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Rationale for transaction premiums to RAB value

Dear Bruce

In accordance with our initial Scope of Work dated 10 March 2014, and subsequent correspondence with you, we set out below responses and observations in relation to the Commerce Commission's (the Commission's) paper '*Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services*'[1] (The Proposed Amendments Paper). In particular you have requested that we further consider why the 75th percentile is unlikely to be driving the RAB multiples, and to respond to the Commission's analysis of our previous letter to you.

1. General observations

In determining whether the 75th percentile is the appropriate upper bound for WACC, the Commission places significant weight on Regulatory Asset Base (RAB) multiples for Powerco and Vector, the two largest electricity lines businesses in New Zealand, as if these businesses are representative of the remaining 27 electricity lines companies. The implication is that the RAB multiples implied by a recent transaction in the case of Powerco, and Vector's current implied capitalisation, suggest that the regulatory rate of return across the sector is too high.

AMP Capital acquisition and implied premium

There are a number of reasons why AMP Capital may have paid a premium to RAB for Powerco's assets which are discussed below. While these are not directly quantifiable (in the absence of AMP Capital providing commercially sensitive information), they are well known and recognised by investors and advisors as common transaction drivers. To ignore them in this case assumes that they are not a consideration in relation to these types of businesses. We consider this to be at odds with market practices and our experiences as the preeminent transaction advisor in New Zealand[2].

[1] Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services; 22 July 2014
[2] PwC has been ranked New Zealand's #1 M&A advisor by number of deals every year since 2005 (based on Thomson League Tables).

Our experience confirms that the uplift should not all be credited to an ability to derive a higher than WACC return.

AMP Capital's acquisition of Powerco is also a single transaction – to extrapolate observations from this transaction to the remaining businesses in the sector cannot be justified. In reality, it is impossible for the Commission to unpick AMP Capital's reasons for paying a premium. More recent transactions, and other market based evidence points to smaller lines businesses being valued at a discount to their RAB.

As an aside, the Commission makes reference in A10.3 of The Proposed Amendments Paper, that the RAB multiple should actually be higher than it calculates, as it does not take account of an additional $145m of financial derivative contracts, which it infers should be added to total debt. It is right for the Commission to not include these contracts – they are not debt. Approximately 50% of the $145m relates to interest rate swaps. As a result, these swaps do not '*alter the company's total debt obligations*', but rather they relate to future interest rate payments. They are a separable contractual obligation from debt, hence they are separately identified in the financial statements. Of the remaining 50% of the financial derivative balance, while a portion of this could arguably be related to the debt itself, a portion of it relates to swapping the currency of the interest payment. Therefore, it would also be incorrect to recognise these financial derivatives as debt.

Furthermore, the Commission focuses heavily on the specifics of AMP Capital's funding costs in its analysis of this transaction, and the costs of debt of Powerco. We consider that these matters need to be considered separately and have considered this in further detail later in this paper.

EDB premia

i. *Horizon*

The Commission noted that Horizon Energy Distribution Limited (Horizon) may actually trade at a discount to its RAB. Horizon has one dominant shareholder (being a consumer owned Trust) which holds over 77% of the shares. However, we would also note that the Auckland Energy Consumer Trust (AECT) (a consumer owned Trust) owns over 75% of the shares in Vector.

While the Commission does consider Horizon's multiple, and a potential discount to RAB, it places little weight on this observation due to its low share liquidity; the size of company and therefore its inefficient size; and lack of a reliable value on its unregulated businesses.

Horizon is a relatively small lines company, but excluding Vector and Powerco, there are still 27 lines companies that are operating in New Zealand (comprising approximately 60% of the RAB value for EDBs), and we consider it convenient for the Commission to dismiss this evidence of a discount, due to the size of the business.

ii. *The Lines Company*

We also note that there has been a more recent transaction involving the sale of shares in an electricity lines business, where we acted as advisor to the vendor. In this instance, King Country Electric Power Trust (KCEPT) sold its shares in The Lines Company to Waitomo Energy Services Consumer Trust in December 2013. While the amount of the transaction is confidential, using the approach adopted by the Commission in assessing the premium paid for Powerco, or the traded premium to RAB for Vector, we note that these assets were transacted at a substantial discount to RAB. It is useful to note that this

was a competitive process, with a number of parties submitting bids, including other lines companies, and their owners.

This indicates to us that there are considerations in relation to the AMP Capital/Powerco transaction (which are specific to that transaction, such as tax considerations), that are unable to be replicated more generally by investors in the New Zealand market and not representative of historical transactions, which have tended to be between other lines businesses and their owners.

iii. Transpower

As highlighted in our previous submission, we consider that there were a number of issues that need to be recognised in relation to the assessment by Northington, that Transpower was valued at a premium to its book value. While the methodology that Northington adopted for determining Transpower's WACC appeared to contain a minor error, it is appropriate for use in these circumstances. However, we raised several issues such as inconsistencies in the application of different risk free rates for WACC and revenue calculations; determination of the debt margins; the application of an asset beta that differs from that of the Commission; and the inclusion of an 'equity risk premium' in its cost of equity.

