Commerce Commission's Proposed Amendment to the WACC Percentile for Electricity Lines Services and Gas Pipeline Services dated 22 July 2014

Report to Major Electricity Users' Group for Submission on "Further Evidence"

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Code of Conduct for Expert Witnesses Declaration

I, Garth Ireland have read the Code of Conduct for Expert Witnesses as contained in Schedule 4 of the New Zealand High Court Rules, and agree to comply with it.

Signed:

Garth Ireland

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1 Instruction

1.1 The Major Electricity Users’ Group (MEUG) has asked Ireland, Wallace & Associates Limited (IWA) to review the “Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services” consultation documentation and submissions related to Regulatory Asset Base (RAB) multiples.[1]

1.2 This review is to cover the further information that may be relevant to the King Country Electric Power Trust’s (KCEPT) sale of shares in The Lines Company (TLC) to Waitomo Energy Services Consumer Trust (WESCT) in December 2013.[2]

1.3 The Commission referred to the submission of PricewaterhouseCoopers (PwC) on behalf of Vector.[3] Contrary to PwC’s assertion that the transaction value was confidential the Commission has identified a public disclosure of that value in the TLC 2014 annual report. My investigations have found additional relevant publicly available information that enables not only the context of the KCEPT sale to be clearly established but also for the calculation of an implied RAB multiple to be estimated.[4]

2 The Lines Company: Implied RAB multiples

2.1 PwC say that the shares in TLC were transacted “… at a substantial discount to RAB.” PwC provided no reason why the implied RAB multiple was at a substantial discount except that the sale process was competitive with a number of parties submitting bids.

2.2 My estimate of the implied RAB multiple in the sale of the 10% of TLC is in the range of **0.7** to **0.8**.

2.3 The dollar value of TLC’s RAB is discounted for good reason. TLC intentionally sets customer charges below the Commission’s allowable cost of capital and the Allowable Notional Revenue. This is the TLC strategic and long term objective.

2.4 The likelihood that implied RAB multiples are significant indicators of the relationship between the regulatory cost of capital (permitted cap on returns on

[1] “Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services”, 22 July 2014 and “Attachment A: Analysis of RAB multiples”.

[2] CC “Further work on cost of capital input methodologies: Invitation for submissions on further evidence”,19 September 2014

[3] PwC “Rationale for transaction premiums to RAB value”, 26 August 2014, p2. Also cited in PwC Submission on behalf of 20 Electricity Distribution Businesses, 29 August 2014, 74, p15.

[4] The transaction value was also disclosed in the KCEPT’s 2014 annual report, p4 financial statements, note 8 p13 and note 14 p15. http://www.kcpowertrust.co.nz/documents/annual-report-2014.pdf http://www.kcpowertrust.co.nz/documents/financial-audit-report-2014.pdf

RAB derived investment) and the true cost of capital for the regulated businesses is underscored by the fact that the only sale transaction offered in evidence in which there is a material RAB discount, is for an investment where there is express evidence that the business controllers are not motivated to price services so as to derive a return at permitted cost of capital levels.

2.5 For the sake of completeness I note that illiquidity, and a discount for a parcel that is clearly not a control parcel, would also affect the multiple. In my opinion they are material, but gain their effect primarily because of the disclosed intention of those exercising control of TCL, not to pursue extraction of the full permitted regulatory cost of capital.

KCEPT

2.6 Based on the information available on the KCEPT website the context for the transaction can be understood. An “Ownership Review” was conducted by PwC in November 2012. The report canvassed the performance of TLC, the advantages and disadvantages of trust ownership and share ownership options for TLC.[5]

2.7 It is apparent that the “… [with a 10% minority shareholding it] is unlikely the Trust will be able [to] influence major issues of strategy and governance.”[6] PwC observe that “… the Trust exerts limited influence over the affairs of TLC, especially considering the extent to which the Trustees have engaged with TLC’s directors and WESCT on this issue” [the controversial demand charging tariffs implemented by TLC in 2009]. The directors also had expressed concern that TLC’s non-network investments maybe destroying the Trust’s share value.[7]

2.8 As a result of the Ownership Review: “KCEPT have determined to investigate selling our TLC shares as we don’t have much influence.”[8]

TLC

2.9 KCEPT recognise that the TLC10% shareholding was in reality a minority interest similar to portfolio shareholding albeit without liquidity provided by a stock market. For a potential investor the TLC expected dividend stream becomes the main value metric. The TLC forecast dividend is an unchanged $5 million per annum for the next 3 years. The pay-out ratio is set at 80%.[9] [10]

2.10 The TLC Statement of Corporate Intent 2014-15 states the strategy and financial objectives of TLC for the next 3 years and for the long term. A potential investor in 10% of TLC must consider fundamental policies and issues such as:

[5] “King Country Electric Power Trust Ownership Review, November 2012” prepared by PwC. http://www.kcpowertrust.co.nz/report_agm.htm

[6] ditto 6.3 p45

[7] ditto 7.6 p49

[8] KCEPT minutes of AGM, 22 August 2013, p2.

