11. DISPOSITION OF PROCEEDS FROM SALE OF ORION GAS ASSETS

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Corporate Plan Output: Trading Activities - Monitoring	

The purpose of this report is to make a recommendation to the Council in respect of the disposition of the proceeds realised by its major trading subsidiary, Orion New Zealand Limited, on the sale of its North Island gas network and related operations.

Attached is a possible form of public consultation for inclusion in the Council's draft Financial Plan. Its content will need to be updated to reflect the impact on rates, once the Council has decided upon its approach to this issue.

BACKGROUND TO THE ENERCO INVESTMENT

In December 1993, Southpower Limited (now Orion New Zealand Limited) acquired a controlling 55% 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. In December 1994, Southpower increased its shareholding to 69%. The average purchase price for the 69% shareholding was $3.06 per share.

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, with gas customer numbers increasing by more than 80% and total gas sales increasing 24%. Significant value gains were also achieved from an amalgamation of the management of the gas network with the electricity network.

In the 1998/99 financial year, the decision was made to sell Enerco's domestic and small commercial retailing operations, while retaining the gas networks and larger industrial customers. The sale, to Contact Energy, achieved significant "first mover" advantage in a rapidly evolving energy market, realising gross proceeds of $100 million.

In October 1998, Orion (as Southpower had then become) commenced a takeover bid for the remaining 31% of Enerco shares not already owned. The value of the shares was independently assessed at $5.70 per share, and full ownership was achieved by February 1999. The average cost per share for the whole business was $3.90.

Also 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 thus 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 (equivalent to a value of about $7 per share), and net gain on sale of $187 million, exceeded expectations. The sale, to UnitedNetworks, was settled on 1 April 2000.

Following the sale, Orion was left with no debt and cash reserves of some $200 million. It has since performed a thorough review of its strategic position and direction, and formulated a proposal to its shareholders (refer to section entitled "Return of Capital by Orion"), including a recommendation that $200 million be returned to its shareholders.

THE ROLE OF CHRISTCHURCH CITY HOLDINGS LTD

Christchurch City Holdings Limited ('CCHL'), as the monitoring agent for the Council's trading investments, has been requested to "advise the Council on:

- the funds to be applied to reduce Orion debt;
- funds to be reinvested to maintain an income stream to the Council;
- options for reinvestment of the funds; and
- funds which might be available for other purposes and investments"

Over recent months, CCHL has reviewed a number of alternative scenarios for the use of the funds with Orion, assessed key financial, legal and taxation considerations and commissioned independent economic advice.

RECOMMENDED COURSE OF ACTION

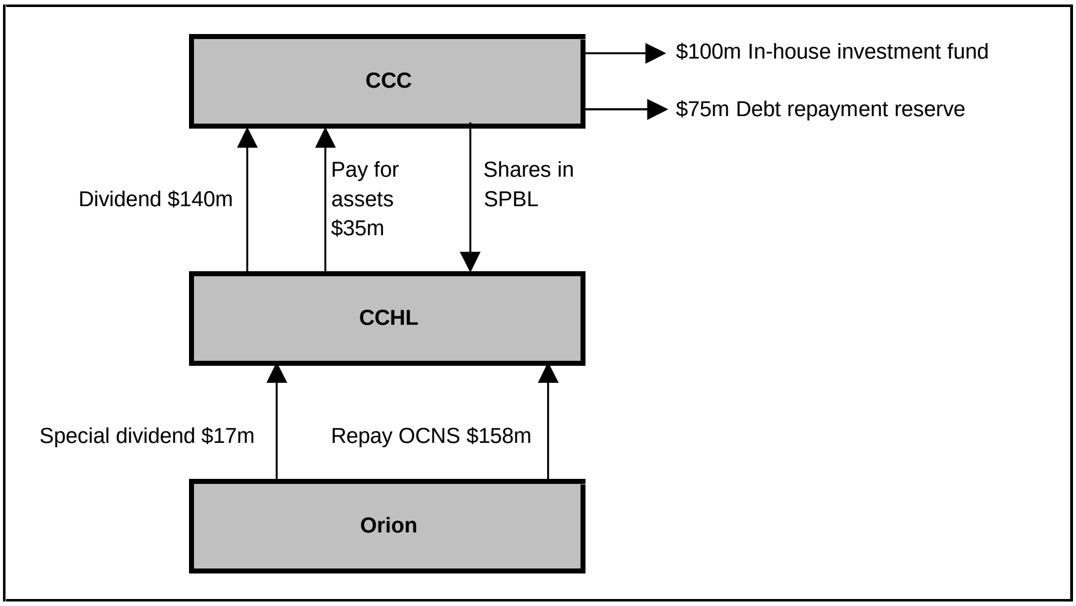
CCHL's recommendation with regard to the use of funds is summarised as follows:

