

Innamincka Petroleum (INP)

Better than it appears, but not clear

ASX Code: INP
Basic Materials and Energy

31 October 2008, 8:27AM AEST

On 30 October, INP filed its September quarterly report.

INP operations

- INP has been trucking oil to Brisbane while it has had issues with its receipt at STO's Moomba operations. The cost penalty is about \$5/bbl.
- Flax 1 and Flax 3 have continued to produce, and are now at just over 300bbl/day.
- Flax 2 has completed its work-over, the pipe has been built to tie in, hydrostatic testing has been completed and it is expected to be producing and on-line by 7 November.
- Flax 4 is ready and will use the pipe from Flax 2.
- Flax 5 is being de-watered, but the drill rig doing the bailing out is not well suited to the task, as the most suitable rig is currently engaged, and so it is taking a long time.
- Testing of Flax East will take place after Flax 5 has been tested for the oil flows from each sand.

INP progress

At present INP has an overwhelming number of issues to work through and the path is not clear.

These challenges are detailed in the body of this note.

Investment view

The current share price gives INP a market cap of \$77m.

There is significant uncertainty on any valuation of INP. However, INP has enough existing cash in addition to the cash it is generating to grow its operations.

Accordingly, CommSec retains its BUY / OUT PERFORM recommendation.

Pieter Bruinstroop – Senior Analyst (Author)
03 9675 6582 | pieter.bruinstroop@cba.com.au

Recommendation*

| | |
|--------------------|-------------|
| Short term call | BUY |
| Long term Call | OUT PERFORM |
| Valuation | \$ 1.78 |
| 12mth price target | \$ 2.21 |
| 52 week high | \$ 1.50 |
| 52 week low | \$ 0.32 |
| Current price | \$ 0.41 |
| Market Cap. | \$ 77m |

Previous short term call n/a
Previous long term call n/a
Date of change since initiation

*SHORT TERM (over the next 6 months we expect the share price to:) Buy – Appreciate by >10%, Accumulate – Increase between 2% and 10%, Reduce – Increase by less than 2% or fall by up to 5%, Sell – Fall by >5%, Rev – Company is under review - no recommendation available. LONG TERM (over the next 24 months we expect the total return to:) Outperform (O / P) – Exceed market return by >5%, Market Perform (M / P) – Be in line with market return, +/-5%, Under Perform (U / P) – Be less than market return by >5%, Rev – Company is under review – no recommendation available.

Forecasts and ratios

| y.e. June | FY 08a | FY 09e | FY 10e | FY 11e |
|-----------|-----------|--------|---------|---------|
| Sales | \$2m | \$26m | \$114m | \$151m |
| NPAT | (\$ 7.4m) | \$2.2m | \$42.6m | \$60.3m |
| EPS | (4.0c) | 1.2c | 23.1c | 32.8c |
| growth | (102%) | 130 % | 1,822 % | 42 % |
| P/E | (22x) | 34.0 x | 1.8 x | 1.3 x |
| DPS | 0.0c | 0.0c | 0.0c | 3.0c |

