FIRST NZ CAPITAL

26 November 2015
Asia Pacific/Australia
Equity Research
Multi Utilities

Spark Infrastructure Group

(SKI.AX / SKI AU)

Rating	**OUTPERFORM***
Price (24-Nov,A$)	2.06
Target Price (A$)	2.30
Target price ESG risk (%)	-2.0
Market cap (A$mn)	3,020.7
Yr avg. mthly trading (A$mn)	164.0
Projected return:	
Capital gain (%)	11.7
Dividend yield (net %)	6.3
Total return (%)	17.9

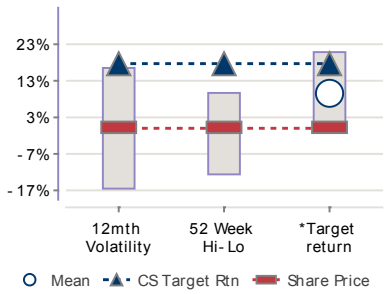
**Stock ratings are relative to the relevant country benchmark.*
[1]Target price is for 12 months.

FORECAST REDUCTION

TransGrid acquisition: Vex or validate?

- **SKI acquires a 15% stake in TransGrid, launches 5-for-34 entitlement offer:** Spark's five member consortium has been announced as the winner of the privatisation of TransGrid. The acquisition price of $10.4bn represents a ~1.6x RAB multiple and a 16.0x FY15 EV/EBITDA multiple.
- **Dividend guidance validates view on SKI's stronger-than-peer potential:** Our OUTPERFORM view has been based on the thesis that SKI's above peer dividend cashflow coverage and asset growth gave it the most potential for medium-term dividend growth. This has been validated by the extended guidance for ~4% pa growth; and by company statements that the potential for "significant" standalone cashflow growth could see upwards revisions. We increase our forecast to 13.0cps in FY16, 0.5cps above guidance.
- **$10.4bn price tag vexes, $1bn higher than our valuation.** We value TransGrid using a framework consistent with that used to value SKI's existing assets and its peers. Either the TransGrid price is too high, or the market needs to adjust its valuations of peers. The valuation impact to SKI is lessened by its relatively small 15% stake.
- **Target price of $2.30 unchanged, retain OUTPERFORM.** We incorporate TransGrid into our earnings forecasts, FY16E proportionate EPS is reduced 10.1%. We set our target price at a $0.05/sh premium to our DCF valuation; although we have reservations about the price paid, the sale has certainly demonstrated the attractiveness of the sector, and SKI retains its above-peer dividend outlook.

Total return forecast in perspective



Source: Company data, Credit Suisse Estimates,Thomson Reuters,IBES

Performance	1M	3M	12M
Absolute (%)	3.78	5.10	6.74
Relative (%)	6.12	4.07	9.26

Financial and valuation metrics

Year	12/14A	12/15E	12/16E	12/17E
Revenue (A$ mn)	287	285	256	253
EBITDA (A$ mn)	272	273	247	244
EBIT (A$ mn)	272	273	247	244
Net Income (Adj.) (A$ mn)	128	129	91	91
EPS (Adj.) (A$)	0.09	0.08	0.05	0.05
Change from previous EPS (%)	n.a.	(10.8)	(19.0)	(19.0)
EPS growth (%)	31.2	(9.7)	(34.0)	0.1
Consensus EPS (A$)	0.09	0.12	0.10	0.11
P/E (x)	22.6	25.1	38.0	37.9
Dividend (A$)	0.12	0.12	0.13	0.14
Dividend yield (%)	5.6	5.8	6.3	6.6
Price/Book (x)	1.6	1.6	1.6	1.6
Net debt/EBITDA (x)	(0.5)	0.8	0.6	0.4

Source: Company data, Thomson Reuters, Credit Suisse estimates

Spark Infrastructure Group (SKI.AX / SKI AU)

Price (24 Nov 2015): **A$2.06**; Rating: **OUTPERFORM**; Target Price: **A$2.30**

Income Statement	12/14A	12/15E	12/16E	12/17E
Revenue	**287**	**285**	**256**	**253**
EBITDA	**272**	**273**	**247**	**244**
Depr. & Amort.	-0	-0	-0	-0
EBIT	**272**	**273**	**247**	**244**
Associates	-	-	-	-
Net interest exp.	(103)	(103)	(127)	(124)
Other	0	0	0	0
Profit before tax	**169**	**170**	**120**	**120**
Income tax	(41)	(41)	(29)	(29)
Profit after tax	**128**	**129**	**91**	**91**
Minorities	-0	-0	-0	-0
Preferred dividends	-	-	-	-
Associates & Other	0	0	0	0
Normalised NPAT	**128**	**129**	**91**	**91**
Unusal item after tax	0	0	0	0
Net profit (Reported)	**128**	**129**	**91**	**91**

