Central Hawke's Bay Consumer Power Trust

Ownership review

Summary report

November 2018

pwc

Alistair Setter
Chairperson
Central Hawke's Bay Consumer Power Trust
PO Box 59
Waipukurau

29 November 2018

Centralines Ownership Review – Summary Report

Dear Alistair,

We are pleased to provide our Summary Report which has been prepared to assist the Central Hawke's Bay Consumer Power Trust (CHBCPT, the Trust) in regards to the periodic review of the Trust's ownership of Centralines.

This report is provided in accordance with the terms of our engagement letter dated 25 June 2018, and is subject to the restrictions set out in Appendix A.

If you have any queries regarding this report please do not hesitate to contact us.

Yours sincerely,

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Summary

CHBCPT overview

Central Hawke's Bay Consumers Power Trust (CHBCPT) was established in 1993 and is the sole shareholder in Centralines Limited, an electricity distribution company based in the Central Hawke's Bay district. The Trust holds the shares of Centralines on behalf of the Beneficiaries, who are defined in the Trust Deed as Centralines' consumers. The direct objective of the Trust is to hold the Shares on behalf of the Consumers, subject to the provisions of the Trust Deed and the outcome of ownership reviews.

CHBCPT performance

- CHBCPT's revenue is made up primarily of dividends received from Centralines. On average, during the review period, revenues and costs were largely aligned.
- The Trust did not make any distributions directly to Beneficiaries between FY14 and FY18 as benefits were passed on by Centralines in the form of consumer discounts.
- However, a significant dividend of $8m was paid to the Trust by Centralines at the beginning of FY19, resulting in a $905 tax-paid distribution payment being made by the Trust to each Beneficiary in June 2018.
- Trustee fees make up the largest proportion of the Trust's total expenditure. Relative to a sample of other consumer energy trusts, CHBCPT's Trustee fees per Trustee were low although fees per customer connection were high. This is largely a reflection of the small size of the Trust.
- The Trust has no significant assets other than its investment in Centralines, holding only a minimal cash balance.
- The Trust has no debt and its only liabilities are short-term accounts payable.
- The Trust has actively encouraged Centralines to support local economic development and engage in community sponsorship. Despite its consumer trust structure, these initiatives resemble those adopted by some community trusts.

Summary

Centralines overview

Centralines provides electricity network services across the Central Hawke's Bay region. Its network is one of the smallest in New Zealand with approximately 8,500 connection points. The rural and rugged nature of the region's terrain is reflected in Centralines' low connection point density.

An important feature of Centralines' network management is the agreement which it has in place with Unison Networks Limited (Unison). This gives Centralines access to the scale benefits, capabilities and technical expertise of a larger network company. Under this agreement, Centralines has focused on improving the resilience of its network, including investing in technology to locate faults and restore power more quickly. In addition, the agreement has allowed Centralines to benefit from work undertaken by Unison in the emerging technology space.

Centralines places a lot of importance on supporting community initiatives which are aligned with its electricity distribution business activities. For example, in FY17 it commissioned a public electric vehicle charging station in Waipukurau.

