

STATEMENT OF JULIE MARIE WILLIAMS

- 1 I am the Chief Financial Officer of CitiPower Pty (**CitiPower**) and Powercor Australia Limited (**Powercor Australia**).
- 2 I have over 20 years experience in finance, treasury and risk management roles in the electricity industry. I have been employed by CitiPower and Powercor Australia and their predecessor organisations since 1989. I was appointed as CitiPower's inaugural Treasurer in 1994 and was appointed Treasurer of Powercor Australia in 2002. I was appointed Chief Financial Officer of both CitiPower and Powercor Australia in 2005. Prior to joining the electricity industry, I worked in the banking and finance industry in a number of roles including cash management, fixed interest broking and securities trading roles.
- 3 I commenced working in the electricity industry in 1989 in the Treasury department of the State Electricity Commission (**the Commission**) and had responsibility for managing the Commission's \$7 billion fixed interest securities portfolio. As the manager of the fixed interest securities portfolio, I was involved in a significant number of debt issues into both the domestic and international markets. In the early 1990's and on behalf of the advisors to the State Government, I managed the allocation of the Commission's debt securities portfolio across the disaggregated electricity businesses. As the Treasurer and now Chief Financial Officer of CitiPower and Powercor Australia, I have responsibility for management of credit ratings, the debt portfolio, new debt issuance and all risk management policies and hedging activities of the group.
- 4 I have a Bachelor of Business (Banking and Finance) and Master of Applied Finance.

1. Structure of this statement

- 5 I have read Appendix P of the Australian Energy Regulator's (**AER**) 'Draft Decision Victorian electricity distribution network service providers Distribution determination 2011-15' dated 4 June 2010 (**Draft Determination**) in relation to debt raising costs, which is annexed to my statement and marked **Annexure JW1**.
- 6 In this statement, I address the following issues related to early refinancing costs:
- 6.1 Why would a prudent firm act to reduce refinancing risk?
 - 6.2 To what extent would a prudent firm act to reduce refinancing risk?
 - 6.3 What methods would a prudent firm adopt to manage refinancing risk?
 - 6.4 Which of the prudent methods of managing refinancing risk is the most efficient (ie lowest cost)?
- 7 Consistent with the approach taken by the AER in the Draft Determination, I have assumed in responding to these questions that a prudent firm in CitiPower and Powercor Australia's circumstances would:
- 7.1 issue ten year bonds into the Australian capital market;

- 7.2 structure the bond issues so that the volume of each bond issue will equate to 1/10^h of the operator's total debt level, resulting in a bond maturity profile of 1/10^h of total debt maturing each year over a ten year period; and
- 7.3 maintain a Standard & Poor's BBB+ credit rating.

2 Why would a prudent firm act to reduce refinancing risk?

8 In the Draft Determination, and in previous AER decisions and submissions by other Distribution Network Service Providers (**DNSPs**) that I have reviewed, there has been a significant focus on the management of refinancing risk for the purpose of maintaining a firm's credit rating.

9 Maintaining a firm's credit rating is one reason for managing refinancing risk. I wrote to Standard & Poor's (**S&P**) asking them several questions related to the impact of early refinancing policies on credit ratings. In their letter in response, which is annexed to this statement and marked **Confidential Annexure JW2 (S&P Letter)**, S&P states:

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11 In establishing a firm's credit rating, S&P analyse the firm's financial risk profile, at which time they evaluate its financial policies including its liquidity policy. Implicit in an investment grade rating is the requirement for the firm to establish and maintain a prudent liquidity policy that incorporates management of refinancing risk.

12 However, maintaining a firm's credit rating is only one reason for reducing refinancing risk and I do not consider that it is the most significant reason.

13 I consider that the most significant reason is managing a firm's liquidity risk and solvency by ensuring that it does not risk the potentially catastrophic consequences of an inability to secure replacement financing that will allow it to repay the maturing debt on its maturity date, for example if unforeseen events restrict access to financial markets at the maturity date.

- 14 Firms that manage their refinancing risk substantially in advance of the maturity date are doing so for risk management purposes and not, as the AER states in the AER's Final decision South Australia distribution determination 2010-11 to 2014-15 (**South Australian Final Determination**) to:¹

trade-off debt raising costs against the cost of debt. Actions that increase the credit rating of a bond issue may increase the transaction costs of raising debt, but consequently decrease the interest costs that must be paid by the DNSP.

- 16 While maintenance (as opposed to upgrading) of the credit rating is of importance to a firm, the critical reason a prudent firm would seek to manage its refinancing risk is to ensure that it remains a going concern and its solvency is not put at risk.
- 17 In this respect, directors have obligations and duties to ensure the business can meet its debts when due and payable and is therefore solvent. Under the *Corporations Act 2001* (Cth), the directors of a company have a duty to prevent insolvent trading by a company.² This duty requires the directors to ensure that the company can meet its debts as and when they become due for payment. Insolvent trading can result in the director incurring civil and criminal penalties of up to a maximum of 5 years imprisonment and a fine of \$220,000.³
- 18 In practice, directors manage this risk by continuously assessing the solvency of the company. In the 12 month period leading up to a significant tranche of debt falling due for repayment, a prudent director would turn his or her mind to how and when that debt will be refinanced.
- 19 As the maturity date approaches within that 12 month period, a prudent director would in my experience take steps to ensure, to the greatest extent possible, that funds will be available to make the repayment in full of the maturing facility. To this end, a prudent director would endeavour to ensure that there is the greatest degree of certainty possible as to the availability of funding by the required time, and that, to the greatest extent possible, any conditions to funding are limited to matters that can be managed by the directors.
- 20 In my experience, Australian capital market debt transactions include standard clauses that result in an event of default under the financing arrangement if the debt issuer cannot meet any financial obligation, including the repayment of the principal on maturity. In addition, there are standard cross-default clauses in all financial transactions that would trigger an event of default if payments are not made under any financing arrangement. It is rare for any grace period to be accorded to a cross-default event of default.

¹ South Australian Final Determination, p376.

² *Corporations Act 2001* (Cth), section 588G.

³ *Corporations Act 2001* (Cth), section 588G.

- 21 As a result of these default and cross-default provisions, the non-repayment of a single debt facility immediately upon maturity is likely to result in all of the company's facilities becoming simultaneously repayable on demand. Cross-defaults in the financing arrangements of the parent entity of the defaulting firm will also often be triggered.
- 22 From a solvency perspective, such an event will almost certainly be a catastrophic problem for the company and its directors. It is extremely unlikely that the company will be able simultaneously to raise all of the required funds in the debt or equity markets for all of its financing needs. Insolvency would result and the firm's survival would be seriously threatened.
- 23 To ensure that such a catastrophic result does not occur, a prudent firm would do all that it reasonably can to ensure that it can repay a maturing tranche of debt on its due date for repayment. The consequences are so high that a prudent firm would not risk being unable to repay its debt on maturity, even if that risk was considered to be relatively low.

3. To what extent would a prudent firm act to reduce refinancing risk?

3.1 Actions that a prudent firm would take to manage liquidity risk

- 24 To manage this liquidity risk associated with refinancing, directors typically require firms to establish risk management functions and policies and require regular reporting of risks. In my experience, a prudent firm's risk management policies would include a Liquidity Risk Management Policy, possibly incorporated into a Treasury Risk Management Policy.
- 25 A firm would manage liquidity risk to ensure that it has the ability to reliably access funds as and when required. In managing liquidity risk, a prudent firm would consider day-to-day liquidity management, short-term crisis event management and long-term liquidity management.
- 26 Day-to-day liquidity management ensures funds are available when needed to fund payments each day. Typical means of managing such risk are through the use of cash reserves, liquid investments, short term working capital facilities or commercial paper issuance programmes (with back up stand-by facilities).
- 27 Short-term crisis event management ensures the firm has sufficient capability to meet financial obligations during the existence of a sudden unforeseen event, caused by either internal or external factors that severely inhibit the firm's expected and/or required inward cash flows. Typical means of managing this risk are through the use of working capital facilities, cash reserves, commercial paper programmes and liquid investment portfolios.
- 28 Long-term liquidity risk management ensures the firm manages its capital structure and longer-term financial profile, including the management of its refinancing risk. Management of long-term liquidity risk typically includes the following strategies:
- 28.1 ensuring maturing debt is refinanced at least three months ahead of the maturity date;

- 28.2 maintenance of a capital structure that facilitates access to credit markets (typically measured by an investment grade credit rating);
 - 28.3 diversification of the debt maturity dates;
 - 28.4 diversification of the source of funding; and
 - 28.5 restricting the level of debt related current liabilities to a manageable level.
- 29 Regardless of the use of strategies 2 to 5 above, it is essential for a prudent firm to ensure the debt is refinanced prior to the maturity date. This is due to the fact that even firms that are in a solid business position with moderate levels of debt may experience an actual or potential liquidity crisis, or an inability to access debt or equity markets. Possible causes of a liquidity crisis may include:
- 29.1 the closing of the financial markets due to a particular event, such as the terrorist attacks of 11 September 2001;
 - 29.2 the closing of the financial markets due to a global financial crisis, such as in August 2007;
 - 29.3 a large, adverse litigation judgment against the firm;
 - 29.4 real or alleged management impropriety; or
 - 29.5 parent company financial or solvency concerns.
- 30 For the purpose of maintaining its credit rating, but more importantly for solvency management, prudent directors would therefore require the existence of a refinancing plan that required maturing debt to be refinanced at least three months in advance of the maturity date through the use of a method that adequately minimised risk. Directors would seek to minimise risk and refinance at least three months in advance due to the possibility that events outside of their control may restrict access to financial markets.
- 31 In addition, the refinancing method itself must ensure refinancing risk is minimised by ensuring that there are no terms or conditions in the refinancing transaction that may result in the financing being terminated prior to, or at, the funding date as a result of a change in the firm's financial condition or the external financial or political environments.
- 32 The Treasury Risk Management Policy of the CHEDA Group requires that CitiPower and Powercor Australia's debt funding requirements are committed, underwritten or fully funded at least six months prior to the requirement for refinancing.
- 33 The need to manage liquidity risk is not new, but has been given increased importance and attention since the global financial crisis where many firms encountered severe difficulties in refinancing debt.
- 34 I consider that refinancing debt three months prior to maturity still leaves the firm exposed to liquidity risk and is the absolute minimum that prudent directors would require. In my experience, many firms would require debt to be refinanced more than

three months in advance, as is the requirement under CitiPower and Powercor Australia's policies.

3.2 Evidence of the actions that comparable firms have taken to reduce refinancing risks

35 I have examined early refinancing activity by major Australian corporate entities refinancing their maturing capital markets debt issuance in 2009 and 2010. Table 1 on the following pages sets out committed early refinancings undertaken by major Australian corporate entities during that period.

36 Table 1 is an updated and expanded version of the table that was included on page 26 of the report by PricewaterhouseCoopers, 'ETSA Utilities: Distribution network service provider refinancing costs: Final Report, February 2010' (**PwC Report**). The PwC Report is annexed to my statement and marked **Annexure JW3**. The first four rows of Table 1 are taken from the PwC Report. The remainder of Table 1 is based on research that I undertook or supervised using publicly available material from sources including the relevant companies' websites, ASX releases, bond market commentaries issued by banks, Reuters releases and Bloomberg releases.

Borrower	S&P / Moody's Credit Rating	Date Refinancing Announced	Previous facility maturity date	Months Prior to Facility Redemption	Facility Amount (\$A million)	Comments
Broadcast Australia Pty Ltd	Not rated	Feb-09	Jun-09	4 months	447	Funds used to replace the A\$250m Fixed Rate Note that matured in June 2009.
Energy Partnership (Gas) Pty Ltd	BBB	Apr-09	Jul-09	3 months	100	Refinancing of existing Medium Term Note. This refinancing represents 9.2% of Energy Partnership (Gas) Pty Ltd's total debt.
Envestra Victoria Pty Ltd	BBB	May-09	Nov-09	6 months	289	Funds used to refinance an outstanding A\$175m of Medium Term Notes that matured in November 2009 and A\$125m loan provided by CBA that expired in Aug 2009. This refinancing represents 87.7% of Envestra Victoria Pty Ltd's total debt.
SPI (Australia) Assets Pty Ltd	A-	Jun-09	Sep-09	3 months	240	Funds used to refinance the company's capital market bonds. This refinancing represents 5.6% of SPI (Australia) Assets Pty Ltd's total debt.
ETSA Utilities	A-/ A3	Jul-09	April 2010	9 months	625	The company issued US\$500m of 5, 7 and 10 year notes in the US Private Placement market with the funds swapped back to Australian Dollars. The debt issue was used to refinance an April 2010 debt maturity.
CitiPower Pty	A-	Sep-09	Feb-10	5 months	175	Funds used to refinance notes that mature in February 2010. This refinancing represents 16.3% of CitiPower Pty's total debt.
SPI Electricity & Gas Australia Holdings	A-/A1	05-Feb-10	Mar-11	13 months	520	The company issued a 5.5 year CHF475m bond, swapped to Australian Dollars, to partly refinance a domestic bond maturing in March 2011 and a bank loan facility.

Borrower	S&P / Moody's Credit Rating	Date Refinancing Announced	Previous facility maturity date	Months Prior to Facility Redemption	Facility Amount (\$A million)	Comments
SPI Electricity & Gas Australia Holdings	A-/A1	05-Mar-10	Mar-11	12 months	100	The company issued a 10 year HKD700m bond, swapped to Australian Dollars, to partly refinance a domestic bond maturing in March 2011 and a bank loan facility.
SPI Electricity & Gas Australia Holdings	A-/A1	17-Mar-10	Mar-11	12 months	300	The company issued a 7.5-year \$300m fixed rate domestic bond to partly refinance a domestic bond maturing in March 2011 and a bank loan facility.
WA Gas Networks	Not rated	Apr-10	Sept-10	9 months	250	The company obtained an 18-month \$250m committed bank loan facility for the purpose of repaying \$200m of MTNs maturing in September 2010.
United Energy Distribution	A-/A1	30-Apr-10	April 2011	12 months	478	The company issued US\$435m (US\$70m of 4 year unsecured notes and US\$365m of 7 year unsecured notes) in a US Private Placement with the funds swapped back to Australian Dollars. Financial close of the USPP was in for October 2010 with funds invested ahead of repaying \$363m of bonds maturing in April 2011.
Energy Partnership (Gas)	BBB-	10-Jun-10	July 2011	11 months	230	The company issued US\$185m of 5 year senior unsecured notes in the US Private Placement market with the funds swapped back to Australian Dollars. The funds were invested before being used to repay a domestic \$200m MTN maturing in July 2011.

Table 1: Refinancing activity engaged in by comparator firms in 2009 and 2010

- 37 This table shows that firms that are very similar to CitiPower and Powercor Australia routinely take action to secure committed refinancing of their debt significantly prior to maturity. All of these examples involved the use of the Completion Method (which I define in section 4.2 below), which involves the lowest level of risk and ensures certainty of refinancing well in advance of the maturity date of the existing debt.
- 38 In all of these examples, the firm obtained committed refinancing at least three months prior to the maturity date of their existing debt, and most firms acted much sooner to reduce their refinancing risk. On average, these firms refinanced their debt 8.25 months prior to expiry.

4. **What methods would a prudent firm adopt to manage refinancing risk?**

- 39 In the Draft Determination, the AER considered the following methods of reducing refinancing risk, which are each defined below:

39.1 Underwriting Method;

39.2 Completion Method; and

39.3 Commitment Method.

- 40 The AER also acknowledged in the Draft Determination that other methods may be appropriate.

- 41 In this section 4, I address each of the methods addressed by the AER and also consider whether any other methods would be adopted by a firm to manage refinancing risk.

4.1 **Underwriting Method**

4.1.1 *What type of underwriting would a prudent firm require to manage refinancing risk?*

- 42 I define the underwriting method as the engagement of a third party under a documented and executed agreement to underwrite the refinancing transaction at least three months prior to the refinancing date (**Underwriting Method**). If the debt is not purchased by investors on the date of issue, then the underwriter will be required to purchase all of the debt. This definition is consistent with the definitions adopted in the Draft Determination and in the PwC Report.

- 43 As with all prudent methods of managing refinancing risk, the underwriting commitment would need to be legally binding and the terms and conditions of the Underwriting Agreement would need to require that funds are received by the borrower regardless of the financial, political or market conditions, the financial or operational status of the borrower and the credit rating of the borrower at the maturity date.

- 44 For the reasons explained above, I consider that a prudent firm would require its debt to be refinanced at least three months prior to maturity. Accordingly, a prudent firm would require that the period of underwriting under the Underwriting Method must be for a period of at least three months. I note that in the Draft Determination, the AER

accepted that the Underwriting Method requires the underwriting to be for a period of at least three months.⁴

4.1.2 *What is covered by the form of underwriting considered by the AER in the Draft Determination?*

45 I consider that the form of underwriting that I describe above is different to the form of underwriting that the AER bases its cost estimates on in the Draft Determination.

46 As explained above, the Underwriting Method as a means of managing refinancing risk requires a committed period of underwriting of at least three months so that the firm has certainty that it will be able to refinance its maturing debt. In the Draft Determination, the AER accepts that three months underwriting is required for the Underwriting Method. However, in finding that the costs of the Underwriting Method are already included in the direct debt raising costs, I consider that the AER confuses the form of underwriting that is required for the Underwriting Method with a very different and much more short-term form of 'book build' underwriting.

4.1.2.1 *Approach taken by the AER in the Draft Determination*

47 The Draft Determination does not set out the process that the AER used to determine the gross underwriting costs that are included in the direct debt raising costs. However, I understand from comments made by the AER in the Draft Determination, the AER's Draft decision South Australia Draft distribution determination 2010-11 to 2014-15 (**South Australian Draft Determination**) and correspondence between the AER and ETSA Utilities that is annexed to my statement and marked **Annexure JW4** that the AER adopted the following approach to determine the gross underwriting costs:

47.1 in the South Australian Draft Determination, the AER undertook an analysis of the gross underwriting costs of a large number of international bond issues by Australian corporates using the Bloomberg 'LEAG' database;

47.2 the AER's bond analysis included about 50 bonds, but the AER determined for the purposes of the South Australian Draft Determination that it would only use bonds with an 8-12 year tenor;

47.3 the AER further reduced the sample that it used for the South Australian Draft Determination and South Australian Final Determination by only including bonds that were issued in the 5 years prior to undertaking the analysis;

47.4 in the Draft Determination, the AER updated this analysis by removing any bonds that were issued more than 5 years prior to the date of the Draft Determination; and

47.5 as a result, the gross underwriting costs were based on a sample of only 5 bonds: 1 issued by Woolworths, 1 issued by Rio Tinto and 3 issued by BHP Billiton.

48 This methodology resulted in an estimate of gross underwriting costs of 7.2 basis points per annum (**bppa**). Based on this analysis and the AER's revisions to the

⁴ AER, Draft Determination Appendices, Appendix P, p339.

estimates set out in the PwC Report, the AER determined that a benchmark firm would incur gross underwriting costs of 4-8 bppa. I understand that the AER used that figure for the purposes of determining the costs of the Underwriting Method, and then determined that this cost was already included in the allowance for direct debt raising costs and no additional allowance was required for the costs of the Underwriting Method.

49 I have analysed the bond issues used by the AER in the Draft Determination to determine gross underwriting costs. The details of those bond issues are set out in Table 2 below.

Issuer in AER List for Direct Raising Cost - "Total Gross Underwriting Cost"	Book Runner(s)	Underwriting Agreement & Pricing Date	Settlement Date	Debt Maturity Date	Amount	Underwriters' Discount / Gross fees (bp upfront)	Terms & Conditions in Underwriting	Use of Proceeds
Woolworths Ltd	Citi, JPM	16-Nov-05	23-Nov-05	15-Nov-15	US\$425m	37.5	No prospectus available	Annual Report balance sheet (note 14) implies proceeds were used to repay bank debt and for general corporate purposes.
BHP Billiton Fin USA Ltd	CSFB, JPM	5-Dec-05	12-Dec-05	15-Dec-15	US\$750m	45.0	See Note Below	Repay a term loan facility established in March 2005 to finance the acquisition of WMC & to repay commercial paper
BHP Billiton Fin USA Ltd	BoA, JPM	26-Mar-07	29-Mar-07	29-Mar-17	US\$750m	45.0	See Note Below	Proceeds to be used for general corporate purposes
BHP Billiton Fin USA Ltd	Barclays, Citigroup, Goldmans	18-Mar-09	25-Mar-09	1-Apr-19	US\$1,750m	45.0	No detail of conditions provided in prospectus	Proceeds to be used for general corporate purposes
Rio Tin Fin USA Ltd	Deutsche, JPM, Morgan Stanley, CS, RBS, SocGen	14-Apr-09	17-Apr-09	1-May-19	US\$1,500m	45.0	No detail of conditions provided in prospectus	The proceeds will be used to repay some amounts outstanding under a syndicated credit facility that was established to acquire Alcan in 2007 and that has principal repayments falling due in October 2009, October 2010, October 2012 and December 2012. [Total debt outstanding as at December 2008 was US\$39.758 m]

Table 2: Analysis of bonds used by the AER to determine gross underwriting costs

4.1.2.2 What form of underwriting was provided in each of the bond issues used by the AER?

50 As noted in Table 2, JP Morgan acted as book runner for four of the five bond issues.

[REDACTED]

51 JP Morgan's letter to me is annexed to my statement and marked **Confidential Annexure JW5**. My letter to JP Morgan is attached to my statement and marked **Annexure JW6**.

52 On average, the committed underwriting period for the transactions considered by the AER was 5.4 days, with the range from 3 days to 7 days.

