

# Report on Cost of Debt of Transpower NZ Limited

February 2006



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# Executive Summary

## PURPOSE OF REPORT

First NZ Capital has been asked by Transpower New Zealand Ltd (“Transpower”) to provide an assessment of the potential impact of a declaration of control by the New Zealand Commerce Commission on Transpower’s cost of debt and its ability to access debt markets in the future (the “Report”).

The Report is subject to the disclaimer and limitations set out on page 3 of this document.

## CREDIT RATING ANALYSIS

We have analysed a range of scenarios presented by Transpower to estimate the likely impact of potential revenue cuts caused by a declaration of control on Transpower’s credit rating. Based on this analysis of the scenarios provided we believe that Transpower could receive a material downgrade from the relevant credit agencies if the revenue cuts modelled in these scenarios are imposed on Transpower. We summarise these scenarios and estimated ratings bands in the table below.

Scenario	Estimated Rating	Key Parameters
Scenario 1	AA range	<ul style="list-style-type: none"><li>• Transpower base case using existing forecasts (“counter-factual” case)</li></ul>
Scenario 2	A range	<ul style="list-style-type: none"><li>• Transpower base case with forecast revenues cut by 10% each year (non-cumulative)</li></ul>
Scenario 3	A range	<ul style="list-style-type: none"><li>• Transpower base case with forecast revenues cut by 20% each year (non-cumulative)</li></ul>
Scenario 4	BBB range	<ul style="list-style-type: none"><li>• Transpower base case with forecast revenues cut by 30% each year (non-cumulative)</li></ul>

## COST OF DEBT IMPLICATIONS

Based on the credit ratio analysis summarised above we have estimated the impact on Transpower’s cost of debt and ability to access debt markets under each scenario. We have also briefly examined the potential impact under a theoretical scenario where Transpower’s credit rating falls below investment grade (e.g. to a ‘BB’ rating).

A fall in Transpower’s credit rating will have a direct impact on the cost of raising debt in both domestic and offshore markets. In addition, there are likely to be a number of less quantifiable, but potentially significant, effects on Transpower’s ability to access debt markets, particularly if Transpower’s rating fell into the ‘BBB’ rating band or below.

The following table summarises the results of our quantitative analysis on the impact on Transpower’s cost of debt under the scenarios provided, with these estimates based on our analysis of the domestic debt market and discussions with Credit Suisse Group (“Credit Suisse”) in respect of offshore debt markets.

Credit Rating Band	'AA'	'A'	'BBB'	'BB'
Scenarios	1	2 & 3	4	n/a
Optimal Cost of Debt (bps over BKBM)	+ 22 bps area	+ 44 bps area	+ 77 bps area	+175 bps minimum
Incremental Increase over 'AA' Rating	n/a	+ 22 bps area	+ 55 bps area	+ ~150 bps minimum
Markets Open	All	All, with some limitations on volume	New Zealand Euro US Private	US High-Yield New Zealand

Below we outline a number of other impacts of a potential fall in Transpower's credit rating which, while unlikely to affect Transpower's cost of debt explicitly, could also have a detrimental effect on Transpower's ability to access debt markets. We note however, that the impact of the majority of these potential issues is likely to be significantly more pronounced at a 'BBB' or non-investment grade rating than at an 'A' rating or above.

- Transpower's ability to access all debt markets will be reduced, increasing Transpower's exposure to market conditions in specific debt markets. Markets which are accessible to lower rated companies are vulnerable to changes in market conditions and sentiment, making fund raising less reliable;
- Transpower's reputation with existing lenders is likely to be harmed;
- Transpower's relationships with contractual counterparties, suppliers and credit agencies could be affected with increased scrutiny placed on negotiations with Transpower;
- The level of management time and resource required to manage Transpower's financial position may increase;
- The credit margin required on swap transactions is likely to increase marginally and break clauses may be required by counterparties to these transactions; and
- Transpower will be required to post collateral as part of its cross-border lease agreements, and Transpower's ability to enter into further such agreements may be reduced.

Overall, we believe that the potential impact of a declaration of control as modelled by the revenue cuts in Scenarios 2 and 3 of 10% and 20%, respectively, is unlikely to have a major impact on Transpower's ability to access debt markets over and above the increased cost of debt margins estimated. We note however, that under Scenario 3, Transpower's credit rating is likely to be close to falling into the 'BBB' rating range which would have an increased impact on Transpower's ability to access debt markets.

However, under Scenario 4, with revenue cuts of 30%, and under other potentially more restrictive controls, the cost of debt to Transpower is likely to increase significantly, both in a quantitative sense (e.g. increased margin required to issue) and in a qualitative sense (e.g. reduced access to markets). In particular we note that if Transpower was downgraded to a 'BBB-' rating then investors are likely to be increasingly cautious about providing funds to Transpower, with both pricing and accessibility of debt markets likely to start to approach those of a non-investment grade rating.

# 1 Introduction

## 1.1 PURPOSE OF REPORT

First NZ Capital has been asked by Transpower New Zealand Ltd (“Transpower”) to provide an assessment of the potential impact of a declaration of control by the New Zealand Commerce Commission on Transpower’s cost of debt and its ability to access debt markets in the future (the “Report”).

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## 1.2 KEY ASSUMPTIONS

The Report is split into two sections: analysis of the potential impact of a declaration of control on Transpower’s credit rating and the application of this analysis to Transpower’s ability to raise debt and the associated cost.

The credit rating analysis is based on financial forecasts for Transpower under a range of potential scenarios provided by Transpower Management that show cuts in Transpower’s revenue caused by a declaration of control. We highlight the following key assumptions underlying these financial forecasts:

- Capital expenditure is assumed to be constant across all scenarios.
- Transpower interest rates are assumed to be constant across all scenarios. The Report demonstrates that a reduction in credit rating under some scenarios is likely, which will in turn increase the cost of debt to Transpower. This is likely to further exacerbate the negative impact of some of the assumed price controls on Transpower’s cost of debt (i.e. there will be a second-order impact on the credit ratios). Following discussions with Transpower Management we have focused solely on the initial impact of the revenue cuts.
- We have used the scenarios exactly as provided by Transpower Management in conducting the analysis contained in the Report. In particular, we have not attempted to verify the financial forecasts outlined in the respective scenarios for accuracy or likelihood of occurrence. We note that the potential form that a declaration of control could take is highly variable, with the scenarios used representing a subset of the potential outcomes.

