Meridian 2010/11 Annual Report - Transcript of Media Briefing 24 August 2011

Page numbers refer to the presentation slides that can be downloaded.

<u>Meridian - Paul Chambers and Tim Lusk</u>

Tim: Welcome to our annual results presentation. I think you all know Paul Chambers. Thanks Paul. [Covers evacuation procedures to 1.27]

The first slide (slide 3) just reminds you that you are with Meridian and we are a renewable company, concentrating on hydro, wind and solar. I think you're well aware of Meridian's credentials.

The year in numbers, at a headline level (slide 4): all I wanted to say about that is that you could describe it as a confident result in the face of considerable adversity this year, which we'll talk a wee bit about in a minute, but to me, I think much more an indication of the resilience that we're building in this company through our concentration on cost control, commercial disciplines, being very focused on strategy-led operational decision-making and much better disciplines around the capital investment. So that is coming through quite strongly under the headline result.

Paul will be unpacking some of the financials there. Suffice to say we did commission Te Uku Wind Farm earlier this year and we also committed to the largest wind farm in Australasia, being Macarthur in Victoria with AGL as our partner.

We'll talk a little bit more shortly around the increase in customer numbers. I just wanted to comment on the very significant improvement in health and safety. It is an issue for our industry. It's something that all CEOs concentrate on. Meridian's attack on that over the last two or three years has been to do the basics really well, that is, high visibility by the executive team, personal accountability, good numbers and excellent site safety committees. So the results are coming through well and we are determined around our Zero Harm initiative.

The other thing at a headline level is that Meridian is very proud of where we continue to box in the hydro asset availability on a world-class stage, where forced outage factor is a key element. You can't generate if your plant is down when you need to generate, so the troops have worked really hard on that and the results are showing up, as they should, with a company like Meridian with considerable hydro assets.

The quick list of the perfect storm (slide 5), if you like, through last financial year: earthquakes, and Canterbury had a major impact on this company. Most of our staff and families live in Christchurch. Our incumbent customer base is in Christchurch. We sold two power stations during the year. We had a flat market demand, an incredibly active retail market and in Christchurch, and as a number of other generator retailers are reporting, high in-flows across the whole country, not just South Island or North Island. And along in the middle of that of course the statement by the Government that Meridian is one of the companies that will go through a mixed ownership process should they be elected later this year.

The next three slides just pick three of our key strategic themes and basically demonstrate that we're on course, we are delivering on our strategic themes. This slide (slide 6) simply picks up the continuing strong total shareholder return. The productivity measure that we worried about three years ago when we were fifth out of five against other SOEs and Contact and TrustPower – on a productivity measure we've again worked very hard on that and are nudging that upwards. It probably would have been a bit higher had it not been for hydro in-flows and things like that, but it's going in the right direction. And we've been able to maintain our credit rating in the face of the sale of two assets.

Tim: The second strategic theme (slide 7) is just around the strength of our story on the development of our renewable portfolio. We actually hold four consented hydro and wind projects ready for commitment when we think the time is right. Maungaharuru in the Hawke's Bay is not on that list, but that's about 120 megawatts I think. So it's a very strong story around our core competency developing our wind and hydro pipeline. Construction has commenced at Macarthur. It has been very very wet in Victoria, so it's probably travelling a little bit behind time, but Meridian's not exposed to that, given the nature of the joint venture with AGL. And we're beginning to get good production out of our solar plant in California.

Lifting our customer game is the third key strategy (slide 8). That's really what's going on in retail. Again through the amazing sequence of earthquakes in Christchurch, we have been able to lift our customer satisfaction ratings so that as a main retail group we're boxing at the head of the queue in the Consumer Institute's latest survey, with Powershop sitting up there as the niche player absolutely at the top of the list – over 90%. Paul will talk a little bit more about what's going on in behind retail, but again through the incentives and the latest regulatory changes, Meridian goes north and is rebalancing our portfolio in the north.