Price relatives

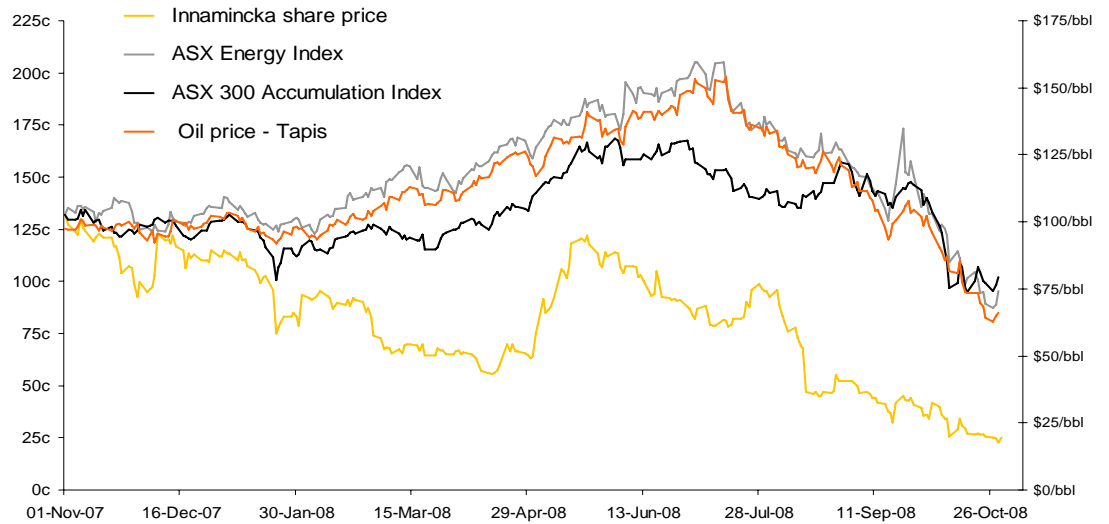


^The S&P/ASX200 has been re-based to the stock's starting share price.

INP's share price has fallen heavily

As shown in Figure 1, the INP share price has under-performed since its equity raising in December 2007.

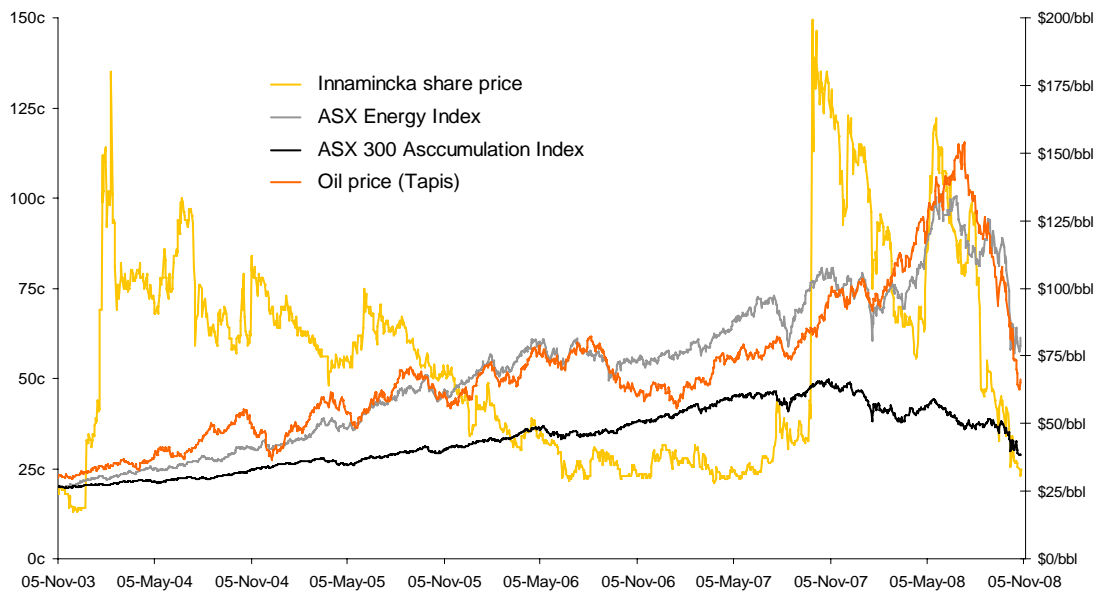
Figure 1: INP's share price



Source: IRESS, CommSec

Figure 2 shows that INP is now as cheap as it has ever been.

Figure 2: INP share price since listing



Source: IRESS, CommSec

CommSec's base case valuation is \$1.78

When CommSec initiated coverage of INP in December 2007, we were assured by the independent reviews by McGee and Associates (3 January 2006), and then again when INP published its March 2006 quarterly report, certifying:

- mean reserves of over 4Mbbbls of recoverable oil from the Flax field, from an assessed 19.8Mbbbls of Oil in Place,
- 65.8Mbbbls Oil in Place in the Juniper field, with
- 19.0Mbbbls Oil in Place in a further eight prospects in PEL 103.

This is the basis for CommSec's base case valuation of \$1.78, as shown in Table 1.

