

**MARLBOROUGH
LINES**

DIRECTORS OWNERSHIP REPORT

OCTOBER 2008

**Marlborough
Lines**

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1. Introduction

- 1.1 This is the third Ownership Review report of Directors to Trustees with the last review being undertaken in 2002/2003. At that time the Ownership Review recommended a continuation of Trust ownership, a position which was ultimately supported by the community and endorsed by the Marlborough Electric Power Trust.
- 1.2 The Trust's request for the Directors to provide an ownership review report was made in March 2008. It was intended that the report be completed by the end of September but was delayed due to the unexpected short term unavailability of one of the company's Directors and the principal consultant and the Trust were advised accordingly.

2. Purpose of Report

- 2.1 The purpose of this report is to address the ownership arrangements for the shares of Marlborough Lines Ltd, a limited liability company with 28 million shares.
- 2.2 The review is specifically in relation to share ownership and it is recognised the Trust Deed does not require or contemplate a general review of the future of the company.
- 2.3 The review is a requirement of section 4 of the Marlborough Electric Power Trust Deed. Clause 4.11 provides for ongoing ownership reviews at intervals of no more than 5 years once the initial review has been completed.
- 2.4 This report is provided in anticipation of a process of public consultation. Decisions which the Directors take in this report should not therefore be seen as being fixed and immovable positions, but rather should be seen as being present positions which are open to change following the process of public consultation.

3. Origins of Marlborough Lines and Trust Ownership

- 3.1 The original predecessor of Marlborough Lines was the Marlborough Electric Power Board which was established in 1923. The Power Board was a special purpose Board formed for the generation and distribution of electricity within Marlborough. It operated on a break-even basis for benefit of the electricity consumers of Marlborough.
- 3.2 The assets of the Power Board were funded initially by way of loan and were ultimately paid for by consumers over successive generations.
- 3.3 It was a requirement of the Power Board to extend the reticulation to all persons seeking an electricity supply and ultimately almost all parts of Marlborough including some of the more remote regions were reticulated.
- 3.4 At the end of the 1980s the emphasis for Power Boards began to change. The Government of the day saw the old Local Authority type structures as being inappropriate to run what had become one of New Zealand's major industries. Thus at the beginning of the 1990s a wave of change struck the electricity industry. The Government of the time changed the legislation to require Power Boards to operate as successful commercial companies. The Energy Companies Act 1992 required these companies to issue shares to be held by shareholders.
- 3.5 At that time there was considerable debate in relation to the ownership of shares. In the case of MEDs it was clear that the assets were owned by the city councils. However in the case of Power Boards, ownership became a matter for intense debate. Some advocated a share give away. Under such a system the company was to be formed and the shares in the company given away to the electricity consumers of the day or the people of the district. Then there was further argument about whether those shares should be tradeable, allowing people to freely buy and sell them on the open market. At the same time there were claims by some Local Authorities that they should be given the shares to hold for the people of the district. Others in the community advocated that a snapshot in time should not determine ownership and that the shares of the then Marlborough Electric should be held for the benefit of current and future customers.
- 3.6 At the time those responsible for the then Marlborough Electric took the view that the interests of consumers on an ongoing basis was paramount. They recognised the assets of the company had been built up over a period of some 70 years and considered the shares should be held for the benefits of the consumers of the day on a continuing basis. A means to achieve this was looked for and found. That was the arrangements where elected Trustees would hold the shares for the benefit of the consumers of the day. Consumers could receive the distributable profits as a reduction in their electricity accounts.

- 3.7 Ultimately after a long process of submissions to Government and extensive consultation within the community the structure proposed by Marlborough Electric was put into place. This structure was one of simplicity. The shares in the company were held by the Marlborough Electric Power Trust and Trustees who were elected by electricity consumers. The Trustees would appoint the Directors to run the company. The distributable benefits of ownership would be received by the consumers.
- 3.8 This same structure was adopted by most of the Power Boards in New Zealand. As part of the Ministerial process for the approval of Establishment Plans it was a requirement that the ownership be reviewed at intervals not exceeding five years. For that reason a provision was included in the Trust Deed to require ownership arrangements to be reviewed. This is the process in which we are now involved.

