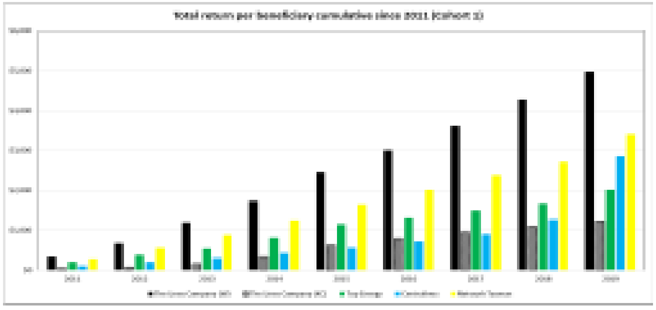
Benefit	Cohort 1			
	The Lines Company	Top Energy	Centralines	Network Tasman
Payment direct from Trust		● [34]	●	●
Credit on electric bill	●	●	●	●
Charging less than DPP allows	●	●	●	●
Trust choosing not to take dividend	●			

Benefit	Cohort 2					
	The Lines Company	The Lines Company	Waipa Networks	WEL Networks	Counties Power	Electra
Payment direct from Trust						
Credit on electric bill	●	●	●	●	●	●
Charging less than DPP allows	●					
Trust choosing not to take dividend	●					

Note – charging less than the default price-quality path allows directly benefits all customers, and not just the beneficial customers (those who are eligible to receive a discount on their electric bill).

[34] The Top Energy Trust made its last direct distribution during the YE 21st March 2011. Subsequent distributions have been from Top Energy on customers' bills.

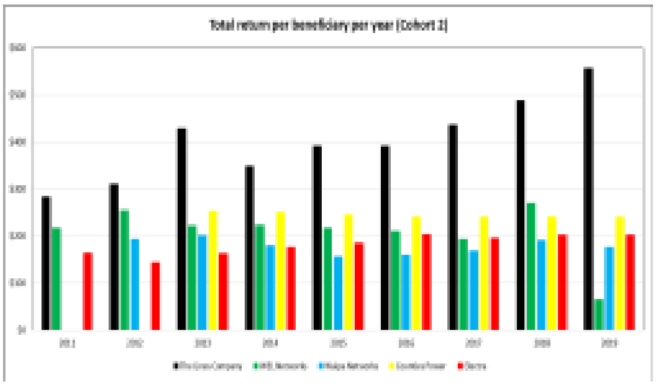


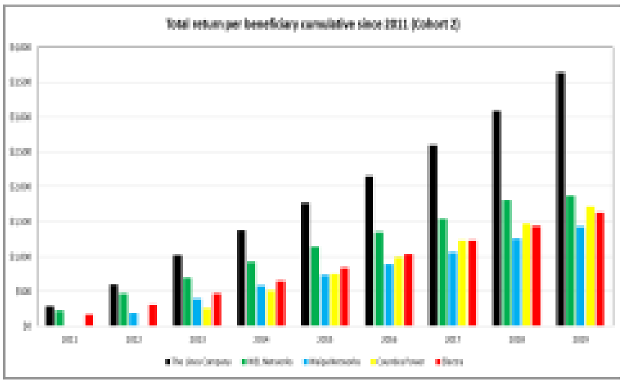


The value distribution to beneficiaries from Cohort 2 is shown in the following charts...

- Total return per beneficiary cumulative since 2011 (Cohort 2).
- Total return per beneficiary cumulative since 2011 from charging less than the DPP (Cohort 2).

The second chart in particular shows that the cumulative return to the Trust's beneficiaries exceed those of other trusts in Cohort 2 (central North Island).

