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Shelly Stormonth
Finance Manager
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2 July 2020

Dear Shelly,

CORPORATE ADVISORY SERVICES

In accordance with our engagement letter dated 22 May 2020, this letter ('this Letter') sets out our review of the Competitive Neutrality Fee ('CNF') rate paid by Gladstone Airport Corporation ('GAC' or 'the Company'). This Letter must be read having regard to the terms set out in our engagement letter and the information included at Appendix A.

1.0 Background

Gladstone Regional Council ('GRC') established GAC on 1 July 2012. GAC is responsible for the ownership and operation of the Gladstone Airport and its related facilities and services.

At the time of its incorporation, we understand GAC entered into a $61.72 million 18-year loan ('the Initial Loan') with Queensland Treasury Corporation ('QTC') for a fixed rate of 6.06% plus an administration fee of 0.115%. At the same time, GAC agreed to pay GRC a CNF of 1.5% to remove any competitive advantage it may receive over a private sector equivalent in terms of creditworthiness.

In April 2014, QTC conducted a review of GAC's ability to service its debt. Following this review, QTC recommended that GAC restructure its debt, which involved converting $28 million of debt into equity and introducing interest only repayments on the outstanding debt balance. In July 2014, GAC and GRC signed a Debt Restructuring Deed, reducing the debt balance to $33 million. We understand the debt restructuring process did not result in any changes to the interest rate and the CNF rate.

Since the date of GAC's incorporation, borrowing rates have decreased materially. As such, GAC currently believes it is currently trading at a disadvantage, as there is no opportunity for the Company to restructure or refinance the loan at current reduced rates of borrowing.

2. Scope

BDO Services Pty Ltd ('BDO', 'we', 'us', 'our') has been engaged to review and comment on the methodology GAC has used to benchmark and estimate the revised CNF rate. We understand that GAC management intends to use the conclusions in this Letter to assist with negotiating a reduction in the CNF rate paid to GRC.

Our approach to undertaking the review of the GAC's CNF methodology consists of:

- Undertaking a high-level review of the applicable CNF frameworks; and
- Calculating the CNF based on the applicable methodology.

2.0 Review of Competitive Neutrality Frameworks

2.1 Competitive Neutrality Principles

As at June 2020, Local Government Owned Corporation ('LGOC') in Queensland implement Competitive Neutrality Principles through a number of instruments. These include:

- The Government Owned Corporations Act 1993 (Qld) (GOC Act);
- Local Government Act 2009;
- Local Government Regulation 2012;
- The Queensland Competition Authority Act 1995 (Qld) (QCA Act);

- Queensland Productivity Commission Act 2015 (Qld);
- The Queensland Productivity Commission Regulation 2015 (Qld); and
- Queensland Government Code of Practice for Government Owned Corporations' Financial Arrangements, March 2019 ('the Code of Practice').

2.2 Competitive Neutrality Fee

A CNF is required to remove any competitive advantage that a LGOC may enjoy over a private sector equivalent in terms of creditworthiness. The fee that is charged is an estimate of what the business would pay for its debt funding (over and above the Queensland State Government's borrowing rate) on a stand-alone basis. The competitive neutrality fee is effectively an interest rate premium that applies to all GOC borrowings.

2.3 Estimating CNF for Queensland LGOC and GOC

GAC is legislated under the Local Government Act [2009], which provide some guidance on application of CNF principles. However, in reviewing applicable CNF legislative instruments, we note only the Code of Practice provides a CNF estimation methodology. The latest Code of Practice was released in March 2019 and is applicable to all GOCs declared under the GOC Act (except QIC Limited) and their subsidiaries.

We note that GAC is not established under the GOC Act. However, as per GAC's 'Statement of Corporate Intent 2019', we note the Board has undertaken to comply with the Code of Practice.

The CNF calculation methodology in the Code of Practice methodology, as currently applied, is summarised as follows:

- The CNF calculation methodology varies based on whether the GOC is classified as a regulated business or a non-regulated business, and according to whether the debt was obtained at a fixed interest rate to fund a specific project:
    - Non-regulated GOCs calculate the CNF rate quarterly to ensure that it moves over time with current market conditions. The CNF rate for each GOC is reset annually;
    - Regulated GOCs may elect to fix their CNF rate at the commencement only of a regulatory period for the term of the regulatory period. The CNF margin which applies is the relevant margin from the survey which is closest to the regulatory rate setting period;
    - GOCs with structured debt to achieve a fixed interest rate for a specific project ('Project Specific Financing') have the option to obtain a fixed CNF at the commencement of the project. The CNF rate is fixed at current market rates for the duration of the debt, with the maximum term of the debt being ten years;
- A credit margin is calculated as the spread between the QTC State government guaranteed yield curve and the corporate yield for the GOC's assessed benchmark credit rating (e.g. BBB or A-);
- To estimate the CNF rate, a scaling factor of 0.75 is applied to the calculated spread to ensure the CNF rate is based on the minimum credit margin for each tenor; and
- Non-regulated GOCs use a standard 3-year tenor to calculate the credit margins. The tenor for regulated GOCs and Project Specific Financing reflects the term of the regulatory period and the project period respectively.