People and health (slide 9), again you would imagine with the earthquakes in Christchurch, that's been a huge focus for us. You can fix buildings and you can fix billing systems; people and families are a lot harder, so that's a continuing focus. I've talked about health and safety. One thing we don't often put up in lights, but our staff engagement survey is very important to Meridian. Two years ago we chose to join the John Roberts Associates Best Practice Benchmark across Australasian companies, and this reports a 3.6% uplift of engagement this year, through a very difficult time for our company. So I think at that point you get a chance to hear Paul present in some more detail the financial results. Paul.

Paul: Thank you Tim. I'm going to take you through some of the highlights of the numbers but you will find in the appendices to the pack that you have more detail, and this year we're actually posting on the website at the same time the full accounts which were delayed last year. So you'll be able to see all of the detail in there.

So just reiterating what Tim said, it's been a fairly challenging year (slide 10), so 3% EBITDAF growth is a pretty good achievement. You can see our NPAT is up significantly, but that includes the gain on the sale of the Tekapo assets on the 1st of June. And the big influence on this year's result has been soft underlying wholesale prices. Our key productivity measure obviously also increases in line with EBITDAF, slightly ahead of that, and all of our other ratios look in good shape.

The big influences on our earnings before interest tax depreciation and fair value movements (slide 11): you can see the big blue box, the big downward box, and that's our unhedged generation if you like, that's the amount of excess generation we have over what we sell to fixed price customers, and we always run in that position because we need to be in a position to take up the slack if it goes dry. Pricing there dropped very significantly, both as a result of water across the country - last year there was quite a lot of rainfall in the south, but some of the northern lakes were relatively empty – both as a result of that and as a result of demand hits through the earthquake. Our own modelling would suggest that at a revenue level, we probably lost $20-25 million as a direct result of the earthquake and that's besides costs associated with getting ourselves back into business.

Paul: You can also see the positive impact from our contracted sales books, so increase in customers and an improving average price across those customers, and that's despite price freezes, that we've improved the quality of our customer base. And the settlement with New Zealand Aluminium Smelters, which was achieved amicably on a take or pay dispute, which we had a couple of years ago.

The other large influences: international revenue started to kick in as those assets actually generate revenues, and employee and other operating expenses going down as cost control measures take effect, slightly off-set or mostly off-set by increases in the costs of paying for the DC Link as the Pole 3 asset comes into being. And look, there's a bit of a list there of those items, which I won't dwell on (slide 12).

So the big story around storage (slide 13): you can see the graph on the right-hand side. The dark blue line is where the in-flow and storage left us through the year and the light blue line is the average, and you can see a very similar pattern to last year. In fact we didn't drop below mean at any point during the year. There was only one point in December where it looked like we were going dry and prices started to climb, but that was followed very shortly by a massive inundation and prices dropped back down to about five bucks. And the net result is you can see a wholesale spot price this year of $41.57 compared to last year of 48 bucks, and way away from what we would see as the long run marginal cost of new generation.

This actually probably should have hurt us more. We don't tend to do very well when it's very very wet and prices are low, but we've spent a lot of time over the last two years making sure that our portfolio, our wholesale position, our retail position and our hedge market position are very very well-integrated, working seamlessly together (slide 14). And that's enabled us to take a little bit more load when it was very wet on a short-term contractual basis in order to firm our position, and that you can see in the top graph in the additional wholesale CFDs, and we've also taken some additional short-term business in the time of use market, without threatening our long-term position in terms of how we defray the risk of dry weather.

Operating expenditure (slide 15): We've seen a decline of $12.5 million on last year. That's, I believe, a pretty good improvement. We've seen a number of things which you would expect to drive cost upwards. New generation sites coming on obviously bring with them the cost of maintenance of those new generation sites. There were costs incurred following the earthquake. Retail competition has been very heavy and that's had its own impact on both retention and acquisition costs. And our international operations are now up to scale and obviously there are costs associated with that. Despite that, we've actually seen a fall-back. There were a number of one-off costs last year, but even if you strip those out we've actually seen a cost reduction.

