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30 March 1999
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Report to the Policy and Finance Committee
from Greg Schollum, Chief Financial Officer

Port Wellington – Development of Exit Strategy

1. Purpose

To fulfil the obligation made in March 1998 to report back to Council in relation to an appropriate exit strategy for sale of Council's Port Company Investment

2. Public Excluded

Grounds for the exclusion of the public under Section 48 (1) of the Local Government Official Information Act 1987 are:

> *That the public conduct of the whole or relevant part of the meeting would be likely to result in the disclosure of information for which good reasons for withholding exists, i.e. to carry on commercial activities.*

3. Background

In March 1998 the Committee considered report PE98.80 (refer **Attachment 1)** in relation to Council's future strategy for its investment in Port Wellington Ltd.

At its March 1998 meeting the Committee resolved:

> **"a)** *that the Council agree, in respect of its port company investment, it is a seller at the right price, rather than a holder at all costs,*

recognising that there are significant issues to be resolved before the Council will be in a position to sell.

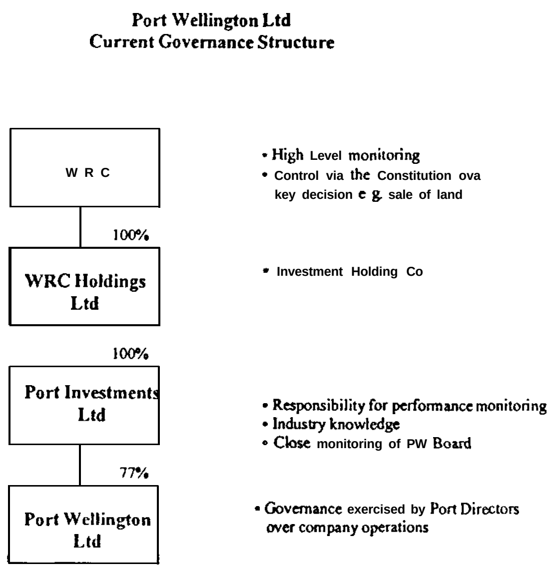
b) *that the Council's long term investment strategy in respect of Port Wellington be clearly outlined within* Facing the Future 1997-2007: 1998 Update *for the purposes of public consultation.*

c) *that officers be instructed to develop an appropriate exit strategy for sale of Council's Port Company investment to be approved by Council preferably before 31 March 1999, and which incorporates an appropriate public consultation process."*

Since March 1998 officers have been working on developing an appropriate exit strategy, with significant input from the Port Company Directors and management, and from external consultants.

The exit strategy is attached as a separate attachment **(Attachment 2).**

In addition, the Council has restructured its ownership of Port Wellington and, as a result, the current governance structure is as follows:



While the ultimate decision regarding divestment rests with the Council (via subsidiary company Constitutions), the Directors of Port Investments Ltd and WRC Holdings Ltd are now also able to provide input into the process.

The Directors have been consulted on the attached Exit Strategy and, where appropriate, their comments have been incorporated into the Strategy.

4.- Overview of Exit Strategy

The Exit Strategy relating to Council's investment in Port Wellington is contained in **Attachment 2.** Essentially it proposes that no sale be undertaken in the short to medium term as the Port Company completes and, as far as practicable, implements its Property Development Plan, the purpose of which is to separate land into that:

- required for port operations
- available for short term development
- available for long term development (alternative use)

The other prime driver in the strategy of "don't sell now" is to allow the Port Company to get some further "runs on the board" in terms of financial results so as to add credibility to the company's increasing forecast returns. This will ensure forecast cashflows are not overly discounted by potential buyers on the basis of **past** results.

In the medium to long term, given a sale price acceptable to Council, officers are recommending that the Port Operating Company including the core land necessary for port operations should be sold in order to release **capital back to** the shareholders and thereby reduce investment risk for the Council.

The views of the Chairman of the Port Company are attached as **Attachment** 3.

5. Recommendations

That the Committee recommend that the Council:

(I) Receive the report and note the contents.

(2) Reaffirm its current policy in respect of its investment in Port Wellington, that it is a seller at the right price rather than a holder at all costs.

(3) Adopt, within the context of (2), the attached exit strategy for Council's investment in Port Wellington which includes.,

(a) *In the short to medium term Council holding its investment in Port Wellington, and*

(b) *In the medium to long term Council selling its investment in the Port Operating Company, including the core operational land.*

GREG SCHOLLUM
Chief Financial Officer

Supported and Endorsed by:

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HOWARD STONE
General Manager

Attachment 1:	**Report PE98.80 Port Wellington – Investment Strategy – March 1998**
Attachment 2:	**Port Wellington - Exit Strategy (March 1999)**

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Public Excluded

Report PE98.80
12 March 1998
File: O/2/1 3/2

Report to the Policy and Finance Committee
from Howard Stone, General Manager

Port Wellington - Investment Strategy

1. Purpose

To fulfil my obligation to advise the Council on how it might develop its Long Term Strategy in respect of its investment in Port Wellington.

2. Exclusion of the Public

Grounds for exclusion of the public under section 48(1) of the Local Government Official Information Act 1987 are *that the public conduct of the whole or relevant part of the meeting would be likely to result in disclosure of information for which good reasons for withholding exists, i.e. to carry on commercial activities.*

3. Background

Councillors will recall a commitment the Council made to the community via *"Facing the Future 1997-2007"* that it would review Council's Port Company Investment Strategy prior to 30 June 1998. This decision required me to report to you by 31 March 1998, including firm recommendations on the 'hold' or 'sell' decision. This report is my delivery against that commitment.

4. Comment

The Council's Port Company Investment Strategy **has** been more influenced by significant external factors, rather than factors within the Council's control.

In presenting this report I am endcavouring to clarify the Council's current view on the 'hold' or 'sell' decision. Once this has been achieved, any move towards divestment bccomcs merely "machinery". Whilc the port company is undoubtcdly facing some difficult times at present this report should not be seen as a rcaction to thc current turmoil in the port industry.

5. Some History

On the 1st of November 1989 the Council became the owner of 76.9% of Port of Wellington Ltd. (now 'Port Wellington')

In May 199 1, the Council confirmed its policy in relation to its port company investment:

- Determination of alternative shareholding should be driven by "what is best for ultimate success of the Port" and "what is most appropriate for the role of Local Government in Port ownership".

- The most appropriate role for Local Government is one of being able to 'influence' and not necessarily 'control'.

- The port company would benefit from a wider base of shareholding especially if drawn from key Port users.

- In line with an influencing role, the Council should agree to a programme of planned divestment with the aim of achieving a position of approximately 30% shareholding.

In the long term, the Council intended, via these 1991 resolutions, to hold no less than 30% of the shares in the port company in order to exercise 'influence' rather than 'control'. An initial divestment of 25% was planned meaning Council would hold 51% in the interim. (76% - 25%)

Since 199 1 the Council has kept under review its long term strategy but a number of factors have continued to impact Council's divestment plans:

- The 1992 Local Govcrnmcnt Law Reform Bill which proposed that 50% of thc proceeds from any sale of Port shares be distributed to territorial authorities of thc region did <u>not</u> become law, but it was a sufficiently matcrial prospect to delay any divestment plans.

- Capital restructuring by Port Wellington in both 1992 and 1995 has had the effect of reducing the Council's exposure to this investment, and has gone some way to achieving the primary objective of risk reduction as shareholder.

- During the 1995 capital restructuring, convertible notes were issued to shareholders and these have since provided a flow of interest equivalent to a market interest rate, thereby further reducing the Council's exposure to solely dividend income.