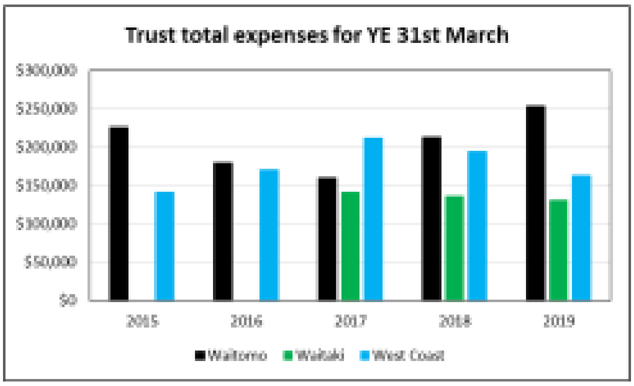


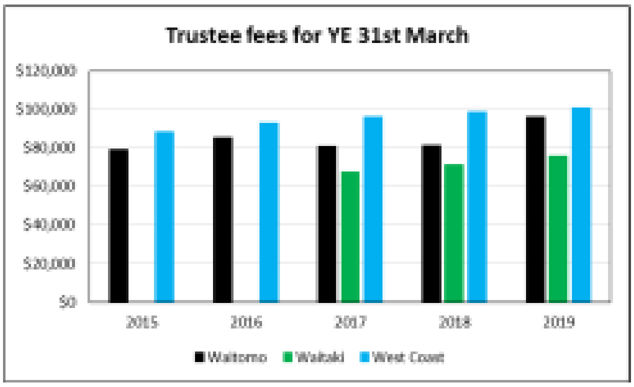


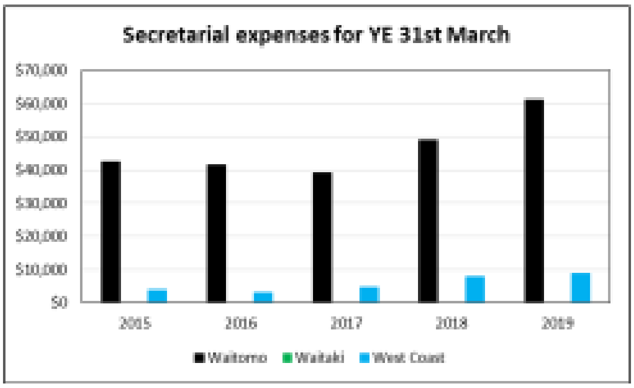
Appendix 4 – comparison of Trust performance

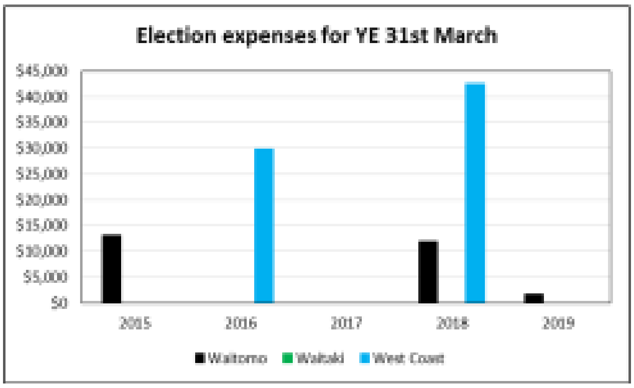
The following charts compare the Trust's various costs with Waitaki and West Coast.

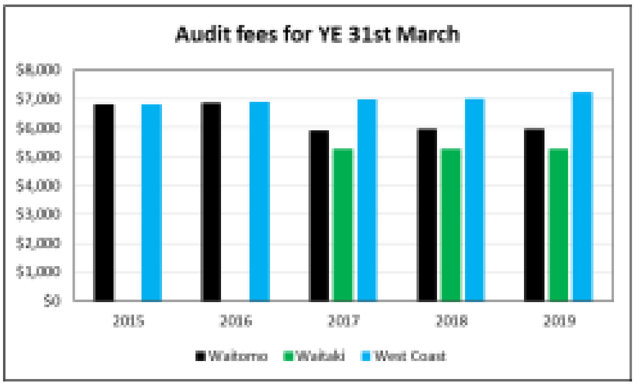
- Trust total expenses.
- Trustee fees.
- Secretarial expenses.
- Election expenses.
- Audit fees.











