

Note on Transpower's Treasury Practices

- 1 Transpower's approach to managing interest rate, liquidity, credit and foreign exchange risk is governed by policy limits set by the Board. This includes:
 - 1.1 ensuring that appropriate facilities are in place to meet both short and long-term requirements;
 - 1.2 managing relationships with funding providers and rating agencies;
 - 1.3 managing financial investments;
 - 1.4 managing credit policy with respect to Transpower's customer counterparties;
 - 1.5 managing the insurance risk transfer and framework; and
 - 1.6 meeting interest cost objectives set by the Board.
- 2 In its updated decision dated 12 November 2010 the Commerce Commission sets out the basis upon which it currently proposes it will determine Transpower's cost of capital for the purposes of Part 4 of the Commerce Act. According to Transpower's calculations, this will lead to an estimate of the cost of capital of around 7.2% to 7.3% (determining the precise level of uplift based on the term credit spread swap is not possible as highlighted in our comments on the IM draft determination).
- 3 In this note we set out the anticipated financial consequences for Transpower of a final determination for the cost of capital at such a level.

Investment requirements

- 4 Transpower is currently in the process of remedying a sustained period of under-investment in the national grid. The ageing grid is in need of considerable upgrading and asset replacement, as well as expanded capacity to meet New Zealand's future electricity demands. In particular, three major infrastructure upgrades are underway:
 - 4.1 an increase in capacity and diversity for North Auckland and Northland;
 - 4.2 a new 400kV HVAC line between South Waikato and Auckland; and
 - 4.3 a replacement pole and increased capacity for the HVDC line between Benmore hydro station and Wellington.
- 5 Further details are available in Transpower's 2010/2011 Statement of Corporate Intent.
- 6 It is widely acknowledged that these projects, as well as other grid upgrades, are of critical importance to the long term capacity, efficiency and reliability of New Zealand's power supply. A reliable supply of electricity is indispensable to sustaining business confidence, creating economic growth, attracting overseas investment, allowing domestic firms to compete internationally, and ensuring the maintenance of appropriate living standards for all New Zealanders. Transpower is committed to completing these upgrades as efficiently and cost-effectively as possible.

- 7 Transpower's forecast capital requirements are in the order of NZD\$3 billion over the period 2009 to 2013. The scale of the required investment is virtually without precedent in recent New Zealand history and places Transpower in a unique position compared with other regulated businesses.
- 8 As a State-owned enterprise, Transpower is currently wholly owned by the New Zealand Government and is thus precluded from raising capital through the equity markets. Instead all capital is currently raised through debt and this mainly occurs offshore. Typically around one third of Transpower's capital requirements are raised in New Zealand and around two thirds offshore. The New Zealand capital markets are simply too thin to be able to provide the entire funds to be raised domestically.
- 9 The debt is raised in whatever capital market is offering the best deal at the relevant time. Tranches of NZ \$100m to NZ\$200m are raised in a markets such as the Swiss (franc), Japanese (yen), Hong Kong (\$), Canadian (\$), and United States (\$). The terms of Transpower's September 2010 capital raising were typical of its funding approach. In short:
- 9.1 Maturity up to 15 years;
- 9.2 In order to avoid roll over risk, Transpower ensures that no more than NZD\$500m matures in any one year and the term of its funding is arranged accordingly;
- 9.3 All debt is swapped back to floating rate NZD.
- 10 A major consequence of Transpower's need to raise finance predominantly off shore, is that it inevitably needs to hedge against currency risk. This is done by swapping all capital raised back into NZD at an NZ floating interest rate. This currency and interest rate swap significantly reduces the foreign exchange risk of offshore borrowing. There are transaction costs associated with this arrangement - notably bank and counterparty fees. These costs do not appear to have been taken into account by the Commission.
- 11 The unavoidable cost of such hedging for Transpower does not arise for other New Zealand businesses, including other regulated network businesses, which are not required to seek the same levels of offshore financing.

Credit ratings

- 12 Transpower's credit ratings are of central importance in attracting investment into the company. Transpower is rated by both major international credit rating agencies, Standard & Poor (S&P)'s and Moody's. These ratings are the main point of reference for the investors which Transpower seeks to attract.
- 13 A credit rating issued by a rating agency informs the market of the issuer's analysis of the rated company's credit risk. That analysis is carried out through consideration of the financial history and key metrics of the company being rated, as well as through direct communication with the company in question. In Transpower's case, it has maintained positive, pro-active engagement with both rating agencies, keeping them informed of its major infrastructure upgrades and the implications of its expansion for its financial position.