## 2 Credit Rating Analysis

### 2.1 METHODOLOGY

As outlined in the introduction, we have based our credit rating analysis on the financial forecasts provided by Transpower Management. These forecasts are represented by Transpower's base case assumptions and three alternative scenarios reflecting differing revenue profiles. We outline these scenarios further in Section 2.2.

We have then used the ratios provided in the financial forecasts and our own calculations to calculate the following key credit ratios as used by ratings agencies (e.g. Standard & Poor's) for each scenario:

- Free Funds from Operations / Interest Expense (**FFO / Interest**)
- Total Debt / Total Debt plus Total Book Equity (**Total Debt / Capital**)
- Free Funds from Operations / Total Debt (**FFO / Total Debt**)
- Earnings Before Tax / Interest Expense (**Pretax Interest Coverage**)

These credit ratios are then tested against the credit rating bands for transmission utility companies to estimate the potential credit rating impact of each scenario. Finally we consider other qualitative factors that may influence the way the rating agencies view Transpower's credit rating in conjunction with these results.

### 2.2 REVENUE SCENARIOS

The key aspects of the four scenarios provided by Transpower Management are outlined below. These consist of Transpower's base "counter-factual" case (Scenario 1) and three scenarios with differing revenue profiles (Scenarios 2, 3 and 4).

We have not sought to modify or comment on the revenue profiles used in these scenarios but note that there is considerable uncertainty as to what the revenue impact of any declaration of control that could be imposed on Transpower would be. As a result we also briefly consider the theoretical impact of tighter regulatory constraints resulting in further declines in Transpower's credit rating in Section 3.

#### *Scenario 1*

- Transpower base case using existing forecasts

#### *Scenario 2*

- Based on Scenario 1 forecasts with revenues reduced by 10% in each forecast year (i.e. the forecast revenue in each forecast year is 90% of the forecast revenue in the equivalent year under Scenario 1).

#### *Scenario 3*

- Based on Scenario 1 forecasts with revenues reduced by 20% in each forecast year (i.e. the forecast revenue in each forecast year is 80% of the forecast revenue in the equivalent year under Scenario 1).

#### *Scenario 4*

- Based on Scenario 1 forecasts with revenues reduced by 30% in each forecast year (i.e. the forecast revenue in each forecast year is 70% of the forecast revenue in the equivalent year under Scenario 1).

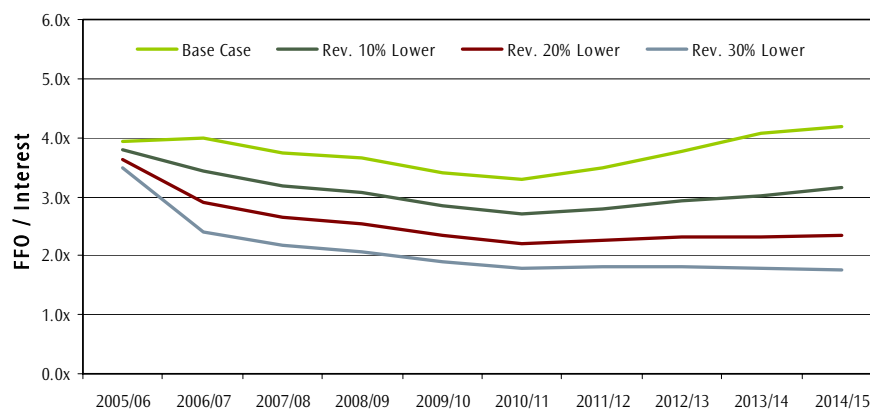
### 2.3 KEY CREDIT RATIOS

The following series of charts graphically illustrates the key credit ratios for each scenario based on the specific financial forecasts. We comment briefly on the relevance of each ratio and summarise the results below.

### FFO / Interest

Net income from continuing operations plus depreciation, amortisation, deferred income taxes, other non-cash items and gross interest; divided by gross interest.

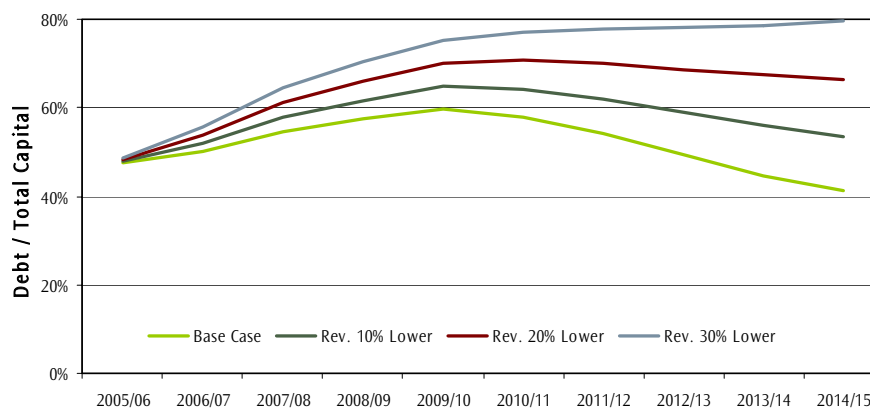
This ratio provides a measure of the company's ability to meet its obligations over and above interest, capital expenditure, increased working capital and debt repayment from the cash flow generated from ongoing operations.



### Debt / Total Capital

Total debt; divided by total debt plus shareholders' equity.