The following comments are made in regard to the Trust's costs…

Cost category	Factors that influence costs	Comments in regard to Waitomo's costs
Trust total expenses	• Refer to cost categories identified below. • Complexity of trust's affairs, including the need to engage with other shareholders. • Need to take legal or financial advice on issues eg. unsolicited takeover bid, dissent amongst trustees, decision to seek independent assurance of company decisions etc.	• Overall the Trust's total expenses are slightly higher than Waitaki and West Coast, except for (i) 2017 where they were lower than West Coast, and (ii) 2019 when they were significantly higher. • The trust may wish to provide an explanation of any increased activity or work volume during 2019 to explain why total expenses were almost $40,000 higher than during 2018. The gap is even more obvious because West Coast total expenses were lower in 2019.
Trustee fees	• Number of trustees. • Fees, which might be expected to vary regionally. • Work volume, especially if a trust has complex affairs or has to respond to an issue.	• Overall, the Trustee fees are slightly more than Waitaki but slightly less than West Coast.
Secretarial expenses	• Hourly rate, especially if the secretary is an employee of the company. • Work volume, especially if a trust has complex affairs or has to respond to an issue.	• A Westpower staff member provides secretarial services to West Coast at what appears to be a substantially lower cost. • The Trust's increased workload (especially during 2019) is noted. • Even at around $40,000 to $50,000 over the 2015 to 2018 years, the Trust's secretarial expenses are high compared to Electra, Network Tasman and Northpower, but significantly less than Counties Power[35].
Election expenses	• Number of beneficiaries. • Possible challenges or recounts. • Governance arrangement that requires more frequent elections.	• Election expenses are much less than West Coast. • The Trust's election expenses are about $1 per beneficiary, which compares favorably with about $1.50 per beneficiary for Electra, Network Tasman and Counties Power.

[35] Extracted from working papers for another ownership review project.

Cost category	Factors that influence costs	Comments in regard to Waitomo's costs
Audit fees	• Complexity of trust's finances. • Auditor's particular view of risks, and hence the level of scrutiny. • New auditor becoming familiar with the trust's affairs. • Requirement to coordinate audit with other work, including audits of related entities. • Regional variation in auditor fees.	• Overall, the Trusts audit fees are slightly higher than Waitaki but slightly lower than West Coast.

keeping you connected.

thelines company

27 July 2020

The Trustees
Waitomo Energy Services Customer Trust
P O Box 209
Te Kuiti 3941

Dear Trustees

Re : 2020 Ownership review

Executive Summary

The Directors of The Lines Company have been asked by the Trustees of Waitomo Energy Services Customer Trust to give feedback and recommendation on ownership of The Lines Company (TLC) shares.

Recommendation 1 - From a commercial perspective, we believe WESCT should for the foreseeable future continue to hold TLC shares with a long-term view and continue to be cognisant of the concept of intergenerational equity.

- TLC is gaining trust from customers and is developing a better social mandate to operate.
- With the potential for TLC to continue its efficiency drive as well as grow off-network revenue, holding shares remains a strong option as enterprise value increases. The Board have confidence in the business going forward.
- Timing is not optimum to sell shares or assets outright due to historic low levels of return driven by regulation via DPP3.
- The ability to fairly apportion and distribute value to equity generated over generations is fraught with difficulty and debate.

Recommendation 2 – In 2014 the then TLC board concluded that a merger with another lines company could be considered. In due course WESCT should carefully explore and consider potential merger options.

Background

TLC is a community owned business with an inter-generational view of the assets, governed by the TLC Board.

TLC largely operates in a regulated environment where price and quality are subject to strong regulation. TLC is also developing off network revenue centred primarily around metering through its 100% owned subsidiary FCL Metering. Off network profits increase company value and ultimately the size of distributions to WESCT beneficiaries, thereby decreasing net energy costs.