[9] TLC Statement of Intent 2014-15, “Dividend Policy” p14 and “Performance Targets” 5.1 6. “Dividends” p16 http://www.thelinescompany.co.nz/media/2014_15-tlc-statement-of-corporate-intent.pdf

[10] Discounts for illiquidity and for non-control work together with the TLC objective not to maximise “profit”.

"The network business returns are below that allowed by legislation and as such the proposals included in this document advance bridging this gap. The generation business is also underperforming and research is underway to establish strategies to resolve this situation.[11]

The high level long term objective is:

To own and manage a network that provides the level of reliability, capacity, quality, service, and community involvement that customers want at a price they accept while generating returns for investors just below the maximum allowable regulated levels.[12]

To have a Notional Revenue to Allowable Notional Revenue ratio as set out in the Default Price Path Annual Compliance Statement of not less than 80%."[13]

2.11 Logically the combination of setting returns [cost of capital] below permitted by the Commission and a positive range guiding under recovery of Allowable Notional Revenue means that an implied RAB multiple must always be less than 1. Other things being equal the RAB discount in dollars should be the present value of the future expected opportunity cost of not charging permitted prices allowed by the Commission.

2.12 **Table 1** illustrates the reality of the TLC policies in the estimation of economic loss for the last three years based on TLC Disclosure Statements.

TLC Economic Performamce				**Table 1**
		actual 31 March		
		2012	**2013**	**2014**
ROI		3.7%	3.4%	4.7%
Cost of Capital 75th percentile		7.1%	6.6%	6.1%
Spread		-3.5%	-3.2%	-1.4%
	$m			
RAB	y/end	173	173	176
Economic Loss		**(6.0)**	**(5.5)**	**(2.5)**

[11] ditto p3.

[12] ditto p3

[13] ditto 8. p17

2.13 **Table 2** shows TLC’s annual experience in complying with the regulated maximum Allowable Notional Revenue and TLC policy.

Default Price Quality Path Compliance Statement				**Table 2**
	actual 31 March			
	$m	**2012**	**2013**	**2014**
Notional Revenue		26.7	27.8	29.0
Allowable Revenue		27.4	29.7	33.4
Under charge		(0.8)	(1.9)	(4.4)
Ratio	≤ 1.0	**0.97**	**0.93**	**0.87**
TLC policy	>0.8 to 1.0	0.80	0.80	0.80

2.14 A potential investor, not being a customer, would not benefit from TLC deliberate under-pricing of its network services. For TLC and its customers a lower profit is generally offset by lower prices. As a potential purchaser of TLC shares WESCT seems to be the natural buyer. In theory it should pay the potential investor’s price absent a customer investor interest.

2.15 Implied RAB multiples for TLC based on the sale of a 10% interest in TLC have been assessed at three points of time: March 2013, March 2014 and March 2015. The TLC net debt is taken from the SCI 2014-15 while the EV for non-network businesses has been based on notes to the financial statements. The RAB is taken from the Disclosure Statements and for 2015 adjusted for TLC new capex net of depreciation taken from the SCI. The 2014 financial statements disclosed a loan of $13.5 million to WESCT, the parent of TLC, to finance the purchase of the TLC shares. The loan was assumed to be repaid in 2015.

2.16 The implied RAB multiple referenced to information available as at 31 March 2013 is estimated at 0.7. The calculation is set out in:

Table 3: RAB 2013 and EV 2013

Minority Share Transaction						**Table 3**
The Lines Company						$m
Minority Interest 10%						13.5
Valuation and RAB multiple Summary						
Date:	RAB	31 March 2013				173.4
	EV	31 March 2013				
TLC EV						
Implied Market Value of Equity				100%		135.0
Net Debt		31 March 2013				42.5
TLC EV						177.5
Less						
Generation EV "value in use"					2013	(27.9)
Other Non-network Businesses EV=5.5 times EBITDA					2013	(25.3)
						(53.2)
Network EV						124.3
RAB						173.4
Implied RAB multiple						**0.7**
Implied Value deficit						(49.1)

Sources: “Net Debt”, TLC SCI para. 5.1 3. p16; “Generation EV”, notes to 2013 Financial Statements, 3 p40; and, “Other Non-network” EBITDA, Business unit analysis, p8-11. The EBITDA multiple of 5.5 is the same as adopted for Horizon Energy and OtagoNet JV. See IWA cross submission, 12 September 2014, para. 3.3.

