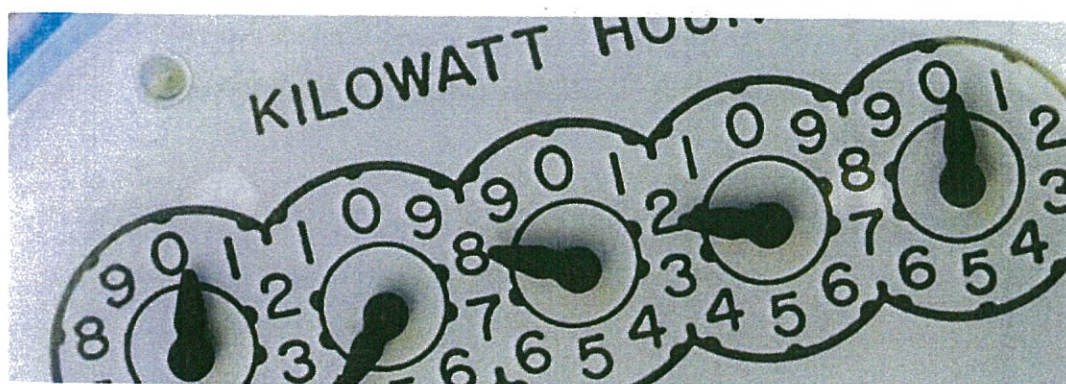


REPORT TO

NETWORK TASMAN LIMITED

COMPANY PERFORMANCE IN
TERMS OF TRUST DEED



	1996	2001	2005	2010	2015
Performance	✓	✓	✓-	✓	✓
Consumer Trust ownership	✓	✓	✓✓	✓✓	✓✓✓

Key Business Partners Limited
7 March 2016

Clean Energy Defies Fossil Fuel Price Crash to Attract Record \$329bn Global Investment In 2015

Published: Jan 14, 2016 1:08 a.m. ET



Aa

LONDON and NEW YORK, Jan 14, 2016 (PR Newswire Europe via COMTEX) -- 2015 was also the highest ever for installation of renewable power capacity, with 64GW of wind and 57GW of solar PV commissioned during the year, an increase of nearly 30% over 2014.

LONDON and NEW YORK, Jan. 14, 2016 /PRNewswire/ -- Clean energy investment surged in China, Africa, the US, Latin America and India in 2015, driving the world total to its highest ever figure, of \$329.3bn, up 4% from 2014's revised \$315.9bn and beating the previous record, set in 2011 by 3%.

(Bloomberg)



Executive Summary

This report considers the performance of Network Tasman Limited “NT” and discusses ownership structures, as required five yearly by the ownership Trust Deed.

Although being a small player with low influence in a very large industry, the company continues to be in robust shape. The Trust as owner should be more than satisfied.

Analysis clearly shows this rural electricity distribution company operating at a good level in the key respects of:

- network reliability (what local consumers – the ultimate owners of this business – experience) – refer pages 18 and 21
- network pricing (which is a function of effective cost management) – which is charged to those consumers in a bundle via electricity retailers – refer pages 19 and 22
- shareholder value stewardship – refer page 23
- future optionality via retaining a strong balance sheet – refer page 12

The evidence for this conclusion is based on solid facts. Aside from accountability via published Annual Reports, Asset Management Plans and Statements of Corporate Intent, many years of prescriptive Government regulations enable performance to be readily compared with peers – by any interested party, both now and in future. This is a key discipline on management.

In this report, historic performance is compared in both absolute terms and where applicable, in trend. NT compares favourably, however it should be noted that one possible explanation is different customer mix, with others perhaps having a lesser number of commercial users such as large manufacturers.

Some NT costs are up in 2015. This is largely explained by completion of the strategically logical opportunity to acquire from Transpower; then integrate and maintain, 158km of high voltage lines in Golden Bay/Motueka.

The Government imposed industry structure continues to be increasingly prescriptive. In response the company and its 30 employees continue to adapt and run the business tightly yet consistently.

At the same time NT is successfully leveraging its core skill base to grow and diversify outside the regulated arena; into complementary lines of business. In this regard the further progress of the 100% owned telecommunications fibre network business is noteworthy; as well as new investments in two electronic metering companies; one at 100%, the other as a partner. Capturing meter data electronically is the obvious starting point for value added opportunity to manage the core business better.



Conceptual merits of consumer trust ownership are again examined; along with other possible options, none of which are new. A large number of both non-financial; and financial benefits of this ownership structure are identified and discussed – a list of benefits which make trust ownership compelling over all other options.

As before in the case of NT, consumer trust ownership has proved effective, truly trustworthy; and continues to deliver the stability to underpin essential long term asset planning. It has insulated consumers from much volatility, while facilitating steady improvements in performance.

Clearly, the company is well positioned to consider its best approach in a more uncertain future. Evolving technologies now presenting to the electricity industry globally, nationally and locally mean that 'business as usual' will change from what has been a stable architecture for several generations.

Accordingly we are strongly of the view that Trust ownership is preferred.



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1.0 Brief for this Report

The requirement this time is identical to our last engagement:

Required:

To fulfil the requirements of the Tasman Electric Power Trust Deed, (and as amended August 1999 and June 2006) specifically Clause 4 Ownership Review:

“

4.1 No later than 1 April 1996 the Trustees shall require the directors of the Company to prepare a report considering proposals and available options for the future ownership of the shares of the Company. Such report shall contain the following detail:

- a) an analysis of the performance of the Company to the date of the report (*see Sections 5 and 6*) together with a discussion of the advantages and disadvantages of trust ownership (*see Section 7.9*);
- b) an analysis of the various ownership options considered including without limitation, a share distribution to Consumers, a sale of shares to the public, a sale of Shares to institutional or other investors and retention by the Trust and some other form of consumer or public ownership (*see Section 7*);
- c) a comparison of the performance by the Company with the performance of other similar companies (*see Sections 5 and 6.2*)

[and]

4.11 If following the initial review provided for in this Clause 4 any or all of the Shares of the Company are retained by the Trustees, the Trustees shall thereafter carry out a review in accordance with Clause 4 every five years until the Termination Date so that the first such review shall commence no later than five years after completion of the first review.

“

The first ownership review was dated 28 February 1996. Subsequent reviews were dated 5 March 2001, 18 October 2005 and 4 February 2011. Therefore this fifth ownership review is commenced with this Report, as required in the usual five year time frame.

Additional:

As an ingredient to this process NT also provided an expanded brief to specifically address:

- investigation and commentary on future new technologies presenting an obvious impact on NT
- detailed consideration of the non-financial benefits of Trust ownership



Note: This review is not required for any regulatory purposes; thus represents a commendable commitment to transparency and accountability by NT and its Trust owner. By way of contrasting example, neighbour Marlborough Lines amended their Trust Deed to eliminate a similar requirement. It should go without saying that the foundation of good company performance is reflection; and being open to an informed discussion of performance.



2.0 NZ Electricity Industry Background

The underlying components are well established and attract heavy political, regulatory, offshore ratings agency and analyst scrutiny:

- generation, transmission grid (bulk, high voltage national network) and distribution (local networks) separated
- heavy overall industry oversight by the Electricity Authority (a Government agency)
- strong regulatory oversight of both distribution companies and Transpower (which are monopolies) by the Commerce Commission (an independent Government entity responsible for enforcing competition laws):
 - o price and quality oversight using direct (rather than targeted) price control for non exempt line companies (e.g. NT¹) and standardised audited information disclosure reporting formats (superseding the Targeted Control regime from 1 April 2010)
 - o mandatory 'strategic' communications driving accountability via annual Statements of Corporate Intent for many industry companies, including NT
 - o mandatory annually updated Asset Management Plan; which is a forced 'look forward' on a prescriptive and rigorous basis²
 - o all 29 lines companies forced to fit nationwide models

Following the sale by Initial Public Offering of former state owned generators there is now significant Australasian share market analyst scrutiny of the NZ electricity industry. This is consistent with global investment trends seeking 'safe' long term investments in a low inflation, low interest rate environment.

An example of 'innovative' (and continually evolving) regulatory scrutiny is the Commerce Commission imposing a revenue linked electricity quality incentive scheme from 1 April 2015; as summarised in a 46 page document. The direct revenue impact for NT is +/- \$0.28M per annum, depending on meeting quality targets or not. An additional Incremental Rolling Incentive Scheme provides more reward or penalty according to how NT's capital costs and operational expenses compare with the Commission's own forecasts.

In contrast, network companies remain free to invest (both profit and debt secured against networks) in non-regulated activities; subject only to compliance with owners wishes.

The Office of the Auditor General has also scheduled work on publicly owned energy companies in the year to 30 June 2016.

¹ To be exempt a distribution company must meet a number of prescribed tests. NT fails because one shareholder Trustee is appointed by the three largest consumers. A proposal is in process to change this and help reduce associated costs.

² In contrast, examples of key long term infrastructure companies which do not have this prescriptive approach are ports, airports and metropolitan solid waste landfills



3.0 NT in industry context

As in most if not all developed countries, the NZ electricity industry is technically complex, mature and large. Aside from everyday significance to homes and industry, this size factor is more evident due to new public listings in the last 5 years; with many ranking in the top 10 largest listed companies on the NZ Stock Exchange:

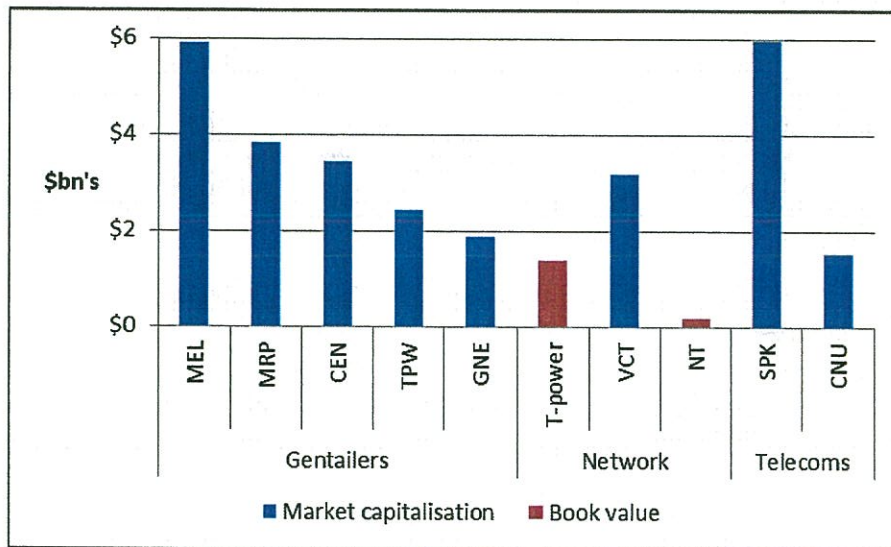


Figure 1 NZ Industry value compared (source: sharemarket where listed and Annual Reports)

In this context NT (Shareholders Funds at Book value \$175M as above) is a minnow. The Government continues to be by far the largest investor, albeit with greater liquidity, as cornerstone owner of now public listed generator-retailers.



4.0 Company Background

NT continues to be 100% owned by Network Tasman (electricity consumer) Trust. This is consistent with our earlier reported opinions.

NT's core business is tightly constrained by regulations, comparatively simple, with stable technology. The opportunity to develop or innovate is limited. This core does however provide a platform for other activities.

The core activity is distributing electricity via overhead and underground lines for a small number of retailer customers including Contact Energy, Meridian Energy, Trustpower etc. to over 38,000 end consumers who are the ongoing beneficial owners. These end consumers, or ICP's³, with whom NT has minimal direct relationship⁴, are located in a 10,800 square km area of the greater Tasman/Nelson rural region, excluding 24 square km of Nelson city itself.

That Nelson city distributor is a separate company Nelson Electricity Limited which is 50% owned by NT in a joint venture.

NT effectively provides, via direct ownership and by contract with Transpower,⁵ the 'pipeline' between points of bulk electricity generation and end use consumer's demand, at the touch of a switch.

A Statement of Corporate Intent "SCI" is published annually in advance. This is a thorough and readable foundation document, establishing clear targets and accountability. It is easily located and accessed.

The current SCI for year to 31 March 2016 records NT's Vision: *"to be a successful network services company for the benefit of our consumers"* (same as last Review).

³ Installation Control Points

⁴ Faults can be advised directly

⁵ In technical terms, SOE Transpower is the national grid assets owner and system operator - see www.transpower.co.nz



Also the Mission, the management aims of the business are: *“to own and operate efficient, reliable and safe electricity networks and other complementary businesses while increasing consumer value”* (unchanged since last Review).

