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 Cross Submission

Ireland, Wallace & Associates Limited
12 September 2014

Author: Garth Ireland
Ireland, Wallace & Associates Limited
PO Box 25359, Featherston Street, (04) 4733403 or 0212 494 359
Wellington 6146, NEW ZEALAND garth.ireland@xtra.co.nz

Disclaimer Statement:

This is policy analysis by a financial analyst. It draws together conventional methodologies commonly applied in the investment and securities markets research and the author's experience and judgement. Many of the measures are also used for regulatory purposes.

This is not investment advice. Nobody is authorised to rely on it for investment decisions. It makes no recommendation to anyone.

The author accepts no liability to anyone for anything in the review or for any action or inaction connected with it whether or not the person has relied on it. It should not be copied or circulated other than in its entirety.

The author has exercised care in producing it but only as far as he considers necessary for reputational purposes.

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:

Table of Contents

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 The review is to cover the discussion on the exclusion of Horizon Energy from the Commission's RAB multiple considerations. The Commission says: "It seems likely that Horizon is trading at an implied discount to RAB", and "… we place little weight on this evidence …"[2]. Its reasons include: low liquidity of shares, the company is small and the value of the unregulated businesses is problematic[3]. Submitters generally were concerned, along with Professor Vogalsang the Commission's expert advisor, that "the NZCC only has a valid sample of two firms in the observations." And, "The exclusion of Horizon, however, is less innocent, because it is one of only three publicly traded electricity distribution companies."[4] Submitters have argued that the Commission had considered insufficient data points or trends and Horizon should be included in the Commission's RAB multiple assessments.[5]

1.3 A second aspect is the implied RAB multiple arising from the just announced sale of 51% share of the OtagoNet Joint Venture by Marlborough Lines to its minority JV partners. It adds another data point(s). Some submitters were concerned that the Commission's RAB multiple conclusions were snapshots and were weakened by insufficient data points.

1.4 The OtagoNet Joint Venture transaction is important because it appears to be free of possible cross border financial and tax advantages of other transactions which some might argue inflate RAB multiples[6], and implicitly incorporates current regulatory information.

[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 A20

[3] CC A20.1 to 20.4

[4] Vogalsang, p1, 4, 31 July 2014.

[5] AMP Capital at 10.4; CEG on behalf of NZ Airports at 86(b)(ii); Chorus at 23; Houston Kemp at executive summary p iv; Orion at 82 and 83; Powerco at 38-42; PWC at 53 and 71-72; PWC on behalf of Vector at p 2; Sapere at executive summary p 6, sections 7.4(p 39); Vector at executive summary 7(c)(v), 56 and 59.

[6] I am not aware of substantial expert support for claims that prices paid by parties with potential financial advantages should be disregarded or discounted in determining market values.

2 Horizon Energy: Implied RAB multiples

2.1 The Commission has expressed the view that Horizon's RAB multiple is 1.0 or under. Vector calculates an implied RAB multiple of 0.98.[7] From my analysis of the empirical evidence available from Horizon activity those multiples are incorrect. They were based on incomplete information.

2.2 **Table 1** sets out the results of RAB multiple calculations made from data drawn from transactions occurring in the context of market regulatory rules (Takeover Panel/NZX) and accounting requirements (mandatory accounting standards). They involve a sequential process and address control and minorities realities. We get a stream of examples of implied RAB multiples in a variety of control situations but also through time. Two separate valuation experts provide a foundation for analysis by the Commission. The experts have had access to corporate information not available to the public or investors.

2.3 Submitters have not recognised the true benchmark Horizon provides.

2.4 **Table 1** summarises the variety of situations which inform the Commission on the size and potential information an implied RAB multiple may provide. The wide ranging RAB multiple contexts have been tested. The overall range is 1.1 to 1.5. If the subset of results from **Table 6** (range of 1.1 to 1.3) is ignored, as it is an extreme test relating RAB as at 2013 to estimated EV as at 2009, then the range is 1.3 to 1.5 over time and in a range of control situations.

[7] CC A20 and Vector 58.