- Port Wellington's integration plans were put into effect in May 1995 at which time the port company purchased Container Terminals Ltd. Since 1972 the port company's container terminal had been leased to a consortium of shipping companies under the name of Container Terminals Ltd and, prior to its acquisition in 1995, Wellington remained the only port company in the country where the container terminal was not controlled by the port company. The integration in May 1995 was a significant step for the company and enhanced its ability to increase efficiency and ultimately value for the shareholders and its customers. The company has more recently been reviewing the flexibility of its cost structure in the container terminal area to respond to variations in revenue, 'and is looking to implement labour reform as a result.

- Since 1991 Council has remained concerned with the issue of port company land. The most significant asset owned by the port company is the land which is considered by Council to be of strategic interest to the residents of the Region. Council has been keen to ensure that any divestment of shares does not result in the ownership of prime strategic land going outside the Region.

- Port Wellington has been involved in a dispute with the IRD in relation to the IRD disallowing certain deductions primarily related to depreciation claims. The company has lodged objections to these assessments.

6. The Key Question

"Is the Council a holder of Port Wellington at any price <u>or</u> is it a seller at the right price?"

In other words, are there factors other than price which would stop the Council from selling its investment on pure commercial grounds? Naturally, the pure investment considerations should always be determined on the basis of risk and return, as is normal commercial practice.

In order to answer the question of "is the **Council** a holder at any price or a seller at the right price?" I have addressed the sub questions posed within the report on Forestry Investment Strategy (Report 98.69) as I consider such a framework of questions is of equal applicability in determining the Council's Port Company Investment Strategy.

6.1 Is an investment in Port Wellington consistent with Council's core business?

It is hard to construct an argument that Council's port company investment is consistent with its core business. In fact, it could be argued that it creates a conflict with Council's regulatory roles exercised with regard to the Harbour.

The Shares in the port company were transferred to the Council in 1989 and had it not been for this, the Council would almost certainly not have actively purchased a controlling interest in the company. It is therefore more a result of history than of an active strategy associated with Council's core business that Council currently holds 76.9% of the shares in Port Wellington.

6.2 If an investment in Port Wellington is not consistent with Council's core business, are there any compelling reasons why the Council could not sell its investment?

The Council has consistently expressed its concern over the issue of future ownership of port company land. The most significant asset of the company to both the city of Wellington and the greater Region is the land. Its proximity to the city centre enhances its potential as prime commercial real estate and certainly has the potential to significantly impact the amenity values of Wellington City and its citizens. The Council, through its approval of the port company constitution has recognised the need to maintain control over the future ownership of land (land cannot be sold without shareholder approval).

If the Council still holds this view but wishes to pursue a divestment strategy then it needs to determine the best mechanism for securing the future ownership of land. It appears that such security of future ownership will be difficult to achieve unless the Council itself (or a body with similar responsibilities) retains ownership of the land. The most appropriate mechanism to achieve this may be the separation of the 'landlord' and 'operating' company functions within the Port Group of companies while ensuring tight control by the Council over the constitution of the landlord company. The Council could retain ownership of the landlord company (either jointly with Manawatu/Wanganui or solely if the minority shareholder wishes to exit its interests), which would lease the land to the operating company. This would enable the Council to divest all of its interest in the operating company and, thereby reduce its risk exposure to the Port industry, while retaining ultimate control of the land.

The Council would continue to receive dividend flows from its investment in the landlord company but with much more long term certainty than is currently the case (as dividends would rely on fixed lease rental income not port company operating profits). Such a structure would also mean that once impfcmentcd many of the benefits obtained from Council's planned restructuring of its ownership interest (from the Council to Port Investment Limited) would be retained.

Council's ownership of the landlord company would also create flexibility for future divestment to an organisation with similar interests in the future use of the prime strategic land (e.g. Wellington City Council). In itself it would create a check on the ongoing significance of the land in that, if the WCC were not concerned to purchase it in order to secure its future use, it is questionable as to whether it is important to the remainder of the Region.

In addition, the Council might also wish to consider some of the key issues facing the port company itself, as matters which must be resolved prior to Council being prepared to sell its investment. even if Council's concerns with the land had been dealt with.

- increased flexibility in labour costs.

Positive resolution of these issues will significantly enhance the future value of the company particularly in an industry which is putting increasing pressure on the revenue line of all companies. They are therefore key issues to resolve as part of the Council's exit strategy, but are not of themselves reasons to 'hold' the investment.

6.3 Conclusion on Port Company Investment Strategy

The issues to be resolved prior to divestment are such that the Council is likely to need to retain its interest in the port company for the short to medium term. **However, in my view, there are no compelling reasons** why in the long **term the Council should not consider itself to be a seller at** the **right price rather than a holder at all costs.**

7. Recommendations

(1) That this Report be received and the contents noted.

(2) That the Committee recommend:

(a) that the Council agree, in respect of its port company investment, it is a seller at the right price, rather than a holder at all costs, recognising

that there are significant issues to be resolved before the Council will be in a position to sell.

(b) *that the Council's Long Term Investment Strategy in respect of Port Wellington be clearly outlined within Facing the Future 1998-2007* **for** *the purposes of public consultation.*

(c) *that officers be instructed to develop an appropriate exit strategy for sale of Council's port company investment to be approved by Council preferably before 31 March 1999, and which incorporates an appropriafe public consultation process.*

HOWARD STONE
General Manager

Supported and Endorsed by:

GREG **SCHOLLUM**
Chief Financial Officer

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Port Company

Exit Strategy

Port Company
Exit Strategy

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Appendices

1 .0 Introduction

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1.1 The Context of fhe Exit Strategy

In March 1998 the Council decided that in respect of its Port Company investment *"it should be a seller at the right price, rather than a holder at all costs, recognising'that there are significant issues to be resolved before the Council will be in a position to sell."*

The Council requested that officers prepare an appropriate exit strategy for Council's investment in Port Wellington which would address the various issues involved.

An investment in Port Wellington could be said to reflect the normal commercial risks and returns of ownership. However, given the nature of the Council, as majority shareholder, the Exit Strategy needs to take into account issues other than the pure investment risks and returns. For instance, a key concern of Council, and one which is explored extensively in this document, is the fact that the Port sits on prime commercial land with high amenity value. As a consequence, it is fair to say that the Council has mixed objectives.

This document explores the associated issues and recommends both a short to medium term, and a long term, strategy in relation to Council's investment in Port Wellington.

1.2 Whaf is an Exit Strategy?

An Exit Strategy is neither a decision to sell nor a decision not to sell. It is merely a step, albeit an important one, in the process. The Port Exit Strategy is primarily focussed on establishing the principles to enable the Council to progress towards any ultimate sale. As such, it is more to do with "what might be for sale and when?' and "what should Council do in the meantime?' rather than how the sale process should be carried out.

1.3 What is the Nature of WRC's Ownership Structure?

On 1 November 1989 the Council became the owner of 76.9% of Port Wellington.

The Council still currently owns 76.9% of Port Wellington, but since November 1998 the Council's interest has been held by its 100% owned subsidiary company, Port Investments Ltd. (see diagram below)

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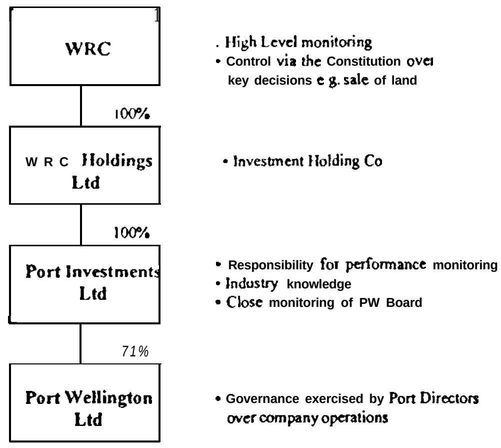
Port Wellington Ltd
Current Governance Structure



Port Investments Ltd also holds 2.634.351 convertible notes in Port Wellington which have a book value of $7.7 million

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2.0 Executive Summary

This report outlines Council's exit strategy for its key investment in Port Wellington.