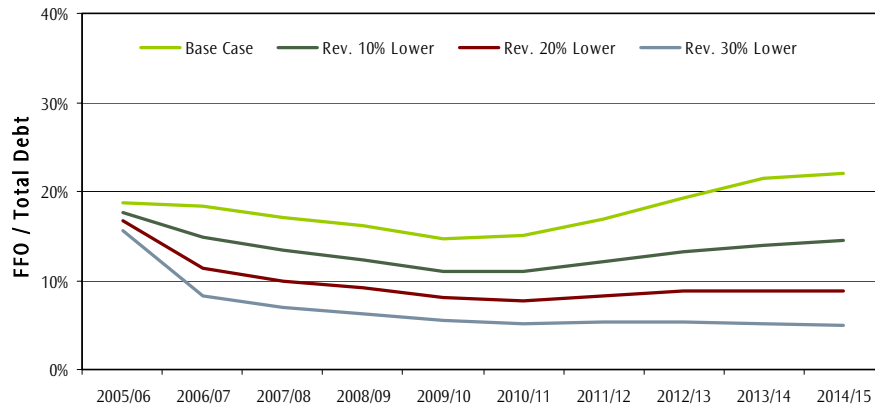
Debt / total capital provides a measure of the buffer provided to debt holders in the event the company goes into liquidation assuming that assets are held on the balance sheet at fair value.



### FFO / Total Debt

Net income from continuing operations plus depreciation, amortisation, deferred income taxes, other non-cash items; divided by total debt.

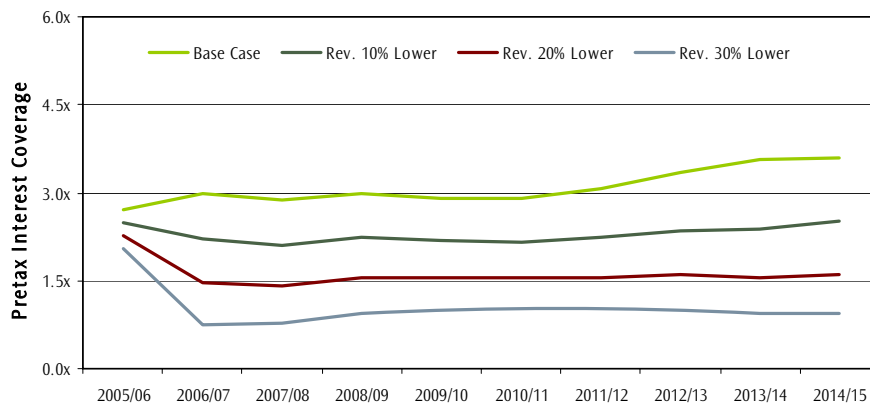
FFO / total debt provides a measure of the surplus cash flow available to pay down the outstanding debt balance.



### Pre-tax Interest Coverage

Net income from continuing operations before interest and taxes; divided by gross interest.

Pre-tax interest coverage gives an indication of the company's ability to meet interest costs out of surplus funds generated from operations and assumes that depreciation is a proxy for the capital expenditure required to maintain company operations.



The above charts highlight the major differences in credit ratios that result from the range of revenue cuts. In particular, Scenario 4 (revenue 30% lower), exhibits a significant deterioration in credit ratios in comparison to Transpower's base case (Scenario 1), with FFO / Interest falling below 2.0x and Pretax Interest Coverage briefly falling below 1.0x. These are key support levels for credit ratios, with FFO / Interest and Pretax Interest Coverage ratios below these levels indicating a lack of available cash flow to service debt.

## 2.4 DESCRIPTION OF RATINGS BANDS

Ratings agencies rely on a mixture of qualitative and quantitative factors when assessing the credit rating of a given company. The nature of the industry in which a company operates strongly influences the level of risk to earnings and hence companies within the same industry typically have similar credit ratings for a given set of credit ratios. In contrast, two companies in different industries but with similar credit ratios may have significantly different credit ratings if the industry profiles are different (e.g. a retailer in comparison to a utility company). Specifically, factors such as regulatory regimes, exposure to the domestic and global economies and the competitiveness of an industry will play a large part in the agencies' views.

Below we present rating bands appropriate for transmission utilities such as Transpower (based on Standard & Poor's research). Transmission utilities are viewed favourably by ratings agencies as they typically exhibit a range of low-risk characteristics, including:

- Large, long-life assets;
- Stable, regulated revenues;
- Absence of commodity risk; and
- Absence of volume risk (in some cases).

Transmission Utilities	'AA'	'A'	'BBB'
FFO <sup>(1)</sup> Interest Coverage (x)	3.0 - 4.0	2.0 - 3.3	1.5 - 2.0
FFO <sup>(1)</sup> to Total Debt (%)	12 - 17	10 - 15	5 - 10
Total Debt to Total Capital (%)	50 - 60	55 - 70	65 – 80
Pretax <sup>(2)</sup> Interest Coverage (x)	2.0 - 3.0	1.5 - 2.5	1.0 - 1.7

(1) Funds from operations

(2) Earnings before interest and tax

As the above table illustrates these ranges are not clear-cut, and additional business specific factors are likely to affect the credit rating given to a company. These factors for transmission companies include but are not limited to:

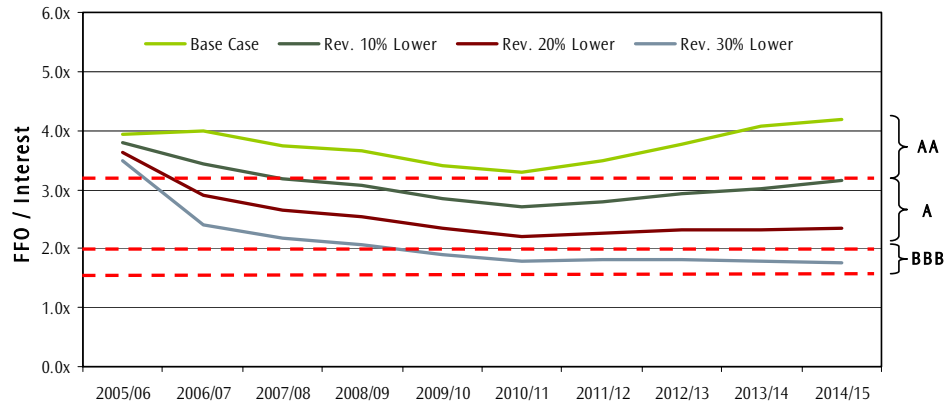
- Age and condition of assets;
- Tariff-setting mechanism;
- Transparency of regulatory regime;
- Exposure to non-core activities; and
- Operational efficiency.