Balance Sheet	12/14A	12/15E	12/16E	12/17E
Cash & equivalents	124	0	13	14
Inventories	0	0	0	0
Receivables	11	11	11	11
Other current assets	2	2	2	2
Current assets	**137**	**13**	**26**	**27**
Property, plant & equip.	0	0	0	0
Intangibles	0	0	0	0
Other non-current assets	2,883	3,710	3,667	3,627
Non-current assets	**2,883**	**3,710**	**3,667**	**3,627**
Total assets	3,020	3,723	3,693	3,655
Payables	82	82	82	82
Interest bearing debt	0	205	155	105
Other liabilities	1,090	1,298	1,327	1,356
Total liabilities	**1,172**	**1,585**	**1,564**	**1,543**
Net assets	**1,846**	**2,135**	**2,126**	**2,109**
Ordinary equity	1,846	2,135	2,126	2,109
Minority interests	-	-	-	-
Preferred capital	-	-	-	-
Total shareholder funds	**1,846**	**2,135**	**2,126**	**2,109**
Net Debt	(124)	205	142	91

Cash Flow	12/14A	12/15E	12/16E	12/17E
EBIT	272	273	247	244
Net Interest	0	8	(8)	(5)
Depr & Amort	0	0	0	0
Tax Paid	0	0	0	0
Change in Working capital	33	-0	-0	-0
Other cash and non-cash items	(108)	(93)	(48)	(52)
Operating cashflow	**197**	**189**	**191**	**187**
Capex	0	0	0	0
Capex - expansionary	*0*	*0*	*0*	*0*
Capex - Maintenance	*0*	*0*	*0*	*0*
Acquistions & Invest	0	0	0	0
Asset sale proceeds	0	0	0	0
Other	-	-	-	-
Investing cashflow	**(199)**	**(751)**	**0**	**0**
Dividends paid	(157)	(189)	(219)	(227)
Equity raised	246	405	0	0
Net borrowings	(1)	205	(50)	(50)
Other financing cash in/(outflows)	(5)	0	0	0
Financing cashflow	**83**	**422**	**(269)**	**(277)**
Total cashflow	**82**	**(141)**	**(78)**	**(90)**
Adjustments	0	0	0	0
Movement in cash/equivalents	**82**	**(141)**	**(78)**	**(90)**

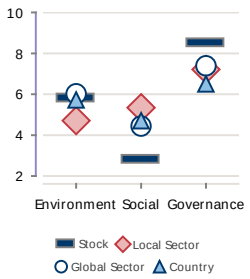
Earnings	12/14A	12/15E	12/16E	12/17E
Equiv. FPO (period avg)	1,408	1,574	1,682	1,682
EPS (CS adj.) (c)	9.1	8.2	5.4	5.4
EPS growth (%)	31.2	(9.7)	(34.0)	0.1
DPS (c)	11.5	12.0	13.0	13.5
Dividend Payout (%)	126.3	145.9	239.6	248.5
Free CFPS (c)	14.0	12.0	11.4	11.1

Valuation	12/14A	12/15E	12/16E	12/17E
P/E (CS) (x)	22.6	25.1	38.0	37.9
PEG (x)	0.7	(2.6)	(1.1)	300.5
EV/EBIT (x)	10.6	10.6	11.7	11.9
EV/EBITDA (x)	10.6	10.6	11.7	11.9
Dividend Yield (%)	5.6	5.8	6.3	6.6
FCF Yield (%)	6.8	5.8	5.5	5.4
Price to book (x)	1.6	1.6	1.6	1.6

Returns	12/14A	12/15E	12/16E	12/17E
Return on Equity (%)	6.9	6.1	4.3	4.3
Profit Margin (%)	44.7	45.4	35.7	36.1
Asset Turnover (x)	0.1	0.1	0.1	0.1
Equity Multiplier (x)	1.6	1.7	1.7	1.7
Return on Assets (%)	4.2	3.5	2.5	2.5
Return on Invested Cap.	12.0	8.9	8.3	8.4

Gearing	12/14A	12/15E	12/16E	12/17E
ND/ND+E (%)	Net	8.8	6.2	4.1
Net Debt to EBITDA (x)	Net	0.8	0.6	0.4
Int Cover (EBITDA) (x)	2.6	2.7	1.9	2.0
Int Cover (EBIT) (x)	2.6	2.7	1.9	2.0
Capex to Sales (%)	-0.0	-0.0	-0.0	-0.0
Capex to Depr (%)				

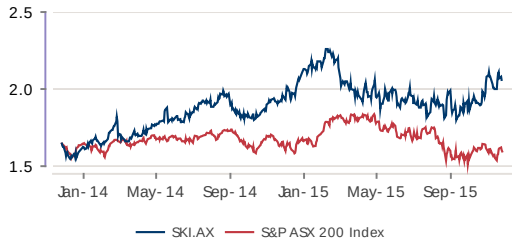
MSCI IVA Rating B



TP ESG Risk (%): -2.00
TP Risk Comment: ESG value impact -2%: we value the tapering of asset growth rates due to the decline in centralised energy demand as a result of high energy prices and environmental concerns.
MSCI IVA Risk: Neutral
MSCI IVA Risk Comment: No current concerns

MSCI ESG Research

Share price performance



On 24-Nov-2015 the S&P ASX 200 Index closed at 5226.389
On 24-Nov-2015 the spot exchange rate was A$1.38/US$1

Source: Company data, Credit Suisse Estimates

Key Points

TransGrid price at the top end of our expectations

Price paid is high relative to comparable assets

We do not dispute that TransGrid is a great asset; a 25-year plus asset with inflation-linked cash flows and governed by a generous regulatory regime which still by design errs on the side of over-incentivising. Nor do we disagree with Spark's view that centralised generation will deliver the vast majority of Australia's electricity for the foreseeable future, and much of this will be new-build renewables within decades. However, we simply can't justify the price paid when applying our DCF valuation framework in a consistent manner as that applied to Spark's existing assets and those of its peers.