Table 1: Detail of CommSec's \$1.78 base case valuation of INP

| discount rate = | 12.0 % real | 30 June 2008 | | | 31-Oct-08 |
|-----------------------|-------------|----------------|----------------|----------------|----------------|
| | | 100 % | Product | per share | |
| Flax field | 85 % | \$ 101m | \$ 86m | 41c | 43c |
| NPV, franking credits | 60 % | \$ 14m | \$ 9m | 4c | 4c |
| Juniper field | 75 % | \$ 267m | \$ 200m | 97c | 101c |
| NPV, franking credits | 53 % | \$ 124m | \$ 65m | 31c | 33c |
| G, G & A | 100 % | (\$22m) | (\$22m) | (10c) | (11c) |
| Cash | 100 % | \$ 16m | \$ 16m | 8c | 8c |
| TOTAL | | \$ 500m | \$ 354m | \$ 1.71 | \$ 1.78 |
| Shares on Issue | | 184.1m | FPO shares | 22.9m | options |

Source: CommSec estimates

Table 1 shows that the current share price reflects only the certified mean reserves in the Flax field.

CommSec's research has previously shown that there is upside potential,

- The estimated recovery factors to derive the reserves estimate in the Flax field are below the experience using Enhanced Oil Recovery in the analogous Tirrawarra field and many tight sands in USA, *so more recovered oil is very possible*
- *The Oil-Water contact had not been found in any well drilled to date, so the oil column could be still larger than that used to estimate the Oil in Place.*

What went wrong?

Progress for INP, as indicated by its share price, has not been smooth.

Delays

Nearly everything has taken longer than expected.

- While a production licence has been granted, INP subsequently found out that it needed separate environmental and heritage clearance for each drill pad, road and pipe route.

- INP had to change from the original proposal for plastic pipes to steel pipes and this approval was delayed.
- And so the list goes on...

Deliveries suspended and production shut in

INP's first production was 1 August 2008. It was originally hoped to be late May, but it was subjected to the above delays.

INP trucked its oil to the Moomba facility so that it could then be piped to Port Bonython for export. However, on 12 September, a tanker with INP crude had the crude released through the top hatches, wetting the driver who was otherwise unharmed.

Santos subsequently suspended deliveries from INP, claiming that INP's very light crude was too volatile for the Moomba system, and hence out of specification.

INP was forced to shut in production.

INP has since started trucking to Brisbane. This costs more, about \$5/bbl more, but more importantly, it is inconsistent with INP's longer term plan to deliver to Moomba by pipe, rather than trucking.

Since trucking to Brisbane, it now appears that the issue was the particular tanker used as there has been the same problem only with the same tanker and it appears that the vents may have been jammed shut, causing the pressure to build up inside the vessel, leading to the overflow.

INP is now working to prove that is the case so that they will be able to deliver to Moomba again at some time. In the meantime, other options are opening up.

Flax 5

The most significant blow was reported on 15 August 2008. The Flax 5 well was:

- flowing 1,000bbls/day, compared with an initial flow of about 300bbls/day for other wells in the field; of which
- 700bbls/day was formation water; and
- the water was fresher than expected, leading to the conclusion that the sands may have a lower oil saturation what was previously believed.

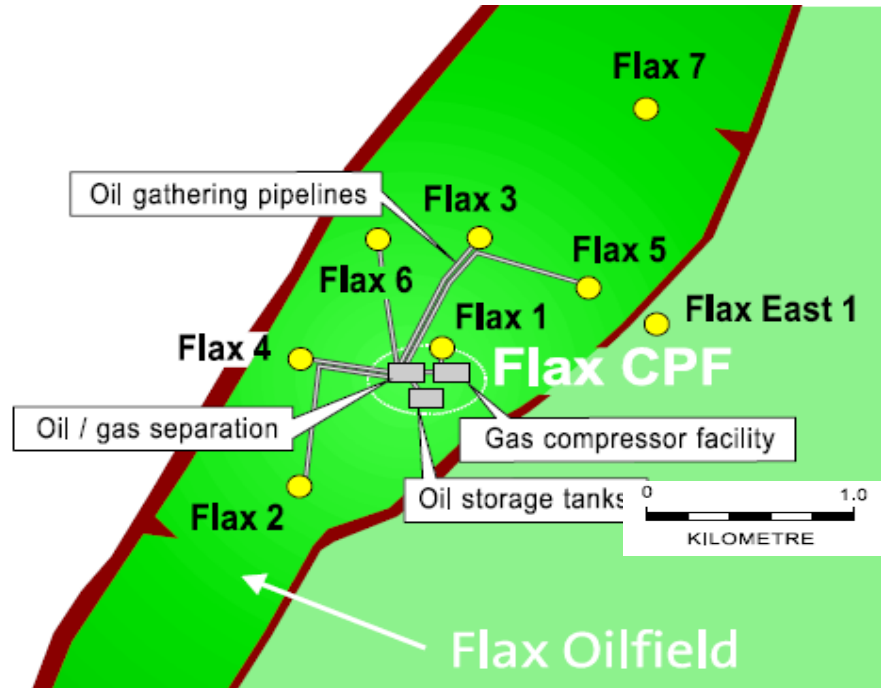
The rate of fluid production, however, fell rapidly soon after the marker was advised of the issue, down to 280bw/d and slowly to 180bw/d before the well was shut for re-completion.

