Infratil

Infratil Operational Report: December 2014

Calendar 2014 has been a good year for Infratil's shareholders. The net after tax gain of approximately 42% put Infratil's returns in the top 10 of the NZX50. (The dividend yield was 13% and share price appreciation 29%.)

Over the two decades since listing Infratil has delivered 18% per annum compound return. Someone who invested $1,000 in Infratil shares as at 1 April 1994 and subsequently reinvested all dividends and other entitlements would now have a holding worth $31,655 (at a share price of $2.92).

Infratil's 2014 performance reflected removal of regulatory risk to Trustpower, the Lumo divestment and its good prospects on several fronts.

A key theme of 2014 has also been the refresh of Infratil's portfolio of businesses to maintain growth into the future. This is being driven by several factors; one of which is sector trends; such as more people flying more often, the increasing elderly population and the societal shift to renewable energy and public transport. Occasionally, however, trends wobble and need to be reviewed to ascertain if the change is a blip or an inflection point. Oil's dramatic price slump and the deprioritisation of initiatives to reduce greenhouse gas emissions are two cases in point.

A reminder of the underlying drivers of energy and greenhouse gas supply and demand came from the recent United Nations revision to its population forecasts, which are now for a global population of 10.9 billion people by 2100, that is 2.5 billion higher than the previous forecast because birth rates are not falling as much as expected.

A 51% rise in the world's population from today's 7.2 billion people will put pressure on all resources along with the environment and climate and will be a major determinant of economic and societal trends.

Wellington Airport

Over the three month period to the end of November, domestic passenger numbers were up 3% on the prior year and international passengers rose 4%. In both instances the increases reflected higher aircraft loadings rather than greater airline capacity.

Domestic Passengers	**Month**	**12 months**	**3 months**
October 2013	408,157	4,780,552	-
November 2013	394,779	4,748,069	1,183,208
March 2014	-	4,683,931	-
October 2014	422,576	4,643,041	-
November 2014	403,561	4,651,823	1,217,349

Inte'l Passengers	**Month**	**12 months**	**3 months**
October 2013	65,817	744,659	-
November 2013	64,235	748,333	187,954
March 2014	-	753,355	-
October 2014	70,400	765,476	-
November 2014	65,054	766,295	196,252

Over the next quarter three new international air services will commence from Wellington, lifting international capacity by almost 20%. For a number of reasons the announcements are very important.

- The services are being provided by JetStar on the Tasman and Fiji Airways to Fiji. Neither of these airlines today provides international services to Wellington and historically it has been shown that it is the new entrant airlines which are more important for growth than incumbents which tend to upscale more incrementally.
- Both airlines will now link Wellington to their respective international networks. Being part of international networks literally puts Wellington on an airline's map.
- Jetstar is a low-fare airline. As shown in the analysis set out below, over the last decade such airlines have dominated international travel growth in this part of the world.
- The three new services demonstrate the strength and dynamism of Wellington's international market. The expansion which has occurred over recent years means that the national carrier now carries only about a third of Wellington's international traffic.

Wellington Airport in the 21st Century

Unlike the expansions to international short-haul links, which is happening now, the project to improve connections with the northern hemisphere is still some years from fruition, but it is progressing positively. The joint venture between the Airport and the Wellington City Council completed preliminary analysis and on the basis of the positive findings the parties have each committed $2 million to seeking consents to undertake the construction of a 300 metre extension to the south end of the runway. If the application is successful the Airport could be ready to commence construction in early 2016.

Extending Wellington Airport to accommodate larger and long-haul aircraft would, amongst other things, improve the resilience of New Zealand's transport infrastructure, the level of services provided by low-fare carriers, and New Zealand's links with Asia. "More of the same" will see New Zealand miss out on enormous potential growth.

