Presentation of Brattle Evidence to the Commission of Inquiry into the UBS Loan

PRESENTED BY

Toby Brown

Rand Ghayad

George Oldfield

Alberto Vargas

15 JULY 2021

Agenda

The Government's stated objectives for the IPIC and UBS transactions

Assessing whether Papua New Guinea could have issued sovereign debt in 2009 or 2014

Other possible alternative sources of financing

Key characteristics of the IPIC transaction

Key characteristics of the UBS transaction

Risks and rewards of the IPIC and UBS transactions

Hedging

Trading in Oil Search shares

Financial cost to the State of the UBS transaction

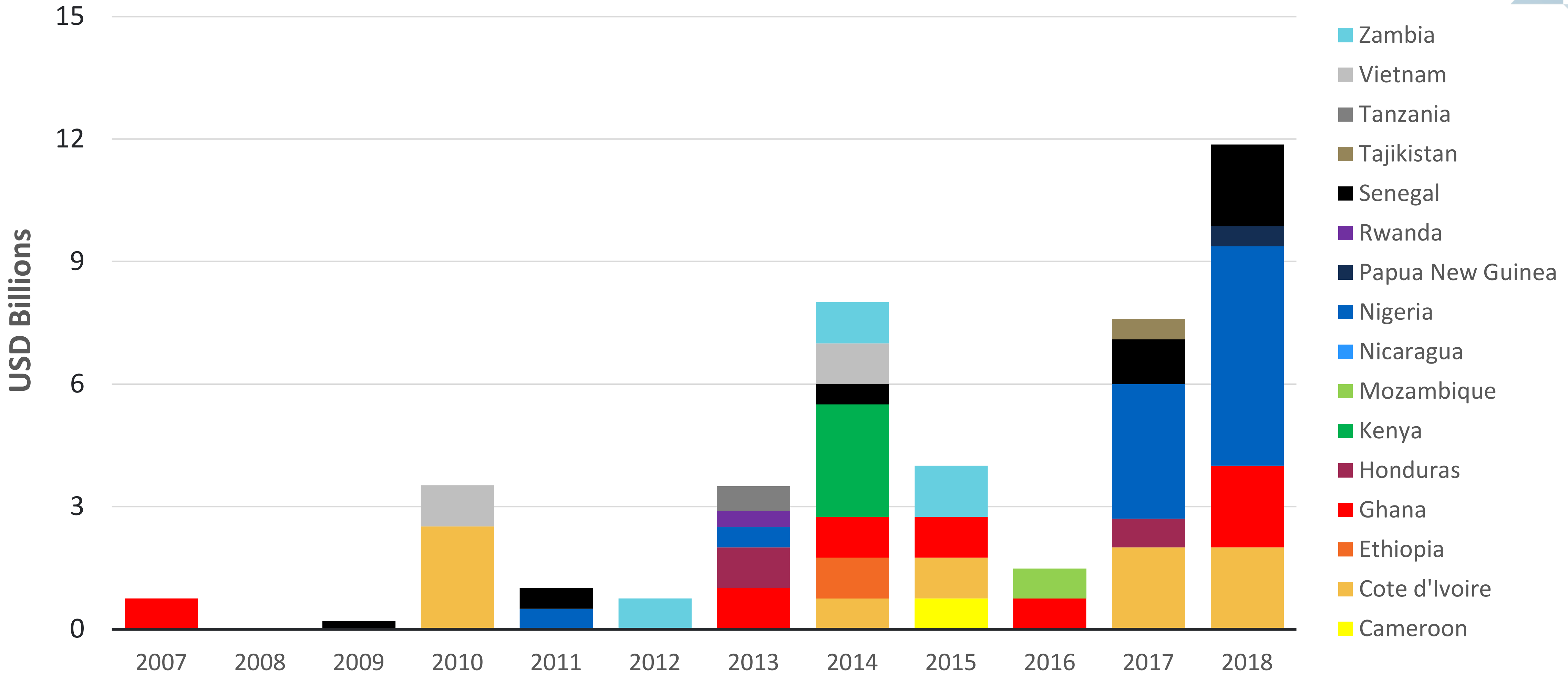
The PRL-15 transaction

Assessing whether Papua New Guinea could have issued sovereign debt in 2009 or 2014

