Statement on the Development of TransGrid's Debt Management Policy (PUBLIC)

STATEMENT OF ANTHONY KEITH MEEHAN

AFFIRMED ON THIRTEENTH JANUARY 2015

I, Anthony Keith Meehan, Executive General Manager/Revenue Strategy and Business Diversification, at TransGrid, of 180 Thomas Street, Haymarket, Sydney of the State of New South Wales, affirm:

1. **BACKGROUND**

1.1 I am the Executive General Manager/Revenue Strategy and Business Diversification at TransGrid. I have been in this position since October 2013. TransGrid is a transmission network service provider that owns and operates transmission and related assets in New South Wales.

1.2 As the Executive General Manager/Revenue Strategy and Business Diversification I am the executive responsible for management of the revenue determination activities, new business and customers.

1.3 I have worked at TransGrid since 1995. Prior to becoming the Executive General Manager/Revenue Strategy and Business Diversification in October 2013, I held roles as Executive General Manager/Finance and Information Systems (April 2010 to September 2013) and Chief Financial Officer (November 2008 to March 2010).

1.4 In my former role as the Chief Financial Officer of TransGrid, my responsibilities included leading and managing the treasury, taxation, corporate reporting, and financial planning functions in TransGrid. My role involved the management of TransGrid's finances, budgets and financial exposure and directing the development and monitoring of financial strategies and policies to achieve the required return to the shareholder including the management of TransGrid's debt position and strategy.

1.5 Immediately prior to being appointed as the Chief Financial Officer for TransGrid in November 2008, I was the manager of TransGrid's reset team for the development of the revenue proposal for TransGrid's transmission determination for the 2009 to 2014 regulatory control period.

1.6 A copy of my curriculum vitae is attached as Annexure AKM 1.

1.7 I am authorised to give this statement on behalf of TransGrid.

2. **TRANSGRID'S DEBT PORTFOLIO**

2.1 For as long as I am aware TransGrid has always structured its debt portfolio on a "trailing average approach". This approach spreads TransGrid's debt maturity profile comparatively equally over a ten year time horizon so that the rollovers in any one year will not cause a major change in the average interest cost. This approach is broadly the same as the trailing average approach that the Australian Energy Regulator (AER) has now adopted as the efficient financing practice of a benchmark efficient entity.

2.2 I consider the trailing average approach adopted by TransGrid to be an efficient and prudent approach. This is particularly in circumstances where alternative approaches to managing interest rate risk, such as the use of instruments such as swaps to fix the underlying interest rate, would be difficult and expensive given the size of TransGrid's debt portfolio.

3. DEBT MANAGEMENT REVIEW

3.1 The development of TransGrid's revenue proposal in 2007 and 2008 for the 2009 to 2014 regulatory control period identified significant new capital expenditure necessary to ensure that TransGrid could provide transmission services in a manner consistent with the national electricity objective. The funding requirements of this capital expenditure program resulted in TransGrid reviewing alternative debt management approaches.

3.2 At the same time, global financial markets were suffering from the effects of the "Global Financial Crisis" with debt markets facing uncertainty and liquidity issues.

3.3 When it lodged its 2009 to 2014 revenue proposal in May 2008, TransGrid requested that the calculation period for the nominal risk free rate be substantially earlier than the usual regulatory practice. The request that the AER agree to an averaging period that was significantly ahead of the date that the AER would make its final determination and the commencement of the relevant regulatory control period reflects the consideration of alternatives approaches to the management of TransGrid's debt portfolio in light of economic and regulatory risks to the financial performance of the organisation. This is reflected in the letter to the AER requesting its agreement to the averaging period sought where it stated:

> "in order to fund its capital program over the next twelve months TransGrid will be required to increase its level of debt. The funding decisions TransGrid will need to make during the period have medium to long term impact. TransGrid is concerned about making these decisions in a period of uncertainty of rates without knowing the parameters that will be applied in this area of its Revenue Determination for 2009/14. In order to prudently manage its commercial risks, TransGrid is seeking the earliest confirmation of these parameters so that approximate [sic: appropriate] commercial risk management strategies can be implemented."

3.4 A copy of the letter to the AER is attached as Annexure AKM-2

3.5 The uncertainty that the market conditions were giving rise to is further illustrated by the letter that the AER wrote to Bruce Foy, who was the acting Chairman of TransGrid's Board, on 27 January 2009 in which it asks:

> "...given the current world economic and financial conditions, I am writing to seek your advice whether your Board is aware of any current or pending matter or circumstance that may affect your ability to obtain finance for the delivery of the capex program proposed by TransGrid in the next regulatory control period."