2.17 The Implied Value deficit of $49.1 million, the difference between the RAB and Network EV, is indicative of the long term expected under-pricing by TLC relative that permitted by the Commission implicit in an RAB multiple of 0.7.

2.16 A plausible test of the non-network business EV is to decrease it by 25% (“value in use” may not reflect “fair market value” and the 5.5 EBITDA multiple and EBITDA may be uncertain) the implied RAB multiple increases to 0.8. The value deficit decreases to $35.8 million.

2.17 **Tables 4** and **5** in the appendix reflect adjusted RAB and EV for 2014 and 2015. Based on information available as at 31 March 2013, as in **Table 3,** with adjustments based on the TLC 2014 Annual Report and the current Statement of Corporate Intent financial performance and targets the estimated implied RAB multiples are estimated from 0.7 to 0.8.

3 Evaluation

3.1 The implied RAB multiple indicated by the sale of 10% of TLC is in the range of 0.7 to 0.8 following the Commission’s methodology.

3.2 The RAB multiple is below 1.0 as a direct result of the TLC policy to include a cost of capital rate (and allowing lower returns) below that calculated by the Commission. TLC also has set a Notional Revenue amount at below the Allowable Notional Revenue. The effect of these policies is shown in **Tables 1** and **2**.

3.3 By setting lower returns than allowed TLC could be suggesting that the Commission’s permitted cost of capital is too high. There is no evidence for this in recent SCIs.. Rather, being a customer owned business the customer beneficiaries would generally be indifferent to receiving lower “dividends” or the equivalent in lower prices.

3.4 Unless provided in a shareholders’ agreement, if any, the minority holding of 10% in the context of TLC has no governance leverage. The liquidity advantage provided by a potential NZX listing is absent. A minority discount for lack of liquidity may also be component of the RAB discount.

3.5 Based on my analysis of the context of the TLC share transaction the implied RAB range of **0.7** to **0.8** reflect the TLC policies of accepting lower returns than determined by the Commission.

Appendix

Table 4: RAB 2014 and adj. EV 2014

Minority Share Transaction						**Table 4**
The Lines Company						$m
Minority Interest 10%						13.5
Valuation and RAB multiple Summary						
Date:	RAB	31 March 2014				176.0
	EV	31 March 2014				
TLC EV						
Implied Market Value of Equity				100%		135.0
Net Debt		31 March 2014				39.2
TLC EV						174.2
Less						
Generation EV "value in use"					2014	(24.4)
Other Non-network Businesses EV=5.5 times EBITDA					2014	(29.4)
						(53.8)
Network EV						120.4
RAB						176.0
Implied RAB multiple						**0.7**
Implied Value deficit						(55.6)

Sources: "Net Debt"(includes "loan to related party" [WESCT?] of $13.5 million), TLC SCI para. 5.1 3. p16; "Generation EV", notes to 2014 Financial Statements, 3 p49; and, "Other Non-network" EBITDA, Business unit analysis, p13-15; capex SCI p15. The EBITDA multiple of 5.5 is the same as adopted for Horizon Energy and OtagoNet JV. See IWA cross submission, 12 September 2014, para. 3.3.

Table 5: adj. RAB 2015 and adj. EV 2015

Minority Share Transaction						**Table 5**
The Lines Company						$m
Minority Interest 10%						13.5
Valuation and RAB multiple Summary						
Date:	RAB	31 March 2015		new capex	6.0	182.0
	EV	31 March 2015				
TLC EV						
Implied Market Value of Equity				100%		135.0
Net Debt		31 March 2015				55.6
TLC EV						190.6
Less						
Generation EV "value in use"					2014	(24.4)
Other Non-network Businesses EV=5.5 times EBITDA					2014	(29.4)
						(53.8)
Network EV						136.8
RAB						182.0
Implied RAB multiple						**0.8**
Implied Value deficit						(45.2)

Sources: "Net Debt", TLC SCI para. 5.1 3. p16; "Generation EV", Notes to 2014 Financial Statements, 3 p49; and, "Other Non-network" EBITDA, Business unit analysis, p13-15, capex SCI p15. The EBITDA multiple of 5.5 is the same as adopted for Horizon Energy and OtagoNet JV analysis. See IWA cross submission, 12 September 2014, para. 3.3.