There is a valid argument to say that the outcome and the list of suitors suggest that market valuations need to adjust higher. However, in our opinion this would necessitate either a very optimistic view on un-regulated revenues, or a significant departure from a generous yet rigid regulatory framework.

We value TransGrid at 1.48x RAB or ~$9.4bn

Our DCF sum-of-the-parts valuation yields an estimated FY15 value of $9.394bn which is appreciably below the $10,392mn paid by Spark's consortium. For Spark's 15.01% share the value is $1,410mn versus its share of the purchase price $1,560mn; equivalent to $0.09/sh adjusted for the rights issue. This is based on what we believe are quite generous assumptions including an initial 35% CAGR for un-regulated revenues to FY18. A detailed discussion of our assumptions can be found in the report below.

Scope for div increase despite dilution of TransGrid

Acquisition FCF dilutive on a 'look-through' basis

Our investment thesis for Spark has long been based on its superior cash flow to dividend coverage which gave it a better medium-term dividend outlook than peers. The improved dividend guidance discussed below is proof of this. While the acquisition of TransGrid is dilutive to steady state cash flows (operating cash flows less maintenance capex), Spark's relatively small equity stake means that it is only mildly dilutive to this thesis.

Spark's presentation highlights that this acquisition is cash flow accretive on a standalone basis (SOCF), but this is a function of both asset level cash flows and payout ratios. Hence, we prefer the 'look-through' measure which is better reflective of the cash flows generated by the assets owned. As shown in Figure 1, we estimate that the acquisition is ~4% dilutive to cash flows which still leaves Spark on a steady state free cash flow yield of ~10.5% versus TERP.

Figure 1: Pro forma cash flow analysis

A$mn	FY16F	FY17F	FY18F	FY19F	FY20F
SKI existing					
"Steady State" free-cashflow	326.2	322.8	326.7	321.2	312.7
Shares on issue	1466.4	1466.4	1466.4	1466.4	1466.4
Look-through FCF per share	0.22	0.22	0.22	0.22	0.21
SKI's 15.01% share of TGD					
"Steady State" free-cashflow	40.9	42.0	44.5	41.3	42.1
New shares issued	215.6	215.6	215.6	215.6	215.6
Look-through FCF per share	0.19	0.20	0.21	0.19	0.20
SKI pro-forma post TGD					
"Steady State" free-cashflow	358.8	356.0	361.9	352.5	342.4
New shares issued	1682.0	1682.0	1682.0	1682.0	1682.0
Look-through FCF per share	0.21	0.21	0.22	0.21	0.20
FCF dilution	-4.1%	-3.9%	-3.4%	-4.3%	-4.5%
FCF yield @ TERP	10.5%	10.4%	10.6%	10.3%	10.0%

Source: Company data, Credit Suisse estimates

We estimate 0.5cps dividend guidance increase from FY16

Management pointed to the potential to review distribution guidance for 0.5cps growth per annum following the final regulatory decision for the Victorian Power Networks due April-2016. It pointed to the potential for a "significant" increase in SOCF.

We estimate that a 0.5cps increase to FY16 guidance of 12.5cps is comfortably achievable based on our current assumptions for VPN which assume only a slight revision versus the draft decision. This would require slightly higher debt funding of capex within SAPN which is possible following its favourable decision (see Positive determination outcomes). We estimate that SAPN's gearing (ND/RAB) will fall to 71% by end-FY15 and its FFO/Debt and interest cover of 12.5-13.0% and ~3.6x remain well above the thresholds required to retain its a- rating (FFO/Debt 10%; Interest cover 2.5x). A 77% funding of growth capex is sufficient to cover the increased distribution, and will only see SAPN's debt increase minimally.

Low real asset growth expected over long term

Much of Australia's thermal generation fleet will need to be replaced by renewables over the next 20 years if the market follows the lead of AGL and Origin in committing to close their coal power stations at the end of their economic life. Further, New South Wales (which TransGrid serves) looks to be one of the more attractive regions with high 'black' spot electricity prices and good solar and wind resources. This will likely drive an increase in connection revenues and form much of the 35% CAGR in unregulated revenues that we model for.

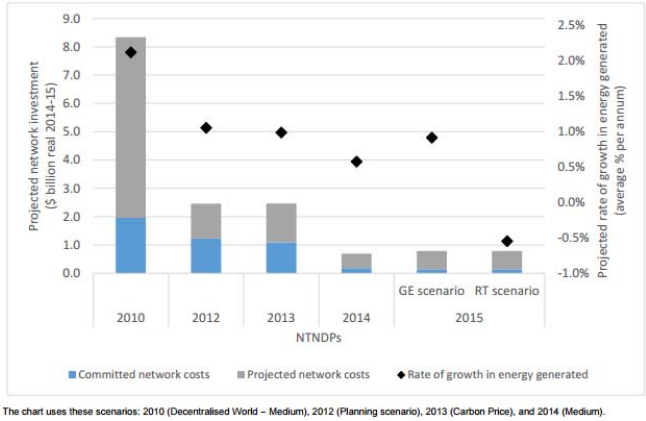
However, it is unlikely to require large augmentation to the transmission network to accommodate this capacity, hence we expect close to zero real asset growth. The market operator (AEMO) recently updated its National Transmission Network Development Plan in which it reviewed the likely constraints to that will emerge over the next 20 years. It found that minimal transmission augmentation is required to deliver 6,700MW of new renewable generation as required under the Renewable Energy Target provided that it is located efficiently in areas with existing capacity (just $800mn for the entire National Energy Market as shown in Figure 2).

