

April 2011

Draft Determination – Issues Paper

Dampier Bunbury Pipeline (DBP)



IMPORTANT NOTE

Note 1

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Note 2

For the purposes of this paper it is assumed 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 (**AMPCI**) has been asked by Dampier Bunbury Pipeline (**DBP**) to comment on the ERA's Draft Decision on Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline.

AMPCI's response has been separated into four key comment areas:

1. Nominal Risk Free Rate
2. Debt Issuing Costs
3. Market Review and Access
4. Benchmark Bond Approach

It is the aim of this segregation into these four distinct sections that the commentary can be more easily disseminated for DBP's response to the ERA.

1.2 AMP Capital Investors (Debt Advisory)

AMP Capital is a leading Asia-Pacific specialist investment manager with over A\$96billion in funds under management.

AMP Capital is one of Australia's longest standing and most successful infrastructure investment managers with an enviable track record over 20 years in the sector. In the Watson Wyatt 2009 Global Alternatives Survey, AMP Capital was rated in the top 10 of global infrastructure investment managers.

Since 2003, the AMP Capital Debt Advisory Team has been dedicated to providing quality debt solutions across both AMP Capital's business as well as specific external mandates. The advice provided by the Debt Advisory Team covers:

- Structuring and execution of debt financing transactions globally;
- Analysing business/fund risks;
- Providing input into the business/fund strategy development;
- Structuring derivative products to optimise hedging of risks; and
- Developing, negotiating and executing hedge protocols and trades.

AMP Capital Debt Advisory Team has built an excellent track record in arranging and executing both bank and capital markets transaction across all major sectors (including the regulated utilities sector) in pre, during and post-GFC environments and transacts with over 50 banks/investors globally.

The impact of the GFC on financial markets (and in particular the debt markets) cannot be under-estimated. The GFC represents a significant paradigm shift in the way debt markets function and all previous market assumptions, rules-of-thumb and methodologies need to be challenged. AMP Capital Debt Advisory has transacted in excess of \$8.9billion of transactions across multiple sectors and jurisdictions since GFC and feels it is uniquely positioned to provide DBP with quality and contemporary debt market advice with respect to current market conditions.

In 2010 alone, AMPCI Debt Advisory advised and executed 18 transactions totalling \$3.745billion of debt market transactions globally across a number of sectors and markets. Chart 1 and Chart 2 on the following page shows the breakdown of these 2010 transactions.

