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Mr. Peter Fredricson
Chief Financial Officer
Vector Limited
PO Box 99882
Newmarket
AUCKLAND

2 March 2004

**Report on Agreed Procedures in respect of gas information prepared pursuant to
Commerce Commission Notice**

Dear Sir

In accordance with your request, we have performed agreed procedures on the gas business information prepared by Vector Limited in response to the Commerce Commission's Notice issued pursuant to S70E of the Commerce Act 1986 on 11 December 2003 ("the Notice").

The information on which we have performed our procedures comprises:

- summary Statement of Financial Performance for the years ending 31 December 2000 - 2008, prepared for the Vector Limited gas business on a stand alone basis using the template supplied by the Commerce Commission, together with supporting calculations
- accompanying narrative detailing the assumptions and allocation bases used in preparing the summary gas Statement of Financial Performance.

This report details the results of our procedures.

Terms of reference

The procedures undertaken by PricewaterhouseCoopers are set out below. These procedures are the same as those set out in our engagement letter dated 2 March 2004.

Vector Limited
2 March 2004

Procedures undertaken

1. Discuss with management the assumptions relating to the allocation of items to the gas business, which have been applied in preparing the information.
2. Based on the results of procedure (1), comment on whether the allocation methodology is consistent with the principles of Avoidable Cost Allocation Methodology (ACAM) set out in the Electricity Information Disclosure Handbook.
3. Read the narrative relating to the methodology and assumptions used in preparing the summary Statement of Financial Performance, and ensure it is consistent with our understanding of the approach used, based on our discussions with management.
4. Communication of results to management.

Our work was based primarily on discussions with and information supplied by management and was performed on the basis that such information is accurate and complete. We have not subjected the information to audit, review, checking or verification procedures.

We emphasise that the responsibility for the preparation of the information rests with management.

Results of procedures undertaken

1. Vector has applied the following hierarchy in respect of allocating revenue and expense components to the gas business:
 - Identification of cost centres which are directly attributable to the gas business
 - Where direct allocation is not possible, such as in the case of shared operating expenses, allocations have been determined based on management's assessment of the non-avoidable components of the relevant cost centres.

This approach is consistent with ACAM Principle II set out in paragraph 2.3.1(b) of the Electricity Information Disclosure Handbook (the Handbook).

Vector Limited
2 March 2004

Management has undertaken an individual cost centre review of shared operating expenses, including discussions with cost centre managers to determine the unavoidable level of resourcing and costs required for the stand alone gas business. The nature of expenditure in each cost centre has been considered in determining the appropriate allocation drivers. The principal methods of allocation have been explained in the narrative information submitted to the Commerce Commission.

We believe the process described above is appropriate. Management's rationale given for the selection of allocation drivers appears to be supportable.

We make the following specific comments in relation to the basis of calculation of interest expense, which is a significant component of the summary Statements of Financial Performance.

Interest expense has been calculated based on the assumption that 33% of the gas business is equity funded. This assumption reflects Vector Group's actual equity ratio. While determining an appropriate debt:equity ratio is outside the scope of our procedures, we note that the guidance provided by the Handbook allows for considerable variation in the method of allocation of debt and equity, with a consequent impact on interest expense. Paragraph 2.5.3 of the Handbook states:

“The line owner should consider the hypothetical question – what would the company's debt:equity ratio be if it only operated the Line business, with no Other business. The allocation must reflect the commercial reality of that Line business...”

Management's approach is consistent with this guidance. We note that it is possible that the Commerce Commission will remove interest expense from any rate of return calculations.

2. Based on the results of procedure (1) above, we consider that the allocation approach used in the preparation of the information is consistent with the ACAM principles set out in the Handbook.
3. We have read the narrative relating to the methodology and assumptions used in preparing the summary Statement of Financial Performance and have provided input into its content. The details are consistent with our understanding obtained during the course of our procedures.

Vector Limited
2 March 2004

Other observations

During the course of our work we noted the additional following matters which we draw to your attention.