The exit strategy is designed to meet Council's objectives of:

- long term risk reduction
- maximisation of any sale value
- protection of future land use

The cornerstone of the strategy is the land issue. Until the land issue can be appropriately dealt with Council will not be in a position to pursue any sale strategy.

This strategy recommends a 'hold' position in the short to medium term to allow the Port Company to further ready the operating company for any sale (including optimising the use of land based on a Property Development Plan and generating more of a track record of financial returns to support the latest financial forecasts). It also recommends a medium to long term strategy of selling the operating company <u>including that portion of current land holdinos which constitutes core operational land.</u>

Council's existing policy of "being a seller at .the right price rather than a holder at all costs" therefore remains valid. However, in the view of officers, Council is not yet in a position to sell and therefore while the policy remains in place, no sale should be undertaken in the short to medium term.

In the meantime, the Council and the company should continue to pursue the risk reduction strategies outlined in section 7.4 of this paper.

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3.0 What is a Port Company and In What Environment Does it Operate?

3.1 Raison d'etre

A port is essentially a set of infrastructural facilities for the exchange of cargo.

The reason for the existence of a port facility operator is to provide a conduit for the exchange of cargo over its wharves and in so doing, charge an economic rent in order to provide a satisfactory return on the value of the investment in infrastructure facilities to its owners, while also replacing its assets at the appropriate point of economic life cycle.

A port is a set of infrastructural facilities that provides an interface between buyers and sellers of international and domestic cargo (in a similar way as a supermarket or trade and exchange provides 'shelf space' to allow the exchange of goods to occur between buyers and sellers of products.)

Here the role of the port is to provide the secure venue and facilities to enable the efficient transfer of cargo between the buyer and seller. Ey making the range of facilities attractive and providing value, the port increases its ability to attract, develop and maintain the critical success factor of volume throughput.

Clearly, having the associated value chain facilities and infrastructure within the port precincts should have a marked impact on the decisions of shippers and shipping lines to aggregate cargo at specific ports.

A port operator by virtue of the size of the infrastructure investment enjoys a natural advantage over potential competitors. Given the size of the trade available and the level of investment required it is unlikely new ports will be developed in New Zealand in the foreseeable future.

The principal issue of too many ports and too much infrastructure in New Zealand highlights the cargo volume per port problems and the subsequent impact on efficiency and profitability of those involved in the operation of ports in the short to medium term. Until such fundamental problems are adequately resolved, the current competitive environment will dictate that only those services which require a minimal level of investment will be attractive to new entrants, and those new entrants will have the ability to make early profits and depart if the conditions make it too tough in the future. This is illustrated by the competition to the port (in its stevedoring role) from the "suit case brigade" of the new generation stevedores. The current scenario does not provide the economic environment to stimulate long term capital

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commitments required for the development of growth in cargo volumes that a committed operator would otherwise do in the interests of improving the facilities and providing regional customers with efficient services.

3.2 Port Industry Overview

In the past decade the ports sector in New Zealand has evolved from Harbour Boards to corporatised commercial entities which are charged with the responsibility of making profits. Of the 13 port companies currently operating in New Zealand, six remain 100% owned by local authorities, including Port Wellington, with the balance having majority local authority ownership. Major labour reform and ongoing operating efficiency improvements since 1989 have characterised the significant changes that have taken place within the industry during this time.

The introduction of specialised information technology systems into port management has accelerated the efficiency gains and has provided additional impetus to further shrink the labour force, with the result being lower fixed costs throughout the sector.

After the first ten years of the corporate port model, it is becoming quite apparent that while operating efficiency gains will continue to be important to users of port facilities, the major focus of long term growth and development of the port sector will be to generate sufficient operator profitability to allow for appropriate long term shareholder returns and the ongoing and timely replacement of substantial and expensive infrastructural assets and equipment required to service the business.

Currently the port sector in New Zealand is characterised by significant over capitalisation of infrastructural assets. Unfortunately, many regional ports with relatively sparse population bases are continuing to build and develop quite extensive infrastructure to compete head to head with the metropolitan ports. The metropolitan ports, on the other hand, by virtue of their substantial population bases, have been natural ports of call to the mainstream lines due to the extent of their large import demand and their natural advantages of cargo aggregation.

In recent years, we have seen the impact of the regional ports taking aggressive infrastructural initiatives to compete directly in the container cargo markets. These developments, driven seemingly through parochial pressures, have led to the overcapitalisation of the industry and caused shipping lines to contemplate additional calls to regional ports in order to chase cargo. The shipping industry itself has experienced a period of intense competition with too much capacity chasing too little cargo.

However, this trend has been changing more recently as a result of shipping line ownership changes and as shipping lines once again appreciate the cost efficiencies of less port calls and increased frequency of service to the centres of import demand where logically they can drop off import cargo and pick up aggregated export cargoes.

While this trend continues and will most likely further consolidate with favourable results to larger ports like Wellington, it is inevitable that there will be more and more **'winners and losers'** shaking out of the ports sector in the future.

It will be the direct resolve of the individual shareholders and management of each port company which will determine the long term value of their port given the economics of oversupply. However, in the short term any inaction or refusal to acknowledge the trends will further erode short term earnings of all port companies, with the possible exception of Auckland, which is likely to continue to dominate international trade.

In the meantime a material amount of economic damage to a range of Port Company shareholders is likely to occur if it comes down to survival of the fittest. Wellington, by virtue of its natural advantages, (refer to section 3.5) and availability of developed and undeveloped infrastructure, looks likely to be one of those survivors.

3.3 What are the Key Success Factors for Ports?

The key success driver for a port is the attraction and maintenance of high volume cargo exchanges with profitable margins to provide efficient and cost effective solutions to import/export customers. The profitable margins are required to provide, both reasonable return to shareholders and to fund infrastructure development and replenishment.

The import/export base of a port needs to be successfully developed in order to generate this volume requirement and the challenge for the industry inevitably is for the consolidation or amalgamation of some port service operations within New Zealand to provide the necessary increase in average throughput for sustainable long term growth and profitability.

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3.4 Trades/Services Underpinning Port Performances

It should be noted that every port has, or had, an underlying trade or service that has backstopped their performance to date, and which has provided leverage for the development of new competing businesses. The major issue of contention is whether or not this development, often necessitating substantial infrastructural expenditure, is for the sustainable long term' benefit of the respective port company shareholders and other stakeholdcrs alike.

- Wellington has its 'roll on roll off' ferry services
- Lyttelton has its West Coast coal trade
- Westgate has its gas and condensates trade
- Tauranga has its forestry/log trade
- Southport has its Tiwai Point aluminium trade
- Napier has its fruit trade
- Marlborough has its 'roll on roll off ferry services
- Nelson has its fishing fleet services
- Northland has its petroleum/oil refinery trade
- Auckland has its large import trade base servicing the majority population

It is therefore significant that only Auckland and to a lesser extent, Wellington and Lyttelton, have the real substantial immediate population bases which demand a major import cargo volume to satisfy local consumption requirements. These centres of import activity by definition, should also be the most logical centres to attract export cargoes thereby allowing shipping lines to aggregate and consolidate the numbers of port calls they necessarily need to make in New Zealand.

Currently, due to the substantial level of inter port competition, there are on offer, what are considered to be, unsustainable inducements by certain port companies to attract shipping lines to what would otherwise be very marginal port calls.