- Orion's proposal to return $200 million of funds to all shareholders through the repayment of $180 million of optional convertible notes and a special fully-imputed dividend of $20 million should be accepted. This would place Orion in a financial position similar to that which existed in 1993 prior to the Enerco acquisition.

- CCHL's share of the above funds would be some $175 million. It is proposed that this be returned to the Council through the payment of a special fully-imputed dividend of $140 million, with the balance being transferred through the purchase by CCHL of selected trading assets from the Council (possibly the Council's shares in Selwyn Plantation Board Limited).

- While it is for the Council to decide on what should be done with the $175 million, CCHL's initial recommendation, in consultation with the Director of Finance, is that $75 million of this sum should be applied to debt repayment, with the balance being invested in a long term fund for the benefit of current and future generations. The income from the investment fund could be applied, for economic and business development.

This flow of funds can be summarised diagrammatically as follows:



The reasoning behind these recommendations, the financial implications thereof, and further explanatory comment, is set out later in this report.

The net financial impact of the above proposal is expected to be an increase in the Council's income over its current budgeted levels of some $7 to $8 million per annum from the 2002/03 year onwards, mainly comprising investment returns from the newly-established fund and reduced interest costs on Council borrowing, offset by lower dividends from CCHL.

RETURN OF CAPITAL BY ORION

Orion Debt Level

Following the Enerco sale, Orion has undertaken a thorough strategic review of its business and capital structure. Arising from this, it has proposed that it returns $200 million to its shareholders, and set out a future investment strategy. The capital return would utilise all of Orion's current surplus cash arising from the sale, but would still leave it with virtually no debt (note – this return of capital is subject to receiving favourable rulings from the Inland Revenue Department).

The source of the surplus capital is derived from the sale of the gas networks and industrial gas division. While the gross proceeds of the sale were $550 million, it should be borne in mind that a significant portion of the Enerco investment was debt-funded. It would therefore not be financially prudent for Orion to return the entire $550 million to its shareholders, as this would leave the company with excessive debt levels in relation to its remaining asset base. In broad terms, the repayment of $200 million could be viewed as Orion effectively repaying the net capital gain on the sale to its shareholders rather than the gross proceeds.

There are alternative arguments for Orion returning a greater amount than $200 million to its shareholders, and increasing Orion's debt levels correspondingly. It would result in a more efficient capital structure and impose capital restraints on subsidiary management. However, CCHL concurs with Orion's recommendation that it be left with a significant amount of financial flexibility. The reasons for this are set out in the section below entitled "Orion's future direction".

Additionally, there are significant tax constraints on the amounts that can be returned tax-free, both from Orion to CCHL (and the other minority shareholders), and from CCHL to the Council.

Orion's Future Direction

Following the sale, Orion has undertaken a thorough review of its strategic direction and capabilities, in consultation with the shareholders.

Orion has concluded (and CCHL concurs with this) that its strengths are in the areas of energy, infrastructure and related technologies. In particular, Orion has demonstrated its ability as an "engaged investor" i.e. where it actively manages the investment to add value. (For example, the proposed $200 million payment will bring the total contributions to shareholders over the last seven years to $600 million).

Over recent years there has been significant change in the energy and technology sectors. This change creates opportunities, and CCHL believes that the current Orion management has the necessary skills to create additional value for its shareholders.

The following is an extract from Orion's proposal to its shareholders in relation to its proposed investment strategy:

"To create value for shareholders, Orion pursues a "value" approach. The company's priorities are to protect the investment in the electricity network, and create shareholder value through energy and technology investments.

