Directors Report to the Trustees of the Electra Trust

Electra Limited: Ownership Review

Executive Summary

The Directors of Electra Limited have prepared this report in response to the request by the Trustees under the Electra Trust Deed. Clause 4 of the Deed states that the Trustees shall require the Directors to prepare a report considering proposals and available options for the future ownership of the shares of Electra Limited. The Trust currently owns 100% of the shares in Electra Limited and this ownership review is pursuant to a resolution by the beneficiaries of the Trust in 2019. Clause 4 specifically requires the Directors to set out their conclusions as to the most appropriate form of ownership for the future period.

Key conclusions following the review are:

- The main advantage of continued 100% Trust ownership is the avoidance of tension between investing in supply reliability and profits being distributed to non-beneficial owners thus ensuring prices and reliability remain both competitive and efficient. The key disadvantage is constrained capital which reduces the ability to diversify away from regulatory and technology stranding risk.

- Of all the ownership options examined, the option of continued 100% Trust ownership would provide the most stable and lowest cost ownership model.

- Electra Limited's performance compares favourably with an identified group of comparators across a range of industry performance measures.

The Directors of the Company have concluded that the objectives of Electra Limited, as reflected in the current Statement of Corporate Intent, are best achieved with the current 100% Trust ownership structure.

The Directors were unanimous in reaching this conclusion and recommend:

That the shares of Electra Limited continue to be 100% owned by the Electra Trust.

For and on behalf of the Directors

Shelly Mitchell-Jenkins

Chair
Dated: 22 May 2020

Contents

1. Introduction

The context for this report is the ownership review of the Electra Trust (the Trust) of its 100% shareholding in Electra Ltd (the Company), as required by the Trust's Deed (the Deed).

The contents of this report have been structured around the review requirements in clause 4 of the Deed as follows:

A. An analysis of the performance of the Trust and the Company to the date of the report together with a discussion of the advantages and disadvantages of Trust ownership.

B. An analysis of the various ownership options considered including without limitation, a share distribution to beneficiaries, a sale of shares to the public, a sale of shares to an institutional investor, exchange of shares for shares or assets of another company or organisation, and retention by the Trust.

C. A comparison of the performance by the Company with the performance of other energy companies.

2. Analysis of the Trust's performance

- ***Electra Trust's operating costs are lower than the operating costs of comparable trusts.***

2.1 Comparators for performance analysis

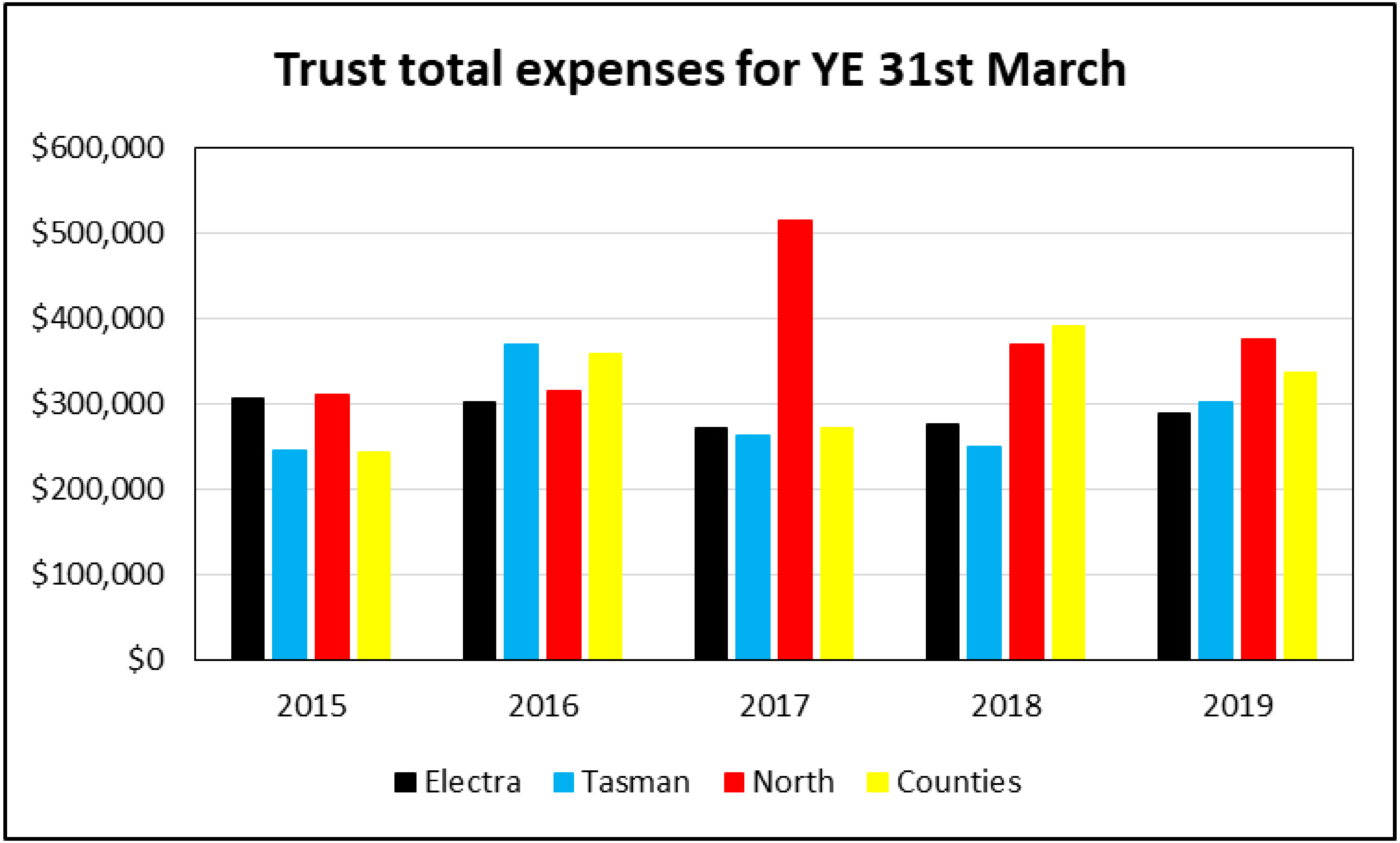
The Trust has approximately 45,600 beneficiaries. The following other energy trusts have been chosen as a Trust Comparable Group due to similar Trust beneficiaries' size.

