

REPORT OF PROCEEDINGS BEFORE

GENERAL PURPOSE STANDING COMMITTEE No. 1

INQUIRY INTO THE GENTRADER TRANSACTIONS

At Sydney on Tuesday 18 January 2011

The Committee met at 10.00 a.m.

PRESENT

Reverend the Hon. F. J. Nile (Chair)

The Hon. G. J. Donnelly
The Hon. L. A. Foley
The Hon. K. F. Griffin
The Hon. Dr J. Kaye
The Hon. T. J. B. Khan
The Hon. G. S. Pearce

CHAIR: Welcome to the second public hearing of the inquiry into gentrader transactions. I refer attendees of today's proceedings to the statement I made yesterday concerning the Committee's proceedings and prorogation of Parliament. The Committee intends to hold further hearings on Friday 21 January and Monday 24 January.

Before we commence, I will make some comments about procedural matters. The Committee previously resolved to authorise the media to broadcast sound and video excerpts of its public proceedings. In accordance with the Legislative Council's guidelines, members of the Committee and witnesses may be filmed or recorded, but people in the public gallery should not be the primary focus of any filming or photographs. In reporting the proceedings, the media must take responsibility for what they publish or interpretation that is placed on anything that is said before this Committee.

Witnesses, members and their staff are advised that any messages should be delivered through the Committee clerks. All persons present should please turn off their mobile phones. I am very pleased to welcome our first witnesses for today and I thank them for their attendance—Mr Michael Schur, Secretary, New South Wales Treasury; Mr Kevin Cosgriff, Deputy Secretary, Fiscal and Economic Directorate, New South Wales Treasury; and Mr Richard Timbs, Deputy Secretary, Commercial Management Directorate, New South Wales Treasury. All witnesses will be sworn or affirmed prior to giving evidence. I know that the witnesses have attended previous hearings of other Committees, but that does not cover this particular Committee's inquiry.

KEVIN COSGRIFF, Deputy Secretary, Fiscal and Economic Directorate, New South Wales Treasury, and

RICHARD TIMBS, Deputy Secretary, Commercial Management Directorate, New South Wales Treasury, Level 27, Governor Macquarie Tower, 1 Farrer Place, Sydney, sworn and examined:

MICHAEL ALAN SCHUR, Secretary, New South Wales Treasury, Level 27, Governor Macquarie Tower, 1 Farrer Place, Sydney, affirmed and examined:

CHAIR: As Chairman, I add my personal thanks for your appearance. There was some debate of whether public servants would attend this Committee's hearings. I am grateful that you accepted the invitation. Do you wish to make any statement, Mr Schur?

Mr SCHUR: No.

CHAIR: We will commence questions with Mr Pearce.

The Hon. GREG PEARCE: Mr Schur, having regard to your previous appearances before this Committee, what guarantees can you give us that your evidence will be truthful, complete and honest?

The Hon. GREG DONNELLY: Point of order: The question goes straight to the throat in terms of impugning the witness's truthfulness and honesty.

The Hon. GREG PEARCE: I suggest you read the transcripts of evidence that Mr Schur previously has given in relation to infrastructure.

CHAIR: Allow Mr Donnelly to complete his point of order.

The Hon. GREG DONNELLY: The question is inappropriate.

The Hon. GREG PEARCE: The question is entirely appropriate.

The Hon. GREG DONNELLY: Greg, I can take the time up if you like and you can talk as long as you like. You are an experienced member of the House. You know the form of questions and how they are to be asked. That is an inappropriate question and I ask you to withdraw it.

The Hon. GREG PEARCE: I am not going to withdraw it. I want the question answered.

CHAIR: It is quite clear that the witnesses have taken the oath or affirmation. That is sufficient testimony to the truthfulness of their statements before this inquiry.

The Hon. GREG DONNELLY: Thank you, Chair.

The Hon. GREG PEARCE: Mr Cosgriff, we know that your evidence will be frank and open. Can you outline for the Committee your role in the energy reform process?

The Hon. GREG DONNELLY: Point of order: The implication of the question you asked impugned the person you asked the first question of.

The Hon. GREG PEARCE: And your point is?

The Hon. GREG DONNELLY: The point is that I ask you to withdraw it.

The Hon. GREG PEARCE: I have already said I am not withdrawing it, and the Chair has ruled on it.

CHAIR: We do not want you to give a preamble to the question.

The Hon. GREG DONNELLY: By impugning a witness to this inquiry.

CHAIR: Just ask him the question.

The Hon. GREG PEARCE: The question to Mr Cosgriff was: Could you outline to the Committee your role in the energy reform process?

Mr COSGRIFF: Yes. I sit on the steering committee along with Richard Timbs. I have in the past run the energy section in the New South Wales Treasury, but that is now the responsibility of Richard.

The Hon. TREVOR KHAN: I am sorry, I just missed that last bit.

Mr COSGRIFF: I have in the past run the energy section in the New South Wales Treasury, but that is now the responsibility of Richard.

The Hon. GREG PEARCE: Did you have a role in setting the retention values for each of the assets?

Mr COSGRIFF: I did not have a role beyond the role of being on the steering committee. There was a subcommittee which was responsible for the work that led to the retention value which has been approved by the steering committee and the budget committee of Cabinet.

The Hon. GREG PEARCE: Do I take it from that that you were part of the recommendation of the retention value?

Mr COSGRIFF: Of the steering committee to the budget committee of Cabinet, yes.

The Hon. GREG PEARCE: And those recommendations were accepted?

Mr COSGRIFF: Yes.

The Hon. GREG PEARCE: Just to be completely clear on this, there was a retention value for each of the individual assets for, in particular, the Delta West assets.

Mr COSGRIFF: Yes. The evaluation was done against the package of assets that Origin and TRU had bid on. To compose that, you have to compose a series of retention value analyses based on your expectation about the cash flows out of the existing generation and retail businesses.

Mr TIMBS: I was heavily involved in any retention value setting process. I am quite happy to take any questions you might have on that.

The Hon. GREG PEARCE: My question is quite clear: Was there a retention value set for the Delta West assets?

Mr TIMBS: Yes, there was.

The Hon. GREG PEARCE: There was—an individual value?

Mr TIMBS: Yes.

The Hon. GREG PEARCE: Was there a retention value set for the Eraring assets?

Mr TIMBS: Yes. The retention value process, consistent with the Government's aims to actually transact all of the assets in one loan in a simultaneous set of transactions, was a retention value that was calculated for all of the assets that were intended to be transacted and then there were retention values calculated for all of the discrete component parts because there might have been the possibility, which turned out to be the case, that we were not transacting everything at the one time.

What we needed to do was to be in a position to have retention values calculated across particular packages or bundles which the Government ultimately decided to transact. In the case of the Origin Energy transaction for the assets acquired by Origin, there was a retention value calculated for that package of assets which was compared to the transaction. In the case of the TRUenergy transaction, there was also a retention value calculated for that package of assets that was compared to those bids.

That process was entirely consistent with the recommendation of the Auditor-General in his report in 2008, which I quote. He recommends, "... calculating a retention value for each generator and retailer"—I am sorry. His quote was, "I am of the view it is also essential for a confidential reserve price for each transaction to be established by the Government before each transaction proceeds." That is the methodology that we followed.

The Hon. GREG PEARCE: Without disclosing the retention values, can you indicate to us whether the price paid for the Delta West assets exceeded the retention value for the Delta West assets?

Mr TIMBS: As you say, I am not in a position to comment on specific retention values because those matters remain commercial-in-confidence and we have a remaining transaction in process. We would not want to prejudice that. What I can confirm is that the bids for each of the transactions that have been signed by Government exceeded the retention values for those packages or those bundles. In the case of TRU, the bid exceeded the retention value for the assets that they are acquiring. In the case of Origin, the bid exceeded the retention value for the assets that they are acquiring.

The Hon. GREG PEARCE: If I understood you correctly in terms of the process, you said that the retention values for the packages were calculated or determined after the bids were actually lodged.

Mr TIMBS: No. I did not say that.

The Hon. GREG PEARCE: When exactly where the retention values for the packages determined?

Mr TIMBS: The retention value work was done in the months leading up to bids being submitted, and the recommendation to approve retention values was put to the budget committee of Cabinet prior to this being lodged and was approved by the budget committee of Cabinet prior to bids being lodged.

The Hon. GREG PEARCE: When the bids came in, you took those pre-approved retention values and bundled them up to match the bids, and that was what went forward for the final decision. Is that it?

Mr TIMBS: That is correct.

The Hon. GREG PEARCE: There has been some public concern about an alleged breach of confidence in relation to negotiations with Hydro Aluminium Kurri Kurri. Mr Schur, can you outline what has occurred there?

Mr SCHUR: I am not aware of that. One of my colleagues might be able to answer that.

The Hon. GREG PEARCE: You are not aware of it?

Mr SCHUR: No.

The Hon. GREG PEARCE: Mr Cosgriff?

Mr COSGRIFF: No, I am not aware of that.

The Hon. GREG PEARCE: You are not aware of it either?

Mr TIMBS: I am also not aware of any breach of confidence.

The Hon. GREG PEARCE: You are not. There is a suggestion that an injunction was taken out against the Government to prevent a breach of confidence. Are any of you aware of that? Is that a no?

Mr COSGRIFF: No.

Mr TIMBS: I think if there is an injunction that has been lodged, that would be a matter of public record.

The Hon. GREG PEARCE: That is right.

Mr TIMBS: But as I stated in my earlier answer, I am not aware of any breach of confidence.

The Hon. GREG PEARCE: You are not aware of any breach of confidence. Are you aware of an allegation of a breach of confidence?

Mr TIMBS: No.

The Hon. TREVOR KHAN: Mr Schur, I do not want to keep you out of the game, so I will talk to you and you can decide where we go from there.

Dr JOHN KAYE: He is thrilled.

The Hon. TREVOR KHAN: I am a lawyer as opposed to an accountant, so you will have to keep it simple. I think what mums and dads are interested in out of the transaction is what the impact of this transaction may be on things like whether we are going to be better or worse off. Keeping it simple, do I take it that you as Treasury Secretary have gone to the task, or have delegated the task to somebody, to work out what the effect of this transaction is on the receipt of tax equivalent payments going into the future? Would that be right?

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: Do I take it that is an exercise that would have gone forward for some years to work out what that effect is?

Mr SCHUR: Correct.

The Hon. TREVOR KHAN: Do I take it that one of the effects of this transaction is that the tax equivalent payment—that is, part of the money that the Government would otherwise receive—is reduced because by selling the gentrader assets and the retailer assets, those will now be paying taxes to the Commonwealth instead of the tax equivalent payments coming to the States?

Mr SCHUR: That is correct, yes.

The Hon. TREVOR KHAN: There is a calculated reduction in the amount of money that is now going to be received into the budget bottom line. Is that right?

Mr SCHUR: Yes, but that is only one side of the equation.

The Hon. TREVOR KHAN: We will get to it. Again, I am simple, so I will just deal with it in its component parts. Are you able to indicate for each of the coming four years what the reduction in tax equivalent payments will be that will be received by the State?

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: Will you do that?

Mr SCHUR: Yes. I can give you some details now.

The Hon. TREVOR KHAN: I am inviting you to.