Oil produced also fell away from the early rush, down to 80bo/d, but not further. This is an anomalous result.

The plan was to re-complete Flax 5 to allow for separate production from the Tirrawarra and basal Patchawarra sands (see CommSec's 3 April note "More than 120Mbbls Oil in Place").

Figure 3 shows the locations of INP's wells

Figure 3: INP's Flax operations



Source: Innamincka Petroleum, September 2008 presentation, slide 9

Flax East 1

At the time that Flax 5 was being production tested, Flax East 1 had a pressure gauge monitoring the impact of Flax 5. The pressure gauge showed no response.

The Flax East 1 well had been fracture stimulated. Since then, some of the proppant has been recovered and it has been very heavy, and it is quite possible that it has clogged around the well bore, explaining the lack of a pressure response.

Flax 2 delay

The work-over rig was on Flax2 at the time the problems with Flax 5 were encountered, completing differential production capability.

However, the packer that separated the lower Tirrawarra reservoir from the higher basal Patchawarra reservoir had to be milled out and this took two weeks.

Flax 2 has since been completed and tied in. Flax 2 is expected to be producing by 7 November.

Flax 5 delay

To re-complete Flax 5 requires that the water be produced. The work-over is not suited to this and is able to only swab about 40 – 50bbls/day, so it will take about two more weeks before testing can even start.

Producers

Flax 1 and Flax 3 have been producing as soon as crude could be trucked. Flax 2 and Flax 4 should be on line by 7 November, and production should then be about 500bbls/day.

When Flax 5 can be re-completed, this should add a further 100bbls/day, after the initial flow has settled, by producing from the Patchawarra.

Flax East should bring this to over 700bbls/day, again producing from a single sand.

Conclusions

There have been numerous delays that have hurt the share price.

At 30 September, INP had over \$7.5m in cash; it is responsible for only 75% of the costs. It has not yet received payment for the crude it has already delivered, as payment terms are typically two months, or even a little longer.

Table 2 shows a brief cashflow synopsis for INP's operations (100% basis). It shows that INP is able to drill a new development well, and hence expand its subsequent cashflow, every quarter.

Table 2: Brief synopsis of INP's cashflows

| | |
|----------------|----------------------|
| Producing rate | 700 bbl/day |
| Oil price | \$ 70.00/bbl |
| AUD / USD rate | 0.700 |
| | \$A 100/bbl |
| trucking cost | \$A 25/bbl |
| Net Revenue | \$A 53k/day |
| Cash op. Costs | \$A 8k/day |
| Royalties | \$A 0/bbl |
| NET | \$A 1.3m /mth |

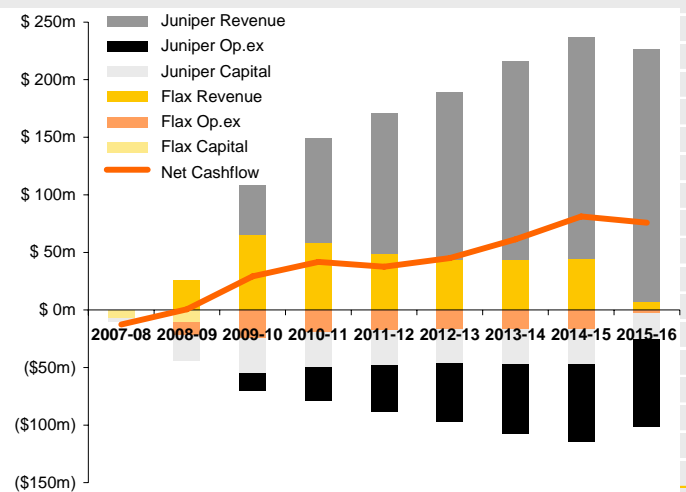
Source: *CommSec estimates*

Note: CommSec assumes no royalties are payable for some time due to carry forward costs.