- “reliable” formerly included the defined aim to be consistently ranked in the 1st (best) industry quartile for SAIDI⁶, it is now more specific numbers which recognises the maturity⁷ and unique characteristics of the NT network; the challenge of lifting the reliability of this rural network up with the best across NZ is for the time being unrealistic without compromising cost and price targets
- “efficient” includes the defined aim of being consistently within the best quartile for cash operating costs for the core business (i.e. excluding Transpower)
- “safe” is defined as zero Lost Time Injuries and Public Injury Accidents; Public injury targets are also outlined and reported on in the annually updated Asset Management Plan

Business activities compare with past reviews as follows:

	<i>Last review 2010</i>	<i>This review 2015</i>
Electricity networks	Network operation including Nelson City JV with Marlborough Lines	Network operation including Nelson City JV; expanded with the purchase and integration of Motueka and Golden Bay 66kV line and substation assets off Transpower in December 2014
	Fibre optic telecoms network operation; contributing 7% of Total Revenue	Fibre optic telecoms network operation; covering parts of Nelson, Motueka, Blenheim and Marlborough contributing 8% of Total Revenue
Generation	Vigorous renewable (hydro and solar) investigations	Reduced in importance
Commercial Property Investment	Now internally managed with two new commercial buildings developed and division producing 2% of Revenue	Division producing 3% of Revenue
Meter ownership at ICP's		Re-entered ownership of meters via playing a leading role in the SmartCo Limited electronic metering consortium and the On Metering Limited JV with Alpine Energy.

⁶ Industry Standard term for reliability – for example refer p15 SCI for the year ended 31 March 2016 which also includes targets

⁷ NTL SAIDI target (Cuts + Shuts) is flatlined at 115 minutes through to year 2025 in Asset Management Plan



NT's audited financial position (see Appendix C for detail) can be summarised:

31-Mar	2000	2005	2010	2015	
Sales	\$27M	\$30M	\$37M	\$48M	
Cash overheads	\$4M	\$6M	\$8M	\$12M	
NPBT ⁸	\$11M	\$14M	\$15M	\$19M	Excludes accounting FX gain on purchasing imported meters; also equity profit on Nelson network JV
Less: Discounts given to consumers	\$4M	\$5M	\$6M	\$10M	
Assets	\$100M	\$121M	\$186M	\$217M	Includes mandatory revaluation, which is little changed in last 5 years
Liabilities ⁹	\$2M	\$4M	\$34M	\$42M	This increase is due to mandatory IFRS accounting standards introduced in 2008 requiring a deferred tax liability to be recorded against asset valuations (a paper transaction)
SHF	\$48M	\$125M	\$144M	\$175M	
% to Assets	95%	97%	81%	81%	This decrease is due to IFRS – as per above – still a strong position
NPBT/Assets	10%	11%	8%	9%	
Sales/Assets	0.28x	0.24x	0.21x	0.22x	

Most energy continues to be consumed, as before, in directly adding value to logs, fruit, milk, fish, meat and other primary produce for export to world markets; as well as support services like Councils. A fibreboard manufacturer remains NT's major customer, accounting for about one fifth of all electricity distributed; or over a quarter if electricity through to Nelson city is excluded¹⁰.

The customer base is highly diverse, a good feature. By way of example, the dairy manufacturing site at Brightwater represents less than 0.3% of total sales revenue.

⁸ Before customer discounts

⁹ Increased in 2008 due to deferred tax on asset revaluations

¹⁰ As a case study; the network cost charged to a large manufacturer in 2014 represented 2.4% of value added, as measured by publicly disclosed EBITDA. This was a significant increase on 5 years ago; but only because EBITDA declined; something outside NT control. The actual cash cost increase to that manufacturer was \$0.017M (+9%) since 2010



Core skills for NT are generally unchanged although there is greater emphasis now in some aspects:

“Hard”

- increasingly analytical skills to ensure that costs and performance data are captured reliably, understood and communicated as ‘information’ to a range of stakeholders; not least Government as the regulator who dictates what data in what format
- operating and capital cost management skills
- network asset management to ensure that the owned distribution network is reliable, secure and cost effective
- commercial skills so that capital investment as ultimately set out in the Asset Management Plan is in fact the most astute use of owners capital
- commercial transaction skills to plan and complete opportunities such as Transpower’s Golden Bay assets and substations rebuilds
- contract management in respect of network capital expenditure and maintenance, vegetation control etc. and a small number of retailer contracts
- management of property rights – legal entitlement and access to land and airspace occupied by the network (now and potentially in future) and associated third party interfaces

“Soft”

- communication and influencing skills to manage NT business risk as a small regional player amongst many larger interests
- strategic skills in both a policy and numeric sense to discern opportunities and threats in a closely controlled and monitored environment; and effectively communicate these to stakeholders
- strategic skills to discern, analyse and communicate threats and opportunities in metering and with evolving technologies such as photo voltaic and electric cars¹¹; each of which have network implications

In addition, entrepreneurial skills are needed more than ever to maximise value from the network resource and associated intellectual property; while not risking value on unusual initiatives.

The challenge continues: to demonstrably lower costs while managing increased levels of industry regulation; plus meeting demand for electricity in homes and businesses; plus identifying and leveraging competitive advantages and competencies in ways that are satisfying to the owner. This time the risk arising from evolving technologies is much more on the horizon – and well known to NT - while at the same time there are significant uncertainties as to how technology will play out; whether by ‘consumer pull’ or lines business push’.

¹¹ This too is on the Government radar, see “Implications of evolving technologies for pricing of distribution services” Consultation paper from Government Agency the Electricity Authority dated 3 November 2015



5.0 Company Performance

5.1 NT Relative to industry - detail

For many so called “commodity” industries, the delivery or logistics systems are highly specialised (non-commoditised) according to the geographical attributes of both resource and demand. This is generally true for electricity in NZ and especially so for NT. Hence all comparisons (including those based on statutory disclosures) must be read subject to the caveat that the underlying characteristics of *each* distribution network will be unique in many ways.

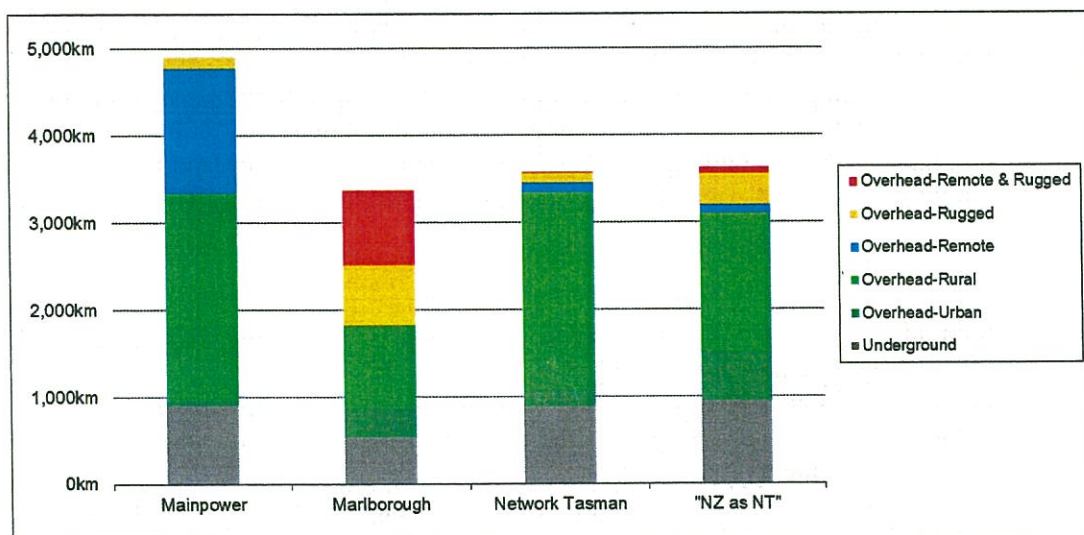


Figure 2 Comparison of physical infrastructure by line type (source PWC)

This chart highlights NT's unique character (two thirds Overhead-Rural but with average underground length); even though these definitions of physical characteristics are prescribed in regulations.

NT's position in the NZ industry is summarised in the following table, drawn from PWC comparative reports for network businesses only:



	2000	2004	2010	2015	Comments
# NZ distribution companies	30	28	29	29	Consolidation has plateaued
Connections (consumers or ICP's)	30,246	33,335	36,219	38,314	Slower 1.1% compound growth, rate than 1.7% prior 5 years
rank	13th	9th	11th	12th	higher growth in other regions
Line length km	3,114	3,244	3,348	3,571	middle of the range for NZ companies
Consumers per km	9.71	10.3	10.8	10.6	On the face of it; a small decline in scale advantages to one every 94m but the main explanation is a 'step change' from the 158km of 66kV lines purchased from Transpower
electricity supplied GWH (excludes that passed on to Nelson Electricity JV ¹²)	477	555	579	593	Note that 2014/15 had a relatively warm winter
Rank	12th	10th	11th	13th	
peak demand MW (excludes Nelson Electricity)	89	105	117	118	
Rank	11th	9th	12th	12th	
Line cost per km	\$1,391	\$1,818	\$2,250	\$2,749	Cash costs only – Direct plus “Non Directly Attributable”; as the distinction can be arbitrary; possibly some definition change here..while there is increase it is industry wide and NT is just outside the best quartile and also affected by 66kV acquisition
Transmission costs (to Transpower) c/kWh	1.77c	1.16c	1.69c	2.38c	Significant increase in NT's major cost item

¹² In February 2014 the Nelson Electricity Limited Joint Venture company established its own Grid Exit Point from Stoke substation; the series in past ownership review reports included NEL.



	2000	2004	2010	2015	Comments
Year End ROI	3.6%	5.2%	4.6%	6.1%	Includes some definition changes over the years – used vanilla WACC
Rank (ROE in earlier years)	19th	16th	21st	10th	many other companies are making higher profits, but do not offer discounts
Network ODV	\$90M	\$108M	\$144M	\$161M	Valuations and assets are compounding at a faster rate than electricity demand, thus the business is becoming more capital intensive
rank	11th	11th	14th	17th	
Network Load factor	64%	64%	60%	60%	Steady
National average	63%	64%	59%	62%	
Network Loss ratio	5.0%	3.9%	5.7%	5.4%	
NW utilisation Capacity	43%	43%	25%*	43%*	Demand/Transformer capacity - ongoing investment in new capacity (*methodology change)



5.2 Relative to industry generally - performance

As in past reviews we draw on published data in PWC's "Electricity Lines Business Information Disclosure Compendium". This 'industry bible' collates public disclosure data and promotes comparison. There are now 120 pages of tables (more than double that of 5 years ago) and NT can be seen as a satisfactory performer by almost any chosen measure.

NT Reliability – what the average consumer experiences

It is clearly not cost effective to build any distribution infrastructure to handle all weather events; minimising SAIDI minutes must be balanced with capital expenditure, maintenance costs and 'self-insurance' by consumers; especially in remote regions. The fact is that 99.96%¹³ reliability was achieved in the 2015 year, on average.

Full detail is shown in Appendix B; right through to 31 December 2015. NT have enjoyed a better run with storms than in the preceding 5 year period; with the 'bad' year of 2009 not repeating. That said, it must be noted that:

- ambitious targets set by NT and disclosed in successive SCIs have not been met
- it is impossible to apportion root cause between Mother Nature and Good Management

¹³ Calculated via 210 SAIDI minutes that the average NT customer lost power for in the year to 31 March 2015 divided by 525,600 minutes in the year



A new chart at Appendix B page 3 is duplicated below:

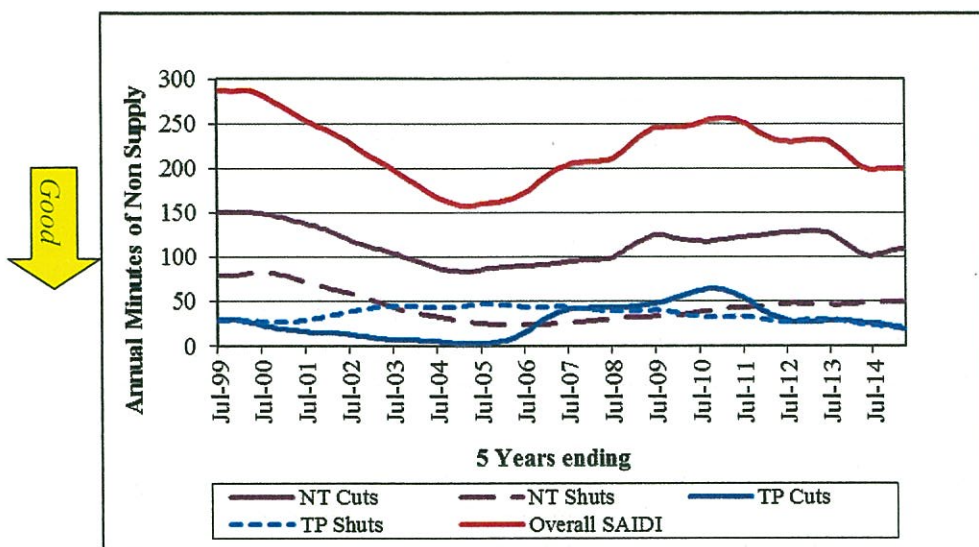


Figure 3 indicative 5 year rolling trend on SAIDI

In line with the 5 year ownership review cycle; this chart considers a 5 year rolling SAIDI. This analysis is tentative as it takes an 'average of an average'. However the trend is encouraging.

