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Orbost woes and refinancing wipe out APA profit for FY21

Company/ASX Code	APA Group/APA
AGM date	Thursday 21 October 2021
Time and location	10.00am. Virtual (https://agmlive.link/APA20)
Registry	Link Market Services
Webcast	Yes
Poll or show of hands	Poll on all items
Monitor	Lewis Gomes assisted by Sue Howes
Pre AGM Meeting	Yes with Chairman Michael Fraser and Rem Chair Peter Wasow

The individuals (or their associates) involved in the preparation of this voting intention have shareholdings in this company.

	Consideration of accounts and reports
ASA Vote	No vote required

Financial performance

APA recorded revenue of $2,144 million in FY21, up 0.7% on FY20 while underlying EBITDA was down 1.3% due to increased investment in strategic development opportunities, increased insurance and compliance costs and softer contract renewals due to challenging market conditions exacerbated by Covid-related issues. However, NPAT was down by an extraordinary 99% to a mere $3.7 million due to pre-tax impairment charges of $249 million on the Orbost gas processing plant in Victoria and another $148 million in costs associated with refinancing $2.2 billion of bond note redemptions which were falling due in FY22 and FY23. Excluding these items, underlying NPAT was $282 million, down 10% on FY21. Free cash flow after stay-in-business (SIB) capex of $135 million was down 6% to $902 million.

Notwithstanding these less than satisfactory outcomes, APA increased its full year distribution by 2% to a record 51 cents per security with an expectation of a further increase to 53 cents for FY22 due to “our confidence in our future outlook”. As a result of the impairments, the FY21 distribution was funded to over 90% by capital returns compared with around 50% in past years.

In ASA’s meeting with APA, we questioned the company on the practice of holding substantial debt whilst distributing capital to security holders. The company’s view is that this is a dominant feature of infrastructure investment structures and that debt is appropriate to support growth and asset acquisition. The trust structure employed by APA is seen as being a tax effective means of managing significant debt and to do otherwise would be seen to have a lazy balance sheet and to possibly encourage private equity players to develop an interest in APA.

The refinancing will result in an annualised reduction in interest costs to 4.8% from 5.2% in FY22 and an increase in the average term to maturity from 6.4 years to 7.8 years. These interest cost savings will assist in funding the expected increase in distributions.

Key Issue – Orbost Gas Processing Plant

Operation and commissioning of APA's new gas processing plant at Orbost continues to be a problem with a number of technical issues requiring modifications to the plant. The facility treats gas from Cooper Energy's Sole Gas Field in the Bass Strait for supply to customers of Cooper Energy via the Eastern Gas Pipeline operated by APA. Reliable plant capacity has been constrained to a figure of around 45 TJ/day, well below the contracted capacity of 68 TJ/day. The two parties entered into a Transition Agreement in 2020 to work together to resolve the problems, but the likelihood of reaching the original nameplate capacity now seems remote.

During FY20, APA assessed the carrying value of the plant at about $444 million and determined that no writedown was required at that point in time. However, the value of the plant was reassessed and as at 31 December 2020, APA determined that, based on a value-in-use calculation, the recoverable amount was $233 million on a pre-tax basis leading to a pre-tax impairment of $249 million. APA has stated that no further impairment triggers were identified in the second half of FY21, but in our recent discussions with APA, we were advised that further writedowns cannot be ruled out. Given the shortfall in achieved capacity of the plant and the need for an extension to the Transition Agreement, further contractual disputes and claims may arise.

Key Issue - Refinancing

During the year APA has undertaken a significant refinancing and debt reorganisation. Please see Appendix 1 for details. Previously APA had a significant portion of debt funded by medium term notes denominated in USD, Euros and Sterling. A significant portion of this debt was due for redemption in FY22 and FY23. In FY21 the company took the decision to reorganise its finances to extend maturity dates and secure lower interest rates as well as reducing the number of currencies involved.

Refinancing of the tranches due in FY22 and FY23 was always going to be required as the funds are fully utilised in the business and the quantum is substantial. Average tenor has been extended from 6.4 years in FY20 to 7.8 years at end FY21 with bond redemptions spread more evenly over the 15-year program than was previously the case.