This is one more for the accountants (slide 16), so I'll be talking to analysts about this, which is the 'below the line' stuff, but it's explaining where the numbers came from. The $174 million gross gain on sale of the Tekapo assets net out to $157 million after some of the tax impacts that relate to that. Underlying NPAT has actually gone backwards by about $35 million I think, and that has been driven almost entirely by one thing which is increased depreciation. At the back end of last year we increased the valuation of our asset base, and that reflects future pricing expectations and that creates additional depreciation, which is non-cash, accounting only, and we strip out when we look at things. We've also seen some increase in net finance costs as a result of our funding programme, and that will result in revenue streams in years to come.

Paul: All that in terms of performance for the shareholder has actually been good (slide 18). In the year we paid out $683 million of dividend, and that included a special dividend following the Tekapo transaction of $521 million. We've declared a final dividend in these results of $69 million, which will be paid in October. And our underlying return on equity remains at a very strong level: 18.5% is a good position to be in.

From a funding perspective it's been great to see us manage to maintain our BBB+ rating (slide 19). All of the headlines around organisations and governments being challenged with ratings sort of indicates some of the stances taken by rating agencies, and we have a good relation and good understanding with S&P as to what our position is. We ended strongly with a lot of cash and withdrawn facilities. That included the net proceeds of the Tekapo transaction after the payment of the special dividend and has since been applied to paying down debt.

We also saw the project finance structure put in place for the Macarthur Wind Farm during the year. It's very important. It means that we're able to fund that without impacting on our credit rating, which means that it doesn't affect our ability to either fund further New Zealand investments or to make payments of dividends. And you can see we've got a healthy variety of tenures on our debt and within that, a lot of different sources of debt. So we're nicely diversified there, which puts us in a good position for future projects, and future projects here are scoped out (slide 20).

The stuff beyond this year is forecast, estimated if you like, and you can see how 2012 is going to be dominated by spend on Macarthur, and as I've said, 70% of that is project finance funded, which means that it doesn't actually draw on our balance sheet. And then you're looking at projects in both New Zealand and later on in Australia. This year obviously the finalisation of Te Uku took up the largest chunk of our spend.

Now I'm just going to take you through some of the segment performance stuff (page 21). Obviously you need to really think about a result in the holistic sense. We do see fluctuations in segments and that's the reason why we are in different segments. We tend to see retail up when wholesale is down, but it's the overall thing that counts.

Retail segment performance (slide 22): Obviously we've had a good result in retail as a result of low wholesale electricity purchase prices. What we really need to look at is our underlying position in terms of both costs and in terms of the average price that we're yielding on our customer base and the average customer numbers. And you can see that if we equalise out our purchase price, the same between two years, we've actually seen an uplift in our underlying result. And that's been a result both of growth in volumes and improvement in the average price achieved per customer. And that's despite a highly competitive market increasing costs relating to retention and acquisition and price freezes through the period.

And here's a picture of our customer growth (page 23). You can see the ICP churn rate on the right-hand side, which is publicly available information and then our graph of where our customers are, and you can see the shift from South to North Island as we've repositioned to match our generation base. And the substantial increase in Powershop over the year – 104% - so more than doubling in the year.

Paul: And it's good to see some of the things behind that, I think. Normally we do show you our internal measures of customer satisfaction (slide 24), but I thought given that the Consumer NZ Customer Satisfaction Survey's fairly recent, it was worth putting out something which is objective in nature. And look from my perspective, this says to me that we're sitting at number one and number one: number one in terms of having the top brand in terms of satisfaction and number one in terms of having the highest customer satisfaction of all of the five major gentailers. And it's been great to see our position lifting.

Tim touched on the Canterbury Earthquake (slide 25). This had a major impact on this sector in the year and it's not something that we can not talk about. Our entire office was rendered uninhabitable in the February quake and we had to relocate our staff. We had the call centre shifted up to Wellington. We had people working out of their homes, out of an old church, out of hotel conference rooms, scattered across Christchurch. And we managed to carry on servicing our customers. We made calls to all our medically-dependent customers and provided financial relief for those customers as well through both a price freeze extension and payment delays. And it was good to see the transistor radios, which we gave out post the September Quake, actually get some use and we got some very good feedback from our customers on that.