Overall underlying trend in NT reliability must continue to be considered as satisfactory.

NT Efficiency

Efficiency can be measured in a number of ways, for example in previous reviews we highlighted Indirect Cost per consumer. Unfortunately the purity of this data series has been lost with new imposed expense categorisations.

It is a fact that NT is efficient in an industry climate of increasing costs. Appendix D sets out analysis of Operating Expenditure by Quartile. This is important, as the evidence set out in Section 5.1 is of increasing costs over many years for NT. This is an industry wide challenge which NT is meeting well; having remained in the lowest cost (best) quartile in most years.

Unfortunately in 2015 NT slipped out of this grouping (as it did in 2009). Logical explanations include:

- inclusion and bedding in of newly purchased ex Transpower 66kV assets (a large contributor)
- an increase in planned expenditure (more planned "Shuts" to minimise unplanned "Cuts", a maintenance strategy which is hinted at in Appendix B chart)
- storms
- a more conservative approach to risk



It should be noted that NT as an expensive to operate rural network was 12% better than the NZ median cost per ICP. Performance this year is good; just not quite as good as it was.

Further evidence is below; that the relatively smaller size of NT (and some others) is *not* an impediment to cost efficiency. NT is marked as the brown diamond; neighbour Marlborough Lines as the red square:

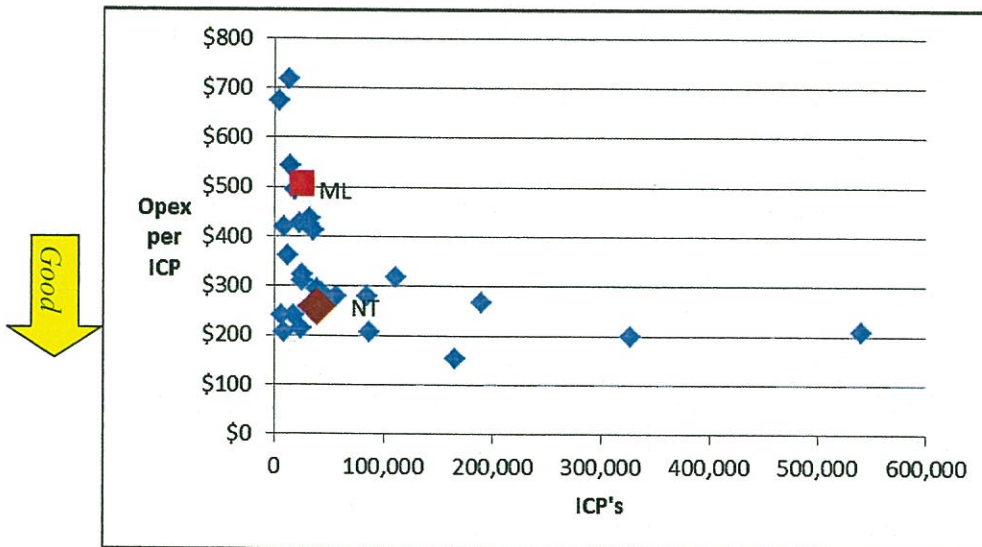


Figure 4 For year ended 31 March 2015 Compare line business by size (number of connections) with Operational Expenditure by Connection Point (source PWC collation from disclosures)

This evidence is consistent with every previous performance review report.



5.3 Relative to peers

Our analysis of performance now focuses on the three fundamental aspects of network reliability, network price and NT's overall investment effectiveness.

Consideration was made of who are the best peers for comparison. For example:

- same group as last time (the underlying lines businesses and physical environments are effectively the same)
- 'friends' in SmartCo Meters (less relevant as 'friendship' in this sense is linked to strategy not physical characteristics)
- Networks with similar ICP's per square km of network area (a measure Scanpower uses; however is not especially insightful as lines will go to where consumers - people - live)

After reflection we still choose the same four peers as before¹⁴:

	NT	EA Networks	Horizon Energy	Northpower	Marlborough Lines
Network area	Tasman including Richmond but excl. Nelson	Mid Canterbury	Whakatane and Eastern Bay of Plenty	Whangarei and Mid Northland	Marlborough
Topography ¹⁵	Hilly, many trees	Flat, few trees	Mixed	Rolling hills, many trees	Hilly
Network type ¹⁶	Dense urban + rural strings	Grid	Mixed	Dense urban + rural strings	Urban plus rural strings
Ownership	Consumer Trust	Co-op/Council	Public listed	Consumer Trust	Consumer Trust
System fixed assets at ODV	\$162M (100%)	\$226M (140%)	\$113 (70%)	\$242M (150%)	\$216M (134%)
System length	3571km (100%)	3012km (84%)	2494km (70%)	5894km (165%)	3380km (95%)

¹⁴ Direct comparisons with the 50% owned Nelson city network are not appropriate because it is a dense urban network, with different characteristics. Marlborough Lines is similar and a reasonable but well known peer, however a broader peer group is deliberately chosen to achieve broader insight

¹⁵ Hills and trees imply higher costs

¹⁶ A grid, where feasible, will tend to mitigate supply interruptions



A performance comparison is as follows:

Network reliability - Faults:

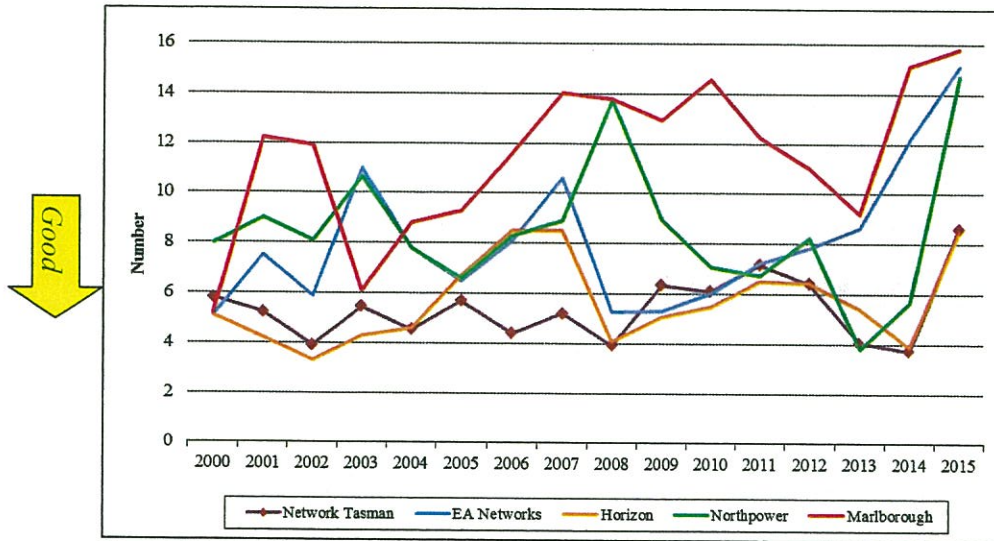


Figure 5 Network reliability – Total Number of Faults (as defined) per 100 circuit km (source PWC)

NT has 'held its own'; the deterioration trend of Marlborough stands out in contrast. It would seem that 2015 was a relatively stormy year right across NZ causing many faults.



Average network revenue charged to customers

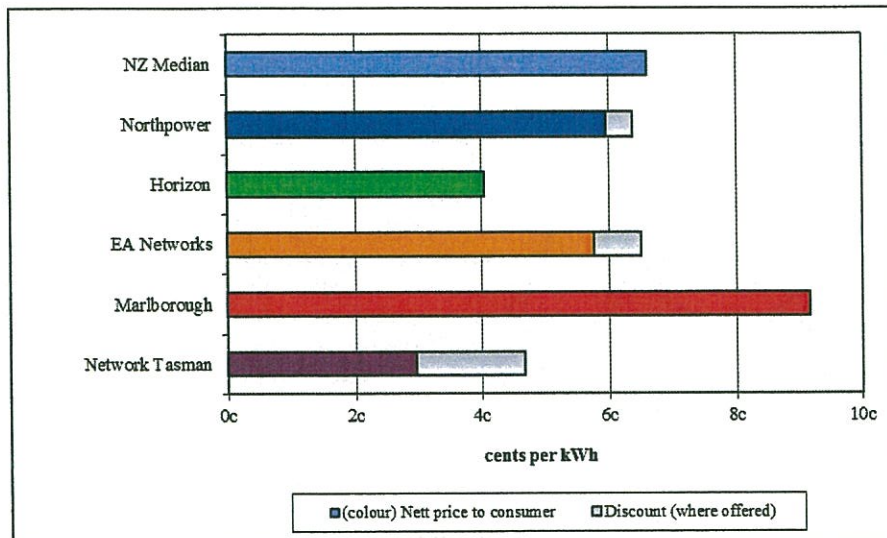


Figure 6 Revenue per kWh for year ended 31 March 2015 (source PWC plus KBP analysis)

This analysis shows a very acceptable (cheap charges on average) performance again from NT¹⁷.

¹⁷ Comparisons can be debated because of the network specific mix of industrial and residential customers (tariff regimes)



Investment effectiveness

This measure captures the concerns of all customers and the regulator: Is the line business profiteering at the expense of consumers?

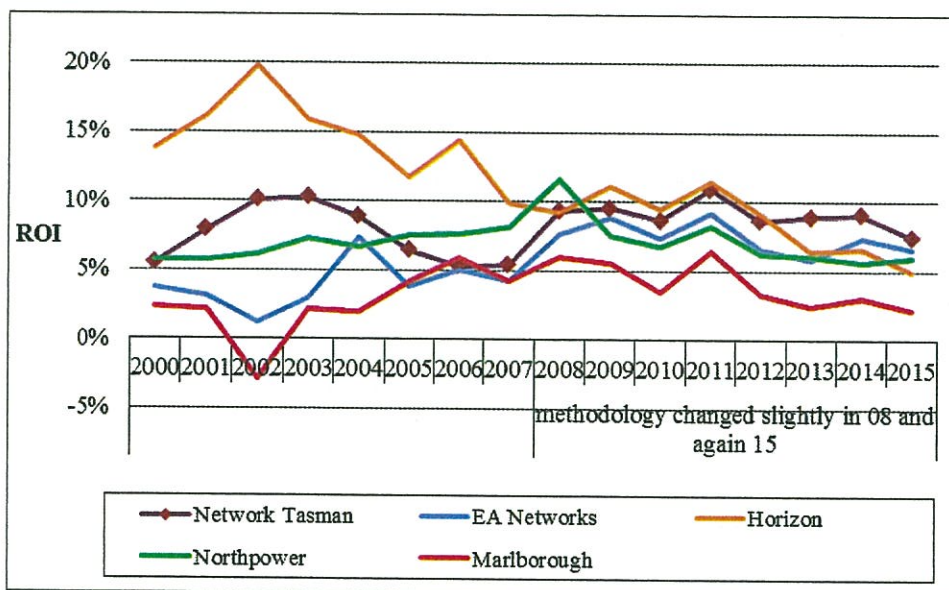


Figure 7 Line business Return on Investment (source PWC)

This chart is included for consistency as there have been regulatory Return on Investment methodology changes affecting all networks¹⁸. Key points are:

- convergence of returns (except for Marlborough), which is a reasonably foreseeable consequence of a prescriptive regulatory regime
- former public listed Horizon's previously high profits being squeezed down

¹⁸ After 2008 ROI has discretionary but not "posted" discounts added back without tax adjustments whereas the old ROI had all discounts removed; NT submitted to Commerce Commission on this anomaly; methodology changed again in 2015 but does not seem to have addressed this point. Thus NT return seems high but is not, due to consumer discounts.



6.0 Network Tasman performance in detail

6.1 Public commitment to performance

Statement of Corporate Intent “SCI”

This document is agreed each year between Directors and Trust as shareholder, setting out NT’s strategic intentions and performance targets in the statutory format.

In a well established process, year by year performance is subsequently scrutinised and explanations sought. Further comment here does not add insight.