It is not clear to us why Northington applied different parameters in their calculation of WACC, compared to the parameters adopted for determining revenue in the two regulatory periods. One of the direct impacts of this approach is the differential that arises between WACC and regulated returns, and hence directly impacts on any premium to the book value of those assets.

2. Marginal investor

One of the Commission's key principles underpinning its analysis is that international investors are the marginal investors in New Zealand. It also proffers that the notion that the impact of the ownership structure for certain firms would alter prices in the markets, is inconsistent with outcomes in workably competitive markets. We agree – ownership structures should not be the focus of the Commission in its analysis.

The Commission considers that it should adopt a single model, which focuses on domestic investors when estimating suppliers' cost of equity, albeit noting that international investors are likely to be the marginal investors.

As highlighted above, while the AMP Capital transaction is a significant transaction, it is not the most recent. In fact the most recent transaction involving the sale of shares in a lines company involved a local acquiror purchasing the shares. As the advisor to the vendor, and without compromising client confidentiality, it was clear to us during the process that bidders were driven by a desire to seek efficiencies, drive growth and provide an opportunity for future consolidation.

3. Why investors might pay a premium to RAB

In this section, we reiterate why acquirers of regulated utility assets might pay in excess of the regulatory value of these assets. In addition we have considered the Commission's responses to these items raised in our letter dated 28 March 2014.

We consider that the Commission has not disproved any of the points raised in our previous letter. Rather, given that it is difficult to attribute 'evidence' to these factors due to commercial confidentiality, the Commission is sceptical as to the impact of other factors to explain RAB multiples. We note that the points raised in our earlier letter were also identified by Frontier Economics in their

report prepared for Transpower[3]. We expect that any practitioner advising on the commercial aspects of market transactions would also be privy to and support these factors.

As highlighted in our previous letter, we reiterate that there are a number of reasons why such premiums are being paid by international acquirers.

We consider these reasons and the Commission's responses to these below.

(i) Cheaper debt

As highlighted in our previous letter, wholesale interest rates in New Zealand tend to be higher than many other OECD countries, including the US and Australia. They also have higher levels of liquidity and commensurately tighter margins. Even once interest rate and currency management costs are factored in, the cost of borrowing for foreign investors (and therefore their WACC) may be lower than the cost assumed in the Commission's WACC.

We note that these benefits are more readily accessible to an international investor which is already active in those markets, and has scale and diversity of investments to source favourable funding. These debt markets are currently being accessed by some larger lines businesses in New Zealand, but are not practicably an option for smaller lines companies, due to cost, complexities and risk exposures from borrowing in foreign jurisdictions.

There is also a distinction that needs to be drawn between the costs at which an international investor can borrow (and then invest into a New Zealand based utility), and the cost at which the regulated utility itself can borrow. An international investor, actively investing in a number of jurisdictions, may be able to fund its acquisition into a New Zealand lines company at a lower cost of debt than would be available to that lines company itself. These benefits are available to that investor and not directly attributed to the cost of debt of the regulated utility.

The appropriate cost of debt to be applied in the WACC, should be that cost which is relevant in the context of the risks associated with the business. WACC can be viewed as an opportunity cost, ie the rate of return capital providers would expect to receive if they invested their funds elsewhere, in a business or asset with the same risk profile. From a cost of debt perspective, this should reflect the costs at which a debt provider would provide direct funding to a business.

How AMP Capital chooses to fund its equity investment is not directly relevant, the fundamental question is whether the benefits of borrowing internationally are able to be accessed directly by the majority of the lines companies operating in this sector.

(ii) Tax structuring

Investing in businesses in an offshore jurisdiction will involve higher levels of scrutiny and due diligence due to the difference in the financial, regulatory and tax environments. Tax structuring advice will be sought in relation to any material transaction undertaken in a different country, to reduce exposures to unwanted tax consequences, while also looking to take advantage of value adding tax opportunities. This could include for example, the double deduction of interest costs in New Zealand and the investor's own jurisdiction.

This would lead to a higher estimate of the cash flows that can be generated from the investment in the business, not a lower cost of capital.

[3] Evidence on the WACC percentile, Frontier Economics, May 2014

The Commission agrees that tax structuring could be a reason for the RAB premium on the Powerco transaction, although it appears that this is largely ignored in the final analysis. It then goes on to state, contrarily, that as a minority investor, AMP Capital would be limited in being able to realise tax advantages specific to Powerco.

This ultimately comes down to how AMP Capital is able to structure its affairs, which is specific to AMP Capital and not other investors. It is therefore not appropriate to assume that these benefits would be available to every international investor, and therefore to all marginal investors.

(iii) Investment imperative

We highlighted in our previous letter that investor funds have an imperative to invest their capital and earn an appropriate level of return on their investment. Fund managers are incentivised to invest by their fee structures, which in turn incentivises them to invest.

The Commission however states that no evidence has been offered in the case of the Powerco transaction. We note, not surprisingly, that evidence is not available as to the bidding behaviour of AMP Capital and other bidders. This information is confidential in nature and commercially sensitive as is the case in any transaction of this nature. However, this does not mean that the Commission should discount this factor as a driver in the Powerco transaction.

