

IN THE AUSTRALIAN COMPETITION TRIBUNAL

of 2013

AGL Energy Limited

RE: PROPOSED ACQUISITION OF MACQUARIE GENERATION (A CORPORATION ESTABLISHED UNDER THE ENERGY SERVICES CORPORATIONS ACT 1995 (NSW))

Statement of: Brett Alan Redman

Address: Level 22, 101 Miller Street, North Sydney 2060 of the State of New South
Wales

Occupation: Chief Financial Officer

Date: 23 March 2014

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Filed on behalf of (name & role of party) AGL Energy Limited, Applicant

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I Brett Alan Redman say on oath:

1. I am the Chief Financial Officer of AGL Energy Limited ACN 115 061 375 (**AGL**) and I am authorised to make this statement on AGL's behalf.
2. Where, in this statement:
 - (a) I refer to information provided to me by a third person, I believe that information to be true and correct and, at the time I was provided with that information, I believed it to be true and correct, unless I state to the contrary;
 - (b) I refer to an email, letter or report sent to me by others reporting on or referencing discussions, meetings or other communications in which I participated or to which I was a party, the email, letter or report accurately records those discussions, meetings or other communications, unless I state to the contrary;
 - (c) I refer to an email or other communication sent by me to others in which I express an opinion, belief or view, I held that opinion, belief or view at the time of sending that email or other communication, unless I state to the contrary; and

- (d) I refer to minutes of any Board meeting at which I was present, I have been shown those minutes and believe them to be an accurate record of the meeting.

1. Background

3. I am the Chief Financial Officer of AGL and a member of AGL's Executive. I have been in this position since November 2012. AGL is a vertically integrated energy retailer listed on the Australian Securities Exchange (**ASX**). Relevantly, AGL owns electricity generation assets, and is also a retailer of electricity to customers.
4. I have been employed by AGL since October 2007. Before I became the Chief Financial Officer I held the roles of Head of Finance, Merchant Energy and Upstream Gas from October 2007 to December 2010 and Head of Group Strategy and Finance from January 2011 to November 2012.
5. I started my career at Deloitte Touche Tohmatsu where I worked for seven years.
6. As Chief Financial Officer, I:
- (a) am responsible for all financial reporting (both internal and external) and external auditing of AGL; and
 - (b) am a member of AGL's Risk Management Committee (**RMC**).
7. In my capacity as Chief Financial Officer I have also been:
- (a) responsible for the valuation of the assets and business of Macquarie Generation (a corporation established under the Energy Services Corporations Act 1995 (NSW)) ABN 18 402 904 344 (**Macquarie Generation**) including assessing AGL's operation of those assets and management of financial risks following acquisition in conjunction with Michael Fraser, who is AGL's Chief Executive and Managing Director; and
 - (b) responsible for the development of AGL's expression of interest, initial bid and binding bid for Macquarie Generation in conjunction with Michael Fraser and Anthony Fowler.
8. AGL's business is divided into three core operational businesses:
- (a) "**Merchant Energy**": the Merchant Energy division manages and develops AGL's diversified portfolio of electricity generation and wholesale gas arrangements. Merchant Energy also manages relationships with AGL's large commercial and industrial customers.



- (b) **"Upstream Gas"**: the Upstream Gas division manages and develops AGL's upstream gas assets located in Queensland and New South Wales.
- (c) **"Retail Energy"**: the Retail Energy division sells and markets natural gas, electricity and energy related products and services to more than 3.8 million residential and small business customer accounts across NSW, Victoria, South Australia and Queensland.
9. In performance of my responsibilities for all financial reporting for AGL I receive information from the three operating divisions, each of which have a Head of Finance who have accountabilities to me.
10. I report to Michael Fraser, who is the Chief Executive Officer and Managing Director of AGL. There are five people who report directly to me, and a further 95 people in the finance group that I am responsible for through those direct reports.
11. During my career I have been involved in a number of acquisition related transactions. My particular experience relates to the valuation of the target company or assets. The operation of the target company or assets following acquisition and the management of risks and benefits from the acquisition is central to determining a valuation. I therefore have expertise in these areas. For example, in 2012 I was involved in AGL's acquisition of the Loy Yang A power station in Victoria. Although I was not Chief Financial Officer at that time, my involvement in managing the process was similar to my current responsibilities. I have also been involved in a number of smaller transactions involving other power plants, capital expenditure proposals and developments.
12. A copy of my curriculum vita is attached as Annexure **BAR-1**.
- 2. AGL Financial reporting and the Application to the Australian Competition Tribunal**
13. I understand that in order to commence its application to the Australian Competition Tribunal for authorisation of its proposed acquisition of the business of Macquarie Generation certain financial information about AGL's business must be set out in the Form S.
14. I understand that the information set out in this statement (other than the financial information presented at Table 6 and in paragraphs 141 and 145 below), have been extracted from AGL's financial reporting system which includes SAP (a transactional recording platform) and BW (a financial reporting platform) and is described in this statement as AGL's **General Ledger**), which is used to produce the financial



Information upon which AGL reports its statutory accounts. Unless otherwise indicated, the financial information that is set out below was compiled under the supervision of Greg Hade, Head of Finance Merchant Energy and Damien Nicks, Head of Finance, Retail, both of whom report to me.

15. The General Ledger is the system for the company wide financial records from which information for AGL's audited accounts is extracted.
16. I understand that the Application to the Tribunal Form (**Form S**) requires AGL to describe the inputs into the production of goods or services and indicate the costs of those inputs. In addition, I understand that Form S requires information about prices and profit margins.
17. As I indicated above, AGL has three operating divisions – two of which are Merchant Energy and Retail. For the purposes of financial reporting, management accountability and business decision making these two divisions operate as separate cost and profit centres. In a commercial sense the "outputs" of the Merchant Energy Division are the "inputs" to the Retail Division. To reflect this commercial reality and to provide managers in the two divisions with appropriate incentives and accountabilities there is an "internal energy transfer price" (which in general terms is set having regard to prevailing wholesale market prices) upon which financial reporting and financial performance is reported and measured.

Merchant Energy

18. There are four groups within Merchant Energy:
 - (a) **Merchant Operations:** which is responsible for the physical operation and maintenance of AGL's portfolio of wind, water, gas and coal fired generation plant (including in the case of Loy Yang A Power Station, a coal mine).
 - (b) **Energy Portfolio Management (EPM):** which is responsible for managing the risks associated with procuring gas, electricity and environmental market certificates, for administering AGL's hedge contract portfolio, and for bidding AGL's electricity generation into the NEM.
 - (c) **The Business Customers group:** which manages AGL's approximately 20,000 Business Customer energy accounts, but not individual smaller industrial and commercial customers or consumer market customers.
 - (d) **Power Development:** which develops wind and solar generation assets. Form S does not require, and accordingly we have not provided, financial information in relation to the Power Development division.



19. The following tables 1 and 2 sets out, for the financial year ending 30 June 2013, the aggregated cost data drawn from the General Ledger for Merchant Operations and EPM. Note that the costs exclude the costs of debt and equity associated with the capital invested and employed in AGL's divisions which are managed on a whole of business basis.

Table 1 Merchant Operations

	Year ended 30.06.13 \$ million	Proportion of total costs %
Labour	(151)	33.8
Contractor services	(114)	25.5
Other operating costs	(52)	11.6
Operating costs	(317)	70.9
Depreciation and amortisation	(130)	29.1
Operating cost including D&A	(447)	

20. Table 1 records the costs associated with AGL's owned and operated generation assets. In addition, AGL has long term power purchase agreements (**PPAs**) with owners of wind farms in particular, gas fired power stations Oakey and Yabulu in Queensland and other small co-generation sites. The contractual costs associated with the PPA's is accounted for within the EPM unit. This table excludes external revenue costs.

Table 2 EPM

	Year ended 30.06.13 \$ million	Proportion of total costs %
Net of assistance – carbon compliance	██████	██
Fuel – gas variable external	██████	██
Market charges	██████	██
Generation capacity costs	██████	██
Other costs	██████	██
Total Operating costs	██████	101*

* Proportion of total costs does not equal 100% due to rounding.