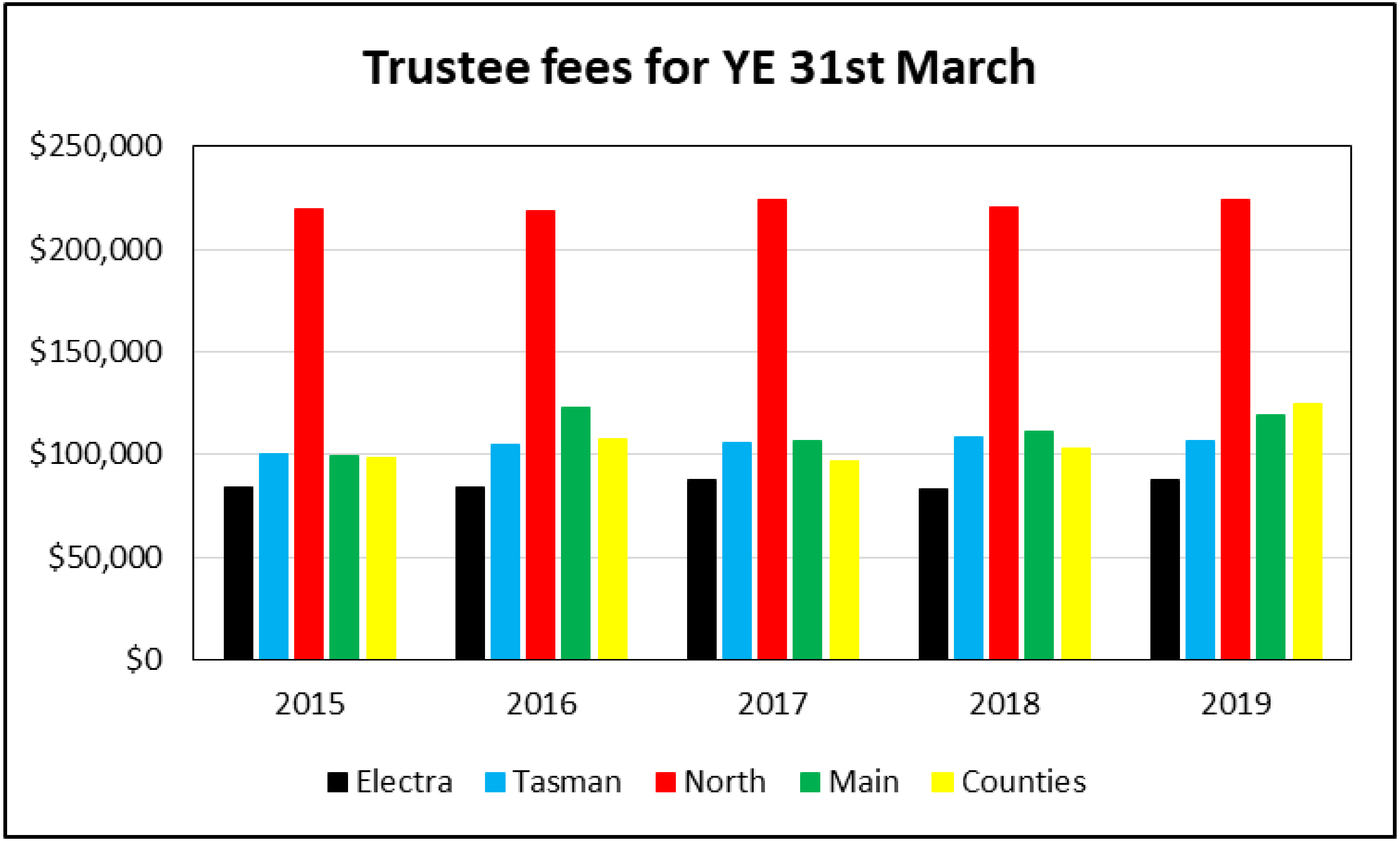
- Network Tasman Trust ("Tasman") – approximately 40,000 beneficiaries.
- Northpower Trust ("North") – approximately 60,000 beneficiaries.
- MainPower Trust ("Main") – approximately 37,000 beneficiaries (not all data available).
- Counties Power Trust ("Counties") – approximately 43,000 beneficiaries.

