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28 March 2014

### ***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 our opinion on the rationale for investors paying a premium to the Regulatory Asset Base (RAB) value of New Zealand electricity distribution businesses. This letter should be read in conjunction with the Scope of Work referred to above, and the Restrictions in the attached Appendix.

We understand that the Commerce Commission is considering its position in relation to the Cost of Capital Input Methodologies which currently use the 75<sup>th</sup> percentile WACC for the purpose of setting revenue allowances<sup>1</sup>. The Commission appears to be considering transactions where the investor has paid a premium to the RAB value, implying a lower cost of capital than the regulator's assumption.

The Commission has referenced the Transpower valuation assessment dated 15 November 2013 prepared by Northington Partners (Northington), and the fact that overseas investors have historically paid premiums to the regulatory asset base value, to suggest that the 75<sup>th</sup> percentile WACC used in the Cost of Capital IMs could potentially be lowered.

In this report we have focussed on the following issues:

1. The valuation methodology used by Northington
2. The cost of capital parameters adopted by Northington in their Market WACC, and
3. Transaction premiums and the relationship to cost of capital.

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<sup>1</sup> "Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies, 20 February 2014"



## **1. Valuation methodology used by Northington**

The methodology that Northington has adopted for determining Transpower's weighted average cost of capital (WACC) is the Brennan-Lally specification, and other than what appears to be a minor calculation issue (see below re equity beta), it is appropriate for use in these circumstances.

For the purposes of determining the return that Transpower may earn under each regulatory control period (RCP), Northington has adopted the Commerce Commission's WACC estimate for Transpower for RCP1, and then estimated the Commission's expected WACC for RCP2 using its own estimates of the risk free rate and debt premium.

In addition, Northington has estimated a Market WACC for the purpose of discounting Transpower's forecast cashflows to derive their valuation assessment.

As a general observation, the WACC used to discount cash flows for the purposes of the valuation, needs to be appropriate for the life of the cash flows being modelled. The theoretical approach for discounting the cash flows is to apply single year discounts to each year's cash flows. However, in a stable environment, a long-term proxy is usually applied to all of the years' cash flows as a simplification. This approach needs to be adopted with a degree of caution, particularly when current rates are coming off a historical low base, which is the current position in New Zealand.

## **2. Market WACC parameters**

**Risk free rate.** Northington has adopted a risk free rate of 4.75% for the purposes of determining a Market WACC. This is low relative to the risk free rate of 5.5% that has been assumed by Northington for deriving Transpower's revenue for RCP2. RCP2 and the following years, comprise the majority of the cash flows included within the DCF calculation. We would therefore expect there to be close alignment between the risk free rates assumed for RCP2 and beyond, and the Market WACC. The use of a market risk free rate that is 75 bp lower than the regulatory risk free rate means that all other parameters being equal, the market valuation will be higher than the RAB value.

**Debt margin.** A margin of 160bp has been added to the risk free rate to determine the pre-tax cost of debt. This appears to be based on the rate adopted for the RCP2 revenue calculation, which has been derived from 'historical' average margins. We do not consider that history is necessarily relevant in the circumstances as there may well have been a structural change in interest rate margins as a result of the GFC. However it is consistent with the rate adopted by Northington in their RCP2 calculation.

**Asset beta.** Northington has adopted an asset beta lower than that determined by the Commission. It is not clear why this is the case and there is no analysis or reconciliation back to the comparable company (Compeco) analysis in Appendix 3, nor is it apparent over which period the asset beta has been assessed.

There appear to be some anomalies in the data presented in Appendix 3. We note that Appendix 3 reports an asset beta for Powerco which is no longer a listed company. The enterprise value reported for Powerco is also double that of Vector, whereas Vector is a significantly larger business than Powerco. It is possible that the data reported for Powerco may in fact be for another entity<sup>2</sup>.

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<sup>2</sup> There are some other anomalies or items that we are unable to reconcile in Appendix 3. For example the gearing levels do not appear consistent with the EV and market capitalisation (although they may be gearing levels based on book values rather than market values).



The asset beta of Vector is presented as 0.03. We have recalculated Vector's asset beta and derived 0.10 as at 20 March 2014.

**Equity beta.** There appears to be a miscalculation in converting the asset beta to an equity beta, resulting in a minor overstatement of the equity beta in Northington's calculations. The impact however is immaterial.

**Market risk premium.** The 7.0% adopted by Northington is consistent with that used by the Commission in determining Transpower's revenue. PwC currently applies a market risk premium of 7.5% in our WACC calculations for valuation purposes.

**Equity premium for risk.** Northington has applied a 15% premium to the cost of equity to take into account an allowance for regulatory risk. They highlight that 'the market' would take a direct approach and explicitly incorporate a regulatory risk premium in determining a WACC for Transpower. There is no justification provided as to how the 15% was determined. They do however acknowledge that their estimate of a 15% uplift is difficult to benchmark.