The currency adjustments also simplify APA's very complex hedging program. Previously the debt was spread over five currencies, which has been reduced to two. However, there was a significant pre-tax cost of $148 million incurred as redemption required translation into different currencies as well as unwinding the associated hedging positions. The debt is now held in debt capital market bonds (non-callable) rather than the previous notes.

While the refinancing has simplified the hedging requirements around borrowings, the company still has a significant and complex set of hedging arrangements that result from operating long-term contracts on both revenue and expense items. These programs aim to minimise (or change to act in the company's favour) the effect of currency and interest rate movements on the business. However, it can be seen by the sensitivity analyses and changes to asset values in the accounts that these may not always work perfectly and are therefore not without risk.

Growth Opportunities

APA continues to seek growth opportunities in the United States through a small team lead by Ross Gersbach. Unfortunately, no specific acquisitions have been secured to date, although one very prospective opportunity was thought to have been won but the vendor subsequently selected a different purchaser of an existing business. Nevertheless, the search continues but for how long is unclear.

Within Australia, the organic growth pipeline now exceeds $1.3 billion, up from $1.0 billion at the start of 2021 including the staged expansion of APA's East Coast Gas Grid ($270 million) and the new Northern Goldfields Interconnect in WA ($460 million). A Kurri Kurri Lateral Pipeline to service the Hunter Valley in NSW is currently being scoped for a final investment decision by late 2022.

APA Offer for AusNet

Subsequent to our meeting with APA, the company announced a non-binding offer for the Victorian-based electricity transmission and distribution company AusNet, which had just received an offer from the Canadian infrastructure investor Brookfield. The Brookfield offer comprised an all-cash bid of $2.50 per security, valuing AusNet at $9.6 billion excluding debt. APA's current offer comprises $1.82 cash and 0.0878 APA securities for each AusNet security. These offers led to a substantial rise in the price of AusNet's securities by about 25% to around $2.55 while APA's securities fell by about 5% to around $8.44 from $8.88. At the pre-bid price, APA's offer was worth $2.60 per AusNet security, trumping Brookfield's offer by 10 cents.

However, AusNet had already granted Brookfield an 8-week exclusive due diligence period and it was noted that AusNet has two large foreign shareholders (Singapore Power and State Grid Corporation of China) collectively owning 52% of total securities, who may not be attracted to APA's less certain mix of cash and equity. There are also potential competition issues for APA and Foreign Investment Review Board issues for Brookfield. Consequently, it is too early to come to a view on the likely outcome of these offers and, if APA were to be successful, what the impact on APA's balance sheet would be. Initial reports suggest that APA would need to raise an additional $1.6 billion in equity but that would depend on the level of interest in equity by the two foreign securityholders.

For most of this year AusNet has been valued at around $6 billion, but this activity has increased its market cap to almost $10 billion, which is similar to that of APA. With an average NPAT of around $300 million and operating cash flow of around $750 million, APA would be seeking to almost double its size on a balance sheet that is arguably already stretched. This offer, if agreed, would seem to be a high price for largely regulated infrastructure assets and appears unlikely to provide a reasonable return to APA shareholders, which probably explains the drop in APA's security price. Having said that, APA's largest shareholder, UniSuper Limited, which holds 14.3% of securities, has expressed support for the bid and has suggested that it offers more local product diversification for APA (i.e. electricity as well as gas infrastructure) than would more gas assets in a foreign jurisdiction.

Financial Summary

Item (as at FYE)	**2021**	**2020**	**2019**	**2018**	**2017**
NPAT ($m)[1]	3.7	311.8	288.0	264.8	236.8
UPAT ($m)	281.8	311.8	288.0	264.8	236.8
Security price ($)	8.90	11.13	10.80	9.85	9.17
Distribution (cents)	51.0	50.0	47.0	45.0	43.5
TSR (%)	(15.5)	7.7	14.4	12.3	4.0
EPS (cents)[2]	0.3	26.9	24.4	23.3	21.2
CEO total remuneration, actual ($m)[3]	2.79	2.51	5.18	5.40	5.04

1.includes significant items 2. adjusted for impact of equity raisings 3. includes components of prior year LTI awards

For 2021, the CEO's total actual remuneration was 30 times the Australian Full time Adult Average Weekly Total Earnings (based on May 2021 data from the Australian Bureau of Statistics).