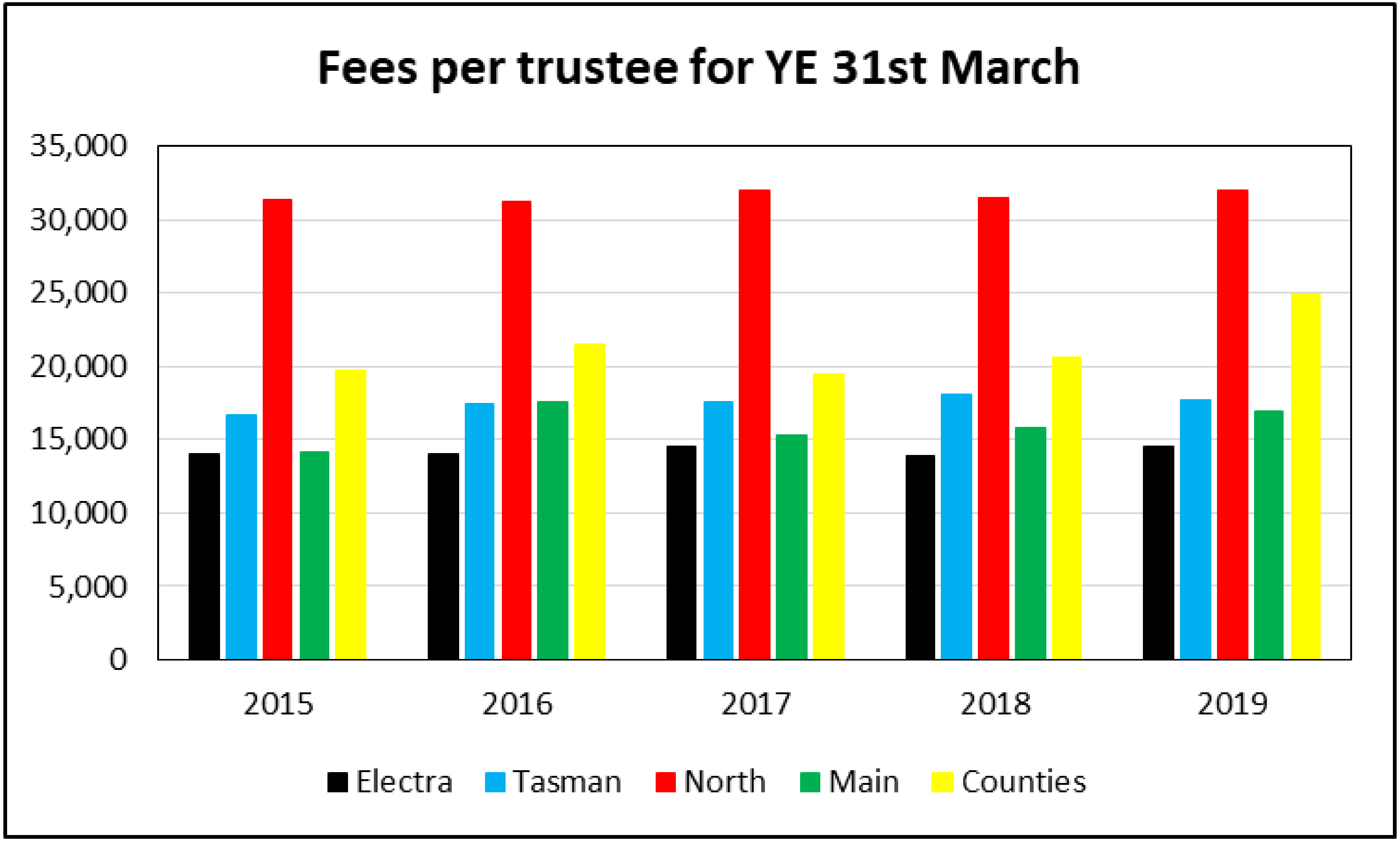
2.2 Performance comparisons

The following performance comparisons for Electra and the Trust Comparable Group are detailed for the years ending 31st March 2015, 2016, 2017, 2018 and 2019.

- Trust total expenses
- Trustee fees


Trust total expenses for YE 31st March
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
2015
2016
2017
2018
2019
Electra
Tasman
North
Counties


Trustee fees for YE 31st March
$250,000
$200,000
$150,000
$100,000
$50,000
$0
2015
2016
2017
2018
2019
Electra
Tasman
North
Main
Counties


Fees per trustee for YE 31st March
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
2015
2016
2017
2018
2019
Electra
Tasman
North
Main
Counties

2.3 Commentary on Trust's performance

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

Cost category	Factors that influence costs	Comments in regard to the Trust's costs
Trust Total Operating Expenses	• Complexity of the Trust's affairs, including the need to engage with other shareholders. • Need to take legal or financial advice on issues such as unsolicited takeover bid, dissent amongst trustees, decision to seek independent assurance of company decisions.	• The Trust's total operating expenses are comparable to the Trust Comparable Group and have reduced in recent years to be one of the lowest in the group.
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.	• Trustee fees are consistently the lowest within the Trust Comparable Group.

3. Advantages and disadvantages of Trust ownership

- The key advantage of Trust ownership relative to the alternative ownership options examined is that 100% Trust ownership provides the most stable and lowest cost ownership model.

Summary:

- Avoids the tension between investing in supply reliability and paying dividends to non-beneficial owners.
- Ownership and management remain localised enabling strategic focus on regional benefits for the wider community.
- More likely to seek professional advice on industry issues as the Trust is not subject to operating cost constraints.
- Direct financial benefits flow to beneficiaries or community including initiatives such as local business network sponsorship.
