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10 May 2007

Dear John

PSEUDO ASSETS

In accordance with our engagement letter, we have reviewed the calculation and depreciation of the four pseudo assets that Transpower is considering incorporating with its financial reporting fixed asset register to facilitate regulatory reporting. The results of our review are set out in this letter.

Background

Transpower's financial reporting fixed register and its transmission system fixed asset ODV register differ by approximately \$112 million (the ODV register is higher). The difference in annual depreciation between the two registers is currently approximately \$18 million.

Transpower is likely to adopt an historical cost approach for regulatory reporting that will involve "freezing" the ODV register as a date (either 30 June 2006 or 2007). Future movements in the transmission system fixed assets, for regulatory reporting (additions, disposals and depreciation) will be aligned with the financial reporting register other than in relation to the \$112 million difference. All other things being equal, the \$112 million difference will diminish over time as the assets at the time of freezing the ODV register are depreciated.

To simplify the administration of the recording of transmission system fixed assets, Transpower is considering maintaining only one register for financial reporting and regulatory purposes. Its preference is to maintain the financial reporting register. To enable this to work for regulatory reporting, the difference of \$112 million between the registers will need to be dealt with.

Transpower has developed the concept of pseudo assets to account for the difference. This would involve adding a small number of notional assets (four) to the financial reporting register. These assets would have a net book value of \$112 million. Augmenting the financial reporting fixed asset register with the pseudo assets will effectively align the registers for regulatory purposes (the assets would be excluded for financial reporting purposes).

John Coulter
10 May 2007

You have quantified the four pseudo assets and the remaining lives for depreciation purposes. You have requested that we review the process of quantifying the value allocated to each pseudo asset and the remaining lives and the implications of the pseudo assets for revenue requirement purposes.

This letter should be read in conjunction with the important notice in Appendix A.

The Pseudo Assets

The values for the pseudo assets have been derived, in effect, by allocating the \$112 million across four principal asset categories using the 2006 ODV as the basis for allocation. The four asset categories are representative of the assets categories in the 2006 transmission system fixed assets ODV.

In the following table we summarise the assets values and remaining lives determined by Transpower. Two sets of remaining lives are included in the table:

- The weighted average remaining lives for the asset categories as extracted from the ODV register
- Transpower's assessment of remaining lives ("selected remaining lives"). This assessment is based on generating an annual depreciation charge on the pseudo assets that approximates the existing difference in the depreciation charge between the two registers.

Table 1

Asset Category	Asset Value	Weighted Average Remaining Lives	Selected Remaining Life	Depreciation
	\$M	Years	Years	\$M
HVDC Assets	38	13	4	9.5
HVDC Line	(4)	14	4	(1)
Substations Assets	14	31	4	3.5
AC Transmission Lines	64	31	10	6.4
Total	112			18.4

Review of Pseudo Assets

We have reviewed the derivation of the pseudo asset values and the remaining lives based on information provided to us by Transpower on its financial reporting and ODV registers. The review process has involved:

John Coulter
10 May 2007

- Reviewing calculations of the financial reporting book value of assets
 - Ensure that the NBV was consistently calculating correctly by reviewing the formulae and the precedent cells in all related spreadsheets; and
 - Verify consistency of NBV of the pseudo asset categories to the value calculated in the register spreadsheets.
- Reviewing the reasonableness of the calculations of the weighted average remaining lives for both the ODV and financial reporting book values. We
 - Re-performed the expired life and remaining life calculations to ensure accuracy of the input in the weighted average remaining life calculations in the spreadsheets;
 - Reviewed the methodology used to calculate the weighted average remaining life in the spreadsheets for appropriateness and accuracy; and
 - Verified the consistency of weight average remaining lives for the pseudo assets to those calculated in the supporting spreadsheets.
- Confirming that the \$112 million dollar difference between the ODV and financial reporting book values relates to transmission system fixed assets only and does not include System Operator Assets or unregulated assets (EMS).
- Preparing a spreadsheet forecasting the impact of implementing the selected and asset register useful lives

Nothing came to our attention during the course of our review to suggest that the allocation of the \$112 million difference across the four pseudo asset categories or the calculation of the weighted average remaining lives was materially incorrect.

Impact on Revenue Requirement

The asset lives required to align the depreciation charge are considerably shorter than the weighted average lives from the ODV register. If the ODV register remaining lives are used to depreciate the pseudo assets, the annual depreciation charge would be approximately \$5.2 million, approximately \$13.2 million less than the depreciation charge using the selected rates.