Net assets per beneficiary have been stable but are forecast to improve over time. Return on investment is stable and above average amongst EDB's.

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Context

Waitomo Energy Services Customer Trust (WESCT) was founded in 1993. Amongst the responsibilities covered by the Trust Deed the Trust is to hold the Shares of the company, to encourage and facilitate the Company to succeed, and to conduct a Customer poll every 6 years whether to retain, distribute or sell the shares in The Lines Company.

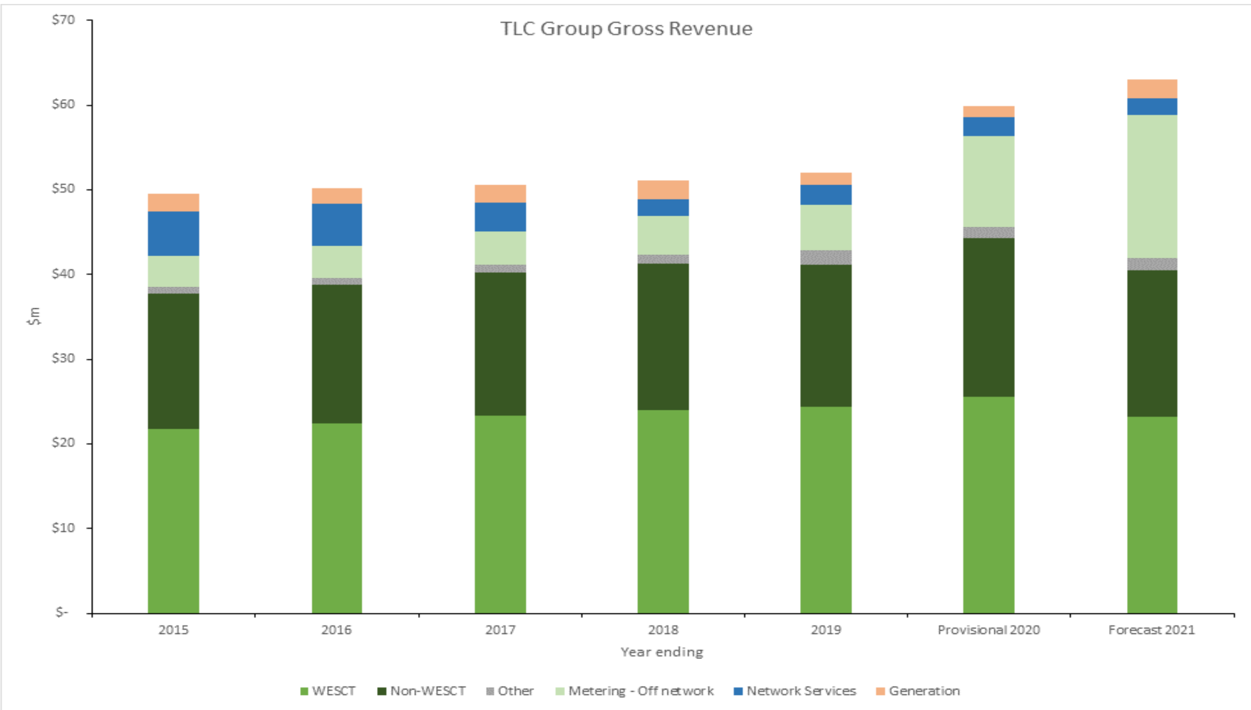
The TLC Board governs the group on the basis of the expectations set by WESCT. The current expectation delivered by the annual Letter of Expectations is that TLC is an intergenerational asset, therefore a long-term view of business assets is taken. We are aware that WESCT sees TLC as an integral part of the community landscape where TLC plays an important role of enabling energy use and keeping the community connected.