3.6 A copy of the letter from the AER to Bruce Foy is attached as Annexure AKM-3.

3.7 Given the significant amount of new debt that TransGrid would have to issue to support its proposed capital expenditure and the conditions in global financial markets at the time, TransGrid's Board requested a review of TransGrid's debt management policy. The objective of this review was to minimise the cost of gross debt within prudent risk parameters, identify and effectively manage financial risks and ensure that the growing debt portfolio is managed to minimise profit volatility in time of fluctuations in interest rates.

3.8 The review was undertaken in conjunction with the New South Wales Treasury Corporation and Barrington Treasury Services. Ernst & Young also assisted with the review.

3.9 The review evaluated a number of alternative debt management options to specifically address:

- management of interest rate volatility;

- alignment of interest expenses with revenue volatility because of CPI movements; and

- management of the potential impact of interest rate movements on implied levels of profitability during a regulatory control period.

3.10 TransGrid's external debt management advisor, Barrington Treasury Services carried out an evaluation of alternative debt management practices, including a survey of debt management practices within Australian regulated electricity companies. The review considered a range of debt management practices:

- management of interest rate risk using a portfolio of debt lines with staggered maturities to ten years;

- financing in line with the regulatory periods to create a portfolio with the same duration as the regulatory period; and

- management of interest cost exposure in line with regulatory periods. Borrowings are made on a floating basis with hedges put in place to fix the interest costs for the regulatory period.

3.11 The Barrington Treasury Services report considered that the volumes required to execute hedging strategies for TransGrid would almost certainly impact on market pricing. They also highlighted TCorp's concerns about adopting these approaches for all of the NSW regulated utilities. The report highlighted transition costs associated with the current portfolio and recommended adoption of a hybrid approach, using swaps to fix the interest costs in a regulatory period for new debt only.

3.12 The Barrington recommendation to adopt a hybrid approach was not accepted for two reasons. Firstly, the hybrid did not adequately address the existing debt portfolio and secondly risks associated with the execution of the change. Discussions with TCorp regarding the execution of the hedging strategy highlighted transition costs, execution risks and the uncertainty created by the GFC. The discussions with TCorp were primarily regarding TransGrid's approach to debt management. TCorp also had much larger concerns at the time about the approach that they could accommodate should all of the NSW network businesses adopt similar approaches at the time of regulatory determinations.

3.13 The risks considered by TCorp during the review included "black swan" events such as a credit market breakdown that could leave TransGrid unable to refinance debt lines when they became due and changes to the AER as the regulator or dramatic changes to the regulatory framework.

3.14 A copy of the report from Barrington Treasury Services and a report to the TransGrid Board on the alternatives being considered in the debt management review are attached as Annexure AKM-4 and Annexure AKM-5.

3.15 The portfolio modelling conducted during the review indicated that the adoption of new debt instruments and changes to the long term "trailing average" approach was the most cost effective and resulted in the lowest overall cost of debt to TransGrid. This reflected TransGrid's risk position taking into account the uncertainty and volatility that was then faced by financial markets and the significant amounts of debt that TransGrid needed to issue in order to deliver its capital expenditure program in the 2009-14 regulatory control period.

3.16 TransGrid's Board, which included several non-executive directors, adopted a new Debt and Investment Risk Management Policy, which is attached to Boon Thiow's statement as

Annexure BT-2. TransGrid has managed its debt in accordance with this policy as described in Boon Thiow's statement.

3.17 In my opinion, even if TransGrid had determined that it should enter into swap arrangements as a means of managing interest rate risk going into the 2009-14 regulatory control period, I do not believe that it would have been possible to do so (or alternatively, that it would have been possible to do so at a reasonable cost) in light of the market conditions that prevailed at that time.

4. Uncertainty as to the averaging period to be applied in the 2009-14 regulatory control period

4.1 There was significant uncertainty heading into the 2009-14 regulatory control period as to what averaging period would actually apply for the purposes of measuring the risk-free rate and the debt risk premium. TransGrid had proposed an averaging period of 20 business days commencing 30 business days after the lodgment of its revenue proposal. That is, 20 business days commencing 14 July 2008. The AER did not accept the averaging period TransGrid had proposed as it considered it was too far removed from when the final determination would be made and from the commencement of the next regulatory control period. The AER instead proposed an averaging period closer to when the final determination would be made.

4.2 While maintaining that the AER was incorrect to reject TransGrid’s proposed averaging period, TransGrid sought to address the reason the AER did not agree with the period proposed by TransGrid by proposing a 20 business day averaging period finishing on 5 September 2008 in its revised revenue proposal. The AER did not accept the averaging period proposed in the revised proposal in its final determination, and instead used a 20 business day period commencing 2 February 2009 and ending 27 February 2009 as the averaging period.