CommSec affirms its BUY / OUT PERFORM recommendation on INP.

Financials

| Innamincka Petroleum (INP) | | | | | Share Price : 12 month return | | Recommendation | | | |
|---|------------------|-----------------|-----------------|------------------|-------------------------------|-------------|----------------|----------------|----------------|----------------|
| June year end | | | | | \$ 0.41 | 438 % | BUY | OUT PERFORM | | |
| Income Statement | FY 08a | FY 09e | FY 10e | FY 11e | | | | | | |
| Sales | \$ 1.9m | \$ 26.1m | \$ 114m | \$ 151m | | | | | | |
| Operating Costs | \$ 2.5m | \$ 13.4m | \$ 43.1m | \$ 52.5m | | | | | | |
| EBITDAX | (\$0.6m) | \$ 12.8m | \$ 71m | \$ 98m | | | | | | |
| Exploration expensed | \$ 10.0m | \$ 7.0m | \$ 0.0m | \$ 0.0m | | | | | | |
| Depreciation & Amortisation | \$ 0.0m | \$ 2.6m | \$ 7.4m | \$ 8.9m | | | | | | |
| EBIT | (\$10.6m) | \$ 3.2m | \$ 63.6m | \$ 89.2m | | | | | | |
| Net Interest Expense (Revenue) | \$ 0.0m | \$ 0.0m | \$ 2.7m | \$ 3.1m | | | | | | |
| Pre-Tax Profit | (\$10.6m) | \$ 3.2m | \$ 61m | \$ 86m | | | | | | |
| Tax Expense/(Benefit) | (\$3.2m) | \$ 0.9m | \$ 18.3m | \$ 25.8m | | | | | | |
| Reported NPAT | (\$7.4m) | \$ 2.2m | \$ 43m | \$ 60m | | | | | | |
| Significant Items (After Tax) | \$ 0.0m | \$ 0.0m | \$ 0.0m | \$ 0.0m | | | | | | |
| NPAT (Pre-Significant Items) | (\$7.4m) | \$ 2.2m | \$ 42.6m | \$ 60.3m | | | | | | |
| EBITDA Margin (%) | (32%) | 49 % | 62 % | 65 % | | | | | | |
| Effective tax Rate (%) | 30.0% | 30.0% | 30.0% | 30.0% | | | | | | |
| EPS Reported (cps) | (4.0c) | 1.2c | 23c | 33c | | | | | | |
| EPS Pre Significant Items (c) | (4.0c) | 1.2c | 23c | 33c | | | | | | |
| DPS (c) | 0c | 0c | 0c | 3c | | | | | | |
| Payout Ratio (%) | 0% | 0% | 0% | 9% | | | | | | |
| Franking (%) | 0% | 0% | 0% | 100% | | | | | | |
| Cash Flow Statement | | | | | | | | | | |
| EBITDAX | \$ 9.4m | \$ 19.8m | \$ 71.0m | \$ 98.1m | | | | | | |
| Change in Working Capital | \$ 0.0m | (\$1.7m) | (\$1.9m) | (\$0.8m) | | | | | | |
| Net Interest (paid)/received | \$ 0.0m | \$ 0.0m | (\$2.7m) | (\$3.1m) | | | | | | |
| Tax Paid | \$ 0.0m | \$ 0.0m | \$ 0.0m | (\$7.0m) | | | | | | |
| Operating Cash Flow | \$ 9.4m | \$ 18.1m | \$ 66m | \$ 87m | | | | | | |
| Exploration / Net acquisitions | (\$10.0m) | (\$7.0m) | \$ 0.0m | \$ 0.0m | | | | | | |
| Project + Sustaining Capex | (\$5.3m) | (\$4.0m) | (\$30m) | (\$40m) | | | | | | |
| Other investing items | \$ 0.0m | \$ 0.0m | \$ 0.0m | \$ 0.0m | | | | | | |
| Investing Cash Flow | (\$ 15m) | (\$ 11m) | (\$ 30m) | (\$ 40m) | | | | | | |
| Inc/(Dec) in Equity | \$ 29.0m | \$ 0.0m | \$ 0.0m | \$ 0.0m | | | | | | |
| Inc/(Dec) in Borrowings | \$ 0.0m | (\$0.7m) | \$ 5.5m | (\$43.6m) | | | | | | |
| Dividends Paid | \$ 0.0m | \$ 0.0m | \$ 0.0m | (\$5.5m) | | | | | | |
| Financing Cash Flow | \$ 29m | (\$ 1m) | \$ 6m | (\$ 49m) | | | | | | |
| Net Inc/(Dec) in Cash | \$ 23.1m | \$ 6.3m | \$ 41.9m | (\$ 1.9m) | | | | | | |
| Balance Sheet | | | | | | | | | | |
| Cash | \$ 34.0m | \$ 40.3m | \$ 82.3m | \$ 80.4m | | | | | | |
| Other Current Assets | \$ 1.8m | \$ 1.0m | \$ 1.0m | \$ 1.0m | | | | | | |
| Total Current Asstes | \$ 35.8m | \$ 41.3m | \$ 83.3m | \$ 81.4m | | | | | | |
| Fixed Assets | \$ 5.4m | \$ 6.8m | \$ 29.4m | \$ 60.4m | | | | | | |