Chart 1

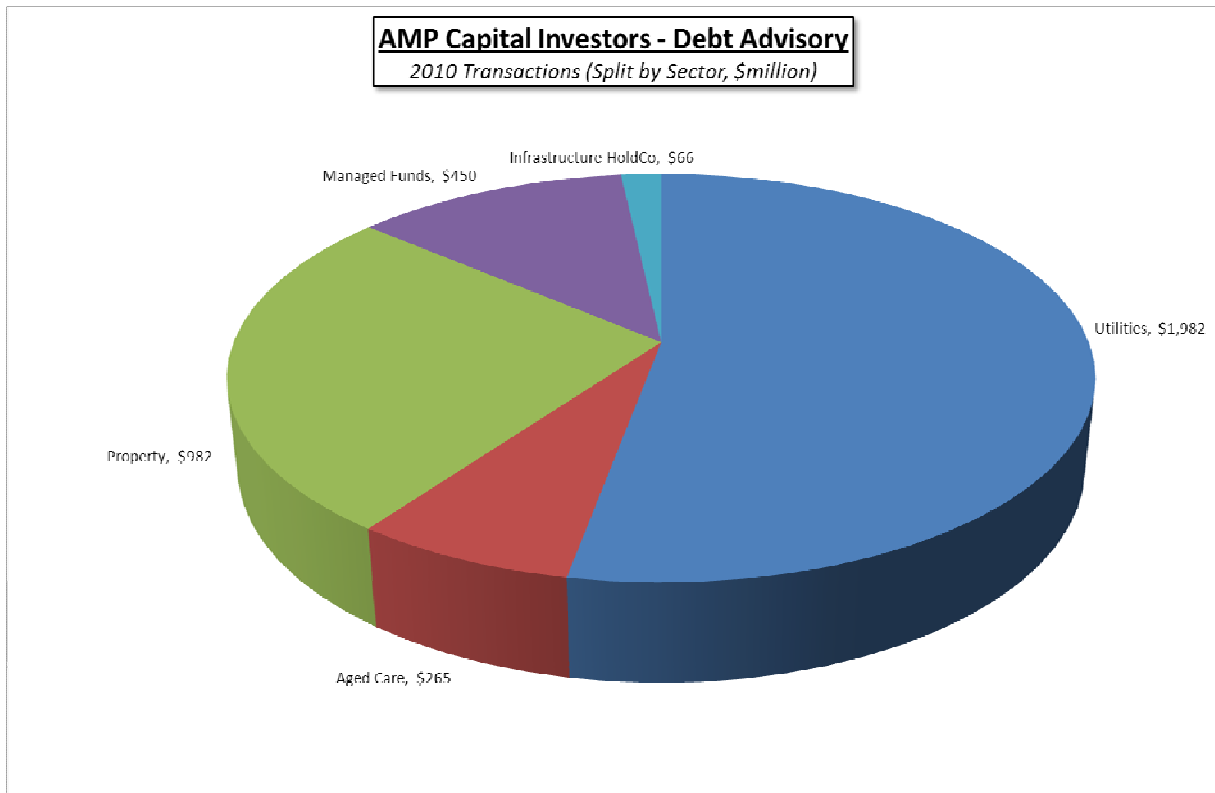
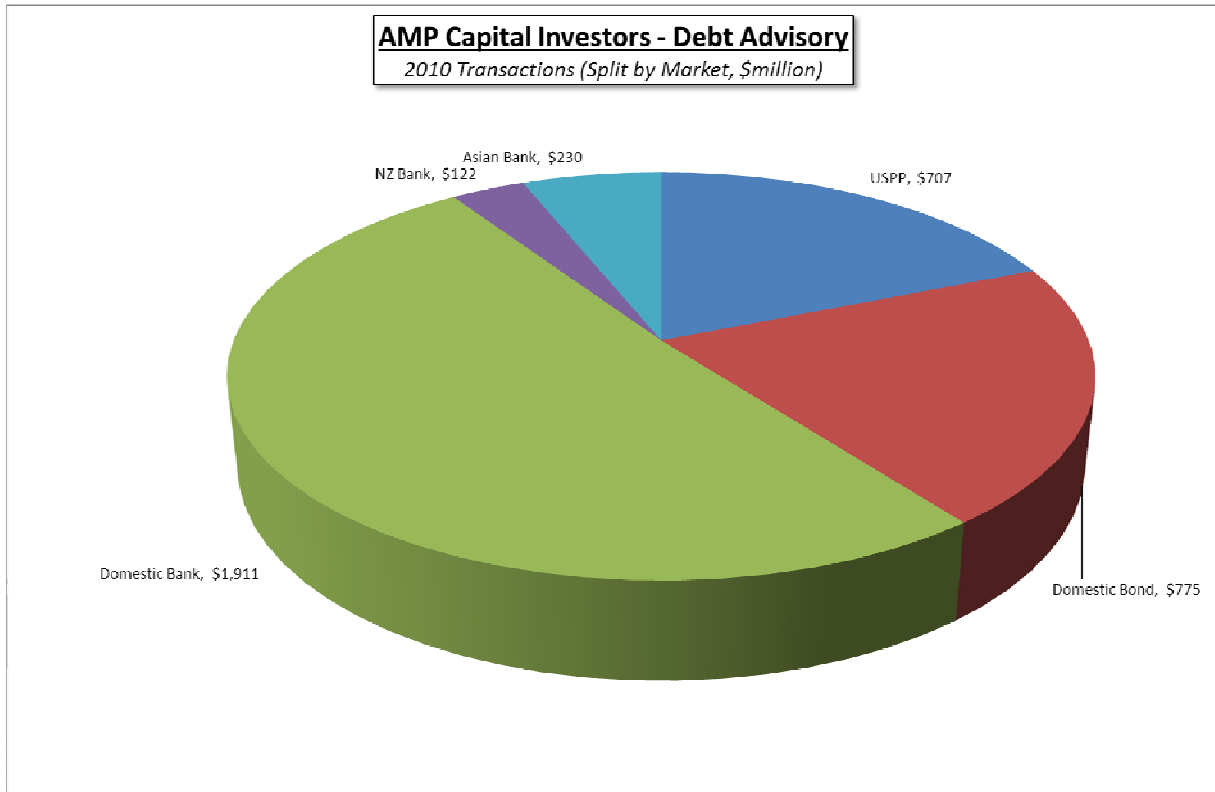


Chart 2



It is with this breadth and depth market experience that AMP Capital Debt Advisory Team has provided their feedback to DBP.