4.3 TransGrid sought review of the AER’s decision with respect to the averaging period. The Australian Competition Tribunal found that the AER’s decision to withhold agreement to TransGrid’s originally proposed averaging period was incorrect. The Tribunal decided that the averaging period in TransGrid’s revised revenue proposal should be adopted, being a period of 20 business days ending on 5 September 2008. The determination was handed down by the Tribunal on 12 November 2009.

4.4 In light of the significant uncertainty that existed as to the actual averaging period that would apply in respect of the 2009-14 regulatory period, even if it is was: (a) open to TransGrid to enter into swap arrangements to hedge the underlying interest rate risk; and (b) TransGrid had determined that it was prudent and efficient to enter into such hedging arrangements, entering into any such arrangements would have carried significant additional risk and complexity.

Affirmed at 180 Thomas Street, Haymarket,

this thirteenth day of January 2015

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Anthony Keith Meehan

Before me:

Signature of witness:

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Name of witness:

DAVID FAYYAD

Qualification of witness: Australian Legal Practitioner

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ANNEXURE AKM 1

Curriculum Vitae - Anthony Keith Meehan

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Anthony has had an extensive career in the Electricity Transmission and Generation industry working for TransGrid since its establishment in 1995 and prior to this in Pacific Power.

Anthony is currently the Executive General Manager/ Revenue Strategy and Business Diversification. This role is the executive responsible for management of TransGrid's revenue determination activities, new business and customers.

His previous role was the Executive General Manager/Finance and Information Systems a position he held from April 2010 to September 2013. This position was created by a restructure and the position had additional responsibilities from the previous role of Chief Financial Officer.

Anthony held the position of Chief Financial Officer from November 2008 to March 2010. The responsibilities included leading and managing the treasury, taxation, corporate reporting, and financial planning functions in TransGrid. The role involved the management of TransGrid's finances, budgets and financial exposure and directing the development and monitoring of financial strategies and policies to achieve the required return to the shareholder including the management of TransGrid's debt position and strategy.

Immediately prior to being appointed as the Chief Financial Officer in November 2008, Anthony was the manager of TransGrid's reset team for the development of the revenue proposal for TransGrid's transmission determination for the 2009 to 2014 regulatory control period.

Anthony was TransGrid's Chief Information Officer for 5 years and during this time restructured TransGrid ICT outsourcing arrangements and was the sponsor of many ICT projects.

Prior to this role he held the position of Financial Controller for 5 years. Anthony carried out a key role in the disaggregation of Pacific Power and the establishment of TransGrid in 1995.

Anthony was involved in several projects that led to the development of the National Electricity Market in the 1990s.

Anthony holds a Bachelor of Commerce from the University of NSW and is Fellow of CPA Australia.

ANNEXURE AKM 2

Letter from Peter McIntyre to the AER 31 May 2008

TransGrid

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PO Box A1000 Sydney South
New South Wales 1235 Australia
Facsimile (02) 9284 3456
Telephone (02) 9284 3000
Web http://www.transgrid.com.au
DX1122 Sydney

Mr Mike Buckley
General Manager Network Regulation North
Australia Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Dear Mike

TRANSGRID REVENUE PROPOSAL NOMINAL RISK FREE RATE CALCULATION PERIOD

As indicated in the AER submission guidelines, TransGrid is required under clause S6A1.3(6) of schedule 6A.1 of the NER to nominate a commencement and length of the period to be used by the AER to calculate the nominal risk free rate for the regulatory control period according to clause 6A.6.2(c)(2) of the NER.

During the first half of 2008 there has been unprecedented volatility in the risk free rate and the debt risk premium. Due to the volatility, TransGrid in its revenue proposal has used a historical average for the nominal risk free rate and debt risk premium.

As the AER has indicated in its final decision for ElectraNet, the volatility is being driven by the ongoing global credit crisis impacting on the financial markets. Current indications are that the US economy may well go into recession and that there will be continued uncertainly that may result in the movement of rates either up or down over the next twelve months.

TransGrid's capital works program has increased in 2007/08 to about $350m and committed major projects for 2008/09 are of the order of $500m. TransGrid's revenue proposal foreshadows significant ongoing capex expenditure with this to peak in 2011/12 at $750m.

In order to fund its capital program over the next twelve months TransGrid will be required to increase its level of debt. The funding decisions TransGrid will need to make during this period have medium to long term impact. TransGrid is concerned about making those decisions in a period of uncertainty of rates without knowing the parameters that will be applied in this area of its Revenue Determination for 2009/14. In order to prudently manage its commercial risks, TransGrid is seeking the earliest confirmation of these parameters so that approximate commercial risk management strategies can be implemented.