- 14 In Transpower's case, Moody's and S&P focus on several key debt ratios – metrics such as debt to debt plus equity, free funds from operations interest cover, debt to EBITDA, and retained cash flow to debt. These ratios will all be negatively impacted by a WACC of the level currently proposed by the Commission.
- 15 Another critical factor in the ratings agencies' assessment is the regulatory framework. Ratings agencies are particularly concerned about regulatory uncertainty, including the risk that the costs of the regulated company (including the cost of capital) cannot be recovered fully through regulated charges. Setting the regulated rate of return below a company's cost of capital is an example of the sort of regulatory risks that are of most concern to the agencies.
- 16 The credit rating of a company has consequences for that company's ability to raise finance, the costs of doing so, and the terms and conditions imposed on that company by lenders. The lower the credit rating a company has, the less favourable all of these aspects become.
- 17 Often credit rating impairment can have a cumulative effect. As a company's rating is downgraded, credit becomes more expensive and more difficult to raise. This in turn has a negative impact on the company's key debt ratios, increasing the likelihood of a further downgrade, and so on.
- 18 Finally, it is well to note the impact of the global financial crisis on credit rating companies. Both Moody's and S&P have been subjected to criticism for being overly optimistic about business' creditworthiness in the period leading up to the crisis. In consequence, they are currently in a period of sustained conservatism, and are thus more likely to take the opportunity to downgrade companies than they are to upgrade them. In consequence, if Transpower suffers a further downgrade, it may be a long time before it is able to regain its previous rating, even once its financial metrics recover to previous levels (if in fact they do so).
- 19 Transpower is currently rated AA- by S&P, the third highest rating which that agency provides (behind AAA and AA+). It is rated Aa3 by Moody's, the fourth highest rating which that agency provides (behind Aaa, Aa1, and Aa2). A ratings downgrade by Moody's will therefore take Transpower to A1, and outside the "double-A" band. Moody's has signalled that such a downgrade is possible if a WACC of 7.06% (or a similar low level) is arrived at by the Commerce Commission.
- 20 In March 2009, Moody's downgraded Transpower's long-term rating from Aa2 to its current Aa3 rating. At the time, Moody's stated that *"the rating downgrade reflects the expected weakening in Transpower's financial metrics over the medium to long term due to its substantial capital expenditure program to upgrade its networks"*. It is relevant to note that this statement was made when Transpower's anticipated WACC was 7.7%.
- 21 On 15 September 2010, Moody's put out a press release in explicit response to the Commission's draft determination.¹ The agency stated that:
 - 21.1 Moody's Investors Service has noted the New Zealand Commerce Commission's interim decision on allowable rates of return and pricing inputs for the 2011/2012 financial year (the

¹ "Moody's comments on NZ Commerce Commission's pricing decision", 15 September 2010.

transition year). Moody's says that the Aa3 rating of Transpower New Zealand Ltd is not immediately affected by the decision.

- 21.2 The interim decision requires Transpower to use a post tax weighted average cost of capital (WACC) of 7.06% in calculating its maximum allowable revenue (MAR) for the transition year. This outcome has negative implications for Transpower as it is significantly lower than the company's currently assumed WACC of 7.7%.
- 21.3 The ultimate impact on Transpower's rating or outlook will be dependent on the outcome of the Commerce Commission's final determination, which will set the allowable rates of return and pricing inputs for the remainder of the regulatory control period (RCP). **If the current parameters are maintained in the final determination and apply for the remaining three years of the RCP there would likely be negative pressure on Transpower's rating or outlook.** (Emphasis added).
- 22 While this language may appear equivocal, it is important to understand the reality of investment markets, in which a clear statement of intention to downgrade a company will operate *de facto* as such an action. The above language is a source of considerable concern to Transpower, and is already likely to have had an impact on its perceived credit-worthiness in the market.
- 23 Movement outside the "double-A" band, signalled as a possibility by Moody's, is a step-change leading to an increase in cost, possible decrease in access to markets, and imposition of more stringent terms and conditions on lending.