3.5 Port Wellington's Situation

Given that a number of metropolitan ports are constrained by the lack of land for development, Wellington would appear to be in an extremely advantageous position to capitalise on the need for the more specialised logistical warehousing type storage facilities such as cool/cold stores, food grade storage, processed timber storage, woodchip storage etc in order to attract and maintain long term cargo commitments. This competitive advantage, along with the city's natural harbour and berth capacity to handle large tonnage vessels without expensive maintenance dredging, provides Wellington's Port

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with the many advantages that positively distinguishes it from other ports.

Other natural advantages of Port Wellington include:

- Wellington harbour is essentially the only natural harbour between Auckland and Lyttelton.
- Wellington is still the second largest population mass within New Zealand, and therefore creates a significant import demand.
- Although Auckland has become by far the largest metropolitan centre in New Zealand, Wellington is geographically the centre of the remaining two thirds of New Zealand's population.
- While there has been the loss of some traditional industries (motor vehicle and agricultural) Wellington continues to have within its region significant processing industries which are reliant upon an efficient port.
- The current port has an excellent proximity to road and rail, and should continue to benefit from inter island aggregation opportunities.

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4.0 The WRC as a Shareholder in Port Wellington

4.1 *The Primary Considerations*

The Council is acutely aware that it is the majority shareholder in a significant strategic asset on behalf of the ratepayers of the Wellington Region.

In exercising its shareholding role in Port Wellington, the Council is primarily concerned with three perspectives:

⇒ the impact of its shareholding as a pure commercial investment from an owner's perspective. (i.e. long term impact on the rate line.)
⇒ the impact of its shareholding on the operations and strategic focus of the Port Company itself.
⇒ the impact of its shareholding in a regionally significant asset on the Regional economy.

From a purely commercial investment perspective the Council is rightly concerned with balancing risk and return considerations. In fact, it was the relative risk of the Port Company investment which led the Council to conclude in March 1998 "that it should be a seller at the right price rather than a holder at all costs". The Council decided that it would be prudent at the appropriate time to sell its investment in Port Wellington and use the proceeds to repay debt.

However, there are clearly other factors which need to be considered as part of the hold/sell decision, the largest of which is the Port Company land.

The Council has consistently been concerned with the future ownership of Port Company land. The most significant asset of the company to both the city of Wellington and the greater Region is the land. Its proximity to the city centre enhances its potential as prime commercial real estate and it certainly has the potential to significantly impact the amenity values of Wellington city and its citizens. The Council, through its approval of the Port Company Constitution, has recognised the need to maintain ultimate control over the future ownership of land (the Constitution states that the land cannot be sold without shareholder approval and since the Council became majority shareholder in 1989 no Port Company land has in fact been sold). Any sale of Council's investment in Port Wellington firstly needs to address the land issue which is dealt with extensively in section 5 of this strategy document.

The Council is also concerned to ensure that any divestment would not have a negative impact on the Regional economy.

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Lastly, for as long as the Council holds its investment, it has been mindful of the need to strike a balance between exercising prudent governance over Port Wellington, while not interfering in the day to day running of the company.

These issues are explored in more detail in the following sections.

4.2 *The Commercial Perspective as an Owner*

To assist in this evaluation officers engaged PricewaterhouseCoopers to undertake a review of Council's investment in Port Wellington (see **Appendix I).**

The PricewaterhouseCoopers review was designed to assess the past performance and future prospects of Port Wellington as a strategic investment, from a purely commercial perspective.

The intention of officers in commissioning this piece of work was to dispassionately stand back and assess the Port Company as a commercial investment on the basis of the returns it has generated (and is forecast to generate) against the risks of an investment of ratepayers' money in the ports industry (and in Port Wellington in particular).

The PricewaterhouseCoopers report indicates that the past performance of the port investment appears to have been satisfactory but when the risk of investment is factored in, the Council has not been receiving sufficient returns given the risks involved. Using an Economic Value Added (EVA) approach the PricewaterhouseCoopers report demonstrates that the company has consistently not generated sufficient returns for shareholders, given the risks involved.

However, looking forward the prospects are considerably brighter as the company now looks better positioned to prosper in a difficult and very competitive environment.

The analysis undertaken by PricewaterhouseCoopers clearly shows that the past performance is unlikely to be a good indicator of future performance based on the company's latest forecasts.

The company's projected earnings indicate growing profitability which will enhance both dividend flows and shareholder value. (The 1998199 YTD results provide good evidence of the robustness of future forecasts.)

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4.3 *The impact on the Company- The Company's Perspective*

By definition, under its Statement of Corporate Intent, the Port Company's primary objectives, as agreed with its shareholders, are as follows:

- To operate as a successful business.
- To operate as a functional commercial port to service the port's customers.
- To provide a commercial return to shareholders and to protect the investment of shareholders.

The Port Company perspective on the impact of WRC's shareholding is as follows:

- Positive Impacts on Port Wellington of WRC's Ownership

  The linkage with the Wellington Regional Council as 'majority owner' of the company has undoubtedly had a positive impact on the borrowing capacity of the port. This capacity also correctly*: reflects the substantial asset base of the port company. 3

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As an example, using the combined strength of the company's balance sheet and Council's 76.9% ownership of its shares, the company's financing arrangements to facilitate the return of capital programme in June 1995 were completed on terms and conditions that were highly satisfactory to the company. In fact, the combined strength referred to above resulted in the achievement of substantial funding lines at extremely competitive rates on an unsecured basis, and without the need for shareholder warranties. It is accepted that any change of majority ownership or a substantial diminution of asset walues of the company would result in a negative impact of the terms and conditions of the funding facilities which the company could obtain. (N.B. This would have the opposite effect in the Council where a sale is likely to impact positively on Council's credit rating.)

- Neutral Impacts on Port Wellington of WRC's Ownership

  The regional councils making up the shareholding of Port Wellington have consistently exercised a commercial approach to the review of the Company's performance in accordance with&e Statement of Corporate Intent each year. This approach has relied on a recurring expectation of satisfactory and reasonable returns on equity and assets (albeit on the basis of historic cost terms). It is only with recent developments and the use of value , based accounting measures that a wider appreciation of shareholder value has come under review.

- Negative Impacts on Port Wellington of WRC's Ownership

  The port business is not a core activity for the shareholder and as the ownership of the company was vested to it, the shareholder has tended to take a <u>passive watching brief</u> over the business as the company continued to have a reasonable dividend distribution policy and continued to contribute to provide the level of rates relief expected.

  Port Wellington Ltd is still perceived to be a local authority organisation by the public and significantly, by a large part of its customer base. It still has not clearly shaken off that belief because of its ownership by the regional councils.

The shareholder is typically identified as being risk averse and not in the business of taking operating risks associated with the management of a commercial port. As a local authority it does not directly add value to the operations of the business and its shareholder returns. contributing to the Council's rates line are vulnerable to the volatility of business factors in what is a highly competitive industry sector. The Port Company notes that this may have a large restraining effect on the company's future propensity to incur capital expenditure and infrastructure development costs (although this hasn't been the case to date).

In summary, the Port Company directors are effectively saying WRC's shareholding has been relatively neutral on the Port Company itself. The negatives are more 'perceived negatives', although it is true that the Council has been reasonably passive to date in exercising its governance responsibilities. Council's recent restructuring of the ownership of Port Wellington should assist in this regard to ensure our governance approach is more than passive in the future.