Implied RAB Multiple Summary			Table 1
Horizon	range		reference
Partial Bid for 51% Control			
Implied RAB multiple	**1.4**	**1.5**	**Table 4**
[Independent Advisor Report]			Oct-09
Minority Bid for 13.89%			
Implied RAB multiple	**1.3**	**1.5**	**Table 5**
[Simmons with RAB 2010, EV 2009]			Jun-10
Implied RAB multiple	**1.4**	**1.5**	
[Simmons with RAB 2010, EV 2009+			
equity at $4.17 per share and Debt/FI updated]			
Minority holding 13.89%			
Implied RAB multiple	**1.1**	**1.3**	**Table 6**
[Simmons with RAB 2013, EV 2009]			Annually
Implied RAB multiple	**1.3**	**1.4**	
[Simmons with RAB 2013, EV 2009+			
equity at $4.17 per share and Debt/FI updated 2013]			
["FI" = financial instruments/derivatives]			

2.5 Horizon provides a valuable set of data points. It appears the Commission and submitters have overlooked the corporate activities surrounding the company. I believe they would recognise Horizon precedent as providing additional benchmarks to compare with other implied RAB multiples. It would reveal that simply taking the market share price may understate the true multiple.

2.6 The detail of each scenario is set out in **Tables 4 - 6** in Appendix 1.

2.7 The Horizon Energy Target Statement including the Simmons Corporate Finance Limited Independent Adviser's Report (Simmons) is attached to this submission.

3 Otago Joint Venture: Implied RAB multiples

3.1 The sale of Marlborough Lines' 51% share of OtagoNet Joint Venture, an unincorporated non-taxable entity, to Electricity Invercargill and The Power Company was announced on 2 September 2014[8]. The buyers paid $152.82 million for the 51% each of the Distribution and Contracting businesses.

[8] Energy News, 2 September 2014

3.2 The transaction was not an open market tender. As no financial accounts have been sighted my analysis relies on public announcements, Disclosure Statements to the Commission and selected information about Otago Power Services in the review sections of Marlborough Lines' Annual Reports. Extracts are included in Appendix 2.

3.3 **Table 2** summaries the calculation of the transaction implied RAB multiple of 2.0. It is assumed there is no debt in the JV and capital work in progress has been ignored. My assessed EV for Otago Power Services was based on 5.5 times recent estimated average EBITDA.[9]

Private Buy out Transaction						**Table 2**
OtagoNet JV						
Partial Bid for 51% Control						
Valuation and RAB multiple Summary						
Date:	RAB	31 March 2014				147.4
	EV	1 September 2014				
	$m					
Network						
Enterprise Value 2014						299.6
less Otago Power Services est.						(8.0)
EV Network						291.6
RAB						147.4
Implied RAB multiple						**2.0**

3.4 **Table 3** sets out the transaction on the basis of a range of implied control premiums: 15%, 25% and 35%. Eliminating the control premiums the implied RAB multiples range from 1.5 to 1.7.

[9] A22. Adopted PricewaterhouseCoopers EBITDA multiple of 5.5.

Private Buy out Transaction						**Table 3**
OtagoNet JV						
Partial Bid for 51% Control						
Valuation and RAB multiple Summary						
Date:	RAB	31 March 2014		147.4	147.4	147.4
	EV	1 September 2014				
	$m					
Network						
Enterprise Value 2014				299.6	299.6	299.6
Premium for control Scenarios				**15%**	**25%**	**35%**
EV absent Control Premium				260.6	239.7	222.0
less Otago Power Services est.				(8.0)	(8.0)	(8.0)
				252.5	231.7	213.9
RAB				147.4	147.4	147.4
Implied RAB multiple				**1.7**	**1.6**	**1.5**

3.5 If the premium for control is assumed to be 50% then the implied RAB multiple is 1.3 (at 40% it is 1.4).

4 Evaluation

4.1 The implied RAB multiple analyses provide robust additional data points and situations through time from 2009 to 2014 for transactions involving Horizon Energy and OtagoNet JV. One of the parties, Marlborough Lines was both a buyer and a seller of shares in these companies.

4.2 The competition for “control” ranged from 49% to 100% (OtagoNet JV), 0% to 51% (Horizon) and 0% to 13.89% (Horizon). Implied RAB multiples can be observed in these situations.