53 Such short-term committed underwritings are referred to in the financial markets as a 'book build underwrite'. All debt securities are purchased by the underwriters at the launch price and then on-sold to investors. Typically, underwriting banks have investors committed to purchase the bonds at the time of book build and price setting, which means that the banks take on extremely little risk.

- 54 Given the short-term nature of the underwriting commitment and the low risk accepted by banks, the fees for such a transaction are very small and are typically absorbed into the cost of establishing the transaction.
- 55 The 45 basis points (**bps**) described by the AER as the gross underwriting fee in the debt raising costs allowance actually reflects the establishment cost of the capital markets transaction. The managers to a capital markets debt issue require a fee for arranging, placing and establishing the transaction. This cost is typically referred to as the 'establishment fee'. The establishment fee excludes all legal fees, roadshow costs, credit rating costs, registry fees and paying fees.
- 56 Because the underwriting risk associated with a book build underwriting is minimal, underwriting/lead manager banks charge the issuer the standard establishment fee only.
- 57 In my experience, all corporate debt issuers into the Australian capital markets pay managers of the transaction a fee for establishing the debt issue. The establishment fee may range between 30 bps and 50 bps, and is typically closer to 50 bps. This is an upfront fee that is calculated by multiplying the bps cost by the nominal value of the bond issue.
- 58 I forwarded the following request for information to 5 banks that are active in managing bond transactions in the Australian capital markets:

'As you are aware, the CitiPower and Powercor Australia businesses are in the process of preparing a response to the Victorian Electricity DNSPs Distribution Determination 2011-2015 and we would appreciate your assistance in respect to information on Debt Arranger/Establishment Fees.

Could you please provide an indicative upfront establishment fee for a 10 year Australian capital markets debt issue for a benchmark BBB+ rated entity? Please exclude any underwriting costs, legal fees, agency fees or other fees from the fee range.'

- 59 The bank's responses are annexed to my statement and marked **Confidential Annexure JW7, Confidential Annexure JW8, Confidential Annexure JW9, Confidential Annexure JW10, and Confidential Annexure JW11.**

[Redacted]

[Redacted]

[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]
[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]	[Redacted]

[Redacted]

Table 3: Bank estimates of establishment fees

- 61 This table demonstrates that the establishment fees that would be charged by a bank for any Australian capital markets bond issue by a BBB+ rated entity would be very similar to the amount that the AER determined as the gross underwriting costs. I therefore consider that the AER's underwriting cost allowance does not compensate a firm for any additional underwriting expense to manage refinancing risks and only

includes a basic form of book build underwriting that only provides 3-7 days of underwriting cover, rather than the required period of at least three months.

62 Accordingly, although the AER's approach in the Draft Determination (and the methodology in the Allen Consulting Group report 'Debt and Equity Raising Costs, Report to the Australian Competition and Consumer Commission, Final Report, December 2004' (**ACG Report**), on which it is based) uses the term 'gross underwriting fees', I consider that it does not compensate a firm for management of refinancing risk on capital markets debt. The AER's approach (and the gross underwriting fee of 7.2 bppa under the ACG methodology) compensates the firm for the cost of executing the transaction, including execution by way of a committed book build. However, it does not provide compensation for management of refinancing risk. A prudent firm would incur both the costs of executing the transaction (part of the direct debt raising costs) and an additional cost for a prudent method of managing refinancing risks (early refinancing costs) and it should be compensated for both of these costs.

4.1.2.3 *Termination conditions in this form of underwriting*

63 The Underwriting Agreement for the BHP Billiton bond issue in row 2 of Table 2 included the following terms and conditions to the underwriting:

Terms and Conditions included in the Underwriting Agreement

The underwriting agreement provides that the obligations of the several underwriters to purchase the notes included in the offering are subject to the following conditions:

- 1 customary delivery of legal opinions, certificates, comfort letters and executed documentation to the underwriters prior to the closing of the offering
- 2 prior to the closing of the offering, there not having been any material adverse change affecting our condition, earnings, business or operations from those set forth in this prospectus supplement, including a downgrading in our credit rating; and
- 3 between the date of the underwriting agreement and the closing of the offering, certain market-related events not having occurred, such as the following:
 - 3a a suspension in trading on the New York stock exchange or American stock exchange
 - 3b a general moratorium on commercial banking activities declared by the US federal or New York state authorities
 - 3c an outbreak or escalation of hostilities or a declaration by the United States of a national emergency or war; or
 - 3d a material adverse change in general economic, political or financial conditions.

64 These terms are standard for such underwritten book build transactions and I consider that it can be safely assumed that similar terms and conditions were included in the Underwriting Agreements of the other transactions listed in Table 2.

[REDACTED]

65 I consider that these terms do not provide the issuer with sufficient certainty that funds will be available to repay its existing debt when it matures. For example, condition 3, in particular condition 3d, provides the underwriter with very broad grounds for not completing the bond purchase. In my experience, a firm would not manage its refinancing risk on capital markets debt by means of a method of underwriting that included these conditions.

66 I consider that it is also important to note that the use of the proceeds from the debt transactions referenced in Table 2 is not equivalent to that of a DNSP seeking to raise funds to refinance a maturing 10 year capital market debt maturity. The use of the proceeds of the bond issues set out in Table 2 shows that each borrower in the bond

issues used by the AER had sufficient flexibility around the date of receipt of the proceeds because it was not using the proceeds to pay existing debt that was maturing on a specified date. Instead, the funds were being used to repay bank debt or commercial paper that may be rolled over, or for general corporate purposes (ie they will gradually be used for capital or operational expenditure within the business).

67 As a result, the issuer did not require the same level of certainty in the form of underwriting that would be required by a firm in CitiPower and Powercor Australia's circumstances that is seeking to refinance 10% of its capital markets debt. Accordingly, the terms set out above may be suitable for a firm that was refinancing bank debt or seeking funds for general corporate purposes, but I consider that they would not be suitable for a DNSP that is seeking to refinance a large amount of maturing corporate bonds.

4.1.3 *Would a prudent firm adopt this form of underwriting to manage refinancing risk?*

68 As explained above, the form of underwriting that was considered by the AER in the Draft Determination was a book build form of underwriting that only provided underwriting cover for a very short period of 3-7 days, and contained termination conditions limiting the certainty of underwriting. The costs of this form of book build underwriting only recover the establishment costs of the bond issue and do not include any additional allowance for managing refinancing risk.

69 I consider that a book build underwriting of this form is not a method of managing refinancing risk arising from a capital market debt maturity. It would not be adopted by a prudent firm to manage refinancing risk. A prudent firm would only use underwriting to manage refinancing risks if the form of underwriting was that provided by the Underwriting Method that I define above, which involves underwriting for a period of at least three months that is not subject to termination provisions that reduce its certainty.

4.1.4 *Would the Underwriting Method be adopted by a firm to manage refinancing risk?*

70 I consider that a firm would require committed underwriting for a period of at least three months in order for the Underwriting Method to provide a prudent means of managing refinancing risk.

71 I am not aware of any three month underwritings of 10 year capital market bond transactions for investment grade rated firms.

72 As noted above, JP Morgan acted as book runner on 4 of the 5 bond issues that the AER used to determine the underwriting costs in the Draft Determination. [REDACTED]

[REDACTED]

[REDACTED]

73 This response is consistent with the lack of market evidence of underwritten transactions with an underwriting period of more than a few days.

74 Accordingly, I consider that this form of underwriting is not available in the market and it could not be adopted by a firm to manage refinancing risk.

4.2 Completion Method

75 I define the completion method as providing the firm with funding at least three months in advance of the need to repay its debt by means of a documented and executed debt issue that has been financially settled with the issuer having received the debt issuance proceeds (**Completion Method**).

76 As discussed in the PwC Report, the funds that are received by the firm may be invested during the three month period in risk-free Treasury note securities, invested in bank bill investments, or used to repurchase bonds from existing investors. Assuming the funds are invested in Treasury note securities or used to repurchase the maturing bonds, this method minimises refinancing risk and provides directors with certainty regarding their ability to repay the maturing debt.

77 Table 1 above demonstrates that firms that are very similar to CitiPower and Powercor Australia regularly use the Completion Method to manage refinancing risk. I consider that the Completion Method is an effective means of managing refinancing risk.

4.3 Commitment Method

78 I define the commitment method as involving the firm negotiating a bond issue with investors that includes a commitment to purchase the bonds at either an agreed rate or the market rate on the issue date, pursuant to an agreement that is documented and executed at least three months prior to the issue date (**Commitment Method**). As with all methods to manage refinancing risk to a prudent extent, the forward commitment needs to be legally binding and the terms of the agreement such that funds are received by the borrower regardless of the financial, political or market conditions, the financial or operational status of the borrower and the credit rating of the borrower.

79 In my experience, the Commitment Method is rarely used in Australian capital markets.

80 Such transactions are more frequent in the United States Private Placement market where investors typically require opportunity cost compensation of between 5 and 7 bps per month in yield terms. [REDACTED]

[REDACTED]

[REDACTED]

81 Although this method is uncommon in Australian capital markets transactions, I consider that it is potentially an effective means of managing refinancing risk.

4.4 Other potential methods

4.4.1 Management of Maturity Dates

82 As discussed above, I consider that a firm would manage long-term liquidity risk by a combination of strategies including diversifying its debt maturity dates to reduce refinancing risk. For the purposes of determining the WACC parameters and other debt costs in the Draft Determination, I understand that the AER assumed that the firm issues 1/10th of its debt each year. However, I consider that this strategy in isolation is not sufficient to manage refinancing risk to the extent that would be undertaken by a prudent firm.

4.4.2 Cash Reserves

83 While most firms carry cash reserves, they seek to limit the amount of such reserves because the cost of carrying the cash reserve is effectively the firm's WACC rate less a cash investment return rate. Firms typically seek to minimise the amount of such cash reserves they hold to levels required for management of day-to-day liquidity and/or short-term crisis events.

84 I consider that holding large cash reserves could be a possible way for a firm to manage refinancing risk. However, this method is not adopted by firms in practice due to its high costs, as I explain in section 5.3 below.

4.4.3 Committed Bank Loan Facility

85 Short term working capital facilities are typically utilised by firms to manage both day-to-day liquidity and short-term crisis event funding requirements. Working capital facilities normally have restrictions on the use of funds and restrictions on the period during which they may be drawn, to ensure the firm uses the facility purely for working capital purposes. I consider that it is unlikely that a firm would be able to use working capital facilities to manage refinancing risk unless this was contemplated at the outset and written into the facility.

86 If a firm sought to utilise a working capital facility to manage its refinancing risk, it would also need to extend the size of the facility by the amount of maturing debt. This would ensure that the firm continues to have a sufficient facility available to manage all future day-to-day liquidity and short-term crisis event and/or refinancing funding requirements.

[REDACTED]

88 I consider that one option that would be available to a prudent firm to manage its refinancing risk would be to establish a committed bank loan facility specifically for the purpose of managing the refinancing risk associated with a maturing capital market

bond (**Committed Bank Loan Facility**). As with all prudent methods to manage refinancing risk, the Committed Bank Loan Facility would need to have terms and conditions to ensure that funds are received by the borrower regardless of the financial, political or market conditions, the financial or operational status of the borrower and the credit rating of the borrower on the maturity date.

89 The Committed Bank Loan Facility would need to have commencement and expiry dates that cover potential refinancing risk associated with a capital markets bond issue. The appropriate commencement and expiry dates may differ depending on the firm's circumstances. However, to manage refinancing risk to a prudent extent, I consider that a firm would require the committed facility to commence at least three months prior to the maturity date and to expire no earlier than six months after the maturity date. The loan facility would need to extend at least six months after the maturity date to manage the risk that events outside the firm's control will restrict access to credit markets at the maturity date (for example, as occurred during the global financial crisis) with the result that the firm will need to wait for the markets to settle before it can refinance its debt. If the refinancing is successful at the debt maturity date, the Committed Bank Loan Facility would be terminated by the firm at the debt maturity date.

90 I consider that such a Committed Bank Loan Facility would be an effective means of managing refinancing risk.

91 Accordingly, I consider that the following methods could be effective means of managing refinancing risk to a prudent extent:

- 91.1 Completion Method;
- 91.2 Commitment Method;
- 91.3 use of cash reserves; and
- 91.4 a Committed Bank Loan Facility.

92 For the reasons I explain above, I do not consider that the Underwriting Method would be adopted to manage refinancing risk on Australian capital markets debt.

5. Which of these methods of managing refinancing risk is the most efficient?

93 I have supervised the preparation of calculations of the costs of implementing each of the methods that I consider a prudent firm could adopt to manage refinancing risk. Those calculations are set out in this section 5. In this section 5, I also set out my conclusion on which of those methods is the most efficient (ie lowest cost).

94 The calculations in this section 5 are based on the following parameters that applied during the averaging period that the AER used in the Draft Determination:

Assumptions	Value
New bond issue	
10 year Government rate	5.65% pa
AER debt risk premium	3.25% pa

Assumptions	Value
Deposit	
3-month BBSW (3-month BBSW in Averaging Period)	4.2788% pa
3-month BBB+ rated yield (BBSW + 50 bps)	4.7788% pa
Other	
Averaging Period	1 March to 19 March 2010
Volume (assumption)	\$100m

Table 4: Assumptions for cost calculations

95 These calculations need to be updated by the AER using CitiPower and Powercor Australia's agreed averaging period prior to the AER's impending final distribution determinations (**Final Determination**). I do not expect that any changes in parameters between the Draft Determination and Final Determination averaging periods will change my conclusion on which method is the most efficient.

5.1 Completion Method

96 Under the Completion Method, the firm will receive the full issue proceeds at least three months prior to the maturity date of its current debt. I consider that a prudent firm would invest the funds during that three month period in risk free Treasury note securities or bank bill investments, or use the funds to repurchase bonds from existing investors. Investing in bank bill securities will have a higher risk than investing in Treasury notes.

97 For the purposes of the calculations below, I have assumed that the firm would either invest all of the funds in bank bills (Method 1) or invest a proportion of the funds in bank bills and use the remaining funds to repurchase existing bonds (Method 2). These calculations are therefore conservative in that they will result in a lower cost than if the firm took the least-risk approach of investing all of the funds in Treasury notes.

98 The calculations set out in Tables 5 and 6 below have been extracted from the PwC Report⁵ and I have updated them to use the interest rate assumptions set out in Table 4.

Calculation element	Upfront cash cost for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bpps)
Method 1: Interest Income (invested in bank credit risk): Interest income received from investment in bank deposit or bank accepted bills at the Bank Bill Swap Rate (BBSW) for 3 months			
3 month interest cost on new bond	2.225	223	35.7
BBSW interest income	(1.070)	(107)	(17.2)
Total cost if invested in BBSW and no redemption / buy back	1.155	116	18.5

Table 5: Completion Method 1 cost

⁵ PricewaterhouseCoopers, ETSA Utilities: Distribution network service provider refinancing costs: Final Report, February 2010, p14.

Percentage bought back / redeemed	0%	25%	50%	75%	100%
Method 2: Partial buy-back of maturing bonds and Interest Income (invested in bank credit risk): Buy-back at BBSW for 3 months plus 50 bps and interest income received from investment in bank deposit or bank accepted bills at BBSW for 3 months					
3 month interest cost on new bond	2.225	2.225	2.225	2.225	2.225
less bond buy-back	-	(0.299)	(0.597)	(0.896)	(1.195)
less investment in bank bill risk	(1.070)	(0.802)	(0.535)	(0.267)	-
Upfront cash cost for \$100m (\$m)	1.155	1.124	1.093	1.062	1.030
Yield equiv (bppa)	18.5	18.0	17.5	17.0	16.5

Table 6: Completion Method 2 cost

5.2 Commitment Method

- 99 In the Draft Determination, the AER disagrees with the approach taken by PwC in the PwC Report of including the opportunity cost of the bond buyer in its calculations of the cost of the Commitment Method.
- 100 I have reviewed the PwC Report and consider that the approach in the PwC Report is consistent with my expectations of investor requirements for domestic and international debt issues.
- 101 First, committing to buy a 10 year corporate bond in three months time gives an investor exposure to default risk from that issuer for 10 years and three months time. This is true even though no cash changes hands for three months. For this reason, a party committing to buy a 10 year bond in three months will, in my experience, require a premium interest rate compared to simply buying a 10 year bond on the day it is issued.
- 102 Secondly, it is contrary to my financial markets experience to suggest that investors are willing to give away forward curve benefits as a result of their preference to invest immediately. Funding opportunity costs/benefits are factored into all financial market forward curves, demonstrating that there is no bias as a result of investor or market participant preferences. Financial market practices are such that the funding opportunity cost/benefits provided by forward start pricing is generally accepted and hence the forward curves reflect such opportunities. Accordingly, it is my view that investors do require to be compensated for the delay between the commitment and the execution regardless of their preferences, particularly given that they have alternatives reflecting forward curve pricing available to them.
- 103 The Draft Determination suggested that investors may not seek opportunity cost compensation if their preference is to lock into pricing and volume certainty in advance of the debt maturity. This assumption is also contrary to my expectations of debt issues. Investors have alternatives that provide them with higher returns, ie alternatives that provide the opportunity cost return to investors. An investor has the opportunity to purchase various corporate bonds in either the secondary or primary

markets at current yields (inclusive of the 10 year credit margin) utilising their cash reserves and/or short term borrowed funds to fund the purchase.

104 Accordingly, the investor need not wait for three months to receive the maturing debt funds to purchase a 10 year bond if its preference is to lock into debt immediately. On receipt of the maturing debt funds, the investor is then able to repay the short term borrowing or their cash reserves pool. The result to the investor is such that the investor immediately earns the credit margin over and above their short term cash investment or borrowing rate.

105 I consider that the AER's view that investors do not require compensation is also inconsistent with the fact that the Commitment Method is rarely used in Australia. If investors did not require compensation for opportunity costs then this method would be significantly cheaper than the Completion Method and market evidence should show that most comparable firms use the Commitment Method in practice. However, that is the opposite of what occurs in the market, as demonstrated by Table 1 which shows that a large number of comparable firms have adopted the Completion Method in the last 12-18 months.

106 [REDACTED]

107 Table 7 sets out my calculation of the costs of the Commitment Method, including forgone interest income arising from the three months delayed settlement.

Calculation element	Upfront cash cost for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bppa)
The investor's alternative is to invest in 10 year bonds and borrow the funds or use cash reserves. The committed investment 3 months forward therefore requires the investor to be compensated for the opportunity cost as calculated below.			
3 month interest revenue on new bond foregone	(2.225)	(223)	(35.7)
BBSW funds invested by the investor	1.070	107	17.2
Opportunity Cost to the investor for the forward start	(1.155)	(116)	(18.5)

Table 7: Commitment Method cost

5.3 Cash reserves

108 Table 8 sets out the cost of utilising cash reserves to manage the refinancing risk, and compares it to the Completion Method and the Commitment Method.

109 Table 8 shows that the use of cash reserves is significantly more expensive than the Completion Method or the Commitment Method. I consider that this higher cost explains why this method is unlikely to be adopted by a firm in practice to manage its refinancing risk.

Calculation element	Upfront cash cost for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bpps)
The firm retains cash reserves that are invested in 3-month bank bills at the BBSW.			
3 month interest cost on cash reserves at the firm's WACC	2.420	242	38.8
BBSW interest income	(1.070)	(107)	(17.2)
Net cost if invested in BBSW	1.350	135	21.6
Comparison			
Completion Method 1: Total cost if invested in BBSW and no redemption / buy back	1.155	116	18.5
Commitment Method	1.155	116	18.5

Table 8: Cash reserves cost

5.4 Committed Bank Loan Facility

110 I wrote to two large Australian Banks and asked them to provide pricing for a Committed Bank Loan Facility. The banks responses to me are annexed to my statement and marked **Confidential Annexure JW13** and **Confidential Annexure JW14**. The indicative pricing provided by these banks is set out in Table 9.

111 Table 9 also includes the rating agency fee for the bank loan. This cost is included because this bank loan is a separate documented transaction to the bond issue transaction and the cost will therefore be incurred in addition to the direct debt raising costs.

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Table 9: Committed Bank Loan Facility indicative pricing from banks

112 Table 10 provides the estimated cost of the Committed Bank Loan Facility method for managing refinancing risk.

Calculation element	Upfront establishment Fee \$100m (\$m)	Upfront cost (bps)	Yield equiv (bpps)
The firm enters into a Committed Bank Loan for a period of 9 months commencing 3 months prior to the debt maturity date. The firm pays the upfront establishment fee and the commitment fee to the bank. Assuming a successful refinancing at the debt maturity date, the Committed Bank Loan Facility is terminated on that date.			
Average Establishment Fee of 59 bps	0.590	59	9.5
3-month Commitment Fee at 73.4 bps	0.184	18	0.3
Total Cost of Committed Loan Facility	0.774	77	12.5

Table 10: Committed Bank Loan Facility cost

114 I note that the use of a Committed Bank Loan Facility would result in additional legal expenses and use of internal and bank resources. Committed Bank Loan Facilities would need to be established each year to manage refinancing risk as each tranche of existing debt matures. I believe that the additional time and resources required to negotiate a Committed Bank Loan Facility for each debt refinancing is an inefficient use of resources and will result in additional costs that are not included in Table 10.

115 In addition, the firm's relationships with its banks would be stretched due to the fact that this method involves the firm establishing a nine month loan facility and then terminating that facility after three months if the refinancing is successful on the maturity date. If the facility was not terminated early in this manner, the costs would be far higher than set out in Table 10.

116 Accordingly, I consider that a prudent firm is unlikely to adopt the Committed Bank Loan Facility as its sole method of managing refinancing risk.

5.5 Summary of costs of each method

117 Table 11 provides a summary of the costs of the methods that are available to a firm to manage its refinancing risk to a prudent extent.