Centralines' performance

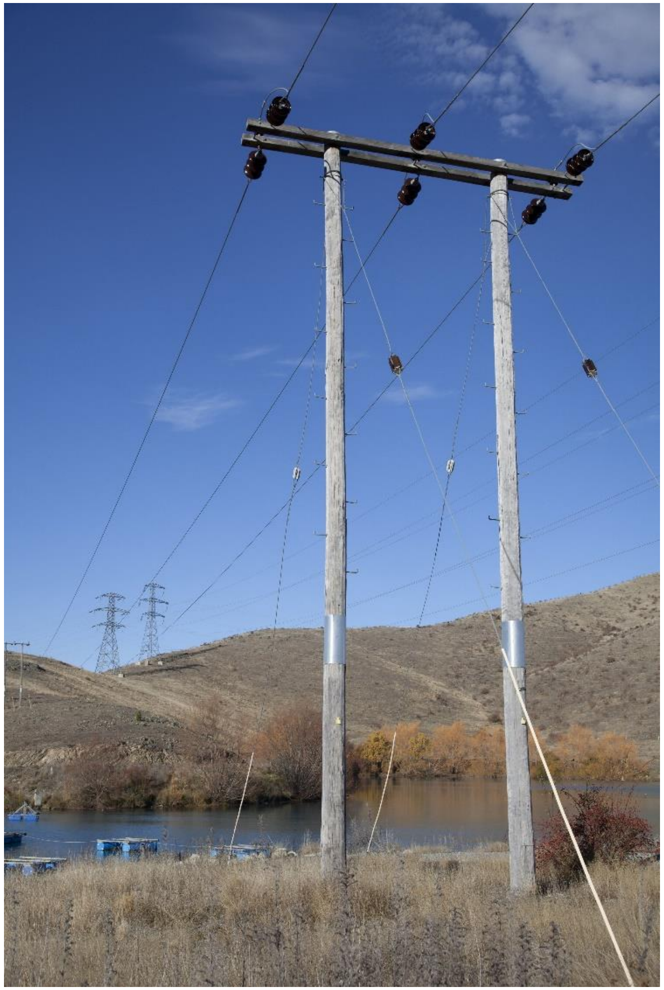
- Centralines' financial performance improved strongly over the review period, with EBITDA rising by over 60% to $8m in FY18. This was mostly due to a significant rise in line revenue (particularly the distribution component), paired with a fall in operating expenditure.
- Centralines returned just under 10% of total line charges to consumers in the form of discounts, in addition to the one off dividend in April 2018.
- Between the FY16 and FY18 assessment periods, Centralines chose not to fully recover the revenue allowance permitted by the Commerce Commission, expecting to be able to recover this in future periods. However, after being informed that this is not permissible, it recognised a correction of $2.1m to its FY17 regulatory pass through balance.
- Centralines maintained a strong balance sheet over the review period. It has no debt in its capital structure and property, plant and equipment increased by $2.5m over the period. This was despite a write-down of $6m in the carrying value of its network assets during FY18, due to the correction in its pass through balance.
- Centralines' spend on capex and maintenance opex declined over the review period. While total capex and maintenance opex was generally in line with target levels defined in its asset management plan, asset replacement and renewal capex was consistently below targets.
- In relation to the reliability of its network, Centralines has performed within regulatory SAIDI and SAIFI limits throughout the review period. The difference between actual levels and regulatory limits narrowed towards the later years of the review period. This was partly due to the increased frequency of severe weather events.
- Centralines' regulated revenue allowance increased strongly over the review period and Centralines collected the majority of this between FY14 and FY17. However, after increasing its pass-through and recoverable prices to equal its forecast pass-through and recoverable costs in FY18, Centralines has now moved to setting distribution prices lower than the regulated cap.

Summary

Centralines comparative performance

Benchmarked against a peer group of comparable EDBs (Buller Electricity, EA Networks, Eastland Network, Network Waitaki, OtagoNet Joint Venture, Scanpower and Westpower) and industry averages, Centralines' electricity lines business has performed well during the FY14-FY17 period.

- Total opex per ICP has declined over the review period, and is now in line with the industry average despite Centralines' low number of connections. This trend has been particularly strong for network opex per ICP.
- Centralines' network capex as a percentage of RAB has consistently been below the peer group average throughout the review period. This holds both for growth capex as well as renewal capex.
- In relation to network interruptions, Centralines has outperformed relative to its peer group over the review period. Power outages occur less often and restoration times are shorter relative to the peer group.
- Centralines' ROI was well below the peer group average at the beginning of the review period. However, this increased strongly over the period and was close to the industry average by FY17.
- Centralines' average unit prices (both with and without taking into account line charge discounts) for electricity network services have consistently been above the peer group average.



Summary

The sector is facing unprecedented change

The electricity sector is facing significant challenges and opportunities:

- new technologies such as more energy efficient appliances, solar, batteries and electric vehicles are impacting the nature of consumer demand
- new business models are enabling a local market place where sector participants are able to more directly engage with customers
- distribution networks are likely to act as the local market place for these activities, and will need to provide for more complex two-way electrical loads.

This has prompted consideration of the role of electricity distributors and other industry participants (for example: retailers) or new entrants, in delivering more customer centric energy solutions. Some advocates have suggested that distributors should be precluded from directly entering these contestable markets, given their monopoly status.

Since being elected in 2017, the government has announced a full-scale review of electricity prices. The initial draft, released in September, highlighted the following key points relating to electricity distributors:

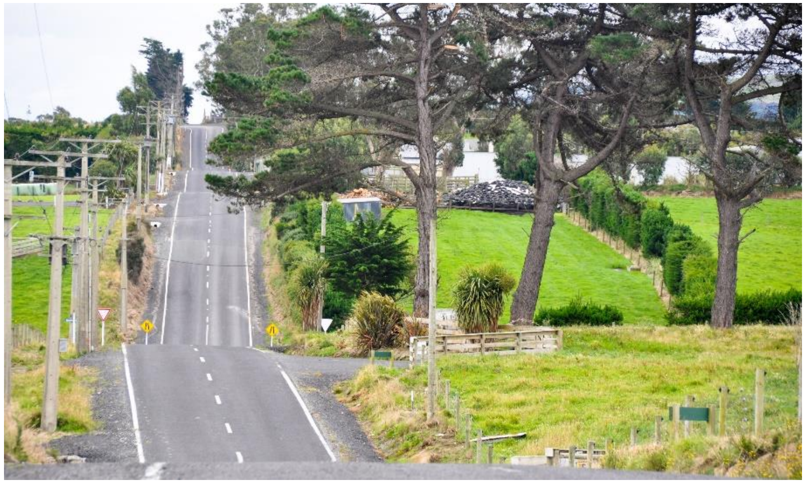
- pricing structures are outdated
- incentives for distributors to reduce costs and improve performance may be weak
- new technologies are expected to increase demand for electricity and small scale electricity generation
- regulations maintain a low-risk investment environment and are largely designed for "yesterday's technologies and business models".