Mr SCHUR: I should say, Mr Khan, that I will provide a detailed analysis—a year-by-year analysis—of the impact of the transaction on the State's finances as part of my updated statement of uncommitted funds, in which I indicated in the first version of that that the statement of uncommitted funds would be updated for any significant change to the State's financial position, in particular in relation to the energy transaction. Let me answer your question in this way: The way we have to consider the transaction is in two ways—What is the impact of the transaction on the State's finances? Does the transaction represent value for money?

The Hon. TREVOR KHAN: I am asking you, with respect—and I know you are trying to do your best.

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: I am asking you: What is the effect in terms of the tax equivalent payments? How much less are we going to receive each year over the next four years?

Mr SCHUR: I am going to answer your question. If you are prepared to bear with me, Mr Khan, I will answer your question.

The Hon. TREVOR KHAN: We will see how far I am prepared to bear.

Mr SCHUR: I will answer your question. As I said, there are two things to consider here: did the State get value for money and what is the impact on the State's finances? When we talk about the impact of the transaction on the State's finances, there are two impacts. It is really important that we understand those two impacts.

The Hon. TREVOR KHAN: Mr Schur, I do not want to be rude. I really do not, believe it or not. I am asking what is the impact of tax equivalent payments?

Mr SCHUR: Mr Khan, I am answering your question. Bear with me and I will answer your question.

The Hon. TREVOR KHAN: I want you to answer the specific question.

Mr SCHUR: You have asked me a question but the point is there is a negative impact from the lost dividends and tax equivalents that we would have received—

The Hon. GREG PEARCE: What are the amounts?

Mr SCHUR: I am going to take you through that, Mr Pearce—but they are more than offset by the impact of the transaction. I cannot give you an answer to that question without explaining the broader implications of the transaction on the State's finances. So please bear with me. There are two impacts on the State's finances. The numbers I am about to give you, which will answer your question, are relative to the aggregates that we published in the 2010-11 half-year review. First of all, there is an unambiguous improvement to the State's balance sheet to the tune of about \$5 billion. So the day we receive the proceeds from Origin and TRU the State's balance sheet is improved by about \$5 billion relative to the—

The Hon. TREVOR KHAN: Can I just cut you off there? Are you saying that at some point in time the State Government is going to receive \$5.3 billion in one lump sum?

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: Subject to adjustments, is that right?

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: So suddenly into the coffers is going to come \$5.3 billion, is that what you are saying?

Mr SCHUR: That is correct.

The Hon. TREVOR KHAN: That is what TRUenergy is giving us—one lump of their part of the transaction?

Mr SCHUR: Yes.

The Hon. TREVOR KHAN: Are they not bleeding it in over some years?

Mr SCHUR: No, they are not. They are paying upfront for the gentrader. The capacity payments they are paying upfront. That is true for both transactions.

Dr JOHN KAYE: They are paying upfront?

Mr SCHUR: Upfront payments.

Mr TIMBS: The \$5.3 billion is a combination from TRU and from Origin.

Dr JOHN KAYE: They are paying upfront?

Mr SCHUR: They are paying that all upfront. When we execute these transactions in a matter of weeks the State's balance sheet will unambiguously improve by the tune of \$5 billion.

The Hon. TREVOR KHAN: By that lump of money coming into a bank account?

Mr SCHUR: Correct, the balance sheet.

The Hon. TREVOR KHAN: By that lump of money coming into a bank account, I asked?

Mr SCHUR: Yes. Let me explain what that means for the State's finances. The State's credit rating—

The Hon. GREG PEARCE: Forget the numbers on the tax—

The Hon. GREG DONNELLY: Point of order.

The Hon. GREG PEARCE: This is what I was concerned about at the beginning.

The Hon. GREG DONNELLY: I am trying to follow the witness giving his answer. He is barely getting the opportunity to speak for 45 or 50 seconds without an interruption. You are entitled to ask your questions but it seems to me that you are getting to the point of almost badgering the witness.

The Hon. TREVOR KHAN: People have seen me badger a witness. He is not getting badgered.

The Hon. GREG DONNELLY: The witness is entitled to be given an opportunity to answer the question as he wishes to do so. You are getting to the point of badgering the witness.

The Hon. TREVOR KHAN: That is ludicrous. Let him get on with it and stop wasting time.

Mr SCHUR: Mr Khan, your question went to the impact of the transaction on the State's finances.

The Hon. TREVOR KHAN: My question actually went to the tax equivalent payments. Anyway, go on.

Mr SCHUR: I will get to that. The State's balance sheet unambiguously improves by \$5 billion. What that means is that that translates into a 7 per cent reduction in the key credit rating metric that the rating agency Standard and Poor's uses to assess the creditworthiness of our State. That credit rating metric, which is the ratio of total State net financial liabilities to total State revenues, at the end of the forward estimates as per our half-year review gets up to about 112 per cent. The rating agencies have told us that a trigger—

The Hon. TREVOR KHAN: Mr Schur—

CHAIR: Would you let him finish his explanation?

Mr SCHUR: Mr Khan, I really would have thought that the inquiry would be interested in the impact of the transaction on the State's finances.

The Hon. GREG PEARCE: Do not lecture the Committee. Just answer the question.

Mr SCHUR: I am answering the question. There is a 7 per cent improvement in the ratio. That gives the State tremendous headroom and flexibility on its balance sheet that it would not otherwise have. Let us go to the impact on the budget. Yes, there is a reduction in tax equivalents and lost dividends when we transact on these assets. That is equivalent to roughly \$600 million of dividend flows, tax equivalent flows that we no longer have. But—

The Hon. TREVOR KHAN: Because I asked about tax equivalents, again, what is the impact year by year for the next four years in terms of tax equivalent payments?

Mr SCHUR: I have an aggregate figure here of forward dividends and tax equivalents. I have an aggregate figure. It is roughly \$600 million over the forward estimates. But that is more than offset by the interest earned on those proceeds. Because the assumption that is made, Mr Khan, is—

The Hon. TREVOR KHAN: Mr Schur, can I just ask this question? In terms of Eraring, for instance, what is the reduction in tax equivalent payments and dividends received from Eraring?

The Hon. GREG PEARCE: Could you table that document, Mr Schur?

Mr SCHUR: I will not table it. I will provide this as part of my statement of uncommitted funds.

Mr TIMBS: It is about \$300 million over forward estimates.

The Hon. TREVOR KHAN: Have you or your department made an assessment on the impact on the profitability going forward of this transaction on Eraring?

Mr SCHUR: Yes, we have.

The Hon. TREVOR KHAN: Are you able to give us what the impact is on its profitability?

Mr TIMBS: Mr Khan, if I can take you back to my comments earlier on retention value. The retention value work was exactly that. It was a comparison of the state of play immediately pre-transaction—so the businesses that we own and an estimate of the expected cash flows from those businesses for the remaining term. That takes into account things like dividends, tax equivalent payments, government guarantee fees. What it compares against that is the bids that we got less any residual liabilities or provisions that we need to create. In respect to Eraring though, the design of the gentrader agreement is such that Eraring's costs broadly will be covered by the fixed and variable operating payments that it gets from the gentrader. So rather than being the trading profit-making enterprise that it is today, it is effectively getting coverage of its costs from the gentrader. So it would be a—

The Hon. TREVOR KHAN: What assumptions have been made with regard to its continuing debt position?

Mr TIMBS: There will be no debt in Eraring. All of the debts in Eraring will be repaid.

The Hon. TREVOR KHAN: Out of the proceeds of sale?

Mr TIMBS: Correct, and the debt apportioned to the Delta West component of the Government's transaction will also be repaid. That must be repaid. Those businesses under the gentrader contract will not have an ability to service debt in the future. So they will be left debt free.

Mr SCHUR: Mr Khan, if I could just add to that, and I was going to get to this. We have got this \$5 billion that comes in when the transactions are executed. In terms of the impact of that on the budget, what we do is we assume that we take those proceeds and use those proceeds to retire all the outstanding debt for these entities.

The Hon. GREG PEARCE: How much is that?

Mr SCHUR: This is essentially the debt for the generators, the gentrader contracts.

Mr TIMBS: It is approximately a bit over \$1.2 billion.

The Hon. GREG PEARCE: Total, for the two?

Mr TIMBS: That is for Eraring and for Delta West, yes.

CHAIR: Would you state that figure again?

Mr TIMBS: It is approximately \$1.2 billion.

The Hon. TREVOR KHAN: In terms of the retailer components, is their debt being retired as well?

Mr COSGRIFF: Effectively the retailers do not have any debt. The debt is carried by the network businesses which they have been associated with.

The Hon. TREVOR KHAN: The network businesses' debt will not be retired?

Mr COSGRIFF: No, the network debt is supported by the revenue flows they get from the regulatory determined rate of return they get out of the Australian Energy Regulator.

The Hon. GREG PEARCE: One final question.

The Hon. GREG DONNELLY: No, it is our question time.

The Hon. GREG PEARCE: You took up enough of our time. Let me ask one question.

Dr JOHN KAYE: It is not your question time, Mr Donnelly, it is mine.

The Hon. GREG PEARCE: There has been a great deal of reliance on the Auditor-General to report on these transactions. In the Auditor-General's report on the lotteries transaction, the most recent report, he made comments about the fact that New South Wales Treasury obtained legal advice which limited his power to undertake the review. He complained about that in his report. Will you give us an undertaking that Treasury will cooperate with the Auditor-General in relation to the inquiry into these transactions and give him full access to allow him to do whatever report he wants to?

Mr SCHUR: We did that in relation to the lotteries transaction. We did not limit his powers in any way.

The Hon. GREG PEARCE: According to him, you obtained two legal advices—not one, but two—from the Crown Solicitor about his powers, limiting him as to what he could do.

Mr SCHUR: Which in no way limited his powers.

The Hon. GREG PEARCE: Why did he write that in the preface to his report? Would you like to have a look at it?

Mr SCHUR: I do have his report. I do not believe he said it limited his powers.

The Hon. GREG PEARCE: Will you fully cooperate?

Mr SCHUR: We have previously and we will.

The Hon. GREG PEARCE: Will you allow him to undertake such report as he wants to?

Mr SCHUR: Absolutely. We encourage his participation.

Mr TIMBS: Mr Pearce, in relation to the second part of your question about access to records, I led the lotteries transaction. I had the primary interface with the Auditor-General. I can assure you that the Auditor-General had complete and unfettered access to every single document in relation to the lotteries transaction. I think if you asked him he would confirm that. There was no restriction as to access whatsoever.

CHAIR: We will move on to questions from Dr John Kaye.

Dr JOHN KAYE: I want to be absolutely clear. Mr Schur, let me take the case of the gentrader Eraring's purchase by Origin of \$950 million, according to Origin's documents. You are saying that \$950 million turns up in the balance sheets. By that, do you mean that goes into general revenue? So tomorrow the Treasurer could write a cheque for \$950 million to buy something?

Mr SCHUR: Yes.

Dr JOHN KAYE: Why then does Origin in its document say, "At completion Origin has agreed to place funds on security deposit for the term of the gentrader arrangements to cover the annual capacity charge payment"? I am terribly confused. On the one hand, you say it comes as a nice cheque in the mail to the Treasurer. On the other hand, Origin does not think that at all. Origin says that it is putting the money into a security deposit for the term of the gentrader arrangement to cover the annual capacity charge payment. Can you unwind that for us, Mr Schur?

