Attention ASX Company Announcements Platform
Lodgement of Open Briefing®

AGL Energy Limited
Level 22
101 Miller Street
North Sydney, NSW 2060

Date of lodgement: 02-Sep-2009

Title: Open Briefing®. AGL. MD & CFO on FY10 Outlook

Record of interview:

corporatefile.com.au
AGL Energy Limited significantly restructured in the last 18 months, selling $3.2 billion of non-core assets, expanding its direct ownership of upstream gas assets in the Australian market, increasing its investment in renewable energy generation and making the final migration of customer accounts to a new SAP platform in the Retail business. What's the rationale for these changes and what's been achieved?

MD Michael Fraser
The rationale was first of all about strengthening our balance sheet. Clearly we were carrying too much debt and our BBB credit rating had been downgraded to "outlook negative." Following the asset sales our net debt had fallen to less than $500 million at 30 June, we've restored a "stable outlook" on our BBB credit rating and we've got growth capacity in our balance sheet.

We've sold off what we regarded as non-core assets, where we had "portfolio" investments, and refocused on, and reinvested in, our core markets: renewables, upstream gas, gas fired generation and Retail.

corporatefile.com.au
When will these new investments in upstream gas, renewables and the Retail business impact AGL's profit growth?

MD Michael Fraser
Our upstream gas investments surround the Sydney and Newcastle markets, which are our core retail markets. Our primary focus over the next couple of years will

be proving up reserves, which we'll then have the option of bringing into our portfolio of contracted gas at a time that suits us. That decision will be based around where we see gas prices heading and where we stand with respect to our contracted gas volumes.

In renewables we're already seeing earnings benefits, with an EBIT contribution of $33.6 million from our Eco-markets business in 2009. We're also seeing benefits flowing through in wind farm development fees.

With respect to the Retail business, we've indicated we expect to see our operating cost to gross margin ratio improving to the low 40 percent range in the next three years, down from over 50 percent in 2009. We expect those benefits to start to flow through in the current year ending 30 June 2010.

corporatefile.com.au
AGL's net debt of $497.1 million as at the end of June was down from $2.0 billion a year earlier. What are your investment priorities for the coming 12 months?

MD Michael Fraser
Our committed projects are primarily in the renewables space and in our exploration and development program in upstream gas. Clearly with the passing of the expanded mandatory renewable energy target (MRET) by federal parliament last month, we have an early mover advantage in renewables: we have the largest development portfolio of renewable energy assets in the country.

corporatefile.com.au
What is your ability to internally fund your medium term growth plans in upstream gas development and renewable electricity generation? What capacity would you have to acquire assets out of the expected New South Wales electricity privatisation?

CFO Stephen Mikkelsen
Our on-balance sheet debt is around $500 million but in assessing our credit rating, Standard & Poor's add off-balance sheet liabilities relating to our off-take agreements for the Hallett 1, Hallett 2 and Wattle Point wind farms. When you add that, we have the equivalent of around $1.1 billion in net debt and given our commitment to maintaining our BBB credit rating, we could increase that to around $1.8 billion, which gives us headroom of up to $700 million.

In 2010 we expect our total capex requirement to be in the order of $650 million. Typically we produce around $200 million of free cash after dividends, leaving $450 million to fund. Our current intention is to sell the Hallett 4 wind farm under a similar structure to Hallett 1 and Hallett 2, and we're well advanced in that process. That would release $300 million to $350 million of cash, leaving an additional debt requirement of around $150 million, which means we'll be very comfortable in 2010 versus our $700 million headroom.

In 2011 there's a similar picture. We've currently got committed capex of a little over $300 million and, given our free cash flow of around $200 million, we'd require debt funding of $100 million to $150 million, again well inside our debt headroom. It's not until the 2012 financial year that under the S&P calculation the Hallett 4 funding would return to our balance sheet as we commence payments under the power purchase agreement.