Wholesale segment performance (slide 26) has really suffered as a result of the 14% reduction in wholesale average prices, and you can also see the impact of transmission expenses increasing as Pole 3 assets come into play. Now that's obviously going to cause additional cost, but as time goes on, that opens up a very important pipe for us between our extremely flexible peak in generation assets in the South Island and North Island customers. So you can see the impact of soft demand and on volumes at the bottom. That shows in this graph here (slide 27). Slightly back on last year in terms of volumes – as I said, wet across the whole country, so the North Island lakes had a fair amount of water this year. It's been a relatively light wind year compared to other years, so a small increase given Te Uku coming on line was about in line with what we expected.

Underpinning all of this, of course, plant performance (slide 28) is absolutely key to us, which Tim mentioned earlier on. And when you hear about a forced outage factor of 0.18 % which is a market-leading performance, you might sort of think well, are they gold-plating their assets, spending too much money on everything, and I was pleased to see the result of the GKS Hydro, and they're a well-recognised hydro consultancy, benchmark study of international players, and this was across various countries across the world, which put us at near or top of class. So it put the Waitaki in the top quartile from a cost perspective, and Manapouri actually market-leading. And it's just great to see that. Our five-year Benmore Refurbishment Programme's now been completed and not only do we have 3% more electricity from the same amount of water, but we also have an asset that's good to go for another 25 years.

Tim's touched upon our pipeline (slide 29). We do believe that in the medium to long term growth will return to historical levels. There's nothing at the moment to indicate anything other than that, and we have a good pipeline of options across a variety of sizes, from quite small to reasonably large that can take advantage of market opportunities as they come in. We apply some very rigorous disciplines on when we press the button on investments, and which types of investments, and we take into account all sorts of factors in doing that.

Paul: This is a little picture of the stuff that's actually in the consenting pipeline (slide 30). That's obviously, if you like, the body of the pipeline hopper and there's more than that which is under investigation. And you can see the geographical and size spread that's manifest in that pipeline.

Just moving on to our international segment (slide 31). I mentioned earlier on that this year saw the first full year of revenues from two assets: Mt Millar and CalRENEW-1, so we're seeing that turn from being a cost centre to a profit centre. We appointed a CEO both to lead our Australian operations this year and we're well into the construction of the largest wind farm in the Southern Hemisphere at Macarthur in Victoria. And again it's important to see that there's a pipeline ahead of us, both in Australian wind and also in smaller scale solar (slide 32). And it needs to be understood that the point of doing this stuff in California is not to use a large slab of our balance sheet; we're actually using other people's money to do most of this and building up our capability to bring the technology back to this region later in the day.

Our Other segment (slide 33), and this sweeps up most of our subsidiaries, what we would have called our venture portfolio in the past, has been historically a fair drain on our cost base and we're putting that into a much more healthy state. The big improver in this year has been Energy for Industry, which has seen some of its assets performing extremely well. And at the end of the year we sold one of our subsidiaries, Right House, which had been loss-making, and we now have a smaller portfolio of those assets.

So just moving on to outlook (slide 35). We never say too much about outlook, because obviously this is a country where if it goes dry 16 weeks later the landscape is massively different. So all I can say at the moment is, in the short term, we enter the 2012 year with still relatively high hydro storage and continued flat demand, and that is likely to suppress wholesale prices in the near term. We saw a short-term spike obviously the other week with the cold weather, but it has other than that been pretty much unseasonably mild. We do believe that active retail competition will continue. Consumers know they have choice and that puts its own pressures, but it also gives you a lot of other opportunities. And next year you will expect to see the results impacted by the sale of the Tekapo stations, so on a wholesale basis, those contributed between $60 million and $70 million per annum to our bottom line.

In the longer medium term we have quite a lot of opportunity in front of us (slide 36). As I've said, we have a great pipeline and that pipeline has a number of options that are well-placed in the medium term merit order. We do expect demand to return to long run historical averages which will then support that sort of investment. We've got a long term agreement from 2013 with our largest and most important customer, which is another 18 years and provides us both commercial certainty and some improvement in the bottom line. And of course Pole 3 coming on line is something we look forward to. It provides us a lot of additional opportunity. We also think our retail brands are both reasonably well placed to continue customer growth. We've been seeing improvement in performance in that area and we think there's still some way to go. So I think that's us. There's a nice picture of Benmore post-refurb, all shiny and painted, for you to look at and I'll pass over to you for questions.