Mr SCHUR: I will get Mr Timbs to talk about the contractual arrangements.

Mr TIMBS: I do not think there is an inconsistency between the two statements. What Origin is saying is that they are paying upfront for the proceeds of the transaction. The reason they do that is rather than the State take credit risk on their ability to pay capacity charges in future years, they are actually giving us all that money upfront and we get access to it upfront.

Dr JOHN KAYE: Can you define the word "us"? What Origin says in its document is that it will place the funds on security deposit. Earlier Mr Schur told us, no, we are going to get the money in a cheque. Mr Roozendaal or Mr Schur will go down to the bank and deposit it and it is there ready to write another cheque against. You are saying that is not the case.

Mr TIMBS: I am saying the money becomes an asset of the State.

Dr JOHN KAYE: It is an asset of the State—

The Hon. GREG PEARCE: It is an annual payment.

Dr JOHN KAYE: —but it is an annual payment. I refer to what Origin is saying as against what Mr Schur is saying. I note that Mr Schur and Mr Cosgriff are busy trying to sort this out. Mr Schur said it was a lump sum of payment. Here it is, here is your money. What you or Origin are saying is that, no, it is an asset of the State but it is placed in a security deposit and we only get it on an annual basis. Are you correct or is Mr Schur correct?

Mr TIMBS: I am saying it is cash and I am saying it is an asset of the State.

Dr JOHN KAYE: It is cash? It is not in a security deposit at all?

Mr TIMBS: A security deposit is cash.

The Hon. GREG PEARCE: Is it accounted straightaway or on a yearly basis when it is due?

Dr JOHN KAYE: That is the question. How is it accounted? Do you put it into the balance sheet today and say that we have got \$950 million in this financial year or does it come in year by year?

Mr COSGRIFF: No, it is accounted for as a financial asset as it is received.

Dr JOHN KAYE: As it is received?

Mr COSGRIFF: As it is received on the day that Origin executes the transaction, or TRU or whomever we are discussing.

Dr JOHN KAYE: Do you have any sensitivity at all for my confusion on this matter? On the one hand, you are saying it is a lump sum payment. On the other hand, Origin is saying it is an annual capacity charge payment. Do you see any contradiction between those at all?

Mr SCHUR: I have not seen the documentation you refer to but—

Dr JOHN KAYE: You have not seen the documentation?

Mr SCHUR: I have not seen the document.

Dr JOHN KAYE: You have not seen Origin's statement to their shareholders?

Mr SCHUR: No.

Dr JOHN KAYE: Fascinating.

Mr SCHUR: But unambiguously it comes into the State's balance sheet on day one on the execution of the contract.

Dr JOHN KAYE: The balance sheet is one thing but does it come in as cash on day one to the State with the State's ability to use that cash as cash without borrowing further money—to use that cash to pay teachers and tram drivers and whatever?

Mr SCHUR: Yes. It is available on day one.

Dr JOHN KAYE: As cash or do you have to borrow to get that money? Could you pile it up in a pile of \$950 million in cash? I am sorry to simplify this but it is totally the opposite of what Origin is saying.

Mr TIMBS: The cash, the security deposit, is an asset that can be borrowed against.

Dr JOHN KAYE: So you have changed your tune. It is not actually cash—

Mr TIMBS: Excuse me, I have said for the last five minutes it is cash, it is an asset of the State. That is the answer I have given to your questions.

Dr JOHN KAYE: But you cannot use it. It is like grandma has left you something but she has left it in a security deposit and if you want to use it you have got to borrow against it. Is that what you are saying?

Mr TIMBS: Correct.

Dr JOHN KAYE: So it is not actually cash in the sense that you can use that cash now. Is that right, Mr Schur?

Mr SCHUR: No, that is not my understanding.

Dr JOHN KAYE: But that was the understanding that Mr Timbs just gave us.

Mr SCHUR: My understanding is that it comes in and on day one it is an asset of the State and it improves the balance sheet of the State to the tune of almost \$5 billion.

Dr JOHN KAYE: Sorry, Mr Schur, we have done that, but the question is: is it cash? Mr Timbs says it is cash but you cannot use it; you are saying it is cash but you can use it without further borrowing?

Mr TIMBS: I did not say you cannot use it; I said you can borrow against it.

Dr JOHN KAYE: You can borrow against it, true. You could borrow against Parliament House; that does not make it a cash asset—it does not make it cash, it makes it an asset. You are saying it is cash; he is saying it is an asset. Basically, what we can take away from this is that you guys do not know?

Mr COSGRIFF: No, Dr Kaye, let us be crystal clear about this. In the budget we produce three statements: we produce an operating statement, a balance sheet and a statement of cash flows.

Dr JOHN KAYE: Yes, I am aware of that.

Mr COSGRIFF: We have for some years in the first two statements done that on an accruals basis. What we are saying is that the payments by those two businesses will be accrued into the State's accounts on the balance sheet as an upfront payment. That means that they will effectively improve the balance sheet of the State to \$5.3 billion.

Dr JOHN KAYE: Let us go somewhere else for a minute. You gentlemen, two, I believe, of the three of you gentlemen were on both the evaluation committee and the steering committee, is that correct?

Mr TIMBS: I was on the evaluation committee and the steering committee.

Dr JOHN KAYE: Mr Cosgriff or Mr Schur, were you on either of those committees?

Mr COSGRIFF: I am on the steering committee; I was not on the evaluation committee.

Dr JOHN KAYE: Can I ask you, Mr Timbs—and I am not seeking specific dollar amounts because I would understand that all I would get back is that is commercial in confidence—can you tell me how you valued the downside risks in these bids? You have these bids: you had a bid from Origin and you had a bid from TRU and you had bids from AGL, but there are a number of downside risks for the State associated with those. There was the risk on maintenance—the decision made somewhere that maintenance would be fixed from day one; there would not be re-negotiation of the maintenance contract. The ALDs, which pose some risk, as we heard yesterday from Mr Yeadon; there are significant downside risks on the ALDs. We will come to the coal contract in a minute, because that is a separate issue. Let us talk about the maintenance and the ALDs. What mechanisms did you use to say what are the long-term risks to the balance sheet, whatever, to the people of New South Wales of those two attributes of those contracts?

Mr TIMBS: On all of those matters we engaged independent expert advisers to do forecasts and to look into those matters precisely. We also worked with the State-owned corporations themselves to get their input, because they are obviously running the businesses. So we received expert independent reports on those precise matters that you are talking about on the issue around the potential for outages and also around the future maintenance profile of the businesses.

Dr JOHN KAYE: So the risk of a substantial outage happening at a bad time causing a substantial liability against the contract and the risk of an unexpected maintenance cost that was not anticipated in the payments from the gentrader to the generator, you looked at both of those risks?

Mr TIMBS: Yes, we did, and I think if we can just talk about the outages for a minute because a very important point which I am not sure came out fully yesterday is that these risks around outages are in fact not new risks at all under the gentrader; they are a risk that was in the business immediately prior to gentrader and they are a risk that is with the State immediately post-gentrader.

Dr JOHN KAYE: We understand that but this is a different situation because surely prior to that the generator had on the one hand risks and on the other hand they had an upside risk of a high price and selling their energy at a high price. They were balancing those in marketing. But these are new days for the State-owned corporations. My real question, Mr Timbs, is: when you looked at the retention value and you asked the question was this bundle of offers, of bids, greater than retention value, did you subtract some measure of risk?

Mr TIMBS: Let me take you through it because it is a very important point. The test on this particular transaction, on these two bundles, as it is with all government asset sales, is are you better off post-transaction, taking into account all of the impacts, the net impact of the transaction, than you would be under the retention value? The best way to think of this is like an equation. On the one side you have got what is the retention value, and the retention value is the value to the government today of that business for evermore—that is your starting point. What you have to do is you have to beat that. So then what we do is look at the gross bids that we have got and then we take off that any amounts that are liabilities created by the transaction for the future.

Dr JOHN KAYE: Can I pause you there for one second and just ask you this question? Those liabilities you are taking off are in respect of events that are yet to happen?

Mr TIMBS: I was about to make that comment.

Dr JOHN KAYE: Which is what Donald Rumsfeld would refer to as, to some extent, unknowable unknowns. The question I want you to address is how do you put a current value on those things that are yet to happen?

Mr TIMBS: I was about to explain. Going back to the equation about retention value, what we are comparing to retention value is the gross bids we received less liabilities that are potential future liabilities that are created through the transaction, and in this case we are looking at any payments we might have to make to gentraders under the contracts and any costs that are incurred by the retail businesses as a result of their sale.

Dr JOHN KAYE: So what probability did you put on a major outage at two units at Eraring simultaneously that will require re-turbining them?

Mr TIMBS: There was an extremely sophisticated piece of work and an algorithm around all of the generators and there were confidence levels derived from zero to 100 per cent as to the likelihood of an amount of payments being made. So we did an analysis of what is the 50 per cent confidence level, which is your sort of expected, your mid-point, your most likely—you might beat that, you might be under that—and 95 to 100 per cent confidence levels. So we looked at the entire range of those possibilities.

Dr JOHN KAYE: But, like all good gambles, underlying that is somebody's expectation of what is going to happen in the future—somebody's understanding of the risk profile of what is going to happen in the future. Was that yours, Mr Timbs, or Mr Schur's or Mr Cosgriff's or Mr Roozendaal's or mine?

Mr TIMBS: No, it was based on a detailed review of the previous operating history of the businesses and detailed and expert technical advice from relevant advisers.

Dr JOHN KAYE: Mr Timbs, you are guaranteeing us that the future will be a repetition of the past?

Mr TIMBS: No, I am not saying that at all. You cannot actually look at the situation with liquidated damages post the transaction in isolation of what it would be today. Those risks are in the businesses today because the business, if it is not producing at times of high market prices, will miss out on profits, which go to profitability, or it might be put in a situation where it has got to go into the market and buy cover for contracts that it has written that it cannot physically deliver on. So there is an inherent volatility and instability in the forward revenue profile of those generators today. We have got that; the State has got that. If there is no gentrader transaction we are at that risk.

If I can just make the point: if you look at the annual dividend coming from Eraring and from Delta for the last five years, the annual dividends for both Eraring and Delta in financial year 2009 and financial year 2010 were less than they were in financial year 2005. So these are our profit-making businesses which are inherently volatile and that is the nature of trading in the electricity market. Those risks are already there today; all we were doing was trying to put a quantum around what is left after the transaction. What we have done in looking at retention value is look at the gross bids, taken off the provision for these ALDs, taken off the costs of separating the retail businesses out, and that net amount exceeded the retention values for both transactions. That was the work that was done.

Mr COSGRIFF: Can I just add to this point, so that it is crystal clear, about the modelling of generator outages, that you could calculate 8,760 hours in a year and say that was the capacity that was available from each of our generation units. In practice they have run historically up to 90 per cent of that—it varies a bit depending on the generator—and that covers both the unforced outages, the outages for repairs and for maintenance, those sorts of things, plus the forced outages, the outages that occur because something unexpected goes wrong, and the 2, 3, 4, 5 per cent of the hours in the year are the historic pattern out of the generators.