21. The costs of carbon recorded in table 2 are the liabilities associated with the Carbon Tax but are represented "net of" the financial assistance provided by the Commonwealth Government for the Loy Yang A Power Station under the transitional assistance provisions in relation to the introduction of the carbon tax. Table 2 also includes the costs of gas acquired by AGL as fuel to the Torrens Island Power Station and other gas fired generation owned by AGL. The cost of gas is in general a variable cost (noting that when AGL has gas contracts that have a take or pay provisions the costs have a fixed component). Because the cost of gas is in general variable it is accounted for in the financial reporting of the EPM business unit including so that managers within EPM have appropriate incentives and accountabilities in relation to their decision making.
22. EPM is responsible for making bids for dispatch of AGL's generation to the Australian Energy Market Operator (**AEMO**) in accordance with the National Electricity Rules. The NEM operates as a gross energy pool which means (with limited exceptions) all electricity generated by registered generators is settled at the spot price and AEMO pays the generators for that generation. Table 3 below sets out the "pool sales" receipts received by AGL for the financial year ending 30 June 2013. AGL's average pool receipt was ██████ on a per megawatt hour basis. Table 4 below sets out the "pool purchases" by AGL for the financial year ending 30 June 2013. AGL's average pool purchase price was ██████ on a per megawatt hour basis.



Table 3 NEM pool receipts (pool sales \$ and \$ per MWh)

Item	Value
Pool sales	██████████
GWh	20,545
\$ per MWh	██████████

Table 4 NEM pool purchases (pool sales \$ and \$ per MWh)

Item	Value
Pool Purchases	██████████
GWh	██████████
\$ per MWh	██████████

23. EPM also buys and sells "hedge contracts". In the ordinary course AGL generates financial information about its hedge trading on a "net basis" – that is, the net position having regard to receipts from hedges sold and payments in relation to hedges bought. Table 5 sets out the "net" position for the various categories of hedges and other risk management products traded by EPM.
24. Pool sales and pool purchases figures outlined in Tables 3 and 4 were extracted from the General Ledger and I subsequently calculated the \$ per MWh figures based on this information.

Table 5 NEM derivatives

	Year ended 30.06.13 \$ million
Hedges	██████████
Futures	██████████
Settlement residual auctions	██████████
Hedge premiums	██████████

25. The net positions of a [REDACTED] and [REDACTED] on hedge and futures trading for the period obscures the volume and value of trading that AGL undertakes over the course of a year. This information is also extracted from AGL's General Ledger. While AGL does not report on gross sales and payments in relation to hedges and derivatives I asked members of Greg Hade's team to calculate the gross or face value of contracts traded in the year ending 30 June 2013. This information is extracted from AGL's wholesale contract administration system and is set out in Table 6 below.

Table 6 Face value of derivative contracts traded

	Year ended 30.06.13 [REDACTED]
OTC	[REDACTED]
SFE	[REDACTED]

26. Merchant Energy is also responsible for the conduct of AGL's retail business for industrial and commercial customers (as distinct from mass market retail and small to medium sized businesses). Business Customers is the unit within Merchant Energy which manages AGL's approximately 20,000 Business Customer energy accounts, but not individual smaller industrial and commercial customers or consumer market customers. Like the "internal transfer price" between the Merchant Energy and Retail Divisions in AGL the internal financial reporting for the Business Customer Unit is undertaken on the basis of an "internal transfer price" from the EPM Unit. This reporting structure provides management within the Business Customers' Unit appropriate financial incentives and accountabilities. "Business Customers" may be described as large single site customers.
27. Table 7 sets out the revenue and certain (but not all) costs associated with the business of selling electricity to industrial and commercial customers for the year ending 30 June 2013, this information is extracted from the General Ledger.

Table 7: Business Customers

Electricity gross margin	Year ended 30.06.13 \$ million
Revenue	██████
Commodity and green transfer price (internal)	██████
Network charges	██████
Metering	██████
Market fees and charges	██████
Sales commissions	██████
Other	██████
Gross margin	65

Retail division

28. Table 8 below outlines the revenue and costs for AGL's retail business for the financial year ending 30 June 2013, this information is extracted from AGL's General Ledger. This table reports for both electricity and gas because many of the customer service costs are common.




Table 8 Retail revenue and costs

	FY13
Revenue	
- Electricity	3,541.7
- Gas	1,302.3
- Other fees and charges	82.6
Total Revenue	4,926.6
Cost of Sales	
- Electricity	(3,078.1)
- Gas	(1,064.3)
Total Cost of Sales	(4,142.3)
Gross Margin - Electricity	463.6
Gross Margin - Gas	238.0
Other fee and charges	82.6
Gross Margin	784.3
Operating Costs (excl D&A)	
- Labour & Contractor Services	(141.8)
- Net Bad Debt Expense	(48.0)
- Campaigns & Advertising	(76.4)
- Other	(86.9)
Total Operating Costs (excl D&A)	(353.1)
Depreciation & Amortisation	(75.6)
Operating EBIT	355.5

29. One of the costs of electricity is the internal transfer price paid by Retail to Merchant Energy described in paragraph 17 above.
30. Table 9 sets out AGL's customer numbers as at 30 June 2013. The customer numbers are outlined in AGL's published director reports and I have subsequently calculated the percentages for each fuel and state based on that information.



Table 9: AGL customer numbers

Customer Numbers ('000)					
	VIC	NSW	SA	QLD	Total
Elec	611	717	444	374	2146
Gas	482	683	129	77	1371
Total	1093	1400	573	451	3517
Elec	17.4%	20.4%	12.6%	10.6%	61.0%
Gas	13.7%	19.4%	3.7%	2.2%	39.0%
Total	31.1%	39.8%	16.3%	12.8%	100.0%

31. Based on the data contained in Tables 8 and 9, I have also calculated that the average electricity revenue per customer for the year ended 30 June 2013 was approximately \$1,650.

Suppliers of inputs to AGL

32. AGL has many suppliers of inputs, however I understand that Form S requires us to identify a representative sample of those suppliers. I instructed a member of my team to prepare a representative list of those suppliers, which I set out below.

Table 10

	Name	Contact details	Goods/services supplied	Value and location of supply
1.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
2.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
3.	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

3. Macquarie Proposal

33. In my role as Chief Financial Officer, I have been directly involved as part of AGL's executive team, in the consideration of the proposal by AGL to acquire the assets and business of Macquarie Generation from the NSW Government (**Macquarie Proposal**).
34. As outlined in the sale and purchase agreement, the Macquarie Proposal involves AGL acquiring the following assets from the State of NSW and Macquarie Generation:
- (a) the 2,640 megawatt (**MW**) coal-fired Bayswater power station located near Musswellbrook in NSW, and its related infrastructure;
 - (b) the 2,000 MW coal-fired Liddell power station located near Musswellbrook in NSW, and its related infrastructure;
 - (c) the 50MW open cycle Hunter Valley gas turbine located near the Liddell power station;
 - (d) the Liddell solar farm;
 - (e) the development site known as the "Bayswater B generation development site" which has Concept Approval under the former Part 3A of the *Environmental Planning and Assessment Act 1979 (NSW)* for the development of a new base load power station with a maximum generating capacity of 2,000 MW powered by either pulverised coal or natural gas, located 4km west of Bayswater, Musswellbrook in NSW;
 - (f) the development site known as the "Tomago generation development site" for which project approval has expired, located 15 km west of Newcastle;
 - (g) various contracts entered into by Macquarie Generation including hedge contracts, coal supply and haulage contracts, diesel supply contracts, operations and maintenance agreements, carbon trading agreements and connection and metering services agreements;
 - (h) various rights, obligations and interests in Macquarie Generation's registrations and authorisations required to operate the power stations;
 - (i) Macquarie Generation's other assets, rights and liabilities including policies of insurance, intellectual property, real property, equipment, consumables and spares,




(Macquarie Generation Assets). The contracts referred to above include the electricity sale and hedge contracts entered into by Macquarie Generation with Tomago Aluminium Company Limited Pty Ltd ABN 69 001 862 228 (**Tomago**) on behalf of the participants in the Tomago joint venture.