Not feasible in 2009, but possible in 2014

	2009	2014
Global conditions	Highly volatile/uncertain	Low volatility
Investor appetite	Risk averse	Strong risk appetite
Funding outlook	High borrowing needs	Ample liquidity
Papua New Guinea macro fundamentals	Declining growth/ uncertain outlook	Strong
Papua New Guinea debt Sustainability	Moderate risk of distress	Low risk of distress

Low-income country debt issuance 2007–2018



First-time issuances from comparable countries in 2014

	Kenya	Ethiopia
Rating	B1	B1
Timing	June 2014	December 2014
Intended use of proceeds	Infrastructure spending & repayment of debt	Infrastructure spending
Orders received	4.5x over-subscription	3.2x over-subscription
Maturity at issuance	10 year	10 year
Coupon	6.87%	6.62%
Performance	Raised **USD 2 Billion**	Raised **USD 1 Billion**

Key characteristics of the IPIC transaction

IPIC transaction

Issuer: Independent Public Business Corporation (IPBC)

On 5 March 2009 issued exchangeable bonds for AUD 1,681 million

The bonds had a 5 year term and paid coupons semi-annually at a 5% rate unless redeemed or exchanged early

The bonds were collateralized by 197 million Oil Search shares

- Trading at AUD 4.82 on the issue date

IPBC had the right to redeem the bonds early if the share price of Oil search exceeded AUD 11.12

Funder: International Petroleum Investment Company (IPIC)

IPIC had the right to exchange the bonds early up to 10 days before the maturity date, or could wait for mandatory exchange on maturity

If the share price remains below AUD 8.55, IPIC would hold to maturity and receive all the shares and a cash “top up” to make up the difference between the share price and AUD 8.55

If the share price rose above AUD 8.55, IPIC could exchange early and receive all the shares

Key characteristics of the UBS transaction

UBS transaction

Issuer: Independent State of Papua New Guinea

On 27 February 2014, Oil Search announced that, subject to approvals, the State would purchase 149 million new shares at AUD 8.20, for a total of AUD 1,225 million

The purchase was financed by two loans from UBS:

- A Collar Loan where the State would pay back AUD 1,011 million after two years
  - 137 million oil search shares collateralized this loan
  - Interest was pre-paid on this loan
- A 6 month (extendable to 1 year) Bridge Loan of AUD 335 million
  - Collateralized by 12 million Oil Search shares
  - Interest was paid monthly and the interest rate increased every three months