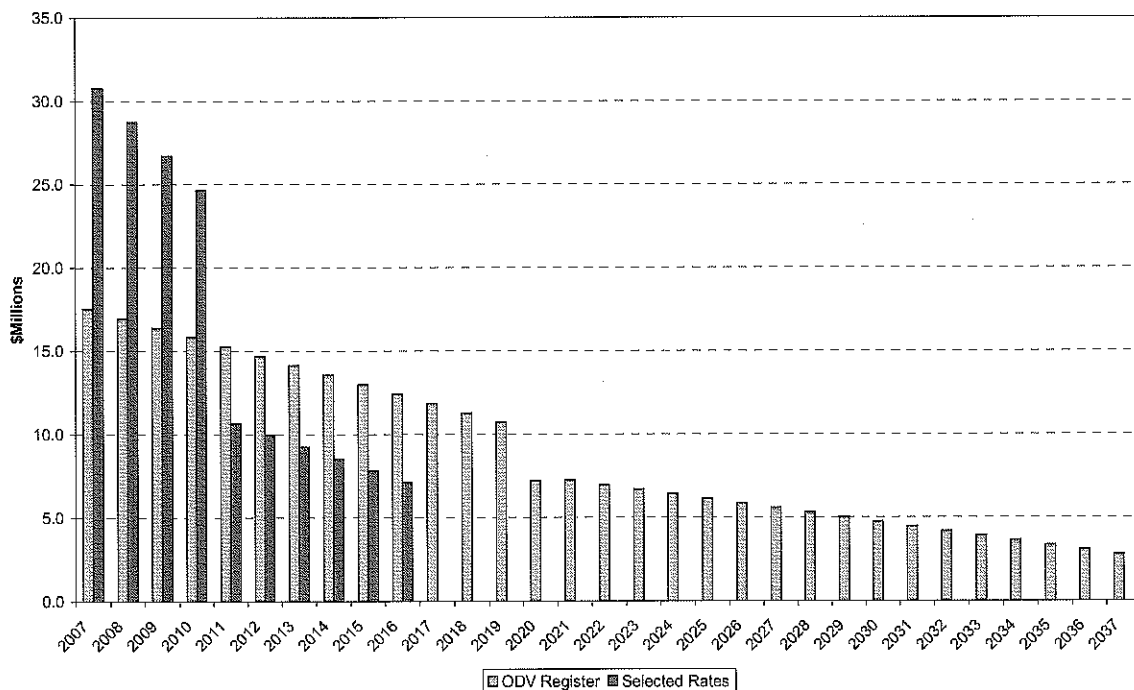
The difference translates into a revenue and cash flow difference. Figure 1 shows the annual revenue requirement relating to the pseudo assets. The revenue requirement is calculated as the sum of annual depreciation and the return on the un-depreciated balance of the assets at WACC, grossed up for tax.

The revenue requirement for both the ODV register remaining lives and the selected remaining lives are presented in the figure. The figure demonstrates that:

John Coulter
10 May 2007

- As expected, the revenue requirement under the selected rates is a lot higher than using the ODV register remaining lives in the near term.
- The cumulative depreciation is the same under both scenarios. The same fixed asset values are being recovered but over different time periods. The revenue requirement under the selected remaining lives ceases a lot quicker than the ODV register remaining lives. The ODV register revenue requirement has a very long tail. The investment in the pseudo assets is recovered a lot quicker using the selected remaining lives.

Figure 1



While the selection of the depreciation rates has a significant impact on the revenue requirement and cash flow profile, it has no impact on the present value of the cash being recovered from customers. At the commencement of the depreciation of the pseudo assets, the present value of the revenue requirement cash flows for both remaining lives scenarios are identical. The present values equate to the un-depreciated value of the pseudo assets. In this regard, and putting aside any preferences for a particular cash flow profile, customers and Transpower should be indifferent between the remaining lives selected so long as an economically neutral approach is taken to calculating the revenue requirement associated with the pseudo assets.

We considered an alternative approach to dealing with the difference in the asset register involving taking the difference to the Customer Account. This should produce the same net present value outcome. However, in our view this approach will not have the same transparency nor consistency

John Coulter
10 May 2007

in logic as the pseudo assets approach given the reasons for the difference in the asset registers and the reasons why the difference is now an issue that must be addressed.

General

Please do not hesitate to contact us if you have any questions or require any further information.

Yours sincerely



Bruce Wattie
Partner

John Coulter
10 May 2007

Appendix A: Important Notice

In preparing this letter and forming our opinions, we have relied upon, and assumed the accuracy and completeness of, all information available to us from public sources, interviewees and furnished to us by Transpower. We have evaluated that information through analysis, inquiry and review but have not sought to verify the accuracy or completeness of any such information. It should not be construed that we have conducted an audit of the information we have used.

This letter has been prepared solely for the use by Transpower. We acknowledge that Transpower will provide a copy of this letter to the Commerce Commission.

We will not accept responsibility to any party other than to Transpower, to whom our letter is addressed, unless specifically stated to the contrary by us in writing. We will accept no responsibility for any reliance that may be placed on our letter should it be used for any purpose other than that for which it is prepared.

Our letter has been prepared with care and diligence and the statements and opinions in the letter are given in good faith and in the belief on reasonable grounds that such statements and opinions are not false or misleading. No responsibility arising in any way for errors or omissions (including responsibility to any person for negligence) is assumed by us or any of our partners or employees for the preparation of the letter to the extent that such errors or omissions result from our reasonable reliance on information provided by others or assumptions disclosed in the letter or assumptions reasonably taken as implicit.

We reserve the right, but are under no obligation, to revise or amend our letter if any additional information (particularly as regards the assumptions we have relied upon) which exists on the date of our letter, but was not drawn to our attention during its preparation, subsequently comes to light.