2. NOMINAL RISK FREE RATE

2.1 Nominal Risk Free Rate Clarification

In response to paragraphs 486, 499 and 506, AMPCI wishes to clarify that it did not submit that the swap rate should be considered the risk free rate.

AMPCI submitted its analysis in the April 2010 Cost of Debt Summary Paper to DBP on Australian market standards as determined by the Australian Financial Markets Association (AFMA) which states that domestic bonds issued by corporates are quoted using the “swap rate” plus a trading margin to deliver a total yield. That is, the Australian corporate bond market does not trade corporate bond on a margin to risk free rate like some other international markets.

To further clarify, for a fixed rate bond, this swap rate is not the Bank Bill Swap Reference Rate as referred to in the footnote 274, but rather the interest rate swap fixing which is provided by Bloomberg on a live market basis or on a reference basis by AFMA at 10am and at the end of each business day. The rates provide the base rate for fixed rate settings for a range of tenors eg. a 10-year corporate bond will use the 10-year swap rate as a base and then trade at a margin above this swap rate to result in an overall yield. This is an Australian market convention.

The issue can be summarised in the following form:

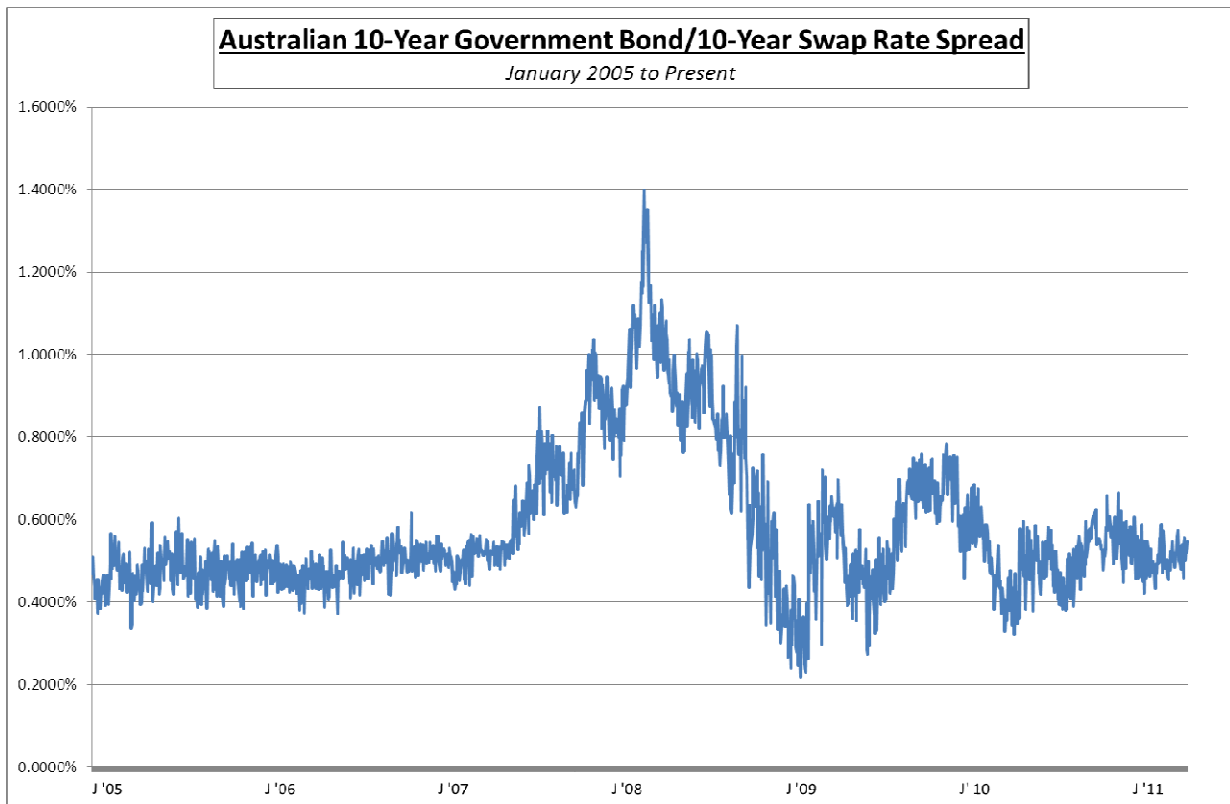
- 10-year swap rate = 10-year nominal risk free rate + bond/swap spread
- 10-year cost of debt = 10-year swap rate + trading margin

AMPCI has endeavoured to clarify this issue by including additional information in Table 1 of the DBP Cost of Debt Paper – ERA Response (April 2011).