The Government is also facing pressure from bodies such as the International Energy Agency to consider changes that include:

- achieving scale economies through amalgamation of distributors or the use of joint ventures and/or regional service and management agreements
- extending economic regulation to include exempt community trust distributors
- introducing regulatory incentives for innovation, and allowing the use of benchmarking to drive distributor-led innovation.

Implications for Centralines

Although these factors are creating some uncertainty for distributors, there are also opportunities to maintain and grow value through innovation and utilisation of new technology. Together with Unison, Centralines has begun to pursue opportunities in this area.



Summary

Ownership analysis

We have evaluated the advantages and disadvantages of the following trust ownership options, representative of the options available to the Trust:

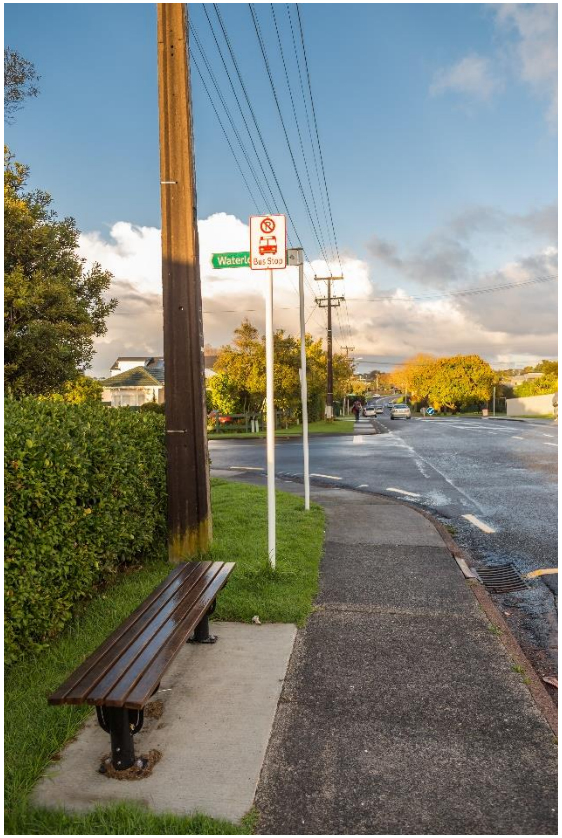
- 100% trust ownership of shares (status quo)
- distribution to Beneficiaries or sale to Beneficiaries, the public or external investors of 24.9% or 49.9% of shares
- distribution of 100% of shares to Beneficiaries
- sale of 100% of shares to Beneficiaries, the public or external investors.

In addition to the ownership options, we consider the following variants to the current trust model:

- a consumer (status quo) versus a community trust structure
- some appointed Trustees (status quo) versus fully elected Trustees.

Options are evaluated against the following criteria. The criteria draw on insights from Centralines' mission and principal objectives (set out in the SCI and agreed with the Trust) as well as sector opportunities and challenges. The criteria capture both the value of trust ownership for current Beneficiaries and – to the extent possible – future Beneficiaries. The criteria are as follows:

- **Operate a successful electricity network business:** in order to continue to provide a successful electricity network to the Central Hawkes Bay region and maintain/increase distributions available to Beneficiaries, Centralines will need to maintain high levels of customer service and strong network performance. At the same time, it must focus on achieving positive health and safety outcomes, underpinned by robust fiscal management.
- **Ability to respond to meet evolving consumer needs:** Centralines must operate successfully in the face of evolving regulations, technology and business models as well as continuing to meet changing customer needs. To do so, it needs the ability to respond proactively to such market developments and pursue new opportunities.



Summary

Operate as a successful electricity network business

Status quo

Overall, Centralines has operated as a successful electricity network business under 100% trust ownership:

- Centralines achieved strong financial performance over the review period with EBITDA increasing by over 70% and a dividend of $8m being paid to the Trust in FY18 for distribution to Beneficiaries
- Centralines invested in improving the resilience of its network and has demonstrated strong reliability of its network in recent years
- a good health and safety record was maintained.