That historical pattern is used in the gentrader contracts to construct an availability. So it is not true to say that the gentrader has got in their contract or the generator is liable for 100 per cent of the hours of generation. What it is true to say is that there is a number there that reflects the historic pattern and the change in that pattern through time of availability of the New South Wales generation plant that is specific to the individual generation plant and different from each other, reflecting their underlying engineering, their track record and how they are expected to perform over time.

Dr JOHN KAYE: Which is fine so long as the future is a repeat of the past?

Mr COSGRIFF: No, so long as the future reflects the patterns of the past, because there is a decay factor built into the capacity for each of the generation units, as you would expect.

Dr JOHN KAYE: Which you know what it is.

Mr SCHUR: Can I just add to that for a moment? I want to correct the record. Dr Kaye is right: it is not the cash position of the State that improves by \$5 billion; it is unambiguously the State's balance sheet and it is the additional fiscal flexibility, that improvement to the State's balance sheet, is what is important here in terms of the overall impact on the State's finances.

Dr JOHN KAYE: But not the cash?

Mr SCHUR: Not the cash. In terms of the cash impact, as I say, I am happy to give that detail when I submit my updated statement of uncommitted funds. In relation to the ALD regime I think it is important that we make a point that I think has been missing so far in some of the debate. This is not a new risk—I think Richard has made the point. The risk associated with unplanned outages is an existing risk; it is a risk that the businesses currently face.

Richard has already made the point that volatility in dividends we receive from these businesses is somewhat a reflection of that risk. Could we have got rid of this risk entirely? The answer to that is there is only one way in which we could have got rid of this risk entirely and that is to have no residual involvement in generation. In other words, the only way you can get rid of this unplanned outage risk is to have entered into long-term leases of the assets or sold them. That is the only way.

Dr JOHN KAYE: Is that your favourite option, Mr Schur?

Mr SCHUR: It was my favourite option.

Dr JOHN KAYE: An option you put to the Treasurer?

Mr SCHUR: An option that was put to the Government and the Government accepted.

Dr JOHN KAYE: So you accept we have got a second-rate option here?

Mr SCHUR: I have said on more than one occasion, and I could quote from my predecessor John Pierce, who I think said it at budget estimates committee hearings, that the gentrader option is the next-best option available to the State for exactly the reason that we are having this discussion about ALDs now, because it does leave the State with residual risks.

Dr JOHN KAYE: It does not de-risk the State?

Mr SCHUR: It does not de-risk the State in the same way—

Dr JOHN KAYE: Your boss said it did yesterday.

Mr SCHUR: —in the same way that you could have de-risked the State if you had sold the underlying assets. That is the only way you could have entirely de-risked the State. As far as the ALD regime is concerned, I think it was mentioned yesterday that there are caps in place to limit that liability. One could have had no caps, and then one would likely have got higher proceeds, but there would have been a higher exposure. One could have had a lower cap and we would likely have received lower proceeds from the sale. But there is no way in which you can get rid of the risk entirely. The best you can do is to mitigate it.

Dr JOHN KAYE: And that cap is the total annual payment for capacity—that is, the size of the cap?

Mr SCHUR: That is correct. I am happy to indicate, because I think this is important and it should be transparent to the Committee, that based on the accounting standard we have calculated what we believe to be the net present value of the expected risk associated with ALDs over the life of the GTA contracts. We determined that to be roughly \$360 million in net present value terms.

CHAIR: There was some concern that this inquiry might in some way hinder the process of the gentrader contract bundle of sales. Can you update the Committee on the current status of the negotiations for the sale of the gentrader contract bundles? Where are we at the moment?

Mr SCHUR: In general terms the transaction is ongoing. I will ask Richard Timbs to talk in more detail insofar as he can, obviously without prejudicing those ongoing negotiations.

Mr TIMBS: As you say, it is very difficult to comment in any detail without prejudicing the nature of those ongoing discussions. Suffice to say that we are expecting further bids for the remaining assets in the near term. Once those bids are considered, if they beat the relevant retention values, the Government would expect to be in a position to sign those transactions during February. If the bids do not exceed retention values, the transactions will not be progressed.

CHAIR: Early or mid February?

Mr SCHUR: I cannot comment at this time.

CHAIR: There has also been a lot of discussion in the community and at our hearing yesterday about the resignations of the eight directors of Delta Electricity and Eraring Energy and the appointment of four new directors to those companies. Do you have any understanding of the circumstances of their resignations or the reasons for their resignations?

Mr SCHUR: I do not.

Mr TIMBS: I was made aware of the resignations some time on the afternoon of 14 December. I am not aware of any of the specific reasons of any of those directors for their resignations and I have had no personal conversations with any of them since that time.

CHAIR: We understand that the former directors were receiving briefings. It seems that the Treasurer was not present at those briefings. Were any of you involved in the briefing of the directors on the progress of the sales?

Mr TIMBS: Yes. On the morning of 14 December a series of board meetings were held by the relevant State-owned corporations—the two generators and the three retail businesses. I was not present at those, but I understand that they were given by the State's financial and legal advisers. In the afternoon I was asked to attend with those same advisers what I believe were board meetings of Delta and Eraring at which we were asked various questions. The advisers answered those questions and then we were asked to leave the room.

Dr JOHN KAYE: What date was that?

Mr TIMBS: It was when the transactions were announced. I think it was Tuesday 14 December. I attended those briefings in the afternoon and after we answered some questions from the directors we were invited to leave. I went back to my office and some time later that day I was called and advised that certain directors had resigned.

CHAIR: During the briefing and when the questions were being asked did you get any indication of their unhappiness with the process to the extent that they would resign?

Mr TIMBS: There was no apparent indication at that meeting of any thought of resignations. It was clear that the directors had concerns around value and there was some discussion about that. Some questions were put and they were answered. But I do not think there was anything out of the ordinary in those discussions.

CHAIR: By that do you mean the viability of those organisations as companies?

Mr TIMBS: I think the key point here is that because of the nature of the transaction the boards of Eraring and Delta were asked to consider transactions that related purely to their business. What they did not know and what they could not be told because of the nature of the transaction and the confidentiality is that there were retail businesses that were being packaged together by a bidder to put together with their business. The consideration for the State as owner and shareholder was whether we were getting value over this combined package. The bids we received from Origin Energy and TRUenergy ascribed value to the gentrader contracts and the retail businesses. We do not know how they ascribed that value. It is not a concern for us; it is a concern for them.

The issue that the directors faced was that they had a transaction in front of them to be dealt with in isolation. The appropriate consideration for them was whether the transaction was in the best interests of the company. That was the decision that was put to them and they had to make a decision on that. It was a yes or no decision. What the transaction team knew was the other retail transactions that sat behind that would be bundled with it. We had the overall value perspective, as was appropriate for the group of people considering the transactions.

CHAIR: So the directors were feeling some tension because as directors they also had primary responsibility to those organisations, not to the Government.

Mr TIMBS: I think they had sole responsibility to those organisations. They have fiduciary duties to act in the best interests of the company. They had a transaction in front of them and they were asked whether they wanted to complete it on the basis of whether it was in the interests of the company. I think the Treasurer made it quite clear yesterday that there was a contemplation by the State's advisers from a long time ago that there might be circumstances where individual boards might be in a position where they decided that the transaction was not in the best interests of their company and therefore they would decline to do that transaction. At that point the Government would issue a direction to the company to execute the transaction. The chronology laid out yesterday by the Treasurer tracked those discussions with the State-owned corporations back for some 18 months. That was not a new issue.

CHAIR: Another important issue that has come out of this gentrader transaction is the impact on electricity prices for New South Wales consumers. I understand that through this process the TRUenergy customer base will increase from 1.3 million to 2.8 million accounts. Is there a danger of a monopoly developing?

Mr SCHUR: I think we must look at what the Australian Competition and Consumer Commission [ACCC] said in relation to the transactions that were executed. We had a long engagement with the ACCC leading up to the transaction. Obviously this is front and centre for the ACCC—what will be the competitive impacts and the degree of competitiveness in the energy sector has an implication for electricity prices. It is important to understand what transactions it specifically approved and what it did not. I will not go into detail; their transcript is on their website. However, it is important to understand one of the things they said in relation to Origin acquiring both Country Energy and Integral Energy. I am quoting here:

In analysing the competition effects if Origin were to acquire Country Energy and Integral Energy—

which is what transpired—

...the ACCC took into account the fact that EnergyAustralia would be acquired by a third party not including AGL.

In other words, the ACCC effectively blocked AGL acquiring EnergyAustralia. To conclude the quote:

The ACCC therefore concluded that Origin would face competition in electricity retailing from the separate acquirer of Energy Australia, smaller players, as well as AGL, which has a large gas customer base and expanding electricity customer base.

The ACCC concluded that new entry, together with continued vigorous competition from existing players, would be likely to preserve competitive tension in the retail markets.

That was a key driving consideration for the State. Obviously without that approval we would have had a different outcome.

CHAIR: These documents also refer to a "contracted term" and to the "remaining technical life of the power station". In other words, you are guaranteeing that the power station will operate for a certain number of years. Can you explain how that would work? Is there a point at which the power station is written off—after 10 or 20 years?

Mr COSGRIFF: Throughout the transaction process engineering advice was taken as to the capacity that the power station would generate and what its technical life would be. That is reflected in the gentrader agreements. Effectively what we are saying is that the power station works for a period and that its technical life can be and has been estimated, and that is included in the gentrader contract.

CHAIR: Do you know offhand the estimated technical life?

Mr COSGRIFF: I do not have that in front of me, but that information is easily obtainable and I can provide it.

CHAIR: I understand that the figure for Mount Piper is 2042.

Mr COSGRIFF: Yes.

CHAIR: The date for Wallerawang is 2028. That is not long in terms of a State's future power needs. Is there any plan for what will happen in 2028?

Mr COSGRIFF: The purpose of the transaction as originally set out in the Owen report was to execute the retail and generation in order to give the private sector the incentive to invest in new generation. Indeed, we need new generation as we go through the next two decades, partly to deal with changes in demand but also changes in environmental regulation and replacement of existing plant. The first significant coal-fired generator, Munmorah, will retire within the next few years.

Dr JOHN KAYE: That is not true. Are you not trying to get a contract to refurbish it?

Mr COSGRIFF: Yes. Delta notified the energy trading market that it would be decommissioned, from memory in 2014, but I will take that date on notice. That provides a refurbishment option. The gentrader contract written for the life of that plant will be very short term.

The Hon. TREVOR KHAN: So it is true.

The Hon. KAYEE GRIFFIN: There has been some discussion this morning in relation to the gentrader transaction reducing risk, but it was caught up in other questions. Can you take us through the risk reduction in relation to this transaction?

Mr SCHUR: I am happy to start and then to hand over to my colleagues to fill in the details. As members know, the gentrader construct effectively separates operations from trading. The volatility in generation is in the trading function. There is tremendous volatility in spot market prices ranging from negative \$1,000 per megawatt hour up to \$12,500 per megawatt hour. We have seen that reflected in the very volatile dividend flows that we have received from these businesses over the past five years. The key volatile risk is being transferred to the gentrader. The other risks that are transferred to the gentrader that are critical in a post Carbon Pollution Reduction Scheme world are the implications of what that carbon world will look like into the future.