- Avoids distributions being taxed in the hands of beneficiaries.
- Ability for a single shareholder to appoint a unified Board.

However:

- Ability to raise capital is limited to debt or retained earnings as 100% percentage ownership by the Trust means ability to introduce new equity is limited. Practically new equity in the core business is limited to retained earnings. However, Electra can share ownership in subsidiaries as a way of introducing equity. E.g. Electra has 50:50 joint ownership in Connect 8 Limited.
- Concentration of regulatory and technology stranding risks associated with delivery of centrally generated energy through poles and wires.

3.1 Advantages

Issue	Comment
• Shareholder value remains 100% owned by beneficiaries	Avoids the tension between investing in supply reliability and paying dividends to non-beneficial owners.
• All the Company's earnings attribute to the beneficiaries	
• 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 acquirer directly from the consumers.	The trust through concentrated ownership is more likely to achieve the best outcome in a sale or extract greater value.
• The Trust is likely to "look after" beneficiaries' interests (particularly pricing), even if the formal governance mechanisms prohibit the Trust influencing pricing policy.	
• Properly structured tariffs and views on distributing income (especially if a "break even" approach was to be adopted) may deliver the lowest cost of service.	Less of the "community wealth" leaks out as tax.
• Inequitable distributions are open to scrutiny and therefore minimised.	Dependent on exactly how the distribution role is struck*[1].
• The present Trust Deed requires regular formal reviews of ownership, ensuring that a substantial beneficiary investment is subject to regular scrutiny.	
• Resolution of shareholder issues should be easier with a trust than with a widely spread group of potentially conflicting interests.	The Trust structure results in a simple governance model and clarity of ownership interests as opposed to external shareholder groups with different objectives.

