COVEC RESEARCH REPORT:

Entrust Dividends and Ownership

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Entrust
Majority shareholder of Vector

ENTRUST: DIVIDENDS AND OWNERSHIP

Summary

Treating all Aucklanders fairly would require similar levies being imposed on households and businesses outside Entrust's region

A proposal has been made to change the current arrangement in which customers of Vector in Auckland, Manukau and northern parts of Papakura receive a dividend payment from the current majority owners, Entrust. The proposal is that the dividend payments would be received by Auckland Council rather than the current beneficiaries. This short paper examines the background to Entrust that has led to the current arrangement and the pros and cons of this proposal.

The latest annual dividend payment in 2014 amounted to $335 per household, with the same amount to businesses depending on how many electricity meters they have. The total amount distributed amounted to $113 million (pre-tax). If this level of payment were to continue into the future, the loss of dividend would be approximately $5,000 - $8,000 per household, depending on the assumptions on discount rate.

Removing dividend payments from current recipients is similar to a poll tax

Our analysis of the proposal for change can be summarised as follows:

1. Removing dividend payments from current recipients is similar to a poll tax. It is a lump-sum payment by households, the size of which they do not determine. Economic theory would suggest that such a tax is relatively efficient as it does not distort behaviour, but rates are equally efficient..

Removing dividends is clearly unfair

2. However, removing dividends is clearly unfair. In other parts of Auckland electricity consumers were treated differently but equivalently. In the North Shore and Waitakere, for example, electricity customers were given shares in their power company at the time of privatisation. The value of those shares was the (discounted) value of the expected future stream of dividend payments from the company.

If it makes sense to take dividends or use other levies to fund transport projects then it makes more sense to use rates as the revenue source

3. Therefore, treating all Aucklanders fairly would require similar levies being imposed on households and businesses outside Entrust's region of an amount equivalent to the long-run expected value of Entrust dividends (approximately $5,000 - $8,000).

4. However, if it makes sense to take dividends or use other levies to fund transport projects then it makes more sense to use rates as the revenue source. Rates are fairer because they would apply more widely in the Auckland region, and the same amount of revenue could be raised with a lower cost per household.

5. It should also be noted that if the level of rates increases is regarded as reaching unsustainably high levels, then the argument of excessive burden also applies to the removal of dividend payments and additional measures for households and businesses outside Entrust's region.

1. BACKGROUND

1.1 - History

The Auckland Energy Consumer Trust (AECT) was established in 1993 to own the assets of the Auckland Electric Power Board (AEPB)

Local power boards that owned electricity distribution and retail assets were privatised during the electricity sector reforms of the 1990s. These new companies included Mercury Energy in Auckland with customers in Auckland, Manukau and northern parts of Papakura, and United Networks with customers in North Shore and Waitakere.

The Auckland Energy Consumer Trust (AECT) was established in 1993 to own the assets of the Auckland Electric Power Board (AEPB) in the form of shares in the newly-formed Mercury Energy (ME). The Deed of Trust that established the AECT defined two classes of beneficiary:

- Income beneficiaries – the electricity consumers within the area served by the AEPB; and

- Capital beneficiaries – the local authorities existing at the termination date of the Trust that have part of the area served by the original AEPB within their area.

Prior to 2073 the income received must be distributed to the income beneficiaries, net of any costs

The termination date of the Deed of Trust is 2073, when the assets are to be distributed to the capital beneficiaries or to the Crown. Prior to 2073 the income received must be distributed to the income beneficiaries, net of any costs.

As a result of further electricity reforms in the late '90s, retail activities were separated from lines businesses and ME sold its electricity retail business to Mighty River Power Ltd and retained its electricity lines business (ELB). The newly-defined business was named Vector Ltd. In 2002 Vector acquired most of the ELB assets of United Networks along with its other businesses. This gave Vector customers in areas of Auckland outside the area served by the AEPB, and in Wellington. These customers are not income beneficiaries of the Trust.