In the end, the outcome for the total cost of debt is exactly the same because if AMPCI were to submit the trading margins as a margin to the nominal risk free rate, it would merely add the spread between the nominal risk free rate and the swap to achieve this, that is, the bond/swap spread.

The chart below shows the spread between the nominal risk free rate and the swap rate over time.

Chart 3



2.2 Inconsistency of Terms to Maturity

In paragraph 594, the Authority acknowledges that there is a tenor differentiation between the debt risk premium and the nominal risk free rate. The Authority's solution is to shorten the tenor of the nominal risk free rate to match that of their sample basket of bonds.

In response to paragraph 594 and 595, AMPCI would contest that the more appropriate treatment here would be to obtain a more appropriate sample of benchmark bonds with longer tenors. The appropriateness of the sample basket of bonds will be addressed in Sections 4 and 5 of this paper.

AMPCI believes that adjusting the tenor of the risk free rate will be counterproductive and result in increased refinance risk for a LRU. If the Authority adopts a shorter-tenor, lower-yielding risk free rate, a LRU is disadvantaged if it chooses to manage its debt maturity profile in a more prudent manner by spreading its risk across a range of longer maturities.

The financially efficient outcome for a LRU, as a result of the Authority's decision to reduce the nominal risk free rate to a shorter tenor, would be to also shorten the tenor of their debt being sourced to a maximum of the tenor of the risk free rate chosen by the Authority so as not to disadvantage them. This will have the effect of condensing the LRU's debt maturity profile and hence increasing the refinance risk.

AMPCI believes this may be an unintended and unwelcome result of this change in the tenor of the nominal risk free rate and that a better approach would be to find a more appropriate sample basket of bonds rather than appealing to the lowest common denominator in terms of data sourcing.

2.3 Pricing Efficiency and Market Standard

In response to paragraph 595, the Australian financial markets have an actively traded government bond market both in terms of physical bonds and futures contracts. High volumes of contracts are traded for both the 3-year and 10-year government bond futures, resulting in the physical bond markets around these maturities being more active than other tenors. There are no other futures tenors available in the Australian market. As a result of the active futures market, pricing is extremely efficient in the physical 3 and 10-year bond tenors.

A movement away from a market standard and highly traded benchmark bond, such as the 10-year government bond, in AMPCI's view, represents a less than efficient outcome and opens up the construct of the Authority's Rate of Return calculations to the vagaries of yield curve interpolation rather than utilising a transparent and fully accepted market standard for the nominal risk free rate.

The 10-year government bond is also commonly used by market analysts, economists and business managers as the benchmark risk free rate as this tenor of bond is able to "look through" temporary anomalies in business cycles, interest rate cycles and inflationary cycles and thus produce a more consistent measure of the true risk free rate over time.

3. DEBT ISSUING COST

3.1 Allens Consulting Group Report

In paragraph 513 and 614, the Authority refers to a December 2004 Final Report given to the ACCC by the Allens Consulting Group on Debt and Equity Raising Transaction Costs. Whilst this report may have been correct at the time of issuance, it is now significantly dated, being over 6 years old.

Like changes in the level of the risk free rate and credit margins for corporate debt issuers, debt issuing costs are also in a state of constant change. This was flagged in Section 1.3 of AMPCI's April 2010 Cost of Debt Summary Paper and again in Section 1.2 of the April 2011 update of Cost of Debt Summary paper.

More importantly however, the age of the Allens Consulting Group report means that the most significant change to the dynamics of the global financial markets since the 1930's, that is the Global Financial Crisis (GFC), has not been taking into account and therefore renders this report obsolete for use in the analysis to determine current costs of debt for a LRU. The impact of the GFC cannot be underestimated on the fundamental dynamics of the financial markets. These shifts in dynamics will be felt for some time and given markets are in a constant state of change, it is unlikely that the market will return in the form seen prior to the GFC.