* 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) tried to avoid this by defining 3 distribution dates and making beneficial consumers eligible for 33% of the maximum distribution for each of the 3 dates they were a connected customer of Vector.

3.1 Advantages cont.

• Any new investors in the Company (should the Trust decide to sell a stake) might find it easier to deal with a trust as opposed to a widely spread group of shareholders.	
• Any minority investor in the Company (should the Trust decide to sell a stake) would be less likely to successfully force their will upon a trust than upon a widely spread group of small shareholders who lack any obvious “push back” mechanism.	
• Directors will almost certainly be more accountable to a trust than to a widely spread group of small shareholders.	Each director will be accountable to an appointing shareholder[2], 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.	
• Provides a more robust defence against unwanted acquisitions of the Company.	
• A trust would be more likely to carefully evaluate an acquisition bid than small shareholders would.	Could also reject fair offers despite trust beneficiaries wanting to sell.
• Continued trust ownership would prevent minority interests gaining effective control.	Depending on how the company’s constitution is written, even a small shareholder may be able to veto Board decisions (e.g. non-voting shares).
• Low cost of maintaining the share register and performing other related activities.	

3.2 Disadvantages

• May limit the Company's ability to raise equity for future development.	To date funding for routine electricity distribution works has been available. Difficulty raising new equity may mean dividends and immediate benefits for beneficiaries are reduced to enable the company to pursue growth opportunities.
• Existing Trust arrangement incurs election expenses.	Although this is a disadvantage it is probably a lower cost option than other ownership models.
• The Trust's decisions represent the majority of consumers' wishes, and by default will probably not represent those who would prefer the cash rather than an "on behalf of" stake in the Company.	A possible advantage is that those individuals who would prefer the cash may be prevented from selling their stakes too cheaply.
• The beneficiaries' investment is fully exposed to the electricity industry vagaries, particularly the risk of line price control[3]*.	However, such exposure is capped.
• The beneficiaries' investment is fully exposed to the technological risk associated with delivery of centrally generated energy through poles and wires.	Declining prices of rooftop solar and batteries make this an increasing risk although it is mitigated by EVs' new load.
• Capital gains due to the performance of the Company or to other industry factors are unlikely to be reflected within shareholder asset value as they would be if the shares were tradable.	Difficult to reflect this within a non-tradeable asset market re-valuation.
• A strong focus on consumer ownership by the Trust could lead to worthwhile amalgamation opportunities being ignored or discarded due to a fervent focus on "local ownership".	

* By way of explanation, because the Trust only owns an EDB, all of its investment is exposed to EDB regulatory risk. If the Trust were to sell a stake in the Company and then invest in other sectors (say a balanced portfolio) then the Trust's and hence the Beneficiaries risk exposure would be reduced. A useful example was Auckland Airport diversifying its shareholders' risk by buying stakes in Queenstown, Cairns and McKay Airports (noting that the commercial and regulatory risk faced by each airport hasn't changed). It is important to distinguish this from the Company's exposure to EDB-sector risk, which is independent of ownership.

3.3 Benefits of trust ownership to consumers

The benefits to consumers of 100% trust ownership include:

- The discounts and dividends paid by the Company to its stakeholder(s) are attributed to the connected consumers rather than to a third-party owner. Alternatively, if the Company was to operate on a "break-even" basis, an equivalent value would be attributed to consumers through lower line charges.
- A trust representing beneficial owners is more likely to be able to afford and engage suitable external advice on either continued ownership or disposing of the shares in the Company, than individual shareholders.
- A single shareholder is likely to lead to a Board that is more united, and able to focus its efforts to improving company performance rather than reconciling potentially competing shareholder interests.
- The Company is likely to give more weight to consumer needs than if it had remote shareholders. An example of this was in the way Electra balances its own profit needs with customer costs when Electra uses portable generators during many planned outages to minimise the large opportunity cost faced by those affected consumers. Even though there is extra nett loss to Electra in doing so, overall, there is a large local benefit.

The key disadvantages of 100% trust ownership include:

- Constrained ability to raise capital limiting opportunity to:
  - Diversify away from regulatory risk.
  - Diversify away from technology stranding risk.

4. Analysis of ownership options

4.1 Ownership options to be examined

1. Share distribution to beneficiaries.
2. Sale of shares to the public.
3. Sale of shares to an institutional investor.
4. Exchange of shares for shares or assets or another company or organisation.
5. Retention by the Trust (retain 100% Trust ownership).