4. **NSW privatisation process - The "Energy Reform Strategy"**

35. The Macquarie Proposal followed a lengthy process of privatisation of NSW electricity generation assets. In 2010, I was involved in AGL's bid for certain electricity assets which were the first to be sold under the privatisation process. During this period I was Head of Finance for Merchant Energy. I have followed this process of privatisation through my time at AGL given the importance of the NSW generation assets to AGL's business and the possibility that AGL would seek to acquire those assets in the privatisation process as it intends to do through the Macquarie Proposal.
36. The privatisation process was commenced in November 2008, when the NSW Government commenced a partial privatisation process referred to as the "Energy Reform Strategy". This strategy consisted of four main elements:
- (a) the sale of the NSW Government retail businesses;
 - (b) contracting out of NSW Government owned generation (**Gentrader Contracts**);
 - (c) the sale of certain generation asset development sites; and
 - (d) retention of NSW Government ownership of the network and transmission infrastructure.
37. The Gentrader Contracts involved the sale of the wholesale trading rights for certain state-owned generators to the private sector. The owner of those rights (the Gentrader) pays capacity charges to the generators (which continue to be owned by the State) in consideration for the exclusive right to trade the electricity output of the power stations. The Gentrader is entitled to all revenue resulting from trading electricity in the National Electricity Market (**NEM**).
38. In 2010 to 2011, as part of this privatisation process, Origin Energy and TruEnergy (now EnergyAustralia) each acquired Gentrader contracts and a NSW retail business (ie a NSW customer base). In particular:
- (a) Origin Energy acquired the Eraring Gentrader "bundle", which included long-term wholesale trading rights for the Eraring and Shoalhaven power stations

(for 22 and 28 years, respectively, starting from 27 February 2011) and the Country and Integral retail businesses; and

- (b) TruEnergy acquired the Delta West Gentrader "bundle", which included long-term wholesale trading rights for the Mt Piper and Wallerawang power stations (for 33 and 19 years, respectively, starting from 1 March 2011), the EnergyAustralia retail business and several development sites.

39. During this time the sale of the electricity trading rights of Macquarie Generation and Delta Coastal were considered by the NSW Government, but not completed. The media release of the then Treasurer of NSW (**Treasurer**) is attached as **BAR-2**.

40. On 29 April 2011, the Honourable Brian Tamberlin QC was appointed to inquire into and report on the 2010-11 privatisation process (**Tamberlin Inquiry**). The Tamberlin Inquiry was required to report on (amongst other things) options for future action that could be undertaken to further the public interest in a competitive NSW electricity sector, including options to address any issues identified in relation to the transactions entered into during the 2010-11 privatisation process, and promote competitive electricity prices and ensure reliability of supply (at page 2).

41. In its final report released in October 2011, the Tamberlin Inquiry found (at page viii):

... that the decision to sell the gentrading rights was made [by the NSW Government] in the knowledge that it was a sub-optimal solution. The best option, however, was not available, that is the sale or long-term lease of the generators under legislative authority. [The Inquiry] accepts that some action was necessary to reform the electricity sector in light of the recommendations made by Professor Owen.

42. The Tamberlin Inquiry went on to state (at page xx):

The Inquiry does not consider that the objectives of a competitive electricity market or reliability of supply are advanced by maintaining the status quo; that is continued State ownership of more than half of the State's generation capacity or by the continuation of the gentrader agreements. However, to unravel the sales which have taken place would be costly and not in the interests of the State's reputation.

The Inquiry finds that it is consistent with a competitive electricity market that the retail businesses and wholesale generation businesses be privatised. It

accepts that the recommendations made by Professor Owen in his 2007 report were well-founded.

43. The Tamberlin Inquiry recommended (relevantly to the Macquarie Proposal) that "legislation be enacted to enable the Government to offer for sale or long term lease the Eraring and Delta West generators, which are subject to gentrading agreements and the Macquarie Generation and Delta Coastal generators" (at page xxi). Accordingly, one rationale and object of the current NSW Privatisation Process is to promote a competitive electricity market.

44. The Final Report of the Tamberlin Inquiry is attached as **BAR-3**.

5. Current NSW electricity generation privatisation process

45. On 24 November 2011, the NSW Government announced that it would implement the recommendations of the Tamberlin Inquiry. In particular, the NSW Government would introduce legislation to enable the sale of the State of NSW's electricity generation assets and electricity development sites. The proceeds of the sales would be put into crucial infrastructure projects across NSW, with at least a third directed to regional areas. The media release of the Premier of NSW is attached as **BAR-4**.

46. The legislation introduced to effect these sales, the *Electricity Generator Assets (Authorised Transactions) Act 2012 (NSW)* (**Authorised Transactions Act**), was assented to by the NSW Governor-General on 6 June 2012. This Act authorises the transfer of Eraring Energy, Delta Electricity and Macquarie Generation to the private sector and sets out various processes and obligations related to those transfers. In particular, section 6 of the Authorised Transactions Act requires the proceeds of any sales under the Authorised Transactions Act to be put into the Restart NSW Fund (**Fund**), which was established under the *Restart NSW Fund Act 2011 (NSW)* (**Restart Fund Act**). The purpose of Fund is to "improve economic growth and productivity in the State [of NSW]" under section 6 of the Restart Fund Act with particular types of infrastructure projects being identified. In addition, payments out of the Fund are limited to projects that promote a purpose of the Fund and various other administrative and statutory expenses of and payments from the Fund. The Authorised Transactions Act and Restart Fund Act are attached as **BAR-5** and **BAR-6** respectively.

47. On 11 September 2012 the Treasurer announced that a scoping study for the sale of the NSW electricity generation assets was underway. The media release of the Treasurer is attached as **BAR-7** and states:



"The sale of the State's electricity generators will release billions of dollars to put toward critical road, school and hospital projects across NSW, while also saving the State billions in avoided costs to meet future generation capacity needs."

48. On 15 November 2012, the Treasurer announced that the NSW Government would proceed with the sale of the NSW electricity generation assets. The sale process announced had two stages:

- (a) first, the assets of Eraring Energy (Eraring and Shoalhaven power stations) and western assets of Delta Electricity (Mount Piper and Wallerawang power stations) would be sold. These were the electricity generation assets for which the output was sold under Gentrader Contracts; and
- (b) second, the assets of Macquarie Generation (Bayswater and Liddell power stations) and the central coast assets of Delta Electricity (Colongra and Vales Point power stations) would be sold.

The media release of the Treasurer is attached as **BAR-8**.

49. The NSW Government has completed the first stage of this privatisation process by selling the assets of Eraring Energy and the western assets of Delta Electricity to Origin and EnergyAustralia (then called TRUenergy) respectively, who were the parties that held the matching Gentrader Contracts for those assets. In particular:

- (a) in August 2013, Origin Energy completed its acquisition of Eraring power station and the Shoalhaven Scheme under a sale and purchase agreement with the NSW Government for a net payment of \$50 million (Origin had also agreed the terms for cancellation of the Cobbora Mine coal supply agreement, which included a payment to Origin of \$300 million); and
- (b) in September 2013, EnergyAustralia acquired the Mt Piper and Wallerawang C power stations (and associated infrastructure) under a sale and purchase agreement with the State of NSW and Delta Electricity for a net cash consideration of \$160 million.

The media releases of the Treasurer announcing the sale of the assets of Eraring Energy to Origin and the sale of the western assets of Delta Electricity to EnergyAustralia are attached as **BAR-9** and **BAR-10** respectively.

50. The formal sale process in relation to Macquarie Generation was commenced on 11 September 2013, following the assent of the Authorised Transactions Act.

51. The sale of the assets of Macquarie Generation is the subject of AGL's application to the Australian Competition Tribunal and is discussed in section 6 below. The sale of the central coast assets of Delta Electricity is yet to commence.