4.4 *The Impact on the Regional Economy*

To assist in this evaluation officers engaged Business and Economic Research Ltd (BERL) to undertake a review of the economic impact of Council's shareholding in Port Wellington, specifically to address the question:

> *Is there any difference in the economic impact of Port Wellington on the Wellington Region between WRC being a 77% shareholder and not being a shareholder?*

Essentially BERL has concluded that WRC's ownership has not inhibited the operations of the Port nor its contribution to the Regional Economy. (i.e. WRC being a shareholder has made no difference to the Regional economy.) However, BERL note that a successful port in a competitive environment is fundamental to it continuing to contribute positively to the Regional economy in the future.

BERL believe that the strategy to benefit the Region most is one where the Port Company is able to successfully implement a competitive strategy. (i.e to beat off the competition!) BERL note that efficiency gains through competition, and indeed through the threat of competition, should provide major gains to the Region in both captive and competitive trades. The real question posed by BERL is "could a different shareholder or shareholders add strategic and synergistic

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benefits that WRC is unable to provide? The answer to this question will only be found if and when the Council proceeds with the sale.

BERL note that while WRC has been a risk averse owner of a port with mostly captive trade, it now appears that the port business is increasingly becoming competitive with margins being squeezed. BERL suggest that from a purely financial perspective it may be preferable for WRC to sell some or all of its investment and convert the proceeds into a lower risk option.

BERL also note that WRC's "hands off' approach to governance in the past, may not be appropriate as the Port Company looks forward. The future prospects indicate a far more active strategy from the shareholders may be required to ensure the Port Company remains competitive. BERL acknowledge the recent holding company restructuring will provide the Council with increased ability to exercise its governance role via the appointment of external Directors with Port industry knowledge.

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5.0 The Key Issue Of Land Ownership

5.1 *Why is the Land Important to the Council?*

In 1989 when the Harbour Board was disestablished, an arbitrary 'line in the sand' was drawn between what land would go to the Port Company (for port operational purposes), what would go to Wellington City Council (Lambton Harbour) for development of the waterfront for amenity and recreation purposes, and what would be declared surplus (e.g. Blair and Allen Street properties which are progressively being disposed of).

The line was seemingly drawn on the basis of a growing port and hence the port company was certainly not short changed in terms of land. As events have transpired, the growth predicted has not eventuated and as a result the port land has exceeded the company's operational requirements, probably since inception.

The important point to note is the 'original line in the sand' was intended to delineate port operational land from other land available for development or alternative use (by parties other than the Port Company).

The key question for Council now to consider is exactly what land is important to secure?

Is it the core operational land which was always intended to be port related or is it the surplus land which has both amenity and alternative use value?

Clearly the close proximity of the port to the city centre increases both the amenity and alternative use value of the land and arguably the future development of the Northern Gateway on the back of the Regional Stadium will only enhance the land development opportunities.

As already noted the Council has long been concerned with the issue of future ownership of Port Company land, despite any indirect control that might be able to be exercised by Council through the Resource Management Act. This concern was crystallised in a Council resolution on 10 April 1997 that *"Port Wellington be advised that Council seeks to amend clause 26.4 of the proposed Constitution to explicitly exclude the sale of land without the approval of shareholders". The* Port Company Constitution now prohibits the sale of any land, without shareholder approval, and also limits the lease of land without shareholder approval, to 20% of the total assets of the company.

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The Council as shareholder is also concerned to ensure utilisation of the company's assets, including land, is maximised and in this sense the Council could be said to have mixed objectives.

5.2 The Effect of the Land on Port Performance

The Port Company's operations have a finite requirement for land at any point in time and on the basis of the current shape of the Port operations there appears to be some surplus land (over and above core operational requirements). While the retention of all land for port operational purposes has been perhaps desirable during the formative period of the Company to allow the necessary decisions to be made regarding future infrastructural port operational requirements (including the potential relocation of the ferry terminal), it is now timely to review the operational requirements for land. The Port Company is currently undertaking an exercise to identify all suboptimal land use.

The Port Company agrees that the key to the land issue is the preparation of a Property Development Plan, which will identify:

- land needed for port operating activities (core land)
- land available short term for development (optional core land/cluster land)
- land available long term for alternative development (non-core land)

Effectively the Property Development Plan will redefine the land 'footprint' required for port operations.

The Port Company is keen to ensure that all future property developments are linked into the "value chain" as far as possible, thereby providing benefits from both a landlord (rental/sale proceeds) <u>and</u> operating (business generation through the port) perspective.

While potentially some land could be freed up for development totally unrelated to the Port Company, this isn't seen by the Port Company as the <u>preferred</u> land use option.

Regrettably the Port has a roughly triangular layout with the most valuable land from a Port utilisation perspective being at each of the three points of the triangle. The most unutilised land generally speaking lies within the centre of the triangle. The comparatively inexpensive land available within the greater CBD area combined with the comparatively slow growth of Central Wellington, means that in the short to medium term there is not significant demand for alternative land utilisation .

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Notwithstanding this, the Port Company acknowledges that the further development of the Northern Gateway with the Regional Stadium nearing completion, should only impact positively upon alternative land use opportunities (i.e. on non core operational land). The future bus and coach parking associated with the Stadium is a prime example of the Port Company enhancing profitability by improving land utilisation.

A key factor which has complicated the land use debate in the past has been the potential relocation of the Tranz Rail ferry terminal. As noted in section 6.1, a decision to relocate now looks increasingly unlikely, at least in the medium term, and therefore the Port Company needs to plan increasingly on the status quo scenario in respect of current tenancies. This should greatly assist the timely finalisation of the Property Development Plan.

As noted above the Port Company intend to produce a Property Development Plan which will address the optimised utilisation of the land by ensuring co-ordinated and environmentally compatible development and which will achieve the maximum financial return opportunities. Market analysis assessments are likely to be necessary to determine the potential alternative use opportunities as part of the plan development.

There is also a need to analyse the performance of the Company's infrastructural holdings in the Seaview and Miramar areas, although the land and buildings in these locations are predominantly leased under long term contracts.

5.3 The Solution to the Land Issue

A seemingly obvious solution for the Council to pursue given its concerns with the land is to take over the ownership of the land (i.e. the Port Company sell the land to the Council). This would seem reasonable as the minority shareholder has little appetite for such land purchase, not surprisingly, given its location some 130 kilometres away.

Unfortunately there are legal impediments to such an approach which mean the land needs to remain within the Port group of companies.

On the basis of legal advice received it appears that while Port Wellington will be able to sell the land, the Council will only have statutory authority to purchase the land where the land either directly relates to, or is necessary or convenient for the performance of, a lawful function of the Wellington Regional Council.

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It is clearly questionable whether the Port land could be said to relate to particular lawful function of the Council and therefore, in the view of our legal advisers, it is likely to be considered unlawful.

Given this proposition, and the fact that the Council's policy position of being a "seller at the right price rather than a holder at all costs", if the Council is to pursue a sale of the Port Company it needs to first deal with the land issue.

5.3.1 Landlord/operating company separation

As signalled in report PE98.80, if the Council still holds the view that it wishes in the medium to long term to pursue a divestment strategy then it needs to determine the best mechanism for securing the future ownership of the Port land.

To do this the Council firstly needs to determine exactly what land it is looking to secure the future ownership of. i.e.

- Is it <u>all</u> port land, including core operational land which is likely to always be required for port purposes?

<u>Or</u>

- Is is just non core/surplus land which has a realistic potential alternative use?

- Separation of All Land

  If it is all land, the only realistic option for achieving this would appear to be to require the Port Company to

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reorganise its affairs into a "landlord" company and an "operating" company. Arguably the current company structure of the Port Wellington group lends itself nicely to such a separation.

However, this would only be a sensible strategy in the short to medium term if ultimate sale of the operating company, excluding the core operational land, was seen as a valid medium to long term risk reduction strategy.