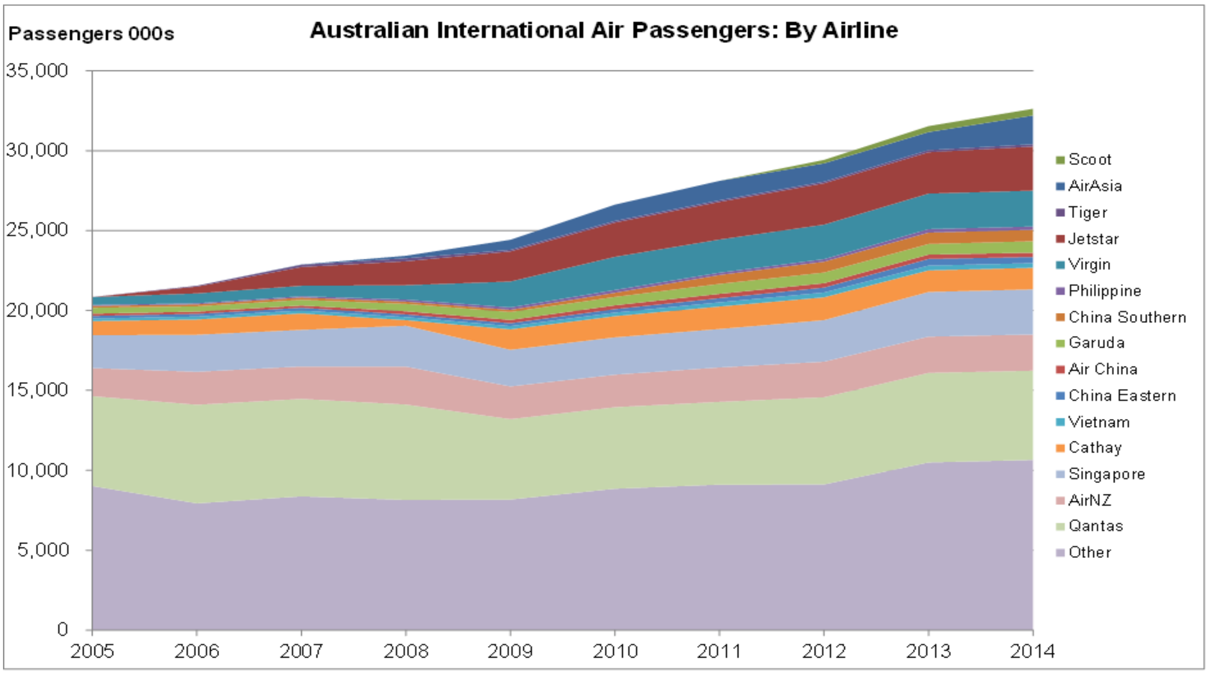
New Zealand & Australian International Air Traffic