Based on Transpower's business characteristics we believe that the above rating bands are appropriate in assessing the likely credit rating impacts of the scenarios presented. In applying these rating bands to Transpower's credit ratios in the following sections we look firstly at the credit ratios outlined in Section 2.3 and then consider other potential qualitative factors that may influence these conclusions.

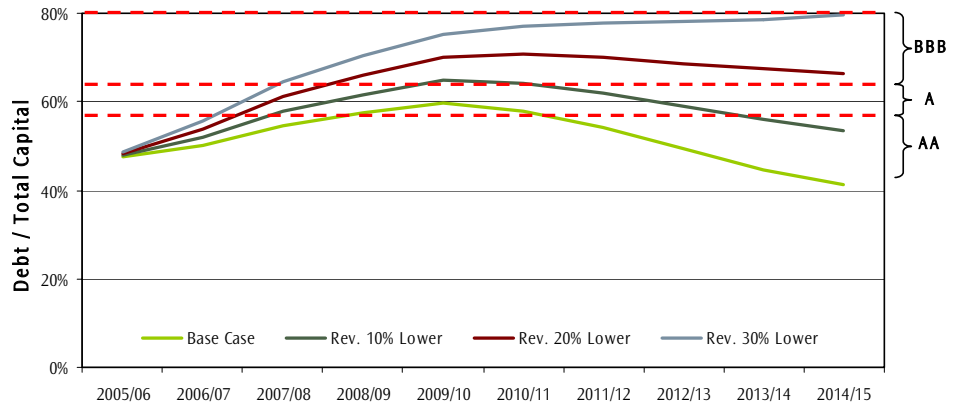
## 2.5 APPLICATION OF RATINGS BANDS

The following charts apply the rating bands to the credit ratios outlined in Section 2.3. We summarise our views on which rating band each scenario is likely to fit into in Section 2.7 after considering other qualitative factors. Given the high level of uncertainty surrounding the scenarios we do not attempt to categorise the scenarios into specific credit ratings (e.g. 'A' versus 'A-'). As presented previously to Transpower, one-notch shifts in credit rating are unlikely to have a major impact on Transpower's cost of debt as long as the ratings remain well above non-investment grade.

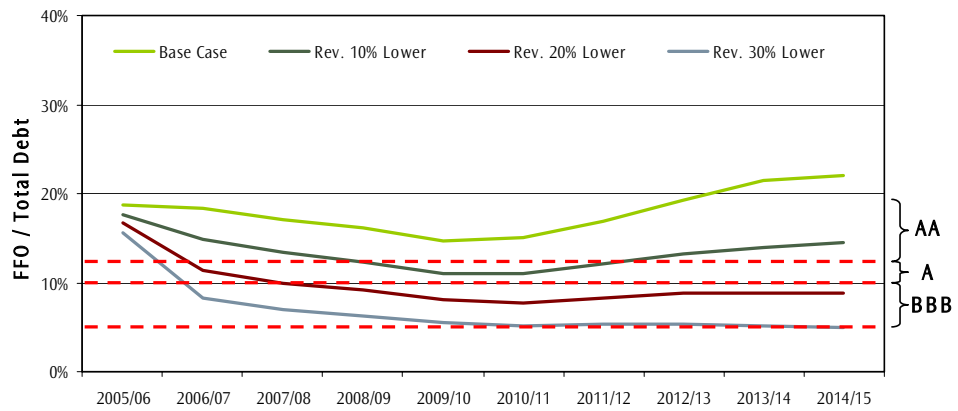
### FFO / Interest



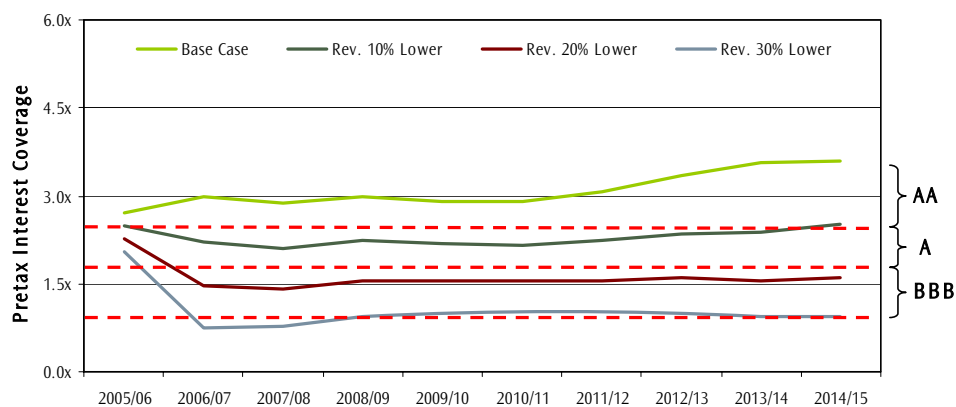
### Debt / Total Capital



### FFO / Total Debt



## Pretax Interest Coverage



## 2.6 KEY CONSIDERATIONS

### Impact of Crown Ownership

Transpower's ownership structure as a State Owned Enterprise potentially impacts both Transpower's credit rating and cost of debt. Although there is no explicit guarantee of support from the Crown, the importance of the services that Transpower provides to the country is likely to increase the possibility of Crown action in the event of Transpower encountering serious financial distress (e.g. Air New Zealand in 2001/2002). As a result, creditors (and ratings agencies) are likely to view Transpower's credit more favourably than the straight credit ratios might suggest. An increase in the order of one or two notches (e.g. 'A-' to 'A') is likely to be appropriate based on our understanding of the approach that the credit ratings take.

The impact of this implicit guarantee is likely to be more pronounced on Transpower's cost of debt at lower credit ratings. We discuss this further in Section 3, although it is noticeable that there are companies with lower ratings than Transpower but with similar ownership structures that have achieved lower costs of debt than their ratios or ratings would suggest (e.g. Mighty River Power).

