South Canterbury Chamber of Commerce submission on the Proposal for Timaru District Holdings Ltd to sell its 47.5% interest in Alpine Energy Limited.

The South Canterbury Chamber of Commerce does NOT support the Council's preferred option for TDHL to sell their shares in Alpine Energy based on the information presented.

The Chamber sought feedback on this issue via our member businesses and encouraged members to also make submissions directly to the Timaru District Council.

The majority of the SCCC members who responded to the survey were opposed to the sale. 80% opposed the sale, while 20% supported.

Introduction:

The SCCC (South Canterbury Chamber of Commerce) appreciated Mayor Damon's briefing of the SCCC Board and the opportunity created to meet with Chamber members and business representatives on the proposed sale of Alpine Energy shares.

The sale of Alpine shares is a major decision and requires:

A longer consultation period:

The timeframe for consultation is short and scheduled at a difficult time for businesses leading into the Christmas holiday period. It is noted that Council are also planning to make a decision within a day of the hearing leaving limited if any time to assess and access additional information. This timeframe for consultation and decision making is at odds with a lack of any reference to urgency or potential deadlines in the information released by council.

The tight timeframe also places unreasonable expectations on other shareholders who have preemptive rights making it difficult for them to be able to take appropriate action.

Additional information to be provided:

The information provided lacks sufficient detail on the proposed investments to enable an appropriate level of analysis to take place.

And a number of the assumptions reviewed and clarified:

As is set out within this submission, we seek a review of the dividends and equity gains.

We believe that a decision of this level of significance should not be rushed and it is respectfully suggested that a decision of this significance should be delayed by at least 3 months.

Further Comments

The feedback received from SCCC members was significant. The key themes received by members and the board have been summarised below:

1. Lack of clarity and detail on how the released investment funds will be used?

A better explanation of how the funds will be used is a common theme (including more explicit details of the investment charter to be adopted etc. potential changes to the governance of

TDHL, and specifics of potential investments.) The examples currently provided have been property at the port, managed funds and reduction of debt.

Diversification has been identified as a key driver for the need to sell the TDHL's holding in Alpine Energy. Purchasing additional property at the port does not achieve diversification as TDHL already owns port property. TDHL currently has 22% of its portfolio in property and 15% in Primeport Timaru Limited. On the limited information released to date it appears rather than further diversification, the shareholding in the Port and related property will be increased.

We understand that the rate of returns currently achieved and referred to in the consultation document represent a higher return than the current interest rate paid on borrowings by TDC. Therefore applying a portion of the proceeds of sale to reduce TDC debt appears counter intuitive. We further note that TDC's debt levels are within normal operating levels and there is no urgent need to reduce debt levels. Against this background, there would appear no justification for applying the sale proceeds to TDC's debt reduction.

2. A better comparative analysis of the value proposition in retaining Alpine is requested.

The return from the shareholding in Alpine Energy being commonly referred to in the consultation document is the after-tax cash dividend. It would be more appropriate to look at the gross dividend plus share value appreciation over the last 5 years and compare this with the proposed investments.

It is commonly understood that Alpine has gone through a period of strategic re-investment leading to a corresponding reduction in dividend over recent years. As such longer-term analysis is required. This analysis should also include the equity gain or share value appreciation as well as the dividend stream and the potential future equity gain.

It would appear that the comparative investments identified within the consultation document have not been assessed on a solely dividend basis. This failure to consistently evaluate investment alternatives creates the potential for confusion when considering alternatives and for the comparative returns of investments other than in Alpine Energy to be overstated.

It would appear that over recent years TDHL has received an average return on investment from its Alpine Energy shareholding well in excess of 10% before tax. A cash dividend of $4.7m (equivalent to $6.5m before tax at a 28% tax rate) on an investment value of $110m equates to a before tax return of 5.9%. Further the capital gain over the previous 5 years (from $82.7m to $110m) is an average of 6.6% per annum

Clarification is also sought on the valuation methodology applied in determining the value of TDHL's shareholding in Alpine Energy. We note Deloitte assessed the fair value of TDHL's holding as reported $181m and $186.7m in the 2016 and 2017 Annual Reports. It is unclear from documents provided to date why an alternative valuer (Ernst Young) have then been used and why the valuation has decreased significantly to between $87.6m and $97.9m.

3. Council's Role

One of TDC's six community outcomes that the Council identified within the recent Long-Term Plan process) is: "High Quality infrastructure to meet community and business needs. **Providing high quality infrastructure is a core role of the Council, and is essential to strong, connected communities and sustainable economic prosperity"**

This clear community outcome is at odds with the approach to consider the value proposition of the shareholding in Alpine Energy primarily on a dividend basis. The shareholding in Alpine Energy is more significant and allows TDC/TDHL to assist in enabling economic growth and development throughout Timaru District and South Canterbury.

TDC has clearly identified its role is to provide and facilitate infrastructure for our community. This same focus would not be maximised under the commercial ownership of Alpine Energy.

4. **Governance:**

Throughout the consultation process, it has been stated that TDHL/TDC does not have the necessary expertise required for the large investment within a lines company. It is concerning that given the long-standing investment in Alpine Energy, that TDHL has not taken steps to address this lack of expertise prior.

We believe that a more suitable alternative to selling the shareholding in Alpine Energy due to a lack of governance expertise would be to nominate directors for the board of Alpine Energy with the necessary expertise. This director could then take a more active role in Alpine Energy and explore ways to improve the dividend.

We also note that expertise of a particular industry is not a necessary pre-requisite for strong and effective governance.