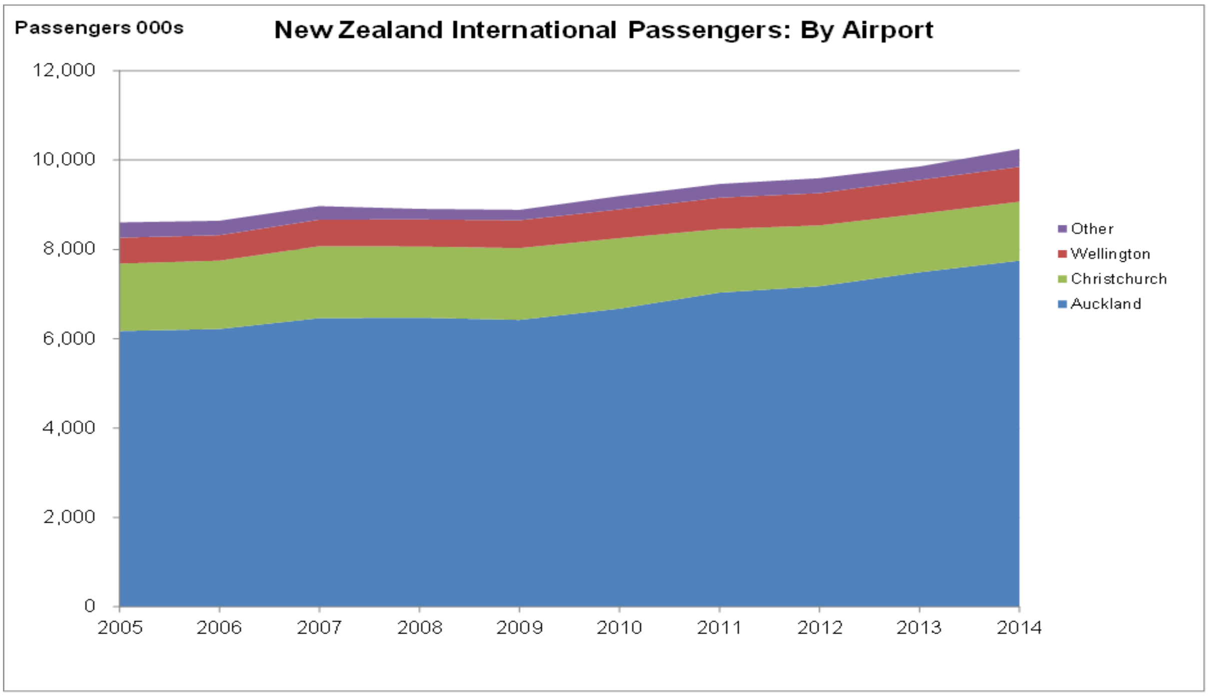
Over the last decade Australian international air traffic has risen 5% per annum (about 55% in total) from about 21 million passenger movements in 2005 to 33 million this year. Over the same period, New Zealand's international traffic has risen only 2% per annum from about 8.6 million passengers to about 10.2 million this year (less than 20% in total). Wellington traffic has grown the fastest of New Zealand's major airports.

Had New Zealand's traffic risen at the same rate as Australia's (and the proportion of international airline passengers who are inbound did not change) then about 800,000 more tourists would have visited New Zealand this year (increasing tourism spend by 25% or $2 billion).

The obvious cause of these different rates of growth has been Australia's better links with Asia, especially by way of services provided by low-cost airlines such as Scoot, AirAsia, Tiger, Virgin and Jetstar.

Over the decade low-cost airlines increased the number of inbound seats to Australia from under 0.4 million in 2005 to 4.8 million this year. Their expansion accounted for almost 70% of Australia's total international airline capacity growth. If they hadn't come along Australia's growth in international air traffic would have been almost the same as New Zealand's.





In part Australia has benefitted from being closer to Asia because low cost carriers have tended to gravitate to shorter routes. But Australian growth has also been propelled by it having more airports than New Zealand at a time when airports are playing an ever larger role attracting airlines. From being just facilities providers, airports now undertake market analysis and work with civic and travel industry partners to provide packages to attract airlines and stimulate demand for new services.

The Chinese-New Zealand Air Traffic Opportunity

One area where the need for greater direct NZ-Asia capacity is particularly pertinent is China. At present about 50% of Chinese visitors to New Zealand come via Australia. At one level this shows that people are willing to take several flights to get to New Zealand, but it clearly discourages many potential travellers.

The vast majority of the traffic comes into New Zealand via Auckland which is why almost 60% of total Chinese visitor spend in New Zealand occurs in Auckland, **Wellington receives not quite 2%.**

The differences between New Zealand and Australian links with China/HK are clearly illustrated in the following table.