4.2 Analysis of ownership options

Option 1 – Share distribution to Beneficiaries

Whether or not a controlling stake is retained by the Trust:

- A possible outcome of this option is that some of those distributed shares would be on-sold (either to another EDB keen on consolidation, or simply to another investor).
- The evidence from the distribution of shares to EDB customers[4] in the mid-1990's was that many customers didn't understand the value of those shares (as noted in the footnotes to Chapter 3 of this Report), and rapidly on-sold them. From an inter-generational perspective, this is inter-generational inequality as one generation benefits at the expense of future and prior generations.
- Higher administration costs would be incurred including costs to maintain a share register.
- Distribution provides no access to capital or capability to respond to industry change

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

- It could be possible to attach a connected customer criteria to the shares, preventing subsequent transfer (or making them worthless) to a non-customer owner[5]. However stable ownership of the company is also achieved by continued 100% Trust ownership.

Option 2 – Sale of shares to the public

Partial or full sale of shares would result in higher administration costs being incurred, although it provides access to additional capital for growth.

- In contrast to the distribution of shares to beneficiaries, it would seem likely that the sale of shares to a presumably knowledgeable public would not result in such a rapid on-sale of shares.
- However, the sale proceeds would require prudent management by the Trust to achieve a risk-adjusted cash return equivalent to the current customer discounts.
- Broadly speaking, any sale of more than 10% of shares in the Company to non-customers would make the Company subject to a default price-quality path, providing a degree of customer protection against excessive price increases[6], however further additional compliance costs would be passed onto consumers via line charges.

Option 3 – Sale of shares to an institutional investor

- This option could result in conflicting objectives for the Company (the Trust trying to balance returns with reliability, and the institutional investor focusing on returns), resulting in continual tension at Board level.
- Any sale of more than 10% of Electra shares to non-customers would make the company subject to a default price-quality path, providing a degree of customer protection against excessive price increases, however significant additional compliance costs would be passed onto consumers via line charges.
- The sale proceeds would then require prudent management by the Trust to achieve a risk-adjusted cash return equivalent to the current customer discounts.
- This may compromise ability to fully deliver on community expectations for quality of service and regional development, even where the Trust has a controlling interest.

5 Similar to Ashburton, where the Council holds 95.6% of the shares in a non-rebate, non-voting format and each connected customer holds 100 shares that attract a discount.

Option 4 – Exchange of shares for shares or assets of another Company

- Additional capability to respond to industry opportunities would depend on the nature of the investor.
- Any sale of more than 10% of Electra shares to non-customers would make the Company subject to a default price-quality path, providing a degree of customer protection against excessive price increases, however further additional compliance costs would be passed onto consumers via line charges.
- This option could result in conflicting objectives for the company (the Trust trying to balance returns with reliability, and the other company focusing on returns), resulting in continual tension at Board level.
- The cash return on the shares received by the Trust would need to achieve a risk-adjusted cash return equivalent to the current customer discounts.
- Community objectives may be compromised or not be met.

Option 5 - Retain full trust ownership

- Retains Electra's exempt status (reducing compliance costs), ensures that line charges, after discounts, are optimised for current and future customers.
- It minimises costs of maintaining a share register.
- Provides a stable environment for the Board and management to focus on supply reliability and cost minimisation.
- Ensures that discounts can continue if appropriate and permitted.
- Ownership and management remain localised, enabling strategic focus on regional benefits for the wider community

5. Comparison of Company performance with other companies

- ***Electra has the lowest revenue per customer within the Electra Comparator Group.***

- ***Electra has among the lowest costs within the Electra Comparator Group.***

- ***Electra has higher reliability than the Electra Comparator Group.***

5.1 Deed requirements

It is noted that the Deed requires “a comparison of the performance by the Company with the performance of other energy companies”. Given the current industry structure in which distribution and energy are separated, this requirement has been reasonably interpreted as “comparisons with other electric distribution businesses”.

5.2 Electra Comparator Group

The basis for choosing Electra’s comparators is the recognised industry measure of customers per line km. The Electra Comparator Group includes:

- Network Tasman
- Powerco
- Unison
- Aurora Energy
- WEL Networks
- Orion

5.3 Performance comparisons

Electra’s performance against the identified Electra Comparator Group is as follows.