The AECT retained 100% ownership of Vector until 2005, when it agreed to Vector's initial public offering in which 24.9% of the shares in Vector were sold so it could raise money to buy the gas company, NGC Holdings. The AECT now holds 75% of Vector's shares.[1]

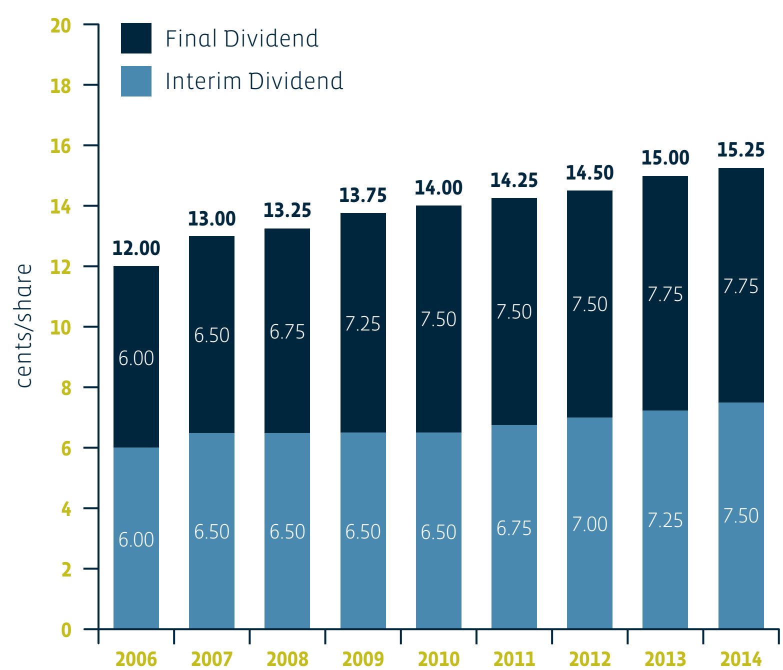
1.2 - Dividends

The income beneficiaries of Entrust are the customers of Vector in Auckland, Manukau and northern parts of Papakura

The income beneficiaries of Entrust are the customers of Vector in Auckland, Manukau and northern parts of Papakura (see boundaries in Annex). These customers receive a proportion of the dividend payment made by Vector to Entrust. They do so on the basis of the number of installation control points (ICPs) on their power account(s). Typically households have one ICP and receive one payment, but businesses (or other large customers) with branch offices or more than one ICP (and pay more than one power bill) receive more than one payment.

The dividends per share paid by Vector are shown in Figure 1. Entrust owns 751 million shares, meaning that it earned $114.5 million in dividend income in 2014 at 15.25 cents per share. After subtracting its costs, it had $112.7 million (pre-tax) to distribute.[2] Distributions amounted to a payment of $335 per customer in 2014 post-tax (at 33%, that is with imputation credits attached); this is a small increase over 2013 ($330). Prior to this, payments had been of $320 from 2007 to 2012 (Figure 2).

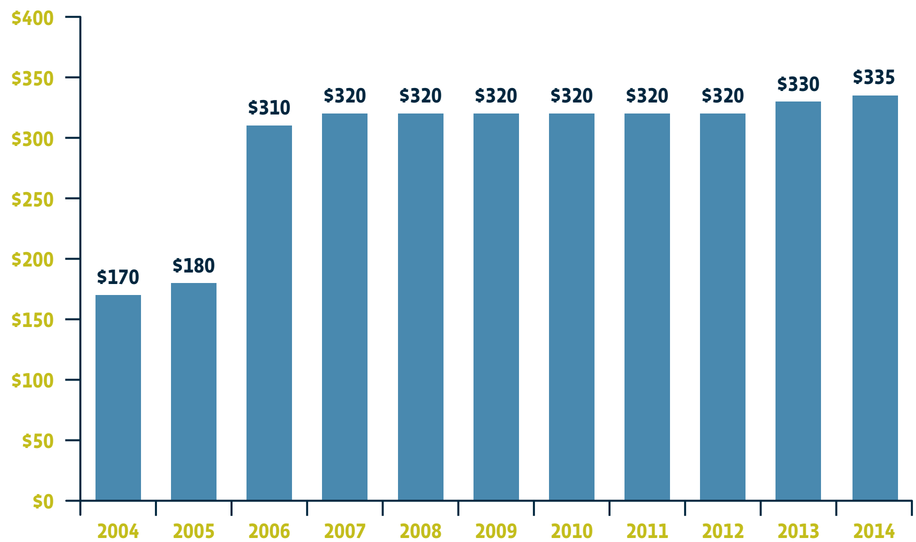
Figure 1: Vector dividend payments



Source: http://vector.co.nz/dividends

[1]Entrust owns 751 million shares of a total of 1 billion. However, because 4,244,923 were bought back by Vector itself, this shareholding is variously described as 75.1% or 75.4% of the company. [2]Auckland Energy Consumer Trust 2014 Financial Statements.