They are responsible for procuring more inputs fuel for these generation plants. The key risks that remain with the State are the ones related to the availability liquidated damages, to which we spoke. We believe in providing a very explicit provision. The \$360 million that I spoke about is the net present value. So there is a profile attached to that provision over time explicitly providing for that potential contingency, and that includes potential mismatches between the actual operating costs of the businesses and the variable and fixed charges they receive from the Government. As I said earlier, in the gentrader construct you cannot get rid of all the risks, but we think we have got rid of the risks that are most difficult to manage in relation to electricity trading and by identifying explicit provisions. Having gone through a robust exercise to determine what those provisions should be, we believe we have mitigated the risks to the greatest extent possible.

Dr JOHN KAYE: Greatest extent possible?

Mr SCHUR: Yes.

Mr TIMBS: If I could just add to that in relation to the retail businesses. The retail businesses are mass market low margin businesses subject to a high degree of churn. Previously we had government-owned businesses effectively competing for customers: spending money on marketing and competing for customers. We have taken that additional cost away from the Government today. So that has been fully passed to the private sector, which is quite free to compete now on pricing terms for retail customers.

The Hon. GREG DONNELLY: Potential values received some coverage in this morning's questions, but I want to return to the issue and invite you to give further explanation as to how potential values are actually calculated? What is the detail?

Mr SCHUR: Again, I will make some general marks. Richard was heavily involved in the working group that determined the retention value. In some ways this goes to the issue of potential differences in valuation that came out of the retention value exercise and what the businesses might perceive to be the value of their individual businesses. I will let Richard go through the detail, but the key difference, if you like, is the fact that we would have developed for the generating businesses a single market model and we would have had a single set of assumptions that reflected views of the expertise that the Government had available in relation to electricity supply and demand, coal prices—domestic coal prices were not as export coal prices—gas prices, the impact of carbon policy, carbon pricing and regulation.

Dr JOHN KAYE: A single scenario?

Mr SCHUR: A common set of assumptions that were applied to all the businesses, which is different to how the individual businesses may have applied those assumptions to their own businesses. I am happy for Richard to add some detail.

Mr TIMBS: Certainly. Let me deal with that point now. The key difference between this particular transaction or series of transactions and past transactions certainly in which I have been involved, such as lotteries and waste, is that in those instances you are dealing with one business. Here we are dealing with multiple businesses in the same energy market. If you think for a minute about the way the boards of Eraring, Delta and Energy Australia might actually go about valuing the assets in their business, they will have underlying assumptions about a whole series of inputs and most likely those assumptions will not be the same across all these businesses because they will reflect their best judgement or the judgement of their advisers as to what are those inputs.

So for things like coal prices, gas prices, energy demand, energy output they will all have different views. What we needed to do to preserve the integrity of this process was to say, "We must come up with a single set of consistent energy market assumptions to be applied to this valuation", otherwise it falls down. You cannot apply different assumptions to different businesses on the market. In fact, and this is the comment I was making earlier, we drew back to the report of the Auditor-General in August 2008 in which he recommended, and I quote again, "calculating a retention value for each generator and retailer using consistent assumptions prior to commencing each transaction". The key thing was that we had to make sure that we had integrity and consistency through the process.

Coming back for a minute though to the concept of retention value, you can boil all of these discussions around balance sheet impact, budget impact and value down to one key thing: are we better off post the transaction? The retention value goes to the heart of that. As I was explaining earlier, what we do is we calculate the value as estimated today of these businesses in government hands under usual business circumstances and we say, "That's the hurdle we have to clear." We then ask, once we get bids, "Do those bids, less any additional costs or liabilities stemming from that, clear the hurdle?" If they do, the State is better off—unambiguously. It is a yes-no test. In that instance the Government is able then to proceed with the transaction.

If I can just talk a bit about the detail as to how we did this. Obviously, I cannot talk about numbers for confidentiality reasons, but it is important that people get a sense of the large amount of work that went into this exercise and the sorts of things that are taken into account in looking at retention values. The methodology for calculating retention value is to value the free cashflows to the Government as shareholder of these businesses over the forecast life of the business. That means the dividends we expect to get, tax equivalent payments we expect to get, and government guarantee fees that we get for providing the debt to those businesses. We then look at the best judgement of what those cashflows are expected to be for the life of the business, we discount it back at an appropriate rate to reflect the risk of those cashflows and come up with a present value.

In addition, on the retail side we had one other element to take into account, which was to value the hedge books of the retailers. Effectively, that reflects their derivative contracts and any power purchase agreements they have. In distinguishing between generation and retail, for the generation businesses we did long-term cashflows and discounted those back as I explained. On the retail side we took a slightly different methodology. We looked at the business plans of the government-owned retailers today, which were five-year plans. The difference is that we replaced in those business plans these consistent energy market assumptions that I referred to earlier that we were advised by our market advisers. We then looked at those cashflows for five years and we calculated a terminal value on those, which basically looks at the forecast growth rate of those cashflows after five years.

There was a slight difference because of the nature of the forecasting for retailers as to generation, but essentially that is bringing back to today, using our best judgement and the best judgement of expert financial advisers and expert market advisers, what do we think are the values of those businesses. The sorts of assumptions that had to be made that went into those valuations and the sorts of inputs are things like coal prices, gas prices, future capital expenditure, energy market demand, supply of energy in the market. So you can see that this is quite a detailed, complicated and complex process and for that reason we had the assistance of, as I say, expert market advisers on the energy market and expert financial advisers that do these valuations for a living; they have a high degree of experience in doing these valuations.

I am happy to take any further questions on retention value, but I just want to leave the Committee with the clear understanding that this is something that is done comprehensively; it is done in a great deal of detail, there is a lot of rigour and, of course, what happens is that post the transaction the Auditor-General will come in and review the retention value methodology and the paper and will opine on that.

The Hon. KAYEE GRIFFIN: This inquiry has had some discussion about the Cobbora decision. Could you provide some clarification in relation to that and the impact on the State's budget position?

Mr SCHUR: The Cobbora project was originally envisaged as a mine that would be developed by the private sector. The exploration area was determined and the generation businesses formed an unincorporated joint venture. The reason they did that was that Cobbora became essential in terms of further coal supply for those generating business, particularly in an environment in which export coal prices have been increasing, poor facilities, particularly at Newcastle, have improved and our generating businesses face this pressure of increasing fuel costs, given the demand for coal internationally. That was the underlying motive.

The commencement of the procurement process for Cobbora coincided with the global financial crisis. Effectively, that financial climate meant that the playing field was thinner than may otherwise have been the case. There was also a fair bit of merger activity that was happening at the time and one or two participants in the process dropped out at very late stages as well.

Dr JOHN KAYE: One or two?

Mr SCHUR: Can I take that on notice?

Dr JOHN KAYE: Yes please.

Mr TIMBS: I do not think we said publicly how many parties were bidding or how many dropped out. I am not sure that we would actually disclose that.

Dr JOHN KAYE: We now know that it is one or two.

Mr SCHUR: I am happy to take that on notice. The point is that we were left with a thin playing field and, essentially, there was a preferred tenderer the Government was negotiating with. The advisers to the transaction had several concerns with the price that was being negotiated with the preferred tenderer. There were issues around a mismatch between the rate of return, in the view of some of the advisers, that the preferred tenderer would have enjoyed relative to the risks of the project. And there was a second view that the coal price to those generators that was set too high would have a very significant impact on the value of the generation businesses.

Dr JOHN KAYE: Or the gentrader contracts?

Mr SCHUR: Independent of whether there were gentrader contracts. Independent of the transaction, a high cost of coal going into those generators would have a very significant impact on the values of their businesses by extension. Obviously, it would have an impact on the value of the gentrader contracts. Was Treasury concerned about a decision to invest what would amount to about \$1.5 billion in a new project? Yes, we always are, but no differently to how we would view a very large investment by the State in any other project, whether it is a transport project or anything else for that matter. The Government is confronted with concerns around the risk, but also this strong view that was held that there was a risk return mismatch from the preferred tenderer and that there was an asymmetrical risk between developing the mine itself and the enhanced value to the businesses of providing reasonably priced coal to those businesses.

Ultimately, the Government decided that in the short term it was in the best interests of the State to take on the mine development, always with the intention that that would be sold at some stage in the future; exactly when will be determined over time. That is the history to this. In terms of the impact on the State's balance sheet, obviously our half yearly review that came out in December reflected the capital costs associated with that project. The reason it was not singled out in the half yearly review is that the actual impact on our capital program is roughly \$43 million only to the end of the forward estimates. There is a ramp-up in costs to 2016-17, I believe it is, but before that stage the capital cost implications are rather small.

The Hon. LUKE FOLEY: I would like to turn to the extension of the power contracts between Delta Electricity and Hydro Aluminium Kurri Kurri Pty Ltd. Are you aware that some months ago Delta and Hydro entered into heads of agreement in relation to the extension of power contracts for the Kurri smelter?

Mr SCHUR: Again, I am not across the details.

Mr TIMBS: I was aware of that, yes.

The Hon. LUKE FOLEY: Treasury was briefed on the contracts at the time, was it not?

Mr TIMBS: I got a very little amount of detail. Typically with these commercial contracts the information flow from the business through to the shareholder, because of the highly sensitive commercial nature of these contracts, is very low. So I knew of the issue. I did not have specific details about the contract.

The Hon. LUKE FOLEY: What involvement have Treasury officials had in the decision to decline permission to Delta Electricity to proceed with the extension of the power contracts?

Mr TIMBS: The way that that decision and other decisions regarding the businesses subject to these transactions have been taken for the last probably 12 or 18 months is under a protocol that was established by the project team. So matters of a potentially material nature in relation to the transaction that the businesses brought forward went through to the steering committee for the transaction and the steering committee took advice from its advisors as to the potential impact of those and then these decisions were typically taken at the steering committee. Often, but not always, these things would come to my attention as the Deputy Secretary with responsibility for the State-owned corporations. But the protocol, I should stress, was through the transaction team.

The Hon. LUKE FOLEY: Can you enlighten us on why permission for Delta to proceed with the extension of the power contract was declined?

Mr TIMBS: I do not think it is appropriate to disclose that information in this particular forum.

The Hon. GREG PEARCE: It is a Government member asking.

The Hon. LUKE FOLEY: Are you aware that all relevant agreements which are needed to legally extend the power contracts have been signed by Hydro and are currently awaiting Delta's signature?

Mr TIMBS: I was not aware of that. That may be true.

The Hon. LUKE FOLEY: Are you aware that the Kurri smelter has more than 500 full-time employees?

Mr TIMBS: I do not know the specifics but I will not doubt your comment.

The Hon. LUKE FOLEY: Do you acknowledge that the future of the Kurri smelter, the security of the workforce and that community are dependent on the existence of a long-term power contract?

Mr TIMBS: I do not have specific knowledge of that business but I have no reason to dispute what you are saying.

The Hon. LUKE FOLEY: Why would the energy reform group decline permission for Delta to extend its power contract with Hydro yet at around the same time allow Macquarie Generation to proceed with an extension of its power contract with Rio Tinto for the Tomago smelter?

Mr TIMBS: I will not comment on that particular matter in this forum other than to say that the way that the transaction team and the steering committee viewed these matters was as they were raised with them by particular businesses and with respect to the impact on each business and the potential valuation transaction impact of any particular contracts.