Measure	Performance	Comments
Return on investment	Electra has the highest return on investment before discount within the Electra Comparators Group.	
Revenue	Electra has the lowest revenue per customer within the Electra Comparators Group.	Customers could be more likely to see revenue stated on a per kWh basis on their electric bill, which makes Electra appear less favourably due to Electra’s lower average KWH usage per customer.
Operating expenditure	Electra’s operating expenditure is around the average of the Electra Comparators Group.	Detailed analysis suggests that any reduction in Electra’s operating expenditure could lead to an increase in both equipment faults and tree-related faults.
Capital expenditure	Electra’s capital expenditure is the lowest of the Electra Comparators Group.	Capital expenditure is a complex issue that depends on demand growth and asset condition, which tend to be unique to each network. Hence care is required in interpreting comparisons between networks.
Reliability	The power is off to Electra’s average customer for less time per year than for customers of the Electra Comparators Group.	
	Electra’s average customer has fewer interruptions per year than customers of the Electra Comparators Group.	

This comparison shows that Electra’s performance compares very favourably with the Electra Comparator Group.

6. Summary of professional advice obtained

The following professional advice has been taken in completing this report.

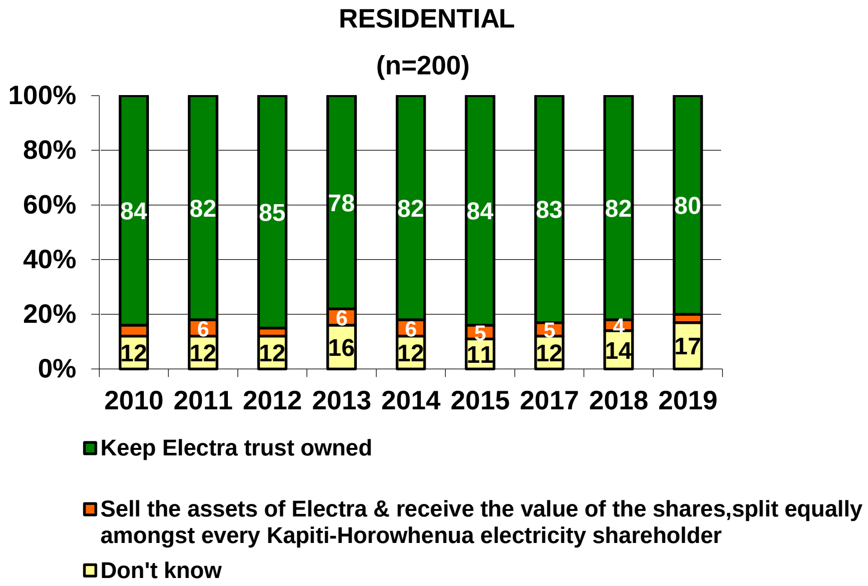
Advisor	Advice obtained
Utility Consultants Ltd	• Preparation of report template. • Analysis of Trust performance in Section 2. • Identification of the advantages and disadvantages of Trust ownership in Section 3. • Analysis of ownership options in Section 4. • Inclusion of South West Consulting work into Section 5. • Finalisation of overall report.
South West Consulting Ltd	• Inter-company comparisons in Section 5.
Energy Outcomes Limited	• Verbal advice on the network asset strategies and engineering that have led to lower costs in Section 9.

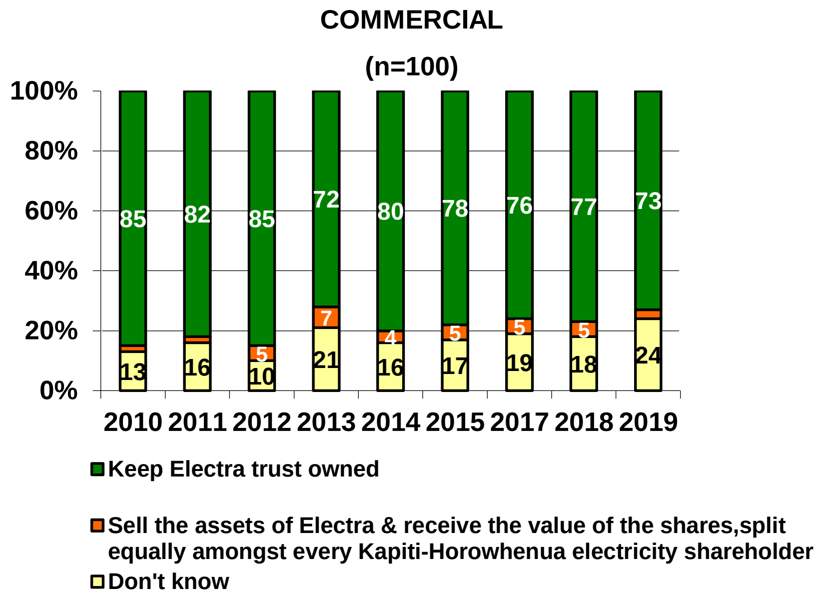
7. Regard to views of Beneficiaries

- ***Beneficiaries prefer the continued community involvement and support that 100% trust ownership provides.***