Figure 2: Payments to income beneficiaries (per ICP)



Source: AECT dividend leaflets and newsletters

Under the Deed of Trust Entrust may differentiate the amount paid to different customers *"as they think fit … including, for example, by reference to the relative contributions to the Company's profit of Consumers in each of the tariff categories prescribed by the Company."* However, to date the Trust has paid out to each customer on a consistent basis.

Vector's ability to continue to increase dividends is constrained by its regulation under Part 4 of the Commerce Act in recognition of its substantial monopoly power. The regulations limit Vector's annual average price increases (to the Consumers Price Index). Set against falling or static electricity demand per customer this may limit future dividend increases, for example if it limits Vector's profits below historical levels. However, these issues are beyond the scope of this report.

1.3 - Proposals for Redistribution of Income or Ownership

Recently there have been suggestions that the share ownership, or the Deed of Trust, is changed so that Auckland Council becomes the beneficiary of the income, at the expense of current beneficiaries. The argument has been raised in the context of the current shortfall in funding for major transport projects in Auckland. Obtaining the income from Vector dividends would enable transport projects to be brought forward in time.

According to the *New Zealand Herald*, Kim Campbell, Chief Executive of the Employers and Manufacturers Association, has argued that *"the Trust should be wound up and its assets returned to Auckland Council control provided the Council uses them to build new infrastructure for Auckland."*[3] The argument was based partly on the assumption that Auckland Council (or some future equivalent) would obtain the shares at the termination date of the Deed of Trust. However, this ignores the clear guidance in the Deed of Trust that the primary beneficiaries are the consumers, for example where *"the Trustees are required or empowered to exercise any discretion, the Trustees shall be entitled to prefer the interests of consumers over the interests of the capital beneficiaries."*

The cost of losing dividend payments can be estimated as the present value of future payments

1.4 - Costs of Losing Dividend Flows

The cost of losing dividend payments can be estimated as the present value of future payments, based on a discounted cash flow analysis. Below we discuss how we might expect these values to be incorporated into current house prices in the Entrust region as it is an expected income as a result of living there.

We use two discount rates in our analysis: an 8% rate that is the NZ Treasury's recommended rate for public policy analysis and a lower 4% that we understand has been advocated by the Auckland Council Chief Economist Unit as a measure of the social rate of time preference. The results are shown in Table 1 based on an ongoing (real) dividend payment of $350 per year. The analysis is undertaken for the full period up to the termination date (to 2073) or for a shorter period that might represent a reasonable assumption of how long someone might be resident in Auckland and in receipt of dividends. Over the shorter period the discount rate assumption has much less effect.

Table 1: Present value of dividends

YEARS	8%	4%
58 (TO 2073)	$4,470	$7,814
10	$2,428	$2,826

These calculations assume no other growth in Vector's business activities, for example investments in other industries or geographic areas that might increase profits and dividends.

[3] http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11375615

1.5 - Fairness Issues

Customers in the Entrust region who receive an annual dividend have not been treated better than those in other parts of Auckland

The fairness question is over whether all Aucklanders have been, and continue to be, treated in the same way. The question applies to the original resident households and business in the 1990s and current households and businesses. We address these in turn below and conclude that customers in the Entrust region who receive an annual dividend have not been treated better than those in other parts of Auckland.

1.5.1 - Original Customers

At the time of the reforms of the power boards, all customers were treated equivalently

Customers in the old AEPB region continue to receive dividend payments while other customers of Vector in North Shore and Waitakere do not. This is exacerbated by Vector's expansion such that it has customers throughout Auckland and elsewhere in New Zealand, and it notes that approximately two thirds of the Entrust dividend is generated outside the original Auckland network.[4]

However, at the time of the reforms of the power boards, all customers were treated equivalently, but differently:[5]

- The **Waitemata Electric Power Board** (North Shore, West Auckland, Orewa, Whangaparaoa). Customers were given shares in the newly established Power NZ Ltd which they could sell. This became a public company (United Networks Ltd), which was bought by Vector in 2002.