Lender: UBS

UBS lent AUD 1,346 million but PNG received AUD 1,225 million

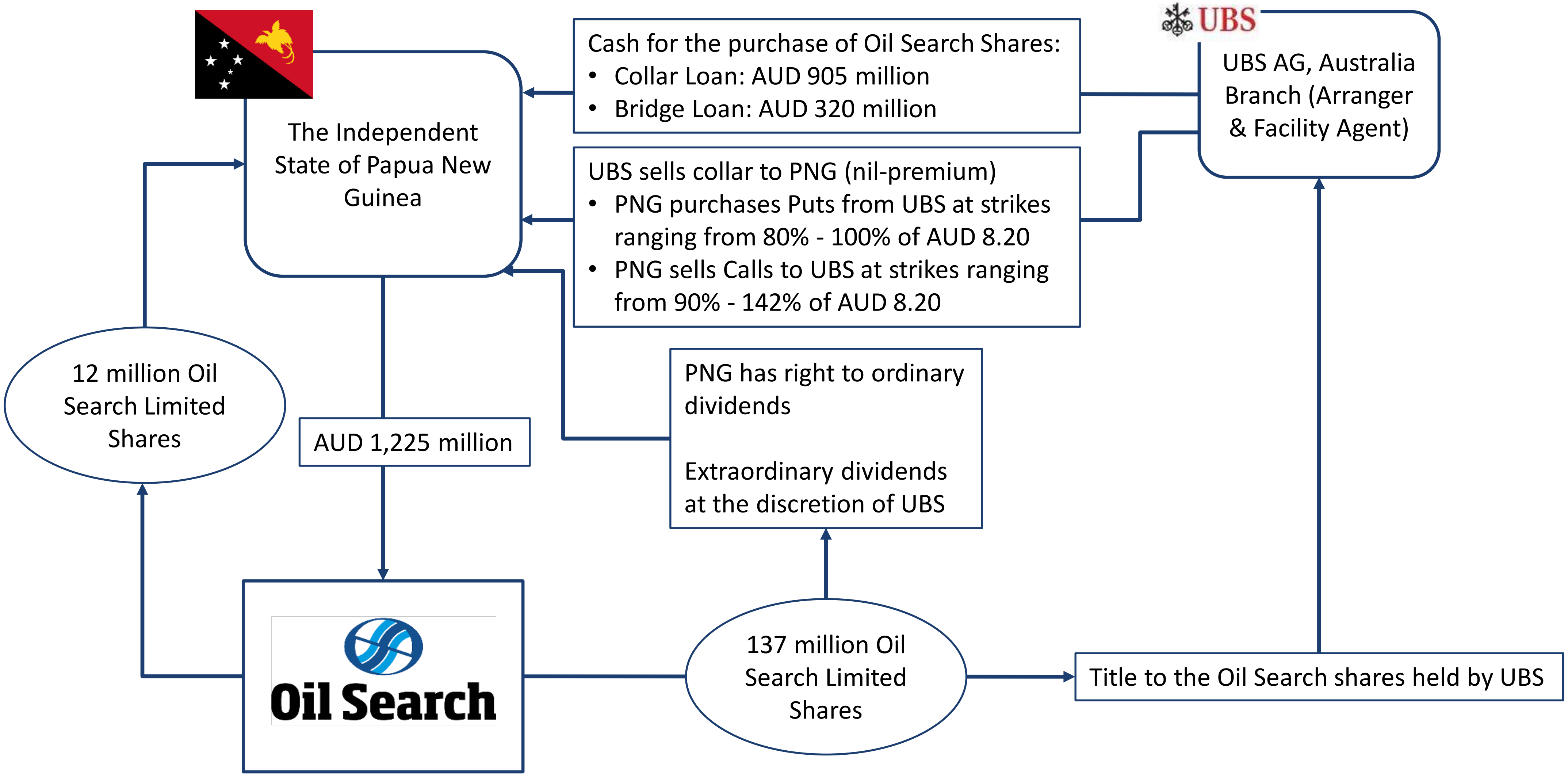
- AUD 107 million in pre-paid interest
- AUD 15 million in fees (AUD 13 million UBS fees)

UBS expected to receive (increasing) interest payments on the Bridge Loan, plus a renewal fee after six months

The collar component ("nil-premium"):

- UBS gave European put options on Oil Search shares to the State
- The State gave European call options on Oil Search shares to UBS

UBS transaction



The Collar Loan

A collar is a financial strategy that limits the possible returns on a financial asset such as a stock