| Explor'n & Evalu'n | \$ 13.8m | \$ 13.8m | \$ 13.8m | \$ 13.8m | | | | | | |
| Other | \$ 27.3m | \$ 30.6m | \$ 41.5m | \$ 16.3m | | | | | | |
| Total Assets | \$ 82m | \$ 92m | \$ 168m | \$ 172m | | | | | | |
| Current Liabilities | \$ 0.7m | \$ 2.4m | \$ 4.3m | \$ 5.1m | | | | | | |
| Long term Debt | \$ 34.0m | \$ 40.3m | \$ 71.2m | \$ 19.7m | | | | | | |
| Other Non Current Liabilities | \$ 0.0m | \$ 0.0m | \$ 0.0m | \$ 0.0m | | | | | | |
| Total Liabilities | \$ 34.7m | \$ 42.8m | \$ 75.5m | \$ 24.7m | | | | | | |
| Total Equity | \$ 47.5m | \$ 49.7m | \$ 92.3m | \$ 147.1m | | | | | | |
| Net Debt (Cash) | \$ 0.0m | \$ 0.0m | (\$ 11.0m) | (\$ 60.7m) | | | | | | |
| Leverage | | | | | | | | | | |
| Net Debt/Equity | 0.0 % | 0.0 % | (12.0%) | (41.3%) | | | | | | |
| Net Debt/Total Assets | 0.0 % | 0.0 % | (6.6%) | (35.3%) | | | | | | |
| EBIT Margin | (558%) | 12 % | 56 % | 59 % | | | | | | |
| Interest Cover (x) | n/a | n/a | 23.3 x | 29.1 x | | | | | | |
| Dividend Cover (x) | n / a | n / a | n / a | 10.9 x | | | | | | |
| Source : IRESS, Commonwealth Securities | | | | | | | | | | |
| | | | | | Assumptions | | | | | |
| | | | | | Oil (WTI) | \$ 96.9/bbl | \$ 107/bbl | \$ 98.8/bbl | \$ 87.5/bbl | \$ 65.0/bbl |
| | | | | | \$A / US\$ | 0.898 | 0.877 | 0.803 | 0.800 | 0.800 |
| | | | | | Production | | | | | |
| | | | | | Flax Oil (100%) | 0 kbbl | 270 kbbl | 451 kbbl | 469 kbbl | 469 kbbl |
| | | | | | Juniper Oil (100%) | 0 kbbl | 0 kbbl | 501 kbbl | 1,046 kbbl | 1,674 kbbl |
| | | | | | TOTAL, INP share | 0 kbbl | 203 kbbl | 878 kbbl | 1,287 kbbl | 1,758 kbbl |
| | | | | | INP Resources | | | | | |
| | | | | | Flax - Juniper | 120 Mbbl | Oil In Place | | | |
| | | | | | Flax | 4.4 Mbbl | 4.1 Mbbl | 3.5 Mbbl | 2.8 Mbbl | 2.1 Mbbl |
| | | | | | Juniper | 30.1 Mbbl | 30.1 Mbbl | 29.6 Mbbl | 28.5 Mbbl | 26.8 Mbbl |
| | | | | | TOTAL, INP share | 25.8 Mbbl | 25.6 Mbbl | 24.8 Mbbl | 23.5 Mbbl | 21.7 Mbbl |
| | | | | | Valuation | | | | | |
| | | | | | 30 June 2008 | | | | | |
| | | | | | 30-Oct-08 | | | | | |
| | | | | | Real Discount Rate : 12.0% | | | | | |
| | | | | | Flax field | 85 % | \$ 101m | \$ 86m | 41c | 43c |
| | | | | | NPV, franking credits | 60 % | \$ 14m | \$ 9m | 4c | 4c |
| | | | | | Juniper field | 75 % | \$ 267m | \$ 200m | 97c | 101c |
| | | | | | NPV, franking credits | 53 % | \$ 124m | \$ 65m | 31c | 33c |
| | | | | | G, G & A | 60 % | (\$22m) | (\$13m) | (6c) | (11c) |
| | | | | | Cash | 53 % | \$ 16m | \$ 8m | 4c | 8c |
| | | | | | TOTAL | | \$ 500m | \$ 355m | \$ 1.71 | \$ 1.78 |
| | | | | | Shares on Issue | | 184.1m | PO shares | 22.9m | options |
| | | | | | Valuation Ratios | | | | | |
| | | | | | P/E Multiple | (14.3x) | (21.8x) | 34.0 x | 1.8 x | 1.3 x |
| | | | | | Price To Book Value | 2.0 x | 3.4 x | 1.5 x | 0.8 x | 0.5 x |
| | | | | | Price To Cash Flow | (14.6x) | (20.6x) | 15.7 x | 1.5 x | 1.1 x |
| | | | | | EBITDA Multiple | 23.9 x | (254.9x) | 5.9 x | 1.1 x | 0.8 x |
| | | | | | EBIT Multiple | 23.9 x | (14.4x) | 23.8 x | 1.2 x | 0.8 x |
| | | | | | Dividend Yield | 0.0 % | 0.0 % | 0.0 % | 0.0 % | 0.0 % |
| | | | | | Major Shareholders | | | | | |
| | | | | | G. Santalucia | 21.4 m | 10.3 % | Macquarie Bank | 21.0m options | |
| | | | | | Adam Johnson (Chair) | 8.5 m | 4.1 % | | | |
| | | | | | Ross Wecker (MD) | 7.3 m | 3.5 % | | | |