### Timing of Credit Ratio Recoveries

Ratings agencies are likely to take a long-term view of Transpower's credit rating, looking at the credit ratios over a period of time rather than focusing on specific points in time. For example, in Scenario 2 (revenues 10% lower), there is a steady recovery in Transpower's credit ratios following FY10 after they dip in previous years. Given the relatively stable nature of Transpower's business, the agencies would potentially give Transpower credit for this recovery and reduce the emphasis on the lower ratios as long as they are comfortable that the deterioration in credit ratios is temporary.

### Regulatory Uncertainty

The current review of Transpower's regulatory position and the potential declaration of control have already impacted Transpower's credit rating through the recent move by Standard and Poor's to place Transpower on negative credit watch. Regulatory certainty and stability of the regulatory regime are two of the key factors that ratings agencies look at, with the current situation and the potential for changes to the way the industry is regulated likely to impact Transpower's credit rating negatively.

## 2.7 SUMMARY

Based on the analysis and discussion above we outline our views on the likely credit ratings bands for each of the four scenarios.

Scenario	Estimated Rating	Comments
Scenario 1	AA range	Strong recovery after dip in credit ratios in FY09 – FY10 supports 'AA' rating
Scenario 2	A range	Strong 'A' rating with recovery in ratios post FY10
Scenario 3	A range	Key coverage ratio (FFO / Interest) suggests a weak 'A' rating with potential downside risk
Scenario 4	BBB range	Low 'BBB' range, with FFO / Interest the key determinant

# 3 Cost of Debt Implications

## 3.1 METHODOLOGY

In this section we estimate the cost of raising debt for Transpower based on a range of credit ratings as implied by the analysis in Section 2.

In order to estimate Transpower's cost of debt we look at the pricing that Transpower could achieve in each credit rating band across a range of debt markets, based on First NZ Capital estimates and our discussions with Credit Suisse's trading desks offshore.

Based on the capital expenditure profile in the scenarios provided by Transpower Management and Transpower's likely refinancing requirements we have assumed annual debt raisings of approximately NZ\$300 - \$500 million when assessing pricing. In addition we have assumed that long-term debt is raised (10-year maturities), given the long-term nature of Transpower's assets and the benefits of reducing refinancing requirements and interest rate risk.

We estimate below the cost of debt for each available market with the lowest available pricing providing our cost of debt estimate for each rating band we consider ('AA', 'A' and 'BBB').

Although the scenarios outlined in Section 2 suggest that Transpower will retain an investment grade rating, we also provide some commentary around the impact of moving to non-investment grade status (e.g. 'BB') in the event that a more severe cut to Transpower's revenues occurs. In particular, the low 'BBB' rating that we believe that Transpower would receive in Scenario 4 (revenues 30% lower), is likely to place Transpower within potential reach of a downgrade to a 'BB' rating in the event of a further downside shock, hence the relevance of exploring this option.

## 3.2 COST OF DEBT BY CREDIT RATING

### 'AA' Rating – Scenarios 1

We have used Transpower's existing 'AA-' rating as a starting point for our analysis of Transpower's cost of debt, with very little likely variance in the cost of debt for Transpower within the 'AA' band.

At the size of debt raisings envisaged a range of debt markets would be open to Transpower. For each market we provide estimated pricing based on our analysis and discussions with Credit Suisse.

#### *New Zealand Market*

Although a NZ\$300 – NZ\$500 million issue is at the upper end of the issue sizes that can be achieved in the New Zealand market, such an issue would be possible via targeting a combination of retail and institutional holders.

We illustrate below a selection of secondary market margins for comparable issues in the New Zealand market.

Issuers	Rating	Issue Size	Coupon (%)	Maturity	Spread to NZ Swap
NZ Post	AA-	NZ\$75m	6.48	Apr 2009	-3 bps
Auckland Airport	A	NZ\$67m	6.67	Jul 2009	+10 bps
Telecom	A	NA	8.20	Apr 2010	+14 bps
BNZ	AA-	NZ\$50m	7.50	Sep 2010	+10 bps
Auckland Airport	A	NZ\$70m	6.83	Jul 2011	+14 bps
Powerco	AAA <sup>(1)</sup>	NZ\$100m	6.39	Mar 2013	+11 bps

Powerco	AAA <sup>(1)</sup>	NZ\$100m	6.53	Jun 2015	+16 bps
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(1) Credit wrapped

Based on the trading levels of these issues, the size of the issue required, current debt market conditions in New Zealand and including a premium for new issuance, we estimate that Transpower could issue 10-year debt at a margin of approximately 25 basis points over swap at an 'AA' rating (excluding issue costs).

#### New Zealand - Indicative 10-Year Pricing for Transpower (AA)

Benchmark yield	6.58%
Reoffer spread	+25 bps area
Issue costs	+4 bps
All-in-cost (NZ fixed) p.a.	6.87%
All-in-cost (NZD swap)	+29 bps area

#### Australian Market

Similarly, a NZ\$300 - \$500 million Kangaroo issue could be achieved in the Australian market despite it being at the top end of potential issue sizes. We illustrate below the trading levels of comparable issues in the Australian Market and our indicative pricing for Transpower.

Issuers	Rating	Issue Size	Coupon (%)	Maturity	Spread to Aus Swap
SPI Aust Fin	NR/A	A\$150,	6.25	Nov 2011	+39 bps
Telstra	A2/A+	A\$500m	7.25	Nov 2012	+45 bps
Telstra	A2/A+	A\$500m	6.25	Nov 2013	+50 bps
Telstra	A2/A+	A\$500m	6.25	Apr 2015	+53 bps
Envestra	Aaa/AAA	A\$45m	6.25	Oct 2015	+25 bps

#### Australia - Indicative 10-Year Pricing for Transpower (AA)

Benchmark yield	5.66%
Reoffer spread	+50 bps area
Approved issuer levy (2% of coupon)	0.12%
Issue costs	+3 bps
All-in-cost (AUD fixed) p.a.	6.31% area
All-in cost vs AUD Libor	+65 bps area
All-in-cost vs USD Libor	+58 bps area
All-in-cost vs BKBM	+60 bps area

#### Euro Market

A NZ\$300 - \$500 million issue is at the lower end of typical Euro market issuance but is still possible, potentially via a private placement. National Grid Transco provides the most comparable pricing from an operational point of view although National Grid Transco's credit rating of 'A-' is below the 'AA' level we focus on here.