It would not be wise to assume that generation is indeed located efficiently, but the order of magnitude of spending is clear.

Spark's average regulated asset growth rate only slightly diluted to 4.5%

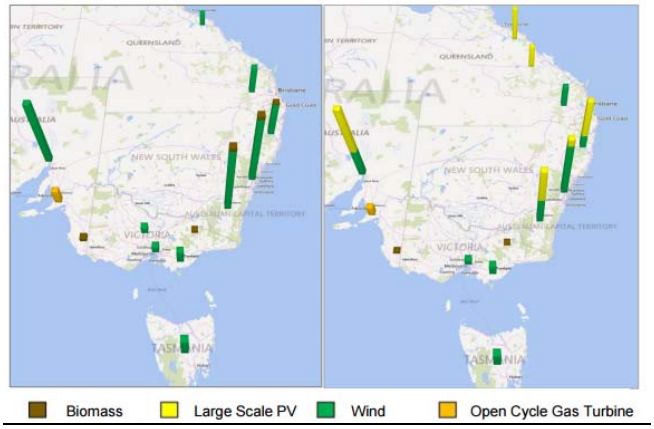
The final TransGrid regulatory determination for 2014-18 allows for 2.51% nominal regulated asset growth; Spark's relatively small equity share sees its total RAB growth rate diluted from 4.8% per annum to 4.5% per annum which comfortably underpins its long-term dividend target of 3-5% annual growth.

Figure 2: Est cost of transmission constraints for NEM in next 20 years



Source: AEMO, NATIONAL TRANSMISSION NETWORK DEVELOPMENT PLAN, Nov 2015

Figure 3: Additional generation location by 2024-25



Source: AEMO, NATIONAL TRANSMISSION NETWORK DEVELOPMENT PLAN, Nov 2015

Summary

- **Spark takes a 15.01% equity share of $10.4bn TransGrid purchase:** The consortium will fund the purchase using $5,500mn in debt (~85% ND/RAB). The purchase price represents a RABx multiple of ~1.6x and FY15 EV/EBITDA multiple of ~16.0x. Spark's consortium took stakes as follows: Hastings – 20.02%, CDPQ – 24.99%, Tawreed Investments – 19.99%, Wren House – 19.99%.
- **Spark to raise equity through 3 for 34 pro rata non-renounceable entitlement offer at $1.88/sh:** Spark will fund its $734mn share of the equity through a $405mn entitlement offer plus $140mn of cash on hand and through a drawdown of an existing corporate facility for $205mn.
- **Extended 0.5cps dividend growth guidance to FY18, and upside indicated:** SKI reaffirmed FY15 guidance for 12.0cps and gave maiden guidance for "at least" 0.5cps growth per annum to 13.5cps in FY18. It pointed to upside to dividend once the final VPN determinations are known in April 2016 based on their expectations of the potential for a significant increase in SOCF.
- **Company guidance that acquisition will be standalone OCF accretive in 2015:** SKI stated that the acquisition would be accretive versus their 2015 forecast of 14.0cps (FY14 14.7cps, FY15 guidance not previously provided). This is based on forecast cash flows from TransGrid of $36.7mn after corporate debt costs which equates to 17.0cps on the newly issued securities.
- **Tax efficient structure approved by ATO:** Spark's management indicated that the consortiums purchase had been structured in a tax optimised manner. We forecast zero cash tax to be paid in the medium term. Importantly, management stated that the structure had been approved both by the State and by the Australian Taxation Office.
- **The consortium will be bound by employment guarantees at TransGrid to June 2020:** During this period TransGrid will maintain 1,000 full time equivalent employees, which is commensurate with current staff levels. Spark's management is confident of achieving operating efficiencies through higher levels of in-sourcing and enhance procurement practices.

Financing

- **Raising $405.4mn in a 5-for-34 pro rata non-renounceable entitlement offer at $1.88/sh:** The offer price represents an 8.7% discount to the last traded price or a 7.7% discount to TERP. Spark will use the $405.4mn in proceeds plus $140mn of cash on hand plus $205mn of corporate debt at the SKI level to contribute its $751mn share.
- **$5.5bn debt implies Net Debt to RAB ~85%, seeking investment grade rating:** Spark's stated that it anticipates receiving an investment grade rating of approximately BBB/BBB+. Using Multinet gas (BBB-/Stable) as a reference; it is required to keep FFO/Debt above 6.5% and FFO/Interest coverage above 2.0x. Our estimates – shown in Figure 4 – indicate that TransGrid should achieve this within acceptable bounds of error.