3.2 The "Completion Method"

The Authority in paragraph 615 refers to evidence provided to the AER by Associate Professor Handley from the University of Melbourne in April 2010 with respect to costs involved with the "completion method". AMPCI can confirm that its estimates of debt issuing costs do not include "completion method" costs such as those highlighted in this paper by Associate Professor Handley.

3.3 Observed Debt Issuing Costs

In 2010, AMPCI acted as co-adviser to DBP for their refinancings conducted during the year. DBP had several refinancing options available to it throughout the year and fully assessed each of these options from a total cost of debt perspective. In the end, DBP chose to execute both a domestic bond transaction and a domestic syndicated bank facility transaction. [REDACTED]

[REDACTED]. Also included in the table are the costs for the USPP transaction which DBP would have incurred should they have decided to proceed with this style of transaction as this option was fully assessed as part of the refinancing process.

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

This actual observed reference data for debt issuing costs is therefore at odds with the Authority's contentions in paragraphs 612-616.

4. MARKET REVIEW AND ACCESS

4.1 Liquidity of the Australian Market

A repeated theme throughout the Authority's analysis and supporting evidence from the Authority's own data sources (such as CBA, Bloomberg, ARTC, the ActewAGL Tribunal and Brookfield) acknowledges that the Australian market is extremely thin in terms of volume. AMPCI agrees with this contention and would go further to say that at times the Australian market is not thin but, in fact, simply not accessible as demonstrated in Section 2 of its April 2011 Update of the DBP Cost of Debt Summary Paper.

Given the history of the domestic market and the experience during the GFC, as a debt manager in a LRU it would not be seen as prudent to place total reliance on the Australian market as a source of funds going forward, particularly given this market's track record.

It is also AMPCI's belief that rating agencies would also be carefully assessing the refinancing risk of any LRU who adopted such an approach.

AMPCI has provided additional evidence in Section 2 of its April 2011 Update of the DBP Cost of Debt Summary Paper regarding diversification which addresses paragraphs 510 and 511 and hence these will not be repeated in this paper.

4.2 WACC Parameters for Offshore Transactions

In paragraph 512, the Authority contends that "...were the debt risk premium to be estimated using data from the US capital market, for consistency, all other WACC parameters such as nominal risk free rate, MRP and inflation would need to be derived using US data." This statement is incorrect.

In both the original April 2010 DBP Cost of Debt Summary Paper and also in the April 2011 Update, AMPCI has quoted the US market on an \$A equivalent basis. That is all components of the bond are swapped back into Australian dollars and the full costs of doing this are included in the pricing. What this allows is for a direct like-for-like comparison of US debt costs versus domestic debt costs.

This like-for-like analysis is the basis by which a LRU would decide whether or not to pursue a US transaction and it is this same analysis that lead DBP to pursue a domestic bond transaction in 2010 rather than a US transaction.

4.3 IPART's Market Assessment

AMPCI agrees with the comments made by IPART in paragraph 533 which states that "In considering the data source, IPART is of the view that the Australian and US bond markets appear to be the most appropriate markets to access when making its regulatory decisions."

IPART's acceptance markets other than the domestic market is backed up by real-life examples whereby most issuers of debt of similar size to that of a LRU have currently accessed, or are seeking to access, the US or European markets as a means of sourcing debt. These debt issuers access alternative markets predominantly due to the reasons flagged in Section 2 of the April 2011 update to the Cost of Debt Summary Paper and remains industry best-practise for a prudent debt manager to assess all available markets.

5. BENCHMARK BOND APPROACH

5.1 Ratings Focus

Throughout the analysis of an appropriate peer group for a LRU, the Authority concentrates on public credit ratings as the key determinant of assessing the appropriateness of the peer group. AMPCI believes this is an overly simplistic assessment of credit risk and it does not accurately reflect the analytical dynamics of the market.

Bond investors, especially in a post-GFC environment, do not rely solely on rating agencies for their analysis of risk and determination of yield requirements. Without divulging AMPCI's own intellectual property on credit analysis, it can be reasonably expected that most investors when assessing credit risk of an entity will use a combination of:

- a) bottom-up analysis, including (but not limited to):
 - company profile;
 - business risk;
 - financial analysis; and
 - global peer group assessment.
- b) top-down analysis, including (but not limited to):
 - economic fundamentals;
 - credit cycle; and
 - industry themes.

This type of detailed analysis conducted by investors seeks to determine an individual company's risk rating/assessment.

