Group Chief Executive's AGM speech 2018

Operating in a climate of change

Thank you, Michael,

It's a time of unprecedented change for Vector, for Auckland and for the energy sector in general. As Canadian Prime Minister Justin Trudeau recently put it, "The pace of change has never been this fast, yet it will never be this slow again."

We have the relentless growth and expansion of Auckland city. We have the rapid convergence of the energy and transport sectors as more electric vehicles are introduced onto New Zealand roads.

We have the growing connectivity of everything around us, including energy networks and distributed energy sources. We have the rising impact and evidence of climate change – most recently felt during the ferocious 'hurricane with no-name' that hit Auckland in April this year.

And most importantly, we have consumers taking charge and demanding more empowerment over how, where and when they use energy.

All these things inform our view of the energy future.

As the custodians of the energy system that delivers power to your home, we have the incentives to ensure that demand spikes can be managed, that new technologies can be encouraged, that consumers can be empowered to make their own choices, and that future generations are not burdened with unnecessary cost.

So, to achieve this aim, we must lead not follow. And that is what we have done. We have diversified and grown a portfolio of energy businesses, each at different stages of maturity.

We have introduced new energy technologies ahead of the rest of the industry. We have explored new ways of doing things, to avoid burdening consumers with the cost of old-fashioned assets that might well become obsolescent within a generation. And we have increasingly focused everything we do around what we believe is in the best long-term interests of consumers.

In the end, we know we can say that we are doing the right thing for the long-term benefit of our customers, our city, our business and our shareholders, even if that essential long-term focus may sometimes have a short-term impact on financial results.

Looking at the FY18 financials, the underlying performance was sound, however the slower than expected growth in our Technology business and additional costs, including the significant April storm related repair costs, did drag on the financial result. Revenue was up to $1,328.4 million from $1,226.7 million. Adjusted earnings before interest, tax, depreciation and amortisation (Adjusted EBITDA) were down to $470.1 million from $474.4 million in the prior period.

Capital expenditure (capex) increased 3.8% to $381.2 million. This was driven by Auckland growth, higher network replacement capital expenditure and an increase in Australian meter deployments. In terms of revenue, while revenue was up across all business areas, net profit was down to $149.8 million from $168.9 million in the prior period, primarily due to a significant increase in depreciation and amortisation in the period, arising from a growth in the asset base, the amortisation of E-Co Group, and a revision to the asset lives for some assets.

It's worth noting that there is a time lag between capital expenditure and this expenditure showing up as additional revenue because of the way we are regulated, and we would like to see greater consistency on this.

Vector has not been earning its full regulatory allowance for some time because the actual CPI has been consistently lower than the 2% assumption used by the Commerce Commission in setting our Default Price Path, and the actual energy consumption volume growth has been lower than the Commission has projected. Absent these various forecast errors, RY18 electricity revenue would have been around $28m higher.

Operationally, Auckland growth has continued, driving more than 11,000 new electricity connections, and more than 3,000 new gas connections in FY18. The city growth, and the increase in replacement spend, also meant an increase in capital investment – with capex up 16.7% in FY18. The first quarter of the FY19 year has seen that growth continue, with 1,900 new electricity connections and more than 560 new gas connections.

Gas volumes in FY18 were up across all business lines, and the new OnGas Bottle Swap plant in Papakura that can fill up to 6000 bottles a day has significantly increased our capacity.

Advanced metering growth has continued. In FY18 Vector deployed over 40k meters in Australia across five leading retailers and we see continued opportunity in that market. In New Zealand, we deployed another 85k meters, which has effectively completed the mass market deployment here.

Regarding the rest of our Technology business segment, we are pleased that E-Co Group launched HRV Solar in the residential market late last year, and we have a new CEO Colin Daly on board to take E-Co into its next phase of growth. And PowerSmart have a lot of commercial solar, battery and micro-grid projects underway in the South Pacific and New Zealand.

I'd like to offer some comments on the April 10 Storm which was one of the worst storms experienced in Auckland in decades. To put that storm into some context, the winds that hit Auckland that evening reached 215 km/h – putting it on a par with Hurricane Florence that recently hit the United States. Much of the damage was caused in a single 15-minute window, with 40% of the network impacted.

It caused widespread power outages and significant inconvenience for customers, as well as drove an additional $4 million in unexpected network costs.

During the recovery, a large amount of cost and time was incurred fixing many customer-owned service lines, which are the lines that run from the house to the grid. While these lines are not the responsibility of Vector, the scale and the ferocity of the storm and the impact it had on so many Aucklanders was such that the right thing to do was to fix as many service lines as we could, whilst also completing the larger restoration work. Otherwise, those customers would have been left to find electricians to fix their service lines which would have exacerbated the situation.

Since the storm, Vector has reviewed its storm procedures and response, has undertaken extensive engagement with a wide range of industry and Government stakeholders, and corrective actions based on lessons from the storm are well underway. These include a complete overhaul of outage management systems, processes and tools to improve the customer experience, and preliminary work with retailers to allow for access to meter information, which was one of the major challenges we faced in identifying individual faults after the April storm.