The Trust has balanced both financial and non-financial considerations in setting expectations for Centralines. These are consistent with the successful operation of an electricity network business and include:

- a strong health and safety culture
- maintenance and sustainable pricing of electricity network services
- ongoing, consistent and robust returns to shareholders
- general discipline in spending.

Retaining 100% control with the Trust is also a simple model, with minimal administrative costs.

Implications of alternative ownership options

Alternative ownership options which involve external shareholders taking a full or partial stake in Centralines shares may bring potential benefits including:

- stronger commercial incentives
- access to additional external expertise and capabilities
- improvements in areas such as operational efficiency and pursuit of value-adding opportunities.

The extent to which such effects will apply is likely to depend on factors including the nature of new shareholder(s) (eg other EDBs or general diversified investors) and the size of the shareholdings.

Disadvantages of alternative ownership options may include:

- financial considerations such as return on investment being prioritised at the expense of non-financial considerations, including health and safety and maintenance of network assets
- inter-generational equity issues if value is passed to current generations of consumers at the expense of future generations
- Beneficiaries realising only a discounted value from the sale of their shares to external investors
- tax implications from replacing discounts with dividends
- loss or dilution of local objectives.

Implications of variants to trust structure

The current consumer trust structure is beneficial in achieving direct alignment of interests between Beneficiaries and electricity consumers. However, a community trust structure would allow funds to be distributed to meet community needs, such as investing in infrastructure to support local economic growth and engaging in community sponsorship.

Having a majority of Trustees elected by consumer-Beneficiaries rather than appointed encourages value maximisation from the perspective of a consumer-Beneficiary. Moving to a fully elected Trustee structure could lead to regulatory exemption status, providing reduced compliance obligations and potentially benefits through lower cost and complexity. However, appointed Trustees may bring stronger sector, commercial, financial and operational expertise and capabilities.

Summary

Ability to respond to meet evolving consumer needs

Status quo

The current trust structure supports Centralines' ability to respond to industry evolution and meet changing consumer needs in that the Trust:

- encourages the pursuit of growth opportunities
- is flexible in allowing different business structures.

However, the fact that the Trust emphasises growth opportunities local to the Central Hawke's Bay region and related to Centralines' current business may present a barrier for Centralines.

Implications of alternative ownership options

Alternative ownership options such as the sale of shares to an interested party with sector experience may improve Centralines' ability to respond to changing customer needs and industry opportunities. However, despite this there is likely to be uncertainty as to whether new shareholders are open to pursuing new and innovative opportunities which meet (future) consumer needs. Short-term returns may be prioritised over investment for longer-term gain.

Implications of variants to trust structure

The current consumer trust structure provides direct alignment of interests between Beneficiaries and electricity consumers. This means that investments in technologies that respond to changing consumer needs can be more easily justified.

Trustees elected by consumer-Beneficiaries rather than being appointed may also have a higher willingness to take risks in relation to such investments. However, appointed Trustees may be more aware and have a better understanding of industry trends and new technologies.

Conclusion

Operating under the trust model, Centralines has performed strongly over the review period, both in relation to financial and non-financial factors. This has included:

- increasing EBITDA by over 60% between FY14 and FY18
- paying a dividend of $8m to the Trust in FY18 which was subsequently distributed to Beneficiaries
- investing in improving the resilience of its network and demonstrating strong network reliability
- maintaining a good health and safety record.

The Company can be expected to continue to perform if the Trust:

- maintains clear expectations for the Company which promote a strong network and balance financial and non-financial considerations
- affords the Company flexibility in pursuing new opportunities in response to industry evolution and changing consumer needs
- establishes and promotes a culture of innovation
- encourages initiatives and business ventures which give the Company access to economies of scale as well as technical and operational expertise and capabilities.

Given current performance and the absence of drivers for significant change, we consider that the trust ownership model represents value for Beneficiaries (both present and future) and should, therefore, be continued. However, a continuing focus on local community investments and sponsorship may be more closely aligned with a community rather than a consumer trust structure. Given the reduced compliance obligations, the Trust may wish to consider fully elected Trustees in future, once the uncertainty around the status of the exemption has been clarified.

Appendix A – Important notice

This report has been prepared to assist the Central Hawke's Bay Consumer Power Trust (CHBCPT, the Trust) in regards to the periodic review of the Trust's ownership of Centralines. This report has been prepared solely for this purpose and should not be relied upon for any other purpose. We accept no liability to any party should it used for any purpose other than that for which it was prepared.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

We have not independently verified the accuracy of information provided to us, and have not conducted any form of audit in this respect. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which we have relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this report are based on information available as at the date of the report. We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report, was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in our engagement letter dated 25 June 2018.