Australian retail competition is still unfolding

Established
- Gas - VIC
- Elec - VIC
- Elec - SA

Prospective
- Elec - NSW
- Elec - QLD

Long Term
- ACT Gas
- WA Gas
- QLD Gas
- SA Gas
- NSW Gas
- NT Elec
- ACT Elec
- TAS Elec
- WA Elec
- Other

Notes:
- Other includes an assessment of unprofitable customers in major markets that would not be targeted in the foreseeable future.
NSW & Queensland have barely begun

Notes:
- Churn rates are 2007 figures based on estimates of contested small customer segments only.
- Published churn rates are generally several % points lower because they are based on total market customer numbers, including customers in markets not pursued by retailers or not contestable (eg: Ergon in QLD).
- QLD annual churn based on annualising period July-Dec 07
2007 strengthened the likelihood of retail consolidation (& increased value of established presence)

Two new players left the market
• Energy One & Momentum

Three other competitors experienced substantial share price falls (far worse and earlier than overall market)
• Jackgreen, APG & AGL

Higher costs of entry
• 2007 corrected any misconception about stability and low prices in both electricity & gas.
• Prices reached previously unprecedented levels and are still above historical levels
• Volatility in 2007 has increased the cash requirements while at the same time creating greater investor caution.
• Requirement for experience/expertise has been brought home
• Value in proven performance & incumbency

Increasing vertical integration in some markets
• SA electricity
• Victorian gas

VE not only survived but performed
• Grew customers significantly
• Positive earnings even after customer acquisition costs.
Market restructuring far from complete
- will trend toward Vic structure with further consolidation

Note:
VE estimates.
Profitability is there to sustain growth, but varies between markets - a matter of timing and approach

- Illustrative typical incremental customer, averaged across distribution areas.
- Based on known GRT paths or CPI, increases in distribution at CPI unless known otherwise – conservative approach to retail prices
- Forward prices as at mid Feb 08, with a carbon premiums evident in Cal 10 (but not reflected in retail pricing)
- Cost of acquisition not included.
Price and margin path is encouraging

Retail price changes have responded to wholesale, at least in part
• Vic Electricity – 13% to 17% increases in total tariff from Jan 08 (approximately double for energy)
• Vic gas – 5% to 7.5% increases from Jan 08
• SA Electricity - 12.3% increase in energy component from Jan 08 (with CPI increases to follow)
• NSW – 20% to 24% increases over three years (2007 – 2010)
• QLD – increased 11% in July 2007, proposed 7% in July (but significant network element)

Ongoing price/margin development
• The Australian Energy Markets Commission has recommended the removal of residential price caps in Victoria from 2009. The Vic Government has already removed price caps for small business.
• The assumption is that price caps are transitional, even in NSW where privatisation is proposed.
• Drought has made climate change real to most Australians – expectation of cost increases.
• High profile inflationary pressures.
• Muted customer response to price changes, within reason.
Cost pressures, but efficient base

Our cost to serve currently compares well with assessments of efficient costs
  - Single, low cost billing system that is capable of growth.
  - Work with sales channels that compare well with others.
  - No legacy issues and traditionally cost conscious environment.

Notes:
- ESCOSA direct figures are for CTS after Project Phoenix
- ESCOSA, IPART and QCA figures are for hypothetical efficient retailer, not actual costs of relevant retailers
Profitable Growth – a winning formula

- Rapid growth through 2005 and 2006
- Ramp down in 2007 due to wholesale erosion of margins
- Sales now back on track – Victoria, SA and Queensland
Profitable Growth – how we do it

A Simple Proposition
• Focus on customer segments with low involvement
• A prompt payment discount (7%) off Government Regulated Tariff
• Active sales programs
• Diverse, but tightly controlled sales channels
• The No Risk Offer
• Monthly, dual fuel billing
• Commercial discipline – grow only with positive net margins

Direct Connect is a Gem
• Australia’s largest utility connection service
• Electricity, gas, telco, broadband, insurance
• Strong channel – VE’s largest single source of sales in the Nov – Dec 07 period
• Connections to AGL since mid 2007 (except for a few months in late 2007)

Retention program is vital
• Minimise cost of acquisition overall
• Success rate is material
• Combined with “no risk offer”, retention team is a formidable barrier to other sales teams
Challenges to the retail model

Consumer Credit
• Universal credit checking - far better performance than benchmarks
• Preparing for a more difficult period in consumer credit

Regulatory tightening on sales
• Consumer advocates opposed to direct sales (eg: Do not call register)
• Strong emphasis on compliant selling – above and beyond.