We outline below a number of relevant comparable issues in the Euro market and the applicable pricing for Transpower.

Issuers	Rating	Issue Size	Coupon (%)	Maturity	Spread to Swap
NGG Finance	Baa1/A-	€750m	6.125%	Aug 2011	+27 bps
EVN	Aa3/A+	€300m	5.25%	Dec 2011	+25 bps
Tokyo Electric Power	Aa3/AA-	€1,000m	4.25%	Mar 2014	+8 bps
Red Electrica de Espana	A2/AA-	€800m	4.75%	Sep 2013	+15 bps
National Grid Transco	Baa1/A-	€600m	5.00%	Jul 2018	+35 bps

#### Euro - Indicative 10-Year Pricing for Transpower (AA)

Benchmark yield	3.61%
Reoffer spread	+25 bps area
Approved issuer levy (2% of coupon)	0.08%
Issue costs	+3 bps
All-in-cost (AUD fixed) p.a.	3.97% area
All-in-cost vs Euribor	+36 bps area
All-in-cost vs USD Libor	+33 bps area
All-in-cost vs BKBM	+35 bps area

#### Swiss Market

The issue size contemplated fits in well with typical issue sizes in the Swiss markets, with high quality credits 'AAA' and 'AA' favoured by investors. The 10-year maturity required by Transpower can be met by the Swiss market at the 'AAA' and 'AA' levels although the ability to do so at a lower credit rating is more variable and dependent on market conditions at the time.

We outline below a number of relevant comparable issues in the Swiss market and the applicable pricing for Transpower.

Issuers	Rating	Issue Size	Coupon (%)	Maturity	Spread to CHF Libor
Kyushu Electric Power	A1/AA-	CHF350m	4.00%	Feb 2007	+7 bps
EVN	Aa3/A+	CHF200m	3.25%	Apr 2008	+3 bps
Statnett	NR/AA	CHF150m	2.25%	Jun 2010	-4 bps
Deutsche Bahn	Aa1/AA	CHF300m	2.125%	Dec 2011	-11 bps

#### Swiss - Indicative 10-Year Pricing for Transpower (AA)

Benchmark yield	2.50%
Reoffer spread	+5 bps area
Approved issuer levy (2% of coupon)	0.05%
Issue costs (p.a)	+5 bps
All-in-cost (CHF fixed) p.a.	2.65%
All-in-cost vs CHF Libor	+15 bps area

All-in-cost vs USD Libor	+18 bps area
All-in-cost vs BKBM	+20 bps area

### Yen Market

The Yen market is typically more suited to smaller issue sizes although we are confident that Transpower could launch a successful issue in the NZ\$300 - \$500 million range. Similar to the Swiss market, 10-year issuance is possible but becomes more dependent on market conditions at the time at lower ratings.

There are relatively few comparable non-Japanese issues but we outline some of more relevant Japanese issues and the applicable pricing for Transpower.

Issuers	Rating	Issue Size	Coupon (%)	Maturity	Spread to swap
Hokkaido Electric Power	NR/AA-	¥20b	1.53%	Oct 2014	-6 bps
Tokyo Electric Power	Aa3/AA-	¥50b	1.435%	Feb 2015	-7 bps
Chubu Electric Power	Aa3/AA-	¥30b	1.42%	Apr 2015	-7 bps
Kansai Electric Power	Aa3/AA-	¥30b	1.46%	Apr 2015	-8 bps
Kyushu Electric Power	A1/AA-	¥20b	1.46%	Apr 2015	-8 bps

### Yen - Indicative 10-Year Pricing for Transpower (AA)

Benchmark yield	1.72%
Reoffer spread	+20 bps area
Approved issuer levy (2% of coupon)	0.04%
Issue costs	3 bps
All-in-cost (JPY fixed) p.a.	1.99%
All-in-cost vs JPY Libor	+27 bps area
All-in-cost vs USD Libor	+32 bps area
All-in-cost vs BKBM	+34 bps area

### Summary

Based on the range of available markets for an 'AA' rated Transpower issue, the New Zealand and Swiss markets present the most favourable pricing, at an all-in-cost vs BKBM of 29 bps and 20 bps respectively. Although the Swiss market represents the most favourable pricing, due to the likely requirement for repeat issuance by Transpower and the potential for market conditions in the Swiss market to restrict 10-year issuance we use a blend of the Swiss pricing and New Zealand pricing (75%/25% respectively), to estimate pricing of approximately 22 bps over 10-year Swap as our base cost of debt for the 'AA' rating.

### 'A' Market – Scenarios 2 & 3

A shift in Transpower's credit rating from the 'AA' band to the 'A' band would have an impact on Transpower's cost of debt even though the 'A' rating still represents a moderately strong investment grade rating.

Importantly, all the markets open to Transpower above should still be available for issuance at this level. Investors are likely to price such an issue marginally higher to reflect the lower rating but this should be consistent across all markets. However, the

length of term contemplated and the potential for repeat issues over a number of years means that Transpower may need to tap a combination of two or more markets to achieve the pricing indicated below.

We do not expect that a fall in credit rating would result in an increase in the level of covenants applied to Transpower as long as Transpower's credit rating remains investment grade (i.e. issuance could be run off a negative pledge agreement). We do note however, that the US private placement market would require the imposition of a range of covenants (US private placement market discussed further under 'BBB' issuance conditions).

We illustrate below the estimated impact of a shift to 'A' in each of the markets.