In addition, we have published a white paper outlining the different options and pros and cons for improving network resilience, and we have been working closely with Civil Defence and Council on the coordination of emergency responses during major power outages.

Our climate change modelling suggests this sort of extreme weather may well become more frequent. A big question is - how do we ensure a more resilient electricity network, which is built on assets with a life span of many decades (that in most cases predate the digital era), that can respond dynamically to these new challenges?

Today, there are a range of choices for delivering resilience solutions, including overlaying physical assets with digital technologies and network 'smarts', replacing traditional power poles with aerial bundled conductors, improving tree management processes, facilitating faster take-up of distributed energy such as solar and battery, using real time network performance data from smart meters, delivering micro-grid solutions or household or community generators, using demand response measures, or continuing to underground the network where it makes sense.

Undergrounding is not a ‘one-size fits all’ option. Vector’s network is already 55% underground and most new parts of Auckland are undergrounded as they are built. This compares well with the New Zealand average of 27%, or with other cities such as Sydney (35%) and Melbourne (40%).

But undergrounding the remainder is costly – we estimate $5 billion, nearly 2 times the current electricity asset value - and, ultimately, that cost would need to be borne by consumers.

Cost aside, undergrounding is not always the optimal solution. Repair times are substantially longer, and undergrounding cannot ensure resilience against flooding, earthquakes, volcanic eruption or even trees falling in strong winds and uprooting buried services. It raises the question, would those costs be better employed on new technologies and distributed energy solutions, such as solar, battery, and vehicle-to-home technology that uses EV’s as mobile energy sources.

More immediately, improving tree management is critical. Under the Electricity (Hazards from Trees) Regulations 2003, only a limited area around lines can be trimmed, and after the first trim, it is the responsibility of the tree owner to continue to trim. The industry has been unsuccessfully asking MBIE to review and update their tree regulation for some years now.

Newer tree regulation can help and is urgently needed, but so can consumers. Tree-owners, including households and Council’s, should be aware of their obligations and the costs that trees can impose on others through damage to networks, often because they have been planted too close to lines. We love trees, but trees that interrupt the security of your electricity supply are a problem, and we don’t think it’s fair for all consumers to bear the cost of tree damage if tree owners aren’t doing their bit. This is why we recently launched an Urban Forest initiative, where we planted more than 15,000 trees in South Auckland, and committed to planting 2 native trees for every tree we need to remove from our network from here on.

In the end, electricity resilience is all about getting the balance right on all the trade-offs and delivering the best resilience solution in the right place at the best cost to consumers.

There are also challenges in balancing safety, price, service quality, and future investment. Like other lines companies, Vector’s prices and service quality are regulated by the Commission using a price-quality path, which means Vector is required to meet certain network quality standards, relative to its own historical performance, and is limited in the amount of revenue it can earn.

One of the Commerce Commission’s quality standards is the average duration in minutes of network interruptions. The Commission found that Vector breached this quality standard in the 2015 regulatory year and in the 2016 regulatory year.

Vector has noted to the Commission the circumstances that it believes contributed to its breach of the service quality standards in 2015 and 2016. These conditions included increased storm frequency and other weather-related impacts, increases in Auckland's traffic congestion, which has slowed travel times and can prevent maintenance crews from reaching network faults in a timely fashion and Vector's decision to prioritise safety of its people by introducing a best-practice policy to avoid working on live lives wherever possible, which can lead to extended outages.

We understand the disruption these breaches have caused for some Aucklanders and we have been working hard on a range of measures to reduce the impact. However, we also believe the existing regime for quality control is out of date and no longer reflects the reality of the changed operating environment, particularly related to health & safety legislation and Auckland growth. This is why we will continue to work constructively with the Commerce Commission on the new quality standards to take effect on 1 April 2020 following the next regulatory reset process.

Looking ahead our objective remains to pay ongoing increasing dividends. But with a significant amount of our earnings being influenced by the outcome of the 2020 reset of our electricity network revenues, this is largely subject to prevailing interest rates at the time and by the expenditure allowances set by the Commission. In simple terms, this is like having money on term deposit, and having your return dependent on the interest rate at the end of the term.

In terms of this financial year, as we guided at the full-year announcement, we still expect adjusted EBITDA for FY19 between $470-$480m.

Looking even further ahead, to the next decade and beyond, Vector will need to continue its transformation and continue to show leadership on technology, sustainability and the provision of customer choice. It is certain that the industry will continue to be disrupted and the impacts of climate change will continue to be felt. Vector will need to not only stay ahead of the curve, but to continue to balance the needs of customers today with those of the next generation.

Finally, I would like to take this opportunity to acknowledge Michael, and our other departing directors James, David and Sibylle for their service to Vector.

Michael has made an enormous contribution to Vector and to Auckland over the last 17 years. He has constantly challenged us to think differently and to maintain the long-term interests of consumers in mind. He leaves behind a significant legacy of growth, innovation, and commitment to the greater good. Thank you.