PROCEEDS FROM ORION SALE OF NORTH ISLAND GAS NETWORK ASSETS

Introduction

In April 2000, Orion New Zealand Limited, the electricity network company owned 87.6% by the Council, sold its North Island gas network and related assets. The gross proceeds of the sale were $550 million and the net gain on sale was some $187 million.

At the time of the sale, the Council stated that it would consider options for the deployment of surplus funds arising from this sale, arrive at a recommended course of action and submit a proposal for public consultation.

The purpose of this section of the Draft Financial Plan is therefore to invite comments from the public on the Council's proposed course of action with regard to the surplus funds arising from the gas asset sale.

Summary of Proposal

The essence of the Council's proposal is that it accepts Orion's recommendation that it return $200 million of capital to its shareholders. The Council's share of this sum would be some $175 million. Of this, the Council recommends that $75 million is invested in a protected long-term fund for the benefit of current and future generations, with the balance of $100 million applied to debt reduction.

Had the Council not received the Orion monies the rates would have increased by 3.91% in 2001/02 and 5.14% in 2002/03. The percentage increases with the proposed application of the Orion proceeds in place is 2.39% and 2.92% respectively. This reflects only the benefit of the amount proposed to be applied for debt reduction as the proposal reserves the balance of the income for specific purposes outlined in more detail below.

The application of the income from the long term fund will be subject to annual consultation as part of the Financial Plan process.

The background to and rationale for this recommendation is explained further below.

Background to Sale

Between December 1993 and December 1994, Southpower Limited (now Orion New Zealand Limited) acquired a controlling 69% shareholding in Enerco New Zealand Limited – a listed public company. Enerco owned gas networks in Auckland, Wellington, Hawkes Bay, Horowhenua and the Manawatu, and had a 44% share of the retail gas market.

The principal reason for the acquisition of Enerco was to strengthen Southpower's strategic position. The investment provided diversity in respect of climate and economic conditions – the two key drivers of energy demand. Additionally, the Southpower board recognised the potential benefits from synergies between the two companies, the considerable scope for sales expansion and the increasing trend for larger energy companies to operate on a national basis.

Between 1993 and 1999, Enerco grew significantly, and a large capital gain was made on the sale of Enerco's retail activities to Contact Energy in the 1998/99 financial year. In February 1999, Orion (as Southpower had then become) acquired the remaining 31% of Enerco shares not already owned.

In 1998, the Government enacted the Electricity Industry Reform Act, a significant piece of legislation that restructured the electricity industry. In particular, the Act required the separation of line-owning businesses from retail and generation businesses. As is well known, Orion chose to divest its retail operations and retain its core business of network management. Following this forced split, the original rationale for acquiring Enerco, which had been intended as a long-term investment, had largely been superseded.

These upheavals in the energy industry resulted in significant premiums being paid for strategic investments.

Orion commissioned independent advice on the value of its gas assets and, after consultation with its shareholders, decided to sell the gas networks and industrial gas division through a competitive sales process. The resulting sale price of some $550 million and net gain on sale of $187 million, exceeded expectations. The sale, to United Networks, was settled on 1 April 2000. Since then, Orion and the Council (the latter primarily through its investment company Christchurch City Holdings Limited ('CCHL')) have spent considerable time investigating options for the surplus funds arising from the sale.

Determining amount to be returned to Council by Orion

There were a number of issues and constraints to take into account in assessing the appropriate amount of capital to be returned by Orion to its shareholders. These included taxation limitations on the amount of capital that can be returned, Orion's future business strategy, appropriate levels of debt and alternative investment opportunities.

Effectively, the proposal to return $200 million to Orion's shareholders (which is subject to receiving favourable rulings from the Inland Revenue Department) involves Orion repaying an amount of capital broadly equivalent to the capital gain realised from the sale of the networks and related assets. The proposal leaves Orion with sufficient financial flexibility to pursue further investments in the energy, infrastructure and technology sectors, subject to consultation with its shareholders.

It would not have been appropriate (nor indeed possible from a tax perspective) to recommend that Orion return the entire $550 million gross proceeds from the gas sale to its shareholders. A substantial portion of the Enerco investment was debt-funded, and Orion would be left with an excessive amount of debt in relation to its remaining assets if the full proceeds were returned.

Use of the Funds by the Council

The Council's proposal is that:

(a) $75M should be invested in a separate fund, to be known as the Capital Endowment Fund, ring-fenced as far as possible from the Council's other funds in order to protect the capital and provide an ongoing income stream to be used for economic, business and civic development projects for the benefit of the city and the region in perpetuity; and

(b) the balance of $100M should be applied to the debt repayment reserve to reduce future debt levels and interest costs.

The Council initially proposed that $100M should be for the Capital Endowment Fund and $75M be for Debt Repayment Reserve. It has reversed these amounts as it now considers that this will be more effective in reducing the level of rates in future years.