More complex sales propositions
• Removal of price caps positive, but removes reference rates
• Introduction of time of use meter data – load profile based segmentation

Wholesale liquidity / vertical integration
• Wholesale price movements tolerable if hedged and reflected in retail price adjustments
• Greater challenge is wholesale liquidity – importance of upcoming NSW privatisation & gas market reforms
WHOLESALE PRICES & LIQUIDITY

• 2007 an unprecedented period of energy price volatility

• IEA risk management and trading expertise proved its worth
  – Essential for successful retailing
  – Robust policy
  – Wholesale focus through dedicated corporate structure
  – Experienced personnel
  – Value adding; not just a cost

• Revised gas market arrangements in Vic
  – Delivered unintended exposures to non-incumbents
  – IEA commodity price exposure well managed but
  – transmission congestion charges costly (~$5m above expectation)
Spot Electricity Prices (Vic)
Spot Gas Prices (Vic)

Daily VICTORIA Gas Price, 12 months pre & post New Market Arrangements (Feb to Feb)
Forward Market Liquidity

Vic Flat 2008 SFE Electricity Futures

Volume
Price
Open Interest
Forward Market Liquidity - Observations

• Increase in financial intermediaries (>10)

• Increased use of futures market
  – To manage / reduce counterparty credit exposure
  – High prices caused shorts considerable “margin stress” but a windfall to longs

• Activity around option expiry dates

• Manipulation of year-end settlement prices
  – Mark-to-market accounting standards

• Carbon pricing observable from 2010
  – but uncertainty impacting liquidity
Vertical Integration

• Operational / short-term hedging benefits overstated (and overpaid for)
  – Low cost hedging available through futures markets

• Regulators/governments conscious to avoid excessive re-aggregation
  – but seemingly powerless in preventing

• Possible long term outcome of consolidation scenario:
  – 3-5 large integrated players
  – A range of independent generators and retailers tolerated
  – Akin to the “4-pillars” in banking

• Will this scenario include a liquid wholesale market?
  – Noting the NZ experience
The VI Dilemma

<table>
<thead>
<tr>
<th>Scenario</th>
<th>FULL VI</th>
<th>Liquid Wholesale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Build Generation</strong></td>
<td>Resilient end-game player</td>
<td>Non-strategic capital in “commodity” assets</td>
</tr>
<tr>
<td><strong>Don’t Build</strong></td>
<td>Exposed retail</td>
<td>Profitable retail</td>
</tr>
</tbody>
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**Infratil view**

- that the futures market will remain liquid and provide hedge cover required to manage an independent electricity retail business, at least in the medium term;
- notwithstanding this view, highly conscious that there remains a real risk this will not be the case, especially in the longer term;
- that generation investments in the current environment do not provide spectacular returns;
- that developing options to construct generation plant, with short lead time, provides the best value strategy to protect Infratil’s retail growth ambitions;
- that future generation will be gas-fired.
Wholesale Gas

• Already displaying vertically integrated characteristics
  – Small number of producers with long term off-take agreements with incumbent retailers
  – Equity interest in CSM producers
  – Physical wholesale supply necessary to participate (and provide dual-fuel retailing)

• Sufficient gas will continue to be found, and brought to market, at current prices
  – LNG export (if successful) may provide some price uplift

• .....but deliverability (transportation) constraints will grow
  – Strongly influencing gas generation economics and/or location

• Wholesale gas positioning is a key focus of IEA management this year
  – Non-incumbency exposure experienced in 2007 substantially reduced
    • though may restrain growth leading into winter 2008
  – VE has sufficient presence and critical mass to negotiate long term supply agreements
    • much harder for a new entrant
West Australia

• PERTH ENERGY
  – IFT 56%
  – to 84% by 2010 with equity contribution for generation project

• WA market effectively vertically integrated with ex-Western Power businesses dominating
  – Alinta (BBP)
  – Synergy / Verve

• Perth Energy is recognised third retailer, though substantially smaller
  – 60+ customers / 160+ sites / 30+ MW peak load
  – Growth constrained through 2007; negative margins due wholesale rise

• Long term wholesale energy contracts in place to enable immediate growth
  – Limited availability for new entrants

• Contracts executed and credit approval received to construct 120MW dual-fuel generation plant for 2010
  – Necessary to cement PE position as third energy supplier

• Positioning for full retail contestability (expected 2010)
  – Utilising VE experience & capabilities
SUMMARY STRATEGY

• Selective retailing
  – Growing only where margins are positive / value is added
  – Locking in margins through wholesale transactions
  – Selective in terms of states & customer type

• Maintain robust wholesale risk management policy
  – Utilising liquid financial contracts where they exist
  – Realising the value of retailing optionality
  – Retaining flexibility to utilise range of financial value-adding products
  – Minimising capital requirements

• Develop generation options to
  – manage risk of wholesale illiquidity
  – ensure long-term resilience

• Build generation only when enhanced value over “normal” return from
  – enhancing / supporting profitable retail growth or
  – additional revenue source

• Secure long term gas supply position to underpin
  – dual fuel retailing and
  – generation