Method	Upfront cash cost for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bpps)
Completion Method 1: Total cost if invested in BBSW and no redemption / buy back	1.155	116	18.5
Completion Method 2: A proportion of funds used to buy-back bonds and the remainder invested in BBSW	1.030-1.155	103-116	16.5-18.5
Committed Method: Forward Start premium required by investors	1.155	116	18.5
Cash Reserves: cash invested in BBSW	1.350	135	21.6

Method	Upfront cash cost for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bppa)
Committed Loan Facility: 9 month bank loan facility terminated after 3 months	0.774	77	12.5

Table 11: Comparison of methods that are available to manage refinancing risk

- 118 This table demonstrates that the Committed Bank Loan Facility based on the indicative pricing I received from two Australian Banks is the cheapest method for a firm to manage refinancing risk to a prudent extent. However, as discussed in section 5.4, I believe that the additional time and resources and the resulting strain on the firm's relationship with its banks means that this method will result in additional costs and a prudent firm is unlikely to adopt the Committed Bank Loan Facility as its sole method of managing refinancing risk.
- 119 The fact that a number of close comparators to CitiPower and Powercor Australia use the Completion Method, as demonstrated in Table 1, supports my view that it is an appropriate method of managing refinancing risk and that its costs are efficient. I also note that the costs of the Commitment Method and the two variations of the Completion Method are very similar.

DATED: 19 August 2010

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Julie Marie Williams

Annexure JW1

P Debt raising costs

P.1 Introduction

Debt raising costs are incurred each time debt is rolled over, and may include underwriting fees, legal fees, company credit rating fees and other transaction costs. The AER has accepted that debt raising costs are a legitimate expense for which a distribution network service provider (DNSP) should be provided an allowance.¹

P.2 Regulatory requirements

The revenue and pricing principles set out that each of the DNSPs should be provided with a reasonable opportunity to recover at least its efficient costs.² Also relevant is the potential for under or over investment, a matter that is particularly relevant to debt raising costs.³ The opex criteria require that the total of the forecast opex reasonably reflects the efficient costs and the costs that a prudent operator in the circumstances of the relevant DNSP would require.⁴ Further, the forecast opex is assessed with regard to, among other things, the benchmark opex that would be incurred by an efficient DNSP over the regulatory control period.⁵

The AER has jointly assessed the benchmark debt raising costs of the Victorian distribution network service providers (Victorian DNSPs) on this basis. Where consultant reports have been submitted by one of the DNSPs, to the extent that the information is pertinent to all DNSPs the information has been jointly considered within this appendix.

For convenience, within this section references to the benchmark firm should be interpreted as a reference to a benchmark efficient DNSP that is a pure play regulated electricity network operating in Australia without parent ownership.

P.3 Direct debt raising costs

The Victorian DNSPs proposed debt raising costs as a component of their operating expenditure forecasts. The direct debt raising costs proposed by the DNSPs, to be applied to the benchmark proportion of the regulatory asset base (RAB) that is financed by debt, are outlined in table P.1.

¹ AER, *Decision, Powerlink Queensland transmission network revenue cap 2007–08 to 2011–12*, 14 June 2007, pp. 94–97; AER, *Final decision, SP AusNet transmission determination 2008–09 to 2013–14*, January 2008, pp. 148–150 and AER, *Final decision, ElectraNet transmission determination 2008–09 to 2013–14*, 11 April 2008, pp. 84–85.

² For electricity, this means efficient costs associated with direct control network services and regulatory obligations; see NEL, section 7A.

³ NEL, section 7A(6).

⁴ NER, clauses 6.5.6(c)(1) and 6.5.6(c)(2).

⁵ NER, clause 6.5.6(e).

**Table P.1 Victorian DNSP proposed direct debt raising costs
(basis points, per annum)**

	CitiPower	Powercor	Jemena	SP AusNet	United Energy
	12.3	12.3 ^a	12.0	12.0	11.8

(a) Powercor in their regulatory proposal have proposed direct debt raising costs of 12 basis points per annum however in their supporting documentation Powercor have proposed direct debt raising costs of 12.3 basis points per annum. The AER believes this error is due to rounding.

Source: CitiPower, *Regulatory proposal*, p. 173, Powercor, *Regulatory proposal*, p. 169, Jemena, *Regulatory proposal*, p. 141, SP AusNet, *Regulatory proposal*, p. 231, United Energy, *Regulatory proposal*, p. 149.

In determining their respective direct debt raising costs, CitiPower, Powercor, SP AusNet and United Energy have all drawn on an expert opinion report on debt and equity raising costs prepared by the Competition Economists Group (CEG) for ETSA Utilities as part of the ETSA Utilities Regulatory Proposal 2010-15.⁶ In support of the CEG report, CitiPower and Powercor have also provided a letter prepared by CEG (CEG letter) which provided an update of the CEG report by incorporating new data and utilising a prescribed discount rate for amortisation.⁷

Jemena's proposal on debt raising costs noted that they would be consistent with a benchmark efficient firm.⁸ Jemena did not refer to any third party consultation in determining its direct debt raising costs.

In addition to direct debt raising costs, CitiPower, Powercor and SP AusNet proposed early debt refinancing costs of 16.6 basis points per annum to refinance their debt three to six months prior to the date it was required.⁹ This early debt refinancing cost approach was first submitted by ETSA Utilities in its regulatory proposal for the South Australian draft electricity distribution determination and was referred to as the 'completion method'. For convenience any reference to this early debt refinancing cost approach here will be referred to as the completion method.

In support of the completion method, CitiPower, Powercor and SP AusNet provided an article from Standard and Poor's on refinancing.¹⁰ In further support of this article CitiPower and Powercor also provided a letter from Standard and Poor's clarifying their position on debt refinancing.¹¹ CitiPower and Powercor in their respective proposals noted the Treasury Risk Management Policy of CHEDHA¹² Group (the

⁶ CEG, *Debt and equity raising costs: A report for ETSA*, June 2009.

⁷ CEG, Letter to Mark De Villiers, Manager Financial and Regulatory Strategy, CitiPower and Powercor, *Update to June 2009 Report: Debt and Equity Raising Costs*, 20 November 2009.

⁸ Jemena, *Regulatory Proposal 2011-15*, 30 November 2009, p. 141.

⁹ CitiPower, *Regulatory Proposal 2011 to 2015*, 30 November 2009 p. 173, Powercor, *Regulatory Proposal 2011 to 2015*, 30 November 2009, p. 170 and SP AusNet, *Electricity Distribution Price Review, Regulatory Proposal*, November 2009 p. 232.

¹⁰ Standard and Poor's, *Ratings Direct: Refinancing And Liquidity Risks Remain, But Australia's Rated Corporates Are Set To Clear The Debt Logjam*, 22 April 2008.

¹¹ Standard and Poor's, Letter to Julie Williams, Chief Financial Officer, CitiPower and Powercor, *Re: Liquidity Risk Management Request for Clarification*, 30 October 2009.

¹² Cheung Kong Infrastructure Ltd and Hong Kong Electric Holdings Ltd Electricity Distribution Holdings (Australia) Pty Ltd.

holding company for CitiPower and Powercor investments) which requires debt funding requirements to be in place six months prior to the requirement for funding.¹³ In line with this, SP AusNet also provided confidential extracts from an internal Board meeting regarding the update of its Treasury Risk Policy to address the "change in the philosophy of the agencies"¹⁴ in refinancing debt.

Taking into account the early debt financing costs of CitiPower, Powercor and SP AusNet the proposed debt raising costs for the Victorian DNSPs are set out in table P.2.

Table P.2 Victorian DNSP forecast benchmark debt raising costs (\$'m, 2010)

	2011	2012	2013	2014	2015	Total
CitiPower	4.0	4.3	4.4	4.5	4.5	22
Jemena	0.5	0.6	0.6	0.7	0.7	3.1
Powercor	6.4	6.4	6.7	7.0	7.0	33
SP AusNet	3.5	3.7	4.0	4.3	4.6	20
United Energy	1.0	1.1	1.1	1.2	1.2	5.6

Source: CitiPower, *Regulatory proposal*, p. 174, Powercor, *Regulatory proposal*, p. 170, Jemena, *Regulatory proposal*, p. 142, SP AusNet, *Regulatory proposal*, p. 234, United Energy, *Regulatory proposal*, p. 87. Note: Totals may not add due to rounding.

P.4 Issues and AER considerations

P.4.1 Direct debt raising costs

Victorian DNSP regulatory proposals

The methodology utilised by the AER in recent decisions for estimating the benchmark direct debt raising costs is one based on the 2004 report commissioned by the Australian Competition and Consumer Commission (ACCC) from Allen Consulting Group (ACG).¹⁵ This methodology involved the calculation of the cost of a benchmark bond size issue (\$200 million), and the number of such bond issues required to rollover the benchmark debt share (60 per cent) of the RAB. The allowance for the benchmark bond issue was based on the (standard) direct costs of raising debt, such as underwriting fees, legal fees and credit rating fees. This methodology has been updated and applied in recent decisions including in the AER's South Australian and Queensland draft and final electricity distribution determinations.¹⁶

¹³ Citipower, *Regulatory proposal*, p. 173 and Powercor, *Regulatory proposal*, p. 170.

¹⁴ SP AusNet, *Regulatory proposal*, p. 233.

¹⁵ ACG, *Debt and equity raising transaction costs*, December 2004.

¹⁶ See: AER, *Draft decision, South Australia Draft distribution determination 2010–11 to 2014–15*, 25 November, 2009, appendix I and AER, *Final decision, South Australia distribution determination*, May 2010.

As stated above, four of the five Victorian DNSPs submitted the CEG report prepared for ETSA Utilities' regulatory proposal. The AER has previously considered the issues raised in the CEG report in the South Australian draft and final electricity distribution determinations. Consistent with these determinations the AER's views on the issues raised in the CEG report are reflected here.¹⁷

The key issues put forward in the CEG report primarily refer to the approach taken in the AER's New South Wales final electricity distribution determination. The report focused on three key issues:

- Underwriting costs
- Treatment of other direct costs
- Comparison to other estimates of direct debt-raising costs.

Underwriting costs

- The issues raised by CEG regarding underwriting costs are:
 - a proposed move from the simple averaging method for annualising upfront underwriting fees to a amortisation approach to better reflect the time value of money,
 - the AER's apparent departure from the 'rolling' five year period calculations as applied under the ACG methodology in the New South Wales final electricity distribution determination where it did not roll forward the five year window but added data to existing data making it in practice a ten year period, and
 - the AER's failure to include all 'live' bond issues in its analysis.¹⁸

CEG concluded from its analysis that based on Bloomberg data and its proposed approach, underwriting costs should be no lower than 9.1 basis points.¹⁹

United Energy drew on this underwriting costs output from the CEG report to determine its debt raising costs and has added its own build up of other direct costs to determine 12.2 basis points per annum for a single issue of \$200 million.²⁰ United Energy outlined that to fund its debt requirements over the forthcoming regulatory control period it would require four issues of \$200 million (\$800 million) and therefore requested 11.8 basis points per annum per issue.

In response to these CEG report issues, the AER in the South Australian draft electricity distribution determination conceded that whilst the ACG methodology for annualising upfront underwriting costs is simple and relatively accurate, in certain circumstances it can under compensate the service provider. Through this analysis the

¹⁷ AER, Draft decision, *South Australia Draft distribution determination 2010–11 to 2014–15*, 25 November, 2009 and AER, *Final decision, South Australia distribution determination 2010–11 to 2014–15*, May 2010.

¹⁸ CEG, *Debt and equity raising costs: A report for ETSA*, June 2009, pp. 4–8.

¹⁹ *ibid.*, p. 4.

²⁰ United Energy, *Regulatory proposal*, pp. 149–150.

AER was able to illustrate that depending on the discount rate, the amortisation approach could be higher or lower than the ACG's method of a simple division of five year costs. The AER therefore concluded that this demonstrated the possibility of under compensation which it considered inappropriate to maintain. The AER noted:

Having considered the issues raised and the operation of the PTRM which multiplies the benchmark debt raising cost allowance in basis points per annum by the notional nominal debt amount each year, the AER has amortised the upfront costs of debt raising costs over ten years at the nominal vanilla WACC relevant to each business for this draft decision. This refined approach is to be used for future regulatory decision requiring benchmark debt raising cost allowances.²¹

As stated, consistent with the ten year term for a benchmark bond in setting the debt risk premium, the AER considered in the South Australian draft electricity distribution determination that the appropriate bond length for amortisation must also be a ten year term.²²

The AER in the South Australian draft electricity distribution determination also undertook an extensive investigation into the claims put forward by CEG regarding the data set used for the New South Wales final electricity distribution determination. The outcome saw changes to the data set with the exclusion of bonds outside the rolling five year window, inclusion of some of the bonds indentified by CEG and the update of data to April 2009.²³ Further consideration of bonds to be included in the data set for determining the debt raising costs was undertaken by the AER in the South Australian final electricity distribution determination in response to particular exclusions raised by ETSA Utilities in their revised regulatory proposal.²⁴ However, the AER again did not accept the claims for the inclusion of these bonds.

After the update of bonds in the data set in the South Australian draft electricity distribution determination the AER noted that there was little overall impact on the pattern of debt raising costs.²⁵

Other direct costs

In relation to other direct costs, CEG raised:

- using the same approach to annualise other direct costs as it had proposed for underwriting fees including the use of a consistent nominal rate of return
- the AER's increase in benchmark bond issue size from the ACG's original amount without applying any inflation to non-underwriting transaction costs.²⁶

²¹ AER, *Draft decision, South Australia Draft distribution determination, 2010–11 to 2014–15*, 25 November, 2009, appendix I, p. 529.

²² *ibid.*, p. 530.

²³ *ibid.*, pp. 518–524.

²⁴ AER, *Final decision, South Australian distribution determination 2010–11 to 2014–15*, May 2010, pp. 125–132.

²⁵ AER, *Draft decision, South Australia Draft distribution determination, 2010–11 to 2014–15*, 25 November, 2009, appendix I, p. 524.

²⁶ CEG, *Debt and equity raising costs: A report for ETSA*, June 2009, pp. 8–12.

CEG concluded that when utilising the proposed approach to annualising both underwriting and other direct costs, an appropriate benchmark for debt raising costs would be no less than 11.8 basis points.²⁷ CEG noted that if its proposed inflation is applied which utilises a method which relies primarily on the Australian Bureau of Statistics (ABS) Financial and Insurance services index to the non-underwriting transaction costs, this benchmark would increase from 11.8 to 12.0 basis points.²⁸

SP AusNet has relied on this analysis from the CEG report to determine its debt raising costs of 12.0 basis points per annum.²⁹

In response to these issues the AER in the South Australian draft electricity distribution determination noted that consistent with its decision to accept the approach to annualise underwriting costs through amortisation, other direct costs would also be annualised utilising the same approach.

In relation to CEG's claim that the lack of inflation on non-underwriting transaction costs was not consistent with the AER's increase in the benchmark bond issue, the AER has previously noted that the benchmark bond issue was not explicitly inflated but rather increased in line with the ACG methodology during the 2006 update of bonds.³⁰ Consistent with this approach the AER increased the benchmark bond issue in the South Australian draft electricity distribution determination. The refined ACG methodology will be applied for the Victorian draft electricity determination and adjustments made where appropriate. However, the AER noted in the South Australian draft electricity distribution determination that the ACG methodology had no corresponding approach to increasing fixed costs which leads to the deflation that CEG refer to.³¹ In response the AER investigated the non-underwriting transaction costs and agreed that this issue should be rectified.

Whilst the AER noted in the South Australian draft electricity distribution determination that the deflation effect proposed by CEG only affected the legal/roadshow costs and the registry fees, all non-underwriting transaction costs were to be updated during this process. Through its analysis the AER confirmed the following updated cost components for the ACG debt raising methodology and the appropriate method to be used to update the inputs.

²⁷ *ibid.*, p. 9.

²⁸ *ibid.*, p. 11. The AER notes that the CEG report refers to this increase as '11.8% to 12.0%' which the AER believes is meant to read basis points instead of percentage.

²⁹ SP AusNet, *Regulatory proposal*, p. 233.

³⁰ AER, *Draft decision, South Australia Draft distribution determination, 2010–11 to 2014–15*, 25 November, 2009, appendix I, p. 525.

³¹ *ibid.*, p. 525.

Table P.3 Updated values for the ACG debt raising methodology

Category	Previous value and basis	Update method	New value and basis
Legal and roadshow	\$100 000 up front per issue (range \$80 000 to \$100 000 per annum)	CPI	\$115 000 up front per issue
Company credit rating	\$50 000 per annum (range \$30 000 to \$50 000 per annum)	Issuer information	\$50 000 per annum (ongoing issuers)
Issue credit rating	3.5 basis points up front per issue	Issuer information	4 basis points up front per issue
Registry fees	\$3 000 up front per issue	CPI	\$3 500 up front per issue
Paying fees	\$4/\$1 million per annum	Below materiality threshold	\$4/\$1 million per annum
Median bond size	\$200 million	Rolling 5 year window	\$250 million

Source: Cited in the AER *Draft decision, South Australia Draft distribution determination, 2010-11 to 2014-15*, 25 November, 2009, appendix I, 25 November, 2009, p. 527.

The AER notes that where the CEG report draws primarily on the ABS Financial and Insurance services index the AER utilises the ABS Consumer Price Index as it considers this to be a more appropriate measure of general inflation.³² The AER has also rounded values where this has been appropriate and applied a materiality threshold to the paying fees. Where a range of values are possible, the AER has been conservative in its approach and applied the upper boundary of this range. The AER notes that this approach will provide the DNSPs with at least an efficient benchmark cost.

As noted above, both CitiPower and Powercor requested CEG to provide them with an update of information used in the CEG report and to use a 10.19 per cent discount rate for amortisation purposes. Utilising the same methodology as the CEG report, the updated information adds estimates of underwriting costs on debt issues by Bloomberg between 1 June and 16 November 2009.³³ This update has increased underwriting costs from 9.1 basis points in the CEG report to 9.4 basis points in the CEG letter.

CEG again approached the issue of updating non-underwriting debt raising costs for inflation using a method primarily based on the ABS Financial and Insurance services index.³⁴ However, the AER notes that the CEG letter was prepared prior to the

³² AER, *Draft decision, South Australia Draft distribution determination, 2010-11 to 2014-15*, 25 November, 2009, appendix I, p. 526.

³³ CEG, Letter to Mark De Villiers, Manager Financial and Regulatory Strategy, CitiPower and Powercor, *Update to June 2009 Report: Debt and Equity Raising Costs*, 20 November 2009, p. 1.

³⁴ *ibid.*, p. 3.

South Australian draft distribution determination being released and therefore does not fully reflect the above considerations of the AER.

CitiPower and Powercor have drawn upon this analysis from the CEG report and subsequent CEG letter to determine their respective debt raising costs of 12.3 basis points per annum.

Other estimates of direct debt-raising costs

In support of its proposed methodology, CEG drew on a report by Lee, Lohead, Titter and Zhao which focuses on US corporations raising debt and equity during the early 1990's.³⁵ CEG concluded that the findings of Lee et al gave strength to the CEG argument that underwriting costs should be no lower than 9.1 basis points.

The Lee et al. report has been considered by the AER in previous decisions.³⁶ In these decisions the data limitations of this report have been analysed. In particular, the AER notes that the Lee et al. report is based on US firms, is over fifteen years old and uses a selection of bonds and a categorisation of data that is questionable regarding whether it applies to the conditions of an Australian benchmark firm. Whilst the AER acknowledges that CEG has included the Lee et al. report in support of its own analysis, consistent with previous decisions, the AER has determined that due to the data limitations of the Lee et al. report it is not an appropriate comparison in determining the benchmark debt raising cost for an Australian regulated utility issuing investment grade debt under prevailing market conditions. Therefore the AER considers that the report is not relevant.

AER conclusions (direct debt raising costs)

The AER notes that the main arguments put forward by the Victorian DNSPs, including the basis of the CEG report and other reports have been previously considered by the AER in the South Australian draft and final electricity distribution determinations. The outcome of this analysis was an update of the selection of bonds to fully align with the ACG methodology as well as some refinements to the ACG methodology itself which is also applied here.

Following the updates to the cost components for the ACG debt raising methodology, the indicative direct debt raising costs for the Victorian DNSPs are shown in table P.4.

³⁵ CEG, *Debt and equity raising costs: A report for ETSA*, June 2009, pp. 11–12.

³⁶ AER, *Draft decision, South Australia Draft distribution determination, 2010–11 to 2014–15*, 25 November, 2009, appendix I, pp. 516–517 and AER, *Final Decision, ACT distribution determination*, 28 April 2009, p. 250.

Table P.4 Draft decision direct debt raising costs with a nominal vanilla WACC of 9.68 per cent (basis points)

Fee	Explanation	1 issue	2 issues	4 issues	6 issues	10 issues
Amount Raised (\$'m, 2010)	Multiples of median MTN (\$250)	250	500	1000	1500	2500
Gross underwriting fee	Median gross underwriting spread, upfront per issue	7.22	7.22	7.22	7.22	7.22
Legal and roadshow	\$115 000 upfront per issue	0.74	0.74	0.74	0.74	0.74
Company credit rating	\$50 000 per annum	2.00	1.00	0.50	0.33	0.20
Issue credit rating	4 basis points up front per issue	0.64	0.64	0.64	0.64	0.64
Registry fees	\$3 500 up front per issue	0.14	0.14	0.14	0.14	0.14
Paying fees	\$4/\$1 million per annum	0.04	0.04	0.04	0.04	0.04
Total	Basis points per annum	10.8	9.8	9.3	9.1	9.0

P.4.2 The completion method

Victorian DNSP regulatory proposals

The completion method refers to debt refinancing that occurs earlier than when the funds are actually required by the DNSP. During the overlapping period (in this case, approximately three to six months) between the early commencement of the new loan and the scheduled repayment of the old loan, the business has effectively doubled its debt load. The business' interest costs are not doubled, since it can defray some of the cost of the loan by reinvesting the funds. However, given the limited opportunities for reinvestment, there is an increase in costs to the business.