4.3 Two expert valuers, Simmons Corporate Finance and PricewaterhouseCoopers were involved: the former estimating the implied RAB multiple directly and the latter indirectly, via a fair value process. The context for the experts was variously the Takeover Panel, NZX as a market Regulator and accounting standards and processes.

4.4 The OtagoNet JV transaction involved three informed existing investors. The Horizon transactions relied on information either in the market or additionally disclosed via the Independent Adviser’s Report.

4.5 The Horizon and OtagoNet JV transactions transited changes (or knowledge of) between two types of Incentive Regulations. The OtagoNet JV transaction was negotiated in full knowledge of the Commission’s proposal to apply a 67th cost of capital percentile. The implied RAB multiple is net of any potential negative effects.

4.6 The Horizon and OtagoNet JV transactions involved New Zealand resident businesses. It is highly unlikely therefore that alleged tax advantages of cross border investment are affecting implied RAB multiples. In any event, theory does not support a view that a tax advantaged buyer will pay more than one dollar above what the next nearest buyer would offer.

4.7 In general the Horizon implied RAB multiples for a minority shareholding suggests a range of 1.3 to 1.4 and for potential control 1.4 plus.

4.8 The OtagoNet JV transaction suggests that with an implied RAB multiple of 2.0 even ignoring a substantial premium for control, the RAB is being valued at a level where expected returns are substantially above the cost of capital attributed in the RAB's regulatory valuation. Based on control premiums of 15%, 25%, 35% and 50% the implied RAB multiples are 1.7, 1.6, 1.5 and 1.3 times respectively. Including the premium for control gives a more reliable market valuation of the underlying assets, because it is control that puts the buyer in the position of and owner of the assets. In either case the RAB multiple implies a true cost of capital for the OtagoNet JV well below the range of the Commission's estimates.

4.9 These implied RAB multiples compare with the two Powerco minority shares sales in late 2010 and 2013 where the implied RAB multiples were estimated by expert valuer Grant Samuel at 1.3 and by the Commission at 1.33 (or 1.3)[10]

4.10 My conclusion in my submission at 9.6 holds, in fact more so. The basis for this view is with the benefit of Horizon and the OtagoNet JV New Zealand domiciled transactions there are additional robust data points supporting implied RAB multiples for non-control transactions at about 1.3 and just above. This translates into the maxim: "invest $1 and it is worth $1.30+ for non-control, or up to $2 for 100% control". The additional analysis supports my view that implied RAB multiples, and their consistent positive values are a significant trend, not a snapshot as claimed by other submitters.

4.11 The Commission now has market evidence from both the Horizon and OtagoNet JV transactions for its implied RAB multiple analyses. It addresses submitters' concerns about insufficient data points and evidence of trends.

[10] IWA submission for MEUG 29 August 2014, 5.16 and 5.17.

Appendix 1

A1. In my 2010 submission headed "Cost of Capital", I stated that: "The current Horizon Energy Distribution transaction involving Marlborough Lines' implied RAB [or ODV] multiple is about 1.4 to 1.5 times" for the network.[11]

A2. This statement was based on an Independent Advisor's Report on the partial takeover offer prepared by Simmons Corporate Finance dated October 2009. The document reveals substantial information relevant to the RAB multiple and its status.

A3. My own analysis of two transactions involved an unsuccessful partial bid for 51% control of Horizon, the subsequent successful minority bid for 13.89%, followed by an annual "fair value" test from 2011 to 2013 by independent advisers, PricewaterhouseCoopers. No impairment has resulted.

A4. I have calculated the implied RAB multiples on the same or similar basis to the Commission and Simmons. **Table 4** summarises the Simmons valuation.

A5. The Takeover Offer was conditional on 51% acceptances.

A6. The consideration was $3.96 cash per share.

A7. Marlborough Lines saw that the future lying in business aggregation.

A8. The full underlying valuation was stated in the range of $3.96 to $4.68. The value is for 100% of Horizon and reflects the value of control. The standard of value was "fair market value".

[11] Cost of Capital, 13 August 2010 (attached to submission 29 August 2014 at 3.43).