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Peter Ephraums Senior Analyst 02 9312 0780 0414 491 956
 Andrew Adams Senior Analyst 02 8223 7904 0408 401 824
 Miriam Herold Analyst 02 9312 0088 0415 683 081

Basic Materials & Energy

Pieter Bruinstroop Senior Analyst 03 9675 6582 0400 3159 35

Non-mining Basic Materials

Pei Wan Wong Analyst 03 9675 7443 0432 037 341

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Rob Sebek Analyst 03 9675 6056 0407 007 522

Commodities

Lachlan Shaw Analyst 03 9675 8618 0417 124 596

Minerals

Andrew Knuckey Analyst 03 9675 6791 0411 429 108

Economics

Craig James Chief Equities Econ. 02 9312 0265 0419 695 082
 Savanth Sebastian Equities Economist 02 8223 7130 0414 188 161

Emerging Companies

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 Danny Younis Senior Analyst 02 9312 4138 0402 819 980
 Prasanna Shan Associate Analyst 02 9312 3319 0423 023 242

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Natalie Kelly Senior Analyst 03 9675 7107 0413 963 150
 Bruce Du Associate Analyst 03 9675 6244 0403 434 717

Industrials

Cassandra Meagher Senior Analyst 02 9312 0223 0439 304 108
 Adrian Lemme Analyst 02 8223 7136 0424 504 412
 Mindy Chia Associate Analyst 02 8223 7165
 Karthi Kannapiran Associate Analyst 02 8223 7396