Australian/NZ Airport	Chinese Airport	Airlines
Auckland	Hong Kong, Shanghai, Guangzhou	Cathay, AirNZ, China Eastern, China Southern
Adelaide	Hong Kong	Cathay
Brisbane	Hong Kong, Guangzhou	Cathay, Qantas, China Southern
Cairns	Hong Kong, Shanghai	Cathay, China Eastern
Melbourne	Beijing, Chengdu, Guangzhou, Hong Kong, Shanghai	Cathay, Qantas, Sichuen, China Eastern, China Southern, Air China
Sydney	Beijing, Chongqing, Guangzhou, Hong Kong, Nanjing, Shanghai	Cathay, Qantas, Sichuen, China Eastern, China Southern, Air China
Perth	Guangzhou, Hong Kong	Cathay, China Southern

Australia has many more links with China than New Zealand and the routes are flown by twice as many airlines. Consequently Australia has better prospects of growth than New Zealand, and the impact and benefits of growth are spread.

Not only is New Zealand only connected to two cities in China, all the direct services are through Auckland.

NZ Bus

Over the three month period to the end of November, Auckland passenger numbers rose 7% while Wellington's fell 1.5%.

Northern Passengers	**Month**	**12 months**	**3 months**
October 2013	3,301,429	37,260,872	
November 2013	3,091,199	37,185,118	9,541,051
March 2014		37,591,015	
October 2014	3,534,312	38,736,626	
November 2014	3,254,015	38,899,442	10,219,300

Southern Passengers	**Month**	**12 months**	**3 months**
October 2013	1,765,374	20,250,629	
November 2013	1,753,457	20,231,459	5,274,478
March 2014		20,373,202	
October 2014	1,713,491	20,464,865	
November 2014	1,693,070	20,404,478	5,195,760

Auckland Transport's proactive focus on public transport patronage, and its substantial investment programme, continues to pay off. The following factors in particular are driving growth:

- A focus on reliability and punctuality, involving a partnership between Auckland Transport and bus operators to improve the timetables and the reliability of the real time information system.
- Integrated ticketing and fares.
- Investment by NZ Bus in driver training using telematics technology to improve ride comfort and safety for passengers.
- NZ Bus's fleet upgrade; with over a third of bus now being new low emission vehicles.
- Integration of different modes of transport.
- A positive advertising programme by Auckland Transport to dispel public transport myths.

Greater Wellington Regional Council's most recent figures for bus, train and ferry patronage unfortunately show that the region's services provided about the same number of rides last year as they have for the previous eight, even as the population has risen about 10%.

This does not mean GWRC is not doing anything, in fact many initiatives are underway, but a more staged process with continuous improvements would reduce risk and grow public transport use and maintain public support. The rail investment has been substantial but has not yet had a material impact on patronage, and in the meantime there has been little focus on bus service enhancements. Council's most material recent bus decision was to announce that Wellington's electric trolley buses are to be turned off from 2017, and their next big initiative is to be the acquisition of a regional ticketing system for which they have budgeted a $50 million acquisition cost. The advent of new networks and bus rapid transit are also in planning for implementation over the next few years.

After a decade of gestation, the new Public Transport Operating Model is moving towards implementation. It is intended to define a new contracting arrangement between bus operators and regional transport agencies with the goals of reducing the cost on tax/rate payers and increasing the use of public transport.