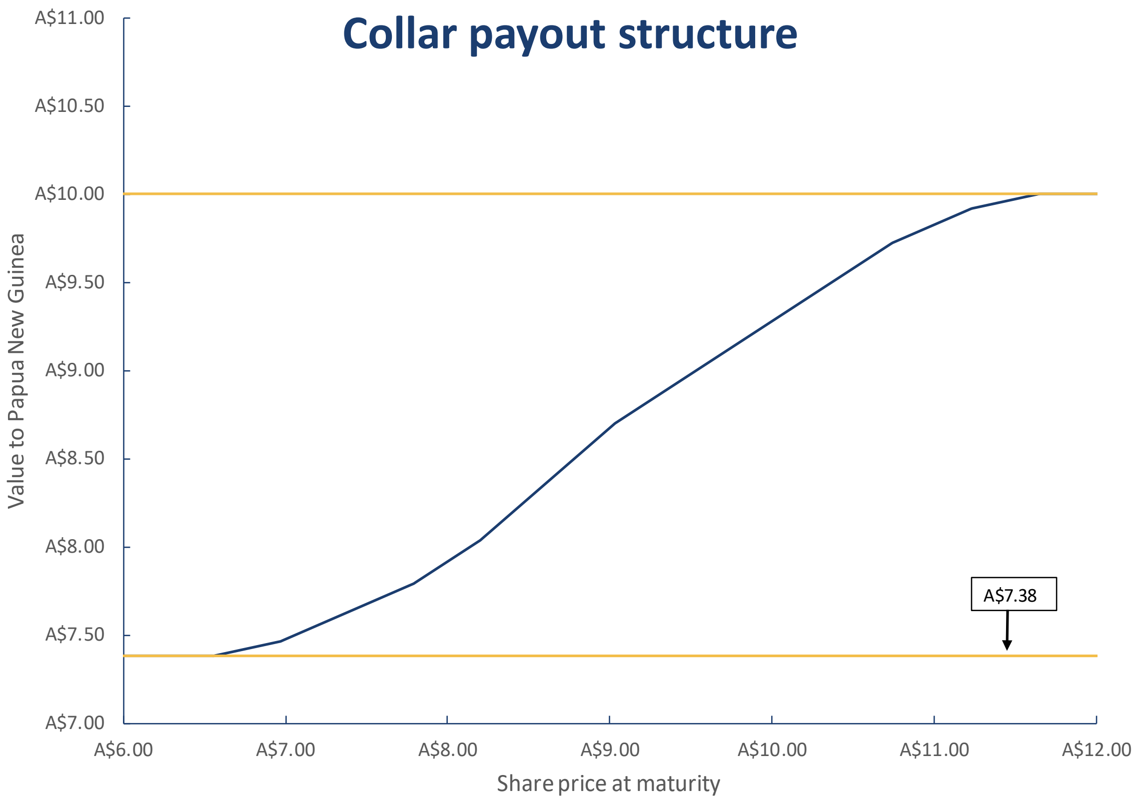
In its simplest form, this strategy is formed by holding a stock, a put option on the stock and writing (or issuing) a call option of the stock

In the case of the UBS deal, each of 30 tranches was made up of Oil Search shares, call options with five different strike prices that UBS purchased from PNG and put options with five different strike prices that PNG purchased from UBS

The resulting payout structure at maturity is shown in the figure

- If at maturity the Oil Search share price was below AUD 6.56, the collar was worth AUD 7.38 per share to the State
- Above a share price of AUD 6.56 the value of the collar to the State increases until it reaches a maximum of AUD 10 per share at a share price of AUD 11.64

Since AUD 7.38 per share was enough to repay UBS, the State would not have to pay additional cash at maturity, regardless of the share price



Structure of the Collar Loan

Put and call option groups

Relevant Group	Put and Call Options	Total Put and Call Options
6 x Collar Groups	22,835,375 per Group	137,012,250 for all Collar Group
5 x Tranches per Collar Group	4,567,075 per Tranche	22,835,375 for all Tranches in a Collar Group
5 x Component Collars per Tranche (A to E)	913,415 per Component Collar	4,567,075 for all Component Collars in a Tranche

Put and call option strike prices for each component collar

Component Collar	Number of Put and Call Options	Put Strike Price (% of $A.8.20)	Call Strike Price (% of A$8.20)
A	913,415	80%	90%
B	913,415	85%	110.12%
C	913,415	90%	130.95%
D	913,415	95%	136.90%
E	913,415	100%	142%
	Total of 4,567,075	Average of 90%	Average of 122%

Unusual features of the UBS transaction

The interest on the Collar Loan was stated at 4.95% pre-paid, which is equivalent to an interest rate of 5.3% per year if paid in arrears

The Collar Loan was structured so that

- UBS was not exposed to the State's credit risk
- UBS was exposed to market risk which could have been hedged with the same collar UBS gave to the State
- UBS stated that this collar had no cost to UBS or to the State ("nil-premium")

Yet, the interest rate UBS charged was above the risk-free rate

- If the risk-free rate had been charged, the State's interest payments would have been AUD 56 million lower

UBS stated that the collar structure was nil-premium

- Yet our modelling suggests the structure was worth AUD 25 million to UBS
- That is, the upside gain that the State gave up through the collar was more valuable than the downside protection it gained

The one-year term of the Bridge Loan, together with the cross-default provision, would have put UBS in a very strong bargaining position to negotiate refinancing beyond the first year

The interest rate on the Bridge Loan was much higher than the rate paid on sovereign debt issued in 2014 by two low income countries that were first-time sovereign debt issuers