As this Letter contains only a high-level summary of the Code of Practice, we recommend that any user of this Letter read and understand the information and the methodology contained in the Code of Practice in full. We also recommend that users of this Letter consider obtaining further legal advice on whether the Code of Practice is applicable to GAC.

3.0 Methodology, Inputs and Assumptions

For this analysis, we followed the methodology and the data sources stated in Appendix 2 of the Code of Practice. Regarding our methodology in this Letter, we specifically note:

- We have assumed an 'S&P BBB' rating for GAC based on the instruction of GAC management;
- We used Bloomberg Fair Value Curve ('FVC') and RBA to source 'BBB' corporate yield data.[1] Corporate yields were calculated as the simple average of the RBA[2] and Bloomberg estimates;
- For QTC Bond yields, we used the QTC FVC reported by Bloomberg; and
- Unless otherwise stated, we have used a 3-year tenor to estimate the credit margins.

[1] The corporate yield estimates may vary across data sources due to differences in data sourced by Bloomberg and the RBA.
[2] RBA statistical table 'Aggregate Measures of Australian Corporate Bond Spreads and Yields – F3' as of 4 June 2020.

4.0 Results

Based on the methodologies and inputs set out in Section 3, we have calculated the CNF rate at various points in time in Table 1. The below CNF calculation is applicable for debt funding obtained by non-regulated GOCs from 30 June 2018 onwards.

Table 1: CNFs for a BBB-Rated Non-Regulated GOC Business

Estimation Date	'BBB' RBA Yield (%)	'BBB' Bloomberg Yield (%)	Average 'BBB' Yield (%)	QTC Yield (%)	Credit Spread (%) [QTC - Average 'BBB']	CNF (%) [Credit Spread * 0.75]
30/06/2018	3.30	3.25	3.28	2.29	0.99	0.74
30/09/2018	3.34	3.25	3.30	2.33	0.97	0.73
31/12/2018	3.40	3.13	3.26	2.13	1.13	0.85
31/03/2019	2.85	2.54	2.70	1.70	1.00	0.75
30/06/2019	2.21	1.98	2.09	1.19	0.90	0.68
30/09/2019	1.93	1.70	1.82	0.99	0.83	0.62
31/12/2019	1.99	1.90	1.94	1.17	0.77	0.58
31/03/2020	2.35	1.73	2.04	0.75	1.29	0.97
04/06/2020	N/A	1.74	1.74	0.72	1.01	0.76

Source: BDO Analysis, Bloomberg, RBA

Regarding Table 1, we note the following:

- The CNF rate for the estimation period ranges from 0.58% to 0.97%. As at 4 June 2020, the estimated CNF rate is 0.76%; and
- The estimated CNF values are significantly lower than the current 1.5% CNF paid by the GAC.

The Initial Loan was a principle and interest loan with an 18-year repayment period. Considering the debt payment profile, we estimate this debt facility would have a cash flow duration of approximately 10 Years.[3] Assuming the Initial Loan is categorised as Project Specific Financing, we have determined the CNF rate referring to a 10-year debt term. For comparison, we have also estimated the CNF rate during a 3-year debt term.

For completeness, we note GAC has not provided us with copies of any work papers or documents used to determine the current applicable CNF rate. For illustrative purposes, we have estimated the CNF rate as of 1 July 2012 based on the current CNF methodology in the Code of Practice.

We have outlined the results of our analysis in Table 2.

Table 2: CNF for BBB-Rated Project Specific Financing as at 1 July 2012

Estimation Date	'BBB' RBA Yield (%)	'BBB' Bloomberg Yield (%)	Average 'BBB' Yield (%)	QTC Yield (%)	Spread to RBA	Spread to Bloomberg	Spread to Average
3 Year Tenor							
01/07/2012	5.83	4.59	5.21	3.19	2.64	1.40	2.02
10 Year Tenor							
01/07/2012	6.96	6.22	6.59	4.11	2.85	2.10	2.47

Source: BDO Analysis, Bloomberg, RBA

Regarding Table 2, we note the following:

- Based on Bloomberg and RBA data, the CNF rate for a 10 Year 'BBB' GOC debt as of 1 July 2012 ranges from 2.10% to 2.85%;
- We note the current 1.5% CNF rate is closest to the CNF rate estimated using the 3-year Bloomberg data (i.e. 1.40%);
- This calculation methodology may be materially different from the CNF calculation adopted at the inception of the Initial Loan. Prior to 1 July 2018, CNF margins were calculated using a matrix of margins for set periods from at least three banks at the end of each quarter;
- We have not included a minimum credit margin for the above calculations, as the minimum credit margin is only applicable from 30 June 2018; and

[3] Duration of the debt cash flows can be approximated using the Macaulay duration formula.