6. Privatisation of Macquarie Generation

52. On 30 July 2013, the Treasurer announced the commencement of the sale of Macquarie Generation as part of the broader privatisation of the NSW electricity generation assets. The sale was to "unlock funds for critically needed infrastructure across NSW" in accordance with the Restart Fund Act "with 30% of funds reserved for projects in regional areas". The media release of the Treasurer is attached as **BAR-11**.

53. Macquarie Generation through the ownership and operation of the Bayswater and Liddell power stations is the most significant merchant generator in Australia and supplies generation capacity of 29.4% of NSW and 10.2% of the NEM.

54. On 30 July 2013, AGL received a Request for Expressions of Interest relating to the sale of the assets of Macquarie Generation. The Request for Expressions of Interest contemplated the sale of:

- (a) the Bayswater and Liddell power stations;
- (b) the Hunter Valley gas turbine; and
- (c) the Bayswater B and Tomago generation development sites,

and refers to the contractual arrangements for the sale of electricity and the management of financial risks, including electricity sale and hedge contracts with Tomago Aluminium and bilateral hedges.

55. The Request for Expressions of Interest permitted respondents to express interest in one or more of the Bayswater power station, Liddell power station, Bayswater B and Tomago generation development sites or all of the assets of Macquarie Generation and required expressions of interest to be received by 19 August 2013. Respondents were also requested to identify any approvals that may be required in order to submit a binding bid, including any approval required from the Foreign Investment Review Board (**FIRB**) and Australian Competition and Consumer Commission (**ACCC**).

56. The Request for Expressions of Interest is attached as **BAR-12**.

57. On 19 August 2013, AGL submitted its expression of interest for the assets of Macquarie Generation.



Indicative bid

58. On 30 August 2013, AGL was invited to make an indicative bid for the assets of Macquarie Generation. The invitation from the NSW Government to submit an indicative bid is attached as **BAR-13**. Following this invitation in early September 2013, AGL received from the transaction information memorandum and access to certain due diligence materials. The information memorandum sets out two transaction structures that the NSW Government was considering for the privatisation of Macquarie Generation:
- (a) an asset sale in which the assets and liabilities of Macquarie Generation are vested in the purchaser; and
 - (b) a share sale where the State of NSW establishes a company to transfer the assets and liabilities of Macquarie Generation into, or converts Macquarie Generation into a company registered under, the *Corporations Act 2001* (Cth) with the shares in the newly established or converted company being sold to the purchaser.
59. Details on the State of NSW's approach towards the transfer of employees (and protections for them) and environmental matters were identified in the Information memorandum. In addition, the information memorandum included further information about the assets of Macquarie Generation and the performance of those assets, Macquarie Generation's maintenance strategy and Macquarie Generation's financial performance. The information memorandum is attached as **BAR-14**.
60. AGL's executive team developed an indicative bid of [REDACTED] million for Bayswater and [REDACTED] million for Liddell, which was considered by the Board on 18 October 2013. On 21 October 2013, AGL submitted an indicative bid in accordance with the decision of the Board.

Binding bid

61. On 4 November 2013, the NSW Government notified AGL that it had been accepted to participate in the binding bid phase for the Macquarie Generation Assets by letter received from Goldman Sachs. This letter required AGL to submit a fully underwritten and legally binding bid by 10am on 28 January 2014. This deadline was later extended by a letter to AGL on 6 December 2013, till 10am on 5 February 2014. The letter requesting binding bids specified that the NSW Government intended to select either one shortlisted bidder for the all of the Macquarie Generation Assets or one shortlisted bidder for each of the Bayswater and Liddell power stations. In addition, AGL was requested to confirm that it did not require

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approval from either the FIRB or ACCC and, if required, that those approvals had been obtained.

62. The letter requesting binding bids also set out arrangements for AGL to meet with the NSW Government's advisors on the sale of Macquarie Generation and to undertake a site visit of the Macquarie Generation Assets. The letter requesting binding bids is attached as **BAR-15**.
63. I understood that ERM Power Limited (**ERM**), Marubeni Corporation (**Marubeni**) and China Shenhua Energy Company (**Shenhua**) were potential bidders but only ERM and Marubeni proceeded to make a bid. I discuss the likelihood of a bid from ERM and Marubeni either Individually or together in section 10 below.
64. In order to comply with the request for binding bids, I understand that Michael Fraser, AGL's Chief Executive and Managing Director, informed Mr Rod Sims, the Chairman of the ACCC, of its intention to seek clearance to acquire the Macquarie Generation Assets on 22 November 2013. AGL's advisors lodged its application for informal clearance on 29 November 2013. The informal clearance contemplated the acquisition of:
- (a) the Bayswater and Liddell power stations, together with the relevant associated wholesale risk management portfolio and major contracts (including the electricity supply contracts with Tomago);
 - (b) the Hunter Valley gas turbines; and
 - (c) the Bayswater B development site,
- the application was amended by AGL's advisors on 5 December 2014 to also include the possible acquisition of the Tomago development site.
65. AGL did not expect the ACCC to reach a decision on AGL's informal clearance application until late February to mid March 2014, which meant that AGL's binding bid would be conditional on receiving ACCC clearance. I understand that AGL advised the State of NSW of this in early December 2013.
66. In addition to applying to the ACCC for informal clearance, AGL employees and advisors attended meetings the NSW Government's advisors and the site visit at Macquarie Generation and undertook further due diligence of the Macquarie Generation Assets. The Board were updated on the Macquarie Proposal on 10 December 2013.



67. The Board met between 17 and 21 January 2014 to consider AGL's binding bid for the Macquarie Generation Assets. The papers considered by the Board were:

- (a) "Proposal to Acquire Macquarie Generation" dated 21 January 2014;
- (b) "Project Hunter: Supplementary Materials" dated 21 January 2014;
- (c) "Project Hunter: Due Diligence Presentation" dated January 2014;
- (d) "Project Hunter Technical Due Diligence" dated 17 January 2014 and
- (e) "Project Hunter: Macquarie Generation Valuation Analysis" dated 14 January 2014.

As the Chief Financial Officer, I had principal responsibility for supervising the development of the investment case for the Macquarie Generation Assets considered by the Board at those meetings, and the valuation of those assets. I have also attended all board meetings at which they have considered the Macquarie Proposal. The board papers are attached as **BAR-16, BAR-17, BAR-18, BAR-19** and **BAR-20** respectively.

68. On 21 January 2014, the AGL Board approved AGL making a binding bid for the Macquarie Generation Assets of up to [REDACTED] on the condition of receiving clearance from the ACCC. The final bid was to be determined by the Chairman of the Board and the Chief Executive. The Board minutes recording this decision are attached as **BAR-21**.

69. From the receipt of the letter requesting binding bids and the board meetings between 17 and 21 January, I considered in detail how AGL would operate the Macquarie Generation assets for the purpose of assessing their value. In particular, I considered AGL's approach to managing the financial risks from acquiring additional generation in NSW in light of AGL's Wholesale Energy Risk Management Policy (**WERMP**) and Treasury Policy, and the likely operation of the Liddell power station. I discuss these issues in more detail in sections 11 and 12 below.

70. On 5 February 2014, AGL submitted a binding bid to acquire the Macquarie Generation Assets for \$1.505 billion conditional on AGL receiving clearance from the ACCC. A copy of AGL's binding bid is attached as **BAR-22**. The NSW Government accepted AGL's bid and AGL entered into a binding agreement with the State of NSW and Macquarie Generation for the sale and purchase of the Macquarie Generation assets on 12 February 2014 (**Agreement**). I describe the relevant terms of the Agreement in section 8 below. A copy of the Treasurer's media release and AGL's ASX announcement announcing the sale and purchase of the Macquarie

Generation Assets are attached as **BAR-23** and **BAR-24**. The Treasurer's media release stated:


- (a) "I have always been clear that the Government would proceed with the sale of state-owned assets only when the sale price offered exceeded the retention value of those assets – that is, the value of the assets if they remain in Government hands";
- (b) "Of the three bids received, AGL Energy was the only one that exceeded retention value"; and
- (c) "Should the ACCC not provide clearance to AGL Energy, the Government will not proceed with the sale of Macquarie Generation at this time".