The Port Company itself has first hand experience as 'a landlord company without control over the operating company, in the period before Container Terminals Ltd was purchased. The landlord and operator model characterised by the Container Terminals Limited example, clearly demonstrated the destiny of the port and the economic impact it has on the critical transport strategies of businesses within the Region is largely in the hands of the appointed operator.

As a consequence, Wellington's Thomdon Terminal, which was the first dedicated container facility in this country, developed 27 years ago as the era of containerisation was born, dropped from processing in excess of 85,000 TEU's in 1979 to a low of 54,000 TEU's in 1994. Port Wellington's decline during this period was largely Port Napier's gain.

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Any separation of land and ultimate sale of the operating company would also expose the landlord company to the credit risk on collection of rental income (i.e. the landlord's financial security would rest on the success of the operator and their ability to continue to pay the rental, which would be an additional fixed cost for the operator.) In other words, the Council, as a majority shareholder in the landlord company, would retain much of the risk of the Port Operating Company (albeit indirectly) without the control over its operations.

A related issue which would compound the risk for the landlord would be the reluctance of the operating company to reinvest in long term assets where it didn't have control over the core operating land.

Another concern with the full separation of land into a landlord company is that the Council is likely to achieve a very low sale price for the operating company without the land (given the need for the operating company to pay rental to the landlord for the operational land). This is unlikely to be desirable politically.

- Separation of only non core/surplus land

Given the apparent risks associated with a full separation of all land out of the port operating company (with a view to ultimate sale of the operating company) the strategy of separating only non core/surplus land requires further examination.

Under this strategy the operating company would retain ownership of the core operational land required for current and future port operations (based on the Property Development Plan referred to in section 5.2) This approach would allow the operating company to release surplus land from its balance sheet and thereby enhance its EVA returns (by reducing its capital base).

The non core/surplus land could be transferred to another company within the Port group charged with the responsibility of obtaining optimum alternative use (as by definition it is not required for Port Company operations).

Potential advantages of this approach, subject to the completion of the appropriate Property Development Plan, include:

⇒ It would promote improved focus on core operational land and clearly identify any non

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core/surplus land for the purposes of short or long term alternative use.

⇒ It would increase the focus on the property assets of the business, which are significant compared with the value of the company.

⇒ It would better facilitate the input of specialist commercial property skills at Board and/or management level.

⇒ It would encourage the Port group to dispose of any truly ‘surplus’ land, with the approval of shareholders of course.

⇒ It positions the Council to pursue the ultimate sale of the operating company (including only the core Port land) in the medium to long term if this is considered appropriate in the future.

The key issue then becomes how to protect the future use of core land if it were to be ultimately sold as part of the operating company.

(i.e. Is the Council comfortable that if ultimate sale of the operating company is to proceed, it makes sense to also sell all core operational land?)

Or put another way ‘does the continuity of future use as a port provide the comfort sought over the land issue?’

While officers have not yet explored this issue fully it is likely that the sale and purchase agreement could include a clause to the effect that the new owner could only undertake port related activities on the purchased land (i.e. it couldn’t develop part of the land for alternative use).

Further the Council could insist on an option clause being included within the sale and purchase agreement that all land declared surplus in future by the port operator be first offered to the Port property company (landlord). The Council would then have a veto over any sale of such land by the port ‘landlord’ through the company’s Constitution.

On the basis that the Council was comfortable to sell core operational land as part of the sale of the operating company, the sale process would be a ‘clean sale’ on commercial grounds. This should significantly enhance market interest in the sale.

6.0 Other Issues Affecting the Exit Strategy

6.1 *Tranz Rail Ferry Location*

For some time there has been uncertainty over the future location of the interisland ferry terminal operated by Tranz Rail.

Over the past few years the Port Company, in conjunction with Tranz Rail, has been investigating the feasibility of moving the interisland ferry terminal from its existing site to Glasgow Wharf. Essentially, despite protracted negotiations, the parties have been unable to agree on the financial terms which would see the ferry terminal moved and' there remains a significant 'gap' in funding required to make the proposition viable (even allowing for the strategic benefits which would accrue to Tranz Rail by way of reducing competition). In recent months it has become less and less likely that the Glasgow development will proceed due to the size of the funds gap and lack of a third party willing to bridge the gap.

Therefore as it is becoming increasingly unlikely that the Glasgow Wharf option will eventuate it means either the status quo or development of options north of the current ferry terminal, primarily on Tranz Rail land.

The size of the current Tranz Rail ferry fleet means that all existing ferries can be adequately accommodated within the existing facilities. However, should Tranz Rail move to purchase larger ships (as has been earlier signalled) either the existing terminal and berthing facilities would need to be upgraded or new facilities would need to be built on another site e.g. K2.

6.2 Political Environment in relation to the Port Industry

The major Port Company reforms took place with the dissolution of the Harbour Boards in 1989 and the establishment of Port Companies pursuant to the Port Companies Act.

Since 1989 there has been no significant change to the specific legislation affecting port companies. However, there is pressure from the shipping industry for further reform in response to concern from the industry that competition is weak, allowing port companies to utilise their monopolistic position. The main regulatory protection offered to port users at present is the general competition policy governed by the Commerce Act. The shipping industry is concerned that the Commerce Act on its own provides insufficient protection and the industry is understood to be seeking:

- Increased disclosure in financial reports of contestable and non contestable business (similar to Airport companies).
- Introduction of a light handed regulatory regime to monitor compliance with disclosure requirements.

It is difficult to determine the likelihood of such reform emerging in the current political environment and, if it were to, it is more difficult to determine the impact of any such increased disclosure.

The Port Company is already subject to a high level of scrutiny from its major customers and there has been considerable pressure on margins in recent years as the shipping companies have squeezed port companies to reduce prices. The Port Company certainly does not accept that there is weak competition and the squeezing of margins tends to support the Port Company's view.

In terms of other reforms which could impact on Port Company operations the proposed roading reforms "better roads, better transport" should have a positive impact on the Port Company if anything, given much of the Port Company's cargo is transported to and from the port by rail (due to the likely increases in transportation costs for road users).

As far as ownership of port companies goes, various lobby groups (e.g. NZ Business Round Table) have long been of the view that local authorities should not own port company shares as such an activity is inconsistent with the core business of local government. While the current Government may well have this view, legislative change in this area is not seen as likely in the current environment given other priorities and the current balance of power. It is interesting to note that the opposition parties appear far more comfortable with ongoing local authority ownership of regionally significant infrastructure such as port companies.

6.3 Ongoing Business Opportunities

The Port Company is continuing to pursue new business opportunities which will enhance the performance of the company. These initiatives can be broadly grouped into two categories:

- Those related to the port's value chain (i.e. those which are integrated with the port operations (such as the proposed development of a coolstore).
- Those unrelated to the port operations but which nevertheless represent opportunities to increase the Port Company's profitability.

Many of these opportunities revolve around better utilisation of the company's assets, including land. With the future development of the Northern Gateway through the Regional Stadium these opportunities should increase in future and provide the company with improved profitability. The preference of the Port Company is to maximise the opportunities which are related to the Port's operations as this creates multiple benefits for the company and its shareholders.

6.4 Future Industry Rationalisation

BERL note in their report the seemingly inevitable rationalisation of the port industry which is likely to occur in future. BERL note quite rightly that parochialism may well get in the way of some industry rationalisation based on regional synergies (i.e. "Councils' and constituents' perceptions about maintaining regional identity and dislike of domination by larger regions"). This is due to concerns over the fall out from highly visible actions required for rationalisation (e.g. closure or downgrading of facilities at some ports and diversion of trade to particular ports).

BERL also note that reduction in port capacity from rationalisation may well increase user costs (at least in the short term) and as such are likely to cause concern for the shipping industry. As a result any substantial rationalisation will be difficult to achieve.

