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Envestra Limited

Debt Financing Costs

September 2010

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1. Executive Summary

1.1. Background

Envestra Limited ('Envestra') is required to submit revisions to its access arrangements for its South Australian and Queensland gas distribution networks to the Australian Energy Regulator (AER) by 1 October 2010.

As part of its submissions, Envestra is required to put forward its position in relation to the rate of return to be earned on its gas distribution assets. Rule 87 of the National Gas Rules (NGR) outlines the way in which the rate of return is to be calculated:

> "The rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. In determining a rate of return on capital:
> (a) it will be assumed that the service provider:
> (i) meets benchmark levels of efficiency; and
> (ii) uses a financing structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice; and
> (b) a well accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used."

We understand that Envestra proposes to calculate the rate of return according to the weighted average cost of capital approach (WACC).

The cost of debt is reflected in two areas of the "building block" approach (detailed in Rule 76 of the NGR) that underpins the access arrangement.

The first area is the WACC. The WACC reflects the benchmark debt risk premium (DRP, defined below) plus the risk free rate. Recent regulatory decisions by the AER[1] have set the precedents that:

- the cost of debt is to be calculated for a notional regulated entity (NRE) which has a debt/equity ratio of 60/40
- the DRP is to be estimated as the difference between the yield on a Standard and Poor's (S&P) BBB+ rated Australian corporate bond and the yield on a 10 year Commonwealth Government security
- the term to maturity on the corporate bond should be equal to that on the Commonwealth Government security, and should be 10 years

[1] Such as the AER's June 2010 final decision on the access arrangement for Jemena in NSW.

The second area is debt raising costs, also known as debt transaction costs (DTC). The AER has provided an allowance for these costs through an operating cost allowance. In estimating DTC, the AER has previously adopted a methodology consistent with that developed in a paper by the Allen Consulting Group in 2004 entitled *Debt and Equity Raising Costs* (the ACG Report). As set out in that report, the methodology is based on using corporate bond / medium term note ('MTN') issue costs as the proxy for DTC incurred by the benchmark firm.

In accordance with our engagement, this report outlines our observations and conclusions with respect to DTC.

1.2. Engagement

Deloitte has been requested by Envestra to provide empirical evidence and relevant commentary to support the following components of DTC for a MTN and a syndicated bank debt issue as they may relate to the NRE as referenced by the ACG report.

MTN Issue:

1. Arranger fees
2. Rating Agency fees
3. Paying & Calculation Agent fees
4. Placement fees
5. Registry fees
6. Legal, Accounting and Roadshow costs
7. Underwriting fees (including fees for delayed drawdowns)
8. New Issuance Fees

Syndicated Bank Debt Issue:

1. Upfront/Establishment fees
2. Credit Margin payable over the applicable Commonwealth Government yield for 3 year and 5 year maturities
3. Commitment fees payable on undrawn balances (as a % of the Credit Margin)

1.3. Conclusions

<u>DTC relating to an MTN issue</u>

The median of each component element of DTC for MTNs is presented in table 1 below, subject to the following exceptions:

- Underwriting costs cannot be presented given the lack of underwriting appetite in the MTN market (refer section 4)

- Paying and Calculation Agent fees have been 'bundled' in Registry fees.

Table 1: Median DTC for MTNs – 5 Year Refinance Cycle

Fees	Domestic - Institutional	Domestic – Retail
Arranger (bppa)	9	24
Structuring (bppa)	-	6
Selling (bppa)	-	20
Rating Agency (bppa)	5	-
Legal, Accounting and Roadshow costs (bppa)	0.8	3.3
Registry (bppa)	0.2	0.7
Total (bppa)	15	54

Note that DTC in table 1 have been expressed in basis points per annum ('bppa')) assuming a 5 year refinance cycle and a standard issue size of $175m, which is consistent with the rationale detailed in sections 2 & 3.

To reflect a 5 year refinance cycle, the median for each component cost of DTC has been divided by 5, to arrive at a bppa equivalent cost), if incurred as an non-recurring, upfront transaction cost. With the exception of rating agency and registry fees all component elements of DTC are incurred upfront.

If a 10 year refinancing cycle is assumed, non-recurring, upfront costs are divided by 10, as illustrated in table 2 below.