7. **AGL's rationale for the Macquarie Proposal**

71. AGL's strategic rationale for the Macquarie Proposal considered by the Board and Executive are set out below:

- (a) **Internal rate of return:** The Macquarie Proposal gives AGL an opportunity to earn an internal rate of return which exceeds AGL's hurdle rate of [REDACTED].
- (b) **Supplying AGL's existing NSW load:** AGL's load in the NSW region is 9.1TWh per annum. Without any dispatchable generation in NSW, AGL currently spends approximately \$650-700 million per annum acquiring electricity from the market to supply its customers. AGL currently uses a mix of surplus generation in Victoria and market contracts to hedge its NSW position. However, AGL's surplus Victorian generation capacity will reduce from 2016 as new Victorian contracts commence. The Macquarie Proposal allows AGL to manage the risk from its NSW load with the Macquarie Generation Assets.
- (c) [REDACTED]
[REDACTED] Both power stations are located close to cost competitive coal mines in the Hunter Valley.
- (d) **Lowest short run marginal cost generators in NSW:** The Bayswater and Liddell power stations are the lowest short run marginal cost generators of scale in NSW meaning that they should always be dispatched by AEMO ahead of any other coal fired plant (other than the 150MW Redbank power station). The carbon intensities of Bayswater and Liddell are similar to the market

average so any change in carbon pricing is unlikely to change their position for dispatch.

- (e) **Portfolio management:** The Macquarie Proposal will significantly improve AGL's ability to manage its load across all states of the NEM. The generation capacity of Bayswater and Liddell will help manage factors such as temperature (as it impacts electricity demand) and planned and unplanned outages in AGL's generation portfolio, which includes wind (intermittent), gas fired (peak or intermediate) and coal fired (base load).
- (f) **Lowering AGL's cost of funding:** Increasing the quantity of self-supplied generation will reduce the risk of earnings volatility. AGL expects that this will be reflected in its credit rating agency, Standard & Poors, lowering its hurdle rate for maintaining a BBB credit rating. I discuss AGL's credit rating further in section 12 below.
- (g) 
- (h) **Earnings balance for investment portfolio:** AGL's near term earnings will be improved by the Macquarie Proposal because the earnings of the Macquarie Generation Assets are weighted towards the beginning of the next 10 years. This will balance the cash flows from AGL's other recent investments, particularly in upstream gas and renewables, which will generate their earnings later in the next 10 years.

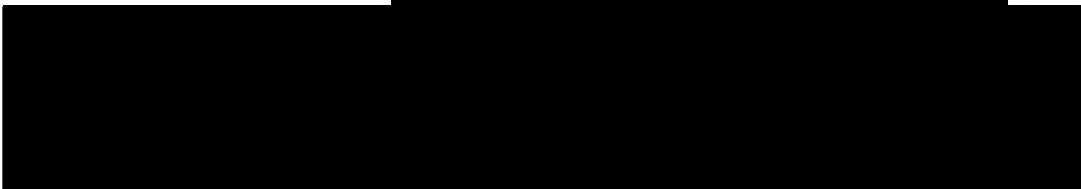
8. Agreement

72. Under the Agreement, AGL acquires the beneficial title to and risk in the Macquarie Generation Assets vesting in AGL free of any security interests on and from completion. In addition to the transfer of the Macquarie Generation Assets, the Treasurer will make an order vesting the business carried on by Macquarie Generation in connection with the Macquarie Generation Assets in AGL by the date on which completion occurs. Various arrangements and obligations are also set out in relation to the employment and superannuation of Macquarie Generation's employees. The consideration paid by AGL is the binding bid of \$1.505 billion,



which is subject to an adjustment mechanism for working capital. The Agreement is attached as **BAR-25** (schedules (9 and 15) and the 4 Annexures to the Agreement ~~are not attached to this statement due to their size These materials are available on request~~).

73. The transfer of the Macquarie Generation Assets was scheduled to occur on 15 April 2014 (**Completion Date**) with the vesting of the Macquarie Generation business in AGL occurring by that date. However, this scheduled completion date was subject to various conditions being satisfied by AGL, the NSW Government and Macquarie Generation and other events,



74. One of the approvals that AGL was required to obtain was from the ACCC. The Agreement deals with this separately from the conditions for completion with AGL being required to obtain notification from the ACCC by 5 March 2014 that it did not propose to oppose, seek to prevent or otherwise object to the Macquarie Acquisition (**ACCC Approval**). As I discussed in section 6 above, ACCC Approval had been the subject of requirements during the bidding process and AGL's binding bid was given on condition that such approval was obtained.

9. ACCC Approval

75. In accordance with these requirements AGL submitted an application for informal clearance to the ACCC on 29 November 2013 (**Clearance Application**). I understand that AGL and its advisors had various communications and meetings with the ACCC following the Clearance Application. I discuss the ACCC's requests for further information in relation to AGL's management of financial risks and hedging strategy in section 12 below.
76. The ACCC published a statement of issues for the Macquarie Proposal on 6 February 2014 (**SOI**). The SOI identified increased barriers to entry and expansion in the market for the retail supply of electricity in NSW as an issue of concern and the horizontal aggregation of generation, which may substantially lessen competition in the wholesale energy market, as an issue that may raise concern. The SOI is attached as **BAR-26**.
77. On 17 February 2014, AGL responded to the SOI by submitting an undertaking to the ACCC under which:

- (a) AGL would make available for sale 500MW (being a notional quantity of 250MWh per half hour trading interval) of financial products (excluding put options) referenced against the NSW spot price for electricity in each half hour trading interval, net of any quantity Macquarie Generation has sold to retailers (defined to be a person holding a NSW retail authorisation and Australian financial services licence unless exempt, but excluding AGL, EnergyAustralia and Origin - Retailer) prior to the Completion Date, for that trading interval;
- (b) AGL would be required to negotiate with Retailers who approach AGL for contracts in good faith; and
- (c) provided AGL has not already met its obligation to sell 500MW, in order to ensure that this quantity is available at a competitive wholesale price to competing Retailers, AGL will, on every trading day offer at least 50MW of contracts that are for products equivalent to those available on a futures exchange, which are priced at or near current futures market prices.

AGL also made a submission supporting its proposed undertaking and provided the ACCC with a summary of its terms.

- 78. In addition, on 20 February 2014, AGL made a submission to the ACCC on the SOI. AGL's submission rejected the ACCC's concerns that the Macquarie Acquisition would increase barriers to entry in the retail electricity market and that the Macquarie Acquisition would result in a substantial lessening of competition in the wholesale electricity market.
- 79. On 4 March 2014, the ACCC announced that it would oppose the Macquarie Acquisition because the ACCC considered that it was likely to result in a substantial lessening of competition in the market for the retail supply of electricity in NSW. The ACCC also remained concerned about the effect of the Macquarie Acquisition on competition in the wholesale electricity market, but did not conclude that the Macquarie Acquisition would result in a substantial lessening of competition in that market. The ACCC's media release is attached as **BAR-27**.

10. Status of the Agreement

- 80. On 20 March 2014, the NSW Treasury wrote to AGL confirming that the agreement would remain on foot and that it would only transact with another entity on terms acceptable to it, including that the transaction value exceeds the State's retention value. A copy of that letter is attached at **BAR-28**.

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81. Following notice from the ACCC that it would object to the Macquarie Acquisition, either AGL or the NSW Government may terminate the Agreement (but have not done so at the time of making this statement). The Macquarie Acquisition will not proceed in its current form without clearance from the ACCC or authorisation from the Australian Competition Tribunal. The Agreement will not therefore complete and AGL will not acquire the Macquarie Generation Assets under it as a result of not obtaining ACCC Approval. The Treasurer's media release and AGL's ASX announcement are attached as **BAR-29** and **BAR-30** respectively.
82. I do not believe that it is likely that the NSW Government will sell the Macquarie Generation Assets to any person other than AGL because, after a lengthy bidding process, AGL was the only party to make a binding bid that exceeded the State of NSW's retention value of the assets. The NSW Government would therefore be more likely to retain the Macquarie Generation Assets rather than to privatise them at the current point in time.
83. I also do not believe that ERM and Marubeni are likely to significantly increase their bid for the Macquarie Generation Assets. As outlined above, the sale process was commenced on 11 September 2013 and they have been aware of AGL's binding bid price since at least 12 February 2014.
84. On the basis of NSW Treasury's press release on 12 February 2014 and on the basis of the letter I received on 20 March 2014 I believe that the NSW Government has made it clear that it will not consider a sale of the Macquarie Generation Assets unless it exceeds their retention value and is in the best interests of taxpayers.