Figure 4: TransGrid stand-alone credit metrics

Credit metrics	FY14F	FY15F	FY16F	FY17F	FY18F	FY19F	FY20F	Rating/ Threshold
TGD								BBB est
FFO/Debt			7.1%	7.1%	7.1%	6.5%	6.4%	est 6.5%
FFO interest coverage			2.8x	2.8x	2.8x	2.5x	2.5x	est 2.0x

Source: Credit Suisse estimates, Company data

Earnings changes and valuation

Earnings changes

- **Incorporating TransGrid into our forecasts, proportionate EPS decreased 10.1%:** We incorporate TransGrid into our earnings forecast and make changes as detailed in Figure 7. Proportionate NPAT is increased 3.1% in FY16 and FY17; Underlying Consolidated NPAT is reduced 18.9% in FY16 and 19.5% in FY17 due to higher loan note interest expense following the rights issue.
- **Assuming zero cash tax in the short to medium term:** Spark's management indicated that the consortiums purchase had been structured in a tax optimised manner. We forecast zero cash tax to be paid in the medium term. Importantly, management stated that the structure had been approved both by the State and by the Australian Taxation Office.
- **Increase distribution forecast 0.5cps to 13.0cps in FY16:** Given Spark's strong position and the indications from its presentation, we increase our forecast to 13.0cps in F16 (from 12.5cps). This is 0.5cps above current guidance for "at least 12.5cps."

Figure 5: **TransGrid (100%) Profit & Loss summary**

Profit & Loss	FY16F	FY17F	FY18F	FY19F	FY20F
Revenue	800.4	819.0	839.0	842.0	863.9
EBITDA	604.1	616.0	631.8	629.5	646.1
Prescribed Services	550.5	542.3	529.4	524.7	538.6
Non-Prescribed Services	44.0	63.9	92.5	94.8	97.1
D&A	238.1	239.7	239.5	239.9	241.3
EBIT	366.0	376.3	392.3	389.6	404.8
Senior Interest	219.3	221.8	227.4	247.7	255.4
Interest income	-	0.7	0.6	0.8	0.8
Derivatives	-	-	-	-	-
PBT	146.7	155.1	165.5	142.7	150.2
Tax	44.7	48.0	50.9	43.9	46.3
NPAT	102.0	107.1	114.6	98.9	103.9
Key ratios					
Revenue growth	-4.8%	2.3%	2.5%	0.4%	2.6%
EBITDA margin	75.5%	75.2%	75.3%	74.8%	74.8%
EBIT margin	45.7%	45.9%	46.8%	46.3%	46.9%

Source: Company data, Credit Suisse estimates

Valuation

TransGrid valuation

Using a consistent framework to Spark's existing assets and its regulated peers, we estimate the value of Spark's 15.01% share of TransGird including the value of its tax efficient structure to be $1,410mn as at December 2015 or $1,446mn using a 12-month forward valuation as shown in Figure 6. Our combined DCF uses a post-tax Weighted Cost of Capital of 4.57% and a cost of equity of 6.41%. Our valuation assumptions for TransGrid are below:

- 6.00% Market Risk Premium, 50bps lower than regulator
- 50bps lower terminal Debt Risk Premium, up to 250bps prior to the end of the current regulatory determination in 2018.
- Gearing of 53.5% (Net Debt/Enterprise Value).
- Un-leveraged asset beta of 0.34, in-line with regulator

- Gamma (regulated value of imputation credits) of 0.40. This is an input into regulated revenues only, we do not value imputation credits in our DCF.
- Zero real asset growth over life of assets.
- 5% Opex reduction versus regulatory allowance.
- 5% Capex reduction versus regulatory allowance.
- 35% CAGR of un-regulated revenues to $123mn in FY18. Assume 75% EBITDA margin, up from 53% in FY14 (Jun-14 year end)

Spark valuation and investment view

- **Target price, adjusted for rights issue, is unchanged at $2.30/sh, retain OUTPERFORM rating:** Changes made to our DCF valuation include ~$0.06/sh for the dilution of the discounted rights issue; a $0.09/sh reduction for the value of TransGrid; a $0.03/sh increase for a mark to market reduction in the risk free rate to 2.7% (12m rolling average 10yr CGS); and a ~$0.05/sh increase as we roll the model six months. We set our target price at a $0.05/sh premium to our DCF valuation of $2.24/sh to reflect comments made by management regarding the near-term potential for increased distributions.
- **Investment view:** The acquisition of TransGrid and the accompanying announcements were in equal parts a validation of our thesis that Spark had above peer potential for growth in distributions; but also a disappointment at the price paid for TransGrid. The value dilution from the TransGrid acquisition was not significant but due to the smaller-than-anticipated 15.0% equity stake. While there may be a near-term 'sticker-shock' reaction to the TransGrid acquisition, Spark retains a strong balance sheet and cash flow profile and the near-term potential for growth in distributions should see Spark trade at a premium to our valuation.