The Hon. LUKE FOLEY: But Macquarie Generation's deal with Rio Tinto for Tomago was struck later than the Delta-Hydro contract extension was struck, was it not?

Mr TIMBS: I cannot comment.

The Hon. LUKE FOLEY: I am just trying to draw out the reasons for the inconsistent treatment. I put it to you that one reason may be that it is because Rio Tinto as a company has far more muscle than Hydro and its parents and that is why Macquarie Generation and Rio Tinto were allowed to proceed but Delta is being stopped from entering into its contract with Hydro at Kurri.

Mr TIMBS: I am not in a position to either comment on that or answer that question.

CHAIR: Does the steering committee that made that decision have a Treasury representative on it?

Mr TIMBS: Yes, it does. Both myself and Mr Cosgriff are on that steering committee.

CHAIR: So you do know the reason for that decision.

Mr TIMBS: I was involved in some of those discussions, not all of those discussions. The steering committee had an input and I am not aware but there may have been government deliberations on these matters as well. I do not know about that.

The Hon. TREVOR KHAN: Mr Schur, you talked about \$5 billion being the proceeds, and I take it that is the balance sheet proceeds because we have gone through that exercise already. But because the headline rate has been \$5.3 billion, do I therefore take \$300 million as being the fees payable to the various banks and other institutions that have had their hand in the pot on this transaction?

Mr SCHUR: No. I think the \$500 million odd is because we deduct from the gross proceeds the allowance for the forecast penalty payments.

The Hon. TREVOR KHAN: What is the amount of the fees that are payable to the various institutions that have made valuable contributions to this transaction?

Mr SCHUR: I do not have that information on me. I am happy to take that on notice.

The Hon. TREVOR KHAN: So whatever it is, we take \$5 billion, we take \$1.2 billion off for the repayment of the debt, is that right?

Mr SCHUR: Yes, roughly.

The Hon. TREVOR KHAN: So again, working on the back of the pad or on a pad on the fridge, we take \$1.5 billion off for Cobbora, is that right, if we are looking at a net position?

Mr SCHUR: No, I would not characterise it the way you are characterising it. By logical extension from what you are saying, if you are subtracting the capital cost of Cobbora from the proceeds, then the logical extension of what you are saying is that we should subtract the operating costs associated with Cobbora from the proceeds and then add back the revenue.

Dr JOHN KAYE: Precisely.

Mr TIMBS: And the sale price.

Mr SCHUR: And the future sale price of Cobbora. Cobbora—it is important to understand this—will be a stand-alone commercial entity. It will have capital costs, it will have operating costs and it will generate revenue. The working assumption and the modelling that has been done to date suggests that there is a reasonable probability that to supply the coal needs of the generators it is likely to be an 11 megatonne per annum mine and given the price that is locked into the gentrader contracts, if it delivers—

The Hon. TREVOR KHAN: Sorry, that is the price for coal locked into the gentrader contracts?

Mr SCHUR: Yes.

CHAIR: It is the \$31 per tonne.

Mr SCHUR: I do not know. I do not have the details.

The Hon. GREG PEARCE: Against the current market value, which is \$70, \$80 or \$90.

The Hon. TREVOR KHAN: But you can get that detail for us?

Mr SCHUR: I am happy to get that detail for you. The current working assumption and the modelling that has been done to date suggests that that project will be able to recover its cost of funds, that is, before we contemplate any export potential associated with that mine. So that would be a further up side that would increase the return to government. So the view on Cobbora is that it is a commercially viable, stand-alone entity that will recover its costs of funds.

The Hon. TREVOR KHAN: You were not able to find an operator of the mine to enter into a transaction to do all of this for you.

Mr SCHUR: No—

The Hon. TREVOR KHAN: Make sure a greater down-side risk on the transaction.

Mr SCHUR: No. The view that was taken ultimately by government was that what the preferred bidder had on the table was not acceptable to government because in the Government's view there was a mismatch between the rate of return embedded in their offer and the risks attached to the project and they were not willing to recognise and pay up-front for the up side associated with the export potential of the mine.

Dr JOHN KAYE: While we are on Cobbora, in that contract who were the risks to? To the Government?

Mr SCHUR: No. What I am saying is that the advice to government was that the bid that was on the table by the preferred tenderer had a mismatch between its return and the risks it would have taken to develop the mine. That is what I meant by that.

Dr JOHN KAYE: When you said it was a commercial undertaking what rate of return were you using on the Government's invested capital? You said you viewed it as a commercial entity, you invested money—\$1.5 billion you tell us—and it can cover its capital. What rate of return were we getting on that \$1.5 billion we were investing?

Mr SCHUR: I do not think we can speculate about what the return will be.

Dr JOHN KAYE: But we know. Hang on a minute—

Mr SCHUR: It will be a function of the size of the mine, the ultimate level of the capital costs—

Dr JOHN KAYE: Eleven million tonnes per annum. We know the price; it is \$32 per tonne. We know what we invested—\$1.5 billion. You know what the costs are.

Mr SCHUR: Those are the estimated costs at this stage.

Dr JOHN KAYE: So what is your estimated rate of return?

Mr SCHUR: It will cover the cost of the Government's funds.

Dr JOHN KAYE: Zero.

Mr SCHUR: No. It will recover the costs of the Government's funds.

Dr JOHN KAYE: If instead the people of New South Wales decided to sell that coal on the open market—they should not do that but if they did—what would be the return?

Mr SCHUR: I do not think it makes sense to speculate now, given the Government's intention to sell the asset at some time in the future.

Dr JOHN KAYE: If you are going to sell the asset, anyone who is going to buy it will ask the question: "Well, if I mine this coal and I sell it to the power stations at \$32 a tonne or I sell it on the open market some time in the next 10 years or so when the price is anticipated to go to \$160 a tonne, why would I mine that coal when there are other coal leases I can get that are probably cheaper to operate"—

Mr COSGRIFF: Can I just make a technical point for clarification of the Committee? We are not comparing like with like with that comparison. The coal at Cobbora is very high ash. Only some parts of it are suitable for the export market. Only some parts of it can be washed cost competitively relative to other coal suppliers in New South Wales. But it is suitable for domestic power generation. So effectively it is priced differently because it is a different quality coal.

Dr JOHN KAYE: So you are saying a private sector investor will come along and buy Cobbora from you with a fixed quantity contract that goes at least—well, the purchases of Eraring and Origin tell us the contract goes through for another 22 years—for 22 years when, if they are interested in coalmining, they could be putting their money into a coalmine somewhere else in New South Wales which could be earning \$160 a tonne. Do you seriously think you will find a buyer for Cobbora?

Mr COSGRIFF: Yes, there are some up-side opportunities there to, for instance, blend the proportion of coal that is suitable for the export market with their existing operations and export that at a better rate of return that is consistent with their other investments.

CHAIR: We have to finish there. Thank you for your attendance today and the helpful information you have provided to the Committee. If you have taken any questions on notice during today's hearing the Committee would appreciate if the response to those questions can be forwarded to the Committee secretariat within seven days.

(The witness withdrew)

(Short adjournment)

HUGH RONALD OUTHRED, Professor, University of New South Wales, Sydney, New South Wales, affirmed and examined:

CHAIR: I welcome our next witness, Professor Hugh Outhred. Professor Outhred, in what capacity are you appearing before the Committee today?

Professor OUTHRED: I hold the position of Professorial Visiting Fellow at the University of New South Wales, but this is my personal submission and not the submission of the university.

CHAIR: Thank you for the detail contained in your submission, which is submission No. 45. Do you wish to add anything to your submission before we ask questions?

Professor OUTHRED: Perhaps I can speak briefly to the submission and pick out a couple of key issues from it that relate to the evidence that the Committee has been hearing. I think it is important to remember that electricity is regarded as an essential service in society and that, as a result, governments retain some responsibility for the service that is delivered, whether the industry itself is State or privately owned. There is an ongoing and active role for government in the industry. The question then is: What is that role? Should it extend to equity, should it extend to active participation in the industry, or should it be more of a pure governance role? I think that question really has recurred in an underground way throughout the proceedings. I am very happy to take questions about that at a later time.

With respect to the value achieved from the gentrader sale, because we do not have full access to the information we can only estimate that or guess it, given the information that has been published. So far as I can work out, if we consider it as a fraction of the replacement value for the assets, the sale so far is achieving about 10 per cent to 15 per cent of the replacement value. In other words, if you had to start with a so-called greenfields power station and rebuild it, it would cost you somewhere between seven and 10 times the amount that the Government will get for the sale.

With the remaining gentrader bundles, the size of the Macquarie gentrader bundle is an issue in itself. It is by far the largest, originally because it was to be in two parts, as you may recall. But because of the failure of the co-insurance proposal—that was not authorised by the Australian Competition and Consumer Commission [ACCC]—that has been amalgamated. That gentrader bundle in itself now is 4,640 megawatts—a very large single entity to sell. Because the retailers have already been sold I think it would be difficult for an independent purchaser to come in and buy it. That is another issue that has not come up as yet. There is less of an issue with the Delta East asset.

Referring to the retention value, which has received a lot of attention, we have heard from Treasury officials as to how that can be looked at and they have talked about a discounted cash flow analysis. If you use that method of analysis one of the critical questions is: What discount rate do you actually use? To the best of my knowledge that is not yet known to the Committee. I think that is a question the Committee should inquire about. Depending on the discount rate that you use it is a question of: How much do you discount the value of future income streams as you look further ahead into the future? If you have a high discount rate it means that you do not look very far into the future. That will mean you will get a much lower value for the asset in relation to what is called the net present value than if you used a low discount rate. So it is a question of significance.

With the retailers now sold it certainly will have an impact on the national electricity market or NEM-wide retail market shares. I have a table in the submission that relates to that. With the outcome of the sale, so far as I can work out from the available information, Origin Energy will have a retail share of roughly 40 per cent; AGL roughly 22 per cent, and it has not really changed across the transaction to date; and TRUenergy will have risen from 8 per cent to 23 per cent. That means we will have three dominant retailers in the national electricity market.

Dr JOHN KAYE: Are those national figures?

Professor OUTHRED: Yes they are NEM-wide.

Dr JOHN KAYE: NEM being the national electricity market.

Professor OUTHRED: It leaves out Western Australia and the Northern Territory. So we have a national electricity market that really is not a national electricity market, but that is another story. With respect to the Cobbara mine, there are obvious questions about the role of the Government in that. It is an obvious irony for the Government to start a new State-owned mine to support a privatisation process. That is something that is curious about this process. I think we can relate that as well to the actual value for the sales that have been achieved—as I said, somewhere between 10 per cent and 15 per cent of the replacement value.

If those power stations, or if the gentraders to be more correct, can access cheap coal for those particular power stations but not for other power stations, obviously that means they are willing to pay more to get access, in the gentrader sense, for those particular power stations than others. So there is a relationship between those two activities. But another issue—and it is an issue really that has not had much attention so far—is the implications for climate change response, which maybe future citizens of New South Wales will wish to take seriously. To the extent that the State Government is now an active player in a mine, until it is sold presumably, then again this I think can be seen as restricting the options available to the Government in relation to climate change response.