For Orion to deliver value to shareholders, it must have considered exit strategies or value points before engaging in the investment. Energy and infrastructure investments require management and/or governance involvement and cash income stream from the time of investment would be expected. However, opportunities for such investments only present themselves from time to time and it is important to take a patient approach to investing with the ability to move quickly when necessary.

On a one-for-one basis, compared with infrastructure investments, technology investments typically require less capital involvement. Technology investments by Orion are likely to be smaller in size but larger in number than Orion's infrastructure investments.

Technology investments are usually higher risk and unlikely to provide an immediate income stream. However, a greater percentage increase in value over the term of the investment typically compensates for this greater risk. A portfolio approach to technology investments further mitigates risks.

Orion targets its technology investment at the expansion phase of the business life cycle. However, Orion supports new innovation and start-up technology businesses through its involvement with the Canterbury Innovation Incubator."

CCHL is broadly supportive of Orion's proposal. It is therefore proposed that Orion is left with sufficient financial flexibility to enter into engaged investments in the energy, infrastructure and related sectors. Any significant investments will, of course, be subject to full consultation with the shareholders, and detailed guidelines for consultation and reporting have been established.

RETURN OF CAPITAL FROM CCHL TO THE COUNCIL

CCHL's share of Orion's $180 million repayment of optional convertible notes and special $20 million dividend will be some $175 million.

CCHL has considered potential uses of this sum. Options investigated included making new investments consistent with CCHL's mission and objectives, repaying debt, establishing a separate balanced portfolio solely for capital protection and income-producing purposes, acquiring minority shares in CCHL subsidiary companies, vesting an independent trust (along the lines of the Community Trust model), or any combination of the above.

After consideration of the various options, it was concluded that none presented a compelling case at this time. CCHL has therefore concluded that the capital should be returned to the Council. It is considered that CCHL still has adequate financial flexibility to make reasonable-sized investments that are consistent with CCHL's mission and objectives if the need arises in the future.

Taxation constraints

There are limits on the amount of capital that can be returned by CCHL to the Council in a tax-free manner. CCHL utilised all of its available subscribed capital in completing the $162 million capital repatriation in the 1999/00 financial year. Therefore further capital returns will have to be made primarily by way of fully-imputed special dividends. CCHL has accumulated substantial imputation credits over recent years, sufficient for it to pay a fully-imputed dividend of some $140 million.

This would leave a balance of $35 million ($175 million less $140 million) to be returned in other ways. It is considered that this could best be achieved through the purchase by CCHL of selected trading assets from the Council. Selwyn Plantation Board Limited is considered to be the most likely candidate, given its current estimated value and the fact that it is a profitable commercial company. An independent valuation of the Council's shares in this company would be required, since any intra-group purchase and sale of assets will need to be at market value to avoid adverse tax consequences. For the purposes of this exercise, however, it has been assumed that its market value would be in the order of $35 million. To the extent that it is less, further assets will need to be acquired or the immediate amount returned to the Council will be less than $175 million.

USE OF THE FUNDS BY THE COUNCIL

Naturally, it is for the Council to decide on how any capital returned will be applied. However, CCHL has been requested to provide some preliminary advice on this matter. The Director of Finance has been able to contribute through his joint role as company secretary of CCHL.

Potential options considered for use of the funds include repaying debt (or at least setting aside sums in a debt repayment reserve to reduce future debt), setting aside the funds in a separate fund to protect the capital and provide a future income stream, establishing an independent "Community Trust-type" fund, making a capital payment to ratepayers, reducing rates, increasing capital expenditure or making strategic investments, increasing operating expenditure, or any combination of these.

Provisional Recommendation

CCHL's provisional recommendation is that:

a) $100 million should be invested in a separate fund, ring-fenced as far as possible from the Council's normal funds, in order to protect the capital and provide an ongoing income stream; and

b) The balance of $75 million should be applied to the debt repayment reserve to reduce future debt levels

As previously noted, this proposal is expected to increase the Council's annual income on average by some $7 to $8 million per annum over the levels currently budgeted, from the 2002/03 year onwards. In broad terms, some $5 million of this can be attributed to the investment fund (after provision for reinvesting an amount equivalent to the annual rate of inflation into the investment fund, management fees etc.), and a similar amount to interest savings from the debt repayment reserve. This total is partially offset by a lower dividend from CCHL, and the fact that the Council will no longer receive dividends directly from Selwyn Plantation Board Limited.

