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Mr Kevin Fincham
Assistant Director, Network Finance & Reporting
Australian Energy Regulator
GPO Box 520
Melbourne
Victoria 3001

Dear Kevin

**Re: Consultant's Questions**

I refer to your email of 24 May 2018.

Outlined below are our responses to the consultant's questions you provided in your email of 24 May 2018. For ease of comparison we have used the consultant's numbering system and our responses are immediately below each question.

This letter contains some general comments in response to the questions. It is recommended that this letter be read in conjunction with the revised EICSI spreadsheet for response to each question by instrument. This is an updated version of the spreadsheet used in our report dated 28 April 2018 and you will see that we have added new columns dealing with each of the questions below.

### Question 1: For each instrument that was excluded, why was it excluded?

**Response 1:** See spreadsheet. The key criteria for exclusion were if the debt was raised outside the time series, i.e. before 2013, or if the debt was somehow non-representative of normal debt funding for corporates. Examples of the latter are working capital facilities and the transitioning debt as part of the NSW State Government privatisation exercise.

### Question 2: Was callable debt excluded and, if so, on what basis was callable debt identified?

For example:

**a.** was a distinction made between callable bonds and make whole callable bonds?

**Response a:** The network providers did not make any distinction in their replies.

**b.** was all debt, such as bank debt, that offered early repayment excluded as callable?

**Response b:** Bank debt facilities are sometimes repayable without penalty such as Revolving Debt. As the option to repay is at the discretion of borrower (excluding covenants, etc.) the lender needs to price the facility as if it will run to full maturity. Therefore, unless the network provider indicated in their debt sheet any special

conditions then bank facilities were scored as being to the contractual maturity date.

**c.** was bank debt that actually was repaid early treated as callable?

**Response c:** See individual spreadsheets. Some of the instruments were callable in the last few months before maturity which would have no or trivial impact on its pricing.

**d.** what was the set of distinctions used?

**Response d:** The network providers determined the criteria.

**Question 3: If not excluded as callable, how was debt that was repaid early treated? Was the maturity adjusted to reflect the actual maturity or was the original maturity retained?**

**a.** There are three types of repayments: (1) full repayment; (2) partial repayments using the same terms as the underlying debt; and (3) partial repayments followed by renegotiation of the terms (maturity/term/amount) of the debt. Were these types of repayments treated differently?

**Response a:** No.

**Question 4: The published Chairmont model does not have any illustrative calculations for how the "adj quarterly spread" was calculated.**

We would like to know:

**a.** How was the spread on FX currency bonds calculated?

**Response a:** The eventual "end" spread in Australian dollars was provided by the network providers either in their data on the debt instruments, or the associated cross currency swaps. Chairmont did not do any calculations for converting foreign currency debt back into Australian dollar spreads.

**b.** How are the quarterly spreads on AUD issues calculated:

**i.** Fixed rate.

**Response i:** A very simplified method was used which left out the base swap rate when converting the spread. The conversion calculation used only the spread itself to compound up or discount down for the difference in payment frequency. For example, if the quoted spread was paid semi-annually, the following formula was used:

$$(\left(1+\left(\frac{SS}{2}\right)\right)^{\frac{2}{4}}-1)*4$$

So, if the semi-annual spread (ss) was 1.65%, an equivalent quarterly spread of 1.644% would be calculated. A more accurate method incorporating the base swap rate, for example of 2.77%, would yield a quarterly spread of 1.635%.

For the purposes of the exercise this level of precision was considered difficult to ascertain, (i.e. which base rate to apply at which times) and not material. If a future

similar exercise were to be undertaken when base rates are substantially higher, some method for incorporating them should be considered. The impact for the EICSI over the five years covered in this report would be to make it no more than one or two basis points lower across the period.

**ii.** Floating rate relative to various benchmarks (BBSY, BBSW, Cash Rate)

**Response ii:** All spreads used refer to versus BBSW.

**iii.** How were BBSY floating rate spreads converted to BBSW, as stated in footnote 35 of the AER discussion paper? Was this done by adding 0.005%?

**Response iii:** Yes.

**iv.** How did Chairmont determine the coupon frequencies of instruments that had non-standard frequency descriptions?

**Response iv:** All coupon frequencies were of a standard nature, i.e. monthly, quarterly, semi-annual.

**v.** Can Chairmont provide further elaboration of the process it used for deciding which debt raising costs should be included in the calculations, and how? (Section 4.1.7 of Chairmont report).

**Response v:** See response to question1.

**c.** Ideally we would like the calculations for each debt instrument based on cell references to the actual business data (debt instruments and financial instruments as relevant).

**Response c:** The data contained in each network providers spreadsheets addresses this. The Consultant should seek this information directly from their clients.

**Question 5: Did Chairmont and/or AER make any pre-analysis adjustments to the raw data for any reason, including to correct data entry errors? If so, what were they?**

**Response 5:** No adjustments were made. During the analysis of responses stage, if data appeared inconsistent or incorrect, it was then checked with the network provider.

**Question 6: How did the AER analyse debts with multiple credit ratings or non-big 3 ratings?**

**Response 6:** Where there were multiple credit ratings if they did not align we took the mid-point. For the US Private Placement market, the rating NAIC-1was treated as equivalent to a A- rating, and NAIC-2 was treated as midway between BBB and BBB+.

I trust the above answers the consultant's questions. As usual, I am available to discuss.

Yours sincerely

Michael McAlary
Chief Executive Officer