11. Intended operation of the Macquarie Generation Assets

85. Consistent with AGL's rationale for the Macquarie Acquisition, AGL intends to operate the Macquarie Generation Assets for the remainder of their economic lives subject to any unanticipated or unexpected catastrophic equipment failure or other change and to manage the financial risks from the Macquarie Generation Assets in accordance with AGL's WERMP.
86. AGL intends to operate the Liddell power station until 2017, maintaining options to operate it until 2022 (the end of its economic life) [REDACTED].
87. I believe that AGL's intended management of the Bayswater and Liddell power stations is consistent with industry best practice. In particular, it is common for an old generation unit at a power station to be retired so that its assets can be re-used to maintain the availability and economic life of the remaining generation units as



AGL proposes to do at the Liddell power station at a time that is yet to be determined.

88.

[REDACTED]

89. The ACCC has raised the issue of the closure of the Liddell power station in its Statement of Issues published on 6 February 2014. At paragraph 78 of the Statement of Issues the ACCC states:

"The ACCC is considering whether AGL would have an incentive (compared to a different purchaser or the status quo) to operate Liddell power station less often, mothball generation units or otherwise prematurely retire the Liddell power station altogether in order to withhold supply".

90. The investment case adopted for the bid valuation for the Macquarie Generation Assets was conservative and incorporated a potential downside scenario [REDACTED]. AGL's intended operation of the Liddell power station described above is based on this valuation.

91. Macquarie Generation has three contracts for the sale and hedging of electricity to Tomago:

- [REDACTED]
- [REDACTED]
- [REDACTED]

92.

[REDACTED]

[REDACTED]

93. [REDACTED]

94. [REDACTED]

95. The suggestion that AGL may "prematurely retire the Liddell power station altogether in order to withhold supply" has not been considered by AGL and nor do I consider it to be a scenario that could be responsibly considered. If the transaction proceeds the Liddell power station will be a material asset which will be exploited for the remainder of its economic life assuming there is no unanticipated or unexpected catastrophic equipment failure or other change.

12. Management of wholesale financial risks and liquidity

96. The ACCC considered AGL's management of its financial risks from the Macquarie Generation Assets following its release of the SOI. In particular, the ACCC sought information from AGL and its advisors on the likely effect of AGL adopting one or more hedging strategies following the Macquarie Proposal. I understand that the ACCC was seeking to understand whether AGL may have an incentive to decline to supply hedge contracts (including in NSW) including in order to try to increase the pool price in the NEM.



97. I am aware that these communications included a request for information by the ACCC for:
- (a) modelling results by Frontier Economics showing the pool price impacts of the Macquarie Proposal assuming a hedging rate of 0%, 25% and 50% for all of AGL's generation assets on 15 January 2014; and
 - (b) the underlying data for the additional modelling results requested on 15 January 2014, further information in relation to the model and the results and underlying data from the model for the years 2015 and 2017 on 7 February 2014.
98. A copy of the ACCC's 15 January 2014 request is attached as **BAR-31** and a copy of the ACCC's 7 February 2014 request is attached as **BAR-32**. I understand that the scope of the request made by the ACCC was narrowed following receipt of the letter on 15 January 2014 and that only modelling results assuming a hedging position of 25% and 50% for all of AGL's generation assets were provided to the ACCC.
99. I understand the request of modelling results of 25% and 50% of AGL's generation assets to be a request for pool price modelling outcomes using Frontier Economics modelling techniques with an input being an assumption that 75% and 50% of AGL's scheduled generation portfolio would be exposed to pool prices (as a consequence of not having corresponding hedge contracts in place).
100. If the Macquarie Acquisition proceeds, AGL will manage the financial risks from the Macquarie Generation Assets in accordance with AGL's WERMP and in a manner consistent with AGL's Treasury Policy. I discuss the effect of these policies on AGL's management of financial risks and hedging strategies in this section. I refer to factual analysis undertaken by AGL to assess the financial risk from undertaking a hedging strategy under which AGL's generation assets are hedged at a rate of 25% and 50%. In each case, the analysis was undertaken by staff working at AGL and is the analysis that would be considered by AGL senior management team when assessing the risks of undertaking such a hedging strategy. This work was undertaken in order to respond to the ACCC's requests for information on 15 January 2014 and is not the result of AGL considering adopting such hedging strategies if the Macquarie Acquisition proceeds.
101. I explain the process used by AGL to assess the risks of undertaking any hedging strategy and the process that would be used by AGL's Energy Portfolio Management (**EPM**) team. I will give my view, as a member of the RMC, as to the likelihood of AGL undertaking the hedging strategies assumed by the ACCC and explain the likely impacts of such strategies on AGL's credit rating and liquidity position.



WERMP

102. The WERMP governs AGL's management of risk in its wholesale energy activities including the generation of electricity. The hedging of AGL's generation assets is governed by the WERMP. The WERMP is attached as **BAR-33**.
103. AGL will manage the financial risks (including in respect of hedging strategies) from the Macquarie Generation Assets in accordance with the WERMP.
104. The effect of these hedging strategies and the purpose of the WERMP is to limit AGL's exposure to the spot price for electricity to acceptable levels. The effect of hedging strategies where AGL has a hedging rate of 25% or 50% across AGL's generation assets as contemplated by the ACCC would be for AGL to be exposed to the spot price by 75% and 50% respectively.
105. The WERMP is approved by the Board. It delegates various responsibilities for the management of risk, including the setting of trading limits for authorised staff. The RMC has a central role under the WERMP and is responsible for overseeing the risk management operations of AGL subsidiary companies with wholesale energy market exposures including the development and management of the WERMP. The Audit and Risk Committee of the Board has compliance oversight of the WERMP. Michael Fraser, as the Chief Executive Officer and Managing Director, is responsible for authorising staff to perform trading-relating functions and the maximum limits for wholesale energy transactions. The RMC meets monthly to consider the risk position of AGL, compliance with various risk management requirements and to review any proposed changes or significant new approaches to AGL's trading strategies. The RMC receives weekly reporting on the risk position of AGL, including the latest projections of the "Earnings At Risk" measure, which I describe below.

Economic risk limit and earnings at risk

106. The WERMP sets out an "Economic Risk Limit" (**ERL**). The ERL for wholesale energy is set by the Board to ensure that the level of risk relating to AGL's wholesale energy activities must be such that AGL's net profit after tax (**NPAT**) outcomes have a low probability of preventing [REDACTED] of projected NPAT being distributed to shareholders as dividends. The ERL has been calculated so that the risk of losses jeopardising a [REDACTED] distribution to shareholders should only be expected to occur 1 year out of 10. A number of factors are considered when setting the ERL including:
- (a) the minimum level of risk capital for base wholesale operations required to support AGL's retail business;