Table 2: Median DTC for MTNs – 10 Year Refinance Cycle

Fees	Domestic - Institutional	Domestic – Retail
Arranger (bppa)	4.5	12
Structuring (bppa)	-	3
Selling (bppa)	-	10
Rating Agency (bppa)	5	-
Legal, Accounting and Roadshow costs (bppa)	0.4	1.7
Registry (bppa)	0.2	0.7
Total (bppa)	10.1	27.4

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Incremental DTC for MTN issues

We note that the lack of underwriting appetite in the MTN market has required regulated utilities and other Australian corporates to consider the syndicated loan market for 12 – 18 month bridge funding, pending the issue of 'replacement' MTNs (referred to as a "bridge to market" funding route), which has the effect of increasing an issuer's overall costs significantly.

The incremental bppa equivalent cost of a bridge facility is approximately 21 bbpa and would be incurred over each MTN refinancing cycle of 5 years (details of how there estimates were derived is located in Section 4). Total median MTN costs, including bridge funding, would therefore be 36 bppa.

Syndicated Debt Funding

We have considered the syndicated term loan market as an alternative to the MTN market.

The cost of arranging syndicated facilities is summarised in table 3 below.

Table 3 : Median Fees and Margin for Syndicated Debt

	Non underwritten	Underwritten
Upfront	100bp	150bp
Margin (5 year) – paid on the utilised portion of debt package)	230bp	230bp
Commitment (paid on the unutilised portion of debt package)	90bp	90bp
Arranger	25bp	Nil
Agency*	3.4bp	3.4bp
Security*	1.1bp	1.1bp
Legal*	5.7bp	5.7bp

* As a percentage of $175m being the median MTN issue size (Section 3)

2. Methodology

The DTC is the estimated basis points per annum costs associated with a BBB+ rated MTN issued by a domestic issuer for a 5 year tenor, whereas DRP (the first component of the cost of raising debt) is measured on the basis of a 10 year tenor.

We selected a 5 year tenor to benchmark DTC for the following reasons:

- Post-GFC there has been a lack of substantive market evidence of 10 year MTN issues rated between BBB- and BBB+.

- Notwithstanding the lack of market evidence, we believe that up-front and ongoing DTC relating to 10 year issues, excluding underwriting costs[2], do not significantly differ from those of 5 year issues. This is because, unlike underwriting costs, the other components of DTC are time and materials basis.
- We note that arrangers are not willing in the current market to underwrite issues with credit ratings in the BBB+ to BBB- range. This is corroborated by the fact that, none of the MTN issues rated between BBB- to BBB+ from 2008 to date were underwritten. Accordingly, our estimates for DTC exclude underwriting costs. Underwriting support is discussed further in section 4.

Our approach is also consistent with the ACG report[3] which assumes a 5 year, rather than a 10 year, refinancing cycle to estimate DTC.

Table 3 : Domestic MTN Issues rated between BBB- to BBB+, by S&P, over the period 2008 to July 2010

Date	Issuer	Amount	Term	Issue Rating
29/06/2010	Sydney Airport	175	5	BBB
15/04/2010	Dexus Property Group	180	7	BBB+
19/03/2010	Mirvac	150	5	BBB
22/10/2009	Downer EDI	150	4	BBB
4/09/2009	Wesfarmers	500	5	BBB+
6/08/2009	Leighton	50	5	BBB
4/08/2009	Holcim Australia	500	3	BBB
20/07/2009	Leighton	230	5	BBB
20/07/2009	Dexus Property Group	160	5	BBB+
12/06/2009	Tabcorp	150	5	BBB+
30/04/2009	Tabcorp*	284	5	BBB+
2008	Nil transactions	N/A	N/A	N/A

* Retail Issue

Source: Reuters

The AER has found the DTC method, outlined in the ACG Report, to be an acceptable proxy for a NRE's DTC. As the AER has noted, "Consistent with previous decisions, the AER considers that an approach based on the Allen Consulting Group's (ACG) methodology produces the best estimate of debt raising costs." [4]

The ACG method for ascertaining DTC is based on U.S. market data that relates to Australian corporate entities. As ACG noted, "These data are only available for Australian companies accessing the Euro–dollar and US private placement markets or for Australian MTN issues jointly sold in Australia and these international markets. Given the extent of international competition in bond markets and the fact that

[2] Debt capital market underwriting services include either a guarantee of the sale of an issue (of securities) of a given volume at a fixed price or a guarantee of the sale of an issue (of securities) of a given volume at market price.