- The **Franklin Electric Power Board** (southern Papakura, Counties and Franklin districts) is now called Counties Power, owned by Counties Power Trust. It pays out discounts to consumers' power accounts.

- The **North Auckland Power Board** (includes Kaipara area) is now called Northpower and owned by Northpower Electric Power Trust. It pays out credits to consumers' power accounts.

The discounts that apply to Counties Power customers differ with the power consumption (Table 2). For a household using a typical 8,000kWh per year the discount is $235.75.

[4] Vector Presentation to the 2014 Annual Meeting 22 October 2014, Ellerslie Event Centre, Auckland
[5] www.aect.co.nz/aect-dividend/faqs/

Table 2: Electricity discounts for Counties Power customers (year to 31 March 2014)

ELECTRICITY CONSUMPTION (kWh pa)	ELECTRICITY	PER METER[1]	TOTAL
LESS THAN 1,000	$11.50	$11.50	**$23.00**
1,000 TO 5,000	$109.25	$11.50	**$120.75**
5,000 TO 7,500	$166.75	$11.50	**$178.25**
7,500 TO 10,000	$224.25	$11.50	**$235.75**
10,000 TO 15,000	$293.25	$11.50	**$304.75**
15,000 TO 20,000	$402.50	$11.50	**$414.00**
20,000 TO 30,000	$552.00	$11.50	**$563.50**
GREATER THAN 30,000	$644.00	$11.50	**$655.50**

[1] Paid to those with a Counties Power meter (95% of customers)

Source: www.med.govt.nz/sectors-industries/energy/energy-modelling/data/prices/electricity-prices/Discounts-distributions-ye-31-march-2014.pdf

Discounts applying to Northpower customers are shown in Table 3. The discount for the equivalent 8,000kWh per annum household is $95 per annum.

Table 3: Electricity discounts for Northpower customers (year to 31 March 2014)

ELECTRICITY CONSUMPTION (kWh pa)	DISCOUNT
LESS THAN 2,000	$35.00
2,000 TO 15,000	$95.00
GREATER THAN 15,000	$145.00

Source: www.med.govt.nz/sectors-industries/energy/energy-modelling/data/prices/electricity-prices/Discounts-distributions-ye-31-march-2014.pdf

The United Networks story is more complicated. When initially privatised, customers were given shares in Power New Zealand Ltd. Later, when the retail assets were removed to create United Networks Ltd, 10.7% of the shares in the new company were vested in the United Network Shareholders Society Inc (formerly the Power New Zealand Shareholders Society Inc) to vest ultimately in North Shore City Council, Rodney District Council and Waitakere City Council according to the number of electors at the vesting date on the local body Electoral Roll of each territorial authority.[6] Prior to that date, the

[6] Waitakere City Council Agenda for an Ordinary Meeting of the Finance and Operational Performance Committee to be held in the Civic Centre, 6 Waipareira Avenue, Lincoln, Waitakere City, on Thursday, 13 December 2001.

income derived (dividends) was applied in accordance with the provisions of the Trust, principally towards the cost of undergrounding the electricity reticulation network for the public benefit.

Auckland residents outside of the area that receive a dividend from Entrust either continue to receive a financial benefit or have obtained benefits previously as shares and/or public benefits in the form of expenditures for which they are beneficiaries

Thus, Auckland residents outside of the area that receive a dividend from Entrust either continue to receive a financial benefit or have obtained benefits previously as shares and/or public benefits in the form of expenditures for which they are beneficiaries. Whether residents in the Entrust region have fared better than those in other areas depends on what residents elsewhere have done with their surpluses, including the value of the shares sold from the Waitemata Electric Power Board (WEPB), and how these individual companies will perform in the future.

1.5.2 - New Residents

It is now some time since the transaction occurred that resulted in the distributions of shares and the pattern of future income flows. However, a new resident in the old AEPB region will receive an annual dividend cheque but a new resident in North Shore or Waitakere will not.