Based on previous indications, beneficiaries may be reluctant to sell the company's assets to a major buyer. End-users have indicated in a recent survey in April 2019 as follows:

Question: *"If you were to vote on Electra's Trust ownership tomorrow, how would you vote?"*





7. Regard to views of Beneficiaries cont.

Retention of the Company as a Trust owned entity includes the following benefits:

- Continued sales discounts
- Higher degree of protection from price rises and poor service
- Lower business operation costs and thus greater returns to beneficiaries
- Provision of local employment, and
- Local ownership of the Company’s net assets.

8. Role of Trustees

- ***Trustees are meeting their obligations.***
- ***No obvious basis to replace trustees with a trustee corporation.***

8.1 Role of Trustees

The role of the Trustees is to fulfil the following:

- All the requirements of the Trust Deed.
- Any associated requirements of the Company Constitution (such as appointing and removing directors).
- The broad requirements of various legislation, including:
  - Trust law (such as the Trustees Act 1956).
  - Commercial and trade practices law (such as the Commerce Act 1986).
  - Sector-specific law (such as the Energy Companies Act 1992 and the Electricity Industry Act 2010).

8.2 Possible replacement by Trustee Corporation

The broad purpose of a trustee corporation is to provide stronger oversight of a trust's affairs than the trustees otherwise might. In order to consider replacement of the Trust by a Trustee Corporation, it would therefore be necessary to prove that the Trust has failed to perform its duties.

The Public Trust provides general oversight of the Trust's affairs (including attending the Trust's meetings and receiving certain documents). Accordingly, the following is noted:

- The Trust has adopted a Code of Practice, which includes a specific requirement for the Public Trust to report on the application of and compliance with that Code of Practice.

- The Trust has provided a certificate to the Public Trust stating that, to the best of their knowledge, it has complied with its obligations under the Deed and the (sic) Electricity Act 1992.

- The Public Trust has certified that, to the best of its knowledge, the Trust has complied *inter alia* with its obligations under the Deed and the Code of Practice.

The Trust is meeting its obligations, and therefore there is no obvious basis for considering replacement of the Trustees by a Trustee Corporation.

9. Additional Benefits to Beneficiaries

- ***Electra advocates to minimise pass-through costs for the benefit of customers, which a non-beneficial owner may not do.***

- ***Electra supports regional growth and development via community activities and events that a non-beneficial owner may not do.***

9.1 Electra's advocacy on transmission pricing

The company advocates for lower transmission pricing benefits for its customers (Beneficiaries).

Electric distribution businesses (EDBs) such as Electra can pass transmission grid (Transpower) charges through to their customers, which has the following implications:

- An EDB is effectively indifferent to those transmission charges (as they are simply passed through to customers).
- The EDB's customers, however, pay higher overall electric bills. In turn, this can mean both hardship for residential customers and declining national and global competitiveness for industrial customers.

9.2 Electra's efforts to reduce peak demand

Electra has undertaken the following efforts to reduce peak demand (which, whilst being a pass-through cost to Electra, must be paid for by Beneficiaries).

- Entering into an arrangement with King Country Energy for Mangahao to (i) generate as much as possible during peaks, and (ii) to signal to Electra when Mangahao cannot generate.
- Continuing the use of legacy load control.
- Development of, and on-going work on an algorithm to assist load control during peak periods.

There are limited incentives for a non-beneficially owned EDB to minimise pass through costs for its customers.

9.3 Electra's support for Business networking

Electra sponsors the monthly Kapiti Electra Business Breakfast and the Levin Business After 5 events, providing networking opportunities and access to high quality speakers, supporting regional business development and resilience.

9.4 Electra's Kapiti – Horowhenua sponsorship

Electra continues to proudly sponsor the annual Kapiti – Horowhenua business awards, New Zealand's longest running regional business awards, applauded as being the best-run and offering business benefits to all motivated Awards entrants.

Electra provides a variety of small sponsorships to community groups such as the Coastguard, Waikanae Air Scouts and Te Raukura ki Kāpiti.