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SP AusNet
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Record of interview:

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SP AusNet today reported net profit after tax (NPAT) of A$119.6 million for the first half ended September 2007, up 22 percent compared with continuing operations in the previous corresponding period. The result reflected growth in revenue of 5 percent to A$583.3 million, and growth in operating expenses of 5.6 percent, adjusting for a one-off A$15.9 million legal provision in the previous first half. How sustainable is the revenue growth in the existing business and can you continue to control growth in expenses?

MD Nino Ficca
We're very pleased to have delivered an NPAT ahead of the prior period. Excluding the prior period legal provision of A$15.9 million, comparable growth in NPAT from continuing operations was 10 percent. The strong result was driven largely by revenue growth from higher tariffs and distribution network reliability incentives being realised.

As a regulated business, our revenues increase each year on a stable basis, subject to volumes on the distribution networks and the impact of regulatory resets. We expect this stable growth profile to continue and, coupled with the growth opportunities the Alinta assets will bring us, continue to deliver value for securityholders.

With respect to operating expenses, we aim to control costs across the business. In the first half we experienced some slight cost increases surrounding environmental provisions. However, our focus continues to be on delivering cost efficiencies within each of our networks.

An important point to note is the seasonality of our revenues, particularly on the gas distribution network, due to higher demand for heating during the winter months. This seasonality results in a larger proportion of revenues being earned in the first half of the year. However, operating costs are more evenly spread over the full year, resulting in lower margins and NPAT in the second half of the year.

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You've announced an interim distribution of 5.776 Australian cents per stapled security, up 2.5 percent from 5.635 cents in the previous year and in line with your full-year distribution guidance of 11.6 cents. The total interim distribution was A$117.9 million and continues to be covered by operating cash flow after interest payments and maintenance capex, which totalled A$144.8 million. In the explanatory memorandum for your proposed A$8.3 billion acquisition of the Alinta businesses it appears that both growth and maintenance capex will be funded from borrowings. Does this represent a change in your distribution model? Won't distribution growth be constrained as borrowings and debt servicing costs increase?

CFO Geoff Nicholson
Our stapled structure enables us to make distributions in excess of accounting profits and this is consistent with our current distribution model and the sector overall. Our expected distribution payout ratio continues to be in a range that compares favourably with similar infrastructure businesses.

Following the acquisition, operating cash flows will continue to cover 100 percent of distributions and interest payments. However in the 2009 year, the amount of capex that will be debt funded is expected to increase compared with prior years. That's because 2009 will be a transitional year for the new business. It will include increased capex for the expansion of the gas transmission pipelines, from which related revenue and EBITDA won't be derived until subsequent periods. Also, synergies won't have reached their full run-rate, yet the cost of implementing those synergies will be incurred in the year. We expect the amount of capex funded by debt will reduce over time.

The sustainability of the business and its financial profile were carefully considered by the board prior to providing the distribution guidance for 2009. We believe the structure is sustainable and Standard & Poor's has indicated that a stable A- rating is appropriate for the new SP AusNet given our medium-term financial profile.

We aim to deliver sustainable and predictable distributions to securityholders and the board will make decisions regarding future distributions based on the overall strength of the business, the underlying cash flows and the ability to maintain distributions.

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The explanatory memorandum states that the acquisition will result in free cash flow per security accretion of 7.4 percent in 2009. You've defined free cash flow as EBITDA less total capex. Why do you think this is the most relevant definition?

CFO Geoff Nicholson
We look at free cash flow in the traditional sense for a discounted cash flow model, which is the cash flow available for debt and equity service from operating cash flows and reinvestment in the business. On the businesses we're proposing to acquire, the free cash flow per security is estimated to provide accretion of 7.4 percent in 2009, after normalising for transitional implementation costs. That's in a year when we'll also have a significant pipeline expansion underway.

The way we look at accretion is on a total capex basis as it's the total capex that needs to be funded and which comes out of the cash flows available to our investors. Therefore when we value assets, clearly we need to take the whole capex profile into account, not just the maintenance capex. This approach is consistent with how our business is regulated, valued and financed and how ratings agencies examine their ratings.

What attracted us when we looked at these businesses was that the overall capital intensity of our business would be reduced. At present our business is very capital intensive and we are required to reinvest a lot of our EBITDA into regulatory capex. However, with the Alinta businesses, more of the EBITDA we earn will be available to service debt and equity capital.

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The acquisition is to be funded by an entitlements issue and securities placement currently estimated to be up to A$3.0 billion and debt of A$4.3 billion, plus existing Alinta debt of A$1.0 billion. Gearing post the deal is expected to be 61.3 percent compared with 58.2 percent before. Given SP AusNet's credit rating is expected to fall to A- from A currently, can you comment on the cost of the new debt and how the reduced rating might impact borrowing costs going forward?