There is no fairness argument relating to the nature of the gift: lump-sum versus ongoing payment

Firstly, there is no fairness argument relating to the nature of the gift: lump-sum versus ongoing payment. We could imagine, for example, that some former WEPB resident might have used the revenue from the sales to purchase some other shares that are supplying an ongoing stream of dividends. Other residents will have used the money for immediate consumption.

Secondly, because there is a certainty of receiving dividends and the level of dividends has been relatively stable over time (Figure 2), it would be reasonable to think either that: (1) the value of dividends would be capitalised into Auckland and Manukau house prices; or (2) if not, then the value of dividends is sufficiently low that it is immaterial. If it is included in house prices then new residents to Auckland would pay the equivalent of a higher price for their house in recognition of the future income flow. Whether this occurs is almost untestable, given the very significant differences between houses that affect relative prices, both within Auckland/Manukau and between Auckland and North Shore/Waitakere. However, the effect, if it were to occur, might be similar to a difference in house price that could apply to a house that, say, had insulation versus one that did not. New residents to the North Shore or Waitakere would face no such price increase.

There would be fairness issues raised if the dividend payment were no longer paid to Entrust beneficiaries but instead appropriated by Council. Households and businesses in the former WEPB area should make a payment to the Council of an equivalent sum to that being given up by Auckland households and businesses

There would be greater fairness issues raised if the dividend payment were no longer paid to Entrust beneficiaries but instead appropriated by the Council. On fairness grounds it would be reasonable to argue that households and businesses in the former WEPB area should make a payment to the Council of an equivalent sum to that being given up by Auckland households and businesses (or that Entrust beneficiaries are compensated for their loss by the Council, which would presumably defeat the assumed purpose). The issue of whether these are new or old residents of North Shore/Waitakere is irrelevant to this. All residents of Auckland/Manukau would face a cost (giving up the dividend), so on the same basis all residents of North Shore and Waitakere should do so also.

2. OWNERSHIP

The proposal to shift the payment of dividends from the current income beneficiaries to the capital beneficiaries might be achieved through a change to the Deed of Trust. There would be a more significant impact if it were to occur through a change in the ownership from the Trust to the Council, for example in the form of a council-controlled organisation.

Trustees have duties defined under the Trustee Act to invest prudently in the best interests of present and future beneficiaries of the Trust

Trustees have duties defined under the Trustee Act to invest prudently in the best interests of present and future beneficiaries of the Trust. The role is clearly defined and focused on this one activity. The trustees of Entrust are elected by the income beneficiaries, who have a clear incentive to elect trustees who would act in their best interests by maximising dividends net of line charges.

Entrust participates in Vector's governance through two seats on the eight-member Board of Directors. In addition, as the majority shareholder of Vector, we assume it also controls the election of the other Board members effectively.

In contrast to the clear set of objectives and incentives under the current trust ownership, Auckland Council has a much wider set of objectives

In contrast to the clear set of objectives and incentives under the current trust ownership, Auckland Council has a much wider set of objectives established under the Local Government Act to meet the needs of its communities cost-effectively. Because Vector distributes electricity throughout the Auckland region (and elsewhere), and not just to beneficiaries of Entrust, arguably the Council could better meet its objectives by ensuring that Vector minimised its prices to Aucklanders. This could have the effect of

Beneficiaries are likely to be better off under the current arrangement

reducing company profits and dividends. Current beneficiaries would gain from the reduced prices but so would non-beneficiaries. Beneficiaries are likely to be better off under the current arrangement.

There is a legal obligation on all directors to behave in the interests of the company. But shareholders, being the residual claimants on profit, can influence the definition of those interests.

In the short run, the transfer of ownership to the Council may deliver total dividends that are similar in magnitude to current payments. However, over the longer run, there is a risk that market discipline may diminish and for the incentive increasingly to shift to serving the interests of all Aucklanders,[7,8] to the detriment of current beneficiaries.

3. REVENUES AND ECONOMIC EFFICIENCY

In this section we explore the issue of whether the choice of distribution to income beneficiaries or to capital beneficiaries is better from an economics perspective. In doing so, we ignore the clear direction given in the Deed of Trust in favour of consumers, as discussed above.