6.2 Network reliability and efficiency

Fundamentally, NT exists to provide a reliable electricity distribution service in its region, in response to consumer needs with a prudent investment approach. Balance must be achieved between service and cost.

This aspect is addressed in preceding sections.

6.3 Capital Expenditure and provision for the future

The first Asset Management Plan was published in 1994; the underlying process and understandings are mature.

NT must generate sufficient free cashflow from tax paid profit, depreciation and working capital management to meet and sustain customer demand (including all network upgrading, renewals and replacement), before profits are shared with consumers in any way and shareholders rewarded for their risk investment.

As well signalled in the past; heavy capex is ahead, notably on Stoke substation. However Appendix C highlights the financial strength to support this planned spend. NT’s position can be summarised:



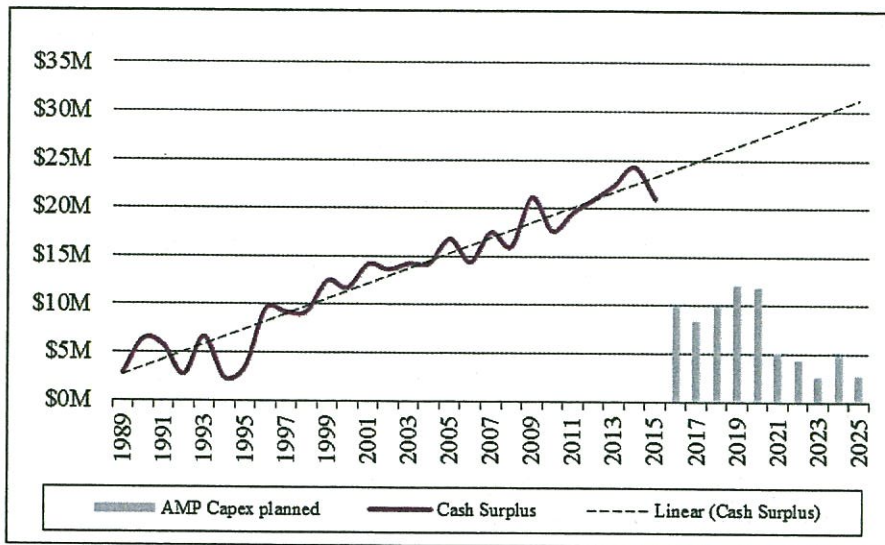


Figure 13 Free Cashflow from Appendix C page 4 as compared with Asset Management Plan needs (trendline R^2 is strong at 0.92; i.e. low variability is evident)

Source data over this period is not inflation adjusted. This is not material to conclusions.

Clearly NT is performing very well, with Cash Surplus from Operations of \$21M in 2015 shared between consumers (\$10M of discounts nett GST), shareholders (dividend \$2M) and most notably fixed asset purchases (\$17M nett). Appendix C page 4 also notes \$2.5M spend on Property Investments. While this all caused a nett \$10M outflow, cash reserves remain strong at \$4M.

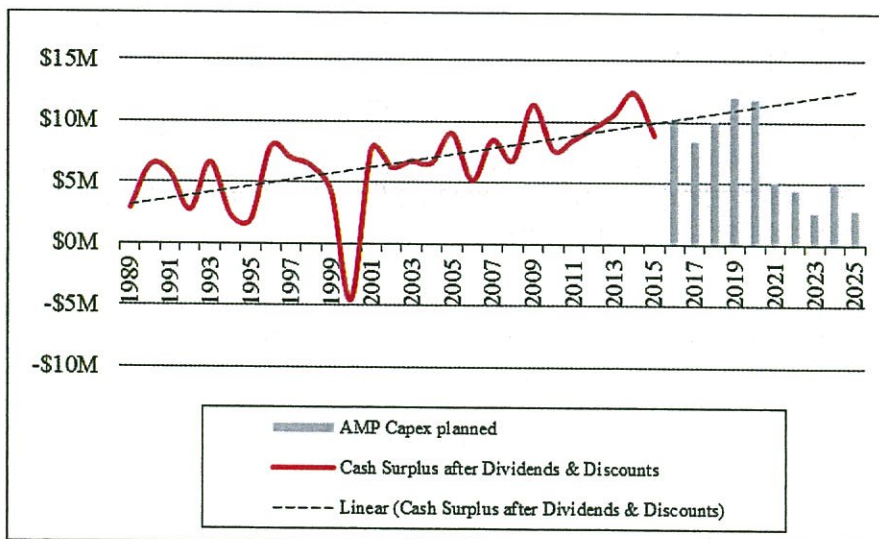


Figure 7 "Available" cashflow; after discretionary returns to both consumers and owner

There seems no reason why past returns to stakeholders cannot be maintained; if not grown.



It must be noted that the Balance Sheet carries just \$5M debt, which would allow a significant uplift for large specific projects or strategic opportunities.

This gap between free cashflow and planned capex also gives comfort in the event of changes in public policy (legislation), corporate policy (Transpower divesting more) or technology such as distributed generation; which will almost certainly present both opportunities and threats to NT. It also enables progress with regionally beneficial initiatives such as fibre and well signalled new technologies such as photo-voltaic systems and electric car charging.

Notwithstanding the comfort of the trendline in the charts above, risks in this area have not reduced and include:

- cash costs growing faster than revenue
- profit constraints in an increasingly regulated environment
- uncertain impact of emerging new technologies

6.4 Shareholder Value

In addition to running a successful business, NT must also be a good investment for its shareholder. Although the Network Tasman Trust is not driven by any need to diversify its high risk concentration, the NT investment must be seen to be reasonable on a portfolio basis.

With the benefit of hindsight this leads to questions of “what might have been” (opportunities foregone) and more significantly “what might be” (today’s opportunity cost) in future. The *average* residual asset life of NT is 26 years¹⁹. For new investments the asset life may be double that. This means that from a pure investment perspective it is difficult to assess NT because it’s “value” will vary hugely with core assumptions of kWh throughput, revenue, cost and interest rates (influencing WACC - cost of capital) over the long term. Plus, revenue from investments such as Nelson Electricity Limited (50% owned), the fibre optic telecoms network and benefits (via both revenue, as well as cost of network management) from electronic metering.

Of these the volume is clearly more risky now, with new technologies more obviously to the fore. In other words, the cost of the network being borne by fewer consumers (more standing alone from the grid) and less volume (more solar generation/battery storage with grid reliance for peak demand only). This may be mitigated by electric cars requiring battery charging subsequently increasing demand for electricity.

It is expected that NT will manage this risk using ‘cost reflective’ pricing at some time in the future, thus moving away from traditional volume based kWh pricing. This risk management strategy is assisted by the electronic metering project.

¹⁹ Fixed Assets (network plus other) \$171M divided by depreciation expense \$6.5M = 26 years



A summary comparison (Appendix C page 2) is as follows:

NT opening Shareholders Funds 31 March 2010	\$144.054M ²⁰
NT closing Shareholders Funds 31 March 2015	\$175.174M
Adding back customer discounts and dividends paid	\$249M (+\$58M) ²¹

	This review	Last review
Compound tax paid growth	+4.0%	+3.6%
Including customer rebates & dividends ²²	+11.5%	+9.6%

The tax paid return of 11.5% above assumes consistent taxation of consumer discounts and shareholder dividends across all customers. A consumer by consumer analysis is impractical; but the following comparison shows that all customers should be very satisfied:

Average first mortgage floating interest rate (RBNZ) (being opportunity cost for non taxpaying end consumers with mortgages)	6.0%
Average 90 day bank deposit rates (RBNZ), after 33% tax (opportunity cost for debt free taxpaying end consumers)	2.1%
NZ CPI increase per annum	1.1% ²³

This suggests that NT is outperforming alternative investments for most consumers.

For those consumers who invested in an NZSE50 portfolio, the outperformance would be far less as the NZX50 index gained 11% p.a. in the time. However in Australia the ASX200 only gained 3.9% (before FX impact converting back to NZD).

Vector, now the only sharemarket listed peer, grew in value by 5.2% compound annual growth rate; plus dividends.

In conclusion, NT as an investment is performing superbly.

Additional amenity value is provided by NT's commitment to undergrounding lines; which has grown from 23% in 2011 to 24% of total circuit km currently.

It should also be noted that these comparisons take no account of benefits provided to end consumers (ie ongoing Trust beneficiaries) in the form of good quality electricity supply at a reasonable nett price. We would expect these benefits to be durable. They will tend

²⁰ Starting Shareholders Funds in 1993 were only \$30M

²¹ see Appendix B page 1 for detail – note also that value per customer is another comparison but introduces arbitrary averaging

²² Assume no reinvestment growth.

²³ Calculated using RBNZ online tool



not to be affected by local and global capital market gyrations and sentiment about a particular listed country or share or industry sector.

6.5 Complaints

Not getting out of step with customers is also vital. One path of recourse is to the Electricity and Gas Complaints Commissioner. Since 2011 there have been just 8 complaints, all resolved.

There were no complaints in the 2015 calendar year²⁴.

6.6 Other lines of business

NT continues to make steady progress in its fibre optic telecommunications business. From revenue of almost \$3.5M in the year to 31 March 2015 this line of business now contributes (after costs) 20% of cash profit (Earnings Before Interest, Depreciation and Tax). Five years ago this figure was only 14% - demonstrating valuable diversity, using core network related skills to bring in revenue from outside the region as well as local consumer benefits should they so choose.

Investment property is performing well, recording a significant lift in rental income to \$1.5M per annum in the 2015 financial year as tenants moved into the new Queen Street building.

²⁴ Sourced from NT internal register



7.0 Ownership options

Our 1996 report (again) identified the following options for ownership of shareholding in Network Tasman:

- listed company
- unlisted company
- local authority ownership
- co-operative
- trust (status quo)

This same set of options applies today. A key driver of ownership structure for any business is the need for capital to fund internal growth, new business development or growth by acquisition. As set out in Section 6.3, NT's anticipated needs in this area can be internally generated. So on the surface, the status quo is preferred.

7.1 Financial performance of different ownership types

It is important to remember that for *any* ownership type applied to such a monopoly business, profitability is not an indicator of efficiency – low costs are. Profits can always flow via adjusting charges to suit the prevailing or regulation-permitted cost structure.

In reviewing PWC data we note that:

- there is no evidence of lower cost structures coming from 'non trust' forms of ownership
- trust owned networks are represented at the best and worst ends of performance ranges
- there is no relationship apparent between good performance and ownership structure

7.2 Overview of ownership types

It is important to note that while NT as a business is 'consumer focused' it has no direct relationship with end consumers. Network charges are on-charged via energy retailers such as Contact, Meridian etc. Discounts are passed through in the same manner.

It is also crucial to appreciate that business performance is ultimately determined by the quality of management (implementing strategy) and governance (strategy development and oversight). No structure can compensate for the overarching strengths and weaknesses of Management operating under effective skills based²⁵ Governance oversight.

²⁵ With skills and a skills mix around the table which are best for the business; as opposed to a 'representative' Board where individuals tend to have only their owners voice



In any sector or market; for every example of a 'great' company with a particular ownership structure there will almost certainly be a poor one. This is the premise of the famous book 'Built to Last' by Collins and Porras, published two decades ago.

Such a 'chalk and cheese' contrast is obvious between NT and neighbour Marlborough Lines; with the latter delivering poor reliability and high cost. Furthermore despite this obvious lack of mastery in the core business, Marlborough Lines recent chose to invest (thus become a competitor to a number of its business consumers) \$89M for 80% of a wine business²⁶.

After all this time and numerous reviews; consumer trust ownership remains the most significant; furthermore no 'conversions' have taken place in the last 5 years; except for Horizon being privatised to 100% Trust ownership.

7.3 Public ownership, listed on a stock exchange

The only relevant example is NZ Stock Exchange (NZX) listed Vector; quite a different company to NT although ownership is a hybrid - 75.1% by Auckland Energy Consumer Trust.

Public listing is understood in global capital markets as the purest ownership form. In theory, shareholders are fully informed via the workings of the 'perfect market' and can make the best *investment* decision as individuals. In particular, shareholders hold the option to liquidate their invested capital by selling their shares any time.

The perfect market is at best a theory; as numerous examples attest - most recently oil markets where highly knowledgeable, independent and well-funded organisations failed to pick the alarmingly steep price decline²⁷.

