Submission No 57

INQUIRY INTO THE CONTINUED PUBLIC OWNERSHIP OF SNOWY HYDRO LIMITED

Organisation:

Name: Mr F.W Heuke

Telephone:

Date Received: 22/06/2006

Theme:

Summary

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2 2 JUN 2006

SELECT COMMITTEE

SNOWY HYDRO

20th June 2006

The Director
Inquiry into the continued public ownership of Snowy Hydro Ltd.
Legislative Council,
Parliament House,
Macquarie St.
SYDNEY NSW 2000

This submission relates to sub-section 1(g) – other related matters – of the inquiry into the aborted sale of Snowy Hydro Ltd.

Of particular concern to me was the stated sale price of about $30 billion for an asset that was clearly grossly under-valued (book value of assets written down to $1.5 billion), and under-performing, the generators said to be running at only 13.5% of capacity. These and other details were highlighted by journalist Alan Kohler in the Sydney Morning Herald, (p.21; 24th May 2006.

Examination and extrapolation of these figures shows that the generating capacity could be trebled yet still operate below 50% capacity. Thus on power generating alone, the sale price of $30 billion would seem to be grossly inadequate.

As regards physical assets, the book value of 1.5 billion for assets described as "irreplaceable" seems to be divorced from reality.

I am not a qualified valuer however, I believe it to be not far from the mark to suggest that the true value of the company is nearer to $300 billion, or 10 times the intended sale price. I sense something suspicious here. I am not qualified to discuss insurance or derivatives.

I believe that the Select Committee should first, and as a matter of urgency, determine the true value of Snowy Hydro and then relate it to the sale price and determine who was responsible for recommending the sale.

I believe this whole affair had the makings of a monstrous and audacious fraud upon the Australian public.

F. Heuke

Mr. F.W. Heuke.

Encl: (1) SMH article, 24/6/06

Why Snowy Hydro prefers to keep the water

SMH 24 MAY '06 p. 21.

ALAN KOHLER

AT ANY moment Snowy Hydro can produce up to 3700 megawatts of electricity – as much as two Loy Yangs. If it ran all the time, like a normal power station, it could produce a colossal 32,412 gigawatt hours of power a year, yet in 2004-05 its output was just 4388 GWh – 13.5 per cent of capacity.

That fact is a clue to the real nature of this company, now being flogged by two Labor state governments and the Commonwealth Government against a background chorus of anguished wailing from water-worriers and nostalgics: Snowy Hydro is not really a power company. It is an insurance company that has water for capital instead of money.

Trying to understand Snowy Hydro, corporatised in 2002 and now about to float after a public issue, is a mind-bending experience and I don't envy investors who will be basing big decisions on understanding it. But I now know two things: water is money and Snowy Hydro's main product is not electricity, it's insurance.

The physical assets of the company are 16 dams, 31 power units, 80 aqueducts and 145 km of pipelines. It also possesses the right to "collect, divert, store and release" water from melted snow on the Snowy Mountains. The physical assets are in the company's books at $1.5 billion and at that, on a replacement cost basis, they are vastly undervalued. It is a truly, totally, irreplacable set of assets.

It now has two other assets, quietly bought or built since last balance date: a gas power station in the LaTrobe Valley bought recently for $250 million and another one at Laverton in Melbourne that the company had built. As a result, debt has increased from $615 million last July to $950 million now.

That, as I understand it, is what the level of debt will be in the prospectus, which is to say the pre-float dividend to the three government shareholders will consist of this year's cash profit – no more and, probably, no less.

Anyway, so far as I can grasp, there are two keys to Snowy Hydro's profits: how much snow falls on the Australian Alps, and therefore how much water goes into its dams; and how unpredictable is the weather in Melbourne and Sydney, and therefore how much volatility there is in the electricity market.

Like all insurance companies, Snowy Hydro profits from the fear of its customers and from the management of its capital which, in this case, is water.

The water is not owned by Snowy Hydro, just rented. It flows when the snow melts into lakes Eucumbene and Jindabyne and the other dams and each year the company is obliged to release at least 1026 gigalitres into the Murrumbidgee River and 1062 GL into the Murray. In addition, it has to put enough back into the Snowy River to meet the NSW and Victorian governments' commitment to get the river back to 21 per cent of its historic flows.

The water going into the Murrumbidgee and the Murray goes through the electricity turbines; the water for the Snowy bypasses them. The big fear of the farmers who rely on Murrumbidgee and Murray water for their living is that Snowy Hydro will release water when they don't need it (that is, when it's cold and rainy on the farms, and electric heaters are going on in south-east Australia). To counter that, the water goes into government-owned holding dams to be released later if there's a timing conflict.

For Snowy Hydro, the important thing is for the level of its dams to be above the "target water level", or TWL, that is needed to meet its obligations for the three rivers. Every litre above that level is pure cash, because the company can write insurance contracts against it in much the same way as, say, QBE writes business, or a bank lends against its Tier 1 capital.

Snowy Hydro makes revenue in three ways: power generation (the least of the three), "insurance" contracts with power retailers, including guaranteed price caps and swaps, and thirdly, settlement residue auctions (SRAs), which involves collecting on the difference in price across a particular interconnection, say between NSW and Victoria (which may differ because of the weather).

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Why Snowy prefers to keep its water

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The simplest type of insurance contract is where Snowy Hydro will do a 100MW swap with AGL at $50 per MW. If the price is below that, Snowy Hydro wins; if it's above that, AGL wins. It's a relatively straightforward derivative-based hedging business; banks like Westpac are active in it as well because it's just an extension of their commodity hedging operations.

But whereas Westpac is trading off the capital on its balance sheet, Snowy Hydro is trading off the water in its dams, especially the water above the TWL.

Snowy Hydro does not reveal the breakdown of its profits between selling electricity and selling insurance, beyond saying the "vast majority" of profit comes from insurance and hedging activities.

That's why, in case you were wondering, the company has to be forced to push at least 2068 GL of water through its turbines to generate electricity so down-river farmers can irrigate their crops; far better for profits to just let the snow-melt fill up the dams and then just write insurance contracts against the "liquid capital".

But why the gas-fired power stations in Victoria (and probably more later in NSW)? Because Snowy Hydro's only real risk is transmission failure – those generators near the market are its own insurance policy.

Alan Kohler publishes Eureka Report, a newsletter financially backed by Carnegie, Wylie & Co.

ak@eurekareport.com.au