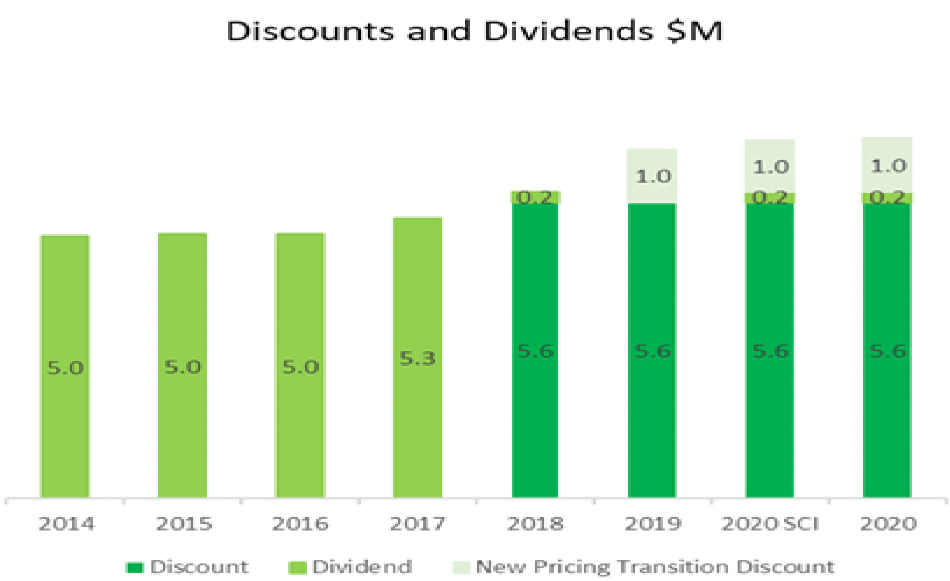
For context we recommend this letter should be read in conjunction with the 2020 Statement of Corporate Intent (SCI), including the Letter of Expectations (LoE), and the FY20 Annual Report.

Returns

TLC has continued to grow revenue and provide solid returns to beneficiaries and has further potential.

TLC derives most of its income through on-network customers, less than half of whom are beneficiaries of WESCT. Pleasingly off-network revenue is increasing as FCL Metering (FCLM) continues to grow revenue through its off-network metering footprint.