The businesses have proposed the completion method in dealing with the increased focus on refinancing risk by credit rating agencies as a result of the global financial crisis (GFC).³⁷ In support of the completion method CitiPower, Powercor and SP AusNet referred to a paper produced by Standard and Poor's regarding their broad view on how firms should approach their debt refinancing arrangements.³⁸ This article indicated that firms should have arrangements in place to ensure that they can refinance their debt three months before an impending large debt maturity or face a

³⁷ Citipower, *Regulatory proposal*, p. 173, Powercor, *Regulatory proposal*, p. 169 and SP AusNet, *Regulatory proposal*, p. 233.

³⁸ Standard and Poor's, *Ratings Direct: Refinancing And Liquidity Risks Remain, But Australia's Rated Corporates Are Set To Clear The Debt Logjam*, 22 April 2008, p. 6–7.

possible risk of having their credit rating downgraded. As this paper was produced in April 2008, CitiPower and Powercor have further submitted a letter from Standard and Poor's which confirms that this approach is still supported.³⁹

In dealing with the completion method, CitiPower, Powercor and SP AusNet have all proposed early debt financing costs of 16.6 basis points per annum. In support of their requests the businesses have provided evidence of their respective Treasury Risk Policies that require them to have their debt funding requirements committed, underwritten or fully funded three to six months prior to actual refunding.⁴⁰ The businesses assume:

... that a DNSP will annually refinance one tenth of its debt three months prior to maturity, at the benchmark cost of debt, and invest the early refinanced debt in Treasury notes over those three months.⁴¹

In determining their early debt financing costs the businesses have applied their respective average costs of debt and Treasury note interest rates as measured over 15 days in October 2009. These values will be recalculated over their proposed measurement periods for the AER's Final Decision.

The AER notes that the completion method was first proposed in ETSA Utilities' regulatory proposal for the South Australian draft electricity distribution determination.⁴² The AER notes that the completion method was proposed by ETSA Utilities as one of three competing alternatives to manage refinancing risk. The AER's response through its draft determination and subsequent recent analysis of the ETSA Utilities' revised regulatory proposal and the PricewaterhouseCoopers (PwC) report has advanced from the information provided by the Victorian DNSPs on this issue in their regulatory proposals. Therefore in addressing the proposals made by CitiPower, Powercor and SP AusNet, the AER refers to its considerations in the South Australian draft and final electricity distribution determinations which are reflected here.

The AER in the South Australian draft electricity distribution determination did not support costs for the completion method noting that:

- the specific circumstances of ETSA Utilities do not define the benchmark firm
- Standard and Poor's indicated that a firm without an implemented finance plan prior to debt maturity would not incur automatic rating action.⁴³

In response and to support its claims for adoption of the completion method in the AER's final distribution determination, ETSA Utilities submitted a report from PwC.

³⁹ Standard and Poor's, Letter to Julie Williams, Chief Financial Officer, CitiPower and Powercor, *Re: Liquidity Risk Management Request for Clarification*, 30 October 2009.

⁴⁰ Citipower, *Regulatory proposal*, p. 173, Powercor, *Regulatory proposal*, p. 170 and SP AusNet, *Regulatory proposal*, p. 233–234.

⁴¹ Citipower, *Regulatory proposal*, p. 173, Powercor, *Regulatory proposal*, p. 170 and SP AusNet, *Regulatory proposal*, p. 234.

⁴² AER, *Draft decision, South Australia Draft distribution determination, 2010–11 to 2014–15*, 25 November, 2009, appendix K.

⁴³ AER, *Final decision, South Australia distribution determination 2010–11 to 2014–15*, May 2010, appendix J, p. 371.

The PwC report estimated the likely costs to be incurred by a benchmark service provider under three scenarios:

- the completion method—the refinancing transaction was wholly executed three months prior to the date it was required
- the commitment method—contracts to commit parties to the refinancing were signed three months prior to the date of the actual funds transfer
- the underwriting method—three months prior to the refinancing, the service provider engages a third party to underwrite the issuance of bonds.⁴⁴

PwC concluded that the completion method results in the lowest cost to the service provider and is common practice in financial markets.⁴⁵

The AER engaged Associate Professor John Handley to review ETSA Utilities' revised regulatory proposal and the PwC report.

Handley found that there were conceptual grounds to support the claim for debt raising costs associated with the completion method:

- Refinancing costs have already been referred to by the AER as a legitimate expense for which a DNSP should be provided an efficient allowance.
- It is prudent for a benchmark DNSP to have a refinancing plan—that is, a plan to eliminate refinancing risk, which may incorporate one of the completion, commitment or underwriting methods identified by PwC.
- The set of comparator firms that inform the benchmark do use refinancing plans, including, observed use of the completion method.⁴⁶

However, Handley stated that there were practical difficulties with implementing the allowance proposed by PwC:

- There may be overlap between the current allowance for standard debt raising costs and the new proposal.
- In particular, the current allowance for standard debt raising costs already includes an underwriting component, and the underwriting method is a direct alternative to the completion method.
- The inclusion of a credit margin premium—effectively underpricing of the debt—would be double counting, since this was already included in appropriate estimates of the cost of debt.
- The time value of money was not consistently handled.⁴⁷

⁴⁴ PwC, *ETSA Utilities: Distribution network service provider refinancing costs: Final report*, February 2010 (PwC, *DNSP refinancing costs*, February 2010), pp.8–9.

⁴⁵ PwC, *DNSP refinancing costs*, February 2010, p. 5.

⁴⁶ Handley, *A note on the completion method*, Report prepared for the Australian Energy Regulator, Final version, 13 April 2010, pp. 6–8.

⁴⁷ *ibid*, pp. 9–11.

Handley noted that although a DNSP may adopt different arrangements, the allowance approved by the AER would be based on the efficient costs incurred by a benchmark DNSP, which would be the lowest cost option available.⁴⁸

Framework for assessment

In response to the PwC and Handley reports, the AER in the South Australian final electricity distribution determination considered the framework for assessment and noted that any evaluation of completion method costs should be undertaken in the context of a benchmark firm. The current allowance for (standard) debt raising costs is based upon a benchmark analysis conducted by ACG in 2004.⁴⁹

Consistent with the ACG report,⁵⁰ the AER in determining a benchmark establishes a comparator set, which is comprised of businesses that closely resemble the theoretical benchmark—that is, the benchmark is informed by the observed actions of the comparator set. The operating expenditure of a DNSP is assessed with regard to prudence, as required by clause 6.5.6(c)2 of the NER, and in the assessment the AER must have regard to benchmark opex that would be incurred by an efficient DNSP, as required by clause 6.5.6(e)4. Therefore, where close comparators to the benchmark firm are observed to undertake a particular action, this supports the conclusion that such an action is prudent.

Consistent with the ACG report,⁵¹ the AER also notes that the cornerstone of an incentive based framework is that a particular DNSP does not have to follow the behaviour of the theoretical benchmark firm. The DNSP is free to adopt an alternative approach, accepting the benefits or detriments that arise as a consequence of deviation from the benchmark.

Key Questions

In assessing the information proposed by ETSA Utilities and PwC regarding refinancing risk, the AER considered in the South Australian final distribution determination that there were three interrelated assessments which need to be made:

- a. To what extent should the benchmark firm act to reduce refinancing risk?
- b. Which of three alternative methods is the most efficient means to reduce refinancing risk—that is, to the extent required by (a)?
- c. Does the current allowance for (standard) debt raising costs already encompass the appropriate actions to reduce refinancing risk—that is, use of the most efficient method under (b) to the extent required by (a)?⁵²

⁴⁸ *ibid.*, p. 8.

⁴⁹ ACG, *Final report, Debt and equity raising costs, Report to the Australian Competition and Consumer Commission*, December 2004, p. vii.

⁵⁰ *ibid.*, p. vii.

⁵¹ *ibid.*, p. 3.

⁵² AER, *Final decision, South Australia distribution determination 2010–11 to 2014–15*, May 2010, appendix J, p. 374.

Validity of a refinancing plan

The AER considers that it is prudent for the benchmark firm to manage refinancing risk. The benchmark firm maintains an investment grade credit rating (BBB+) and therefore should meet the requirement of credit rating agencies such as Standard and Poor's for a firm of this credit rating. The AER considers that the benchmark firm will manage its refinancing risk through a refinancing plan and notes:

- the refinancing plan will set out a timeline for actions by the firm to ensure that it does not default on its debt
- may include the use of the completion, commitment or underwriting methods but is not limited to these and will encompass a broader range of actions by the firm
- the refinancing plan also includes management of maturity dates, cash reserves and other credit facilities (such as working capital account) to reduce refinancing risk.
- Further the AER notes:
 - managing refinancing risk did not arise with the GFC but has been a long term fundamental requirement
 - from a theoretical perspective, there will be a point where the marginal cost to further reduce refinancing risk outweighs the marginal benefit to do so. In this respect the AER will only allow the costs for the benchmark firm to take the minimum actions required to maintain the benchmark credit rating.

Evaluating the three PwC approaches

The AER in the South Australian final electricity distribution determination undertook a comprehensive evaluation of the three approaches to reduce refinancing risk as presented in the PwC report.⁵³

Overall, the AER found that the PwC estimates were higher than those of its own analysis. A summary of the PwC estimates and the AER's conclusion of the costs of the three approaches in the South Australian final electricity distribution determination are presented in table P.5

⁵³ AER, *Final decision, South Australia distribution determination 2010–11 to 2014–15*, May 2010, appendix J. pp. 376–382.

**Table P.5 Comparison of the cost of the three PwC approaches
(basis points, per annum)**

Method	PwC estimate	PwC estimate revised by AER
Completion method	20–24	15–19
Commitment method	22–24	0–19
Underwriting method	46–54	4–8

Source: AER, *South Australian final electricity distribution determination 2010–11 to 2014–15*, May 2010, Appendix J, p.382, PwC, ETSA Utilities, *Distribution network service provider refinancing costs*, Final report, 15 February 2010; AER analysis.

The AER notes that in its analysis it adjusted for current market data and accommodated for the time value of money. The AER notes the following in regard to the particular methods proposed by PwC.

With respect to the completion method, the AER notes that in its analysis it updated values to reflect more current market data to that utilised in the PwC report. The AER also clarified its preference to adjust for the time value of money by discounting annual payments. In the context of the PTRM, this discount should be the nominal vanilla WACC, not the cost of debt as implemented by PwC.⁵⁴

With respect to the commitment method, the AER considers that PwC incorrectly included the opportunity cost for the bond buyer in its calculations. Where PwC assumed that investors would prefer to purchase a bond immediately and therefore be compensated for the delay between the commitment and execution, the AER considers that this ignores that some buyers would prefer to purchase a bond in three months time and want certainty in advance that such a purchase can be made. In its calculations the AER considers a possible range of opportunity costs between zero and one hundred percent to reflect this.

With respect to the underwriting method, the AER notes that the PwC report proposed a range of different underwriting options. The AER considers that the approach to underwrite the volume only, rather than the volume and the price is appropriate for the benchmark firm. As the cost of debt is set during the agreed averaging period, three months in advance of this the benchmark firm would enter into a contract with the underwriter to issue the debt during the averaging period. The advantage of this approach is that the benchmark firm does not need to lock in a price in advance and can sell at the prevailing price during the averaging period. Also, this type of underwriting is relatively cheaper.

The AER notes that another approach proposed by PwC is to underwrite volume and price. However, the AER notes that the cost calculation is overstated by PwC which includes a credit margin premium. Handley noted:

⁵⁴ Discounting debt-related cashflow at the cost of debt would be appropriate if all payment streams were discounted according to their individual level of risk—for instance, discounting equity-related cashflow at the cost of equity. The PTRM does not do this, adopting the simpler (and conceptually sound) approach of discounting all flows at the WACC.

However, it appears that this credit margin premium may in effect represent underpricing of the new debt. As discussed in an earlier report, assuming allowed revenues are determined using an appropriate estimate of the cost of debt then it is my view that, underpricing should not be allowed as a (direct) cost of raising debt capital (otherwise double counting would result). In this case, the relevant PwC estimate for compensation purposes would then appear to be the upfront underwriting fee of 16-4 basis points per annum.⁵⁵

The AER notes that extensive prior analysis of empirical evidence found that the methodology used to set the debt risk premium accurately prices the cost of debt, such that there is no requirement to add an underpricing allowance.⁵⁶ Since refinancing risk is a long term problem, it would be reasonable to assume that the credit margin premium described by PwC has been encapsulated in this empirical data. Based on its analysis and outcomes which are summarised in table P.5, the AER notes that the least cost option may be the commitment method which has a cost range that extends down to 0 basis points per annum. However, there is considerable uncertainty in the cost estimate for this method, which extends up to 19 basis points per annum. The AER therefore concludes that the efficient cost of a refinancing plan, based on the PwC report, is between 4 and 8 basis points per annum, using the underwriting method.

Comparison with the (standard) debt raising allowance

The AER notes that the proposal for costs associated with the completion method is in addition to the (standard) debt raising costs allowance based on the ACG methodology. The AER in the South Australian final electricity distribution determination examined the ACG methodology to ensure that there is no double counting of costs.⁵⁷

In particular the AER noted:

- the PwC terms of reference made no reference to excluding costs that are already included in the (standard) debt raising cost allowance, undermining the findings in the PwC report⁵⁸
- there are strong grounds to consider that (standard) debt raising costs already includes sufficient provision for managing refinancing risk considering:
 - the 2004 ACG report was a comprehensive review of the transaction costs involved in raising debt (and equity)
 - the issue of refinancing risk was known and relevant when ACG undertook its analysis

⁵⁵ Handley, *A note on the completion method, Report prepared for the Australian Energy Regulator, Final version*, 13 April 2010, p. 11.

⁵⁶ AER, *Final decision, NSW distribution determination 2009–10 to 2013–14*, 28 April 2009, pp. 543–550.

⁵⁷ AER, *South Australian final electricity distribution determination 2010–11 to 2014–15*, May 2010, Appendix J, pp. 382–384.

⁵⁸ *ibid.*, pp. 382–384.

- the AER considers that it is reasonable to conclude that ACG took into account the need for a refinancing plan to mitigate refinancing risk (to an appropriate level) when estimating a benchmark for debt raising costs
- although the figures have been updated since 2004, the (standard) debt raising cost allowance still uses the same cost components recommended by ACG which explicitly includes an underwriting component, currently estimated at 7.2 basis points per annum.⁵⁹

The AER notes that the underwriting description from the ACG report matches that in the PwC report. In particular, PwC included a ‘volume only’ underwriting method, where the underwriter did not guarantee the price at which the debt would be raised.⁶⁰ ACG explicitly noted this type of underwriting, although it used a different label:

With “best efforts” underwriting, a “bookbuild” is undertaken to determine the market-clearing price.⁶¹

The AER notes that the underwriting cost estimate based on the ACG methodology (7.2 basis points per annum) falls within the AER revised cost range based on the PwC report (4 to 8 basis points per annum), albeit at the upper end of this range. The AER has decided to continue to use the ACG-derived estimate of 7.2 basis points per annum for the underwriting component, noting that this is conservative relative to the midpoint of 6 basis points per annum that would apply based on the PwC range. The AER considers that this supports both internal consistency—all components of the allowance are based on the same source—and regulatory consistency—since this figure is based on the same methodology as applied in previous regulatory decisions.

Finally, the AER considers that the ACG report presents a more comprehensive assessment of the benchmark costs associated with debt raising than the PwC report. ACG explicitly models—in addition to underwriting fees—legal and roadshow fees, company credit rating fees, issue credit rating fees, registry fees and paying fees.⁶² ACG added these categories to the underwriting fee to derive a range for debt raising costs of between 9 and 11 basis points per annum.⁶³

PwC did not state whether any of these components have been included in its considerations. If they were included in the overall cost estimates, this was not indicated. In one instance, PwC stated that it explicitly excluded legal costs:

This amount does not reflect the additional administrative and legal costs that would be incurred as a consequence of negotiating a deferred settled bond transaction for a period of as long as 3 months.⁶⁴

On balance, the AER considers that the ACG methodology provides the most comprehensive total estimate of the costs involved in raising debt, including non-underwriting components.

⁵⁹ *ibid.*, pp. 382–383.

⁶⁰ PwC, *DNSP refinancing costs*, February 2010, p. 19.

⁶¹ ACG, *Debt and equity raising costs*, December 2004, p. 38.

⁶² *ibid.*, pp. 51–52.

⁶³ This cost varies based on the size of the debt assumed.

⁶⁴ PwC, *DNSP refinancing costs*, February 2010, p. 17.

P.5 AER conclusion

AER conclusion (the completion method)

The AER considers that the benchmark firm should be compensated for the efficient costs of a refinancing plan. However, the AER does not consider that the allowance proposed by CitiPower, Powercor and SP AusNet should be added to the (standard) direct debt raising costs allowance based on the ACG methodology. The AER considers that this would be double counting the costs of managing refinancing risk.

The AER considers that the allowance for (standard) direct raising costs already includes the efficient costs of a refinancing plan and that no increase in these costs is required.

AER conclusion (debt raising costs)

The AER considers that medium term note issuance costs are the appropriate proxy for (standard) direct debt raising costs incurred by the benchmark firm (based on the ACG methodology). The AER considers that the ACG methodology for assessing the total direct costs of debt (including underwriting spreads and other transaction costs) produces the best estimate possible, principally because none of the proposed alternative methodologies closely match the circumstances of the benchmark firm.

The (standard) direct debt raising cost allowance for each firm will be dependent on the number of standard sized debt issues required by each DNSP (based on the debt value of the RAB), and the nominal vanilla WACC applying to each DNSP (to be incorporated in the amortisation calculation). The allowance expressed in basis points per annum as an input to the PTRM, is applied to the debt portion of each DNSP's RAB for each year of the forthcoming regulatory control period to determine the benchmark debt raising costs included in the opex forecast.

Table P.6 AER conclusion on benchmark debt raising costs (\$'m, 2010)

	2011	2012	2013	2014	2015	Total
CitiPower	0.70	0.73	0.76	0.79	0.81	3.79
Powercor	1.17	1.22	1.26	1.30	1.35	6.30
Jemena	0.43	0.43	0.44	0.45	0.46	2.21
SP AusNet	1.11	1.14	1.19	1.23	1.29	5.96
United Energy	0.75	0.78	0.80	0.81	0.82	3.96

As a result of the AER's analysis of the Victorian DNSP's regulatory proposals and additional information, the AER is not satisfied that the Victorian DNSP's proposed debt raising cost allowances reasonably reflect the opex criteria, including the opex objectives.

The AER considers debt raising allowances set out in table P.6 represent the efficient costs that a prudent operator in the circumstances of the respective DNSPs would

require to achieve the opex objectives. In coming to this view the AER has had regard to the opex factors.

Confidential Annexure JW2

Annexure JW3

ETSA Utilities

Distribution Network Service Provider refinancing costs

Final Report

February 2010

Patrick Makinson
Manager Regulatory Finance
ETSA Utilities
1 Anzac Highway
Keswick SA 5035

15 February 2010

Dear Patrick

Distribution Network Service Provider refinancing costs

We are pleased to present PricewaterhouseCoopers' ("PwC", "us" or "we") report outlining the costs associated with early refinancing. The methodology, and this report, has been prepared in accordance with the Scoping Brief dated 11 December 2009 (reproduced at Appendix A).

The report has been prepared by us for ETSA Utilities as expert witnesses in this matter. While a detailed curriculum vitae is provided in Appendix B, my credentials can be summarised as follows:

- **Matthew Santoro** – Matthew has over 20 years of corporate and institutional banking experience, including 12 years at Deutsche Bank and eight years at Citibank. At Deutsche Bank he held various senior banking positions covering the origination, structuring and syndication of debt facilities. Matthew is experienced in a wide range of financing and fundraising transactions, in particular in the area of acquisition financing, leverage financing, re-financings, project and property financing and procurement of debt capital markets instruments across the Australian, European and USA markets. His experience includes dealings with credit rating agencies such as Standard & Poor's and Moody's

Prior to joining PwC, Matthew jointly established and was Joint National Head of KPMG's debt advisory practice for a period of five years. During that time, Matthew advised numerous companies on their debt and capital management needs, including the procurement of debt across a very broad industry sector. Matthew's experience covers capital management and financing applications for a wide range of structures, asset types and industries.

This report has been prepared with the assistance of the following PwC staff members:

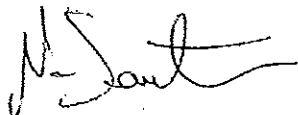
- John Henderson (Associate Director – Debt & Capital Advisory)
- Dean Glasscock (Executive – Debt & Capital Advisory)

As a professional services firm, PwC has an ongoing relationship with each of the electricity distribution businesses. This relationship includes advising on matters pertaining to the upcoming regulatory review; the subject of this report. Further details of PwC's relationship with the businesses can be provided if necessary.

Based on the scope of our engagement and the assumptions outlined herein, we have made all the inquiries that we believe are desirable and appropriate and that no matters of significance that we regard as relevant have, to our knowledge, been withheld from this report. We have been provided with a copy of the Federal Court's "Guidelines for Expert Witnesses in Proceeding in the Federal Court of Australia" and this report has been prepared in accordance with those Guidelines.

Should you wish to discuss this report in any way, please do not hesitate to contact Matthew on (03) 8603.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M Santoro', with a stylized flourish at the end.