- The summary Statements of Financial Performance have been prepared on the basis that there is no change in New Zealand generally accepted accounting practice over the period of the forecast. This assumption is stated in the accompanying narrative information. We understand Vector intends to adopt International Financial Reporting Standards (IFRS) in 2006. The impact of the adoption of IFRS, which will include non-amortisation of goodwill and changes in the basis of calculation of the tax expense, has been ignored for the purposes of preparing the forecast information

We attach as an appendix the information on which we have performed our procedures.

Distribution of our advice

Any opinions, reports and any oral advice that we provide will be given to the management and Board of Directors of the Company as our client for the purposes set out in this letter and we shall accept no liability to any other party. Accordingly you may not provide copies of any opinions, reports or convey our advice orally or otherwise to any other party without our prior written consent.

Limitation of liability

We will use reasonable skill and care in the provision of the services set out in this letter. However, in the unlikely event that we fail to do so, the liability of PricewaterhouseCoopers, its partners and staff will in no circumstance exceed five times the assignment fee paid.

The limitation of liability extends to both the engagement contained in this letter and any variation to it, and to claims arising from breach of contract, negligence or in any way.

Vector Limited
2 March 2004

General

Please contact Pip Cameron on (09) 355 8253 should you wish to discuss the matters addressed in this letter.

Yours faithfully



Graeme Pinfold
Partner
Assurance

Copy: Richard Sharp - Vector Limited
Peter McAuley - Vector Limited

APPENDIX

Information required from <<Company>> under Section 70E Not 9 months 12 months 12 months
 33% equity injected at start 2000 2001 2002

Nominated balance date is 31 December

Revenues and expenses

	2000 31-Dec-00	2001 31-Dec-01	2002 31-Dec-02	2003 31-Dec-03 Actuals	2004 31-Dec-04 Forecast	2005 31-Dec-05 Forecast	2006 31-Dec-06 Forecast	2007 31-Dec-07 Forecast	2008 31-Dec-08 Forecast
Revenue (\$000)	29,057	37,099	44,478	43,945	44,329	45,531	47,483	49,571	51,818
Price per GJ (\$)	3.50	3.41	3.86	3.80	3.82	3.85	3.94	4.03	4.14
Gas conveyed (GJs)	8,306,041	10,872,396	11,535,341	11,554,771	11,613,084	11,832,994	12,058,501	12,290,838	12,520,511
Operating expenses (excluding tax, depreciation and interest)(\$000)	14,804	14,473	18,459	17,059	17,447	17,752	18,093	18,446	18,859
Maintenance	2,936	1,984	2,454	2,769	2,833	2,802	2,760	2,743	2,882
Other direct costs	314	672	3,920	1,931	1,975	2,024	2,113	2,183	2,150
Employee Related Expenses	5,546	5,672	5,801	5,933	6,067	6,205	6,346	6,490	6,637
Accommodation costs	970	992	1,014	1,037	1,061	1,085	1,109	1,135	1,160
Professional fees	1,182	1,209	1,236	1,264	1,293	1,323	1,353	1,383	1,415
Computer Costs	1,057	1,081	1,106	1,131	1,157	1,183	1,210	1,237	1,265
Advertising & Promotion	1,362	1,393	1,425	1,457	1,490	1,524	1,559	1,594	1,630
Administration expenses	1,436	1,469	1,502	1,537	1,571	1,607	1,644	1,681	1,719
Interest expense (\$000)	16,528	17,195	16,435	17,310	17,856	17,500	16,732	15,744	15,170
Tax expense (\$000)	3,315	1,347	1,531	1,985	2,106	2,348	2,956	3,687	4,314

The basis for apportioning common operating expenses across activities.

Vector has applied the avoidable cost allocation methodology (ACAM), as described in the Electricity Information Disclosure Handbook (30 June 2000), to apportion the revenues, expenses and assets of Vector to the stand-alone gas business.