One final point I would like to make is to do with coming back now to the question of retention value. The methodology for retention value that we heard discussed—the net present value or discounted value style of methodology—is the traditional way of assessing retention value, but there is a more modern technique that would normally be used by any party considering either an investment in a new project or the valuation of a present project, and that is called option valuation techniques, or real option theory. The underlying idea behind that is that you should not necessarily assume that whatever asset or resource you have is going to continue to be used in the same way as it was in the past. In other words, you need to consider all options for the use of that resource or that aspect.

Again, in the context of climate change response, State ownership of coal power stations gives the Government an important option value in terms of determining and having some discretion over climate change response. To date I have not seen any evidence or any recognition of that fact. Sooner or later this is an issue that is going to have to be taken seriously by government, or more seriously than it has been taken to date. I will stop at that point.

The Hon. GREG PEARCE: Professor, thank you for coming along. Can I just take you back to your opening statement. By your calculations—and obviously we do not have all the details—you are saying that the proceeds for the gentraders look like they represent about 10 to 15 per cent of replacement costs of those assets.

Professor OUTHRED: Yes.

The Hon. GREG PEARCE: For somebody coming into the market who was going to build a generator with 2,000 megawatt capacity, they have actually achieved these assets for 10 to 15 per cent of what it would cost them to build them themselves.

Professor OUTHRED: That is correct. These assets, of course, have been used for some time so we would depreciate their value compared to a new plant. But, for example, Alan Moran in an article in the *Herald* suggested that, all other things being equal, they would be worth roughly \$1,000 a kilowatt as a reasonable representation of that discounted value as against what this sale is achieving, which is more like about \$300 to \$350 a kilowatt is what is being achieved from the sales to date, as far as we can work out from the published information.

The Hon. GREG PEARCE: So we are selling the assets at less than a third of the actual value?

Professor OUTHRED: Yes. Mr Moran goes on to point out that then the question arises: Why are they so low? He hypothesises that one reason is because of climate change risk.

The Hon. GREG PEARCE: Just taking you back to the coal deal, these transactions are taking place on the basis that if you buy this discounted power station or the rights to the trading, you will get, into the future for the whole contract, cheap coal. The effect of that would be, you would think, that the price would be greater than if they had to pay full price for the coal.

Professor OUTHRED: Yes.

The Hon. GREG PEARCE: Do you have any sort of feel for the amount of that discount?

Professor OUTHRED: No, I do not, but in terms of working that out, the people interested in the gen-trader contract would be looking at what they perceive the electricity would be worth sold onto the market compared with the cost of production. So it is the differential that matters. If you increase the coal price somewhat, that will reduce the differential or that profit if you like—the operating surplus—by a more substantial amount than you might think.

The Hon. GREG PEARCE: Just to undertake an exercise on it, assuming that the coal under these contracts is at \$32 a tonne and the market price is \$65 a tonne, so it is half price, what would that do to the purchase price, if they did not get the \$32 and they had to pay the \$65 instead?

Professor OUTHRED: One way we can see some information related to that is to look at the recent publication by the Australian Energy Market Operator [AEMO] called the National Transmission Network Development Plan. What that does is look ahead to 2030 across the national electricity market and it looks at the various new generation facilities that might be dealt compared to the expectations of increasing demand and retiring plants. By the way, they consider a range of scenarios. They do not just look at one scenario, which seems to be the story we are hearing from Treasury.

With that range of scenarios it is a rare for a coal power station to appear in any other scenarios primarily because of the expectation that with rising market prices for coal combined with possible climate change regulation of various kinds—and they have different scenarios of that—compared to the alternative technologies, including gas and renewables, then very few coal-fired power stations will be built. Down the track towards the end of the period, they do see the possibility of coal-fired power stations with carbon capture and storage being built, but with the type of coal-fired power stations we presently have, it comes up very rarely in those scenarios. I think that indirectly answers your question in a way that is, if you like, more objective than my opinion would be.

The Hon. GREG PEARCE: The sale that seems to have taken place has locked in the Independent Pricing and Regulatory Authority [IPART] price increases to 2012-13 effectively.

Professor OUTHRED: To the best of my knowledge, but I do not have knowledge, obviously, of the details of these sales. And of course, for the retailers only some of their customers are eligible for those tariffs so they would be acquiring a set of customers from the existing retailers. Some of those are subject to an Independent Pricing and Regulatory Authority effective cap and others are not.

The Hon. GREG PEARCE: Perhaps this is a bit hypothetical, but do you think it is possible that electricity prices will go down for retail customers as a result of these transactions?

Professor OUTHRED: Yes, that is an important question. To answer that, again, we have information available to us, in this case from the Australian Energy Regulator state-of-the-market report that they publish every year. In that they provide a breakdown of the costs that go into a typical tariff for residential consumers according to different functions in the market—generation, transmission, distribution and retailing. Retailing contributes about 5 per cent of cost. In other words, if we have retailer-on-retailer competition, the savings that we can achieve within that are 5 per cent. Most of the cost in this electricity industry comes from generation in the network and in particular in the network case from distribution rather than transmission.

Again if we look at the scenarios study by AEMO to which I referred earlier, the National Transmission Network Development Plan, it estimates to 2030 expenditures on generation and transmission alone of the order of \$40 billion to over \$100 billion, depending on the scenario. It depends on economic growth and things like that. To that we would have to add distribution network investment. Typically, distribution network investment is of the order of generation capacity investment, so that would be another probably \$30 billion plus. Those are the costs that are going to be folding into this industry that will have to appear one way or another in electricity prices. The effect of these retailer's sales, I would suggest, will at best have a marginal downward impact on price.

Furthermore it will vary from situation to situation. For example, given that the retailers have been allowed to use the existing retailer names, particularly in country areas—the name of Country Energy is one that has a high retention value because of the perceptions of country people that that is their retailer—therefore the effectiveness of competition in country areas I would say would be particularly unlikely to be strong. There are

a number of factors that play here which means that at best the reduction in electricity price due to the privatisation and due to the retailer competition will be small.

The Hon. GREG PEARCE: Obviously you are aware of the Owen report.

Professor OUTHRED: Yes, I am.

The Hon. GREG PEARCE: It indicated that it was expected the Government would have to spend in the order of \$7 billion to \$8 billion by 2013-14 for generation assets. That was the basis of what has taken place since. The latest Australian Energy Market Operator [AEMO] report that I have looked at says it is not likely we will need that expenditure until 2018 or 2019. Were we all operating under a misconception arising from the Owen report?

Professor OUTHRED: I think the report itself was operating under a misunderstanding of what the various pieces of information were, unfortunately. The information from AEMO refers to the ability of generating capacity to meet peak demand. A new version is published every year in what is called the "Electricity Statement of Opportunities". The information in that does not relate to any need to build baseload generation, which seems to be the way that was interpreted within the whole Owen inquiry process. What it says is: Have we got enough generation in total? In an electricity industry we typically have a mix of what we call generation types. We have baseload capacity, intermediate capacity, peaking capacity. Of those the baseload is the most expensive in capital terms and the peak capacity is the least expensive.

The AEMO statement of opportunities is really just flagging whether there is enough total capacity to meet demand. The typical concern there is to do with investment in peaking capacity. The way our National Electricity Market works is that peaking capacity comes first, so to speak, when new demand appears. Then later on as that demand becomes, if you like, proven and clearly there for the long term, then baseload capacity comes in behind that where it is cost effective to build the baseload. In our National Electricity Market the location of baseload generation does not matter a great deal. It does not matter a great deal whether it is in, for example, southern Queensland, New South Wales or Victoria.

Again, in the latest National Transmission Network Development Plan AEMO is talking about the possibility of even further strengthening the transmission network, which they call NEMLink, which would make the location of baseload capacity even less important. So the whole story and line that New South Wales has to be somehow self-sufficient in baseload capacity has never been correct and never will be correct unless we take a hacksaw and disconnect ourselves from the National Electricity Market and go back to some sort of island State network in New South Wales.

The Hon. TREVOR KHAN: Do I take it that in the context of what you talk about as the National Electricity Market we are talking about, at least, southern Queensland, New South Wales and Victoria?

Professor OUTHRED: Yes. Let me clarify that. It covers all of the parts of Queensland, New South Wales, Victoria, South Australia, the ACT and Tasmania that have access to the conventional electricity grid. In western New South Wales and western Queensland not everybody is connected to the grid. So there are some people, if you like, who miss out. But for well over 90 per cent, probably over 95 per cent, of the population in those States, their electricity supply comes to them through this national electricity grid and the wholesale market part of this is called the National Electricity Market.

The Hon. TREVOR KHAN: If, for instance, a new power station was built in the Latrobe Valley, it would be quite capable, using its brown coal supplies, of supplying Sydney with baseload capacity or baseload power?

Professor OUTHRED: For the last few years New South Wales has been a net importer of electrical energy, primarily recently from Queensland but also from Victoria.

The Hon. TREVOR KHAN: Is there an added transmission cost that needs to be built into the equation?

Professor OUTHRED: That is already built into the equation through the outworkings of the National Electricity Market and the charges for transmission and distribution networks associated with the market.

The Hon. TREVOR KHAN: In a sense, therefore, stripping away our parochialism, we do not need to build another power station in the Hunter Valley?

Professor OUTHRED: No. That is another curious thing about the documentation in this process. In some of the documentation from the State Government it appears as though New South Wales has a sole obligation to build capacity. That is not true, never was true and never will be true so long as we have the National Electricity Market. Might I also say that in the scenarios in the AEMO National Transmission Network Development Plan they look at where generation is likely to be located. In their modelling studies—presumably the same expertise that was available to our Treasury friends—only under some scenarios does much of that capacity appear in New South Wales. It is more likely to appear in either Queensland or in Victoria because the various cost advantages that those locations have.

The Hon. TREVOR KHAN: Do I take it the principal cost advantage relates to feedstock, that is, coal supplies being available to the baseload generator?

Professor OUTHRED: For a coal-fired power station, obviously the cost of coal is critical. The nature of the site and construction costs are critical. Access to cooling water is critical. Those are the kinds of factors that feed into the process. Coming to the question of mines, by the way, and the concept we heard about export and local mines, most coalmines are what we call "two product" mines where some of the coal goes to export and what is called the high ash coal, which has a higher basically non-burnable component, is used locally because it is obviously very expensive to send rocks to Japan, for example, and they do not want them when they get there.

So the export market pays more for a product that is purer in the sense of having more burnable material in it. But the power stations are designed to burn coal with a higher ash content. So that this concept of the two product mine is a standard construct. In terms of coal exporter, of course, Queensland and New South Wales are both the major coal exporting States and they both have mines that are so-called two product mines producing coal for local use and for export use.

CHAIR: We will move on to questions from Dr John Kaye.

Dr JOHN KAYE: I will allow Mr Khan to ask one more question.

The Hon. TREVOR KHAN: I want to ask about the implications of Cobbora. I think you are aware that Cobbora is a project that essentially is owned by the three current generators/gentraders? Is that your understanding?

Professor OUTHRED: That was my understanding before this process worked through. To be honest, I do not understand if there has been any change. There may or may not have been a change in the way it is organised.

The Hon. TREVOR KHAN: Let us assume that structure is the same. Would it not be the case that the effect of providing cheap coal to the three existing generator companies acts as a barrier to any new entrant in the market providing baseload capacity in New South Wales because they will not get the cheap coal?