Matthew Santoro
Executive Director

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1 Executive Summary

1.1 Scope of work and assumptions

The current regulatory control period applying to ETSA Utilities is due to expire on 30 June 2010, and the next regulatory control period will commence on 1 July 2010 and run until 30 June 2015. ETSA Utilities submitted its regulatory proposal to the AER on 1 July 2009, and the AER issued its draft decision on 30 November 2009.

As a component of forecast operating expenditure, ETSA Utilities proposed a cash cost for the early refinancing of debt using the "completion method". As part of the material relied upon by ETSA Utilities to support the inclusion of an amount representing costs associated with the early refinancing of debt as a component of forecast operating expenditure, ETSA Utilities referred to a publication by Standard & Poor's¹ ("S&P"). The S&P publication outlined various aspects of debt refinancing and liquidity risk management and included the following requirement of S&P for Australian rated companies:

"For the Australian investment-grade corporates, we expect to see a measured and logical approach to meet upcoming debt maturities. We would want to see that the company has a credible strategy for repaying or refinancing debt maturing up to 18 months ahead. As maturities move into the forward 12-month time horizon, we will start placing more weight within the short-term rating analysis on the materiality of upcoming maturities and the company's refinancing strategy and execution ability. To avoid negative rating consequences, the ideal progression would be:

- 12-to-18 months ahead of maturity, the company would have a detailed and credible refinancing plan (including a contingency plan);
- No less than six months ahead of the maturity, the company would have documentation substantially in place for the replacement debt issue/s; and
- No less than three months ahead of maturity, the refinancing would be essentially **completed², committed², or underwritten².**"

The AER, in its draft determination, rejected the forecast operating costs associated with the completion method as it did not consider that this method represented the costs that would be incurred by an

¹ Standard & Poor's. Refinancing And Liquidity Risks Remain, But Australia's Rated Corporates Are Set To Clear The Debt Logjam. April 22 2008.

² Emphasis added

efficient benchmark network service provider.³ The AER noted two principal concerns:

- that the financing choices made by ETSA Utilities may not necessarily reflect the efficient benchmark firm – for example, ETSA Utilities has structured its debt such that this large tranche of debt requires refinancing at this time; and
- that ETSA Utilities did not appear to have closely investigated the alternative approaches of the “commitment” approach and the “underwriting” approach.⁴

PricewaterhouseCoopers (“PwC”, “us” or “we”) has been engaged to undertake the following for ETSA Utilities:

Part 1. In relation to the three refinancing options identified by S&P:

- Define the three options of completing, committing or underwriting
- Generically cost the three options of refinancing three months prior to the maturity date
- Identify any other considerations for an Australian investment grade corporate in selecting between these three options
- Identify the approach that is likely to be most efficient for an Australian investment grade corporate

For this section of our engagement we have been asked to make the following assumptions:

- Consistent with the benchmark financing assumption that is prescribed in the National Electricity Rules,⁵ the borrowing entity is assumed to be funded entirely by a portfolio of bonds
- Our cost methodology for the three refinancing options is based on the hypothetical scenario that the maturing debt is a bond instrument and is being refinanced by the issue of new bonds
- The refinancing risk is addressed 3 months prior to the scheduled debt maturity
- Consistent with the benchmark financing assumptions adopted in the National Electricity Rules and in the AER’s Statement of Regulatory Intent,⁶ the new bonds comprise 10 year fixed interest instruments with a BBB+ credit rating

³ AER, *South Australia Draft Distribution Determination: Draft Decision*, 25 November 2009, p 238.

⁴ AER, *South Australia Draft Distribution Determination: Draft Decision*, 25 November 2009, Confidential appendix K.

⁵ National Electricity Rules, clause 6.5.2(e).

⁶ AER, *Electricity Transmission and Distribution Network Service Providers – Statement of Revised WACC Parameters (Transmission) and Statement of Regulatory Intent (Distribution)*, May 2009, p.7.

- The bonds described above would be issued at a yield equivalent to 10 year Government Treasury bond rate plus a debt risk premium of 4.29% pa
- Given the assumed term of the debt of 10 years, the annual refinancing volume is approximately 1/10 of the debt-share (60 per cent) of the regulatory asset base (RAB)

Part 2. Identify whether it is currently market practice for an Australian investment grade corporate to complete, commit or underwrite the refinancing of an impending debt maturity, at least three months prior to the maturity date. We have also been asked to consider whether standard practice differentiates for varying volumes of maturing debt. We have been asked to provide evidence to support the conclusion.

1.2 Conclusion

In this report, based on the scope of our engagement and the assumptions outlined herein, we conclude that:

- the cash cost associated with the refinancing of debt based on \$100 million, if it was **completed** no less than three months ahead of maturity, is estimated to be between \$1.248 million and \$1.498 million (equivalent to 20 bps pa and 24 bps pa);
- the cash cost associated with the refinancing of debt if it was **committed** three months ahead of maturity would be similar to the costs for the completion method, however unlike the completion method the borrower would not have much scope to reduce costs. The cash cost associated with the refinancing of \$100 million of debt, if it was committed three months ahead of maturity, is estimated to be between \$1.373 million and \$1.498 million (equivalent to 22 bps pa and 24 bps pa);
- the cash cost associated with the refinancing of debt based on \$100 million if it was **underwritten** three months ahead of maturity is estimated to be between \$2.87 million and \$3.36 million (equivalent to 46 bps pa to 54 bps pa) over the 10 year tenor of the bond;
- given the above conclusions, and based on the assumptions set out in this report, the cash costs associated with the completion method represent the lowest cost of the three options for securing suitable arrangements for renewing debt three months out; and
- it is common practice for commercial business to refinance debt according to the completion method at least three months prior to the relevant debt facility expiring.

Based on the scope of our engagement and the assumptions outlined herein, we have made all the inquiries that we believe are desirable and appropriate and that no matters of significance that we regard as relevant have, to our knowledge, been withheld from this report.

2 Incidental costs incurred by a Distribution Network Service Provider as part of its refinancing

2.1 A hypothetical bond refinancing

This report is intended to address a defined scope within the limits of the author's area of expertise, which is to advise upon how a debt market practitioner would derive the cost of certain actual or hypothetical debt market transactions and to offer observations upon related debt market issues. The report should not be interpreted as advising upon how those estimates and observations should be interpreted and applied for the setting of regulated prices, which is a matter that is outside the author's area of expertise.

We note that the cost methodology we have applied to the three S&P refinancing options is based on the hypothetical benchmark financing arrangements that are adopted in the National Electricity Rules and the AER's Statement of Regulatory Intent, namely that the entity is funded by Australian corporate bonds and that the refinancing of the maturing bond is via the issue of new bonds. We note that this benchmark is not intended to be descriptively accurate, as it is well known that DNSPs raise their debt from a number of sources and across a spread of maturities. One reason for this, amongst other reasons, is to reduce their risk associated with raising debt from markets or during time periods when there may be constraints to the quantity of debt that can be raised. We note that even when the Australian corporate bond market is well functioning, it is not sufficiently deep to provide borrowers with the required certainty in volume and pricing. Rather, all that is intended is that the benchmark provides a reasonable proxy for the cost of debt from any source, relying upon the assumption that market forces will lead to the full cost of debt raising to be equated across different funding sources, at least on average over time.

For the purpose of the current assignment, the fact that the benchmark does not describe how the DNSPs actually raise debt means that it need not be the case that the transactions that are described below would be observed in large number in Australia. This is particularly the case at the current time when there are very few issues from any firm in the Australian corporate bond market.

Having said that, it is important for the benchmark financing assumption to be applied consistently for all purposes, including when estimating the cost associated with refinancing debt. The equilibrium proposition described above that justifies the use of a simple financing benchmark applies at the level of the *total* cost of debt. Thus, for example, if the debt margin is drawn from observed yields on Australian corporate bonds but some other instrument is

assumed when estimating the refinancing cost, it is possible that the latter instrument may offer greater flexibility over refinancing but demand a higher debt margin for an equivalent term as a consequence. Mixing components from different instruments may lead to an estimate of the total cost of debt that is either not available under any of the instruments, or that exceeds what is payable under any of the instruments.

We note, however, that when applying the hypothetical benchmark described above there may be some argument as to whether it would be appropriate to build in premia for the lack of liquidity in the Australian market. For the avoidance of doubt, in costing the three S&P refinancing scenarios, we have assumed well functioning debt markets and accordingly have not added any pricing premium in our calculations. In this regard our approach may be viewed as conservative.

The table below summarises the three S&P refinancing options, and associated potential cash costs, if the refinancing options were to apply to a bond-to-bond transaction, that is, the scenario of a borrower refinancing maturing bonds through the issue of new bonds. It is our opinion that a borrower with a financing structure matching the hypothetical benchmark described above would utilise one of the three options specified by S&P to mitigate its refinancing risk.

S&P option	Description	Cost considerations
Completed	<ul style="list-style-type: none"> New bonds fully documented and funded at T_0 Proceeds of new bond issue are deposited At the end of the 3 months, the cash on deposit is used to repay the old bonds/maturing bonds 	<ul style="list-style-type: none"> New bonds assumed to be issued at T_0 and proceeds deposited for 3 months at a predetermined interest rate (thus generating interest income) Cash costs = interest rate on new bonds issued less interest income on deposit over 3 months Some of the above costs could potentially be mitigated by approaching investors to sell the bonds to the issuer at an agreed yield/price. Market practice indicates a low acceptance/take-up by investors.

S&P option	Description	Cost considerations
Committed (with forward/delayed bond settlement)	<ul style="list-style-type: none"> New bonds fully documented and price/yield locked in at T_0 Bond investors agree to delay funding/purchasing the new bonds until T_0+3 months At T_0+3 the proceeds from the new bond issue are used to repay the maturing bonds 	<ul style="list-style-type: none"> Costs/fees bond investors would require to hold unfunded commitment for 3 months Investor would be required to "put aside" sufficient funds to satisfy the commitment to purchase bonds in 3 months time Under a "normal bond issue" investors would purchase the bond within a short timeframe of committing to purchase the bond, thus receiving the bond yield immediately Cash costs = income foregone on new bonds for the 3 month period issued less any income recovered by placing the "committed funds" on deposit for 3 months
Underwritten	<ul style="list-style-type: none"> Bond Agent/Underwriter agrees to underwrite the bond transaction (volume and pricing) at T_0 for funding at $T_0 +3$ months 	<ul style="list-style-type: none"> Underwriting costs of Bond Agent Bank Recognising that the underwriting fees are in addition to fees Bond Agent normally charge on a non-underwritten bond transaction

Each of these alternatives is further discussed below.

2.2 Completion of refinancing 3 months prior to maturity

Under the "completion" scenario, it is assumed that the borrower addresses its refinancing risk by undertaking the new bond issue 3 months ahead of the existing bonds' scheduled maturity date. As issuers of bonds do not customarily have early redemption / repayment rights under the bonds, the issuer would be required to place the proceeds of the new bond issue on deposit until the old bonds mature. At maturity of the old bonds, the cash from the new bond issue is applied to repay the maturing bonds.

The additional cash cost incurred by the borrower refinancing under this scenario is the difference between:

- The cost of debt under the new bond issue over 3 months, and
- The income generated on the cash investment / deposited for 3 months

Over the 3 month period, the proceeds from the new bond issue may be invested by the borrower as follows:

- Bank risk: Represented by either placing the funds on deposit with a bank or purchasing bank accepted bills of exchange. Either form of investment is regarded as bank risk and likely to be offered at substantially the same interest rate. A reasonable interest rate assumption is regarded to be the Bank Bill Swap reference rate (BBSW).⁷ This form of investment is regarded low risk⁸ and common market practice. The temporary investment of bond proceeds in the form of bank deposit or purchase of bank accepted bills until the old bonds mature is likely to have neutral credit rating impact on the borrower; or
- Government risk: Purchase of 3-month Government treasury bills. This is a lower credit risk strategy to investing in bank-risk deposit / bank bills. The interest income generated under this option will be lower than the bank options due to the lower credit risk profile of the investment. The temporary investment of bond proceeds in the form of Government treasury bills is

⁷ BBSW is the Australian Financial Markets Association's bank-bill reference rate, published daily on AAP Reuters page BBSW and on Telerate page 2676. BBSW is calculated as the average mid rate for Australian Dollar bills of exchange, accepted by an approved bank, having a tenor with a designated maturity, that appears on an approved information vendors service.

⁸ We note that under normal market conditions bank risk is regarded as low. However, during the Global Financial Crisis, there was a high level of uncertainty over the credit quality of banks, resulting in many banks experiencing difficulties in raising funds from the wholesale market. To restore confidence in the banking market, many Governments offered guarantees (for a fee) over bank deposits as well as guarantees for bonds issued by banks.

likely to have neutral credit rating impact on the borrower.

We have considered the refinancing costs impact under both investment options.

In estimating the cash costs under the "Completion" option, we have also considered that the borrower may be able to reduce costs by negotiating with some existing bond holders for the early redemption or purchase of the old bonds 3 months prior to the scheduled maturity. As bonds do not commonly provide issuers with the ability to redeem or buy-back bonds, any buy-back or redemption will be subject to negotiation between the issuer and the holder, consequently the outcome is highly unpredictable. Below we have summarised the cost mitigation of a buy-back ranging from 0% acceptance to 100% acceptance.

It is reasonable to expect a relatively low acceptance from fixed interest investors to a buy-back or redemption offer. All else being equal, most fixed interest investors would prefer to hold the bond to maturity than to accept a buy-back proposal. Accepting a buy-back would result in the investor receiving cash ahead of expectations, therefore requiring the investor to quickly find reinvestment opportunities for the cash. Buy-backs also cause investors unnecessary or avoidable additional administration costs. For the purpose of our cost estimates, we have assumed that the borrower is able to buy back a percentage of its bonds on the open market at a yield equivalent to BBSW + 50 bps⁹, being an estimate of the negotiated yield for a 3 month BBB+ rated instrument.

Buying back its own bond generates an equivalent return for the borrower to one of using the surplus funds from the new bond issue to invest in a 3 month instrument yielding BBSW + 50 bps being the assumed yield on a BBB+ 3 month rated instrument, and is detailed in the calculations below.

⁹ Based on experience advising in capital markets our estimate of a 3 month BBB+ rated credit margin is based on pricing for BBB+/A-2 issues in the Commercial Paper market pre-GFC.

Cost Calculation

To illustrate the cash costs associated with the completion refinancing option, we have used the variables in the below table. The base rates¹⁰ used in the illustrative example were market interest rates as at 15 December 2009.

Assumptions	Units	Value
New bond issue		
10 year Government rate	% pa	5.40%
AER debt risk premium	% pa	4.29%
Deposit		
3-month BBSW	% pa	4.20%
3-month Government Treasury bills	% pa	3.70%
3-month BBB+ rated yield (BBSW + 50 bps)	% pa	4.70%
Other		
Volume (assumption)	\$m	\$100

Calculation involves three components:

- A. 3-months interest expense on the new bond
- B. Offsetting interest income generated on monies invested over 3 months
- C. Cost mitigation through successful negotiating with some bond holders to accept borrower's offer to buy-back / redeem old bonds 3 months ahead of scheduled maturity.

The calculation methodologies of each of these are outlined below.

A. Interest expense: New bond issue, coupon for first 3 months

= (10 year Government Treasury bill rate + AER debt risk premium) *
Volume / number of quarters in a year

$$= (5.40\% + 4.29\%) * \$100m / 4 = 9.69\% * \$100m / 4$$

¹⁰ Base rates are: 10-years Government rate, 3-month BBSW and 3-month Government Treasury bills

= \$2.4225m or 2.4225% this equates to 39 bps pa over 10 year tenor¹¹

B.1 Interest Income (invested in bank credit risk): Interest income received from investment in bank deposit or bank accepted bills at BBSW for 3 months

= volume * 3-month BBSW / number of quarters in a year

= \$100m * 4.20% / 4

= \$1.05m or 1.05% this equates to 17 bps pa over 10 year tenor¹¹

or

B.2 Interest Income (invested in Government credit risk): Interest income received from investment in Government Treasury bills for 3 months

= volume * 3-months Government Treasury bills / number of quarters in a year

= \$100m * 3.70% / 4

= \$0.925m or 0.925% this equates to 15 bps pa over 10 year tenor¹¹

C. Partial Buying back / redeeming old bonds

As previously mentioned, the borrower has potential scope to reduce the costs by negotiating with some existing bond holders the early redemption or purchase of the old bonds. This method assumes the borrower is able to successfully negotiate with existing bond holders to buy-back a percentage of existing bonds 3 months prior to the scheduled maturity. We have assumed the borrower is able to buy back its bonds at a yield equivalent to BBSW + 50 bps, being the estimated interest rate for a 3 month BBB+ rated issuer.

Based on our experience we would expect that the buy-back would have a low acceptance rate by investors. The majority of investors are expected to be fixed interest managers whose mandate requires them to hold bonds and as a result would have an aversion to hold cash received from a bond buy-back.

¹¹ The annual basis point equivalent has been calculated based on a discount rate equivalent to 10 year Government Treasury bill rate + AER debt risk premium

Cost summary

The table below summarises each of the above cost components under the completion refinancing alternative.

Calculation element	Upfront cash cost for \$100m (\$m)	Annual equiv ¹² for \$100m (\$m)	Upfront cost (bps)	Yield equiv (bps pa)
B.1 Interest Income (invested in bank credit risk): Interest income received from investment in bank deposit or bank accepted bills at BBSW for 3 months				
3 month interest cost on new bond	2.423	0.39	242	39
BBSW interest income	(1.05)	(0.17)	(105)	(17)
Total cost if invested in BBSW and no redemption / buy back	1.373	0.22	137	22
B.2 Interest Income (invested in Government credit risk): Interest income received from investment in Government Treasury bills for 3 months				
3 month interest cost on new bond	2.423	0.39	242	39
Treasury bill interest income	(0.925)	(0.15)	(93)	(15)
Total cost if invested in Treasury bills and no redemption / buy back	1.498	0.24	150	24

¹² Upfront cash cost annualised over 10 years.

Summarised in the table below is the cost mitigation of a buy-back ranging from 0% acceptance to 100% acceptance.

Percentage bought back / redeemed	0%	25%	50%	75%	100%
C. Partial buying back / redeeming old bonds					
Total cost assuming investment in BBSW					
3 month interest cost on new bond	2.423	2.423	2.423	2.423	2.423
less bond buy-back	-	(0.294)	(0.588)	(0.881)	(1.175)
less investment in bank risk	(1.050)	(0.788)	(0.525)	(0.263)	-
Upfront cash cost for \$100m (\$m)	1.373	1.342	1.311	1.279	1.248
Annual equiv for \$100m (\$m)	0.22	0.22	0.21	0.21	0.20
Yield equiv (bps pa)	22	22	21	21	20
Total cost assuming investment in Treasury Bills					
3 month interest cost on new bond	2.423	2.423	2.423	2.423	2.423
less bond buy-back	-	(0.294)	(0.588)	(0.881)	(1.175)
less investment in government risk	(0.925)	(0.694)	(0.463)	(0.231)	-
Upfront cash cost for \$100m (\$m)	1.498	1.436	1.373	1.311	1.248
Annual equiv for \$100m (\$m)	0.24	0.23	0.22	0.21	0.20
Yield equiv (bps pa)	24	23	22	21	20

In conclusion, based on \$100 million, the cash cost estimate associated with the completed refinancing alternative is between \$1.248m and \$1.498m (equivalent to 20 bps pa and 24 bps pa.)

2.3 Bond holders Committed to purchase new bonds in 3 months time (i.e. forward / delayed bond settlement)

Under the "committed" scenario, it is assumed that the borrower addresses its refinancing risk by successfully negotiating with bond holders the purchase of the borrower's new bonds a date 3 months forward. The forward commitment would need to be in a legally binding form that is fully documented, otherwise there would be insufficient certainty as to the refinancing of the debt. Under this scenario, the timing of the new bond issue would coincide with the old bonds' scheduled maturity date, with the proceeds from the new issue applied to refinance the maturing bonds.

Under a "normal bond issue" (where no delay in settlement is involved), bond investors would financially settle the bond purchase within a short timeframe of committing to the transaction and accordingly generate the agreed bond yield / return immediately. However, under a forward / delayed bond settlement, bond investors would effectively be required to "put aside" sufficient funds to satisfy the commitment to purchase bonds in 3 months time.

The methodology for calculating the foregone interest income arising from the 3-months delayed settlement is consistent with the methodology outlined in 2.1 above. Namely, in setting aside the funds that have been committed to forward purchase the new bonds, the investor is likely to be investing the cash in very liquid and low credit risk instruments. Similar to 2.1 above, this is likely to be in bank-risk instruments or Government Treasury bills, if the investor is highly risk averse. The income generated on 3-months investment will only partially offset the income that would have been generated if the bond was purchased immediately.

Accordingly, the compensation that would be required by the bond investor for a delayed start bond purchase is estimated to be the difference between:

- The opportunity cost over a 3 month period of receiving the agreed yield on the bond immediately after committing to purchase the bond, and
- The income generated on the cash investment / deposited that has been committed to purchase the new bonds 3 months forward

Unlike the completion scenario set out in section 2.2 above, we do not believe the borrower would have much scope to reduce these costs. However, we note that from time to time bond markets can be in a state where the demand for bonds greatly exceeds the supply of new bond issues. Under such conditions, the cost premium for a delayed start bond can be below the hypothetical cost estimate.

Deferred settled bond transactions are not common in the Australian market for periods as long as 3 months. Very short delays (days)

sometimes take place at no / negligible cost. However, if compensation was offered to investors on the basis described above, it is reasonable to expect investors would accept delay settlements of up to 3 months.