Key Board or Senior Management Changes

Following the appointment of new CEO Robert Wheals in mid 2020, there were a number of new executive appointments. Adam Watson has been appointed CFO together with new Group Executives to head up Transformation and Technology (Hannah McCaughey) and Strategy and Commercial (Julian Peck). Ross Gersbach continues to be based in the US as President North America Development looking again for acquisition opportunities. Most recently, Jane Thomas has joined the executive team in May 2021 as Group Executive People, Safety and Culture.

There are no new appointments to the board.

Item 1	**Adoption of Remuneration Report**
ASA Vote	**For**

Summary of ASA Position

APA undertook a significant revision of the REM structure during FY20 to make a larger proportion of REM relate to security awards instead of cash settlements for STI and LT awards. The changes have been fully implemented for the new CEO and new hire KMP's and other executives for FY21.

The table below shows the overall REM framework in FY21 for the CEO, which is structured around fixed remuneration of $1.60M making up 32% of Target REM. Short Term Incentive (STI) target has been set at 60% of Fixed Pay (FP) whilst the LTI target has increased to 150% of FP. The STI may increase to 90% of FP for outperformance but the LTI target does not increase. Two thirds of the STI is paid in cash with the other one third of STI paid in APA restricted securities to be held for two years prior to vesting or until the security holding reaches the required minimum equivalent to one year's FP. The LTI award will be measured over a three-year period and will be delivered as rights to receive APA securities, which will vest in three equal tranches over the third, fourth and fifth years after grant.

Remuneration Summary for FY21

CEO REM Framework	Target $m	% of Total	Max. Opportunity $m	% of Total
Fixed Pay	1.60	32%	1.60	29%
STI - Cash	0.64	13%	0.96	18%
STI - Equity	0.32	7%	0.48	9%
LTI	2.40	48%	2.40	44%
Total	4.96	100.0%	5.44	100%

STI was assessed against a scorecard of financial and non-financial measures at the Board's discretion and resulted in an assessed STI award of 73.1% of Maximum Opportunity for the CEO. However, the board exercised its discretion to reduce the overall award by 10% for the CEO on account of the problems with the Orbost Gas Processing Plant, to 66.4% of Maximum Opportunity. For other executives, the STI was reduced by up to 20% depending on their level of responsibility for Orbost. In our discussions with the Chairman, he noted that the problems with Orbost go back quite a few years to the initial technical assessments and plant design, and most of the personnel responsible at the time are no longer employed by APA.

LTI awards comprise 50% on the basis of relative TSR (rTSR) assessed against the ASX100 and 50% on the basis of Return on Capital (ROC = EBITDA divided by Funds Employed), both measured over a period of three years. The rTSR hurdle vests 50% at 50th percentile with straight line pro-rata vesting to 100% at 82.5th percentile. The ROC hurdle vests 33% at 11.1% ROC with straight line pro-rata vesting to 100% at 11.4% ROC. Awards are made in performance rights, which vest in three equal tranches over a period of three years commencing at the end of the performance period. The performance rights are allocated on the basis of a 30-day market VWAP prior to the award.

Given that the new LTI plan was introduced in FY20, no LTI grants were made for FY21 but some awards vested (cash settled) from the previous plan following performance testing. There were no pay increases in FY21 except for the Group Executive Operations and there were no increases in director fees.

Whilst the above revised incentive methodology is a significant improvement over the previous scheme, ASA would prefer LTI to be assessed over a period of four years rather than three and would prefer 50% of STI to be paid in securities. On the other hand, LTI awards are paid over a period of a subsequent three years during which time the value is adjusted in accordance with the security price and all KMP's are required to hold a minimum number of securities, so they have "skin in the game". In addition, there is evidence that the Board has exercised judgement in setting STI awards at less than actually assessed by its methodology.

It was noted that new KMP's Adam Watson (now CFO and ex Transurban CFO) and Julian Peck (now GE Strategy & Commercial) were each granted securities to the face value of $600,000 to compensate them for unvested securities earned in their previous employments. Two thirds of these securities vested during FY21 with the remaining one third being subject to a holding lock for two years from commencement date. While the ASA would not normally approve of such payments, the Chairman assured us that these two new executives bring substantial skills and experience to APA and their costs of recruitment are more than compensated by their ability to bring immediate benefits to the company.