Figure 6: Spark – sum-of-the-parts DCF valuation

Spark Infrastructure SOTP Valuation			EBITDA		EV / EBITDA		RAB	EV / RAB*
	A$mn	$ps	FY16F	FY17F	FY15F	FY16F	FY15F	FY15F
VPN	3,711	2.21	358.2	347.7	10.4x	10.7x	2,867	129%
SAPN	2,940	1.75	269.7	289.4	10.9x	10.2x	2,136	138%
TGD	1,359	0.81	90.7	92.5	15.0x	14.7x	978	139%
Corporate (SKI) costs	-121	-0.07	(8.9)	(9.1)	13.7x	13.3x		
Other / DUE	257	0.15	46.0	47.3	na	na		
Asset valuation	8,145	4.84	755.6	767.7	10.8x	10.6x	5,981	136%
Tax benefit - VPN	215	0.13	24.7	18.0	8.7x	12.0x		
Tax benefit - SAPN	193	0.11	14.0	15.6	13.8x	12.4x		
Tax benefit - TGD	86	0.05	6.6	7.0	13.0x	12.3x		
Total EV	8,640	5.14	801.0	808.3	10.8x	10.7x	5,981	144%
Net Debt - SKI	-142	-0.08						
Net Debt - VPN	-2,374	-1.41						
Net Debt - SAPN	-1,552	-0.92						
Net Debt - TGD	-813	-0.48						
SKI Equity value	3,759	2.24						
Target price		2.30						

Key WACC parameters	
Tax rate	30%
Risk free	2.7%
Debt margin	1.50%
Gearing	53.5%
MRP	6.0%
Asset beta	0.34
Equity beta	0.61
Ke	6.41%
Kd	4.2%
WACC (Pre-tax)	5.25%
WACC (Post-tax)	4.57%

Source: Company data, Credit Suisse estimates

Figure 7: Spark – Proportionate earnings changes

Proportionate P&L	FY14	FY15F	FY15F	Change	FY16F	FY16F	Change	FY17F	FY17F	Change
VPN	575.6	624.4	624.4	0.0%	611.9	611.9	0.0%	608.2	608.5	0.0%
SAPN	581.8	559.4	559.4	0.0%	490.7	490.7	0.0%	501.8	501.8	0.0%
TGD		0.0			120.1			122.9		
DUE		16.5	16.5		46.0	46.0		47.3	47.3	
Total revenues	1,182.3	1,200.3	1,200.3	0.0%	1,268.7	1,148.5	10.5%	1,280.3	1,157.6	10.6%
EBITDA	812.0	830.7	830.7	0.0%	847.2	756.6	12.0%	861.6	769.4	12.0%
...VPN	394.7	450.0	450.0	0.0%	408.4	408.4	0.0%	399.2	399.4	-0.1%
...SAPN	406.9	375.8	375.8	0.0%	311.0	311.0	0.0%	331.8	331.8	0.0%
...TGD		0.0			90.7			92.5		
...SKI	-14.6	-11.6	-11.6	0.0%	-8.9	-8.9	0.0%	-9.1	-9.1	0.0%
...DUE		16.5	16.5	0.0%	46.0	46.0	0.0%	47.3	47.3	0.0%
Less: Depreciation & Amortisation	231.3	243.4	243.4	0.0%	291.4	255.6	14.0%	304.6	268.7	13.4%
EBIT	580.7	587.3	587.3	0.0%	555.9	501.0	11.0%	557.0	500.8	11.2%
...VPN	255.8	307.5	307.5	0.0%	258.9	258.9	0.0%	242.3	242.5	-0.1%
...SAPN	314.6	275.0	275.0	0.0%	205.0	205.0	0.0%	220.0	220.0	0.0%
...TGD		0.0			54.9			56.5		
...DUE		16.5	16.5		46.0	46.0		47.3	47.3	
...SKI	-14.6	-11.6	-11.6	0.0%	-8.9	-8.9	0.0%	-9.1	-9.1	0.0%
Less: Net interest	224.1	206.8	206.8	0.0%	218.2	176.8	23.5%	225.5	183.1	23.1%
...VPN	124.7	128.1	128.1	0.0%	102.8	105.0	-2.1%	109.0	111.3	-2.1%
...SAPN	99.5	86.7	86.7	0.0%	74.4	74.8	-0.6%	78.3	78.4	-0.1%
...TGD		0.0			32.9			33.2		
...SKI	-0.1	-8.1	-8.1	0.0%	8.1	-3.1	-364.7%	5.0	-6.6	-175.8%
Profit before tax	356.6	380.6	380.6	0.0%	337.7	324.2	4.2%	331.5	317.7	4.4%
Less: Tax	57.6	72.6	74.4	-2.5%	60.3	55.1	9.4%	54.0	48.4	11.6%
...VPN	17.1	31.7	31.7	0.0%	24.7	24.1	2.7%	18.0	17.4	3.5%
...SAPN	0.0	0.0	0.0	na	0.0	0.0	na	0.0	0.0	na
...TGD		0.0			6.7			7.2		
...SKI	40.5	40.9	42.7	-4.3%	28.8	31.0	-7.0%	28.9	31.1	-7.1%
OEI	0.0	0.0	0.0	na	0.0	0.0	na	0.0	0.0	na
NPAT	299.0	308.0	306.1	0.6%	277.4	269.1	3.1%	277.5	269.3	3.1%
Revenue growth	5%	2%	2%	0.0pp	6%	-4%	10.0pp	1%	1%	0.1pp
EBITDA growth	6%	2%	2%	0.0pp	2%	-9%	10.9pp	2%	2%	0.0pp
EBIT growth	7%	1%	1%	0.0pp	-5%	-15%	9.4pp	0%	0%	0.2pp
NPAT (normalised) growth	12%	3%	2%	0.6pp	-10%	-12%	2.2pp	0%	0%	0.0pp
EBITDA margin	69%	69%	69%	0.0pp	67%	66%	0.9pp	67%	66%	0.8pp
EBIT margin	49%	49%	49%	0.0pp	44%	44%	0.2pp	44%	43%	0.2pp
Effective tax rate	16%	19%	20%	-0.5pp	18%	17%	0.9pp	16%	15%	1.1pp

