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HD **Fraser's power bet on AGL's future**
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By any measure, AGL **Energy** chief executive Michael Fraser scored one over the competition regulator when the Australian Competition Tribunal overturned the watchdog's veto of the \$1.5 **billion** takeover of Macquarie Generation in June.

But Fraser's win may yet come back to bite the **company**.

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Ahead of a \$1.2 **billion equity** raising expected next week to help fund the **purchase** of the giant NSW power producer, the market remains starkly divided on whether taking the utility deeper into **coal**-fired electricity is the way to go, and especially right now.

Even those not concerned about how the **acquisition** stacks up in light of the world's long-term inexorable shift toward lower-emission **energy** sources have worries about the short-term financial impact given the dire state of the wholesale power market.

The yet-to-complete MacGen takeover will boost AGL's generation capacity by 79 per cent to more than 10,600 megawatts.

While AGL remains the largest private owner and developer of renewable power plants, it will now also be the second-biggest owner of thermal power plants behind only the Queensland government.

In 2007 just before Fraser took over to steady the ship after a turbulent 18 months under predecessor Paul Anthony, AGL was a different beast.

Its annual report of that year markets the **company**, then chaired by Mark Johnson, as "a breath of fresh air", highlighting its credentials in the renewable **energy** and carbon abatement space.

It is a different, blacker animal now. AGL's minority **stake** in Loy Yang A, the largest brown-**coal**-fired power plant in the country, was raised to 100 per cent in a \$488 **million** buyout of its partners in 2012. And then there's MacGen.

AGL, now chaired by Jerry Maycock, is far from alone in choosing the **coal** path.

Archival Origin **Energy** has similarly left well behind its "green" tone of the late noughties, buying large NSW black-**coal** generator Eraring **Energy** in the last wave of the state power privatisation.

Certainly the clear – if not publicly articulated – change in strategy over the years has some justification given the changed market conditions.

Electricity demand has firmly departed from its seemingly ever-upward path, while the emergence of Queensland's LNG export industry means gas has failed to take over from **coal** as a key power fuel source, instead being priced out of that market. Carbon abatement is far from the policy driver it used to be. Pragmatic and sensible, then, to delve deeper into what is set to remain the linchpin for Australian power generation for likely decades to come: **coal**-fired power.

On paper it's a good match: MacGen is the lowest-cost baseload generator in NSW, with 4600 MW of capacity split between the Bayswater plant and the older, less reliable Liddell generator, both in the Hunter Valley. For AGL, NSW is its largest electricity market, with more than 800,000 customers.

The tighter vertical integration within AGL will provide an "internal hedge" between its generation and retailing businesses. But picking the bottom of the market is tricky and plenty in the market fear AGL has moved too soon. After all, in May 2012 Fraser was telling investors the Loy Yang deal was being done "at – or near – the bottom of the cycle".

After the **purchase** of MacGen, AGL will be "long" generation, in that its electricity production will exceed the supply it needs to meet the needs of its 4.1 **million** customers. Market plagued by overcapacity

That poses problems in a market plagued by overcapacity. The Australian **Energy** Market Operator declared last week that, for the first time in the history of the National Electricity Market, no new capacity is required in any individual region of the market for at least the next 10 years.

It puts the excess capacity at 8950 MW in 2014-15. Even 10 years down the track, surplus capacity is expected to be in the region of 4000-to-10,000 MW. While the expected winding back of the 2020 Renewable **Energy** Target would shave down the surplus, it won't eradicate the problem.

The severity of the oversupply has compounded worries about returns from power production. Wholesale prices in the NEM so far in 2014-15 are averaging lower than they did in 2000-01.

The pain being felt in the market was put on full show by rival EnergyAustralia in its first-half earnings report last week.

The **Hong Kong**-owned utility, the number three "gentailer" after Origin **Energy** and AGL, suffered a sharp 12.6 per cent dive in sales volumes for electricity in the June half.

EA, the old TRUenergy, has effectively closed down its gas-fired power station at Wallerawang in NSW and is flagging further shutdowns or mothballing of high-cost plant across the sector.

Rock-bottom-cost MacGen is not at risk from that point of view. But analysts crunching the numbers on its sensitivity to wholesale power price declines have come up with some worrying conclusions that make AGL's confidence that MacGen would add immediately to underlying earnings per share look misplaced.

UBS's David Leitch notes that forward curves for wholesale power prices have softened by about \$10 per megawatt-hour since February. Taking into account the **equity** raising and \$300 **million** extra debt that will fund the deal, AGL's planned offering of hedge products and the \$345 **million** it has pledged to invest in MacGen over five years, Leitch calculates the **acquisition** will actually erode earnings per share by 5.1 per cent in the 2015 financial year.

JPMorgan calculates that after the **acquisition**, a \$1/MWh drop in wholesale prices could reduce AGL's earnings before interest and tax by up to 4.2 per cent.

But whereas Leitch also criticises the fundamental strategy of increasing investment in thermal generation amid mass-market cost reductions in **solar** and broader decarbonisation policies, JPMorgan analyst Christopher Laybutt has no doubts on that front for the foreseeable future, only questioning the timing.

As to the former issues, AGL's camp points to the expected investment payback on the MacGen deal of just seven years, hardly a long-term bet.

Still up in the air on how the MacGen takeover will play out in the short term is the fate of its contract to supply the Rio-Tinto-controlled Tomago aluminium smelter in the Hunter Valley, its biggest customer.

Tomago, partly owned by CSR, struck a deal with MacGen in late 2010 on an 11-year contract to replace an existing one when it lapses in 2017. On some calculations the increase in price that would then kick in would yield more than \$130 **million** in increased revenues for MacGen.

But with the way the dollar and aluminium prices have gone, Tomago will be struggling to pay and has been seeking to renegotiate it with AGL to a level that, in the words of CSR chairman Jeremy Sutcliffe, "reflects change in the global aluminium market".

With the impact of Alcoa's Point Henry smelter closure on Loy Yang fresh in AGL's mind, the incentive is there to reach a compromise. The outcome will have bearing on the future of MacGen's Liddell generator, which is far from assured.

While AGL has said little in public, the statement of its merchant **energy** boss Anthony Fowler to the ACT made it clear that Liddell's life may be cut short by five years and the plant retired in 2017, to the benefit of Bayswater and the rest of the market.

AGL's determination to challenge the Australian Competition and Consumer Commission on the MacGen deal also points to further ambitions in base-load power acquisitions, presumably in Queensland.

Fraser, who has advised he intends to retire by mid-2015, likely won't be there to see those realised.

He has won plenty of plaudits for AGL's achievements on the retailing side: few would question now the decision not to pay up for the NSW electricity retailers snapped up by Origin and the then TRUenergy in late 2010. AGL's strategy there, to grow organically instead, has paid off.

However, there's some way to go before investors can be as convinced about his decisions in power generation.

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