Independent Advisors's Valuation				**Table 4**
Horizon				
Partial Bid for 51% Control (Simmons)				
Valuation and implied RAB multiple Summary				
Date:	RAB	31 March 2009		88.0
	EV	October 2009		
	$m			
Network			low	high
Enterprise Value range			120.0	135.0
RAB			88.0	88.0
Implied RAB multiple			**1.4**	**1.5**
Contracting				
EBITDA multiple			5.0	6.0
Enterprise Value range			4.5	5.4
DCF			4.5	8.8
Enterprise Value range			5	8
Horizon Energy				
EV			125.0	143.0
less Debt+Derivatives			(26.0)	(26.0)
			99.0	117.0
Per share range			3.96	4.68
Shares (m)	24.991			

A9. The partial offer for 51% excludes any potential synergies that might be available at 100% ownership.

A10. The pre offer price was $2.95. The bid premium was 34% at the offer price of $3.96. The offer price was at the bottom of Simmons' valuation range of $3.96 to $4.68.

A11. The Enterprise Value (EV) of the network was estimated at $120 million to $135 million by a combination of DCF and capitalisation of EBITDA.[12]

A12. The implied RAB multiple is 1.4 to 1.5 based on a RAB of $88 million as at 31 March 2009. Simmons consider this is reasonable albeit slightly below the industry average.[13] The Contracting business EV is estimated in a range of $5 to $8 million as at October 2009.

A13. The value of Horizon shares is the sum of the two businesses less Net Debt and financial derivatives. The value per share is $3.96 to $4.68.

[12] Simmons, p44.

[13] Simmons, table p45.

A14. The implied premium for control is reasonably less at 51% than 100% control. Simmons say: "… the combination of an illiquid share and limited earnings guidance provided by the company means that the observed share prices may not be a reliable indicator of the market value of Horizon Energy's shares."[14] Hence, implying that the premium for control of 25% to 59% may be misleading.

A15. As the Independent Valuer Simmons had access to information not available to the public.

A16. The Marlborough Lines partial bid for 51% was unsuccessful.

A17. On 11th June 2010 Marlborough Lines stood in the market for 10.1% of Horizon's shares at $4.14 per share or $4.06 per share ex dividend.[15] A 13.89% shareholding was acquired at a carrying value of $14.474 million with an average holding value of $4.16 per share.[16]

A18. **Table 5** shows the implied RAB multiples of 1.3 to 1.5 at the EV as at 2009, and at 2010 multiples of 1.4 to 1.5 after adjustments for equity and debt.

Market Transaction				**Table 5**
Horizon				
Minority Bid for 13.89%				
Adjusted Simmons Valuation and RAB multiple Summary				
Date:	RAB	31 March 2010		92.0
	EV	June 2010		
	$m			
Network			low	high
Enterprise Value range 2009			120.0	135.0
RAB			92.0	92.0
Implied RAB multiple			**1.3**	**1.5**
Enterprise Value range 2009			120.0	135.0
Adjust EV to $4.17 per share equivalent				
$3.96 to $4.17 = +21c per share			5.2	5.2
Adjust for change in Debt/FI			(0.6)	(0.6)
Adjusted EV			124.6	139.6
RAB			92.0	92.0
Implied RAB multiple			**1.4**	**1.5**

A19. As the Horizon shareholding is classified as a non-current asset "held for sale" under accounting rules must be subject to a fair value test each year. Independent valuations in 2011, 2012 and 2013 indicated that the holding value

[14] Simmons, p49.

[15] Marlborough Lines, Annual Report 2010, note 26.2.

[16] Marlborough Lines, Annual Report 2011, p73.

of $4.16 per share was within the valuation range and no adjustment was required to the carrying value.

A20. Based on a separate independent valuer an estimate of the implied RAB multiple can be derived. The key assumptions disclosed by Marlborough Lines provide a basis for estimating or inferring an implied RAB multiple.