Source: Company data, Credit Suisse estimates

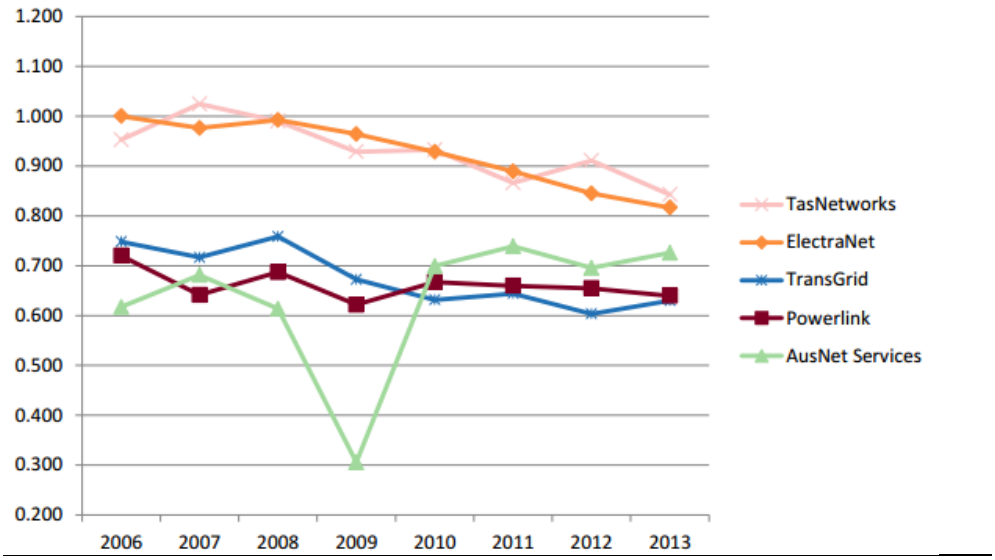
Appendix A: Regulatory backdrop

- **Market operator predicts minimal new investment required even to meet renewables targets:** In its annual National Transmission Network Development Plan (NTNDP), the market operator (AEMO) concluded that minimal transmission augmentation is required to deliver 6,700MW of new renewable generation provided that it is located efficiently in areas with existing capacity. Just $800mn in augmentation capex for the entire east coast is required; which will result in minimal real asset growth for the foreseeable future.
- **Transmission less responsible for sharp increase in consumer bills:** A doubling of consumer bills was largely responsible for triggering the enhanced scrutiny of opex/capex that resulted in decisions such as the 25% real decline in opex allowance for AusGrid. As TransGrid points out in its regulatory proposal, while Transmission and distribution comprise ~50% of a consumer bill in NSW&ACT; transmission alone accounts for just 7%.

Benchmarking

- **Benchmarking of transmission networks not yet used to compare relative efficiency of networks:** The AER has acknowledged the current shortcomings in using the results of the transmission network benchmarking to measure the relative efficiency of networks; as it did with the distribution networks. At this stage it is only used to measure changes in efficiency of individual networks over time. In the most recent determination, the regulator used the declining measured productivity of TransGrid (see Figure 8) to inform and reduce its replacement capex allowance.

Figure 8: **Relative MTFP performance of transmission networks**



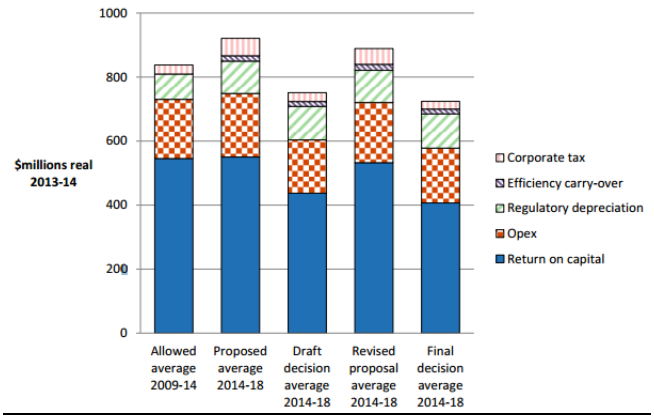
Source: AER

Most recent AER determination 2014-18

- **Practically no revenue scale-back from revised proposal except for rate of return:** As shown in Figure 10, TransGrid's final decision allowed for almost all the revenues put forward in their proposal outside of the return on capital. The AER used a final WACC of 6.84% (nominal vanilla pre-tax) for 2014-15 compared with 8.65% put forward by TransGrid in its revised proposal.