It is quite common for this risk assessment of investors to differ from the published ratings. Despite having similar public ratings, investors commonly view banks, property companies, diversified corporates and LRUs as having significantly different risk profiles.

The resulting impact of this investor analysis is that bonds of the same credit rating do not necessarily trade at similar levels. The evidence of this can be seen in the market levels for similarly rated bonds. If investors only took into account public ratings into their risk assessment then these bonds would all trade at the same yield. This is clearly not the case and the variance in yields can be seen in Authority's data in Table 38, page 165.

As such, it is crucially important when constructing a peer comparison to ensure that the comparison is completed across a peer group which displays similar risk characteristics rather than simply having the same public credit rating.

5.2 Benchmark Sample of Bonds

With reference to Section 5.1, using the methodology outlined in this section, AMPCI would assess that out of the bonds listed in Authority's report, table 38, page 165 of the , only the following bonds would be considered appropriate for the construction of a peer group for a LRU:

1. APT Pipelines, 7.75% coupon, maturing 22/07/2020;
2. DBNGP Finance, 8.25% coupon, maturing 29/09/2015;
3. Envestra Victoria, 6.25% coupon, maturing 14/10/2015;
4. Sydney Airport Finance, 8.00% coupon, maturing 06/07/2015; and
5. New Terminal Financing, 6.25%, maturing 20/09/2016.

5.3 Statistical Significance

In light of Section 5.2, the comparable sample of bonds in the benchmark as outlined, being only five bonds, would be too small to draw any reliable statistical data points. This data set would be subject to unacceptably high residual variations for any regression analysis performed on the sample, that is, analysis aimed at obtaining a "line of best fit" or "credit curve" for a LRU.

5.4 Criteria for Benchmark Bonds

In paragraph 550, the Authority sought to establish criteria for the benchmark bonds. Comments on each of the criteria are as follows:

- Criterion 1: have the same Standard and Poor's credit rating as the regulated businesses (ie. BBB/BBB+).
As stated in Section 5.1 AMPCI believes this criteria should be based on a risk assessment along the lines flagged rather than simple public credit rating test.
- Criterion 2: be in the same industry (ie. the regulated utility sector).
Once again, as per Section 5.1 it is not necessarily the case that a benchmark bond is required to be in the same sector. So long as the risk profiles are deemed to be similar it would be appropriate to include in the benchmark.
- Criterion 3: have a maturity of 2 years or longer
A maturity cut-off of 5-years is far more appropriate when looking to establish an appropriate benchmark for total cost of debt purposes. As flagged in Section 2.2, an unintended and unwelcomed consequence of driving the benchmark sample of bonds to shorter maturities may be an increase in refinance risk as LRU's are unwilling to finance their debt longer due to the disadvantageous nature of the benchmark pricing.

Additionally, AMPCI firmly believes that all bonds issued by comparable Australian issuers to an LRU in any global market, so long as the yields are provided on a fully swapped back to Australian dollar basis, this will address the issues highlighted being:

1. Small sample size;
2. Illiquidity of the Australian market; and
3. Statistical error due to low sample size.

5.5 Debt Risk Premium Scenarios and Weightings

Based on the assumption that a more appropriate benchmark of bonds can be derived for an LRU, much of the analysis in paragraphs 605 – 618 falls away as the entire basket of bonds derived would be selected as being appropriate for the benchmark.

The question then becomes whether to weight by volume issued and/or weight by term-to-maturity. AMPCI believe that it would be an appropriate methodology to weigh the basket of benchmark bonds by both volume and tenor. This will result in the longer and larger market transactions to be given appropriate recognition by the process as a true test of the market.



6. CONCLUSION

AMPCI believes there are quite a number of issues with the methodology being proposed by the Authority with respect to the Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline. AMPCI has sought to provide an analysis of each of these issues under the four key sections of this paper, namely:

1. Nominal Risk Free Rate
2. Debt Issuing Costs
3. Market Review and Access
4. Benchmark Bond Approach

AMPCI has endeavoured to flag the issues with the Authority's approach using our experience and expertise in global debt markets and in particular, the regulated utilities/infrastructure sector.

In summary, given AMPCI's breadth and depth of experience in the global debt markets, particularly in the post-GFC world, we reiterate and support our position, outcomes and process outlined to obtain the cost of debt calculations in the Cost of Debt Summary Paper (April 2010 and April 2011 Update).