In conclusion, it is not clear to us why Northington has applied different parameters in their calculation of WACC, compared to the parameters adopted for determining revenue in RCP1 and RCP2. While we appreciate that there are some slight timing differences, it is not clear why for example the risk free rate adopted for the WACC is 75bps lower than that used in RCP2 (which is the period over which most of the cash flows are earned). One of the direct impacts of this approach is the differential that arises between WACC and regulated returns.

### ***3. Transaction premiums and the relationship to cost of capital***

In this section, we consider why acquirers of regulated utility assets might pay in excess of the regulatory value of these assets. We do not agree with Northington's assertion that premiums mean that acquirers of the assets have a lower cost of capital.

Based on our experience advising on numerous EDB transactions including recently advising Brookfield on the sale of its 42% shareholding in Powerco to AMP Capital, we are aware of a number of reasons why such premiums are being paid by international acquirers. We consider these reasons in further detail below.

#### ***(i) Cheaper debt***

Wholesale interest rates in New Zealand tend to be higher than many other OECD countries, including the US and Australia. This may be due to a number of reasons, including domestic savings and investment imbalances and/or risk premiums imposed by foreign investors. Furthermore, in addition to lower wholesale interest rates, larger international markets have higher levels of liquidity than New Zealand, given the limited scale in the New Zealand market. Higher levels of liquidity suggest tighter margins, which translate into lower debt margins for borrowers.

This means that the cost of borrowing for foreign investors (and therefore their WACC) is likely to be lower than the Commission's WACC. However, we note that domestic investors are unlikely to be able to access the cost of debt advantage that may be available to an overseas investor.



***(ii) Tax structuring***

Investing in business 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 typically 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.

***(iii) Investment imperative***

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. A typical model involves a management fee (based on the quantum of the investments in the portfolio) as well as a performance fee (based on the performance of the fund ie its returns). As a result, the fund manager will not receive a management fee or performance fee until it has actually made investments. An investment will trigger the commencement of the management fee component of the overall fee.

We are aware that this incentive can lead to funds paying a premium to secure investments in a competitive sale process, in order to activate their management fee.

***(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, 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.

***(v) Establishing a New Zealand beachhead***

Establishing a beachhead in a market provides a business an entry point for future growth. It provides a strategy to grow into those markets, giving an acquirer an opportunity to test the market, get a better understanding of a market's dynamics, regulatory frameworks, and assess the market for further opportunities to grow.

Our discussions with potential investors into New Zealand, including within the electricity sector, indicate that this has driven investment decisions in New Zealand in the past. AMP Capital has already announced that it would like Powerco to make more acquisitions in future. We expect that this is in part due to an increased understanding of operating in the New Zealand environment.

Offshore investors are in many cases prepared to pay a premium to establish a beachhead in New Zealand. The logic is similar to that which underpins an 'option', whereby an investor is prepared to pay a premium to have access to future value upside in those markets from other opportunities.



**(vi) Outperformance perceptions**

While some investors will use the opportunity to establish a beachhead in a country to learn about a business and the operating environment, others may expect that what they have learned in other markets, will translate to another geography. It is not uncommon for a country to adopt frameworks that have proved successful in other jurisdictions. Businesses may similarly anticipate that the regulatory environment will develop to a model that is consistent with their experiences elsewhere.

Where regulated business have outperformed the regulator’s parameters in their local market, this may lead them to apply the same logic to their assessment of the performance of regulated New Zealand businesses. In this case, they will have a propensity to pay a premium, in anticipation of receiving higher future cash flows.

**(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 other sectors, it is a well-known phenomenon that investors will pay over and above the book value or the fair value of a business’ tangible assets. This was the case when Beijing Capital acquired Transpacific Industries Group on 4 March this year. Beijing Capital noted that a key driver for the acquisition was “the technical knowledge base of TPI” which they believed could be leveraged into the China market.

We expect that similar drivers will prevail in relation to regulated utility businesses, in that there may be intellectual assets that an acquirer may place significant value on.

**Summary**

In the following table we have summarised which of the above factors would lead investors to adopt a lower discount rate:

<b>Factor</b>	<b>Lower Cost of Capital?</b>
Cheaper debt	Yes, but available to offshore investors only
Tax structuring	No, enhances cash flows and available to offshore investors only
Investment imperative	No
Investment portfolio balancing	No
Establishing a New Zealand beachhead	No
Outperformance perceptions	No, reflected in higher cash flows
Accessing intangible assets	No



Our analysis above indicates one reason why an offshore investor might adopt a lower cost of capital in valuing New Zealand electricity distribution businesses, but an additional six reasons why a premium to the regulatory asset base value might be paid that are unrelated to an investor adopting a lower cost of capital. Accordingly, it is our view that in nearly all cases where an investor pays a premium to the regulatory asset base value, this is NOT because that investor has adopted a lower cost of capital.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Craig Rice', written in a cursive style.

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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.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

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.