AMP Capital Investors Limited
ABN 59 001 777 591 AFSL 232497

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April 2011 (Update)

Cost of Debt Summary Paper

Dampier Bunbury Pipeline (DBP)

IMPORTANT NOTE

Note 1

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Note 2

For the purposes of this paper it is assume that the definition of a **"Large Regulated Utility" (LRU)** is one which:

- operates in the Australian market;
- currently has a Regulated Asset Base in excess of A$2billion;
- possesses a Standard and Poor's investment grade credit rating of at least BBB- (or similar rating with any other internationally recognised rating agency); and
- has a gearing level of around 60% of the Regulated Asset Base.

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1. BACKGROUND

1.1 Purpose of paper

AMP Capital Investors Debt Advisory Team (**AMPCI**) has been asked by Dampier Bunbury Pipeline (**DBP**) to prepare an update on the April 2010 Cost of Debt Summary Report prepared by AMPCI covering changes in the financial markets since this time.

The paper will then draw an updated conclusion around AMPCI's opinion of the cost of debt funding LRUs could reasonably expect in current market conditions. This conclusion will be based on the approach to cost of debt analysis AMPCI uses for its broad client base and reasonably assumes is an approach commonly used in the market.

In general, the market will assess the individual credit quality of an entity (such as a LRU) by assessing using both top-down and bottom-up analysis. Top-down will assess big picture aspects of the credit such as the stage of the economic and credit cycles as well as overall asset class analysis. The bottom-up approach assesses the business and financial risk of the entity. Many investment managers will determine an internal credit score or rating and then compare and contrast this rating with external rating sources. The end result is that individual credit names are compared against each other on a global relative value basis.

1.2 Update on Market Conditions

Financial markets continue to be volatile and susceptible to shocks. The European sovereign debt crisis which dominated the new throughout 2010 is one such example. Whilst markets remain open and the availability of capital has improved, shorter term credit margins have showed signs of improvement, however longer dated credit margins have remained stubbornly high, with little in the way of improvement since last report.

Good improvement has been seen in the credit margins for cross-currency and interest rate swaps and minor improvements have been experienced in upfront costs. Having said this, all of these costs remain significantly higher than those achieved prior to the Global Financial Crisis (GFC).

[redacted]

[redacted]

2. DIVERSIFICATION

One of the key risk management tools for a debt manager to adopt when managing a portfolio of debt is diversification. AMPCI strongly recommends to its clients debt diversification strategies. AMPCI believe there are several key reasons for adopting such a strategy, particularly in the case of a LRU, which is detailed in Sections 2.1 – 2.4.

2.1 Lessons Learnt

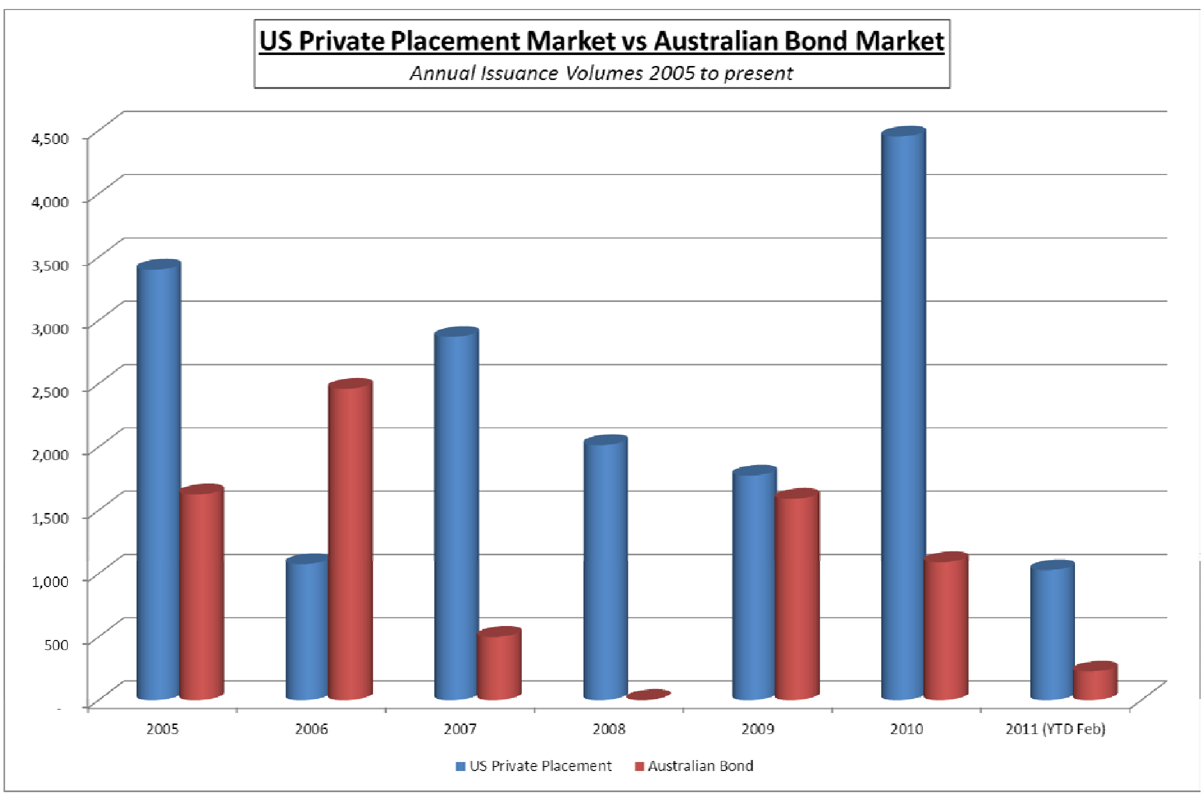
Diversification has been a commonly used tool for business managers and investors for many decades/centuries. The phrase "don't put all your eggs in one basket" has long been the mantra of these business managers and investors. In addition, diversification is the key lesson learnt by debt managers since the GFC and hence this saying has never resonated so loudly.