Taking regular dividend payments away from current beneficiaries in favour of the Council is equivalent to a tax on those beneficiaries

Removing the dividend stream from households and paying it to the Council raises a number of economic issues that need to be assessed. These include the following that we address below:

- Whether the removal of dividends can be characterised as a tax;
- The marginal utility of income to households and the Council.

3.1.1 - The Costs of Taxation

Taking regular dividend payments away from current beneficiaries in favour of the Council is equivalent to a tax on those beneficiaries.

A number of studies have analysed the costs of taxation and have concluded that the costs of raising $1 for the Government are more than $1. Although economists generally consider tax to be a transfer that moves money from one group (taxpayers) to another (government), there can be a cost where the mechanism used to raise tax distorts behaviour. Distortions, where people do

[7] Since Vector's pricing is regulated by the Commerce Commission we assume that it would not be permitted to raise prices outside Auckland (for example to its Wellington customers) by enough to leave dividends unaffected. [8] This depends on how the Auckland Council views its objectives however. For example, it could regard pricing up to the regulated level as being consistent with the well-being of Aucklanders on the basis that it represents an efficient form of taxation revenue that can be used to deliver other publicly-desired services.

something different from what they would do otherwise, result in economic costs.[9]

When taxes are raised via increasing the costs of consumption (GST) or reducing the rewards of work (income tax), behaviour is changed. People spend and work less than they would otherwise, and they spend and work differently. This distortion to consumption behaviour involves a cost that is additional to the amount of tax paid. As a result, the Treasury recommends that public expenditures should be multiplied by a factor of 1.2 to take account of these deadweight costs.[10] More recent Treasury analysis has suggested that the impacts are greater than this.[11]

However, in contrast to income and consumption taxes, the removal of dividends is a 'lump sum' tax. The amount of dividend currently received by beneficiaries does not depend on the level of activity of the recipient; it is simply as a result of having an ICP. There is nothing that the beneficiary can do to increase the amount of dividend paid without obtaining another electricity connection (at some expense). The flip side of this is that the removal of the dividend payment (equivalent to a tax of an equal amount) would have no distortion of behaviour either.

Although lump-sum taxes have little or no incentive effect, they do affect the income of taxpayers, and this will result in some changes to their consumption patterns. The things that people do with incremental increases in income would be lost. These are highly varied across the community, as illustrated by the various accounts recorded by Entrust of what people have done with their dividend payments. Because of the wide distribution of electricity account holders and the equal payments[12] for all, removal of dividends operates like a poll tax (as does an increase in the price of electricity connections).

3.1.2 - Marginal Utility of Income

The marginal utility of income is a question over the value of an additional dollar to the Council versus an additional dollar to a household or other beneficiary. However, rather than seeking to measure this empirically, for example by assessing what the Council or some average household might do with an additional dollar, the discussion can be simplified by noting the similarities between taking dividends and increasing rates.

[9] New Zealand Treasury (2009) Estimating the Distortionary Costs on Income Taxation in New Zealand. Background Paper for Session 5 of the Victoria University of Wellington's Tax Working Group. [10] New Zealand Treasury (2005) Cost Benefit Analysis Primer. [11] Claus I, Creedy J and Teng J (2012) The Elasticity of Taxable Income in New Zealand. New Zealand Treasury Working Paper 12/03. [12] www.aect.co.nz/aect-dividend/how-it-helps-the-community/

The effects of dividend removal and rate increases are very similar. Broadly speaking, both are lump-sum taxes that have low levels of distortion. However, rates are fairer because they would treat all Auckland residents in the same way. And, as discussed above, making North Shore and Waitakere residents pay an equivalent amount to the loss of dividend payments for residents of the AEPB region would be fair also. A mechanism already exists to do all of this: household rates.

Rates are fairer because they would treat all Auckland residents in the same way

If it makes sense to take dividends to fund transport projects then it makes more sense to use rates to fund these. It is fairer because it would apply more widely in the Auckland region, and the same amount of revenue could be raised with a lower cost per household. However, if the level of rates increases reaches unsustainably high levels (which would reflect a decision that the marginal utility of income to households was greater than the marginal utility of revenue to the Council), then the same applies to other means of raising revenue from residents, including through the removal of dividend payments.