Advantages

- Economic purity - investment performance is decoupled from network service performance
- Liquidity – shareholders can sell at any time rather than being captive investors
- Value is enhanced by commoditising the investment and making it easy for buyers and sellers to transact under agreed rules and specified quality e.g. NZX listing rules²⁸

²⁶ <http://www.stuff.co.nz/business/industries/69862966/Marlborough-Lines-buys-80pc-stake-in-Yealands-Wine-Group>

²⁷ The Australian Financial Review on 13 Jan 2016 noted that in March 2015 not a single economist surveyed by the Wall Street Journal saw oil prices below USD50 per barrel, yet overnight oil prices had sunk to USD30 per barrel

²⁸ Auditing standards would be common across both listed and unlisted companies and Trusts



- The value of a minority shareholding is determined continuously in the market (takeovers pay a 'rule of thumb' 30% premium for control)
- Shareholders can take personal responsibility and exercise their democratic 'vote' by buying or selling if they approve or disapprove of company strategy, growth prospects or performance²⁹
- Similarly, management obtain regular feedback about investor perceptions of their performance - ultimately poor managers will lose their jobs through takeover
- Broadens scrutiny of financial performance
- Increased company profile
- Access to new equity capital via the market
- Better access to debt capital from bankers attracted to the high profile
- Management can be rewarded via share options i.e. benefit from increase in shareholder value as determined by the market (scheme needs to adjust for market index movement to target underlying company performance)
- Potential for unwelcome takeover activity may sharpen governance and management performance focus
- Avoids risks associated with local politics, trusts and associated parochialism

Disadvantages

- The 'perfect market' is at best a theory
- Market valuation of shares is imperfect and is often decided reactively by expert opinions in a high stakes takeover situation
- Management are incentivised to maximise pricing to customers and minimise service costs to lift profit and return on capital
- The threat of takeover while a fundamental driver of behaviour, is not necessarily a good thing for all stakeholders, especially in a regional context
- Benefits present generation of electricity consumers at the expense of future individuals living at the same ICP – in other words is not fair in terms of preserving inter temporal equity between network consumers, because shares (ownership rights) can only be issued at a single point in time
- Furthermore, this present cohort of consumers are most unlikely to have 'written a cheque' for their network assets
- Despite the best efforts of market surveillance committees and regulators, markets do not always serve all shareholders equally or fairly
- Small shareholders are always at a disadvantage both buying and selling compared with the research resources and information networks of major investing institutions (who are often from offshore)
- Research institutions and analysts prioritise their scarce time and increasingly less frequently cover 'small capitalisation' companies which NT would be; well outside the top 50
- Small size would also provide low liquidity for investors and poor market price signalling

²⁹ Typically in the Network Tasman Trust elections, only 1/3 of consumers exercise their democratic right to vote



- If taken over, it would likely be by a larger network company seeking economies of scale – well illustrated by NZ examples. Hence it is most unlikely that the local distribution network could ever be repurchased
- High initial costs of listing – direct legal, advisory and indirect management time in preparing an Investment Statement
- Ongoing compliance costs eg maintenance of share register, meeting analysts etc
- Likelihood of management emphasis moving to share price (capital gain for self and shareholders) and it's drivers rather than underlying business performance and in particular consumer service
- In large corporates there is no connection between management (seeking their next promotion) and consumers (who are thinking about the next generations of their family/business)
- Ongoing 'noise' in the share price from macro factors such as interest rates, China, quarterly reported earnings of other companies etc
- With a focus toward 'earnings per share', listing introduces a bias towards expansion and debt financing, which implicitly raises the risk profile of the underlying network business
- With management necessarily focusing on maximising growth in share price there can easily be a bias away from long term capital decisions which benefit consumers but reduce short term profitability
- Market perceptions of company performance (bad or good) may lead to control leaving the region, with end consumers having no say and small shareholders little say
- Even with control retained; unconstructive and activist influences can emerge as minority shareholder representatives on the Board
- A listed company has few 'checks and balances' to prevent consumers being disadvantaged by a merger or takeover proposal or a grandiose idea by management
- Finally, because distribution is a natural monopoly of huge regional economic significance, listing could lead to exploitation by absentee managers and owners with little vested interest in the economic success of the region

Note that there are listing options in addition to the NZX. For example, small hydro generator King Country Energy Limited (under takeover from Trustpower) trades on the Unlisted facility. The NZSE's alternative trading Board NZAX is another option. However these are less liquid than the much larger NZX which attracts more buyers and sellers and is thus more likely to expose true value on any given day.

7.4 Public ownership, unlisted

No examples.

This structure with the company running its own share exchange retains most of the advantages and disadvantages of public listing, but with greater simplicity and lowered cost. It can work well – for example Fulton Hogan Limited is a successful public unlisted



company – much larger than NT. After decades of high growth many of the 5000 employees are shareholders; some in modest roles are wealthy after long careers.

The trade-off for lower ‘compliance’ costs is a lack of marketability for shares (drives price down) and the need for a share price setting process and trading mechanism that may not reflect ‘fair value’ at any one time. In other words there would be no daily price discovery on market.

7.5 Local Government

For example Orion (Christchurch), Aurora (Dunedin).

In this model shares in the network company – a LATE³⁰ or other structure - are held by the local authority(ies) in a region.

Advantages:

- Optimises ability to operate in sync with Local Authority policy on business development and town planning
- Simple administration eg governance via an appointed Board of Directors without elected Trustees or a share register
- Access to capital and credit standing via Council’s power to rate
- Potential economies of both scale and scope with other local networks such as water and wastewater

Disadvantages:

- High political involvement
- Local Government is necessarily focused on minimising the impost of rates and ownership of monopolies gives a safe mechanism to do so
- Any profits – retained earnings and dividends - from providing the network are available to the Local Authority as shareholder and could directly or indirectly subsidise any kind of endeavour without end consumers or ratepayers having a say
- In the worst case, borrowing ability or cash reserves can be stripped out by capital restructuring and payment of “Special Dividends” and substituted with debt as has happened with many ports including Nelson; this is also an avenue of recourse by Christchurch after the earthquakes³¹
- The network business is ultimately responsible to a small group of Councillors led by an elected Mayor (not voted as leader by peers, as in a governance Board) who whose futures are determined via a three yearly electoral cycle

³⁰ Local Authority Trading Enterprise

³¹ For example from Christchurch Press 19 January 2016: “Councillor Manji said proceeds from the [City Care] sale, together with an \$80M special capital payment from Orion [network], would be enough to meet this year’s financial commitments”



- A highly politicised structure, which must balance local interest with skills in appointing qualified Directors
- While the company may have a commercial Board, there is the probability of weak appointments due to Council related influence elsewhere – and if made, this allegation is hard to rebut
- Linkages with local development may in practise be tenuous and lead to choosing between (say) undergrounding power lines or building social housing due to issues of capital scarcity and lack of direct focus on the network
- Perceptions of paternalism
- A strong and hard to rebut possibility that decisions will be made on the basis of political expediency
- Public distrust from cynicism about Local Government (evidenced by low voter turnout in elections), increasingly fuelled by media channels who see elected representatives as fair targets in the name of public debate
- Local Authority ownership does not imply good stakeholder relationships
- Delinked democratic process between consumers and network management

7.6 Co-operative

These are a well known business model despite being considered old fashioned in some circles. Co-operative business is huge both globally and in NZ and continues to be commercially successful in general. There are two types: ‘purchasers’ such as Fonterra and meat companies; and ‘suppliers’ such as fertilizer, Foodstuffs (wholesale groceries), Farmlands (farming suppliers) and Electricity Ashburton.

Essentially it is like a ‘club’ with payment of a nominal joining fee (a shareholding) relating to usage. This allows access to services and a share of any profits either directly via rebates, discounts etc or by dividends. On retiring, the shareholder redeems the shares and does not share in the capital growth of the business, which lives on for existing and new users.

Silver Fern Farms Limited recently illustrated the weaknesses of all co-operatives in a competitive market. Its structure (including Board and Management) was essentially not trusted by owners thus did not deliver the required capital to survive, so a new shareholder had to be found from China. Fonterra faces challenge, as the co-operative structure is not delivering stable milk returns for owners.



Advantages

- Specific, identified shareholders joined together by the 'common good'
- Customer service is placed first (in theory)
- High assurance of input supplies or markets
- Provide collective economies of scale
- Risk sharing by pooling of risk; including risk on implementing new innovations
- Company is governed by shareholder elected directors, who in turn appoint management
- Well suited where capital needs are low and intergenerational value is similar
- Strengthened sense of 'community', especially in farming

Disadvantages

- Somewhat complex legal structure which 'locks in' the status quo
- Quite politicised with an electoral cycle and more reliant than other models on management quality
- Benefits of 'community' can be lost in a larger organisation
- In event of a good takeover offer there are hard decisions to be made on how value is shared

In summary, co-operatives are somewhat like a Trust but without any compelling relative structural advantage.



7.7 Other/Combined

Various other ownership models can be conceived, such as Central Government 'mixed ownership' or a Joint Venture or cornerstone institutional shareholding. These could have merit in some circumstances however we make the following comments:

- The less 'mainstream' a business ownership model is, the less valuable it will be, as it will be less well understood and less trusted; this would particularly apply to a small business such as NT; it is to some extent impacting Fonterra now with Morningstar having ceased analyst coverage recently
- With value not readily understood, the chance is higher that one knowledgeable party will understand value and take control of the business cheaply
- This lack of transparency will cause concern from Board level down as people grapple with meeting the needs of all stakeholders
- Joint Ventures need a high level of trust (both intent and capability) between the partners to be a durable business model (most do not endure)
- Mixed shareholding structures will be more challenging at Board level due to the need for Directors to act in the best interests of the company ie put profits and shareholder value ahead of consumers and any other community interests
- Polarised Boards are unlikely to meet the needs of any stakeholders effectively, whether financial or public good

Thus our opinion is that the best business model is a 'mainstream' one that is well understood. On the surface we would not be in favour of a Trust selling down from 100% ownership on 'investment portfolio' or other grounds. We believe that it is an 'all or nothing' decision.



7.8 Trust

NT is a stellar example of this model, in that the management team report through a Chief Executive to Board, who in turn report at longer intervals to elected Trustees. The annual Statement of Corporate Intent is the key linking document to drive strategy and performance accountability down from the Trust as owner, through the Directors they appoint, to Chief Executive and his/her management team.

NT is a *consumer* trust, with NT operating for the benefit of electricity users connected to the regional network, at a point in time. In our opinion this is a strongly preferred arrangement to a community trust where the trust beneficiaries and company end consumers are potentially different groups – without the same alignment.

The Trust is therefore the collective voice of all network users, from large manufacturers down to small consumers such as a rural public hall and craft artists.

This chain of influence ensures that management are compelled to take into account the effect of their decisions on consumers, in all market and regulatory circumstances. In other words, a constructive tension exists between the profit/shareholder value motive; customer requirements of service and price; and government commands.

Whether or not this is a healthy tension depends on the relationship between Trustees and the Board.

The Trust model in our view is more demanding of Board and Trustee skill as complex and technical issues have to be worked through (sometimes in public and nowadays in even social media) and risk/reward tradeoffs justified.

At a higher level, in an industry climate of high change, the Trust ownership structure allows Trustees to receive and review major strategic or rationalisation proposals which may be good for consumers as ultimate shareholders.

Conceptually the Trust ownership model can be considered as a **family** business, taking concentrated risks with knowledgeable attention from older, less involved family members who want to see all family members thrive, long term. This Board and Trust model mirrors the balancing governance of Board (what is best for the business) and Family Council (what is best for the family) model which is considered best practise³² for family businesses – of which there is no shortage of large and sustainable exemplars globally.