The real question posed by BERL is what is likely to happen in the absence of industry rationalisation? (i.e. How long can the existing players keep beating each other up?). The answer probably lies in the appetite for, and ability of, shareholders to withstand below par returns (e.g. negative EVA returns)

From our perspective as majority shareholder in Port Wellington all the analysis completed suggests that Port Wellington is starting to prosper in the competitive environment and the longer the intense competition lasts the more damaging it is likely to be for Port Wellington's prime competitors. On this basis, the Council is in a relatively strong position compared with Council shareholders of competing ports e.g. Napier.

However, as majority shareholder we must expect Port Wellington to continue to improve its performance in response to the competitive environment.

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7.0 What Is An Appropriate Exit Strategy

7.7 What Should be for Sale and Why?

The most appropriate strategy designed to meet Council's objectives Of:

long term risk reduction
maximising any sale value
protection of future land use

would appear to be the ultimate sale of the operating company including core operational land. This presupposes all non core/surplus land has been first separated into a property company within the Port group.

Given the different risks involved a rational investor would expect higher returns from a Port Company investment than a bank deposit.

Therefore as pointed out by PricewaterhouseCoopers higher potential returns from a riskier investment is not a good rationale on its own for holding the riskier investment. The question that the Council must address is "is it Council's role to risk ratepayers' money long term by retaining its port investment?' assuming there are no other compelling reasons not to sell.

BERL note in their report that an alternative shareholder is likely to be able to add synergistic benefit to the Port Company that WRC cannot, and this, coupled with the risks for the ratepayer, means the Council should move to an ultimate sale of the Port Operating Company.

It is unlikely that all of the above objectives would be achieved if a sale occurs in the short term and therefore it is recommended that an immediate sale process is not considered.

Ideally, the sale of the operating company should be as 'clean' as possible with few caveats. However, areas to explore further in the meantime include caveats over future land use for port related activities.

On the basis of past decisions the Council has moved from a position where it wished to retain an "influencing" role (approximately 30% shareholding) to a position where it should be a "seller at the right price rather than a holder at all costs" (0% shareholding). Therefore any sale of the operating company should be for the entire 76.9% interest that the Council currently holds.

It is generally accepted that a controlling interest in a company carries a premium, as any alternative shareholder would normally be striving to achieve control. Therefore the Council could be foregoing some premium in sale price if it chose to sell down in tranches or if indeed it chose to only partially sell its interest.

7.2 *What would be the Impact of a Sale on the Rates Line*

PricewaterhouseCoopers have compared the indicative cashflows from continuing to hold the Port Company investment with the cashflows from sale. Using the latest available forecast information from the Port Company and the other assumptions outlined on page 40 of the PricewaterhouseCoopers report indicates that cashflows in the next five years are likely to be marginally higher from Council selling its investment (i.e. positive impact to the rate line from selling). However, due to the retention of 50% of NPAT by the Port Company (the current dividend policy) Council does not receive all the benefits of owning the Port Company in annual dividends.

When the difference in accumulated value of the respective investments in five years' time is taken into account, the "hold" strategy looks significantly more attractive as you would expect, given that the indicative cashflows are not adjusted to reflect the different risk profiles of a Port investment vs a bank deposit.

As with Council's investment in forestry, there appears to be a 'pot of gold' in the long term but this will only be the case if all the company's forecast profits are achieved and if current interest rates do not increase significantly. (An increase in interest rates is likely to reduce the Port profitability and increase the attractiveness of the sell option.)

We have undertaken some indicative sensitivity analyses to assess the different cashflow (and therefore rate line) updates by varying some key factors:

- Port Company dividend % payout
- Interest rates
- Port Company profits

- Scenario 1 – Increasing dividend payout

  If the Port Company increases its dividend payout percentage from 50% of NPAT to 60% of NPAT the forecast cashflows from holding in the next 5 years increase marginally about the forecast cashflows from selling. In effect, under this scenario more of the

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value generated by the company is passed on to shareholders each year, rather than retained within the company and only realised on ultimate sale.

- Scenario 2 – Increasing interest rates

  As interest rates are currently at historic low levels, we have looked at a scenario where interest rates increase to 8%. Increasing interest rates enhances the 'sale' option in the short – medium term (cashflows in the next five years) by increasing the returns the Council could generate from an alternate investment. In addition, the value of the company is reduced under an increasing interest scenario which reduces the expected long term benefits of holding.

Indicative Cashflow/Value Scenarios		
	Cashflows Next 5 years	**Value of Investment after 5 years**
Base case (PWC)	$1.8 m sell	$14 m hold
Increasing Dividend %	$0.8 m hold	$11.2 m hold
Increasing Interest rates	$5.0 m sell	$8.0 m hold

7.3 *How Might a Sale be Achieved?*

The options for how any ultimate sale of the operating company might be achieved include:

- Share float
- Trade sale
- Exchange of shareholding as part of industry rationalisation
- Management buy out

Further work would be required on how an ultimate sale might be achieved, but this is of little value until Council has approved the recommendations contained within this exit strategy. Given the nature of the recommendations (i.e. they do not recommend an immediate sale) officers have not yet fully explored the 'how' question.

Specialist expertise will be required if indeed the Council chooses to implement an ultimate sale strategy. Consultation with key stakeholders including the Manawatu/Wanganui Regional Council will also be undertaken as part of the implementation of the exit strategy.

7.4 *How can Risk be Reduced prior to Sale?*

For as long as the Council remains a majority shareholder in Port Wellington, there are a range of strategies available which should contribute to reduced risk for the ratepayers.

7.4.1 Strategies to be undertaken by shareholders

- Ongoing proactive governance particularly over key strategic initiatives of the company (eg development of the Property Plan).

  The Council's recent restructuring of its ownership of the Port Investment should assist in this regard.

- Ultimate control exercised through the three key planks:
  - Constitution
  - Statement of Corporate Intent (SCI)
  - Appointment of Directors

  These processes all work effectively at present and through the SCI the Council is able to monitor financial performance on an ongoing basis.

- Monitoring and, if appropriate providing proactive leadership, on the issue of industry rationalisation.

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Clearly industry rationalisation, if it is to occur, will require considerable energy and leadership from Shareholders - we must be ready to respond, and if necessary be prepared to take the lead.

7.42 Strategies to be undertaken by the Port Company

- Improved uti!isation of the asset base, including land.

  The company is continuing to pursue strategies which will improve the utilisation of existing assets. The company is aware that it is not currently utilising assets to their full potential. (e.g. container terminal only used to approx. 40% of its capacity.) Clearly the "on again, off again" Glasgow ferry relocation option has had a detrimental effect on asset utilisation.

  The company should be encouraged to continue to pursue opportunities which will result in improved land utilisation (through finalisation of a Property Development Plan) and which will result in improved profitability and/or freeing up of capital for return to shareholders.

  While any sale of land currently requires Council approval, pursuant to the Company's Constitution, the Port Company should be encouraged to look at sale or long term lease opportunities of non-core/surplus land.

- Separation of non core/surplus land into property company (landlord).

  Currently all the Port land is owned by Pox-t Wellington which is also the main port operating company.

  To assist in the better utilisation of land the Port Company should be encouraged to separate all the non core/surplus land from the operating company. This would enable a focusing on two quite different businesses with opportunities for new skills in the property area to be introduced to the land owning company.

  The port operating company would need to determine which land it required for operations (core land) with all non-core/surplus land being available for lease or sale (with Council approval) to third parties.

- Further reduce the level of capital from the shareholders.

  The existing convertible note agreement provides that $10 million convertible note debt can be either converted to

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additional share capital or redeemed back to shareholders on 28 June 1999.