The Chairman advised us that the CEO is to receive a 4% increase in his FR for FY22 as he has had no increase since 2019, when he joined APA. A further change is proposed to the rTSR component of the LTI to make the comparison group a more bespoke group of 18 companies with infrastructure businesses such as Transurban, Sydney Airport (now subject to private takeover) and Atlas Arterial.

Overall, we consider the remuneration scheme is reasonable and a substantial improvement on the previous scheme. The remuneration report gives clear explanations of the overall incentive methodology and with hurdles well aligned with shareholder interests so we will vote undirected proxies in favour of the resolution.

Item 2	**Re-election of Michael Fraser as a Director**
ASA Vote	**For**

Michael Fraser was appointed as a director of Australian Pipeline Limited, the responsible entity for the two trusts that comprise APA, in September 2015 and became Chairman in October 2017. Michael has more than 35 years of experience in the Australian energy industry including CEO of AGL Energy for seven years until February 2015. He is director of Aurizon Holdings Limited and former chairman of the Clean Energy Council, Elgas Limited, ActewAGL and NEMMCo Participants Advisory Committee. He was also a director of Queensland Gas Company Limited.

The ASA views Mr Fraser as an effective and diligent director and will be voting FOR his re-election.

Item 3	**Re-election of Debra Goodin as a Director**
ASA Vote	**For**

Debra Goodin was appointed a director of Australian Pipeline Limited in September 2015. She is an experienced non-executive director and chairman of both listed and unlisted corporates, including Atlas Arterial Limited and Australia Pacific Airports Corporation Limited. For APA, Debra is the

Chair of the Audit and Risk Management Committee and a member of the Health, Safety, Environment and Heritage Committee and the Nomination Committee.

The ASA views Ms Goodin as an effective and diligent director and will be voting FOR her re-election.

Item 4	**Approval of LTI grant to CEO/Managing Director Robert Wheals**
ASA Vote	**For**

As a result of the change in FY20 from cash settled LTI benefits to an equity-based scheme, APA is seeking approval for a maximum of 270,362 performance rights to be issued to Mr Wheals in accordance with the LTI performance conditions, measured over a period of three years commencing on 1 July 2021 and ending on 30 June 2024, as part of his FY22 LTI award. The number of rights has been calculated by dividing the maximum LTI opportunity of $2,512,000 by the VWAP face value of $9.2931 over a 20-day period prior to the start of the performance period. The actual value the CEO receives will depend on the extent to which the performance conditions are achieved and the security price on vesting.

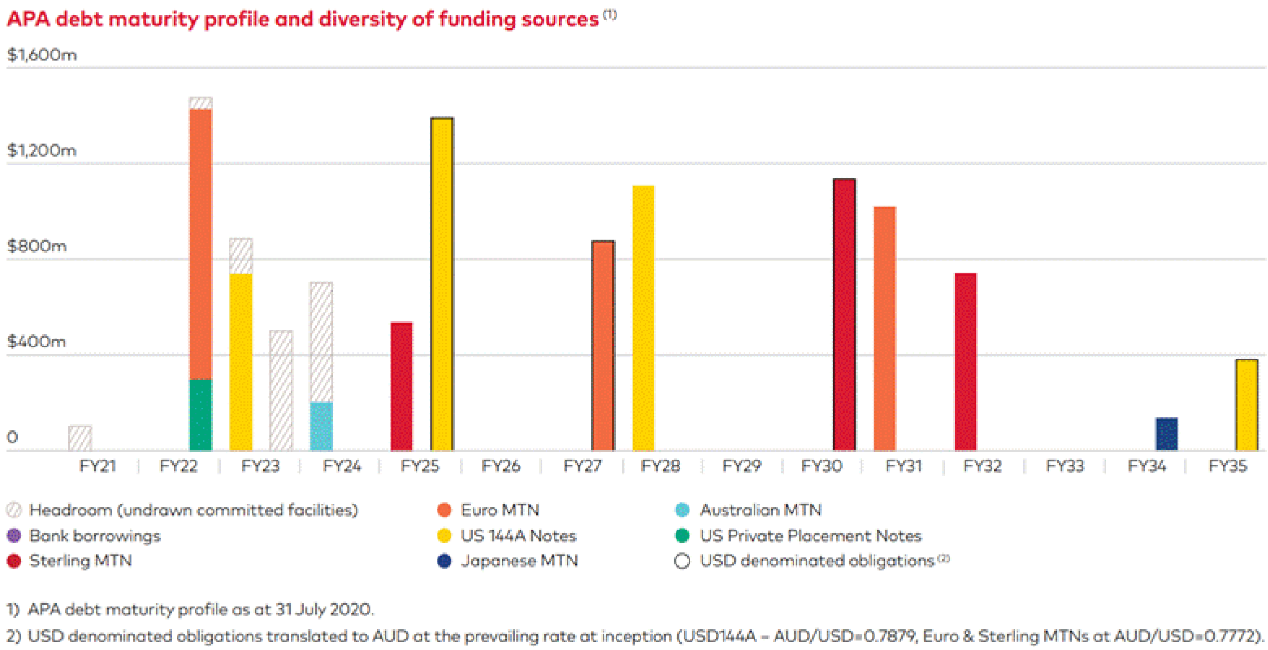
One third of securities meeting the testing criteria will vest at the end of the testing period (end year 3), one third at the end of year 4 and the final one third at the end of year 5. Performance rights are tested 50% against relative Total Securityholder Return (rTSR) and 50% against Return on Capital (ROC). Details are described in the Notice of Meeting.