Market	Availability	Cost of Debt Impact Over and Above 'AA' Rating	All-in-Cost vs BKBM
New Zealand	Open	+ 17 bps area	+ 46 bps area
Australia	Open	+ 15 bps area	+ 75 bps area
Euro	Open	+ 15 bps area	+ 50 bps area
Swiss	Open	+ 15 bps area	+ 35 bps area
Yen	Open	+ 15 bps area	+ 49 bps area

Based on this analysis, the Swiss market is still likely to offer the most attractive pricing to Transpower in the event that its credit rating was downgraded to an 'A' rating.

However, as indicated previously, the availability of the Swiss market is more variable at this rating, particularly in terms of issuing 10-year debt, potentially requiring issuance from the New Zealand or Euro markets as back-up. In addition, the fall in credit rating to 'A' is likely to correspond to an increase in overall debt levels, potentially increasing the level of issuance required.

We therefore use a blend of the Swiss, New Zealand and Euro markets (33%/33%/33%), to reflect the possibility of a combination of markets being required to satisfy Transpower's demand. Based on this blend we estimate market pricing of approximately 44 basis points over 10-year Swap as our base cost of debt for the 'A' rating, a 22 basis point increase from the 'AA' rated debt cost estimate. This increase reflects both the increased cost of debt of moving to an 'A' rating across all markets, combined with the possible need to access the Euro market at this level.

#### 'BBB' Market – Scenario 4

As a company's credit rating falls towards the lower investment grade ratings the ability to access all markets deteriorates significantly and the costs of issuance increase.

We believe that that the Australian, Swiss and Yen markets would no longer be available to Transpower at a 'BBB' rating with investors in these markets focused on strong investment grade issues from offshore issuers. The US private placement market could be accessed at this level, as other companies in the utilities sector have done so previously, although the issue costs are typically higher than in other markets and covenants are likely to be required.

We illustrate below the estimated impact of a shift to 'BBB' in each of the markets.

Market	Availability	Cost of Debt Impact Over and Above 'A' Rating	All-in-Cost vs BKBM
New Zealand	Open	+ 23 bps area	+ 69 bps area
Australia	Closed	n/a	n/a
Euro	Open	+ 35 bps area	+ 85 bps area

Swiss	Closed	n/a	n/a
Yen	Closed	n/a	n/a
US PP	Open	+ 85 – 100 bps over US Treasury Rates	+ 103 – 118 bps <sup>(1)</sup>

(1) Assumes issue costs of 16 bps p.a.

The incremental increase of shifting from 'A' to 'BBB' in the New Zealand market is significantly less than in the Euro market. This is largely due to the impact of crown ownership as discussed in Section 2.6. This is likely to receive much more focus from New Zealand investors than offshore and is illustrated by the tight pricing of Mighty River Power's 'BBB+' rated issues.

Mighty River Power	Rating	Yield	Margin over Swap <sup>(1)</sup>
5 + 5 Year (15 Sep 2011)	BBB+	7.57%	+ 4 bps
5 + 5 Year (15 Sep 2013)	BBB+	6.98%	+ 2 bps

(1) Priced over five-year initial maturities in September 2006 and September 2008 respectively

Based on this analysis, a New Zealand issue would achieve the best pricing for Transpower although the large issue size at this credit rating level may mean that a joint issue in the Euro market is required to raise the full NZ\$300 - \$500 million.

We therefore use a blend of the New Zealand market pricing and Euro market pricing (50%/50%) to determine an estimate of approximately 77 basis points over 10-year Swap as our base cost of debt for the 'BBB' rating, a 55 basis point increase from the 'AA' rated debt cost estimate.

It is important to note that while there is little difference in terms of cost and accessibility of a one notch move at higher ratings, a shift from 'BBB' to 'BBB-' or below is likely to have more of an impact as the rating approaches non-investment grade. While still within the 'BBB' rating band, 'BBB-' ratings typically cause greater concern to investors, given the lack of head-room in the company's credit ratios to prevent a move to non-investment grade in the event of a further negative shock.

### 'BB' Market – Theoretical Scenario

Although none of the scenarios used are likely to result in Transpower's rating declining to the 'BB' level or below, we briefly outline the impact of such an occurrence given the high level of uncertainty as to the eventual outcome of a declaration of control. In addition, if Transpower ended up with a weak 'BBB' rating (e.g. 'BBB-'), then the 'BB' pricing is likely to become increasingly relevant if investors become concerned about a potential downgrade.

At the 'BB' level the majority of standard debt markets would no longer be available to Transpower. The US high-yield market would offer the best alternative although pricing and availability in this market varies significantly with market conditions, particularly for non-US domiciled issuers. The only other market that Transpower would be able to tap is likely to be the New Zealand market, although the volumes and pricing that Transpower could achieve at this level in New Zealand are highly uncertain.

Based on indicative analysis of such an issue, pricing of 175 basis points over swap could potentially be achieved from a US high-yield market at present.

## 3.3 KEY CONSIDERATIONS

In addition to the direct impact of increased funding costs from a fall in credit rating as outlined above, there are a number of additional affects that may result from a fall in Transpower's credit rating that, while less quantifiable, should also be considered.

### **Ability to access debt markets**

As illustrated in Section 3.2, the range of markets that Transpower would be able to access as its credit rating falls becomes highly limited (reduced to New Zealand, the Euro market and the US at a 'BBB' rating). This presents a high risk in terms of Transpower's ability to secure diverse funding sources at lower credit ratings.

While loosely linked by global market conditions, each individual debt market is subject to a number of country/regional specific factors at any given time, including but not limited to:

- Economic confidence;
- Recent and forecast interest rate movements;
- Level of recent issuance; and
- Level of forthcoming maturities of comparable issues.

These various factors mean that when one debt market may be offering attractive pricing and terms another may offer significantly higher pricing or more restrictive covenants, or not be available at all. Therefore the ability to access a range of debt markets provides a safety net against the possibility of unfavourable market conditions existing in any given country or region when Transpower is looking to raise debt.

At lower credit ratings, Transpower may find that its options to raise debt are severely limited or the pricing that is on offer is unfavourable.

### **Reputational Risk**

A significant fall in Transpower's credit rating is likely to concern investors in Transpower's existing long-term debt facilities with yields on existing debt issues potentially rising in the event of a downgrade. This could have the effect of harming Transpower's reputation as a stable issuer, particularly in offshore markets, which could hamper future issuance options.