Like family business; it is not all about the money. So this time we have sought to divide Advantages into Non-Financial and Financial – although in practise the lines are blurred and many are mutually reinforcing:

³² Advocated by both Harvard Business School and Insead in programs run each year



Non-Financial Advantages:

- The opportunity to be a trusted and strong 'local' organisation providing a complex and essential long term input to daily life and business
- Retains a commercial relationship between network service and quality; and end consumers with a channel to return discounts to consumers in a manner beneficial to both homes and businesses
- While being 'commercial' can balance the needs of less commercially attractive/cross subsidised consumers such as distant farms and the underprivileged/unemployed/sick, in a focused way; with heart
- Similarly, that part of NT's annual capital expenditure program steadily undergrounding lines offers modest operating cost savings but perhaps more importantly is aesthetically pleasing in those fortunate neighbourhoods; as well as lowering risk from car vs pole opportunities
- Clear shareholder and customer accountability established for management – via the Board to the Trustees
- The Trust's position as shareholder receiving dividends is that of a well empowered consumer advocate
- The common good is given an efficient corporate voice at the company Board table and in the community
- Trust ownership with the SCI guiding the operating company is a mainstream business model which is widely understood
- As such it should attract good quality people at all levels (evident at NT in our opinion but can never be taken for granted)
- It is a durable structure which at the same time gives flexibility to meet opportunities and threats in the heavily controlled NZ electricity environment
 - This seems particularly important right now as evolving technologies will present threats and opportunities locally along with community possibilities (i.e. enriching family life of consumers) – fibre to school is a historic example of this non-financial benefit
- Preserves other ownership options for ongoing consideration
- Open process is assured in event of ownership change
- Provides another funding option in the local community for worthwhile (risky) projects both inside (e.g. evolving technologies) and outside core business

Financial Advantages:

- Allows benefits to be passed on to consumers in the most optimal form e.g. dividends, discounts, vouchers etc. as tax rules may change from time to time
- Cash stays in local community, for agreed community benefit
- A good mechanism to prevent excessive profits being extracted from consumers of a natural monopoly business
- In any event there are reasonable checks and balances so 'surpluses' (if any) flow back to consumers³³

³³ This can be manipulated for example if a Trust owned network purchased another network in which consumers were not Trust beneficiaries (Nelson Electricity, Unison Taupo and Rotorua)



- Maximises the option, should a sale possibility arise, of achieving a control premium in the price of a dominant share block
- Allows due consideration of long term customer benefits which is appropriate when dealing with fixed assets which will almost certainly still be in service two generations hence

Disadvantages:

- Requires a high skill level of Trustees and Boards to balance stakeholder needs and assess risks; without being too close to stakeholders and losing objectivity
- Risk of parochialism getting in the way of good business practise
- In particular there is risk of capture via the Trust by misguided 'local' investment interests e.g. wineries, railways, tourist ventures etc.
- The Trust can be subject to accusations of being either too weak or too dominant
- End consumers who feel they have some claim on the network investment cannot liquidate their investment
- Satisfactory participation rates in Trust elections are required to ensure effective democracy; ongoing engagement is critical (and at times both costly and painful)
- 'Trust' ownership can be an acronym for 'conservatism' in the name of 'prudence' when good business is about identifying, taking on and managing specific risks

It should be noted that little or no dissent from Trust ownership has been found in reviewing a range of other reports. For example refer to Appendix E which incorporates the Conclusion of the Victoria University academic paper "New Zealand's Electricity Lines Companies: an ownership analysis June 2012".

As a matter of note; Switzerland is an interesting example as an open and wealthy economy with GDP per capita more than double that of New Zealand. *"From the highly centralised New Zealand perspective [including electricity], one might conclude the Swiss have achieved this despite a highly devolved form of government (2,408 communes, 26 cantons and a central government). The Swiss are more likely to argue that this has been achieved because of this devolved structure..³⁴"*

If the interests of local consumers are truly paramount, the consumer Trust model remains hard to beat.

³⁴ The Local Formula – Myths, Facts and Challenges; by Jason Krupp and Bryce Wilkinson of the NZ Initiative, 2015 p37



8.0 Summary

In light of ongoing change in the industry since Tasman Energy Limited was initially formed on 1 May 1993, it is clear that Trust ownership has served the company, its consumers and its shareholders well. The degree of change imposed externally has been significant and has been effectively managed while:

- delivering good network service quality
- lowering average network prices
- providing low variability in quality and price; year in, year out
- expanding into non-core fibre and property businesses
- stepping into new technologies (electronic meters)
- adding shareholder value

At this time it is well noted that the most significant external change on the horizon – presenting both challenge and opportunity - is from new technologies.

Consideration of all the above factors implies that any alternative ownership structure must present a strong case. Once again there is clearly no beneficial alternative.

9.0 Appreciation

We have once again received all the information and explanations we sought from NT staff. We acknowledge their input in the preparation of this Report.

Yours faithfully

Key Business Partners Limited



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Appendices

- A Definitions of Technical terms
- B Network reliability charts
- C Summary Financial Analysis
- D Quartile analysis
- E Summary of Academic paper

References

Chronology of NZ Electricity Reform dated August 2015 by Energy Markets Policy; Energy and Resources Branch of Ministry of Business and Enterprise (“MBIE”)
<http://www.mbie.govt.nz/info-services/sectors-industries/energy/electricity-market/electricity-industry/chronology-of-new-zealand-electricity-reform/chronology-of-nz-electricity-reform.pdf>

NT website www.networktasman.co.nz

- NT Annual Reports
- NT Asset Management Plan for the 10 years 1 April 2015 to 31 March 2025 as published on NT website
- NT Statement of Corporate Intent up to years ended 31st March 2016

Tasman Electric Power Trust Amended Trust Deed; plus Proposed Deed of variation dated 2015 and associated process detail

PWC Electricity Line Business Information Disclosure Compendia

Other lines business ownership reviews (few are available):

- 2011 Scanpower Limited Ownership Review Report
- 2014 Counties Power Consumer Trust (includes NT as peer)

Implications of evolving technologies for pricing of distribution services Consultation Paper by Electricity Authority dated 3 November 2015

NZ Electricity Lines companies: an ownership analysis dated June 2012 by Talosaga Talosaga and Bronwyn Howell of NZ Institute for Study of Competition and Regulation Inc

Tauranga Energy Consumer Trust ownership review January 2013 by PWC





Appendix A

Definitions of Technical Terms

CAIDI – Customer Average Interruption Duration Index: This gives the average duration of an interruption. In other words a CAIDI of 40 minutes means that if a customer experiences an interruption, the average duration of that interruption will be 40 minutes. It is a measure of how fast a power company can locate and repair a “typical” fault. See SAIDI and SAIFI.

$$\text{CAIDI} = \frac{\text{Sum of interruption duration for all interruptions (mins)}}{\text{Average total number of consumers affected by the interruption}}$$

Capacity Utilisation measures the utilisation of transformers (hence lines) in a network.

$$\text{Capacity Utilisation (\%)} = \frac{\text{Maximum demand (kW)}}{\text{Transformer Capacity (kVA)}}$$

Low capacity utilisation can mean

- Low need for future capital expenditure
- An over-designed system
- Substantial potential to handle future growth
- Nature of customer mix eg high number of irrigation consumers

But more likely it means a system with transformers sited to meet peak loads which do not all occur at the same time. It is an *average* figure.

Thus increasing capacity utilisation is desirable for an EPC, ie. greater use of assets. But because of averaging across a widely divergent customer base, rural EPC's with long line length will tend to have lower capacity utilisation than those in more densely populated areas.

CPI Index – The ‘Consumer Price Index’ is a measure of inflation, by reference to a standardised basket of household goods and services originally indicates costing “100” when the index started. An increase in CPI indicates inflation in the economy.

EBIT – Earnings Before Interest and Tax is a measure of the earning capacity of a business (investment) before providers of “capital” are serviced by way of interest taxes and dividends. It is directly comparable to the net rental return on a property or interest received on a bank deposit.

EBIT/Funds Employed – this treats debt and equity capital as the same – “funds employed”. It measures the absolute profitability of the business before considering how it is financed. Therefore high EBIT/Funds Employed is generally desirable.



Direct Costs – as defined by legislation, expenditure directly related to operating or maintaining the business and specifically excludes capital expenditure, depreciation, interest, tax and Transpower charges.

Equity Ratio – Total Shareholder's Funds divided by Total Assets. Simplistically, what proportion of the business is financed by the shareholders, either as capital input or retained profits/reserves.

Imputed dividend – a dividend paid to a shareholder with a tax credit attached in reflection of tax already paid by the company. A 'fully imputed' dividend of \$100 is worth \$149.25 to the shareholder due to the \$49.25 (33%) tax credit attached.

kWH - Kilowatt – hours 1,000 watt-hours. Relates to power output or consumptions. A "1kW" heater switched on for one hour will use 1 kWH of electricity.

Natural Monopoly refers to a market situation in which a single firm can supply the entire market more efficiently than any number of larger firms due to the good or more commonly service being so complicated or expensive from economies of scale or other reasons.

NZSE50 Capital Index is a measure of the aggregate change in share prices for the 50 largest companies listed on the NZ Stock Exchange. (Previously the NZSE40, the index was expanded in February 2003)

ODV – Optimised Deprival Value – a valuation methodology applied to long lasting infrastructure assets such as electricity networks in markets where there is little competition.

ICP – Installation Control Point, which signifies an electricity consumer connected to the network.

Indirect Costs – as defined by legislation, in effect is cash overheads.

Risk Premium is the return to investors over and above what they could earn from a "riskless" asset such as NZ Government Stock. This reflects the Government being the lowest risk borrower in New Zealand. Businesses have to offer investors a risk premium over this to attract either debt or equity capital. In turn the business needs to earn at least the Government Ratio Stock Rate plus Risk Premium on capital to provide investors an appropriate return.

ROA – (Return on Assets) is the profit (either pretax or tax paid) divided by the total assets (either average or closing) owned by a business.

ROE – Return on Equity or Return on Shareholders Funds.

ROE = Net Profit After Tax



Closing Shareholders Funds (Equity)

This is the return on the equity capital invested in the business. It is influenced by the split of total capital (funds employed) between debt and equity.

SAIDI – System Average Interruption Duration Index: This gives the average total time in minutes per year that each customer is without supply. A SAIDI of say 100 minutes means that every customer on a particular network experiences an average total time without electricity of 100 minutes per year. See SAIFI and CAIDI.

$$\text{SAIDI} = \frac{\text{Sum of interruption duration for all interruptions (Minutes)}}{\text{Average Total number of Consumers}}$$

SAIFI – System Average Interruption Frequency Index: This gives the average number of interruptions every customer experienced in a year. A SAIFI of 2.5 means that on average every customer experiences 2.5 interruptions in the year. See SAIDI and CAIDI.

$$\text{SAIFI} = \frac{\text{Number of consumers affected by the interruptions}}{\text{Average total number of consumers.}}$$

Transmission losses refers to electricity entering a network which never arrives to be used by a customer. It is generally lost in the form of heat; with the longer the line length the higher the transmission loss.



Appendix B

Insert 5 excel spreadsheet charts of network reliability

Appendix C

Insert 4 excel pages Summary Financial Analysis

Appendix D

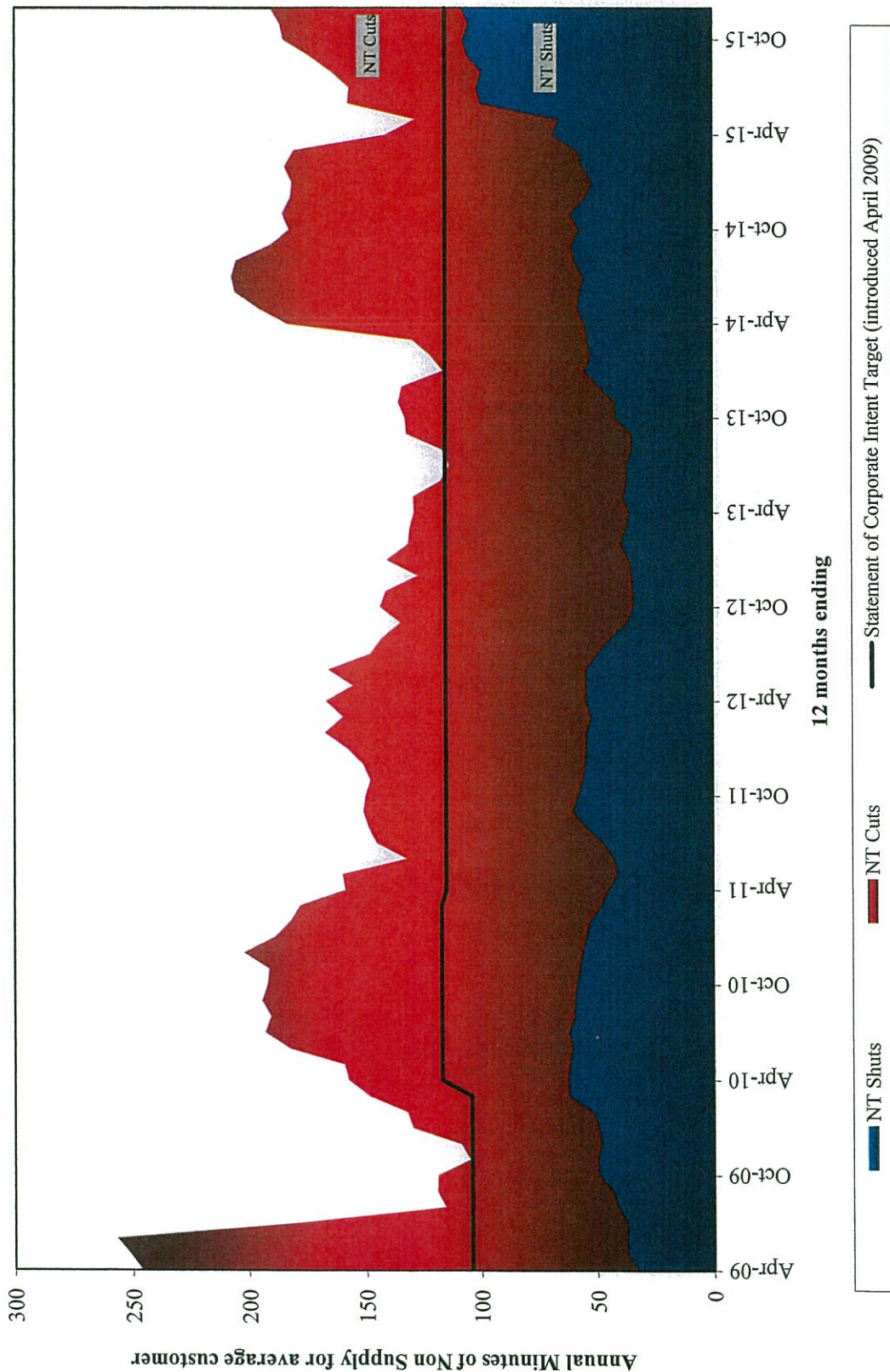
Quartile analysis of Indirect Costs/ICP, insert Excel sheet