If it makes sense to take dividends to fund transport projects then it makes more sense to use rates to fund it

4. CONCLUSIONS

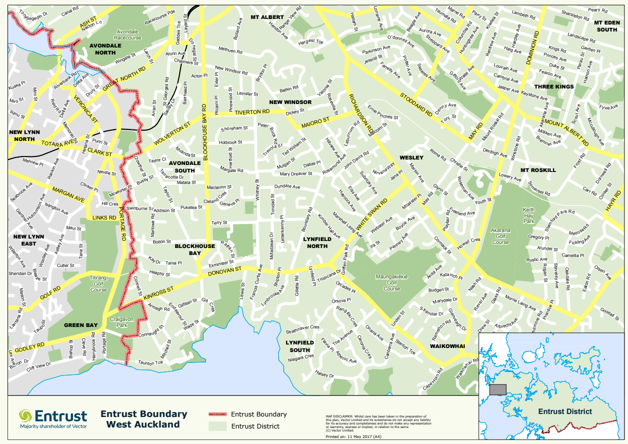
The suggestion has been made that the dividend income currently paid to households and businesses that are Vector customers in the old AEPB region should be diverted to Auckland Council. This proposal would not be economically inefficient; it is a lump-sum tax. However, it would not treat all Aucklanders fairly. Specifically it is levelling costs on households and businesses in certain parts of Auckland only. A mechanism already exists, in the form of rates, for more fairly raising revenue for the Council. It is more certain in terms of the income generated, is fairer, and would impose a lower burden per household.

This proposal would not be economically inefficient; it is a lump-sum tax. However, it would not treat all Aucklanders fairly

If more revenue is required by the Council then the rates mechanism should be used. Conversely, if the arguments against increasing rates are valid then the arguments equally apply to removing dividend payments from current income beneficiaries of Entrust.

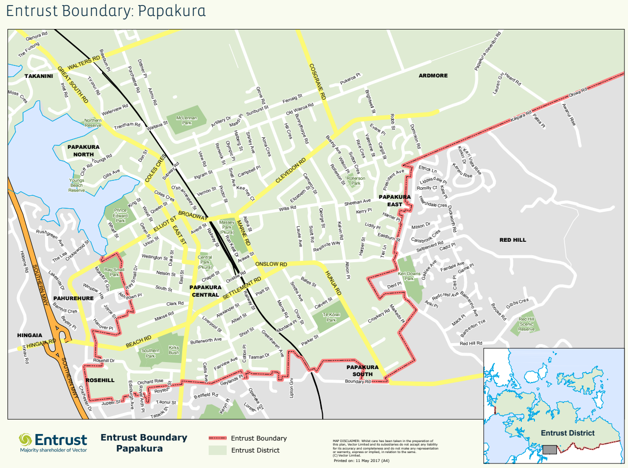
ANNEX: ENTRUST BOUNDARIES

Entrust Boundary: West Auckland



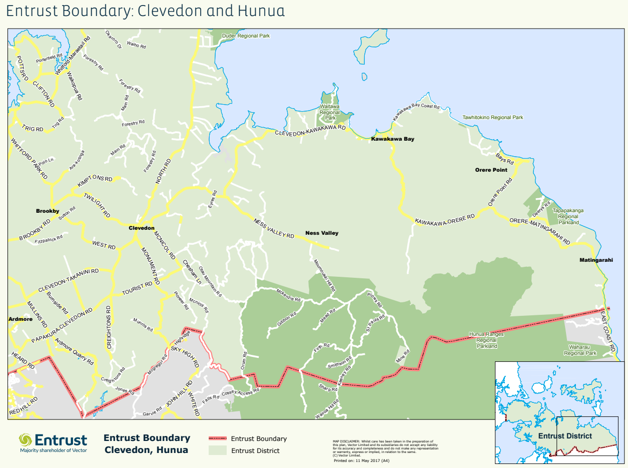
Source: www.entrustnz.co.nz/media/12194/West-Auckland.pdf

Entrust Boundary: Papakura



Source: www.entrustnz.co.nz/media/12191/Papakura.pdf

Entrust Boundary: Clevedon and Hunua



Source: www.entrustnz.co.nz/media/12188/Matingarahi.pdf

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