The approach Vector has taken under this methodology is as follows:

- Revenues and costs solely related to the gas distribution business are captured in separate cost centres within Vector's financial records. These cost centres have been allocated in full to the stand-alone gas business, including line revenue, customer contribution revenue, network maintenance expenditure and gas channel partner expenditure.
- Where practicable some individual cost items (insurance and some professional fees) have been reviewed at the invoice level to determine the most appropriate cost allocation between gas and the other businesses.
- Common operating expenses have been allocated on the basis that all cost centres not directly allocated to a business line have been reviewed in consultation with the cost centre manager, to determine the appropriate staffing levels and the most appropriate allocator, according to the cost centre function and cost type.
- One-off expenditure items related to the integration of UnitedNetworks into Vector have been excluded.

The results have been presented on the basis that there is no change to NZ GAAP over the forecast period.

The current year forecast for Vector to June 2004 has been used as a base for both directly allocated costs and for cost apportionment of common expenses. The base has been adjusted using a weighted-average of the Producer Price Index (PPI) and Labour Cost Index (LCI) to derive the forecast and historical results for financial years each side of the base year (which is presented as the 2003 calendar year).

The index trends (for historical and forecast purposes) were calculated using the annual average change over the last 5 years (being a length of time consistent with the historical and forecast information reported by Vector) in order to smooth out annual fluctuations. This approach of using a historical trend to forecast a future trend in the indices was used as there are no publicly available projections of all relevant indices for the forecast period. As noted elsewhere in this response, for consistency, a 5-year historical average was also used for forecast price increases (where the CPI and PPI are used).

The blend of the LCI and PPI was used, as this is the cost escalator (including with respect to the weightings) used in Vector's contracts with its service providers, including zone-based contractors.

Allocation and forecast methodology specific to major expense categories is as follows:

- Maintenance expenditure is directly allocated in Vector's financial records to a gas-specific cost centre. Therefore actual expenditure has been used for historical purposes and the forecast is based on the new contract that has been negotiated with the service provider.
- Other direct costs (channel partner payments) are directly allocated in Vector's financial records to a gas-specific cost centre. Therefore actual expenditure has been used for historical purposes and the forecast based on

an average unit rate per new connection applied to the increase in connection numbers.

Common operating expenses have been allocated using the following principal allocators by cost type:

- Employee related expenses and administration expenses have been allocated on the basis of the staffing levels required for the stand-alone gas business as a proportion of the current staffing levels (for each individual cost centre).
- Accommodation costs have been allocated on the basis of the square meterage of floor space required for a stand-alone gas business relative to the total meterage of the current building occupied by Vector.
- Professional fees have been allocated on the allocator most appropriate to each cost centre. The most common allocator used is total gas ICPs as a proportion of total ICPs (gas plus electricity).
- Computer costs have been allocated on the basis of gas staff numbers as a proportion of total Vector staff numbers, reflecting expected system usage and typical scaling of support fees to numbers of users.
- Advertising and promotions expenditure has been allocated on the basis of total gas ICPs as a proportion of total ICPs (gas plus electricity).

Interest and Taxation

- Interest expenses have been calculated using the average actual and projected interest rates on borrowings by Vector, applied to the total funds employed in the gas business, after deducting a notional equity of 33% (which is representative of Vector's current level of equity). The funds employed have been adjusted each year for projected cashflows including inflows from earnings and outflows on capital expenditure, interest and dividends.
- Taxation has been calculated at 33% for each year on the net profit before tax after adjusting for permanent differences (which is consistent with Vector's current taxation calculation). The taxation charge includes a deduction for interest, the effect of which needs to be reversed when calculating a return on investment consistent with that required under the Electricity Disclosure Regulations 1999.

Basis for apportioning non-system assets

Non-system assets identifiable in the Vector fixed asset register as being gas specific have been directly allocated to the stand-alone gas business.

Common assets have been allocated to the stand-alone gas business on the basis of:

- Personal computers – standard cost per person for both hardware and software based on Vector average cost per person.
- Computer Hardware – based on a direct estimate by IT Managers of the number of servers and items of office equipment, relative to the staffing levels and business requirements of a standalone gas business.

- Computer Software – billing system based on gas revenue as a proportion of total Vector revenue billed, other software based on total gas staff numbers as a proportion of total Vector staff numbers.
- Furniture & fittings – based on standard cost per employee for the current premises occupied by Vector applied to the staff numbers applicable to the gas business.