Insert Excel sheet



NetworkTasman

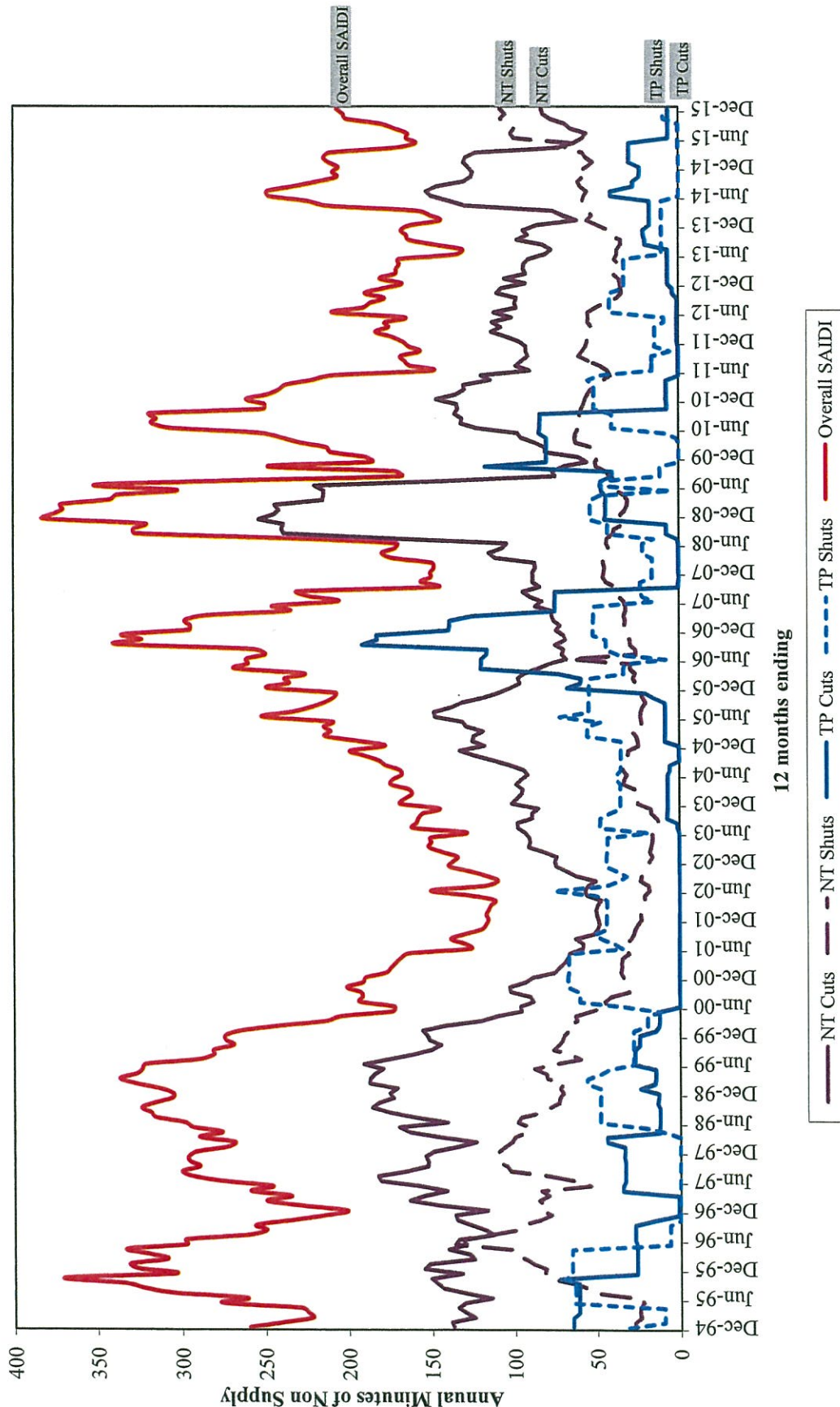
12 MONTH ROLLING AVERAGE SAIDI TREND, NT ONLY
(Class B + Class C reliability, as directly managed by NT)





NetworkTasman

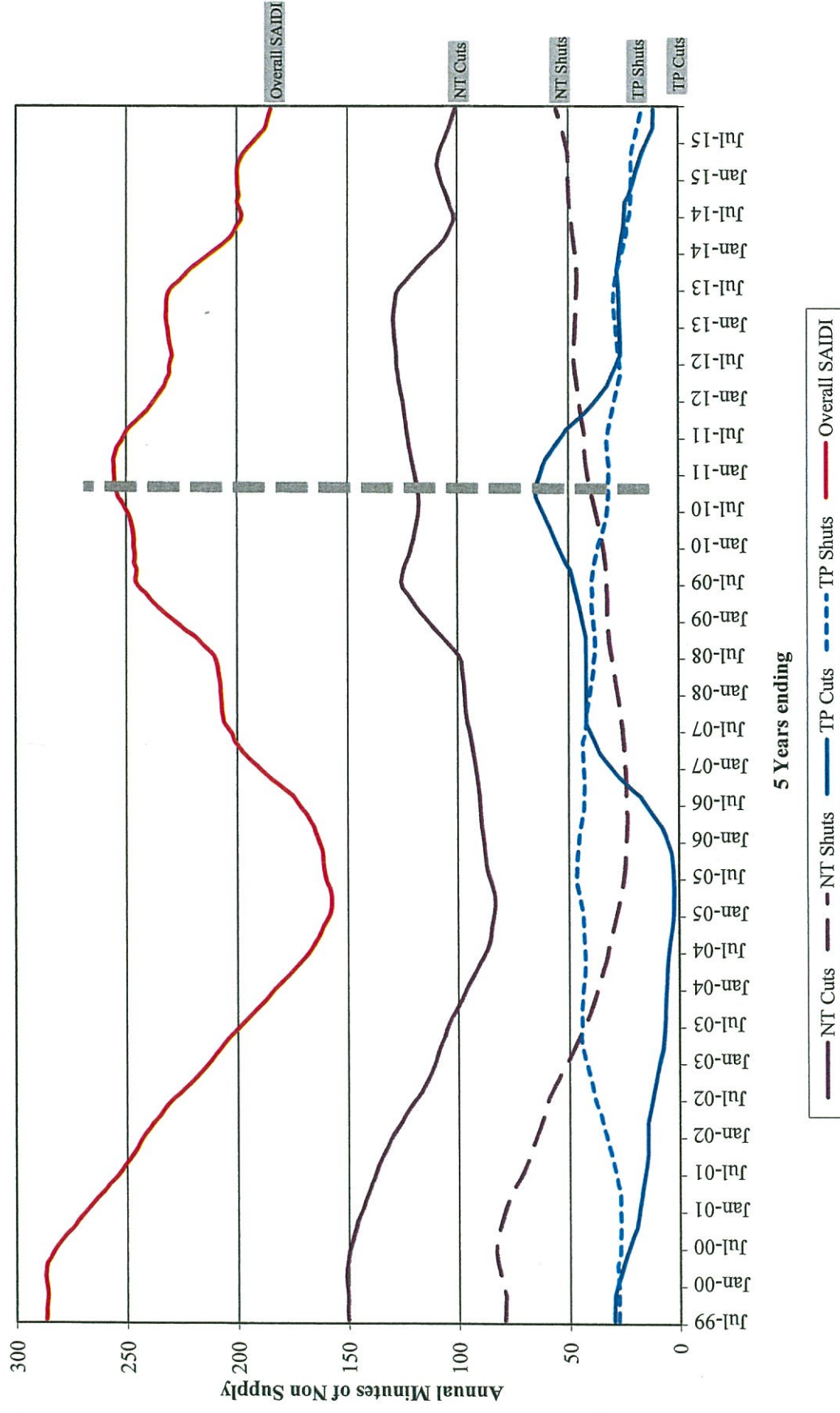
NETWORK TASMAN - 12 MONTH ROLLING AVERAGE SAIDI TRENDLINES
(reliability as observed by consumers)





NetworkTasman

NETWORK TASMAN - 5 YEAR ROLLING AVERAGE SAIDI TRENDLINES
(reliability as observed by consumers, last Review date marked)





TOTAL SAIDI Minutes (Classes B & C)

	2010	2011	2012	2013	2014	2015
Alpine	332	226	162	148	858	140
Aurora	73	112	144	76	95	130
Buller	302	289	253	184	172	2,747
Centralines	133	192	267	124	163	141
Counties	78	138	88	127	125	120
Eastland	312	334	395	287	285	256
Electra	163	75	132	58	67	139
Electricity Ashburton	186	263	193	163	832	198
Electricity Invercargill	30	45	64	32	25	41
Horizon	140	177	175	192	198	173
Mainpower	140	337	117	254	951	192
Marlborough	284	423	240	139	246	130
Nelson Electricity	79	115	64	44	22	20
Network Tasman	148	178	159	131	130	181
Network Waitaki	64	61	51	55	95	51
Northpower	132	135	146	117	156	380
Orion	61		231	94	474	126
Otagonet	333	247	321	253	471	356
Powerco	223	274	331	176	226	278
Scanpower	66	104	99	89	71	68
The Lines Co	293	297	325	200	271	279
The Power Co	210	209	238	191	178	259
Top Energy	463	440	435	395	500	1,838
Unison	111	128	249	89	113	120
Vector	67	123	96	96	151	496
Waipa	127	114	242	152	123	201
WEL	75	83	69	75	91	105
Wellington	41	35	46	43	191	39
Westpower	279	297	136	213	108	600

Well out of Top
(best) quartile**QUARTILES**

1	75	114	99	89	108	120	<= are best
2	140	178	162	131	163	173	
3	279	278	249	191	271	278	>= are worst

Median	140	178	162	131	163	173
NT variation with median	+6.0%	+0.2%	-1.9%	+0.0%	-20.6%	+4.4%



SUMMARY FINANCIAL ANALYSIS:

ACCOUNTS ANALYSED:

CONSOLIDATED/

NETWORK TASMAN LIMITED

(2004, 2007 and 2009 Network revaluations normalised for consistency)

	Periods Ending: Number of Months:	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
AUDITED - Audit Office		12 IFRS	12 IFRS	12 IFRS	12 IFRS	12 IFRS	12 IFRS
INCOME STATEMENT:							
<i>(STATEMENT OF FINANCIAL PERFORMANCE)</i>							
INCOME:-							
SALES (pre customer discounts, excl GST)		37,070	37,981	38,920	41,883	44,813	48,109
OTHER INCOME -		4,347	5,325	5,972	6,513	6,319	6,026
Less TransPower		(12,369)	(12,061)	(12,695)	(13,678)	(16,730)	(17,088)
GROSS PROFIT		29,048	31,245	32,197	34,718	34,402	37,047
Less: Cash overheads		(8,159)	(8,856)	(9,358)	(9,621)	(10,331)	(11,661)
Less: Depreciation		(5,651)	(6,095)	(6,152)	(6,190)	(6,066)	(6,562)
EARNINGS BEFORE INTEREST and TAX		15,238	16,294	16,687	18,907	18,005	18,824
Less: INTEREST COSTS		(92)	(86)	(76)	(57)	(216)	(193)
OPERATING PROFIT BEFORE TAX		15,146	16,208	16,611	18,850	17,789	18,631
Less: TAX PROVISION		(2,239)	(1,660)	(2,068)	(2,242)	(2,517)	(2,312)
Less: MINORITY INTERESTS							
OPERATING PROFIT AFTER TAX		12,907	14,548	14,543	16,608	15,272	16,319
UNREALISED PROFITS/(LOSSES):							
EQUITY ACCOUNTED PROFITS		1,287	1,223	1,276	942	1,726	972
OTHER - specify						FX gain	364
NET PROFIT AFTER TAX		14,194	15,771	15,819	17,550	16,998	17,655
EXTRAORDINARY & ABNORMAL ITEMS:							
PROFIT ON SALE OF ASSETS		(177)		3		(318)	(262)
OTHER - specify		(415)	4	31	42		364
TOTAL EARNINGS AFTER TAX		13,602	15,775	15,853	17,592	16,680	17,757
APPROPRIATIONS:							
Less: SALES DISCOUNT PROVISION & DIVIDEND		(9,980)	(11,043)	(11,391)	(11,739)	(11,913)	(12,087)
Less: GOODWILL							
Less: OTHER - specify							
RETAINED EARNINGS FOR THE YEAR		3,622	4,732	4,462	5,853	4,767	5,670
Consumer connections (ICP's)		36,219	36,679	37,089	37,500	37,938	38,314
Number of GWh delivered (excl NEL from 2015)		734	767	779	781	772	718
CPI (2009 series)		1,097					
NT Cash cost/kWh		1.11c	1.15c	1.20c	1.23c	1.34c	1.62c
NT Real cash cost/kWh		0.85c	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!
TP Cash cost/kWh		1.69c	1.57c	1.63c	1.75c	2.17c	2.38c
TP Real cash cost/kWh		1.29c	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!	#DIV/0!
EBIT less discount per ICP		\$258	\$283	\$291	\$347	\$319	\$337
Real							