Cost Calculation

As described above, an investor in a deferred start bond will be required to commit funds prior to investment and will look to invest these funds in a low risk interest bearing instrument, such as a bank deposit, bank bills or Government Treasury bills. The investor would receive a minimum BBSW return or Government Treasury bills for three months and would, most likely, look to be compensated through increased running yield on the bond. The additional cost to the borrower would therefore be similar to components A and B in section 2.2 above. Based on \$100m, the additional cost would be between \$1.373m and \$1.498m (equivalent to 22 bps pa and 24 bps pa). This amount does not reflect the additional administrative and legal costs that would be incurred as a consequence of negotiating a deferred settled bond transaction for a period of as long as 3 months. The calculations below, detail the above summary.

A. Interest expense: New bond issue, coupon for first 3 months

= (10 year Government Treasury bill rate + AER debt risk premium) *
Volume / number of quarters in a year

= (5.40% + 4.29%) * \$100m / 4 = 9.69% * \$100m / 4

= \$2.4225m or 2.4225% this equates to 39 bps pa over 10 year tenor¹³

B.1 Interest Income (invested in bank credit risk): Interest income received from investment in bank deposit or bank accepted bills at BBSW for 3 months

= volume * 3-months BBSW / number of quarters in a year

= \$100m * 4.20% / 4

= \$1.05m or 1.05% this equates to 17 bps pa over 10 year tenor¹³

or

B.2 Interest Income (invested in Government credit risk): Interest income received from investment in Government Treasury bills for 3 months

= volume * 3-months Government Treasury bills / number of quarters in a year

¹³ The annual basis point equivalent has been calculated based on a discount rate equivalent to 10 year Government Treasury bill rate + AER debt risk premium

$$= \$100\text{m} * 3.70\% / 4$$

$$= \underline{\$0.925\text{m or }0.925\%} \text{ this equates to } 15 \text{ bps pa over } 10 \text{ year tenor}^{13}$$

2.4 Securing bank underwriting of new bond issue 3 months prior to maturity of old bonds

Under the “underwriting” scenario, it is assumed that the borrower addresses its refinancing risk by securing a bank underwriting of a bond issue 3 months before the old bonds’ scheduled maturity. Accordingly, the bank would agree to underwrite the issue of 10 year bonds, at an agreed volume and credit margin at T_0 for executing at $T_0 + 3\text{months}$.

The key risks to the underwriter are:

- Market volatility over the 3 months period that the underwriter is required to “hold” the pricing exposure on 10 year bonds. The combination of the 3 months “hold” period and ten year tenor of the bonds makes this the most significant risk component to the underwriter
- Market credit margins (for underlying 10 year bonds) may increase and reduce the market appetite for the underwritten bond, leaving the underwriter holding the bond and/or having to issue at a discount
- Underlying credit risk of the issuer, whereby the underwriter is taking borrower credit risk for 3 months. If the issuer’s credit profile deteriorates, market appetite will decrease for the issuer, making the successful sale of bonds into the market difficult to achieve

Underwriters would mitigate these risks through a combination of:

- Charging of upfront / underwriting fees to remunerate the bank for the risks
- Require the underwritten price (i.e. credit margin) to be at premium to where benchmark issuers / credits would normally be expected to price comparable bond transactions. The premium would be required to provide the bank comfort that it would be able to successfully sell all the bonds
- Underwrite the volume only, rather than volume and price. Under such scenario, the underwriter may incorporate a “market flex” provision in the pricing of the bond, providing the underwriter the flexibility to increase the yield/credit margin of the bond until sufficient bids are received from investors to complete 100% sale of the bonds.
- Ability to reprice or terminate the underwriting risk under certain circumstances. As this underwriting risk mitigation method is likely to weaken the underwriting and therefore expose the borrower to refinancing uncertainty, it is unlikely to satisfy the S&P requirements. Accordingly, we have assumed that the borrower would require an “unconditional” underwriting

The pricing structure for an underwriting is twofold:

- upfront / underwriting fee, and
- premium credit margin over benchmark issuers.

The quantum of upfront fees and credit margin premium are inversely related. Based on industry experience our best guess estimate of possible price ranges are:

- Upfront underwriting fees: 25 bps to 100 bps
- Premium credit margin to benchmark issuers: 50 bps to 30 bps pa

Accordingly, estimated cost combination of an underwritten bond transaction may range from:

- upfront / underwriting fees of 25 bps with required credit margin premium of 50 bps pa; to
- upfront / underwriting fees of 100 bps with required credit margin premium of 30 bps pa

For an underwriting that incorporates volume underwriting only, our cost estimate is that an underwriting fee of 25 bps to 50 bps would apply.

Underwritten bond transactions are customarily expensive. As a 3 months underwriting timeframe is regarded longer than normal, this refinancing option would be difficult to obtain from banks, and would be regarded the most expensive and not be commonly utilised by borrowers.

Cost Calculation

To illustrate the costs associated with this refinancing alternative, we have used the variables in the below table.

Assumption	Units	Value
Underwriting cost (upfront)	bps	25 bps – 100 bps
Credit margin premium (pa)	bps pa	50 bps – 30 bps
Volume (assumption)	\$m	\$100m

Estimated Fees	Present value for \$100m (\$m)	Annual equiv for \$100m (\$m)	Present value (bps)	Yield (bps pa)
Lower end				
Underwriting cost = 100 bps	1.00	0.16	100 bps	16 bps pa
Credit margin premium = 30 bps pa	1.87	0.30	187 bps	30 bps pa
Total cost	2.87	0.46	287 bps	46 bps pa
Upper end				
Underwriting cost = 25 bps	0.25	0.04	25 bps	4 bps pa
Credit margin premium = 50 bps pa	3.11	0.50	311 bps	50 bps pa
Total cost	3.36	0.54	336 bps	54 bps pa

The costs associated with an underwriting refinancing alternative, based on \$100m is estimated at \$2.87m to \$3.36m (equivalent to 46 bps pa to 54 bps pa) over the 10 year tenor of the bond.

2.5 Considerations for selecting between the three refinancing options

The completion option is regarded as the most cost efficient and simplest to complete. Key observations are:

- The completed refinancing alternative provides the borrower more control over the execution phase. The borrower is able to undertake a “normal bond transaction” and is likely to attract the widest investor base to purchase its bonds. The buy-back / redemption option is a cost minimisation mechanism, but its success or otherwise is not detrimental to the borrower
- The commitment alternative, and certainly for a period that would involve a delay of more than a few days, is not regarded a “normal transaction” and accordingly increases execution risk. This option may exclude certain bond investors for the new issue as some investors are likely to be deterred by the “complexity” of a delayed funded bond (of some three months) when they are more familiar with or used to the commitment alternative where the delay is very short or not longer than a couple of days. Further complexity arises for the borrower as it involves the borrower taking a performance risk on the investor fulfilling its commitment to purchase the bonds in 3 months time
- The underwriting alternative is the most unlikely to occur of the three options in a bond transaction. The high risk nature of the underwriting means that this alternative would be very expensive for the borrower.

3 Market practice of refinancing maturing debt

3.1 Introduction

We have been asked to identify, and provide evidence to support, whether it is currently market practice for an investment grade corporate to refinance an impending debt maturity, at least three months prior to the maturity date. We have also been asked to consider whether the practice differentiates for varying volumes of maturing debt.

Our response is based on our extensive experience in dealing in the debt markets and evidence sourced from publicly available information on companies undertaking refinancings. Information sources include:

- Reuters LPC LoanConnector
- Company annual reports
- Company press releases

The data sample chosen was based on the following:

- 1 Refinancing of a bond transaction in Australian market in the last year;
- 2 Large caps rather than small and mid-sized firms; and
- 3 Transactions where data is available from LoanConnector, with financial statistics including maturity and refinancing dates being published.
- 4 The data excludes ETSA Utilities' July 2009 US Private Placement to refinance US\$750m of debt due in April 2010.

The analysis presented in this section shows that companies do undertake refinancing of an impending debt maturity in advance of the debt maturity and, in any event, at least three months prior to the maturity date.

3.2 Market practice

Although the mitigation of refinancing risk has been heightened by the Global Financial Crisis, refinancing risk has always been a major focus for borrowers.

It should be noted that whilst the main reason corporate borrowers focus on managing refinancing risk is to ensure the business remains a going concern the management of refinancing risk also provides the benefit of maintaining a stable credit rating.

Debt requires the servicing of both interest and principal payment obligations. As the failure to satisfy a financial obligation under a loan agreement has very dire consequences for a borrower, market practice is to address refinancing risk in a sufficient timeframe prior to maturity.

In some instances, refinancing obligations can be satisfied by other sources such as operating cash flows, cash deposits and other committed lines of credit. Despite the source of repayment, an investment grade borrower would customarily secure the source of the refinancing well in advance of the scheduled maturity of the debt. Unless the borrower has surplus cash holdings on deposit available to repay the maturing debt, in most instances, the maturing debt is satisfied through the establishment of a replacement debt facility.

It is our opinion that the quantum¹⁴ of the refinancing does not materially change the general practice of securing the source of refinancing in advance of the scheduled maturity date. If the borrower's forecast shows that the quantum of the scheduled repayment amount cannot be satisfied by internal sources, a prudent investment grade borrower is expected to secure the required replacement debt within an adequate timeframe of the scheduled repayment date of the existing debt. A three month prior timeframe is not unreasonable and as shown in the table below, refinancing are also secured more than three months ahead of the scheduled maturity date. The fact that S&P has specified that it expects investment grade borrowers to secure the refinancing at least three months prior to the maturing debt will result in most, if not all, rated investment grade borrowers complying to ensure they satisfy the rating agency's requirements.

CPA Australia Ltd, identify their "top tip" for Australian corporate treasurers is to start refinancing early.

"Due to the limited funds available at acceptable cost and tenor, it is important to get in early in seeking to re-finance or financing. The risk of not being able to refinance (being the uncertainty regarding the continuation of some businesses as a going concern) is placing many businesses of all sizes under intense scrutiny to demonstrate that they have addressed refinancing risks. Given the smaller pool of potential lenders, lenders having less capacity to lend and a lower risk appetite, it may take time to effectively address refinancing risk."¹⁵

Also emphasising the need to refinance early, Standard & Poor's have published numerous articles surrounding refinancing risk, identifying the greatest challenge for Australian Utilities over the medium term will be refinancing maturing debt.

¹⁴ The quantum of the refinancing needs to be material relative to the size of the borrower.

¹⁵ CPA Australia Ltd. "Top tips for the accidental corporate treasurer" <http://www.cpaustralia.com.au/> accessed, January 21, 2010.

"With capital markets still effectively closed, funding options for Australian utilities remain invariably linked to the bank market, which has tightened terms and conditions, increased costs and shortened the tenor of funding (mostly to three years). Indeed, for the next 12 months, we expect the refinancing process to be costlier and take a lot longer than expected."¹⁶

Refinancing at least three months prior to maturity reduces refinancing risk, ensures the business does not default on the principal repayment of a debt issue, and removes the risk of any credit ratings negative action.

In a ratings announcement on March 18, 2009, Standard & Poor's placed TRUenergy on CreditWatch Negative, stating that the "short three-month timeframe to maturity of TRUenergy's A\$300 million working capital facility places pressure on the company's ability to preserve adequate liquidity in a timely manner".¹⁷

3.3 Refinancing activity of sample Australian corporates

The table below summarises refinancing activities of major Australian corporates over the past year, based on the criteria outlined in 3.1 above.

The data supports that borrowers do undertake refinancing at least 3 months prior to the scheduled maturity date.

¹⁶ Standard & Poor's "Industry Report Card: For Australian Utilities, The Challenge Remains to Manage Refinancing And Balance Sheets" May 7, 2009.

¹⁷ Standard & Poor's "Research Update: Ratings on TRUenergy Holdings And TRUenergy Placed On CreditWatch Negative Due To Refinancing Risks" March 18, 2009.

Borrower	S&P Long-term Credit Rating	Date of announcement of refinancing.	Previous Facility Maturity Date	Months prior to facility expiration	Facility Amount (\$A million)	Comments
SPI (Australia) Assets Pty Ltd	A-	Jun-09	Sep-09	3 mths	240	Funds used to refinance the company's capital market bonds. This refinancing represents 5.6% ¹⁸ of SPI (Australia) Assets Pty Ltd total debt.
Energy Partnership (Gas) Pty Ltd	BBB	Apr-09	Jul-09	3 mths	100	Refinancing of existing Medium Term Note. This refinancing represents 9.2% ¹⁹ of Energy Partnership (Gas) Pty Ltd total debt.
Envestra Victoria Pty Ltd	BBB	May-09	Nov-09	6 mths	289	Funds used to refinance an outstanding A\$175m of Medium Term Notes that matured in November 2009 and A\$125m loan provided by CBA that expired in Aug 2009. This refinancing represents 87.7% ²⁰ of Envestra Victoria Pty Ltd total debt.
Broadcast Australia Pty Ltd	NR	Feb-09	Jun-09	4 mths	447	Funds used to replace the A\$250m Fixed Rate Note that matured in June 2009.
CitiPower Pty Ltd	A-	Sep-09	Feb-10	5 mths	175	Funds used to refinance notes that mature in February 2010. This refinancing represents 16.3% ²¹ of CitiPower total debt.

¹⁸ Based on \$4,312.0m, at 31 March 2009, as quoted in S&P Ratings for SPI (Australia) Assets Pty Ltd, 29 May 2009

¹⁹ Based on \$1,084.9m, at 30 June 2009, as quoted in S&P Ratings for Energy Partnership (Gas) Pty Ltd 22 December 2009.

²⁰ Based on \$329.7m at 30 June 2009, as quoted in note 19 of Envestra's 2009 Annual Report.

²¹ Based on \$1,076.3m at 31 December 2008, quoted in S&P Ratings for CitiPower Trust 5 June 2009.

Conclusion

In this report, based on the scope of our engagement and the assumptions outlined herein, we conclude that:

- the cash cost associated with the refinancing of debt based on \$100 million, if it was **completed** no less than three months ahead of maturity, is estimated to be between \$1.248 million and \$1.498 million (equivalent to 20 bps pa and 24 bps pa);
- the cash cost associated with the refinancing of debt based if it was **committed** three months ahead of maturity would be similar to the costs for the completion method, however unlike the completion method the borrower would not have much scope to reduce costs. The cash cost associated with the refinancing of \$100 million of debt, if it was committed three months ahead of maturity, is estimated to be between \$1.373 million and \$1.498 million (equivalent to 22 bps pa and 24 bps pa);
- the cash cost associated with the refinancing of debt based on \$100 million if it was **underwritten** three months ahead of maturity is estimated to be between \$2.87 million and \$3.36 million (equivalent to 46 bps pa to 54 bps pa) over the 10 year tenor of the bond;
- given the above conclusions, and based on the assumptions set out in this report, the cash costs associated with the completion method represent the lowest cost of the three options for securing suitable arrangements for renewing debt three months out; and
- it is common practice for commercial business to refinance debt according to the completion method at least three months prior to the relevant debt facility expiring.

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Appendix A Terms of Reference

Scoping Brief – Early refinancing

1. Purpose

The purpose of this brief is to set out the nature, scope and purpose of work that ETSA Utilities is seeking PricewaterhouseCoopers Australia (PwC) to undertake in relation to early refinancing.

2. Background

ETSA Utilities' current regulatory control period is due to expire on 30 June 2010 and the next regulatory control period will commence on 31 July 2010 and run until 30 June 2015. ETSA Utilities submitted its regulatory proposal to the AER earlier this year, and the AER recently issued its draft decision.

ETSA Utilities proposed a cost for the early refinancing of debt using the completion method, and attached a Standard & Poor's article²² as supporting evidence. The AER, in its draft decision, rejected the costs of the completion method as it did not consider that this method represented the costs that would be incurred by an efficient benchmark network service provider. The AER noted that ETSA Utilities did not closely investigate the two alternative approaches - the commitment approach and the underwriting approach - referred to by Standard & Poor's.

3. Scope of works for PwC

3.1. Preparation of the Report

ETSA Utilities is seeking PwC to:

- Identify whether it is currently standard practice for an Australian investment grade corporate to complete, commit or underwrite the refinancing of an impending debt maturity, at least three months prior to the maturity date. Also, to consider whether standard practice differentiates for varying volumes of maturing debt. Provide evidence to support the conclusion; and
- Define the three options of completing, committing or underwriting the refinancing mentioned in the Standard & Poor's article. Generically cost the three options of refinancing three months prior to the maturity date. Identify any other considerations for an Australian investment grade corporate in selecting between these three options. Identify the approach

²² Standard & Poor's. Refinancing And Liquidity Risks Remain, But Australia's Rated Corporates Are Set To Clear The Debt Logjam. April 22 2008.

that is likely to be most efficient for an Australian investment grade corporate.

The report must contain the following:

- The terms of reference;
- The qualifications of the person(s) preparing the report;
- Identify any pre-existing relationship the person(s) and/or PwC has with the businesses;
- Clearly and fully set out all the relevant facts;
- Explain the person(s) process of reasoning;
- Reference any documents relied on by the person(s);
- Include specified wording at the end of the report stating that "[the person(s)] has made all the inquiries that [the person(s)] believes are desirable and appropriate and that no matters of significance that [the person(s)] regards as relevant have, to [the person(s)] knowledge, been withheld"; and
- State that the person(s) have been provided with a copy of the Federal Court's "Guidelines for Expert Witnesses in Proceeding in the Federal Court of Australia" (Attachment 1) and that the Report has been prepared in accordance with those Guidelines.

ETSA Utilities emphasises that the report prepared by PwC will be provided to the AER in support of its revised regulatory proposal. Accordingly the report may become a public report.

3.2. *Expert Witness*

As noted, ETSA Utilities intends to provide a copy of PwC's report to the AER in support of its revised regulatory proposal. The person(s) may be required to act as an expert witness in relation to the advice provided in the report.

ETSA Utilities has attached a copy of the Federal Court's "Guidelines for Expert Witnesses in Proceeding in the Federal Court of Australia". These Guidelines contain useful direction regarding the steps that should be taken by potential witnesses to ensure the appropriate level of objectivity.

3.3. *Timing*

A draft report should be provided by 18 December 2009, and finalised by 8 January 2010.

Attachment 1

Guidelines for Expert Witnesses in Proceedings in the Federal Court of Australia

Practice Direction

This replaces the Practice Direction on Guidelines for Expert Witnesses in Proceedings in the Federal Court of Australia issued on 6 June 2007.

Practitioners should give a copy of the following guidelines to any witness they propose to retain for the purpose of preparing a report or giving evidence in a proceeding as to an opinion held by the witness that is wholly or substantially based on the specialised knowledge of the witness (see - **Part 3.3 - Opinion** of the *Evidence Act 1995* (Cth)).

M.E.J. BLACK

Chief Justice

5 May 2008

Explanatory Memorandum

The guidelines are not intended to address all aspects of an expert witness's duties, but are intended to facilitate the admission of opinion evidence (footnote #1), and to assist experts to understand in general terms what the Court expects of them. Additionally, it is hoped that the guidelines will assist individual expert witnesses to avoid the criticism that is sometimes made (whether rightly or wrongly) that expert witnesses lack objectivity, or have coloured their evidence in favour of the party calling them.

Ways by which an expert witness giving opinion evidence may avoid criticism of partiality include ensuring that the report, or other statement of evidence:

- (a) is clearly expressed and not argumentative in tone;

- (b) is centrally concerned to express an opinion, upon a clearly defined question or questions, based on the expert's specialised knowledge;
- (c) identifies with precision the factual premises upon which the opinion is based;
- (d) explains the process of reasoning by which the expert reached the opinion expressed in the report;
- (e) is confined to the area or areas of the expert's specialised knowledge; and
- (f) identifies any pre-existing relationship (such as that of treating medical practitioner or a firm's accountant) between the author of the report, or his or her firm, company etc, and a party to the litigation.

An expert is not disqualified from giving evidence by reason only of a pre-existing relationship with the party that proffers the expert as a witness, but the nature of the pre-existing relationship should be disclosed.

The expert should make it clear whether, and to what extent, the opinion is based on the personal knowledge of the expert (the factual basis for which might be required to be established by admissible evidence of the expert or another witness) derived from the ongoing relationship rather than on factual premises or assumptions provided to the expert by way of instructions.

All experts need to be aware that if they participate to a significant degree in the process of formulating and preparing the case of a party, they may find it difficult to maintain objectivity.

An expert witness does not compromise objectivity by defending, forcefully if necessary, an opinion based on the expert's specialised knowledge which is genuinely held but may do so if the expert is, for example, unwilling to give consideration to alternative factual premises or is unwilling, where appropriate, to acknowledge recognised differences of opinion or approach between experts in the relevant discipline.

Some expert evidence is necessarily evaluative in character and, to an extent, argumentative. Some evidence by economists about the definition of the relevant market in competition law cases and evidence by anthropologists about the identification of a traditional society for the purposes of native title applications may be of such a character. The Court has a discretion to treat essentially argumentative evidence as submission, see Order 10 paragraph 1(2)(j).

The guidelines are, as their title indicates, no more than guidelines. Attempts to apply them literally in every case may prove unhelpful. In some areas of specialised knowledge and in some circumstances (eg some aspects of economic evidence in competition law cases) their literal interpretation may prove unworkable.

The Court expects legal practitioners and experts to work together to ensure that the guidelines are implemented in a practically sensible way which ensures that they achieve their intended purpose.

Nothing in the guidelines is intended to require the retention of more than one expert on the same subject matter – one to assist and one to give evidence. In most cases this would be wasteful. It is not required by the Guidelines. Expert assistance may be required in the early identification of the real issues in dispute.