- (b) an acceptable level of risk capital which would allow AGL to choose to take some exposures with the objective of minimising wholesale energy costs while maintaining a level of risk management; and
- (c) sufficient "headroom" to ensure that AGL should be able to pay its dividend with high probability.
107. The current ERL for wholesale energy has been set at [REDACTED] against earnings before income and tax (**EBIT**) before the Managing Director must be notified and [REDACTED] against EBIT before the Board must be notified. The RMC is responsible for setting trading limits below these amounts and for dividing the ERL into ERLs for geographic regions. While the inclusion of the Macquarie Generation Assets in AGL's asset base will increase AGL's EBIT, I do not believe that the ERL will change significantly if the Macquarie Acquisition proceeds given that integration risks from the Macquarie Generation Assets will also be considered when setting the ERL.
108. The ERL is assessed against the total of the market risk measure, credit risk measure and operational risk measure. Hedging rates primarily affect the market risk measure. Market risk is calculated using an EBIT (or earnings) at risk measure (**EAR Measure**), which calculates the potential deterioration in the wholesale energy portfolio in a financial year, at a probability of 1 in 10 years. The EAR Measure is calculated by the Wholesale Energy Risk Management Team, which is led by the Head of Wholesale Energy Risk Management, Gary Gavin. Gary Gavin reports to Paul McWilliams, who is the Group Head of Corporate Support Services and Company Secretary.
109. The EAR Measure is derived from adverse movements in parameters such as demand and market (spot, supply) price. It uses 13 years of historical spot electricity prices, which is adjusted to reflect AGL's hedging position. This model is used to calculate the average return on the portfolio in a financial year and the potential deterioration in the value of the portfolio in a financial year, at a probability of 1 in 10 years. The difference between these two amounts is the EAR Measure, being the maximum change in the return on the portfolio at a probability of 1 in 10 years that would ensure that AGL could continue to distribute [REDACTED] of NPAT to shareholders.
110. The EAR Measure is a reasonable proxy of the impact on AGL's forecast and disclosed earnings in 1 year out of 10 with respect to the specified level of hedging of AGL's generation assets.

Application of WERMP to the ACCC's assumed hedging rates


111. The EPM team is responsible for developing the trading strategies for new generation assets, such as the Macquarie Generation Assets. In addition, any trading strategy in which AGL targeted a hedging rate for its generation assets (including those contemplated by the ACCC) would be developed by the EPM team. The Head of Finance for Merchant Energy, who is one of my direct reports, is a member of the Merchant Energy leadership team that would review such a strategy.
112. The EPM team would consider the impact of the proposed hedging strategy on AGL's EAR and its position against the ERL, which would be calculated by the Wholesale Energy Risk Management team. I also expect that the EPM team would advise of such a strategy to the Wholesale Strategy Committee and that the strategy would be tested against the ERL and the RMC would be notified if it was realised that the ERL would be exceeded. If the strategy proceeded in spite of this expected breach of the ERL, the RMC would then notify the Managing Director and/or the Board depending on the EAR calculated.
113. The Head of Wholesale Energy Risk Management, and members of his team have calculated the EAR Measure associated with the hedging rates specified by the ACCC. The EAR model does not currently incorporate the Macquarie Generation Assets and the exercise associated with adjusting the model requires time and verification. Consequently, in order to determine the EAR Measure associated with the ACCC specified hedging rates a volume of (bought) swap and cap contracts were calculated by the EPM team to simulate an AGL generation portfolio which included those assets and assumed a 25% and 50% hedging rate across AGL's portfolio.
114. The results of the EAR model run with these assumptions for a hedging rate of 25% and 50% across AGL's generation assets (excluding Queensland) are set out in Table 11 below.



Table 11

Region	Earnings at Risk (\$m) - 25% hedging rate	Earnings at Risk (\$m) - 50% hedging rate	Economic Risk Limit (\$m)
ALL	268.02	193.71	████████
NSW	189.20	136.87	████████
Queensland	42.33	11.13	████████
South Australia	32.69	29.73	████████
Victoria	85.35	61.26	████████

115. The figures set out above do not assume a hedging rate of 25% or 50% for AGL's Queensland generation assets because of the small generation capacity of those assets.
116. I have reviewed these results and consider that they have been developed in a manner consistent with the process that the Wholesale Energy Risk Management team would use in the ordinary course to establish the EAR Measure from a particular trading strategy, although with various work-arounds to take account of the fact that the Macquarie Generation Assets are not currently incorporated in AGL's EAR model.
117. The EAR for hedging rates of 25% and 50% shown above exceed the ERL set by the RMC for each region other than Queensland. The overall limit is exceeded for hedging rates of 25% and 50% as well and exceeds the ERL that may be approved by the Managing Director under the WERMP. Such a strategy would therefore require the approval of the Board under the WERMP.
118. I do not believe that the Board would contemplate amending the WERMP to allow a hedging strategy of 25% or 50% for all of AGL's generation assets as I explain further below, including because this would involve AGL either acquiring hedge contracts to manage the risk of its customer demand or leaving this customer demand exposed to the spot price. Any trading strategy under which AGL did not offer substantial hedges sourced from the Macquarie Generation Assets would be likely to exceed the ERL. Instead, I believe it more likely that AGL would adopt a hedging rate of 75-80% for the Bayswater power station and up to 65% for the Liddell power station because it is consistent with the WERMP and would not require approval from the Board. ██████████


Market disclosure

119. In AGL's half-year and annual reporting to the Australian Securities Exchange, AGL includes a description of AGL's risk strategy that is set out in the WERMP. A copy of AGL's most recent disclosure to the Australian Securities Exchange is attached as **BAR-34**.
120. I consider that a change in the WERMP to allow a hedging rate in excess of the current ERL would require AGL to notify the ASX because if that change is caused by a fundamental change to how AGL calculates or manages its risk. The hedging rates of 25% and 50% contemplated by the ACCC would fall into this category and would have to be disclosed to the ASX in my view. In addition, I consider that the reduced likelihood of being able to pay a dividend as calculated by the EAR would also need to be disclosed to the ASX as would any change to AGL's dividend policy that would be required allow AGL to increase its ERL.
121. I would expect based on my experience that AGL's share price would reduce as a result of these disclosures. AGL's share price reflects its management of risk and a change in the WERMP that results in AGL being able to take on greater risks would be likely to reduce AGL's share price.
122. In my view, it is highly unlikely for the Board to approve a change in policy that would have the effect of reducing AGL's share price because doing so will increase AGL's cost of funding, which is not in the best interests of AGL's shareholders.

Credit rating

123. The Treasury Policy requires AGL to maintain a BBB credit rating with Standard & Poors. AGL's credit rating gives it access to greater debt facilities at lower costs and greater access into international capital markets.
124. As Chief Financial Officer, I have regular discussions with Standard & Poors about AGL's credit rating. Standard & Poors consider a number of factors when assessing AGL's credit rating including, AGL's interest cover, debt cover, debt/EBIT ratio, company risk, country risk and industry risk.
125. When AGL acquired the Loy Yang Power Station in 2011, Standard and Poors discussed with me possible integration risks from the acquisition. Similarly, I have discussed the Macquarie Acquisition with Standard & Poors in recent meetings given

that the acquisition is likely to change AGL's risk position (both in respect of its physical operation and its exposure to pool prices).

126. A key factor in any discussion about the integration and operation of the Macquarie Generation assets is the WERMP. Any material change to the WERMP that increases AGL's risk position by increasing AGL's exposure to the spot price of electricity (such as a change in the WERMP to permit AGL to implement a hedging strategy of 25% or 50% of AGL's generation assets) would result in a very real risk that AGL would lose its BBB credit rating.
127. In the event of a downgrade, AGL would encounter the following implications:
- (a) increased funding costs on existing and new debt facilities;
 - (b) restricted ability to access offshore capital markets; and
 - (c) new or increased prudential requirements, including the need to provide credit security to market counter-parties.

Treasury Policy

128. The Treasury Policy also limits the hedging strategies that AGL may implement. The Treasury Policy sets out a liquidity buffer that AGL must maintain. The liquidity buffer represents AGL's callable cash in 24 hours and is currently set at a minimum of [REDACTED]
129. This liquidity buffer would need to be increased if AGL's hedging rates were significantly reduced and correspondingly, hedging rates were significantly increased, (including if 25% and 50% hedging levels assumed by the ACCC were adopted) because AGL will require greater reserves of callable cash to meet AGL's increased exposure to the spot price and increase risk in volatility of operating cash flows. In order to increase the liquidity buffer, I would have to submit a recommendation to AGL's Board of Director's Audit and Risk Committee for recommendation to, and approval by, the Board.
130. I do not consider that the Audit and Risk Committee would make, or that the Board would approve, such a recommendation given that it would need to be raised solely to support the hedging strategy which breaches the ERL and because maintaining a greater liquidity position would require additional finance.
131. A copy of AGL's Treasury Policy is attached as **BAR-35**.