Regarding the New South Wales privatisation, the process is still up in the air so it's difficult to say what our funding requirement might be. At the upper end of the range, if we were to acquire a retailer plus a "gentrader," and depending on the structure of any acquisition, we'd potentially require an equity raising. Of course, any acquisitions would have to be accretive and add substantially to shareholder value, so we'd expect the market to support such a raising.

corporatefile.com.au
AGL paid a fully franked dividend of 54.0 cents for 2009, up from 53.0 cents in 2008. Given the potential investment required to grow the business, do you foresee a conflict with your current policy of paying out 60 percent of earnings as dividends?

MD Michael Fraser
As Stephen said, we're in a very comfortable position regarding our forward funding. The view of the Board is that we've done very well over the last year and should share some of that success with our shareholders. That's why we decided to increase the dividend. One of the features of this company as an investment proposition is the consistency and reliability of its dividend stream and given the strength of our balance sheet we're quite comfortable with that payout ratio.

corporatefile.com.au
AGL's Retail business booked operating EBIT of $266.8 million in 2009, down 1.8 percent, reflecting a 22.2 percent increase in operating costs to $293.7 million as the business transitioned to the new Phoenix platform. Specifically what were the problems with Phoenix and are they resolved?

MD Michael Fraser
Migrating customers to a new billing system is a big and complex project. In our case the migration gave rise to a sharp increase in our billing backlog for a variety of reasons including the quality of data from external parties and from our legacy billing systems, and the process of gaining expertise and building up knowledge around the new operational environment. In March we were sitting at around 270,000 unbilled customers and that obviously translates into an increase in the number of calls coming into contact centres, an increase in the length of those calls and an increase in bad debts as you're not issuing bills.

We acted decisively to address those issues, but that meant we incurred substantial additional costs. We've got on top of those issues and the unbilled backlog greater than 30 days is now less than 3,000 customers, which is a historical low for the business. We're also starting to see an improvement in the operating performance of the business: we're seeing improvements in productivity in our contact centres, with average handling times coming down.

corporatefile.com.au
What has been the total investment in the Phoenix project? Can you define the likely benefits from Phoenix and the expected time line?

MD Michael Fraser
The total capex investment in Phoenix was $162.4 million. The benefits will come from a range of areas including reduced operating costs from lower call centre and back-office staff numbers and productivity improvements as our processes are streamlined around a single billing system. Also, the fact that we now have a single view of our customers means we're able to get a much better understanding of individual customer value, so we're able to segment and target our marketing and service levels appropriately and focus more closely on our higher value segments.

Strategically, completing the migration process leaves us very well placed should the New South Wales retail businesses be put up for sale. We now have a platform in place that will provide significant economies of scale going forward.

CFO Stephen Mikkelsen
The final migration we completed in November last year transferred 1.6 million customers to the new system. That's equivalent to the size of the largest New South Wales retailer, Energy Australia. Clearly we had billing and process issues but we've learnt from that and the corporate knowledge we have means we'd be well placed to integrate a New South Wales retailer into our system within six to 12 months.

corporatefile.com.au
You've highlighted gross margin and the opex/gross margin ratio as the most appropriate KPIs for the Retail business and set a three-year target for opex/gross margin in the low 40 percent range. Why are these indicators valid and what will get you to the opex/gross margin target given a ratio of 52.4 percent in 2009?

CFO Stephen Mikkelsen
Now we have our customers on a single system, these are the two measures we use internally to monitor performance. We believe absolute gross margin per mass market customer better captures our added value than a measure such as EBIT to sales, given many of our costs are simply "passed through" to customers, affecting both the revenue and earnings lines and generating no margin.

The opex to gross margin ratio captures the efficiency of our expenditure: we may have to spend more to attract and retain higher value customers, but that will deliver a higher gross margin than the lower value customers that we need to service more cost effectively.