Guidelines

- 1. General Duty to the Court (footnote #2)**
 - 1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.
 - 1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential (footnote #3).
 - 1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

- 2. The Form of the Expert Evidence (footnote #4)**

- 2.1 An expert's written report must give details of the expert's qualifications and of the literature or other material used in making the report.
- 2.2 All assumptions of fact made by the expert should be clearly and fully stated.
- 2.3 The report should identify and state the qualifications of each person who carried out any tests or experiments upon which the expert relied in compiling the report.
- 2.4 Where several opinions are provided in the report, the expert should summarise them.
- 2.5 The expert should give the reasons for each opinion.
- 2.6 At the end of the report the expert should declare that "[the expert] has *made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert's] knowledge, been withheld from the Court.*"
- 2.7 There should be included in or attached to the report; (i) a statement of the questions or issues that the expert was asked to address; (ii) the factual premises upon which the report proceeds; and (iii) the documents and other materials that the expert has been instructed to consider.
- 2.8 If, after exchange of reports or at any other stage, an expert witness changes a material opinion, having read another expert's report or for any other reason, the change should be communicated in a timely manner (through legal representatives) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court (footnote #5).
- 2.9 If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate

without some qualification, that qualification must be stated in the report (footnote #5).

- 2.10 The expert should make it clear when a particular question or issue falls outside the relevant field of expertise.
- 2.11 Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports (footnote #6).

3. Experts' Conference

- 3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

footnote #1

As to the distinction between expert opinion evidence and expert assistance see *Evans Deakin Pty Ltd v Sebel Furniture Ltd* [2003] FCA 171 per Allsop J at [676].

footnote #2

See rule 35.3 Civil Procedure Rules (UK); see also Lord Woolf "Medics, Lawyers and the Courts" [1997] 16 CJK 302 at 313.

footnote #3

See *Sampi v State of Western Australia* [2005] FCA 777 at [792]-[793], and *ACCC v Liquorland and Woolworths* [2006] FCA 826 at [836]-[842]

footnote #4

See rule 35.10 Civil Procedure Rules (UK) and Practice Direction 35 – Experts and Assessors (UK); *HG v the Queen* (1999) 197 CLR 414 per Gleeson CJ at [39]-[43]; *Ocean Marine Mutual Insurance Association (Europe) OV v Jetopay Pty Ltd* [2000] FCA 1463 (FC) at [17]-[23]

footnote #5

The "*Ikarian Reefer*" [1993] 20 FSR 563 at 565

footnote #6

The "*Ikarian Reefer*" [1993] 20 FSR 563 at 565-566. See also Ormrod "*Scientific Evidence in Court*" [1968] Crim LR 240.

Appendix B Curriculum vitae

**Matthew
Santoro**

Executive Director

Qualifications and memberships:

- Bachelor of Economics (Honours), University of Adelaide
- Affiliate, Institute of Chartered Accountants

Matthew has over 20 years of corporate and institutional banking experience, including 12 years at Deutsche Bank and eight years at Citibank. At Deutsche Bank he held various senior banking positions covering the origination, structuring and syndication of debt facilities. Following this and prior to joining PwC, Matthew jointly established and was Joint National Head of KPMG's debt advisory practice for a period of five years.

Project experience:

Matthew is experienced in a wide range of financing and fundraising transactions, in particular in the area of acquisition financing, leverage financing, re-financings, project and property financing and procurement of debt capital markets instruments across the Australian, European and USA markets. His experience includes dealings with credit rating agencies such as Standard & Poor's and Moody's.

Matthew has advised numerous companies on their debt and capital management needs, including the procurement of debt across a very broad industry sector. His clients have included the following:

- CSL
- David Jones
- Boom Logistics
- Pacific Brands
- Healthscope
- Hastings Funds Management
- Future Fund
- Australian Super
- Deutsche Asset Management
- South East Water
- Computershare
- ORIX Corporation
- Toll Holdings, and
- Tabcorp

Matthew's experience covers capital management and financing applications for a wide range of structures, asset types and industries. Matthew has over 20 years of debt markets experience with extensive dealings and established relationships with key participants in the capital markets such as banks, borrowers, fund and fixed interest managers, private equity investors, credit rating agencies, legal firms, etc.

Matthew's sector experience includes:

- debt structuring, arranging and procurement, onshore and offshore
- US Private Placement, Australian and European Bond markets
- capital management, and
- credit rating agencies.

Annexure JW4

AER response to ETSA Utilities information request dated 8 December 2009

Gamma

1. Please provide the supporting document from Handley as referenced by footnote 807 on p.257 – J.C.Handley, RE: Advice on gamma in relation to the 2010-2015 QLD/SA electricity distribution determinations, Memorandum to the AER, 23 October 2009.

Please see attached advice, '2009 10 20 – Gamma – Handley – Final'.

2. The AER note on p.258 that it is reasonable to assume a retention period of between one and five years. Please outline the basis for this assumption including details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER.

The range between one and five years was selected to reflect a retention of imputation credits reflective of the regulatory period.

3. The AER note on p.270 that the data set used as an input by SFG to regression appears not to use historically consistent price and dividend data, which may introduce unnecessary noise into the estimation results. Please outline and clarify the basis for this conclusion including details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER.

The AER compared the SFG data (on a selective basis) to data from Bloomberg, and found that the SFG stock price and dividend data are prone to errors:

1. The share price and dividend data are not adjusted to smooth out the effect of bonus issues, right issues, share splits and other events that may change the number of shares on issues. It is desirable to use adjusted series to reflect the same basis of quotation for shares of a company.
2. Company-specific information (including the share split and bonus share issues) is announced around the ex-dividend days, the firm share price changes substantially, reflecting market reaction to both.

For example, KAZ made several announcements around the ex-dividend day (10/04/2001) when it paid out a dividend of 0.0025, including: an announcement that it had signed a three-year IT outsourcing contract; and an announcement that it has successfully implemented a national contract with Elders.

3. Observations on special cash dividend payments are not excluded from the sample or properly controlled in the analysis.
4. Incomplete data as not all dividend-paying events for a firm paying regular interim and final dividends during the sample period are included.

Please also see page 441 of the AER's final decision on "Review of the weighted average cost of capital (WACC) parameters"; <http://www.aer.gov.au/content/index.php/itemId/722190>

- 3A. The AER note on p. 271 that the use of Cook's D analysis may fail to identify observations which in themselves are not influential, but when combined are jointly influential. Please identify the types of events the AER considers would cause observations which in themselves are not influential, but when combined are jointly influential.

Examples of such events include, but are not limited to, ongoing merger speculation (an example of this was Alinta AGL, which went on for a long period of time but did not affect the market), the issuing of new shares, signs of financial stress of a specific business over a period of time (e.g. Envestra, Timbercorp, Babcock and Brown, etc.), and other events which may affect the volatility of a stock's prices over a prolonged period of time but not the entire market.

3B. The AER note on p. 273 that it has concerns with the presence of multicollinearity in dividend drop off studies, including that conducted by SFG. Please explain how the AER considers the consequences of multicollinearity might manifest themselves in the results obtained in a dividend drop-off study, including the results of 2008 and 2009 SFG studies.

The two explanatory variables used in the regression analysis for the 2008 and 2009 SFG studies, namely cash dividends and franking credits, are highly correlated.

The value of franking credit distributed as a function of the cash dividend paid out, changes with the latter, since the franking credit is calculated based on

$$FC = D \cdot \left(\frac{T_c}{1 - T_c} \right) \cdot fr$$

Where FC is the franking credit, D is the cash dividend per share, T_c is the company tax rate, and fr is the proportion of cash dividend upon which Australia Tax has been paid.

Although several steps has been taken to mitigate this problem, (such as including unfranked, partially franked and fully franked dividends in the sample) the extent of the mitigation was not specifically examined in the SFG study.

A symptom of the multi-collinearity problem is that regression estimates are very sensitive to small changes in the sample or model specification. The SFG results appeared to be sensitive to a small numbers of observations, as by changing a small numbers of data points resulted in large variations in the regression results.

The high level of collinearity between the cash dividend and franking credit would pose the following problems in the regression analysis used in the 2008 and 2009 SFG studies:

- It may restrict the value of R-squared, as the two explanatory variables are after the same variations in the ex-dividend share price changes, and therefore unable to make independent contribution to the prediction of the price changes.
- It may make the determination of the impact of an explanatory variable difficult as the effects of correlated variables are confounded. The coefficients may not be precisely measured as each estimated coefficient will capture part of the effect of the other variable.
- It may increase the variances of the regression coefficients and thus make them less significant and possibly insignificant. In some cases, the coefficients may change substantially or even reverse the sign.

Debt Risk Premium

4. Please provide the underlying data the AER has relied on and the analysis performed (including in spreadsheet form) with respect to its testing of the Bloomberg and CBASpectrum services, including details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER. We anticipate this would include:

- Bond yield estimates from the RBA, UBS, CBA Spectrum and Bloomberg;
- Fair value estimates relied on from Bloomberg and CBA Spectrum; and
- Information the AER has relied on to determine credit ratings for each bond.

The AER is not in a position to disclose information from the services providers as a condition of the use, in particular, the information derived from their respective rate sheets used in the draft determination DRP analysis. However, the method of searching can be disclosed and this should allow ETSA to duplicate the results.

Set out below are the details on when and where the AER extracted the information from the respective providers and an attached spreadsheet 'SA DRP 18 day analysis workbook'.

Bonds Sourced:

Issuer	Maturity	ISIN
Tabcorp	13 October 2011	AU300TPP0010
Coles Myer	25 July 2012	AU300CML1014
Snowy Hydro	25 February 2013	AU000SHL0034
GPT Group	22 August 2013	AU300GPTM218
Santos	23 September 2015	AU300ST50076
Babcock & Brown Infrastructure	9 June 2016	AU300BBIF018

Bloomberg

Bonds

Bond data was sourced from Bloomberg on the 15th October for the above mentioned bonds for dates between 1 July 2009 and 14 October 2009. Estimates were extracted for both Mid Prices and Last Prices (mid prices to be consistent with the mid rates for the nominal risk-free rates), however, we note that Mid Prices are exactly the same as the Last Prices.

This data was entered in the Bloomberg Yields tab in the analysis spreadsheets.

Fair Yields

Fair yield data was sourced from Bloomberg on the 15th October for dates between 1 July 2009 and 13 October 2009. Estimates were extracted for Mid Prices.

Bloomberg BBB+ Fair Yield 1 to 10 year estimates are derived by using a combination of proxy Bloomberg data.

1, 2, 3, 4, 5, 7 and 8 year BBB+ estimates are derived from Bloomberg BBB estimates. Note that Bloomberg ceased publishing 8 year BBB estimates on the 18th August and 8 year estimates after the 18th August are calculated using an extrapolation method. The estimate years and corresponding Bloomberg identifiers are set out below;

Bloomberg BBB Fair Yields and Identifiers

1 year	2 year	3 year	4 year	5 year	7 year	8 year
C3561Y	C3562Y	C3563Y	C3564Y	C3565Y	C3567Y	C3568Y

This data was entered in the Bloomberg BBB FV tab.

6, 9 and 10 year estimates as well as 8 year estimates after 18th August are derived by extrapolating a combination of BBB rated, A rated and AAA rated Fair Yield estimates. These calculations can be seen in the Bloomberg BBB FV tab and are denoted by being in blue data.

Bloomberg A Fair Yield 8 and 10 year estimates are sourced from Bloomberg for dates between 1 July 2009 and 18 August 2009. This data was entered in the Bloomberg A FV tab.

Bloomberg A Fair
Yield
8 year 10 year
C3598Y C35910Y

Bloomberg AAA Fair Yield 7 and 10 year estimates are sourced from Bloomberg for dates between 1 July 2009 and 13 October 2009 and entered into the Bloomberg AAA FV tab.

Bloomberg AAA
Fair Yield
7 year 10 year
C3577Y C35710Y

CBA Spectrum

Bonds

Bond data was sourced from CBA Spectrum on the 14th October for the above mentioned bonds for dates between 1 January 2007 and 13 October 2009.

This data was entered in the CBA Spectrum Yields tab in the spreadsheets.

Fair Yields

Fair yield data was sourced from CBA Spectrum on the 14th October for dates between 1 January 2007 and 13 October 2009. CBA Spectrum produces Fair Yield estimates across all years from 1 to 10 years.

This data was entered in the CBA Spectrum BBB+ FV tab.

UBS

Bonds

The data set used for the SA DRP analysis contains data supplied by UBS from 13 October 2009 back to 1 February 2005.

Fair Yields

UBS do not produce Fair Yields.

5. Could the AER also advise how it derived a 10 year BBB+ estimate using Bloomberg data.

The 10 year BBB+ yield was calculated using the 7-year BBB Bloomberg yield and an extrapolation using the difference between the 7-year and 10-year AAA curve.

Debt and Equity Raising Costs

6. Please provide the underlying data the AER has relied on and the analysis performed (including in spreadsheet form) with respect to the issue of debt and equity raising costs, including details of:
 - All Bloomberg data on capital raising costs referred to in the AER decision;
 - The documentary basis for facts described in the analysis (for example, various prospectus' and offering documents, communication with S&P, sources detailed in the notes to the AER tables including *Table J2*);
 - Spreadsheet analysis of the data.

The AER considers that the information contained in the draft decision (including the appendices) should be sufficient for ETSA to understand the calculations and access any publicly available source documents.

Spreadsheet analysis of the data

The attached spreadsheet file, *Spreadsheets_For_ETSA_V2.xls* (contained in ETSA_files_V2.ZIP), contains five worksheets underlying the key calculations presented in the draft decision.

International bonds analysis – This shows the aggregation of international bonds (filtered from Bloomberg as per the discussion below) to obtain a benchmark basis points per annum (bppa) figure for gross underwriting fees. Values from this table are then presented in table I.7 (page 524), table I.9 (page 529) and table I.10 (page 531). Changing the discount rate (cell K3) will give various outcomes.

Calculation of bppa – This shows how the various categories of costs, including the underwriting spread from the 'International bonds analysis' tab, are aggregated to obtain a total cost for debt issuance. The categories of costs are taken directly from table I.8 (page 527) of the draft decision.

Domestic bonds analysis – This shows the aggregation of domestic bonds (filtered from Bloomberg as per the discussion above) to obtain a median bond size. This is mentioned on page 525, page 526, table I.8 (page 527) and table I.10 (page 531). Note that no domestic MTNs have met the inclusion criteria since 2007, as is shown in the table.

Seasoned equity offering analysis – This shows the aggregation of individual SEO costs to obtain a benchmark figure. The selection of companies to include in this table occurs as per the description above.

Dividend Reinvestment Plan analysis – This shows the aggregation of individual DRP costs to obtain a benchmark figure. Note that the company ASX codes are included in this spreadsheet to allow ease of identification of annual reports on the ASX website.

Bloomberg data

The following section addresses every reference to Bloomberg analysis from the debt and equity raising sections of the draft decision.

Page 519 (table I.2), page 520 (table I.3), page 523 (table I.4). The exact bonds in the AER data set (as at April 2009) were already communicated to ETSA (via email, May 2009). The bonds in the CEG data set were included in the CEG submission, which is publicly available.

Page 521. The draft decision states:

'One possible explanation is that the additional bonds may not be listed in the official LEAG tables (which detail underwriting costs) presented by Bloomberg. Although a particular table presentation is not relevant for the purposes of establishing a debt raising cost benchmark, the criteria for inclusion of bonds in the LEAG tables align with the ACG criteria.'

The key document is the attached Bloomberg criteria, (see ETSA_files_V2.ZIP). This criteria can also be obtained direct from Bloomberg.

Page 523, table I.5 and table I.6. The bonds listed in these table may be located in Bloomberg using the search function, based on the company names and announcement dates.

Page 524, table I.7. The revised data set is constructed as detailed in the text:

The effect of the changes to the data set, including the exclusion of bonds outside the five year window, the inclusion of bonds identified by CEG and the addition of data up to April 2009 is shown in table I.7.

The revised data set is also available in the file *Spreadsheets_For_ETSA_V2.xls* (contained in *ETSA_files_V2.ZIP*). Note that in its previous communication with ETSA, the AER had recorded an announcement date incorrectly [two bonds from BHP Billiton issued on 5/12/2005 were listed as 12/5/2005] and CEG had picked up this error in its report.

Page 526–527. The draft decision gives the criteria used to search Bloomberg for these domestic bonds:

The median domestic bond issue size has also been updated, based on the ACG methodology.¹⁴⁸⁸ This involves a five-year rolling window of Bloomberg-reported domestic MTN, filtered to include infrastructure companies.¹⁴⁸⁹

¹⁴⁸⁸ ACG, Debt and equity raising costs, December 2004, pp. 39, 49–50, 52.

¹⁴⁸⁹ The Australian infrastructure companies with bonds currently included in the data set are Alinta Network Holdings, Australia Pacific Airports Melbourne, Brisbane Airport Corporation, DBNGP Finance, Energy Partnership Gas, Envestra, ETSA Utilities Finance, Origin Energy, Santos Finance, Sydney Airport Finance and Westralia Airports.

Page 529, table I.9. The conversion from upfront costs to a basis points per annum (bppa) figure occurs as described in the text:

The AER's statement that the established methodology (simple division of five year costs) produces a better outcome for the business than the alternative (amortisation of ten year costs) was made on the basis of the conditions relevant to the businesses at the time.

The amortisation implementation is also available in the file *Spreadsheets_For_ETSA_V2.xls* (contained in *ETSA_files_V2.ZIP*).

Page 541, table J.2. The data was obtained as described in the draft decision:

The AER further clarifies that the starting point for the data presented in table J.2 was accessing Bloomberg statistics on the value of equity raised by each company each year. The AER then examined each company's annual report, for each year in the sample, which generally contained a clear statement on the purpose of that year's equity raising activities. Where this was not sufficient to identify the purpose of the additional equity, the AER obtained individual ASX notices (and associated press releases) to further clarify the purpose. If, at this point, it was not able to clearly categorise the purpose as either internal expansion or merger/acquisition, the figure was assigned to the unidentified purpose category.

Page 565, table J.3. The methodology to produce this table mirrors that of table J.3. This is described in the draft decision table source note:

Note: The AER identified candidate firms using equity raising figures from Bloomberg, then consulted the company's annual reports for the last two years to identify direct equity issuance costs associated with dividend reinvestment plans.

Documentary basis for facts described in the analysis

The following section addresses references from the debt and equity raising sections of the draft decision, where the documents are not publicly available. The AER considers that the AER website provides a large number of the public documents,

including all decisions by the AER/ACCC and consultant reports; and that it is reasonable to assume that all published academic research is available to ETSA.

Academic research (unpublished) – The working paper by Saunders, Palia and Kim is already known to ETSA (referenced in submissions). The unpublished thesis by Jindra (2000) is also attached (see ETSA_files_V2.ZIP).

ASX.com.au. Most annual reports, company notices and prospectuses are available at www.asx.com.au (search for the company code and past announcements). This includes the annual reports for table J.2 (page 541) and J.3 (page 565), and the FMG offer prospectus (page 522). Also see the individual company details for DRP and SEO costs in the file *Spreadsheets_For_ETSA_V2.xls* (contained in ETSA_files_V2.ZIP).

Queensland Treasury Corporation, Annual Report 2008–09 – publicly available at www.qtc.qld.gov.au

Toyota Motor Finance documentation – Two documents referred to on page 521 are attached (see ETSA_files_V2.ZIP).

Standard and Poor's correspondence – the quotation written out on page 526 is taken from the following email from Standard and Poor's:

Subject: RE: Credit rating information [SEC=UNCLASSIFIED]

Hi [removed]

As discussed, we are currently engaged by a number of electricity companies and whilst we use our standard fees as a guide in setting fees, there are many factors that are taken into consideration such as ownership structure, size and complexity of the entity etc. As such, we would prefer a bit more clarity around (1) so that there is no confusion.

The standard initial issuer credit rating fee for an Australian corporate is set at A\$70,000. Thereafter, analytical surveillance is maintained and a surveillance fee, currently set at A\$50,000 is levied on the anniversary of the initial rating date. Standard & Poor's considers the characteristics [sic] of each individual entity when setting fees, and arrangements can and do vary from the standard fees.

In respect of (2), we would prefer wording to say "The current standard fee for a long term (maturity over 12 month) corporate bond is 4bp".

In addition, Standard & Poor's revisits its fee schedule on an annual basis and fees are subject to change from time to time.

Let me know if you need anything further at this stage.

Kind regards

[removed]

Note that the text as written on page 526 was then checked with Standard and Poor's, with the inclusion of the words 'credit rating' in the sentence "The current standard *credit rating* fee..." to ensure that there was clarity on the purpose of the 4 basis point fee.

Consumer Price Index measures – publicly available at www.rba.gov.au or www.abs.gov.au. Note that the ACG report was submitted to the AER in December 2004, but values were indexed from September 2004 to allow for the time between measurement and submission of the ACG report.

Australian Financial Markets Association – 2009 financial markets report is publicly available at www.afma.com.au.

7. Please provide details as to the AER's assumptions for the standard asset life of ETSA Utilities' assets, which the AER considers relevant to the capitalisation of equity raising costs. We note that the life quoted in the draft decision is 47.8 years whereas the provided copy of the Post Tax Revenue Model calculates 51.2 years. Please advise which of these values intended by the AER to apply and outline the basis for this assumption, including details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER.

The standard life for equity raising costs (ERCs) is 52.3 years. The calculation of this standard life is shown in the 'input' sheet of the amended PTRM (See cell S27). The figure of '47.8 years' quoted on page 166 of the ETSA draft determination is incorrect.

Rollforward and Post Tax Revenue Models

8. We have been unable to reconcile the AER's draft decision for capex, per *Table 7.17* with the net capex input into the AER's copy of the Post Tax Revenue Model "*30 11 09 - ETSA - Attachment L1 PTRM-ETSA Utilities FINAL - amended.xls*". We request a reconciliation between *Table 8.17* and the PTRM.