Questions and Answers

Question: Wholesale prices are way way below long run marginal costs. What is your sense of long run marginal costs? What would be a sustainable wholesale price, if it's less than that now?

Paul: Wholesale prices are not just below long run marginal costs. It's been below what we'd expected the mean result to be at this point in time. So there's a jump to what we'd expect mean to be, and that's significantly higher than where it is. Our view on the long run marginal cost is probably in line with most market players. So our forward cost curve would look very similar to them.

Question: Do you think that the current sort of heightened competition and the need to rebalance portfolios is resulting in retail prices that are unsustainably low?

Paul: It'll be interesting to see what happens if there's a dry spell. But competition is a good thing from our perspective.

Question: Do you break out Powershop anywhere? I mean Powershop's done very very well at acquiring customers, no-one doubts that. Do we know whether it's profitable? Can you tell us? Is this a good commercial operation?

Paul: It's a good commercial operation.

Question: Can you elaborate … specifics?

Paul: I don't think I've included numbers where you can split out Powershop's operation, but it's a good commercial operation, principally because it's got a very low cost to serve, relative to its size.

Question: Right, but it's not just cannibalising more profitable business elsewhere?

Paul: No.

Question: Can you tell us how you've come to pay such a high dividend to the government when the net gain on the sale of Tekapo's only about a quarter of it? Have they sort of hollowed out your balance sheet in some way or what's the story behind that?

Paul: When you sell an asset for a large sum of money, it's appropriate that you return to your shareholder what you can bearing in mind what your future investment needs are. That would be a normal piece of commercial discipline, so it's not an unusual thing to have happened.

Comment: No, it's the difference between the two numbers. You talked about a net gain of a $150 or $100.

Paul: That's the accounting game, but in terms of cash that flowed in there was $820-plus million came in and of that, $520 million went out.

Question: Can you tell us about long run marginal costs that you'd need in Australia and how far off wholesale prices are there from heading towards that?

Paul: To build in Australia you need similar long run marginal cost incentives to you do here, so you need to have the black plus the REC to be in similar sort of scale to here. I mean the economics of building there are not massively different to the economics of building here.

Question: So how far off is the current situation over there towards your next build?

Paul: It depends on whether you look at PPA prices available or actual spot price on the market from a PPA pricing perspective not hugely far away, from a...(interrupted)

Question: In a time sense, years?

Paul: Well we're expecting the REC overhang to be sort of consumed by '13. We would expect it all to be gobbled up by then. That's the sort of general analysts view.

Question: So in that sense can you tell us about Mt Mercer and how that will fit in and whether that's in a short term option for Meridian?

Paul: Mt Mercer's a real option. We haven't made a call on when we're going to deploy that at this point in time. I'm not going to get into giving timings out on assets because that would imply that we weren't going to be commercial about deployment.

Question: Any impact on these results from the UTS?

Paul: So the UTS, we've accounted for it on the basis that the EAs $3,000 price ruling holds and in the notes to the accounts you'll find a contingent liability which explains how much would drop out this year if the appeal is successful and I think it's $14.5 million.

Question: Your colleagues at Contact say that the EA decision, it doesn't rectify the causes that lead to the situation and that in effect they say – they didn't use such frank words - but basically it'll encourage risk taking. Do you agree with that? Has the situation caused any changes in risk taking and if the decision is overturned by the Courts, as some of your rivals are attempting to have it done, what then?

Paul: I can say that the event that occurred was something that we hadn't seen before. So the occurrence of the event, the March event, has changed our approach to transmission outages and short term outages. So rather than making us more risk taking, it's probably quite the opposite.

Tim: You would also expect that going forward, whether it's a court action or further action by the Electricity Authority, or in fact a shift in the way that companies manage risk, it has changed the market, that particular event. So just how it will all turn out I think will be kind of a multi iteration thing. It won't rest on one court or one EA decision. It was a significant disruption in the operation of a market and the solution or the stabilisation of that in terms of market rules and market behaviour, I think it will just take a bit of time to unfold.

Question: Do you think it's desirable that there should be a price cap in that market?