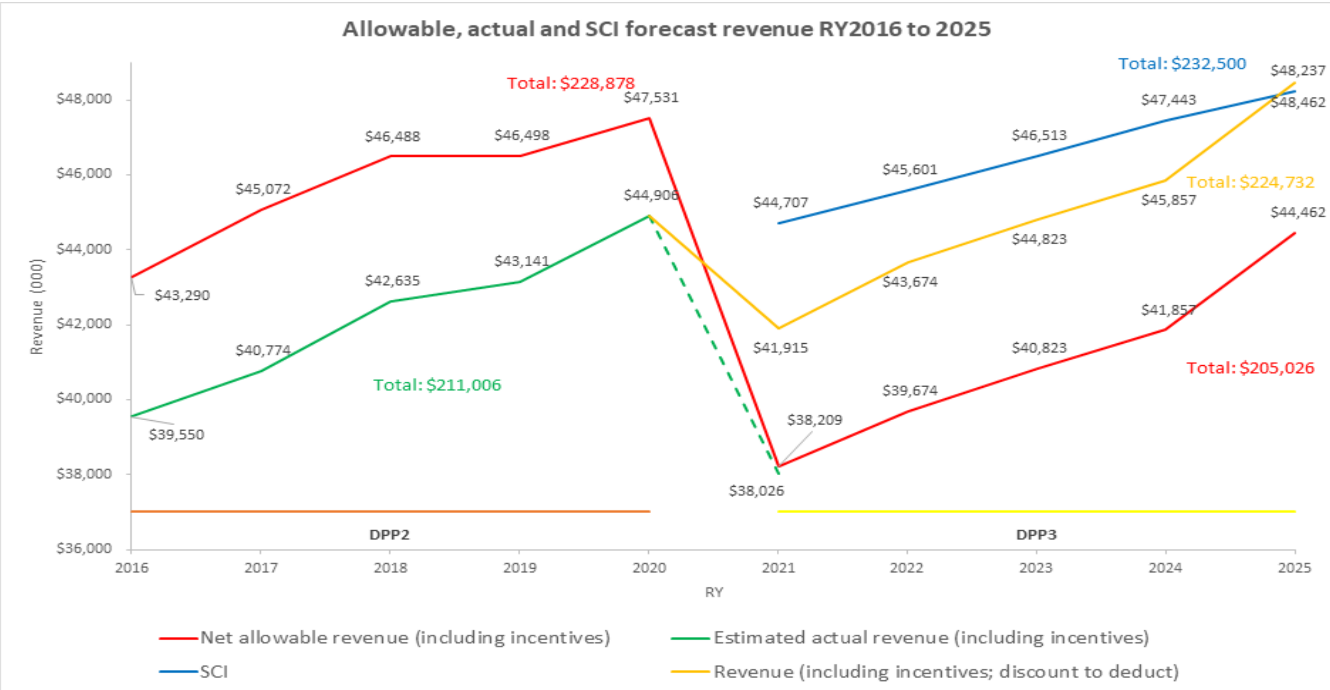
Prior to 2020 TLC did not charge the maximum allowable revenue (MAR). This would have been unlikely to occur under alternative non community ownership. Under DPP3, MAR has dropped significantly from 1 April 2020, which is largely a factor of a lower interest rate environment which has led to an underlying lower weighted average cost of capital (WACC) allowable for TLC. Under DPP3, TLC now charges to MAR but the charges to all non-contract customers have still decreased by a net 8% in 2020.

In considering any potential sale, the 2020 to 2025 DPP3 period is unlikely to be an optimum time to sell given the regulated MAR is at historically low levels. A significant premium would have to be derived by a strategic, scale or geographic benefit from another EDB, Iwi or infrastructure investor taking a long-term view, which is unlikely at this time.

Key matters impacting value

Regulated Revenue Profile - Along with 16 other electricity network companies, TLC is subject to price-quality regulation which is enforced through the Commerce Commission. Every five years the Commission resets the revenue and quality expectations for regulated electricity networks through the DPP.

The third DPP (DPP3) began on 1 April 2020 and reflects a number of material changes – most significant is the reduction in the regulated WACC used to determine the net allowable revenue that EDB's such as the TLC are allowed to earn over the next five years. The average WACC has reduced from 7.12% in DPP2 to 4.57% in DPP3 impacting the revenue profile and network asset values. This mirrors and is derived from changes in the OCR.



DPP2 and DPP3 Revenue Profile

In considering any potential sale, the 2020 to 2025 DPP3 period would not be optimum given regulated MAR is at historically low levels, unless it was an EDB merger with relative value.

Economics – the current recession / depression - The Covid-19 pandemic is a 1 in 100-year economic event that will have a profound effect on the world's economy. This poses massive uncertainly and downside for the economy which will translate to risks for TLC including lower business activity and an increase in bad debts. An EDB generally has a stable profile of revenue and is a safe-harbour investment in times like this, but still not without downside risks.

Technology disruption - The view of the Board is that the risk of off-grid technology materially affecting TLC revenue is low due to a number of factors including the unreliable nature of solar and wind-based energy generation, particularly in the King Country relative to other areas of New Zealand.

However, our view is that where smart integrated high technology networks start to develop, the lines network assets will be important for energy trading and a modern distributed TLC network will enhance the efficiency and economic returns of these new systems. The Board keep a close watching brief on technology and disruption and will actively participate going forward.

The Board thanks WESCT for the opportunity to provide feedback on the forthcoming beneficiary ownership poll.

Yours Sincerely

Mark Darrow

Mark Darrow
Chair – of behalf of the Board of Directors