Accordingly, TransGrid requests that the period to be used by the AER to calculate the nominal risk free rate for TransGrid's 2009/14 Revenue Determination commence thirty business days after lodgement of its Revenue Proposal. Also, as required, TransGrid requests that the length of this period be twenty business days.

As provided under the NER, TransGrid requests that the agreed period be kept confidential until the expiry of the agreed period.

Yours sincerely

21/5/08

Peter McIntyre
General Manager/Network Development and Regulatory Affairs

ANNEXURE AKM 3

Letter from the AER to Bruce Foy dated 27 January 2009

AUSTRALIAN ENERGY REGULATOR

GPO Box 520
Melbourne Vic 3001

Telephone: 03 9290 1444
Facsimile: 03 9290 1457

www.aer.gov.au

Our Ref: C2008/801-02
Contact Officer: Kenny Yap
Contact Phone: 02 6243 1224

27 January 2009

Mr Bruce Foy
Acting Chairman
TransGrid
PO Box A 1000
Sydney South
NSW 1235

Bruce

Dear ~~Mr Foy~~,

Re: Deliverability of capital expenditure program – 1 July 2009 to 30 June 2014

Under the National Electricity Law and the National Electricity Rules (NER), the Australian Energy Regulator (AER) is responsible for the economic regulation of electricity transmission services provided by transmission network service providers in the National Electricity Market.

The AER is currently reviewing the transmission regulatory proposal for TransGrid for the next regulatory control period (1 July 2009 to 30 June 2014) and must make its final determination by 30 April 2009. In that regard, the AER published its draft decision in November 2008 which includes a significant capital allowance for capital projects proposed by TransGrid. TransGrid's capital expenditure (capex) proposal is around 81.5 per cent higher than the capex expected to be incurred during the current regulatory period.

Clause 6A.6.7(c) of NER provides that the AER must accept the capex forecast included in a revenue proposal if it is satisfied that the total of the forecast for the regulatory control period reasonably reflects the capex criteria, which are:

(1) the efficient costs of achieving the capital expenditure objectives

(2) the costs that a prudent operator in the circumstances of the relevant TNSP would require to achieve the capital expenditure objectives; and

(3) a realistic expectation of the demand forecast and cost inputs required to achieve the capital expenditure objectives.

The AER's review process has considered the submissions made by interested parties, the independent advice of its consultants and the additional information provided by TransGrid.

As you would be aware, global economic conditions changed dramatically over the course of 2008. At the predetermination conference held on 9 December 2008 in Sydney, a number of stakeholders raised the current economic circumstances and questioned the impact of the changes in economic conditions on TransGrid's capital expenditure proposal. These changes could potentially impact on both the need for capital expenditure, and the ability to access finance to support that expenditure.

Subsequent to the release of the AER's draft decision and the predetermination conference, TransGrid submitted a revised regulatory proposal. There is no indication in TransGrid's revised proposal that current economic conditions are likely to have a significant impact on the need for capital.

As set out in the AER's draft decision at page 85-86, the AER is satisfied that TransGrid is well positioned to physically deliver the adjusted forecast capex program during the next regulatory control period. This assessment is made subject to the proviso that TransGrid can adequately finance its proposed capex program. The AER's draft decision states at footnote 197 on p.86:

> The AER notes that the NSW Government's *Mini Budget 2008-09* provides for an $857 million reduction over three years in the borrowing capacity of the NSW DNSPs and TransGrid. The AER has assessed this financing constraint against the proposed capex programs from 2009-10 to 2011-12 and is satisfied that this need not adversely impact on the deliverability of the program. The reduction in the borrowing program represents a relatively small proportion of the capex program and its impact may be offset by increased internal efficiencies in each of the businesses and or by a change in the timing of dividend payments to the shareholder...

In normal circumstances the AER would not consider access to finance as a factor influencing the deliverability of a proposed capex program. However, given the current world economic and financial conditions, I am writing to seek your advice whether your Board is aware of any current or pending matter or circumstance that may affect your ability to obtain finance for the delivery of the capex program proposed by TransGrid in the next regulatory control period.

To fit within the mandated timings of the revenue determination process I would appreciate your advice by 18 February 2009.

The contact officer for this matter is Kenny Yap.

Yours sincerely

Steve Edwell
Chairman

cc:
Mr Michael Schur
Acting Secretary, NSW Treasury

Mr Mark Duffy
Director-General, NSW Department of Water and Energy