CFO Geoff Nicholson
The impact of an A- credit rating on our cost of debt is expected to be modest overall as our existing debt will be unaffected. The cost of new debt will depend on the markets we access and the term of the debt, and we aim to maintain a well diversified maturity profile for our existing and new debt. Despite recent credit market volatility, two types of issuers that have been able to raise sizable amounts of debt in both US and European markets are corporate (rather than financial) issuers with a strong investment grade credit rating and companies in the utilities sector. We're in both these categories and are confident we'll be in a strong position to refinance our debt commitments moving forward.

On average, our cost of debt is likely to rise by around 0.10 to 0.20 percent per annum. However, it should be noted that the credit margins for a significant portion of our existing debt are locked in and won't change until that debt matures.

It should also be noted that our credit rating is stronger than the former Alinta and therefore our cost of funds is more competitive.

Changes in interest rates will also be factored into future regulatory return decisions, which essentially provide a natural hedge on interest rate risk.

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The forecast 2009 distribution of 12.1 cents represents accretion of 2.5 percent compared with an expected distribution of 11.8 Australian cents for the existing business. Couldn't this level of accretion be achieved by gearing up the existing business to a similar level proposed for the new business?

MD Nino Ficca
We have the highest rating in the utilities sector in Australia and we've always maintained we'll target an "A" range credit rating. It wouldn't necessarily have been possible to gear up the existing business to a similar level and maintain our credit rating, due to the smaller size and less diverse nature of our existing business. The addition of the Alinta businesses significantly diversifies the business, allowing greater leverage whilst maintaining a strong financial position. In addition, the Alinta businesses are less capital intensive and therefore will increase the free cash flow available. We consider the expanded group to have a better business mix than the existing business as we'll retain a very strong defensive regulated asset base with greater opportunity to create higher value for our securityholders over time.

The board and management consider this acquisition a unique opportunity to deliver against our strategy. The assets we're acquiring are of the same high quality as our existing portfolio and provide significant strategic benefits and enhanced future growth opportunities. Our "A" range credit rating is considered conservative relative to our peers, and it provides us with flexibility to pursue significant growth opportunities within the business.

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The Alinta acquisition price is equivalent to a 2009 EV/EBITDA multiple of 13.6 times versus a multiple of 9.3 times for the existing business and the acquisition is expected to be EPS decretive by 24 percent, excluding one-off synergy implementation costs, in 2009. Why should existing SP AusNet securityholders support a transaction leading to this level of dilution?

MD Nino Ficca
To come to an informed view on the multiple we're paying, you need to take into account the synergy benefits we'll deliver as a result of the transaction, the one-off costs associated with implementing those benefits, and our share of the EBITDA of both United Energy Distribution and the ActewAGL JV Partnership (both equity accounted businesses). Using this methodology, we're paying a multiple of 12.1 times which is well within the range of comparable acquisition and trading multiples in sector.

In our opinion, the positive cash flow and distribution accretion benefits outweigh an EPS dilution driven by the higher earnings multiple attributed to the Alinta businesses. The multiple we're paying for these businesses reflects the higher growth embedded in the assets, with pipeline expansions delivering EBITDA growth beyond the forecast 2009 year, as well as the lower capital intensity of the Alinta businesses.

At current trading prices our 2009 distribution per security guidance of 12.1 cents for the new SP AusNet would mean that we will be offering an attractive, tax effective yield of over 10 percent.

We believe securityholders will view the transaction as having long-term benefits.

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SP AusNet has indicated it will not issue new securities at less than A$1.10 per security. What were the metrics you considered in setting this price floor and what will happen if the securities cannot be priced above this level?

MD Nino Ficca
In deciding not to issue securities at less than A$1.10 per security, the board considered the impact of possible issue prices on existing securityholders, our ability to pay distributions and the impact on our credit rating and gearing.

The board will make a decision on the final issue price based on its assessment of the interests of SP AusNet and its securityholders at the time of the securityholder meeting. If the board isn't satisfied with the issue price, it will not proceed with the transaction.

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Unregulated and contracted revenue is expected to account for 31 percent of the new SP AusNet's total revenue, up from 10 percent for the existing business. To what extent will this provide benefits to securityholders and will it erode the quality of your cash flows or the predictability of the cash available for distribution?

MD Nino Ficca
Growing our unregulated revenues is a strategy we've been working on for some time and this acquisition will enable us to realise that strategy immediately. However, it's important to note that regulated revenues will continue to make up 70 percent of our total business, ensuring continued stability of earnings. Moreover, the transaction will lower the sensitivity of our regulated revenues to the performance of any one asset and improve diversity across regulatory periods.

Revenues from gas transmission pipelines will increase long-term revenue certainty as they're contracted for terms that extend beyond the period of regulatory decisions. From April 2008, 100 percent of the current capacity of the Eastern Gas Pipeline (EGP) is contracted to 2016 and over 88 percent of the forward capacity of the Queensland Gas Pipeline (QGP) is currently contracted to 2014. In addition, a large proportion of the asset management revenue is subject to long-term operating service agreements that extend for terms beyond 2011.

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Can you comment on SP AusNet's strategy in relation to the asset management business?

MD Nino Ficca
We're very excited about the opportunities asset management brings and we're committed to growing and extracting value from this business. We'll offer a unique spectrum of asset management services with capabilities across the full suite of electricity and gas transmission and distribution networks.