There are two ways we'll achieve the target opex/gross margin ratio. First, by keeping our costs down. We're now in a position with Phoenix that we're confident we can extract the benefits Michael talked about earlier. The second way is by increasing our gross margin. That's about targeting higher value customers using the data that's now available to us through Phoenix.

corporatefile.com.au
The Merchant business was the key driver of underlying EBIT growth in 2009, with EBIT of $447.3 million, up 32.5 percent. The business benefited from price volatility in the wholesale gas market and from a substantially improved contribution from Loy Yang A. To what extent is the 2009 performance sustainable?

MD Michael Fraser
Over the year the Merchant business operated through all sorts of wholesale energy market conditions, both in gas and in electricity, from periods of high prices, high volatility and high demand, through to periods of very moderate demand, very moderate prices and low volatility. We believe the strong Merchant result demonstrates the strength of the combination of our physical assets and our financial portfolio. We think we've demonstrated the ability of the business to handle different conditions and therefore its ability to sustain that kind of performance in the year ahead.

CFO Stephen Mikkelsen
It needs to be emphasised that our integrated strategy means that in different years profits will be in different parts of the business: in different parts of the Merchant business and/or different parts of the company as a whole. That's why we're pursuing vertical integration and why it's important to look at the integrated result.

corporatefile.com.au
EBIT contribution from Upstream Gas fell to $16.3 million in 2009 from $108.3 million, reflecting the sale of your stake in the PNG Gas Project in December. Your 2P gas reserves increased 56 percent to 1,056 petajoules in the six months to June. What are you seeking to achieve by expanding this portfolio and what are your longer term Upstream Gas aspirations?

MD Michael Fraser
We have the largest contracted gas portfolio in the country today. It includes a number of major long-term contracts, but post 2017 there's a drop-off in some of those major contracts, notably out of the Cooper Basin and Bass Strait. Looking forward, we aspire to a 50:50 split in our portfolio between gas we buy under contract and gas we supply ourselves out of our own projects.

For our own projects we've focused particularly on acquiring assets in our core markets: the assets we acquired in the Gloucester Basin and through the acquisition of Sydney Gas give us reserves in close proximity to our Sydney and Newcastle markets, so there's a competitive advantage in terms of haulage costs associated with those reserves. We believe the position we've taken creates a lot of long-term value.

corporatefile.com.au
AGL had 3,940 megawatts of electricity generation capacity as at the end of June 2009, 34 percent of which comprised renewable sources. You intend to expand the portfolio to 6,000 megawatts, 46 percent of which will be renewables. Can you define the likely benefits to AGL of the federal government's recently passed legislation increasing the MRET to 20 percent by 2020?

MD Michael Fraser

The legislation passing confirms our early mover advantage in this space: we've been positioning the company for exactly this outcome over the past few years. The government's 20 percent target will mean somewhere between $25 billion and $30 billion worth of investment will be required over the next decade. Clearly meeting the target will mean there's going to be upward pressure on the pricing of renewable energy, both in terms of the price of renewable energy certificates (RECs) and in terms of underlying electricity prices.

Wind power will clearly dominate the early build, and for wind projects you need four things: wind, proximity to transmission, planning approvals and customers. We're building at the bottom of the cost curve, so we stand to benefit as prices rise over the next decade in line with the increase in the target. In later years, to meet the target, projects will have to be built that have lower wind resources, are further away from the transmission grid or require longer planning approval processes. That's where being an early mover will give us a very clear competitive advantage.

corporatefile.com.au

What's the outlook for earnings in the current year ending June 2010? Why have you not provided formal earnings guidance?

MD Michael Fraser

It's been our policy for the last 18 months to provide guidance at our AGM. This enables us to provide more robust guidance following the important winter months. All things being equal, a cold winter is more beneficial to us than a warm one. While it's been a mild winter so far, we expect to deliver another improved result in 2010.

corporatefile.com.au

Thank you Michael and Stephen.

For more information about AGL, visit www.agl.com.au or call CFO Stephen Mikkelson on +61 2 9921 2777

For previous Open Briefings by AGL, or to receive future Open Briefings by e-mail, visit www.corporatefile.com.au