Investment Fund

The prime reason for part a) of the recommendation is to preserve a substantial portion of the capital for future generations. It is envisaged that a separate fund, with its own governance procedures, be established, to invest in a balanced portfolio of securities. The fund would be professionally managed, on a similar basis to the Community Trust. A portion of the annual returns would be re-invested to protect the fund against inflation. The balance of the returns would flow to the Council as part of its annual income. While it is for the Council to decide how this income should be utilised, CCHL's recommendation is that it be applied for economic and business development.

As the prime purposes of the fund are seen as capital protection and income generation, it would not necessarily be appropriate for the fund to invest in local initiatives unless they met the fund's investment criteria. It is envisaged that the capital will be invested in solid "blue chip" securities as part of a balanced portfolio. The substantial annual income generated from the fund could, however, be applied to local initiatives.

While the fund would be separate from the Council's normal operations, the Council would have full ownership and legal control of the fund. It is recognised that the current Council cannot legally bind future councils, and hence there is a risk that the fund could be "raided" in later years if the council of the day was so inclined (it was for this reason that the creation of a separate trust was considered – see "Other options considered" below).

CCHL believes that it is important to set in place protocols to protect, as far as possible, the capital of the fund in perpetuity. This can be done by making a clear "contract" with ratepayers, so that there will be sufficient public scrutiny and moral pressure to make it very difficult for a future Council to "dip into" the capital of the fund without very good reason. The suggested elements of this protocol are:

a) The Council passing a resolution to the effect that the capital for the fund will not be used unless 90% of the Councillors vote in favour. This should prevent the use of the capital as an easy funding solution for ordinary projects, but still make them available in the case of real need (eg. a major civil emergency or a large investment over which there is general agreement). However, it must be recognised that the 90% requirement cannot legally bind future councils.

b) A statement in the Council's Funding Policy outlining the structure and purpose of the fund, the intention to protect the capital and the process of applying the income to projects for the benefit of the community. The Local Government Act requires that a summary of the Funding Policy be published each year in the Financial Plan and that any significant variation from the Funding Policy be reported in the Financial Plan.

c) The Council establishing a practice of reporting on the capital of the fund in its Financial Plan and Annual Report as a separate activity.

While these protocols cannot legally bind future councils, points b) and c) in particular are designed to establish a transparent accountability regime that makes it clear if there is any variation from the original intentions of the fund.

Governance procedures in respect of the fund have not been considered in detail at this stage. However, a possible scenario would be for a committee (perhaps comprising a mix of Council, CCHL and external appointees) to oversee the management of the fund. Alternatively, CCHL could monitor the management of the fund on behalf of the Council, with perhaps a smaller Board committee performing a more detailed oversight role. In either case, it is recommended that appropriately qualified and experienced professionals be used to assist with an investment strategy and to manage the fund on a daily basis.

Use Of Income From Investment Fund

As previously stated, it is recommended that provision is made for reinvesting an amount equivalent to the annual rate of inflation into the investment fund. After allowing for this, the question arises as to how the balance of the income should be utilised.

One option would be simply to include the income with all of the Council's other sources of income, and make no distinction as to the source.

Alternatively, the income from the fund could be earmarked as a source for unspecified economic and business development projects, with the detailed expenditure decided upon during the Financial Plan process. While it would be preferable not to commit the income too far in advance, this could be done where an initiative needed to span several years.

Another option would be for all or part of the income to be kept out of the normal budget process and utilised as required during the year.

CCHL's view is that the second of the three options has the greatest merit. The first option would run the risk of the additional income being swallowed up by normal operating expenditure without any visible benefit, whereas the third option would run the risk of loss of accountability, with expenditure not being subject to the thorough priority setting practices of the Financial Plan process.

It is noted that returns from the investment fund will vary from year to year, and hence there will need to be an element of conservatism in the budgeting process to ensure that there are sufficient funds to meet the planned expenditure. If this approach is not followed, the Council runs the risk of unavoidable increases in rate levels in years where income from the fund does not reach its budgeted target.