Media & Gaming

Craig Shepherd Senior Analyst 03 9675 7972 0406 402 646
 Sacha Krien Analyst 03 9675 6933 0422 688 471

Retailing, Food & Beverages & Agriculture

Eugene Tan Analyst 02 9312 3331 0422 287 575
 Jordan Rogers Associate Analyst 02 8223 7945 0401 197 440
 Belinda Sanith Associate Analyst 02 9312 2875 0434 503 697

Utilities & Toll Roads

Paul Johnston* Senior Analyst 03 9675 7101 0414 200 902
 Wei-Sun Teh Associate Analyst 03 9675 7275 0413 565 298

Distribution & Compliance

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 Hayley Greensmith Research Editor 02 9312 7016
 Natasha Meuli Desktop Publisher 02 9312 0334
 Kelly McGregor Research Assistant 02 9312 0354
 Silvana Palmieri Research Assistant 03 9675 7106

Fax Sydney 02 9312 4170
 Fax Melbourne 03 9675 7622

Quantitative Research & Investment Strategy

Investment Strategy

Gary Morris* Developer 03 9675 7685 0432 213 425
 Hendrik Botha Quantitative Analyst 02 8223 7948

Quantitative Strategy

Jason Schyschow Analyst 02 9312 4614

Fax Sydney 02 9312 4170
 Fax Melbourne 03 9675 7622

To contact any of our staff via email, type their [first name.surname@cba.com.au](mailto:first_name.surname@cba.com.au)

*Except following staff: Paul Johnston – paul.a.johnston@cba.com.au
 Casey Girardi – cgirardi.cas@cba.com.au
 Gary Morris – gary.s.morris@cba.com.au
 Ai-Quynh Mac - maca@cba.com.au

Research Sales

Electronic Trading

Suzie Toohey 02 9312 0237 0414 326 920
 Andrew Millward 02 9312 7061 0422 900 890
 Hun Low 02 9312 0234

Equity Research Sales

Lance Jenkins 02 9312 0981
 Christine Leonard 02 9312 0533 0414 372 495
 Chris Mears 02 9312 0951 0433 882 133
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Equity & Derivative Sales

Johnny Cattell 02 9312 0273 0414 382 505
 Matt Bromfield 02 9312 0273 0416 252 590

Hybrid Sales

Steve Anagnos 02 9312 2306 0412 379 793

Asian Sales

Wai Hoey 03 9675 6967 0419 882 225
 Toll Free (HK) 800 901 636
 Toll Free (Sing) 800 616 1949
 +852 2844 7535

Leo Au

European Sales

James Scott +44 (0)20 7710 3573 +44 (0)7 921 687 305

US Sales

Casey Girardi* +1 (1)212 336 7749

Fax Sydney 02 9312 0934
 Fax Melbourne 02 9675 7622

Global Markets Research

Commodities

David Moore Chief Commodity Strategist t 02 9312 0398
 Luke Mathews Commodity Strategist 02 9312 4150

Currencies

Richard Grace Chief Currency Strategist 02 9312 4080
 Joseph Capurso Currency Strategist 02 9312 0429
 Sara Hoening Economist 02 8223 7928

Debt

Adam Donaldson Head of Debt Research 02 9312 2841
 Divyang Shah Chief Strategist (London) +44 (0)20 7710 3986
 Jarrod Kerr Interest Rate Strategist 02 9312 4118
 Michael Bors Credit Research Analyst 02 9312 4134
 Steve Shoobert Credit Research Analyst 02 9312 0130
 Winnie Chee Securitised Product 02 9312 0182
 Tally Dewan Quantitative Research Analyst 02 9312 4614
 Aaron Ball Senior Development Analyst 02 9312 7098

Economics

Michael Blythe Chief Economist 02 9312 4135
 Michael Workman Senior Economist 02 9312 0197
 John Peters Senior Economist 02 9312 0112
 James McIntyre Economist 02 9312 4142
 Nicola Chadwick (UK) International Economist +44 (0)20 7710 3631
 Chris Tennent-Brown NZ Economist +64 (0)9 374 8819
 Nick Tuffley ASB Chief Economist +64 (0)9 374 8604

Delivery Channels & Publications

Monica Eley Internet/Intranet 02 9312 0853
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Fax Sydney 02 9312 0304