While the direct impact of a fall in Transpower's credit is quantified in the cost of debt analysis in Section 3.2, Transpower may find that issuers seek an additional premium over and above these levels if they feel there is the possibility of further shifts in Transpower's credit rating.

### **Relationship with Customers / Suppliers**

In addition to the financial cost of a lower credit rating, a significantly lower credit rating could potentially affect the ease with which Transpower deals with its contractual counterparties, particularly in relation to contract discussions and negotiations.

Given Transpower's role as the sole supplier of electricity transmission services in New Zealand, lines companies (and end consumers) require certainty of supply and surety that Transpower will be able to deliver on its contractual obligations. Overall, a fall in credit rating to 'A' or high 'BBB' ratings is unlikely to affect the way these customers view Transpower significantly, but if Transpower's credit rating declines further these customers are likely to place increased scrutiny on Transpower's operations and underlying financial health. Although unlikely to affect Transpower in a direct financial sense, this is likely to result in an increase in the time required to manage these relationships.

Similarly, suppliers are likely to become increasingly cautious in dealing with Transpower in the event of a serious downgrade in credit rating (e.g. low 'BBB' range). This would also most likely result in increased time to negotiate contracts as well as potentially affecting Transpower's terms of trade.

While many participants in the New Zealand electricity sector (in particular the generators), have clauses in their contract for difference (CFD) contracts that require increased payments / margins as credit ratings decrease we understand that Transpower

is not subject to such clauses.

We note that this is only likely to be a serious issue in the event that Transpower’s credit rating was downgraded to a point at, or very close to, non-investment grade ratings (e.g. ‘BB’).

### Increased Management Time

In the event that Transpower’s credit rating falls significantly, Transpower Management could be required to spend an increased amount of time and resources focusing on its financials and key credit ratios due to the potential consequences of a further fall in credit rating (e.g. to below investment grade).

While at current credit rating levels, Transpower has a high level of head-room in the event of an unexpected negative shock to its business, at credit ratings close to non-investment grade the consequences of a negative shock are more significant (e.g. rapid increase in cost of debt and reduction in accessibility to markets).

In particular, Transpower Management would need to devote an increased amount of resources to its relationship with the ratings agencies in order to provide them with comfort as to Transpower’s financial health and outlook.

We note that this is only likely to be a serious issue in the event that Transpower’s credit rating was downgraded to a point at, or very close to, non-investment grade ratings (e.g. ‘BB’).

### Increased Credit Margins on Swap Transactions

A fall in credit rating is likely to lead to an increase in the credit margin charged by banks when conducting swap transactions for Transpower in relation to its debt issues. Although the increase is likely to be relatively small the need to lock in ten-year interest rates could exacerbate this impact.

Based on discussions with Credit Suisse and assuming 10-year maturities, we estimate that this incremental impact will be an increase of approximately 1 – 2 basis points for a decrease in Transpower’s credit rating from an ‘AA’ rating to an ‘A’ rating with an additional 3 – 4 basis point increase for a move from an ‘A’ rating to an ‘BBB’ rating.

In addition to this, break clauses may be imposed on long-term swap contracts that Transpower enters into at lower credit ratings as counterparty risk is seen to increase. We understand from Transpower Management that break clauses are not currently required by counterparties to Transpower’s swap arrangements.

### Collateral Requirements

Under Transpower’s existing cross-border lease agreements, a fall in Transpower’s credit rating to ‘A-’ or below would require the posting of collateral, with the level increasing as the rating falls. Collateral is normally supplied in the form of a bank letter of credit. The fee on this will increase as credit rating drops so there is both a volume and cost impact compounding as rating falls.

Furthermore, a lower credit rating may affect the ability for Transpower to enter into similar cross-border lease agreements in the future.

## 3.4 SUMMARY

The following table summarises the findings of each potential credit rating band examined, based on the quantitative analysis in Section 3.2.

Credit Rating Band	‘AA’	‘A’	‘BBB’	‘BB’
Scenarios	1	2 & 3	4	n/a
Optimal Cost of Debt (bps over BKBM)	+ 22 bps area	+ 44 bps area	+ 77 bps area	+175 bps minimum

Incremental Increase over 'AA' Rating	n/a	+ 22 bps area	+ 55 bps area	+ ~150 bps minimum
Markets Open	All	All	New Zealand Euro US Private	US High-Yield New Zealand

We note that the further considerations in Section 3.3, while unlikely to affect Transpower's cost of debt explicitly, could also have a potentially detrimental effect on Transpower by:

- increasing Transpower's exposure to unfavourable debt market conditions;
- affecting Transpower's reputation with existing lenders;
- increasing the scrutiny placed on Transpower by contractual counterparties (e.g. lines companies);
- affecting the terms of trade Transpower receives from suppliers;
- increasing the level of management time and resource required to manage Transpower's financial position and relationships with credit agencies;
- increasing the credit margin required on swap transactions and break clauses may be required by counterparties to these transactions; and
- requiring collateral to be posted under Transpower's cross-border lease agreements at 'A-' levels and below, and Transpower's ability to enter into further such agreements may be reduced.

Overall we believe that the potential impact of a declaration of control as modelled by the revenue cuts in Scenarios 2 and 3 of 10% and 20%, respectively, is unlikely to have a major impact on Transpower's ability to access debt markets over and above the increased cost of debt margins estimated in Section 3.2. We note however, that under Scenario 3, Transpower's credit rating is likely to be close to falling into the 'BBB' rating range which would have an increased impact on Transpower's ability to access debt markets.

However, under Scenario 4, with revenue cuts of 30%, and under other potentially more restrictive controls, the cost of debt to Transpower is likely to increase significantly, both in a quantitative sense (e.g. increased margin required to issue) and in a qualitative sense (e.g. reduced access to markets). In particular we note that if Transpower was downgraded to a 'BBB-' rating then investors are likely to be increasingly cautious about providing funds to Transpower with both pricing and accessibility of debt markets likely to start to approach those of a non-investment grade rating.