If it is accepted that TDHL does not have the expertise to manage the Alpine Energy investment, it is unclear whether they have the necessary expertise to manage a significant investment across a number of potentially higher risk investments.

A revised constitution for TDHL should have formed part of this consultation and the proposal put forward by TDC. The current constitution may not be correctly structured for an investment company and may not allow for best practice governance.

It is also noteworthy that of the $4.7m after tax cash dividend TDHL only returns $2.65m to TDC, another clear option would be to return the full dividend.

5. **Community Interests protected**

SCCC does not accept the assumption that because Alpine Energy operates in a regulated market that the community interests will be protected. Aurora Energy in Otago is the most recent example of a lines company under-investing in asset maintenance and renewal, which led to significant proportions of its assets – such as poles, cables and transformers – being in a deteriorated condition and at or near the end of their service lives.[i]

We are seriously concerned that a potential purchaser of the Alpine Energy shares may not have the same considered approach to re-investment in the network, that is currently being illustrated by Alpine Energy.

The Local Government Act states that local government/council's role is to meet the current and future needs of communities for good quality local infrastructure in a way that is cost effective – managed well this is exactly what the current shareholding in Alpine Energy ought to achieve.

6. **Risk mitigation**.

It is not accepted that a complete sale of the shareholding in Alpine Energy is the only means to establish a balanced portfolio for TDHL. A partial sale of its shareholding would allow TDHL to retain an investment which is insulated (to an extent) from a range of global economic influences.

As set out above, potential investment of the proceeds of sale in land at the port does not represent diversification or risk mitigation. Rather this shifts the reliance on Alpine Energy to a reliance on the port and associated activities.

7. **Why was this proposal not part of the LTP process?**

It is unclear as to why this proposal did not form part of the Long Term Plan process. It is clear a significant amount of work has been done in considering and preparing this proposal and it is unclear why this could not have been included within the Long Term Plan.

8. **Ownership**

TDHL and TDC clearly have the legal right to sell the shares however many believe that TDC are custodians of these shares on behalf of this community. It is understood the shares were gifted to TDC.

9. **Alpine contributes to our community in many ways**

Alpine has a significant sponsorship and community contribution arm. This contributes significantly to the provision of local amenities and services for our community. This does not appear to have been considered in evaluating the shareholding in Alpine Energy. It is by no means clear that such sponsorship and community contribution will continue following any sale of shares.

The consultation document presents only two scenarios and the SCCC believes that should the sale proceed different scenarios should be developed including:

Retention of a percentage of Alpine shares to enable TDHL to achieve the stated objective of a diversified portfolio

A sale scenario that includes a majority ownership retained by the Lines Trust - This scenario should facilitate the Lines Trust owning a minimum of 51% of Alpine Energy's shares to ensure local control and ownership. This scenario should enable the purchase of shares at a fair value and a timeframe which means this is achievable for the Lines Trust.

A sale scenario whereby TDHL partners with another shareholder to ensure that they receive the benefit of any "majority leverage" on the sale of the shareholding in Alpine Energy. The current proposal allows for this leverage to potentially be received by other minority shareholders rather than TDHL.

Comments that were submitted in support of the sale:

While the majority of feedback received was against TDC's preferred option, comments in support of the proposal were also received. This positive feedback included the following comments:

Invest the money in tourism and bringing young people back to the district.

The sentiment/ interest is well placed.

Support – reduce debt, invest in new infrastructure. Alpine has not spent sufficient on upgrading old cables and lines. Alpine have increased costs at a higher rate than inflation.

Accept the proposal but more information needed on proposed investments.

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[i] Press Release: Commerce Commission 17 September 2018

The Commerce Commission has decided to file court proceedings against Dunedin-based electricity lines company Aurora Energy for breaching its regulated quality standards in 2016 and 2017. The Commission will be asking the High Court to impose financial penalties on Aurora under the Commerce Act.
Aurora is subject to price-quality path regulation that sets limits on the total revenue it can earn as well as the level of outages or interruptions (known as quality or reliability standards) that can occur on its network each year.

As part of its regulatory reporting obligations, Aurora disclosed to the Commission it breached its quality standards for both 2016 and 2017. The Commission has now completed an investigation of the reasons for the breaches and concluded they resulted from Aurora failing to comply with good industry practice.

Specifically, the Commission alleges Aurora under-invested in asset maintenance and renewal, which led to significant proportions of its assets – such as poles, cables and transformers – being in a deteriorated condition and at or near the end of their service lives. The Commission considers that this led to an increased level of power outages and therefore significantly contributed to Aurora's breaches of the quality standards.

Separate to this investigation, Aurora has agreed to engage independent experts to undertake a full assessment of the state of its network. As part of the obligations applying to all electricity distribution businesses, Aurora is also required to provide a detailed asset management plan this *year on how it will refurbish or replace priority assets moving forward. Both the state of the network report and asset management plan are expected to be completed by the end of October.*

The Commission considers that the quality and robustness of both documents will be critically important to all Aurora stakeholders. They should provide a reliable baseline view on Aurora's current network condition and set out its plans to get its network reliability back to appropriate levels.

Aurora has also reported it breached its 2018 quality standards, which will be subject to a further investigation.

As Aurora's quality standard breaches will be before the Courts, the Commission cannot comment further at this time.

Background

Aurora Energy supplies electricity to more than 88,000 homes, farms and businesses in Dunedin, Central Otago and Queenstown Lakes. It is a wholly-owned subsidiary of Dunedin City Holdings Limited, owned by the Dunedin City Council.

Aurora previously breached its quality standards in 2012 and was issued with a warning.

The maximum penalty for a business that breaches its quality standards under the Commerce Act is $5 million.