With the exception of equity raising costs (ERC), the ECM Capex carryover and removal of metering capex, the forecast capex and disposals numbers in the 'input' sheet of the amended PTRM are based on the spreadsheet SI606 as provided by ETSA.

One difference between *Table 7.17* and the figures used in the amended PTRM and the sheet SI612 provided by ETSA is the level of customer contributions. The AER has chosen to present in *Table 7.17* the level of customer contributions as originally proposed by ETSA. An alternative would have been to present the figures based on the revised customer contributions, including gifted assets. In this case, the gross capex in *Table 7.17* would have been larger and the offsetting capital contributions adjustment larger by an equal amount.

The figures presented in *Table 7.17* and those contained in the row 173 of the amended PTRM differ marginally, due to rounding errors. The figures for 2010-11 differ more significantly and are explained by ERCs, which are included in the PTRM but not *Table 7.17*.

9. We have been unable to reconcile the AER's draft decision for opex, per *Table 8.17* (after converting to nominal dollars) with the Annual Revenue Requirement (*Table 16.5*). We request a reconciliation between opex per *Table 8.17* and the opex input into the Post Tax Revenue Model.

Table 8.17 refers to the AER conclusion on debt raising costs. *Table 8.17* appears to be a reference to the draft determination provided to ETSA to comment on issues of confidentiality. Please review *Table 8.20* (AER conclusion on ETSA's total opex allowance) in the draft determination dated 25 November to determine if there are any remaining issues with the reconciliation of the numbers.

10. We have been unable to reconcile the AER's draft decision for opex, per *Table 8.17* (after converting to nominal dollars) revised submission expenditure model provided by ETSA to the AER on 12 November 2009. We request a reconciliation between opex per *Table 8.17* and the expenditure model.

Please refer to response 9 above.

Market Risk Premium

11. Please provide the underlying data the AER has relied on and the analysis performed (including in spreadsheet form) with respect to its determination of Market Risk Premium, including details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER. We anticipate that this would include:
- Spreadsheet analysis underlying changes to CEG MRP estimate (to arrive at the 6.0% to 7.8% range as expressed on p.31.6); and
 - Data and analysis underlying the derivation of *Figure 11.1*.

In response to the above request, please see attached spreadsheet analysis:

- '2009 08 11 - MRP – CEG – DGM – AER Analysis'; and
- '2009 12 07 – ETSA request 11b – IV Analysis'.

Summary: Bond Issue Raising Costs Calculation

Domestic Bond Issue:
Assumptions (\$,000)
Issue size assumption

No. 1	No. 2	No. 3	No. 4	No. 5	No. 6	No. 7	No. 8	No. 9	No. 10	No. 11	No. 12	No. 13	No. 14	No. 15	No. 16	No. 17	No. 18	Total Debt	Total
263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	263,000	2,104,000	82.0
																			50.0
																			84.2
																			28.0
																			2.1
																			0.01

WITH AMORTISATION
8.50%

Underwriting and Management Fees
Tenor assumption

7.17

Other Costs	Per	Par	Issue	Total
Legal and redshow	115	4	115	92.0
Credit rating (p.a.)	4	4	4	50.0
Issue rating up front (bp)	3.5	3.5	4	84.2
Registry fees p.a.	0.26	0.26	3.5	28.0
Registry fees p-\$ mill.	0.26	0.26	0.26	2.1

7.17

Other costs 236.3
Broker Fees 1.2
Total (bpps) 237.5

7.17
8.9

Domestic Medium Term Notes - Infrastructure Issuers

Source: Bloomberg
Issuer Name

Issuer Name	Announcement	Tenor	Ave. Tenor	Rolling Median Tenor	AUD Issue Size	Ave. AUD	Rolling Median Amt
2000							
1 Citipower P/L	19-Jan-00	7		7.0	7	200	200
2 Citipower P/L	19-Jan-00	7		7.0	7	200	200
3 ETSA Utilities Finance	30-Mar-00	7		7.0	7	350	250
4 ETSA Utilities Finance	30-Mar-00	10		7.8	7	750	375
5 ETSA Utilities Finance	06-Apr-00	5		7.2	7	225	345
6 ETSA Utilities Finance	06-Apr-00	5		6.8	7	275	333
7 Brisbane Airport Corp Ltd	28-Jun-00	10		7.3	7	200	314
8 Brisbane Airport Corp Ltd	28-Jun-00	10		7.6	7	150	294
9 SPI Australia Finance P/L	01-Sep-00	7		7.6	7	103	273
10 SPI Australia Finance P/L	01-Sep-00	10		7.8	7	370	282
11 TXU Australia Holdings	14-Sep-00	5		7.5	7	200	275
12 TXU Australia Holdings	14-Sep-00	7		7.5	7	275	275
13 SPI Australia Finance P/L	28-Sep-00	5		7.3	7	150	265
14 Electranet P/L	28-Nov-00	7		7.3	7	284	267
15 Adelaide Airport Ltd	11-Dec-00	10		7.5	7	240	265
2001							
16 Powercor Australia	08-May-01	5		7.3	7	150	258
17 Powercor Australia	08-May-01	10		7.5	7	350	263
18 Australia Pacific Airports Melbourne P/L	24-May-01	7		7.4	7	150	257
19 Australia Pacific Airports Melbourne P/L	24-May-01	7		7.4	7	300	259
20 Australia Pacific Airports Melbourne P/L	24-May-01	10		7.6	7	250	259
21 SPI Australia Finance P/L	12-Dec-01	3		7.3	7	100	251
22 SPI Australia Finance P/L	12-Dec-01	3		7.1	7	145	246
2002							
23 GasNet Australia Group	15-Mar-02	7		7.1	7	200	244
24 GasNet Australia Group	15-Mar-02	7		7.1	7	100	238
25 Australian Gas Light Ltd	13-May-02	5.5		7.1	7	325	242
26 Australian Gas Light Ltd	29-Jul-02	7		7.1	7	275	243
27 Transurban Finance Company	30-Jul-02	3		6.9	7	90	237
28 Transurban Finance Company	30-Jul-02	3		6.8	7	65	231
29 Transurban Finance Company	30-Jul-02	3		6.6	7	175	229
30 Transurban Finance Company	30-Jul-02	3		6.5	7	260	230
31 Transurban Finance Company	30-Jul-02	5		6.5	7	240	231
32 Transurban Finance Company	30-Jul-02	7		6.5	7	360	235
33 Southern Cross Airports	08-Oct-02	5		6.4	7	620	246
34 Southern Cross Airports	08-Oct-02	5		6.4	7	600	257
35 Southern Cross Airports	08-Oct-02	10		6.5	7	240	256
36 Southern Cross Airports	08-Oct-02	10		6.6	7	40	250
37 SPI Australia Finance P/L	06-Nov-02	4		6.5	7	100	246
38 SPI Australia Finance P/L	06-Nov-02	4		6.5	7	110	243
39 Envestra Victoria Ltd	15-Nov-02	7		6.5	7	175	241
2003							
40 Envestra Ltd	18-Feb-03	5		6.4	7	80	237
41 Envestra Victoria Ltd	18-Feb-03	5		6.4	7	20	232
42 Envestra Victoria Ltd	18-Feb-03	12		6.5	7	45	227
43 Citipower P/L	24-Feb-03	4		6.4	7	100	221
44 Citipower P/L	24-Feb-03	7		6.4	7	175	220
45 Citipower P/L	24-Feb-03	7		6.5	7	300	222
46 Citipower P/L	24-Feb-03	10		6.5	7	300	222
47 GasNet Australia Group	31-Jul-03	5		6.5	7	150	220
48 Electranet P/L	19-Nov-03	6		6.5	7	50	217
49 Electranet P/L	19-Nov-03	6		6.5	7	150	216
50 Brisbane Airport Corp Ltd	08-Dec-03	10		6.5	7	50	212
2004							
51 Brisbane Airport Corp Ltd	01-Jun-04	9.5		6.6	7	300	214
52 SPI Australia Finance P/L	07-Jun-04	4.5		6.5	7	30	210
53 SPI Australia Finance P/L	07-Jun-04	4.5		6.5	7	140	209
54 Energy Partnership Gas P/L	23-Jul-04	5		6.5	6.5	135	208
55 Energy Partnership Gas P/L	23-Jul-04	7		6.5	7	100	206
56 Energy Partnership Gas P/L	23-Jul-04	7		6.5	7	150	205
57 SPI Electricity and Gas	28-Oct-04	7		6.5	7	200	205
58 SPI Electricity and Gas	16-Nov-04	7		6.5	7	85	203
59 SPI Electricity and Gas	16-Nov-04	7		6.5	7	150	202
60 Transurban Finance Company	26-Nov-04	5		6.5	7	150	201
2005							
61 Envestra Ltd	04-Mar-05	21		6.7	7	300	202
62 Envestra Ltd	04-Mar-05	19		6.9	7	300	204
63 DBNGP Finance Co Pty Ltd	13-Apr-05	7		6.9	7	275	205
64 DBNGP Finance Co Pty Ltd	13-Apr-05	12		7.0	7	275	206
65 ETSA Utilities Finance	14-Jun-05	10		7.1	7	300	208
66 Alinta Networks Holdings Pty Ltd	19-Sep-05	7		7.1	7	250	208
67 Alinta Networks Holdings Pty Ltd	19-Sep-05	5		7.1	7	200	209
68 Santos Finance Limited	20-Sep-05	6		7.0	7	350	210
69 Santos Finance Limited	20-Sep-05	10		7.1	7	100	207
70 Australia Pacific Airports Melbourne P/L	29/11/2005	10		7.1	7	200	209
71 Australia Pacific Airports Melbourne P/L	29/11/2005	10		7.2	7	100	211
72 United Energy Distribution Holdings Pty	30-Sep-05	9		7.2	7	500	211
2006							
73 Envestra	09-Feb-06	19		7.3	7	150	210
74 DBNGP Finance Co Pty Ltd	07-Apr-06	12		7.4	7	325	212
75 DBNGP Finance Co Pty Ltd	07-Apr-06	7		7.4	7	325	213
76 Brisbane Airport Corp Ltd	22-Jun-06	10		7.4	7	400	216
77 Origin Energy Ltd	28-Jun-06	5		7.4	7	100	214
78 ETSA Utilities Finance	21-Sep-06	11.5		7.4	7	350	216
79 Origin Energy Ltd	28-Sep-06	5		7.4	7	100	215
80 Westraia Airports Corp	17-Nov-06	10		7.4	7	240	215
81 Westraia Airports Corp	17-Nov-06	7		7.4	7	100	213
82 Sydney Airport Finance	01-Dec-06	21		7.6	7	659	219
83 Sydney Airport Finance	04-Dec-06	5		7.6	7	250	219
84 Sydney Airport Finance	04-Dec-06	5		7.5	7	150	218
85 Sydney Airport Finance	04-Dec-06	7		7.5	7	217	218
86 Sydney Airport Finance	05-Dec-06	15		7.6	7	200	218
87 Sydney Airport Finance	08-Dec-06	16		7.7	7	750	224
2007							
88 Energy Partnership Gas P/L	08-Jun-07	10		7.7	7	300	225

Median from last 5 years 263

SAMPLE OF 30 AUSTRALIAN SEOs (2007-2009)

Company	Reason
Alumina	Preserve balance sheet due to GFC Institutional entitlement offer
Amcors	Acquisition – company Non-renounceable pro rata entitlement offer
ANZ	To target efficient capital structure Offer of convertible preference shares
Asciano	Reduction of debt Non-renounceable pro rata entitlement offer
Bendigo and Adelaide	To strengthen balance sheet Non-renounceable entitlement offer and placement
BlueScope Steel	Reduction of debt Non-renounceable entitlement offer
Boart Longyear	Reduction of debt Non-renounceable pro-rata entitlement offer
Commonwealth Bank	Capital management Issue of hybrid securities
GPT	Debt reduction Pro-rata entitlement offer
Grange	Reduction of debt Placement to major shareholders
Resources Gunns	Acquisition – ITC Hardwood Institutional and retail entitlement offer
Iluka Resources	Acquisitions – mines Pro-rata entitlement offer
Incitec Pivot	Maintenance of desired capital structure Retail entitlement offer
Incitec Pivot	Institutional entitlement offer
Lihir Gold	Capital management Retail entitlement offer
Lynas Corp	Capital management Retail entitlement offer
Mount Gibson Iron	Adverse business conditions with GFC Renounceable rights issue
Newcrest Mining Ltd	Target capital structure Retail entitlement offer
Nexus Energy	Adverse business conditions with GFC Pro-rata non-renounceable rights issue
Orica	Maintaining efficient balance sheet
Photon	Debt reduction Non-renounceable pro rate rights issue

Rio Tinto	Target of capital structure and strengthening of cash flows 21:40 rights issue
Sino Gold	Increase exposure to the spot gold price Renounceable entitlement offer
St Barbara	Sustain business activities Pro rata entitlement offer and institutional placement
Westfield Group	Strengthen balance sheet Pro-rata entitlement offer
Elders Limited	Recapitalisation and refinancing plan Conditional placement and share purchase plan
Transpacific	Recapitalisation and refinancing plan Institutional offer
Transpacific	Retail offer
Valad Property	Acquisition of business and property Non-renounceable entitlement offer, priority offer and public offer
Windimurra Vanadium	Working capital requirements Non-renounceable entitlement offer
MEDIAN	

Expected proceeds	Total Cost	Cost as % proceeds
\$737 million	\$23.3 million	3.16%
\$1.611 billion	\$36.25 million	2.25%
\$500 million	\$11.18 million	2.24%
\$2.35 billion	\$59 million	2.51%
\$300 million	\$9 million	3.00%
\$1.413 billion	\$55.00 million	3.89%
\$756 million	\$60 million	7.94%
\$1.5 billion	\$34 million	2.27%
\$1.6 billion	\$54 million	3.38%
\$38.1 million	\$1.9 million	5.00%
\$145 million	\$5 million	3.45%
\$351.9 million	\$9.68 million	2.75%
\$351 million	\$9.65 million	2.75 % (retail)
\$819 million	\$28.67 million	3.50 % (institutional)
\$1.2 billion	\$14.4 million	1.20%
\$450 million	\$19.0 million	4.22%
\$79.7 million	\$2.79 million	3.50%
\$2.042 billion	\$24.51 million	1.20%
\$43.5 million	\$3.045 million	7.00%
\$600 million	\$9.6 million	1.60%
\$76.6 million	\$2.11 million	2.75%

\$4.24 billion	\$116.6 million	2.75%
\$136 million	\$4.1 million	3.00%
\$120 million	\$3.9 million	3.25%
\$3.0 billion	\$43 million	1.43%
\$420 million	\$15.44 million	3.25%
\$561.0 million	\$16.8 million	3.00%
		(institutional)
\$175.6 million	\$3.2 million	1.80%
		(retail)
\$1192.6 million	\$55 million	4.61%
\$54.67 million	\$1.64 million	3.00%
\$530.5 million	\$14.92 million	3%

Dividend Reinvestment Plan Costs
Update for 2009

Ticker	Company	Amount Raised	Annual Report Page	Cost	DRP cost
AGK	AGL ENERGY LIMITED	\$112,900,318.18	93	\$200,000.00	0.18%
MOF	MACQUARIE OFFICE	\$56,601,772.94	77	\$100,000.00	0.18%
RCY	RIVERCITY MOTORWAY	\$34,677,731.56	68	\$194,952.00	0.56%
GFF	GOODMAN FIELDER.	\$29,768,201.10	96	\$100,000.00	0.34%
RHC	RAMSAY HEALTH CARE	\$12,363,590.87	84	\$37,000.00	0.30%
ENE	ENERGY DEVELOPMENTS	\$6,496,579.99	59	\$34,000.00	0.52%
CWP	CEDAR WOODS PROP.	\$5,414,850.24	52	\$73,000.00	1.35%
AMH	AMCIL LIMITED	\$4,106,958.00	19	\$14,000.00	0.34%
ASL	AUSDRILL LIMITED	\$2,640,345.43	65	\$16,000.00	0.61%
IBC	IRONBARK CAPITAL LTD	\$2,359,452.54	19	\$62,000.00	2.63%
TGG	TEMPLETON GLOBAL	\$1,654,492.84	50	\$6,365.00	0.38%
ESS	ESSA AUSTRALIA	\$1,638,379.31	48	\$65,546.00	4.00%
WHF	WHITEFIELD LTD	\$1,612,210.68	32	\$11,974.00	0.74%
NOD	NOMAD BUILDING	\$1,382,582.75	65	\$6,000.00	0.43%
AEZ	APN EUROPEAN RETAIL	\$786,450.02	65	\$138,000.00	17.55%
MIR	MIRRABOOKA INVEST.	\$771,019.92	32	\$4,000.00	0.52%
CVC	CVC LIMITED	\$732,324.00	21	\$2,347.00	0.32%
TAG	TAG PACIFIC LIMITED	\$357,431.23	23	\$5,000.00	1.40%
ALF	AUSTRALIAN LEADERS	\$249,838.00	28	\$11,966.00	4.79%
OAK	OAKS HOTELS & RESORT	\$240,972.88	87	\$3,000.00	1.24%
					0.54%

median

Confidential Annexure JW5

Annexure JW6

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Dear Natalie

Underwriting Cost – Request for Information

As you are aware, the CitiPower and Powercor businesses are in the process of preparing a response to the Victorian electricity DNSPs Distribution determination 2011-2015 and would appreciate JP Morgan's assistance in respect to information on underwriting costs.

The AER provides the DNSPs with an allowance for debt raising costs that are incurred each time their debt is rolled over. In determining an appropriate debt raising cost allowance the AER has referenced the gross underwriting fee of five capital markets debt transactions from the Bloomberg system. The five capital markets transactions are listed in the table below.

ISSUER IN AER LIST for Direct Raising Cost - "Total Gross Underwriting Cost" (1)	Book Runner(s)	Underwriting Agreement & Pricing Date	Book Build Date	Debt Maturity Date	Amount	Underwriters' Discount (Gross fees (bp upfront))	Terms & Conditions in Underwriting	Use of Proceeds
Woolworths Ltd	Citi, JPM	16-Nov-05	23-Nov-05	15-Nov-15	US\$425m	37.5	No prospectus available	Annual Report balance sheet (note 14) implies proceeds were used to repay bank debt and for general corporate purposes.
BHP Billiton Fin USA Ltd	CSFB, JPM	5-Dec-05	12-Dec-05	16-Dec-15	US\$750m	45.0	See Attachment 1	Repay a term loan facility established in March 2005 to finance the acquisition of WMC & to repay commercial paper
BHP Billiton Fin USA Ltd	BoA, JPM	26-Mar-07	29-Mar-07	29-Mar-17	US\$750m	45.0	See Attachment 1	Proceeds to be used for general corporate purposes
BHP Billiton Fin USA Ltd	Barclays, Citigroup, Goldmans	18-Mar-09	25-Mar-09	1-Apr-19	US\$1,750m	45.0	No detail of conditions provided in prospectus	Proceeds to be used for general corporate purposes
Rio Tin Fin USA Ltd	Deutsche, JPM, Morgan Stanley, CS, RBS, SocGen	14-Apr-09	17-Apr-09	1-May-19	US\$1,500m	45.0	No detail of conditions provided in prospectus	The proceeds will be used to repay some amounts outstanding under a syndicated credit facility that was established to acquire Alcan in 2007 and that has principal repayments falling due in October 2009, October 2010, October 2012 and December 2012. [Total debt outstanding as at 31 December 2008 was US\$39,758 m]

Given that JP Morgan were a Lead Manager/ Book Runner on four of the transactions referenced, we would very much appreciate you responding to the questions detailed below in respect to those transactions.

1. Excluding legal and roadshow costs, registry costs, paying agency fees and credit rating fees, did the gross underwriting fee represent the only cost paid to Underwriters and Book Runners? If not,

please provide a description of the category of other fee(s) paid eg placement fees, establishment fees, commitment fees and also provide a range of fees paid.

2. Please confirm the accuracy of the "Use of Proceeds" as detailed in the table above.
3. Please confirm the underwriting period was for the period between the date of the "Underwriting Agreement & Pricing Date" and the "Book Build Date" as detailed in the table above.
4. Please confirm the underwriting was for both price and volume.
5. Please confirm that the Terms & Conditions in the Underwriting Agreement as detailed in Attachment 1 are typical for such book build underwriting transactions.

Thank you in advance for your assistance with this matter. If you have any queries please do not hesitate to contact me on 03 9683 4441.

Regards

Julie Williams
Chief Financial Officer

ATTACHMENT 1

Terms & Conditions included in the Underwriting Agreement:

The underwriting agreement provides that the obligations of the several underwriters to purchase the notes included in the offering are subject to the following conditions:

- 1 customary delivery of legal opinions, certificates, comfort letters and executed documentation to the underwriters prior to the closing of the offering
- 2 prior to the closing of the offering, there not having been any material adverse change affecting our condition, earnings, business or operations from those set forth in this prospectus supplement, including a downgrading in our credit rating; and
- 3 between the date of the underwriting agreement and the closing of the offering, certain market-related events not having occurred, such as the following:
 - 3a a suspension in trading on the new York stock exchange or American stock exchange
 - 3b a general moratorium on commercial banking activities declared by the US federal or New York state authorities
 - 3c an outbreak or escalation of hostilities or a declaration by the United States of a national emergency or war; or
 - 3d a material adverse change in general economic, political or financial conditions.

Confidential Annexure JW7

Confidential Annexure JW8

Confidential Annexure JW9

Confidential Annexure JW10

Confidential Annexure JW11

Confidential Annexure JW12

Confidential Annexure JW13

Confidential Annexure JW14