The GFC proved to companies that they simply cannot rely on a narrow group of counterparties, markets or debt instruments.

Australian Bank Market: During the GFC, participants in the Australian bank market dramatically reduce the pool of available debt by rationing the debt to their client base. [redacted]

Australian Bond Market: Disappointingly, the Australian Bond Market for an issuer like a LRU was effectively closed for business during a significant time throughout the GFC. Pricing was not the issue during this period, the market just simply did not support transactions. At the same time, international markets such as the US Private Placement market continued to operate effectively for similar quality Australian issuers.

The table below shows the comparison of the issuance volumes in Australian Bond market versus the US Private Placement market for Australian-based issuers of comparable credit quality to a LRU for the period 2005 to current.



Source: National Australia Bank

2.2 Price Tension

Price tension is another derived outcome from a diversification strategy. By not exhausting counterparty limits, market capacity or instrument capabilities, the LRU is able to create more of a “scarcity” factor to its debt profile. This puts the LRU in more of a position whereby it can derive more competitive outcomes with respect to price and terms, rather than having to accept the lowest common denominator.

[redacted]

[redacted]

2.3 Tenor

It is AMPCI’s experience that the Australian bank and bond markets have historically (and currently) only provide access to capital in shorter tenors versus many other international markets. The Australian market tends to be focussed on 3 and 5 year transactions, some 7-year transactions, with transactions longer than 7-years tend to be the exception rather than the rule. International markets (even during the GFC) offer the borrower a broad range of maturity choices extending out to 30-years, with the 7 to 15 year timeframe proving to be the most popular. As such, if a LRU wishes to adopt a smoother debt maturity profile and lessen the point-in-time refinance risk, markets offering longer debt maturities need to be considered.

2.4 Australian Market Dynamics

Australian Bank Market: The market continues to be dominated by the four major banks with other banks rarely dominating a transaction. Given this market domination, there is significant transaction risk for LRU’s should they not gain the support from the key market players. This becomes increasingly risky should the LRU need to effectively exhaust the market for volume and thereby not being able to afford to have one of the major banks drop out of the transaction.

Australian Bond Market: Similarly, the Australian Bond Market tends to be dominated by 6-8 key investors which creates similar transactions risk to that identified above.

By international standards, the Australian Bank and Australian Bond markets are small in size, thin in terms of liquidity and dominated by a small number of players.

A prudent and efficient approach to debt management means that at all times a company should minimise refinance risk through full diversification. By having multiple debt options available and never exhausting a single counterparty, market or instrument, historically this has proven to provide:

- improved pricing outcomes;
- improved terms;
- reduced execution risk;
- improved debt maturity profile; and
- financing flexibility.

3. MARKET SUMMARY

[redacted]. As such, the most appropriate key markets for LRUs in the current market environment are still the:

1. Australian bank market
2. Australian bond market;
3. US public market (144a); and
4. US private placement market.

By accessing these markets the LRU accesses investors who not only have investment capacity but also who understand the mechanics and credit metrics of a LRU.

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

4. OVERALL COST OF DEBT

[redacted]

[redacted]

5. AER METHODOLOGY

Using the methodology generated by the Australian Energy Regulator in its Final Decision on the Victorian electricity distribution business in October 2010 and updating the data inputs to be consistent with the current observed period of the 20 business days up to 28 February 2011 (with the exception of Bloomberg's 10-year AAA vs 7-year AAA spreads which is the 20 business days up to 22 June 2010) this delivers a Debt Risk Premium of 4.24% and a total cost of debt of 9.97%. In addition to this, it must be remembered that this methodology gives no regard for upfront fees incurred by the business to establish and issue the bonds it assess.

6. CONCLUSION

AMPCI remains of the view that the most prudent and appropriate debt strategy for a LRU is one which achieves:

- ✓ Pricing efficiency – given volume of debt required to be issued;
- ✓ Market risk minimisation – risk that the target market ceases to function;
- ✓ Execution risk minimisation – ensuring sufficient limits and transaction can proceed in a timely manner; and
- ✓ Refinance risk minimisation – through tenor diversity.

The most efficient way of achieving these aims is to adopt the approach to debt management outlined in this paper.

In consideration of estimating the total cost of debt for a LRU it is also crucial to include relevant up-to-date market benchmarks for not only credit margins, but also for the cost of transacting the debt such as upfront costs.

AMPCI has looked at two methodologies to generate an outcome for the total cost of debt for a LRU. Firstly, the approach AMPCI believe is the more common approach amongst professional, institutional-level financial market investors, estimates the cost of debt for a LRU to be 9.52%. The second approach considered was to utilise the methodology adopted by other regulators in Australia, such as the Australian Energy Regulator (AER). This second methodology generated a total cost of debt outcome of 9.97%.

AMPCI has endeavoured to provide transparent and accurate indications of debt costs throughout this paper and as such, believe that this range is the appropriate range for the total cost of debt for a LRU.