Fair Value Test				**Table 6**
Horizon				
Minority holding 13.89%				
Adjusted Simmons Valuation and RAB multiple Summary				
Date:	RAB	31 March 2013		104.5
	EV	31 March 2013		
	$m			
Network			low	high
Enterprise Value range 2009			120.0	135.0
RAB			104.5	104.5
Implied RAB multiple			**1.1**	**1.3**
Enterprise Value range 2009			120.0	135.0
Adjust EV to $4.17 per share equivalent				
$3.96 to $4.17 = +21c per share			5.2	5.2
Adjust for change in Debt/FI			9.0	9.0
Adjusted EV			134.2	149.2
RAB			104.5	104.5
Implied RAB multiple			**1.3**	**1.4**

A21. The 2013 Marlborough Lines' Annual Report disclosures provide the Commission with details of the method, assumptions and sensitivities that support the conclusion of the valuer.

A22. Note 15.2 "Investment" in Marlborough Lines Annual Report:

> *"The 13.89% shareholding held by Marlborough Lines is categorised per NZ IFRS as a non-current asset 'held for sale' investment and must be assessed for fair value each year. PricewaterhouseCoopers undertook an independent valuation consistent with the requirements of NZ IAS 39 at year end and indicated that the holding value of $4.17 per share was within the valuation range and no adjustment to the carrying value ($14.474m) was required.*
>
> *PricewaterhouseCoopers has applied a combination of valuation techniques, rather than the quoted price of HEDL shares since the trading in HEDL shares is very light and there is a very small percentage free-float.*

Key assumptions made

- *FY2014 revenue is sourced from HEDL's 2013/14 Pricing Methodology Disclosure.*
- *FY2015 revenue is calculated by escalating FY2014 revenue by the Consumer Price Index.*
- *5.8% and 6.6% discount rates which set the range for the EDB valuation.*
- *To value the contracting business, an EBITDA multiple range of 5.5x-5.5x was applied.*
- *Net debt is sourced from HEDL's 2013 annual accounts.*
- *A minority discount has been applied between nil and 5%.*

Sensitivity

The most sensitive inputs are the discount rate and the terminal growth rate, which shift the mid-point valuation by approximately +/- 14% and -10% to +12.5% respectively.

The valuation is moderately sensitive to capital expenditure:

- *• The average impact on the mid-point valuation of a +/- 10% movement in capital expenditure is approximately +/-8%."*

A23. In essence the fair value process tests whether the carrying value of the minority shareholding in Horizon should be written down or impaired. The test is on the downside or impairment of value. The carrying value $14.474 million has remained unchanged since purchase in 2010. The valuer has included a minority discount of 0% to 5% in its assessments.

Appendix 2

Extracts: Marlborough Lines Limited Annual Reports:

2013 Annual Report page 65

> *"Otago Power Services Ltd provides electrical contracting services and network construction and maintenance throughout the Otago and Southland regions. Otago Power Services has a staff of 90, and is based in the rural Otago town of Balclutha with additional branches in Gore, Palmerston and Ranfurly. The company is managed by Marlborough Lines in conjunction with its own contracting business. The board of Otago Power Services comprises two directors, Mr Ken Forrest of Marlborough Lines (Chairman) and Mr Greg Buzzard of PowerNet. In the 2013 financial year the company's turnover increased from $11.688m to $12.157m and recorded a tax paid surplus of $1.361m (2012 $1.142m). Total dividends of $950k were distributed to shareholders (2012, $900k). This result is pleasing to the OPSL directors and management and has been achieved by reinvestment within the business, continuous improvement of systems and a focus on staff training that has resulted in a better utilisation of the available resources."*

2012 Annual Report page 65

> *"Otago Power Services Ltd provides electrical contracting services and network construction and maintenance throughout the Otago and Southland regions. Otago Power Services has a staff of 87, and is based in the rural Otago town of Balclutha with additional branches in Gore, Palmerston and Ranfurly. The company is managed by Marlborough Lines in conjunction with its own contracting business. The board of Otago Power Services comprises two directors, Mr Ken Forrest of Marlborough Lines (Chairman) and Mr Greg Buzzard of PowerNet. In the 2012 financial year, the company's turnover increased from $11.132m to $11.688m and it recorded a tax paid surplus of $1.142m (2011 $1.183m). Total dividends of $900k were distributed to shareholders (2011, $700k). In view of the recessionary period currently being experienced, the OPSL directors and management are pleased with this result. This has been achieved by reinvestment within the business, improvement of systems and a focus on staff training that has resulted in better utilisation of the available resources."*