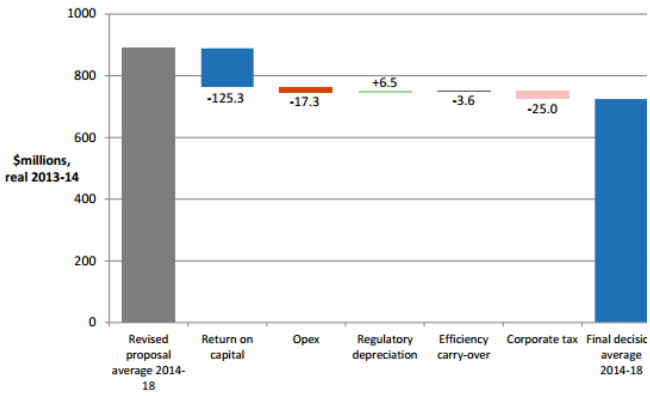
- The reasons for the difference are identical to those that occurred for the NSW, SA and VIC distribution networks: the AER's reliance on a single 'foundation' CPM model; and a different approach to transitioning to the trailing average debt approach.

Figure 9: Allowed revenue building blocks vs 2009-14 period and 2014-18 proposal



Source: AER

Figure 10: Avg revenues- final decision vs proposal



Source: AER

Summary of opex and capex allowance

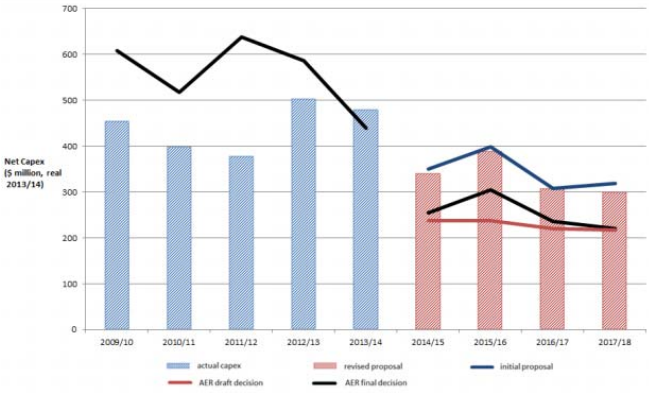
Capex summary

- **Capex allowance results in zero real asset growth rate:** The final capex allowance determined by the regulator is approximately equal to depreciation, resulting in an asset growth rate of 2.52% per annum (only slightly above assumed inflation of 2.38% per annum).
- **Accepted capex proposal included just $65.2mn I augmentation:** No doubt cognisant of the subdued demand outlook, Transgrid proposed just $65mn in augmentation cpex which was accepted in full by the regulator.
- **$733.8mn or ~60% of total capex related to replacements:** The regulator accepted ~70% of TransGrid's proposed replacement capex. The reason was that the regulator disagreed with TransGrid's risk assessment of its assets and found that it had been applied inconsistently between 2009 and 2014. The AER also used the observed decline in productivity over time – as measured by the AER's benchmarking study – to reduce the allowance under its top down approach.
- **$310mn capex contingent on new generation projects:** The AER has provided for $308.9mn in contingent capex allowance which will be triggered if new generation projects exceeding 350MW are classified as 'committed' by AEMO in the Southern NSW area around Yass/Canberra/Marulan. The investment will still need pass a regulatory investment test (RIT-T) to demonstrate positive market benefits. We understand that the Boco Rock and Taralga wind farms (with combined capacity 220MW) which were completed in early 2015 count towards this 350MW as does the 20MW Royalla Solar farm.
  - Currently there are no committed renewables projects in NSW outside of the 56MW Moree Solar farm in northern NSW. As is typical however, there is >4,500MW of publically announced projects although we do not expect a significant proportion to proceed on a three year view.

Opex summary

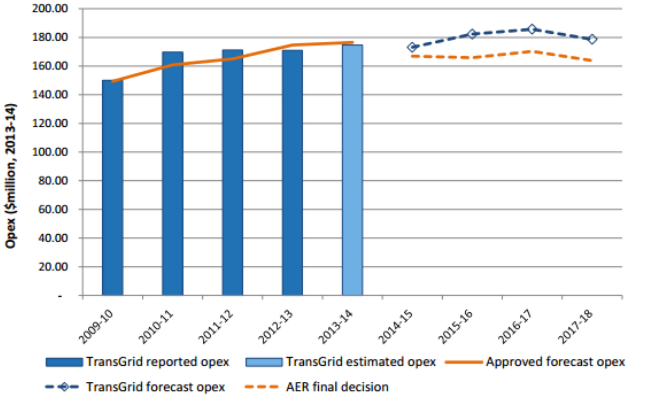
- **Opex allowance slightly below actual revealed expenditure:** The key differences between TransGrid's proposal and the final decision were slightly different forecast for output and productivity growth and minor methodology differences.
- **Decline in productivity shows scope for efficiency gains:** TransGrid's productivity has been measured as having deteriorated over the last regulatory period as shown in Figure 8. This provides scope should the new owners be able to arrest this decline and reverse it.

Figure 11: Final capex allowance vs actual



Source: AER

Figure 12: Final opex allowance vs actual



Source: AER

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