[3] The ACG report, p.xix

[4] AER, Final decision, Jemena Gas Networks, February 2010, p213

these markets should equilibrate over time, ACG believes that this benchmark is a reasonable proxy for Australian bond underwriting fees."[5]

However, we also note that the AER has recently determined that DTC and DRP are to be determined using data pertaining to the Australian market[6] . Accordingly we have sourced current DTC estimates directly from three major (by cleared volume) Australian debt arrangers and underwriters of capital market debt issues.

The use of U.S. market data, as ACG has done, is not consistent with the AER's current position.

The method used in this report to estimate DTC was as follows:

1. We interviewed three major (by cleared volume) Australian debt arrangers and underwriters of capital market debt and syndicated bank debt issues

2. We identified the services and the fees related to those services as presented by each arranger/underwriter for an instrument with a 5 year term and issuer with a BBB+ rating

3. We calculated the median of each fee.

4. We calculated the equivalent median basis points per annum for a 5 year issue for each fee

5. We also calculated the incremental cost for refinancing MTN's taking into account bridge funding costs. These costs are outlined further in section 4.

3. Results

As noted above, we have collected and analysed fee data relating to the issue of 5 year MTNs rated BBB+ by S&P.
The types of fees and services provided that we have considered are set out below:

Table 4 : Schedule of Services

Fees	Service Description
Arranger Fees	• Co-ordination - central point of contact to management and syndicate of selling agents. Conducts book - build and elicits a clearance price for the issue
Structuring Fees also know as New Issue Fees	• Advises client on optimal structure and features of security to be issued

[5] ACG Report, p52
[6] "As outlined in the draft decision, while the NGR do not expressly state what the market for funds is, the AER considers that the relevant market for funds for a benchmark service provider needs to be relevant to the reference services. The draft decision outlines that the relevant market for funds is the Australian market and that this position is based on consideration of the relevant market for funds identified in the WACC review." AER, Final decision, Jemena Gas Networks, June 2010, p112-113

Rating Agency Fees	• Assigning and maintaining coverage of issuer and Issue credit ratings
Selling Fees also known and Placement Fees	• Sale of issue to selling agent's client base. Normally paid to financial planners and others in the retail distribution channel
Legal Fees	• Preparation and vetting of Legal documents
Registry Fees	• Maintenance of the bond register
Agency Fees (includes Paying and Calculation Fees)	• Calculation and payment of coupon and principal to the security holder on behalf of the issuer

We have estimated fees in respect of raising debt from the Domestic-Institutional market as well as the Domestic–Retail market.

The Domestic – Institutional market requires the issuer to have an investment grade (S&P) credit rating. Transactions of the median[7] size of $175m are normally executed by one or two banks and fees and charges related to the Domestic-Institutional market assume the involvement of only two banks. For larger transactions, requiring more than two banks, it is likely that the arranger and structuring fees will be higher than those identified in this report.

The Domestic – Retail market comprises of the portfolios of individual investors that are managed by independent financial planners or financial planning/advisory arms of banks, insurers and wealth managers. The retail distribution channel is fragmented when compared with the institutional channel. The fragmentation results in multiple layers of fees.

The maximum, minimum and median fees for each of the domestic debt capital market segments available to the NRE are tabulated below in tables 3, 4 and 5 respectively.

Table 5 : Maximum Fees

	Domestic - Institutional	Domestic – Retail
Arranger (bp)	50	120
Structuring (bp)	-	30
Selling (bp)	-	175
Rating Agency (bppa)	5	-
Legal ($)	55,000	300,000
Registry ($ pa)	15,000	60,000

[7] ACG Report, p.xviii.