4. Marlborough Lines

4.1 Marlborough Lines:

- Had its origins in the Marlborough Electric Power Board which was formed in 1923; and
- Then became Marlborough Electric Limited in 1993; and
- Then became Marlborough Lines Limited in 1999.

4.2 Marlborough Lines has assets which are both physical type assets, and investment type assets.

4.3 The physical assets are:

- Lines, substations and all of the other physical assets which are required to carry electricity from the national grid to consumers.
- Buildings, vehicles, administrative systems and everything else required to operate the business.

4.4 The investment assets of Marlborough Lines are:

- A half interest in Nelson Electricity Limited, the network company which delivers electricity to the city of Nelson; and
- A 51% shareholding in the OtagoNet Joint Venture, an entity which has responsibility for the delivery of electricity in the greater Otago region, and
- A 51% shareholding in Otago Power Services Limited, a Balclutha based electrical contracting firm which employs about 80 staff.

4.5 The current ODV values (2007) of the respective networks are:

- Marlborough Lines \$111.05m
- Nelson Electricity \$20.22m (for 100%)
- OtagoNet \$89.66m (for 100%)

4.6 ODV values are not market values:

- Partly because not all assets are included in ODV valuations; and
- Because ODV is based on a standard range of replacement costs and asset lives prescribed by the Commerce Commission whereas market values are most often related to cash flow and future earnings potential; and
- As the market has repeatedly indicated, premia above ODV values have been paid throughout New Zealand. These have typically been in the range of 1.7 to 2.1 times ODV.

4.7 The company currently has debt of \$20.5m.

4.8 The company is restricted under current law from owning significant generation or retailing electricity directly. Hence Marlborough Lines and the network companies in which it has part ownership are responsible for the delivery of electricity from the Transpower points of supply to the consumers. The charges for the delivery of electricity are recovered from the energy retailers by the network companies.

4.9 Aside from the ownership of the electricity network, Marlborough lines owns and operates a substantial electrical contracting business which undertakes work on the company's own network and provides services to entities such as Transpower, energy retailers, and individual customers seeking an electricity supply. Otago Power Services undertakes the same operations in the greater Otago region and northern Southland. It is the contracting divisions which employ the majority of the staff.

5. Commercial Performance

- 5.1 Consistent with legislative requirements Marlborough Lines is required to operate as a successful business which inherently requires the production of profit.
- 5.2 Since 2002 the company has had to balance the need for profit with a regulatory system imposed by Government and managed by the Commerce Commission. The process of regulation includes a number of pricing, operational and financial disclosures and a price restriction process which is intended to limit network price increases to an annual level less than the equivalent movement on the consumer price index. However the Commerce Commission has repeatedly stated and advised that its price path was intended as a screening mechanism and that where appropriate breaches of the price thresholds would be accepted by the Commission. Equally the Commission stated it did not wish to curtail necessary capital expenditure. In Marlborough's case the company has set its annual pricing requirements having regards to the need to earn an appropriate rate of return on equity, fund significantly increased capital expenditure requirements from surpluses and to pay tax effective customer discounts. This process has resulted in some annual increases which have exceeded the Commerce Commission formula resulting in the need for the company to negotiate an appropriate price path with the Commission.
- 5.3 On a comparative basis Marlborough's network charges before discount are slightly higher than the New Zealand average reflecting the low density, predominantly rural nature of the network and the current requirement for significant capex driven by customer demand.
- 5.4 Aside from achieving returns from its own network and contracting business, the company also receives dividends from Nelson Electricity Ltd, the OtagoNet Joint venture and Otago Power Services Ltd. Cash flow from these investments has increased to a total of \$5.884m inclusive of management fees.
- 5.5 Hence the forced sale of the generation and energy retail businesses as a result of the 1998 Bradford Reforms has been offset by the acquisition of additional network investments enabling continued growth in shareholder value within the legislative constraints under which the company must operate.