The strategy will be to continue to organically grow the business in the external market with a particular focus on servicing the needs of non-related government and privately owned utilities. Infrastructure spend across these utilities is increasing significantly and, in a constrained labour and resource market, our asset management business will be well positioned to capture this growth.

We also intend to pursue "build-own-operate" (BOO) opportunities such as Project Camellia, which is a 20 kilometre recycled water network in New South Wales utilising disused gas mains, and the development of gas storage and transportation facilities. The asset management business will also manage our own distribution and transmission assets.

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Recent regulatory decisions relating to gas and electricity distribution networks have disallowed network management fees paid to third-party providers, and suggest future margin pressure in the asset management business. To what extent have you taken these developments into account in your valuation of and planning for the business?

MD Nino Ficca
In assessing the transaction, we considered the impact of the current and expected regulatory environment on the margins earned by the asset management business and reflected this in our forecasting. We have had a positive relationship with regulators. Going forward, we'll continue to work with them to ensure they understand our proposed business model.

We'll be looking to grow the asset management business outside of servicing our own assets.

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SP AusNet estimates it will generate cost savings of A$89.8 million by 2010 from combining its existing business with the acquired businesses. What assumptions underlie this forecast and in which specific areas will the savings be generated?

CFO Geoff Nicholson
Singapore Power International (SPI), SP AusNet and Alinta all have considerable experience in separation and integration, as each has undertaken a number of successful acquisitions and divestments. These include the acquisition of TXU by SPI and subsequent divestment of the Merchant Energy Business and Alinta's

acquisition of the Duke Energy International assets, divestment of assets into AIH and acquisition and merger of the AGL businesses.

The forecast synergies will be derived from a number of areas. One key synergy benefit will be the elimination of a corporate office relating to a listed entity.

Regarding labour synergies, we expect the combined group to have around 2,700 employees and we expect approximately 150 senior management will join SPI Management Services. We have plans in place to ensure we capture and retain talent from both organisations. However, we expect potential redundancies of approximately 280 people.

We also expect a number of synergy benefits arising from the consolidation and optimisation of various IT systems and through streamlining business critical processes such as procurement and logistics. There will be one-off implementation costs to achieve the expected synergies and these are expected to be A$11.8 million in 2008, A$20.4 million in 2009 and A$13.8 million in 2010.

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To what extent do you expect SP AusNet to be able to retain these synergy benefits as opposed to being forced to return them to consumers at upcoming regulatory resets?

CFO Geoff Nicholson
We operate in an incentive based regulatory regime whereby regulators encourage and reward innovation and efficiency.

With respect to the ability to retain the forecast synergies, obviously where they relate to the regulated businesses we expect to share our cost savings with customers over time. This will depend on the reset periods for each regulated network which are well diversified across future periods.

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Can you provide any insight into your long-term targets for the new SP AusNet in terms of revenue and distribution growth?

MD Nino Ficca
The broader portfolio of assets resulting from the acquisition will diversify our revenue sources whilst ensuring continued stability of earnings. We'll continue to enjoy stable and predictable earnings with around 70 percent of revenues derived from regulated activities. Higher growth, unregulated and contracted revenues will deliver strong long-term revenue growth.

We expect the revenue and EBITDA contributions from the pipelines to increase substantially in the short term as we undertake the expansions of both the EGP and QGP. Capacity on the EGP will increase by more than 25 percent after the Stage 1 expansion in 2009 and capacity on the QGP will almost double by 2010. Expansion Stages 2 and 3 on the EGP will further increase revenues and EBITDA, with capacity expected to increase by an additional 35 percent. We note that the recent Owen Inquiry review in New South Wales indicated that gas-fired electricity generation growth was more likely than coal given the current uncertainties around a carbon trading scheme for generation investors.

The management team and board look forward to the opportunities this transaction will provide us and our securityholders now and into the future.

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What will happen if securityholders do not approve the transaction at the meeting on December 11?

MD Nino Ficca
We're confident securityholders will view the transaction as having long-term benefits and will therefore vote in favour of the transaction. The Independent Expert, Grant Samuel has also assessed the transaction to be fair and reasonable and in the best interests of securityholders.

However, in the event that all of the resolutions are not approved by the requisite majority of non-associated securityholders, the transaction won't proceed and SP AusNet would continue to operate in its current form. In that case, we'll have incurred a portion of the costs of the transaction, estimated at approximately A$26 million.

In the scenario where the transaction doesn't proceed, SPI will be free to explore all options and to deal with the Alinta businesses as it sees fit. This may include SPI keeping the Alinta businesses, selling all or parts of them to other investors who may compete with SP AusNet, or separately listing the assets in another vehicle that may compete with SP AusNet.

We're unlikely to secure any opportunities for the expansion of our business that are of a similar scale and scope to this transaction.

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Thank you Nino and Geoff.

For more information about SP AusNet, visit www.sp-ausnet.com.au or call Adrian Hill, General Manager Corporate Development & Investor Relations, on (+61 3) 9695 6701 or +61 438 533 193

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