Debt Repayment Reserve

The second part of the recommendation is that the balance of the capital repatriation (some $75 million) is invested in the Council's debt repayment reserve. This will significantly reduce the Council's future debt burden.

The impact of reducing debt will also be to reduce future interest costs, which will give the Council additional flexibility in its budgeting process. This interest saving is expected to be up to $5 million per annum, although it will be partially offset by reduced dividends from CCHL.

OTHER OPTIONS CONSIDERED

Establishing an independent "Community Trust-type" fund

Detailed consideration was given to vesting an independent charitable trust with a substantial portion of the proceeds. This trust would invest in a balanced portfolio of investments under professional fund management. The primary rationale for considering this option was the ability to protect the capital for future generations, and to provide an ongoing income stream for community projects.

On further examination, however, a number of issues arose which made this option less attractive. In order to achieve charitable status for tax purposes, the trust would need to be largely independent of the Council. It would have to consider applications for funding from all parties, not just the Council. This would make the Council's long term forecasting very difficult, as it could not automatically rely on funds being available when required. It could potentially weaken the governance of the City if its activities were not co-ordinated with, or indeed opposed to, the Council's policies, and would add yet another public funding body to the local scene. It would also weaken the financial position of the Council, since it would involve the transfer of a large sum of capital outside the Council's financial reporting group. There would also be additional complexity and cost to address legal and taxation issues.

For these reasons, CCHL decided not to recommend this option to the Council.

Making a Capital Payment to Ratepayers

There has been recent publicity regarding capital repayments to consumers made by some electricity trusts, and hence this is a topical issue.

On a political or philosophical basis, there will always be a divide between those who believe that individual ratepayers should be able to decide how best to spend money that they perceive to be their's, and those who believe that greater public benefit can be obtained by combining the resources of individuals to enhance the City as a whole. This has been a long-standing debate, and it will not be resolved here.

CCHL has attempted, using advice from leading economists, to assess the economic impact of a capital repayment to ratepayers versus retention of the money by the Council for use on projects with community-wide economic benefit. The results are not conclusive. There have been few studies of this area, and the results are mixed from the studies that have been performed. On balance the evidence suggests that a capital repayment leads to a short term boost in spending, but also a reduction in household debt. Studies of recent demutualisations in Australia and the UK indicate that a significant proportion of windfall gains are spent on holidays, home improvements and consumer durables rather than saved. Other sources available to CCHL have tended to confirm the latter finding – increased spending on consumer durables, but little long-term benefit to the local economy as a whole.

On balance, CCHL has concluded that there would be greater public good from retaining the capital in a separate investment fund to provide a continuing benefit to the City, and using at least part of the resulting annual income on initiatives that strengthen the local economy. CCHL views the availability of this capital as a unique opportunity to further enhance the long- term wealth of the City for the benefit of current and future generations.

Quite distinct from the philosophical or economic viewpoint discussed above, there would be some very significant legal, equitable and practical issues to be addressed before a return of capital to ratepayers could be contemplated.

Legal capacity to return capital
From a legal perspective, local government legislation is restrictive as to what councils can do. The legislation is expressed in terms of what councils are legally permitted to do, with the corollary that any action outside the specified activities is illegal. CCHL has received advice from the Council's Legal Services Manager to the effect that a capital repayment to ratepayers is not specifically permitted by the Local Government Act and hence would be illegal.

Distinction between councils and electricity trusts
Additionally, the Council's situation must be distinguished from those of local electricity trusts. The Energy Companies Act 1992 established energy companies out of two previous structures, with the resulting ownership of the newly-corporatised bodies depending on their former structure.

The first of these structures – Municipal Electricity Departments ('MEDs') – evolved from departments of urban councils. Generally when the MEDs were corporatised under the 1992 Act, the shares were vested in the local authorities that had owned them.

The other types of structure were the power boards, which had no obvious owners as they were established by Act of Parliament in the 1930s to reticulate rural areas. When the 1992 Act required the power boards to be corporatised, ownership of the shares had to be vested in someone. Typically, it was vested in a local trust to represent the local consumers.

Any capital repayment by an energy company will be made to its owner – the local council in the case of the urban electricity companies and the trust in the case of the rural companies. Often the trust will in turn return the capital to the consumers, since it has no alternative use for the money. Councils, on the other hand, have a multitude of uses for the capital, and it is quite proper that they use the funds for council purposes, given that the MEDs were established and developed using council funds.