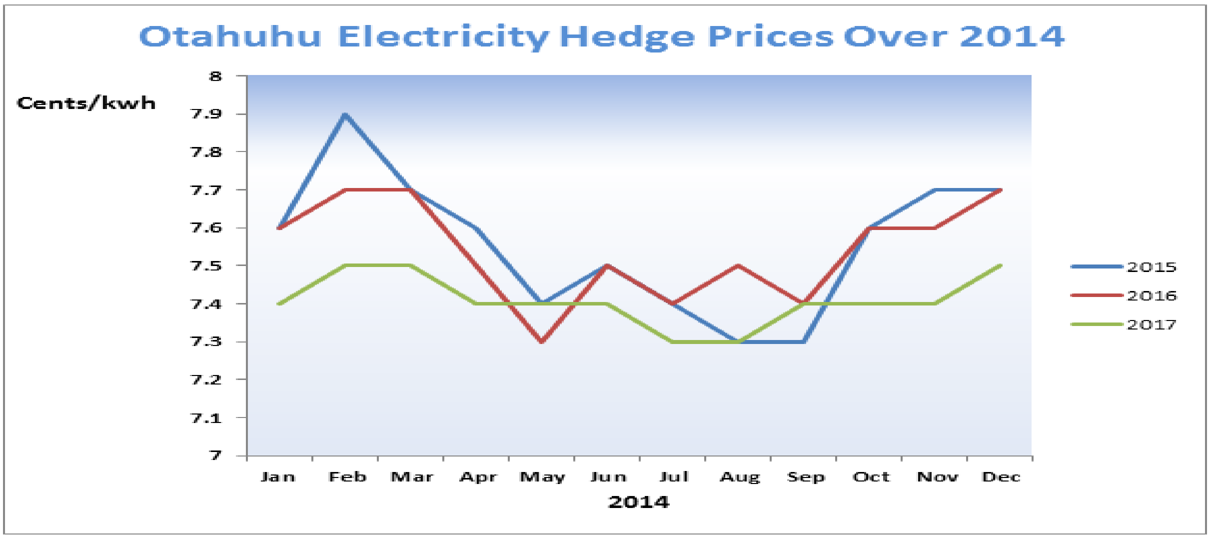
The first offer of the new contracts is expected to occur in Auckland in mid-2015 and is widely recognised as an opportunity to develop partnering arrangements to capitalise on the positive development of the last three years.

Auckland's public transport has massive upside if the contracts can encapsulate a positive and durable partnering relationship.

Trustpower

For the New Zealand electricity industry 2014 will go down as a period most notable for what didn't happen. The threatened industry restructure was thwarted by the Election outcome, while supply and demand were both predictable and stable.

Over the year the average spot electricity price at Otahuhu was 7.9c/kwh and the hedge prices for the next three years are almost the same (the graph copied below shows how the contract prices for the next three years moved over 2014). If the hedge market illustrates industry thinking, it seems the consensus view is that prices will stay locked to where they are now for at least another three years.



One consequence of these low wholesale electricity prices is that today no one is building a power station in New Zealand. The spot and hedge prices for electricity do not provide the prospect of sufficient revenue to give an adequate return on the capital that would have to be invested.

Australia faces a similar hiatus, but with most of its generation coming from coal and gas-fired power stations there is greater incentive to retire higher cost facilities (renewable generation which makes up the bulk of New Zealand's production has no fuel cost which gives it different short term operating economics. In New Zealand the one coal-fired station primarily provides back up rather than base load generation).

The question hanging over Australia is whether its Government continues with the policy target of requiring 20% of electricity to be generated by renewables by 2020. If this occurs it will mean further construction and Trustpower is confident that it owns consented sites with a high probability of supporting investment in new wind farms.

Trustpower quarterly performance

	Sep 2014	Jun 2014	Mar 2014	Dec 2013	Sep 2013	Jun 2013
Energy customers	255,000	246,000	238,000	233,000	228,000	204,000
Telco services provided	61,000	59,000	54,000	51,000	48,000	46,000
Mass market electricity sales	473GWh	420GWh	381GWh	346GWh	445GWh	406GWh
Time of use electricity sales	579GWh	579GWh	488GWh	466GWh	492GWh	488GWh
NZ generation	655GWh	570GWh	473GWh	518GWh	639GWh	579GWh
Aust generation	322GWh	256GWh	206GWh	137GWh	108GWh	85GWh
Av. Spot price of NZ electricity generated	6.0c/kwh	6.6c/kwh	9.6c/kwh	7.1c/kwh	5.4c/kwh	8.2c/kwh
Av. Spot price of NZ electricity purchased	6.6c/kwh	7.2c/kwh	10.6c/kwh	6.7c/kwh	6.0c/kwh	8.3c/kwh