6. Ownership Options

6.1 To enable an impartial assessment of ownership options the company has commissioned PricewaterhouseCoopers to undertake an independent review of the performance of the company, Trust ownership, and to provide consideration of other options for ownership as required in Clause 4.1 of the Trust Deed.

6.2 The various alternative forms of ownership considered are detailed below:

- 100% Consumer Trust ownership - (continuation of status quo)
- Joint Ventures – (a means of entering new business relationships whilst retaining some of the existing ownership structure)
- Merger by way of equity exchange – (a merger with a similar business where one entity continues and issues new shares in exchange for the assets and business of the other business)
- Distribution of 24.9% or 49.9% of Shares to Beneficiaries – (a distribution of 24.9% of the company's shares allows continued control over the constitution, a distribution of 49.9% allows continued outright control by the Trust)
- Sale of 24.9% or 49.9% of Shares to Consumers, the Public, Industry or Institutional Investors
- Distribution of 100% of the shares to beneficiaries – (A full share give-away to consumers would mean the Trust would cease to exist)
- Sale of 100% of Shares to Consumers, the Public, Industry or Institutional Investors (the Trust would need to consider whether it retains the proceeds and continues to manage them for the benefit of the beneficiaries)

7. Trust Ownership

- 7.1 It is the view of the Directorate that Trust ownership continues to serve this community and electricity consumers well. Trust ownership has ensured the successes of the company are shared with the consumers of the day through the provision of discounts, and the support of the Trust in relation to new investments in other networks has contributed greatly to the increase in net worth of the company following the Bradford reforms. Whilst there have been some restrictions in the ability of the company to move to its target rate of return, these are generally related to the Governments process of industry regulation and it is the view of the Directors that this should not result in a rejection of the ownership model. Indeed, given the recent amendments to the Commerce Act consumer controlled Trust owned companies have a greater level of self-determination in regulatory terms relative to other companies.
- 7.2 In any event if Trust ownership continues then in accord with the provisions of the Trust Deed it must continue to be subject to ownership reviews at intervals of at least every five years.
- 7.3 When the former Marlborough Electric was established under Trust ownership the majority of other companies were established using the same model. The majority of these companies have been through the review process and have elected to continue with Trust ownership. It is clear that the establishment of the industry regulatory process has put a significant brake on the level of industry rationalisation which might have been expected during the period since the Bradford reforms.
- 7.4 It is the view of the Directors that the company should continue under Trust ownership and continue to look toward further growth opportunities which will further enhance the value of the company.

8. Involvement of Shareholders and Consumers in Decision Making

- 8.1 The Trust ownership model has proven to be simple and effective in that the interests of consumers are maintained through Trust representation. This is necessary because a commercial business cannot operate in a commercial environment where a large number of people need to be consulted in the process of decision making. Whilst the threshold for shareholder involvement in major business decisions is set in the Companies Act 1993 as the major transaction level as defined in the Act, there is an interactive relationship between the Trust Deed which defines the Trusts objectives and duties, the company's constitution and the requirements for electricity companies in the Energy Companies Act 1992. These documents note the Trustees primary roles in relation to the appointment of Directors and the approval of the annual statement of corporate intent in addition to the base line requirements for shareholder/director/company relationships established in the Companies Act.
- 8.2 With the Trust model of ownership, the beneficiaries of the Trust (the customers of the day) have delegated the authority to the Trust to act on their behalf and it is the trustees who have the duty and responsibility of the decision making as shareholders.
- 8.3 Such an arrangement enables the company to operate in a commercial environment and undertake commercial decisions which could not be undertaken were there numerous shareholders. In many situations of commercial decision making, a loss of confidentiality which would result from widespread consultation would be fatal to the satisfactory completion of the commercial transaction in question. This is an important aspect to consider in the future ownership of the company if its objective is to continue to grow and expand for the benefit of consumers.