Tim: I think there's a variety of solutions. I don't think we have in our own mind any sort of point solution to it.

Paul: No. I mean we're not lobbying for any solution. The EA will form its view and that's its role in the market.

Question: Well what do you say to people who say that Meridian and Mighty River Power are just being cry-babies here and going to the regulator because you made bad commercial decisions? What's your response to that?

Tim: Depending on where the different market players were positioned on the day, we all felt differently about it. All you can say is that it was a significant event. It was unpredicted. It happened and now the market and the regulator need to adjust to that, but it is true. We all had different views as to what happened on the day, but I think that's exactly what the EA is there to do and they've made their first consideration of that situation known. I suspect it will go through a number of iterations.

Question: Do you expect to carve off further some of these subsidiaries, Energy for Industry or Powershop especially in the context of perhaps under a mixed ownership model? Will it be appropriate for the company to keep those under that model?

Tim: Paul will comment in detail, but I don't think there's any difference to our approach to subsidiaries whether it be a mixed ownership model or in fact achieving a sustainable financial performance in the long term. So we have been going through our portfolio and making those considerations as to whether we hold or look for an exit point or tidy up. So for each subsidiary it's a different answer. You've seen the outcome of the Right House rationalisation of that ownership piece and there's quite a lot of work still to be done.

I think you'll be aware we put independent chairs over those subsidiaries three years ago and have worked hard to get good governance and be demanding as a shareholder of those subsidiaries. Probably there'll be others that we may exit shortly, while it's a very small investment in terms of our total operation, the investment in those kinds of disruptive technologies or new sort of complementary technologies are very important to Meridian going forward.

Question: So can you say where current thinking is on which one might be the next to go?

Paul: I don't think you'd expect us to again lay that sort of thing out. That would hamstring us in terms of our actions. In that portfolio we have stuff that's very close to our core activities. We have stuff that's profitable and doesn't distract the organisation and we have other parts which we would keep under review.

Question: Does the prospect or possibility of an ownership change, is that making any difference to the way you run the company in the meantime?

Tim: Oh look, materially Brian, in terms of operating the company, I don't think so. I made reference at the outset to this - we have been very concentrated on the idea of performing as a State Owned Enterprise under our Act which is absolutely performing relative to like listed companies. So all the work we've done in the last three years I think is very much delivering a more sustainable performance, albeit in quite a volatile market. That, at a macro level, doesn't change under a mixed ownership model - the pursuit of high sustainable performance and shareholder return.

Question: I can't find the figure now, but you talk about your return on investment excluding revaluations. Excluding revaluations from going how far back? Just last year or from which point is that?

Paul: All the way back, so in the actual accounting numbers you can pick up how that's done. So it excludes the valuation from the asset base and from its impact on depreciation as well.

Question: Right. Can you tell us what the return is based on the current book value of the assets?

Paul: I don't have that right to hand but it's relatively low as you'd expect, because if you have a balance sheet value which is based on tomorrow's prices and you compare that to today's profits, you are naturally going to have a mismatch. It's like dividing an apple by an orange and that's the reason why we rebase it.

Question: Can you tell us how the Pukaki hydro scheme would fit into the mix in terms of the generation pipeline, whether it will come perhaps before wind or before the next Australian project?

Paul: We're actually working on it quite hard at the moment to see what price we can get it down to, so I'm not quite sure at this point in time. It's looking hopeful because it's a relatively small lump of capital, but there are a few technical bits and bobs that we need to get sorted first.

Question: Are there any issues with what Genesis now has to do with the Tekapo assets and how that would affect building a new dam on Pukaki?

Paul: We've taken into account as far as we can all of that in terms of that investment.

Question: Any update on the search for a new CEO? Am I right? There's a search for a new chief executive?

Tim: You'll have to ask Chris Moller that. Look, it's in process. Chris and I have committed to a seamless transition, so the expectation is that sometime in the next two months or so the board will be able to make an announcement and I'll be able to move on.

Convenor: Okay, any more questions anyone, or are we ready to close?

Tim: Thank you very much everybody.

Paul: Thank you.

BRIEFING ENDS 43.11