Allocation of capital repayments – inter-generational and other equity issues
If, for the sake of argument, it was legally possible for the Council to return capital to the ratepayers, there would be significant issues regarding the allocation of the payments. For example, ratepayers are not the same body of people as Orion's electricity consumers. In particular, non-ratepaying consumers such as tenants would not benefit from such a repayment, even though they may have been long term Southpower/Orion customers. Should people who have only just moved to Christchurch benefit equally to long-standing residents ? Should the present generation of ratepayers receive a windfall payment at the expense of future generations ?

Reducing Rates

CCHL has not considered this option in detail, since it is clearly a Council decision. Additionally, on an ongoing basis, it is not a separate decision per se. If CCHL's recommendation were adopted, the interest saving from the reduction in debt combined with the income stream from the separate investment fund would significantly increase the Council's net income. It would then be for the Council to decide whether this increase in income would be applied to increased expenditure, rate reduction or a combination of the two. This decision is of course subject to the normal public accountability requirements of the Financial Plan process.

It is noted that if there were a one-off rate reduction, there would be a sharp percentage increase in rates in the following year. If the Council wished to avoid such an increase, the rates reduction would have to be continued indefinitely. This could be achieved if the net interest reduction on debt remained uncommitted.

A One-Off Increase in Capital Expenditure or a Major Investment

Again, this option has not been considered in detail, since this decision-making process is subject to the Council's normal public accountability requirements. CCHL notes, however, that the existence of additional unbudgeted capital funds should not, in itself, be a catalyst for additional expenditure. Valid new projects will arise from time to time, but these should be subject to the normal disciplines of the Financial Plan process. It is noted, however, that the reduction in debt levels arising from this proposal will provide future flexibility if such projects eventuate.

PUBLIC CONSULTATION

There is no legal requirement to conduct public consultation on the use of these funds. However, when the sale of the network assets was first announced, the Council gave public assurances that it would consult before any commitments were made. It is therefore necessary to determine a process for this consultation.

The principal process for consultation on financial issues is normally through the Financial Plan process and, with this due to take place in April/May, it seems sensible to carry out the consultation as part of that process. Additionally, at the same time the Council will be consulting on its triennial review of its Funding Policy. Since the proposal for the establishment of a protected capital fund will have an impact on the future funding of the Council, it will need to be referred to in the Funding Policy and consulted on through that process as well.

A draft public consultation format for inclusion in the Financial Plan is attached.

Recommendation:

1. That the Council approve in principle:

   (a) The proposal from Orion to return $200 million of funds to all shareholders through the repayment of $180 million of optional convertible notes and special fully-imputed dividend of $20 million.

   (b) That CCHL's share of the above funds (some $175 million) be returned to the Council through the payment of a special fully-imputed dividend of $140 million, with the balance being supplied through the purchase by CCHL of selected trading assets from the Council.

   (c) That $100 million should be invested in a long-term economic development fund, to be known as the Capital Endowment Fund, the income to be applied for the benefit of current and future generations.

   (d) That $75 million be applied to the debt repayment reserve for the reduction of projected long-term debt.

   (e) That the income from the Capital Endowment Fund be applied to:

      (i) maintaining the value of the fund after inflation; and
      (ii) providing for economic and business development projects that will enhance the region;

   (f) That the capital of the Capital Endowment Fund require a 90% voting majority of the Council before the capital can be used.

   (g) That to maintain accountability for the protection of the capital and use of the proceeds of the Capital Endowment Fund, the structure of the Fund be outlined in the Council's Funding Policy and reported on separately in the Financial Plan and Annual Report of the Council.

2. That the Council consult the public on the proposals in the report through the Financial Plan process, using the attached draft as a basis for the consultation.

The Chairman comments:

I strongly support the recommendations from CCHL because they provide a formula by which residents of Christchurch will benefit for generations to come. My only reservation is that I consider the purpose of the proposed Capital Development Fund should be widened to include civic development.

Chairman's Recommendation: That the recommendations be endorsed subject to recommendation 1(e)(ii) being amended to read "providing for economic, civic and business development projects that will enhance the region".