9. General Decisions Required

9.1 It is recognised the Trustees have some major decisions to make.

- Whether the Trustees see Marlborough Lines as having a strong independent future or whether the company is seen to be something which should be brought to an end? If the company is seen to be something which should be brought to an end then the process would be by the sale of all of the remaining company assets with a distribution to consumers then following.
- Whether the shares in a continuing Marlborough Lines should be held under the Trust arrangement or whether the shares should be distributed to consumers?
- Whether if shares are to be distributed to consumers they are to be distributed on a tradeable basis or on a non-tradeable basis?
- Whether any of the other ownership options outlined in section 3 of the PricewaterhouseCoopers report are appropriate for Marlborough Lines?

10. Conclusions and Recommendations

- 10.1 Clause 4.1(d) of the Trust Deed requires the Directors of the company to come to a conclusion *"as to the most appropriate form of ownership together with an indication whether the conclusions are unanimous and if the decision is not unanimous, a summary of the conclusions of the dissenting Directors shall be included"*.
- 10.2 The Directors have considered the requirements of the Trust Deed and the alternative forms of ownership that are outlined in section 6 of this report. In reaching their conclusions the Directors have had the benefit of considering the PricewaterhouseCoopers report, the various processes of industry management and regulation which have evolved since the last review and the record of progress achieved with investments in other network entities since the Electricity Industry Reform Act came into being. The Directors have sought external advice from time to time in relation to investment opportunities and which forms of ownership might best facilitate further rationalisation of the network industry. The Directors have also sought advice from PricewaterhouseCoopers in relation to the tax consequences of various ownership structures. The conclusions and recommendations of this report are unanimous.
- 10.3 The Directors of Marlborough Lines see the company as having a strong future. That strong commercial future is there to be captured just as the strong commercial and investment gains of recent years have been achieved. The strong future will only be achievable with the support of the Trust and its beneficiaries. If that support is given then we see:
- Growth in the company and continuing increases in capital values;
 - Continuing benefits to Marlborough electricity consumers; and
 - Incidental benefits to the Marlborough community from having a substantial commercial entity located in and focused upon this region.
- 10.4 This company can only prosper with the support of this community. If the community demands a break up of the company and the release of its capital then the end of the company in its present form must be contemplated.
- 10.5 If the Trustees decide to bring Marlborough Lines to an end then the proper way of doing that is to put its assets on the market in a competitive sale process.

10.6 We now turn to the ownership arrangements which would apply on the assumption that the company is to continue. We believe that the present ownership arrangements have proven to be good overall for this community. In our opinion they should be retained in the meantime at least. If there is to be movement away from them then it is logically as a result of an expansion requiring the issue of tradeable shares. However that move should only be made:

- When values have been maximised;
- When the community wants to see tradeable shares issued and understands the disadvantages (as well as the advantages) which flow from the issue of tradeable shares; and
- When the community is comfortable about continuing benefits not being available to future incoming electricity consumers.

10.7 If this company is to be continued then the Directors believe that at some time in the future the form of ownership will need to be reconsidered. Whilst the Directors note that rationalisation of the number of players in the network industry has slowed as a result of Government policy and the current regulatory environment they expect an environment which will have fewer, larger network entities. The Directors believe that it is important to at least signal this likely period of change to the Trustees and to the wider community. The current stability of ownership is essential if future opportunities are to be capitalised on.

10.8 The Directors recommend that:

- (i) The company not be liquidated;
- (ii) The company's capital not be reduced;
- (iii) The present Trust ownership structure be retained;
- (iv) The present commercial focus of the Trust Deed and Statement of Corporate Intent be retained; and
- (v) If the process of public consultation takes Trustees to a point where they believe that all or part of the share capital should be released then this should be in a process where tradeable shares are issued.

- (vi) If the present ownership structure is continued then it will be further reviewed in five years time as provided for in the Deed or earlier if required as a result of a restructuring/investment opportunity which is supported by the Company and Trust.

DWR Dew, Chairman
D A Ashton
TM Shagin

KJ Forrest, Managing Director
R G Butler
H Stone