In the absence of any firm need for this capital the company Directors should be encouraged to return the convertible note debt to shareholders (WRC share $7.7 million).

[N.B. this won't have a large impact on the WRC rate line as interest is already earned on convertible notes.]

- Further reduction in the percentage of fixed costs.

  The company has been successfully reducing its fixed costs, with the 1998 labour reform particularly noteworthy.

  This strategy has meant that the percentage of fixed costs to revenue has reduced which has enhanced the company's ability to withstand a negative variation in revenue.

  The company should be encouraged to further reduce the percentage of fixed costs, which will continue to reduce the risks for shareholders.

- Maximise the payout of dividends.

  The Port Company has consistently paid out in dividends 50% of each year's net profit after tax. This has allowed the company to retain some profits for reinvestment in capital expenditure. While this is an acceptable level of dividend distribution, it does result in a build up of cash within the business which is only realised on ultimate sale (assuming there are not further capital repayments). As noted in section 7.2 the analysis conducted by PricewaterhouseCoopers suggests on a purely cashflow basis the Council would be better to sell its Port investment. The prime reason for this result is that only 50% is projected to be paid out in dividends. Any increase in the dividend percentage would increase the net cashflow under the "hold" scenario.

7.5 How can Risk be Further Reduced – in the Event of Sale?

From a purely commercial perspective the issues associated with sale revolve around maximising the sale price to ensure the future projected cashflows and the value of any surplus assets are fully reflected in any sale price achieved. Currently the Port Company's assets are based on historic costs and therefore the fair value of the land is not fully

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reflected in the balance sheet. It is important that prior to any sale the real value of the company, including the land, is fairly assessed.

A future sale of any of the Council's interest in Port Wellington, whether it be a partial sale, full sale or sale of the port operating company, should be carried out with the objective of reducing risk exposure for the Council. In accordance with Council policy any sale proceeds would be applied to reduce debt which would provide a certain stream of benefits to the Council's rate line. Whether the long term benefits of sale would exceed the long term benefits of holding is difficult to determine at this time as this depends on interest rates and future Port Company returns which are in turn impacted by a range of factors. In theory, as long as Council sells for a fair price (including the value of surplus assets) it should receive full value for future projected cash flows and therefore the decision to hold or sell in net present value terms should be neutral.

More importantly what a sale achieves is certainty and whereas the Council has had to rely on uncertain returns from the Port Company, a sale (where the sale proceeds are used to repay debt) would significantly reduce uncertainty. It should also impact positively on Council's credit rating.

Clearly the risks of sale of the operating company alone without the core operational land have been well signalled but further analysis of these views would be required before Council should proceed to any ultimate sale of the Port operating company including core land. (This need not stop the separation of non core/surplus land from the current operating company within the port group in the meantime.)

A key issue which would require careful planning prior to any sale is how to maximise the value of imputation credits available within Port Wellington. On sale, if the Council sells down below 66% ownership, the stock of remaining imputation credits is lost. The normal method of extracting value presale is by way of special dividend.

Any sale process also has other risks such as the risk to the Port Company and the Region of a new owner significantly downsizing the port operations. There are unlikely to be any practical mechanisms available to totally eliminate this risk that do not have significant impacts on sale value.

Given the likely value of the operating company it is reasonable to expect that any new owner will wish the Port to continue to prosper in order to justify the purchase.

However, clearly the Council will wish to ensure if it does proceed to sell the operating company that it selects the appropriate party to sell to.

Any future sale should also closely involve the minority shareholder (Manawatu-Wanganui Regional Council), as it is possible that Council may also wish to take part in the sale process.

7.6 *What Public Consultation is Required?*

The Port Company is widely considered to be a Regionally significant asset. As such it is appropriate that any planned sale by the Council of its 76.9% ownership would be the subject of extensive public consultation.

While there are legal requirements with respect to consultation there is also the moral obligation to ensure that the Regional public is well informed of the pros and cons of any sale.

We have sought legal advice in relation to our legal obligations to consult on asset sales. The advice received is summarised below:

- Section 122k of the No 3 Act provides that every local authority shall, not less than once every three years, prepare and in accordance with the special consultative procedure set out in section 716A of the Act, adopt a long term financial strategy which will include its plans in relation to its investments.

- There is no strict legal requirement to consult in respect of Council's intentions to sell <u>prior to commencement of the sale process</u>, although it is common practice to do so.
- However, if and when the Council decided to sell, and sought expressions of interest resulting in a firm sale proposal, the receipt of such a proposal requires the Council to enter into a special consultative procedure. The legal requirements involve some public disclosure of the actual proposal but not the consideration of pros and cons of various options.

The Chairman received a letter dated 17 March 1998 from the Deputy Prime Minister and Treasurer and the Minister of Local Government outlining the Government's expectations in relation to consultation over sale of significant assets. Although there have since been changes to the composition of the Government (i.e. dissolution of the coalition which existed at the time) the joint Ministers' letter of 17 March 1998 includes some useful guidelines for consultation.

The Government expects that consultation will include:

- Giving adequate public notice of any proposal to sell significant assets;
- Providing sufficient information on the rationale for considering such sale;

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- Setting aside a sufficient period of time for detailed public submissions;
- Enabling the public to be heard in support of their submissions; and
- Genuinely considering each submission before a final decision is taken.

It is generally accepted that given the normal lead times for decisions on asset sales local authorities will be able to utilise the annual plan and associated financial management planning processes as a vehicle for seeking community input into those decisions.

As required by the Council's resolution 2(b) in report PE98.80 the Council's 1998/99 Annual Plan *(Facing the Future 1997-2007:1998 Update)* did include reference to the fact that "in respect of both forestry and the Port, the Council should be a seller at the right price rather than a holder at all costs".

While some feedback was received from the community, in both support and opposition to Council's position, there was insufficient feedback to feel confident that the community had fully taken the opportunity presented by consultation.

This suggests a far more targeted form of consultation, such as the survey associated with the Council's involvement with the Regional Stadium, may be needed to supplement the consultation associated with the release of the Council's next long term financial strategy ("Operation Emerald II").

7.7 What Should Happen Next?

The Exit Strategy should be provided to the Port Company and the minority shareholder (Manawatu-Wanganui Regional Council) with a view to agreeing the actions required by the various parties. The key first step is clearly the completion of the Property Development Plan and the subsequent separation of the land considered to be non core or surplus to operational requirements into a property company within the Port group.

The implications for management and the Board of such a separation would need to be worked through with the Port Company.

The risk reduction strategies outlined in section 7.4 should continue to be followed with a view to readying the operating company for sale at some time in the future.

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8.0 Recommendations

It is recommended that the following strategies be adopted:

8.1 Short to Medium Term Strategy

The Council should hold its investment in Port Wellington as this would have the following benefits for Council:

- It will allow the Port Company Property Development Plan to be completed and fully implemented.
- It will enable Port Wellington to separate all non core/surplus land into a property company and to increase the focus on alternative use opportunities.
- It will enable the Port Company to "get more runs on the board" in relation to increasing financial returns, thereby adding credibility to the company's improved fiscal outlook (To sell prematurely would be to risk losing a lot of the potential value enhancement).

In the meantime the risk reduction strategies outlined in section 7.4 should be followed.

No public consultation is legally required should Council adopt the above strategy, but of course Council is free to conduct pre-consultation at any time.

8.2 Medium to Long Term Strategy

The Council should continue to be a "seller at the right price rather than a holder at all costs" and should sell the Port Operating Company (excluding non core/surplus land but including core operational land).

Prior to any sale the issues identified in section 7.5 will need to be addressed along with the mechanisms of achieving ultimate sale.