- Straight-line interpolation has been used to estimate the 10 Year 'BBB' corporate yield as of 1 July 2012.

5.0 Conclusion

In our professional opinion, the ability to revise the CNF depends on the interpretation of the terms of the Initial Loan.

If the GAC debt represents a loan to a non-regulated GOC, GAC may attempt to reset the CNF annually as per the Code of Practice. Assuming this is the case, our analysis suggests that it is appropriate to adopt a CNF rate lower than 1.5%.

If the debt facility represents Project Specific Financing, the CNF may need to remain fixed for the life of the loan.

If you have any questions or require further information, please contact me on +61 7 3237 5661.

BBO Services Pty Ltd

Chris Catanzaro
Director

Appendix A: Important Information

Limitation of Scope

Our review is limited in scope for reasons that include the following:

- We have not completed a detailed industry analysis;
- We have been instructed in relation to the appropriate credit rating to adopt for GAC (i.e. BBB) and have not determined our own credit rating; and
- We have not conducted any site visits.

Sources of Information

This Letter is based on information from sources including the following:

- Capital IQ;
- Bloomberg;
- RBA;
- The Code of Practice; and
- Other publically available information deemed necessary to perform our analysis.

Indemnities, Representations & Warranties

GAC has agreed to our usual terms of engagement and the following indemnities and representations.

Indemnities

In connection with our engagement to prepare this Letter, GAC has agreed to indemnify and hold harmless BDO, BDO Group Holdings Limited and/or any of the subsidiary companies, directors, agents or associates (together 'BDO Persons'), to the full extent lawful, from and against all losses, claims, damages, liabilities and expenses incurred by them. GAC will not be responsible, however, to the extent to which such losses, claims, damages, liabilities or expenses result from the negligent acts or omissions or wilful misconduct of any BDO Persons.

GAC has agreed to indemnify BDO Persons in respect of all costs, expenses, fees of separate legal counsel or any other experts in connection with investigating, preparing or defending any action or claim made against BDO Persons, including claims relating to or in connection with information provided to or which should have been provided to BDO by GAC (including but not limited to the directors and advisers of GAC) as part of this engagement. GAC will not be responsible, however, to the extent to which such losses, claims, damages, liabilities or expenses result from the negligent acts or omissions or wilful misconduct of any BDO Persons.

Representations & Warranties

GAC recognises and confirms that, in preparing this Letter, except to the extent to which it is unreasonable to do so, BDO Persons have used and relied on publicly available information and on data, material and other information furnished to BDO Persons by GAC, its management, and other parties, and may have assumed and relied upon the accuracy and completeness of these, and has not assumed any responsibility for independent verification of, such publicly available information and the other information so furnished.

Experience, Disclaimers & Qualifications

BDO has extensive experience in the provision of corporate finance advice, including takeovers, valuations and acquisitions. BDO and its related entities have a wide range of experience in transactions involving the advising, auditing or expert reporting on companies that have operations domestically and in foreign jurisdictions. BDO in Australia is a national association of separate partnerships and entities and is a member of the international BDO network of individual firms.

Chris Catanzaro has prepared this Letter with the assistance of staff members. Mr Catanzaro is a director of BDO and has extensive experience in corporate advice and the provision of valuation and company services to a diverse range of clients, including large private, public and listed companies, financial institutions and professional organisations.

This Letter is not a valuation engagement as defined by APES 225 'Valuation Services' issued by the Accounting Professional and Ethical Standards Board Limited and has not been prepared in accordance with APES 225.

We understand that GAC management intends to use the conclusions in this Letter to assist with negotiating a reduction in the CNF rate paid to GRC. BDO hereby consents to this Letter being used for that purpose. Apart from such use, neither the whole nor any part of this Letter, nor any reference thereto may be included in or with, or attached to any document, circular, resolution, statement, or letter without the prior written consent of BDO.

BDO takes no responsibility for the contents of other documents supplied in conjunction with this Letter. BDO has not audited or reviewed the information and explanations supplied to us, nor has it conducted anything in the nature of an audit or a review of any of the entities or assets mentioned in this Letter. However, we have no reason to believe that any information or explanations supplied to us are false or that material information has been withheld.

Any forecast information which has been referred to in this Letter has been prepared by the relevant entity and is generally based upon best estimate assumptions about events and management actions, which may or may not occur. Accordingly, BDO cannot provide any assurance that any forecast is representative of results or outcomes that will actually be achieved.

The statements and opinions included in this Letter are given in good faith and in the belief that they are not false, misleading or incomplete. This Letter is current as at the date of this Letter.