Inconsistent with rationale of the Macquarie Acquisition

132. As I explained in section 7 above, one of the rationales for proceeding with the Macquarie Acquisition is to reduce earnings volatility and increase AGL's balance sheet in order to support future investment. Amending the WERMP to allow AGL to take on more exposure to the spot price for electricity through reduced hedging rates is inconsistent with this rationale because it would increase AGL's cash flow volatility, and increase the cost of funds through reductions in AGL's share price and credit rating. I do not believe that the Board would approve AGL acting inconsistently with that rationale following the Macquarie Acquisition. Such a scenario would call into question the rationale for proceeding with the Macquarie Acquisition in the first place and would be inconsistent with AGL's investment strategy.

13. AGL's commercial incentive to supply hedge contracts in NSW

133. In my capacity as Chief financial Officer I receive financial information from the three operating divisions of AGL referred to in paragraph 8 above and I am responsible for the financial reporting by each of these divisions. In this role I am required to have a sound understanding of the financial performance of the divisions and the factors that drive that financial performance. In particular I have a clear understanding of the operating conditions faced by the Merchant Energy Division and the Retail Division and the incentives that influence business decision making.

134. To the extent that AGL has insufficient generation, or just enough generation to meet its retail load, it will have minimal commercial incentive to supply hedge contracts to third parties in NSW. However, to the extent that AGL has generation capacity available that exceeds the demand of its retail customers, AGL will have an incentive to supply hedge contracts in NSW.

135. The ACCC considered whether AGL would have an incentive to sell hedge contracts to third parties, and in particular independent retailers, and expressed concerns in the SOI that AGL would not have this incentive and would therefore withhold such contracts. I note that in paragraph 61 of the SOI issued by the ACCC on 6 February 2014 it stated:

"The ACCC's preliminary view that the proposed acquisition is likely to substantially lessen competition in the retail supply of electricity in NSW as a result of ...the increased incentive of AGL to withhold competitively priced and customised hedge contracts to independent retailers."

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136. I am of the view that it is entirely within AGL's interest to sell hedge contracts to third parties, and in particular independent retailers, not only to manage the risk of earnings volatility, but also to maximise a commercial return.
137. I am aware, including as a result of the period I spent as Head of Finance Merchant Energy and Upstream Gas Division, that hedge contracts are traded at a premium to the expectations of future spot prices. I also understand that retrospective analysis of contract prices as against actual spot price outcomes is consistent with the proposition that contracts trade at a premium to the pool price. Similarly, there is a margin to be gained by selling electricity to retail customers. To the extent that AGL has generation capacity that exceeds its customer demand, it will seek to maximise profit by selling hedge contracts in order to earn a premium over what it would otherwise earn selling electricity into the spot market, and it will seek to acquire additional retail customers in order to earn a margin. To simply have that excess generation capacity earning the spot price does not maximise profit to AGL.
138. On a whole of business basis I believe the appropriate way in which to consider this question of incentives is to ask what does AGL gain by selling a hedge contract to an independent retailer in NSW and what does AGL potentially lose by doing so. In selling a contract, AGL locks in the premium over the spot price but may lose some margin earned from the portion of retail customers that it may lose to its competitor.
139. The Head of Finance Merchant Energy has, with other AGL analysts, undertaken an analysis on the financial impacts of selling hedge contracts to third parties, and in particular, independent retailers. The results of this analysis are set out in the following paragraphs.
140. These calculations involves estimates of margins based on data drawn from AGL's General Ledger and are performed in order to illustrate what the businesses incentives are.
141. The premium of the hedge contract price over the actual NSW spot price was calculated for the period from 1 January 2012 to 31 December 2013. Over this period of time the price of hedge contracts in NSW exceeded the spot price in NSW for the same period by, on average, \$8.41/MWh.¹ This is the additional profit AGL could have made if it had excess generation that could have been sold as hedge

¹ This has been calculated by averaging the difference between the contract prices for the periods of calendar year 2012 and the actual pool price for 2012 and the difference between the contract prices for calendar year 2013 and the actual pool price for 2013. The contract prices are for flat swaps and have been sourced from ICAP, an energy market broker that records market contract prices on a daily basis and distributes this information to its clients.

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contracts to third parties for this period, rather than simply selling this excess generation into the spot market.


142. If AGL provides hedge contracts to a retail competitor, that retailer wins customers from AGL and also AGL's major competitors (EA and Origin).
143. To the extent that AGL had sold a 20MW hedge contract for a year during this period, the total value of the contract premium to AGL from this transaction would have been \$1,473,432 (20MW times 8,760 hours times \$8.41 /MWh).
144. This transaction has minimal operating costs associated with it and the effort required to execute and administer this transaction could be managed within AGL's existing cost structure.
145. As part of the analysis I requested to be undertaken, I asked how many retail customers a third party retailer could acquire with a 20MW hedge contract. The answer to this is dependent upon many factors, including the pattern and quantum of consumption of those customers throughout the day and seasons, and the risk management practices of the retailer. I am aware that this analysis has therefore been undertaken with reference to the aggregate average pattern and quantum of consumption of the customers that AGL supplies in NSW (this includes mass market and commercial and industrial customers). The risk management practices of the retailer are assumed to be prudent in that a combination of swap and cap contracts are used to hedge the maximum demand of the customers. With these assumptions as a reference point, I was advised that a retailer could acquire 16,364 customers.²
146. Given that AGL has approximately a 15% share of the volume of electricity sold in NSW (on the basis of electricity consumption excluding the demand of the Tomago smelter), it could reasonably be expected that an independent retailer would acquire 2,515 customers from AGL. This data is drawn from the General Ledger, AEMO data and AGL estimates of load shaping of customer demand.
147. I am aware that the gross margin AGL earned from selling to retail and business customers in NSW in FY2013 was approximately [REDACTED] customer. To the extent that

² This has been determined by reference to the following calculation: Customer consumption divided by the number of hours in the year divided by the customer load factor to determine the customer maximum demand. It is assumed that 40% of the customer maximum demand is met by a flat swap contract (efficiency of managing the portfolio means that a combination of swaps and caps would be used to meet customer maximum demand). Based on 40% of customer maximum demand being met by the swap contract a 20MW flat swap would service 16,364 customers. AGL's actual average customer consumption and customer load factor for all customers in NSW has been used as in the calculation as an example of the expected consumption and load shape for customers a small retailer may acquire.

AGL lost 2,515 customers to an independent retailer to whom it had sold a 20MW hedge contract, AGL could expect to lose [redacted] in gross margin. AGL will continue to incur costs in relation to those lost customers (because not all costs are variable).

- 148. This loss of retail margin is more than offset by the wholesale margin earned on the sale of the 20MW hedge contract to a third party.
- 149. I believe AGL would also seek to increase its retail market share to the extent that it has excess generation capacity. However, in order to do this there is a substantial cost associated with acquiring additional customers (in FY2013 I am aware this cost was \$71.75/customer). In addition, it is reasonable to expect that AGL would need to discount its retail price more heavily in order to acquire those customers, thereby reducing its gross margin.
- 150. Such a strategy would be expected to take some time, leaving this excess generation capacity earning only the spot price for the time it took to acquire additional customers.
- 151. It is my expectation that AGL would seek to pursue both strategies to maximise its profit from any excess generation, being the sale of hedge contracts to third parties, and in particular independent retailers, and growth in its retail market share as there is a commercial incentive to pursue both strategies.

Sworn by the deponent
at Sydney
in New South Wales
on 23 March 2014
Before me:

)
)
) 
)
) Signature of deponent


Signature of witness

Emily Jessica Reynolds, Solicitor



I, Emily Reynolds, solicitor, certify the following matters concerning the making of this statement by the person who made it:

1. I saw the face of the person.
2. I have not known the person for at least 12 months, but have confirmed the person's identity using an identification document and the document I relied on was a drivers licence.



Signature of authorised witness

Date: 23 March 2014