As APA intends to purchase any securities allocated to the CEO on vesting of the performance rights on market, it does not strictly require this resolution, but APA prefers to have securityholder approval in the interests of transparency and to provide flexibility in the event that circumstances change. As the rights are to be issued in accordance with new LTI plan criteria and are valued at face value (rather than fair value) ASA will be voting FOR this resolution.

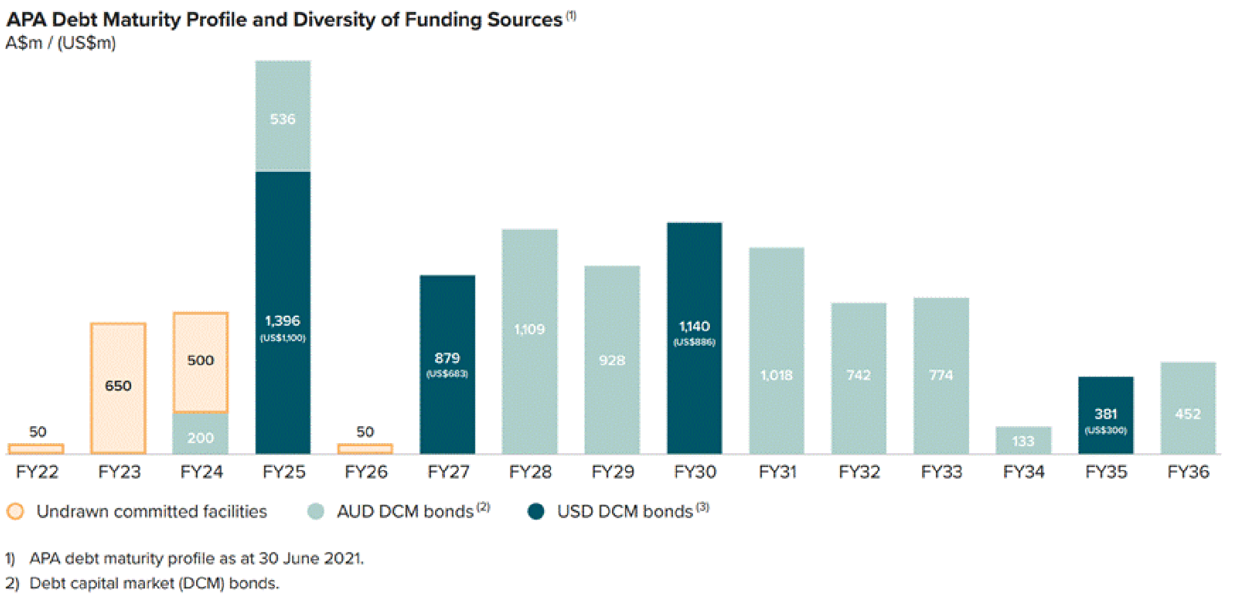
Appendix 1

Debt refinancing details

Profile of debt from FY20 Annual Report (page 30)



Profile of debt from FY21 Annual Report (page 23)



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