SUMMARY FINANCIAL ANALYSIS:

ACCOUNTS ANALYSED:

CONSOLIDATED/

NETWORK TASMAN LIMITED

(2004, 2007 and 2009 Network revaluations normalised for consistency)

	Periods Ending: Number of Months:	31-Mar-10 12 IFRS	31-Mar-11 12 IFRS	31-Mar-12 12 IFRS	31-Mar-13 12 IFRS	31-Mar-14 12 IFRS	31-Mar-15 12 IFRS
AUDITED - Audit Office							
BALANCE SHEET:							
(STATEMENT OF FINANCIAL POSITION)							
PAR VALUE OF SHARES		100c	100c	100c	100c	100c	100c
ORDINARY SHARES ON ISSUE - number		57,185	57,185	57,185	57,185	57,185	57,185
(000)							
FUNDS EMPLOYED:							
SHAREHOLDERS FUNDS:							
ISSUED AND PAID UP SHARE CAPITAL(\$):							
ORDINARY		57,185	57,185	57,185	57,185	57,185	57,185
PREFERENCE							
RESERVES - REVALUATION		52,472	52,571	51,877	50,426	51,167	50,807
- OTHER		34,397	46,430	50,892	56,745	61,512	67,182
Less: INTANGIBLE ASSETS - GOODWILL							
TOTAL SHAREHOLDERS FUNDS		144,054	156,186	159,954	164,356	169,864	175,174
MINORITY INTERESTS							
INTEREST BEARING DEBT		1,089	944	786	610	624	7,872
CREDITORS		4,288	4,366	4,154	5,108	7,899	5,856
PROVISIONS - DIVIDENDS							
- TAX (Incl deferred tax)		29,042	28,368	28,551	28,413	28,203	28,322
		178,473	189,864	193,445	198,487	206,590	217,224
EMPLOYMENT OF FUNDS:							
FIXED ASSETS		143,696	153,783	153,369	156,591	161,599	171,491
LONG TERM INVESTMENTS:							
ASSOCIATES - SHARES & Advances		8,353	8,678	9,054	9,096	13,197	13,169
Properties		12,850	14,049	14,664	16,684	19,532	22,672
OTHER						158	159
STOCKS							
DEBTORS AND PREPAYMENTS		4,028	4,522	4,328	5,629	5,278	5,609
CASH AND SHORT TERM INVESTMENTS		9,546	8,832	12,030	10,488	6,826	4,124
		178,473	189,864	193,445	198,488	206,590	217,224
CONTINGENT LIABILITIES		1,253	1,422	4,788	1,404	1,476	4,129
(Incl next 12 months Lease commitments)							
TOTAL CURRENT ASSETS		13,574	13,354	16,358	16,117	16,853	12,267
TOTAL CURRENT LIABILITIES		5,160	4,730	4,802	5,966	8,129	6,102
bal check		y	y	y	y	y	y



SUMMARY FINANCIAL ANALYSIS:

ACCOUNTS ANALYSED:

CONSOLIDATED/

NETWORK TASMAN LIMITED

(2004, 2007 and 2009 Network revaluations normalised for consistency)

	Periods Ending: Number of Months:	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
		12	12	12	12	12	12
AUDITED - Audit Office		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
DEBT PROFILE:		(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
SECURED:							
BNZ Overdraft							
Various Other							
Transpower Finance lease		1,089	944	786	610	624	372
UNSECURED:							
Deferred Income							
(Capital contributions from customers)							
BNZ Negative Pledge							7,500
		1,089	944	786	610	624	7,872
CURRENT PORTION		167	182	217	258	227	117
RATIO ANALYSIS:							
INTEREST COST COVER - times		165.6x	189.5x	219.6x	331.7x	83.4x	97.5x
EARNINGS - cents per closing share no.							
BEFORE EXTRAORDINARY ITEMS		24.8cps	27.6cps	27.7cps	30.7cps	29.7cps	30.9cps
AFTER EXTRAORDINARY ITEMS		23.8cps	27.6cps	27.7cps	30.8cps	29.2cps	31.1cps
EBIT/AVERAGE FUNDS EMPLOYED - % (inc minority interests)		10.6%	10.8%	10.5%	11.6%	10.7%	10.6%
EQUITY RATIO (SHF/ASSETS) - %		80.7%	82.3%	82.7%	82.8%	82.2%	80.6%
NET TANGIBLE ASSETS PER SHARE - c		252c	273c	280c	287c	297c	306c
CURRENT RATIO		263%	282%	341%	270%	207%	201%
Productivity: Sales/Fixed assets (non revalued)		0.26x	0.25x	0.25x	0.27x	0.28x	0.28x
Cashflow: Cash Profit - EBITDA margin		44.6%	44.9%	43.3%	44.4%	39.6%	40.2%
NPBT/Closing Assets		8.5%	8.5%	8.6%	9.5%	8.6%	8.6%



SUMMARY FINANCIAL ANALYSIS:

ACCOUNTS ANALYSED:

CONSOLIDATED/

NETWORK TASMAN LIMITED

(2004, 2007 and 2009 Network revaluations normalised for consistency)

	Periods Ending: Number of Months:	31-Mar-10	31-Mar-11	31-Mar-12	31-Mar-13	31-Mar-14	31-Mar-15
AUDITED - Audit Office		12	12	12	12	12	12
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
FUNDS STATEMENT:							
		(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
CASH INFLOW/(OUTFLOW) FROM OPERATIONS:							
OPERATING PROFIT BEFORE TAX		15,146	16,208	16,611	18,850	17,789	18,631
DEPRECIATION		5,651	6,095	6,152	6,190	6,066	6,562
OTHER NON-CASH/(CASH)		0	4	31	43	(1)	364
TAX PAID		(2,420)	(2,334)	(1,885)	(2,380)	(2,727)	(2,193)
WORKING CAPITAL (INCREASE)/DECREASE							
STOCKS		0	0	0	0	0	0
DEBTORS AND PREPAYMENTS		(558)	(494)	194	(1,301)	351	(331)
CREDITORS		(168)	78	(212)	954	2,791	(2,043)
CASH SURPLUS/(DEFICIT) FROM OPERATIONS		17,651	19,557	20,891	22,356	24,269	20,990
INVESTING ACTIVITIES:							
DIVIDENDS and Cust. Discounts PAID		(9,980)	(11,043)	(11,391)	(11,739)	(11,913)	(12,087)
NETT FIXED ASSETS - Sold							
- (Purchased)		(7,353)	(8,881)	(5,735)	(9,412)	(11,392)	(16,716)
NETT INVESTMENTS - Sold							
(Incl. MI and G'will movement) - (Purchased)		(2,328)	(202)	(409)	(2,571)	(4,640)	(2,501)
TOTAL FUNDS SURPLUS/(NEED)		(2,010)	(569)	3,356	(1,366)	(3,676)	(10,314)
SOURCE/(DISPOSITION) OF FUNDS:							
SHARE ISSUES		0	0	0	0	0	0
CASH DEPOSITS (INCREASE)/DECREASE		2,130	714	(3,198)	1,542	3,662	2,702
INTEREST BEARING DEBT -INCR/(DECR)		(120)	(145)	(158)	(176)	14	7,248
FX TRANSLATION RESERVE		0	0	0	0	0	364
TOTAL FUNDS PROVIDED/(DISPOSED OF)		2,010	569	(3,356)	1,366	3,676	10,314
bal check		y	y	y	y	y	y
SURPLUS FROM OPERATIONS / AVGE T.A.		9.9%	10.6%	10.9%	11.4%	12.0%	9.9%



TOTAL Cash Costs \$/ICP

PWC page	changed methodology			55		123	121
	2009	2010	2011	2012	2013	2014	2015
Alpine		336	391	405	394	486	436
Aurora		245	231	242	224	266	278
Buller		570	643	761	937	727	673
Centralines		329	394	417	493	516	420
Counties		263	267	261	251	279	293
Eastland		355	359	236	291	307	309
Electra		230	228	226	200	243	268
Electricity Ashburton		196	183	395	432	454	495
Electricity Invercargill		257	274	299	312	280	240
Horizon		280	278	281	283	313	322
Mainpower		262	295	281	291	312	285
Marlborough		650	687	558	473	507	506
Nelson Electricity		239	193	225	255	243	207
Network Tasman		205	218	231	226	227	258
Network Waitaki		255	243	299	287	309	362
Northpower		289	272	270	282	296	278
Orion		213		317	253	269	267
Otagonet		340	347	406	423	520	542
Powerco		181	179	207	203	209	200
Scanpower		268	287	306	342	386	239
The Lines Co		281	292	357	414	453	427
The Power Co		334	329	354	389	390	411
Top Energy		370	408	473	417	411	424
Unison		238	271	275	295	317	318
Vector		171	173	186	177	198	208
Waipa		218	230	197	199	188	213
WEL		201	213	220	217	220	206
Wellington		190	192	189	172	180	154
Westpower		578	586	614	596	619	718
QUARTILES							
1		218	226	231	226	243	240
2		262	273	281	291	309	293
3		334	350	395	414	453	424
Median							
		262	273	281	291	309	293
NT var with median							
		-21.8%	-20.1%	-17.8%	-22.3%	-26.5%	-11.9%

Slightly out of
Top (best)
quartile

FROM: New Zealand's Electricity Lines Companies: an ownership analysis

June 2012

Talosaga Talosaga and Bronwyn Howell

New Zealand Institute for the Study of Competition and Regulation Inc.

Victoria University

“

6 Conclusion

Our analysis confirms that a mix of ownership forms for New Zealand's electricity lines businesses has emerged from the reforms of the 1980s and 1990s. Whilst the reformers structured the firms initially as trusts, but with a set of conditions strongly biasing the firms towards fully private ownership, this outcome has failed to eventuate. Whilst fully and partly investor-owned firms supply nearly 60% of New Zealand electricity consumers, the consumer trust form prevails in more than half the ELBs.

Whilst this result may be surprising to those who predicted the rapid dominance of the investor-owned form, when analysed through the lens of Hansmann's theories of the ownership of enterprise, the result may be less controversial. When trading off the costs of market contracting and the costs of ownership of ELBs, the case for investor ownership is not necessarily clear-cut. Countervailing the market power of ELBs offers a strong rationale for consumer-owned firms as an alternative to costly explicit regulation of investor-owned monopolies, and the benefits of private ownership may not be as great for firms where there are lower costs of consumer ownership due to high levels of consumer homogeneity. Correspondingly, we find that consumer ownership is far more likely to have persisted in smaller ELBs serving rural constituencies, where consumer homogeneity is high and the corresponding costs of ownership are likely smaller. By contrast, investor ownership dominates in larger and urban ELBs, likely as a consequence of the higher costs of ownership associated with both higher customer numbers and greater heterogeneity of the customer base.

We contend therefore that these findings are not inconsistent with the evolution of ownership forms in response to the changing costs of ownership and market contracting in Hansmann's model. The plurality of models observed would appear to broadly reflect the different sets of incentives facing consumers in different ELB constituencies, and the different costs and options for regulating ELBs in the New Zealand context. As long as consumers have the option as beneficial owners to revisit the ownership form of trust-controlled ELBs, then it would appear feasible for the ownership form of all ELBs in New Zealand to continue to change in response to changes in the economic environment in which the ELB operates.

”

[KBP emphasis]