(iv) Investment portfolio balancing

There are a number of factors that influence an investor fund's investment decisions. In weighing up the investments it intends to make, we highlighted that funds are guided by their underlying investment philosophies and objectives. These set out the asset classes the fund is able to invest in, risk-weightings required and geographic dispersion. The imperative to meet their fund's and investors' objectives, mean that fund managers will pursue investments in particular asset classes and/or geographies. This may lead investors to pay a premium to acquire assets that meet these criteria.

The Commission infers that this is likely to lead to funds paying a discount, as they rebalance by moving money from areas which have outperformed to areas which have underperformed (and thus may be able to be bought at a discount).

The point we were highlighting, is that investment balancing may require that a fund manager, under its strategic asset allocation, allocate a specific percentage of its portfolio into a class of asset. If, for example, this required a fund to increase its holding in utilities in a specific geographic region, then this places pressure on the fund manager to identify and invest in businesses that meet these criteria. This may incentivise a fund to invest, and in doing so, pay a premium.

Again, this should not be dismissed as a potential driver in the Powerco transaction, simply because it cannot be evidentially proved.

(v) Establishing a New Zealand beachhead

Establishing a beachhead in a market provides a business an entry point for future growth. The Commission recognises that AMP Capital see Powerco as a beachhead for expansion into the electricity lines and gas pipeline sectors, however infers that it is not evident why AMP would pay a 30% plus premium to RAB to acquire its stake, unless the WACC was too generous.

Historically, we agree that there have been a limited number of recent transactions in the sector, but there are wide ranging views across the sector as to the sustainability of this model – however, the Commission is second guessing AMP Capital's view on the opportunities to consolidate and use

Powerco as a vehicle to do so, if it does not consider that there may be 'option' value associated with establishing a beachhead, and paying some premium for this option.

We acknowledge that this may not be the sole reason for AMP Capital paying a premium, but we are of the view that it was a factor in AMP Capital's assessment of value.

(vi) Outperformance perceptions

In our letter we highlighted that historical returns in another market or jurisdiction could potentially lead investors to perceive those returns may be achieved in other jurisdictions.

The Commission is dismissive of this argument on the basis that the materiality of this driver was not evidenced. We acknowledge that the ability to provide evidence of the materiality of this would be difficult, without confirming with the acquirors of such assets the impact this had on their decision making.

However, there is strong logic to this argument, and in the absence of AMP Capital confirming that this was not considered in formulating their bid, it cannot be dismissed.

In addition, AMP Capital may have factored in that it expected that Powerco would be able to outperform efficiency targets set under the regulatory framework, therefore partially supporting its position of paying a premium to the RAB.

(vii) Accessing intangible assets

The regulatory asset base of a regulated utility will not necessarily capture all of a business' assets. Intangible assets owned by a business can include intellectual property, technical expertise and experience, and internally developed systems, processes and software. In our previous letter we provided evidence of recent transactions in New Zealand where this has been a driver in other sectors, particularly in relation to technical knowledge and how this could be leveraged into other markets.

On a basis consistent with our previous points, the Commission comments that there is a lack of evidence as to the value of Powerco's unregulated businesses, their growth prospects, or the value of intangible assets.

Again, we highlight that this factor shouldn't be dismissed outright. The point being made is that that there are a number of reasons that may have contributed to AMP Capital paying a premium in this instance.

Summary

The Commission places significant weight on AMP Capital's acquisition of 42% of Powerco, and the premium to RAB inferred by that acquisition, to suggest that the regulatory rate of return across the sector is too high, and the 75th percentile should therefore be reduced.

This letter identifies a number of reasons why AMP Capital may have paid a premium, which may well be specific to its investment only, and therefore should not be applied more broadly across the sector. More recent transactions, as well as the implied value from one of the listed lines companies, indicate that these assets have been transacting, or may be valued by the market, at amounts lower than RAB. Other supporting evidence provided by the Commission, is also dependent on work undertaken by third party valuers (in the case of Transpower), that appear to have inconsistencies in their calculations.

We have reiterated that there are a number of other reasons why an investor may pay an amount higher than RAB that are unrelated to having a lower cost of capital. While it is difficult to quantity that these specific considerations were a factor in AMP Capital's acquisition of Powerco (due to commercial sensitivity), we do not consider it appropriate for the Commission to dismiss these arguments on the basis of limited evidence.

Yours sincerely

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Appendix: Restrictions

This report has been prepared for Vector Limited to provide our opinion on the rationale for investors paying a premium to the RAB value of New Zealand electricity distribution businesses. This report has been prepared solely for this purpose and should not be relied upon for any other purpose. We accept no liability to any party should it used for any purpose other than that for which it was prepared.

We understand that this report will be submitted to the Commerce Commission who will publish it on their website.

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The statements and opinions expressed in this report are based on information available as at the date of the report.

We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report, was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in our Scope of Work dated 10 March 2014.