Table 6 : Minimum Fees

	Domestic - Institutional	Domestic – Retail
Arranger (bp)	40	100
Structuring (bp)	-	30
Selling (bp)	-	100
Rating Agency ((bppa)	5	-
Legal ($)	40,000	300,000
Registry ($ pa)	10,000	60,000

Table 7 : Median Fees

	Domestic - Institutional	Domestic – Retail
Arranger (bp)	45	120
Structuring (bp)	-	30
Selling (bp)	-	100
Rating Agency (bppa)	5	-
Legal ($)	55,000	300,000
Registry ($ pa)	15,000	60,000

4. Syndicated Debt

As noted above, the lack of underwriting appetite in the current MTN market stems from arrangers being unwilling to accept market risk, particularly for issuers in the BBB ratings band.

The lack of underwriting appetite in the MTN market has required regulated utilities and other Australian corporates to consider the syndicated loan market for 12 – 18 month bridge funding, pending the issue of 'replacement' MTNs (referred to as a "bridge to market" funding route), which has the effect of increasing an issuer's overall costs significantly.

Bridge funding is necessary to address rating agency requirements. Under the current S&P rating regime borrowers must secure debt funding at least 3 to 6 months prior to the maturity of term debt to mitigate refinancing risk and preserve their investment grade credit rating.

That is, S&P's rating methodology requires issuers to demonstrate a refinance strategy for current debt maturities if they want to avoid a downgrade of their short-term credit rating, "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 completed, committed, or underwritten."[8]

Accordingly, bridge funding, as a committed line, provides assurance that funding is available to re-finance near-term Corporate Bond/MTN maturities.

Observed market practice is that a bridge to market funding route would attract discounted upfront fees equivalent to between 40% and 60% of term syndicated facilities. The borrower would also pay an undrawn commitment fee equivalent to between 40% and 60% of the funding margin over the base rate. The base rate is, typically, BBSY (bid).

Assuming a bridge facility is instituted 6 months prior to an MTN expiry, we have calculated the cost of a bridge facility (for a 6 month period) to be 115 bp comprised as follows:

- Arranger fees – 60 bp
- Commitment fees[9] – 35 bp (given facility is in place for only 6 months)
- Agency, security and legal – 10 bp

Accordingly, the incremental bppa cost of early refinance is approximately 21 bbpa (obtained by dividing 105 bp by 5) and would be incurred over each MTN refinancing cycle of 5 years. Total median MTN costs, including bridge funding, would therefore be 36 bppa.

Australian corporates with current MTN maturities may consider syndicated bank debt as a refinancing route. Unlike the MTN market arrangers may consider underwriting (at market price, i.e., only volume is guaranteed) in the syndicated loan market.

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

[9] Commitment fee is calculated on the following basis; average margin for 364 day bridge facilities executed for issuers comparable to the NRE is estimated to be 175bp based on feedback from bankers. Commitment fee is 40% of the margin (as a minimum). The facility is used for only 6 months so only half the commitment fee will be incurred over the life of the bridge.

The individual components of financing costs for a syndicated bank debt issue with a term of 5 years and with an issuer credit rating of BBB+ (S&P or proxy) are as follows:

1. Upfront/Establishment fees
2. Credit Margin payable over the BBSY (bid) or the applicable swap rate 3 year and 5 year maturities
3. Commitment fees payable on undrawn balances

Syndicated bank debt financing costs have been presented below.

Table 8 : Schedule of Services for Syndicated Debt

Fees	Service Description
Upfront/Establishment Fees – *Non-underwritten*	• Due diligence and financial modelling. • Central point of contact to management and lending syndicate
Upfront Fees/Establishment - *Underwritten*	• Guarantee of issue proceeds (but not price) to issuer. This is known as a 'best efforts' underwrite
Commitment fees	• Commitment fees are calculated on the unused portion of the credit limit that participating banks have committed to provide
Legal Fees	• Preparation and vetting of Legal documents
Agency Fees	• Calculation and payment of coupon and principal to the security holder on behalf of the issuer
Security	• Security trustee function

Table 9 : Median Fees and Margin for Syndicated Debt

	Non underwritten	Underwritten
Upfront	100bp	150bp
Margin	230bp	230bp
Commitment Fees	40% of Margin	40% of Margin
Arranger	25bp	Nil
Agency	$60k	$60k
Security	$20k	$20k
Legal	$100k	$100k