Professor OUTHRED: In my submission you will find a comment on that point. In fact, the Nature Conservation Council of New South Wales has applied to the ACCC for a ruling on that matter.

The Hon. TREVOR KHAN: You are essentially saying that it does act as a barrier to added competition?

Professor OUTHRED: I guess we will await the ACCC's learned judgement on that matter.

CHAIR: We now will take questions from Dr John Kaye.

Dr JOHN KAYE: I will go back to the very beginning to the Owen inquiry report, which you referred to earlier. You spoke about the issue of misuse of the forecast in terms of baseload versus peaking plant. That was your general remark earlier?

Professor OUTHRED: I would be cautious about "misuse" there. Shall we say there seems to be some discrepancy between the way in which AEMO uses the term and the way in which the inquiry interpreted it. I would point out that AEMO made a submission to the Owen inquiry relevant to that point of interpretation.

Dr JOHN KAYE: Of course, it was not called AEMO then.

Professor OUTHRED: At that stage it was NEMMCO, the National Electricity Market Management Company.

Dr JOHN KAYE: Given that the Treasurer continues to rely on the Owen inquiry report, can you point to any other issues with the Owen inquiry report that we should be aware of or cautious about?

Professor OUTHRED: I need to take that question on notice. I can certainly come back to the Committee on that point.

Dr JOHN KAYE: That would be very useful, thank you. I will deal with the issue of Cobbora. I understand that the Nature Conservation Council's complaint to the ACCC is about a barrier to entry to other coal-fired power stations in that those power stations that have a contract with Cobbora at a suppressed price will have an unfair market advantage against those that do not. Would you also say that effectively what is a coal subsidy against market prices coming out of Cobbora would also be a barrier to entry to other forms of generation other than coal?

Professor OUTHRED: Yes. I think that is clear to the extent that if somebody is subsidising the price of coal, whether it is the State Government or whoever, that is obviously a competitive advantage for coal-fired generators per se as against particular power stations that do not use coal. In some ways that arrangement has some similarities to the co-insurance proposal which the ACCC declined to authorise in the sense that it is creating a relationship between the particular set of power stations. In terms of the ACCC consideration the question would be: Is there some public value that outweighs the existence of that relationship, assuming it is a Trade Practices Act-type consideration. Then one would presumably have to identify some public value that outweighed the existence of some sort of cooperative agreement between a small number of players within a competitive industry.

Dr JOHN KAYE: Do you think the Cobbora coal contract will undermine the economic viability of other forms of generation, specifically, wind, solar thermal, solar photovoltaic?

Professor OUTHRED: Unfortunately, the answer is it depends. So long as we have a scheme like the Mandatory Renewable Energy Target [MRET] Scheme, there is a floating amount of money in there for a renewable energy certificate, which is designed, so to speak, to pick up the difference between the price of the income needed by the investor in a renewable generation activity compared to the income stream available through selling electricity into the National Electricity Market. If for some reason the average price in the National Electricity Market drops, then the renewable energy certificate [REC] price will go up to compensate for that. But there is a second issue here as to whether if you subsidise the price of coal that actually influences the average price of electricity or not. It depends on the bidding strategy of the generators concerned. They may prefer just to take the profit without passing it on through the market.

There is another important point here. Because New South Wales participates in the National Electricity Market, if New South Wales subsidises something on the generation side, firstly, the benefits may not flow through the market to consumers as a general class. Secondly, if the benefits do pass through the market to the consumer side, that will not be restricted to the New South Wales consumers. All consumers in the National Electricity Market will have some access to that benefit. So we can end up with a situation where New South Wales subsidises costs within its territory or somehow bears some unrevealed costs, like the availability liquidated damages—and I would like to come back to that point. You can see the benefit through that, if there is a subsidy there, maybe spread amongst all electricity consumers across the National Electricity Market. There is no way of capturing them purely for New South Wales, which was a problem that arose with some of the earlier Treasury schemes.

Dr JOHN KAYE: You are effectively saying that the lost value and money that the people of New South Wales put into the Cobbora coalmine will end up in three locations. It will end up as increased profits for the gentraders; it will end up as benefits outside of New South Wales to retail customers across the market throughout Australia; and it will end up as an increased cost in the REC market. To some extent, we are being

clever in a weird way of passing on some of our costs to the Commonwealth by pushing up the amount of money they have to put into the REC market?

Professor OUTHRED: Yes, you can see once you are dealing with these complex situations actually finding the money trail itself is a problem, and understanding who the winners and losers are is a further problem. So we need to be very cautious in these types of interventions.

Dr JOHN KAYE: Can I just go back very briefly to one remark you made before about Cobbora coal mine being some distance from the generators that it is supposed to provide, particularly Eraring, which presumably gets its coal currently from Central Coast and Lower Hunter coal mines? Presumably what is happening here will be a need for augmentation of the railways. Do you have some sense of how much augmentation would be required and the sorts of costs that will need to go into the augmented railways?

Professor OUTHRED: No, I do not, but I think it is an important question and presumably there are people who can help you with the answer to that. But it has another interesting little wrinkle on it in that in prior years Eraring used to face, on average, a higher coal cost than the inland power stations like Bayswater. This process of the joint venture presumably results in some sort of levelling up of the coal costs amongst the power stations, so it seems to give an added advantage to Eraring that it did not have before. I do not know what effect that might have on the value achievable for the Macquarie gentrader bundle but it would be of less attractiveness to a purchaser of the gentrader bundle than if it had its own local cheap coal compared to the other power stations.

CHAIR: Moving on to some questions relating to your submission. You state in your submission on page 5 that you believe the sale price has not been adequate, in other words, it is inadequate. In other words, based on the retention value of the assets, the Government—that is, the taxpayers—are not getting full value for this asset. Would you like to comment on that proposition in your submission?

Professor OUTHRED: First of all, I think I was a little more cautious than that. I said, "Costs potentially resulting from the sale process to date: 1. Inadequacy of sale price with respect to the retention value". I did not say that was the actual outcome; I said that was something we had to consider and look into and decide whether it was or was not adequate. The problem, of course, that we have is that we do not know what the calculated retention value for the asset happens to be and the problem is they should not be considered on a bundle basis because they are totally different businesses—the generation business and the retail business are totally different businesses, so you have to consider them separately.

CHAIR: You did make the point that it was difficult for you to make detailed assessments because of a lack of information.

Professor OUTHRED: Yes.

CHAIR: What particularly was lacking that would help you?

Professor OUTHRED: As we heard in the evidence over the last day and a half, the details of the retention values have not been released; the information is regarded as commercial in confidence.

CHAIR: Because they are still dealing with further sales?

Professor OUTHRED: Yes, and whether they will be released after that I do not know. This is not a matter over which I have any control.

CHAIR: You made another point, quoting your submission: "Creation of an industry structure that has a small number of dominant privately owned firms", that this, in a way, does not provide for competition. I think the Treasurer made statements that he was confident that the new setup would lead to reduced pricing through the competition, but there does not seem to be any point in those two or three large operators reducing their prices; they could just share the market.

Professor OUTHRED: Yes. We end up, effectively, with three dominant players. Most economic theory on markets suggests you need more than that to have adequate levels of competition. It is a fairly simple, well understood situation. In the case of electricity it is further complicated by this vertical integrated ownership structure that we are developing where we have so-called gentailers with dominant players in both generation

and retail. You will notice at one point I quote concerns, on page 10, that are arising in the UK about a similar matter. I have a quotation there from Ian Marlee, partner, GB Markets for Ofgem—Ofgem is the regulatory body for the electricity and gas industry in the UK—with respect to electricity. He said:

Over the last 18 months we have been monitoring and investigating the liquidity of wholesale power in Great Britain. We have concerns that the wholesale market might not be delivering the products and signals that all market participants need to operate their business effectively. In particular, independent suppliers and generators have expressed concerns that they find it difficult to manage risk with the wholesale products currently available. This could be having a negative impact on the outcomes for consumers in the supply market—

that is, the electricity retail market—

especially if it means that there is no viable threat to existing suppliers.

Threat of entry is a really important issue in markets. We notice, for example, the debate at the moment about Internet sales, of the concerns that large retailer chains have about that; it is the threat of entry issue for them. If we consolidate ownership of retailers into large retailers, as we are now doing, that makes it very hard for a small retailer to gain entry, and, secondly, on the generation side, if we concentrate generation ownership as well it makes it very hard for a new entrant retailer to find a generator counterparty to the derivative contracts which are needed to support that new entrant retailer.

Further steps being taken are significant, and because New South Wales is the largest component of the national electricity market in terms of megawatts, the number of people and so on, the steps that are taken in New South Wales are of significance for the market as a whole.

CHAIR: You state in your submission on page 8—you are quoting other reports but you appear to agree with them: "Bidders for the coal assets have estimated this subsidy"—the Cobbora—"would add as much as \$2 billion in value to the power assets which are being sold". Can we, from that, deduct \$2 billion from the sale price of \$5.3 billion?

Professor OUTHRED: Unfortunately, as I say, I am not aware of any official information on the matter. I do not know how valid that figure is but I think what I was trying to flag here was an issue that should be of concern and that the Committee should seek more information on this matter.

CHAIR: The point is that when the Government quotes the \$5.3 billion as the sale income, should there be a deduction from that amount for such things as the Cobbora mine, that, in a sense, it is an indirect subsidy and therefore it should be deducted from the total sale price?

Professor OUTHRED: Going from the information that has been released, you can see how one could form that impression. But, of course, I do not have access to any of that information so I cannot express an informed view on that matter.

CHAIR: We will move on to Government members. Mr Foley?

The Hon. LUKE FOLEY: Professor, have you been involved in the development of the Greens' electricity policy?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Have you given advice to Dr Kaye and/or other members of the Greens on electricity policy matters?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Have you had any involvement at all in any aspect of these specific transactions which the Committee is holding hearings into?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Did you have any access to the data rooms in this reform process?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Are you working for any of the successful or unsuccessful bidders?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Have you had any contact with the eight directors who resigned from Delta and Eraring?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Have you had any contact with any of the directors who did not resign?

Professor OUTHRED: No.

The Hon. LUKE FOLEY: Could I put it to you then, Professor, that you are not sufficiently informed about the particular transactions here that we are inquiring into to shed light on them for us?

Professor OUTHRED: I think in my submission I made clear what I was in a position to say and what I was not in a position to say. May I draw your attention to that? At the start, under the scope of submission heading I say, "I have played no role in the energy reform transactions, thus this submission does not address Terms of Reference 1 and 2. Instead it first summarises the process to date and then comments on the following issues". I have made no claim to have any detailed information of the transactions. I would not make such a claim. But to suggest that that means I am not in a position to make any comments I regard as just faintly ridiculous.

The Hon. GREG DONNELLY: In terms of the evidence you have given, on page 3 of your submission under the heading "The nature of the electricity industry", at the end of the first paragraph you state, "The complex technological system can be subdivided into generation, transmission and distribution (poles and wires) and end-use sub-systems". Could you explain to the Committee the meaning of "end-use sub-systems" so we are all clear about that?

Professor OUTHRED: The end-use services—what happens is that people who use electricity in their homes or commerce or industry, we are not actually interested in the electricity per se, we are interested in the services that it provides, like the light in this room so that we can have this conversation, air-conditioning, heating and all the machinery that is operated in industry and so on, and those are known as the services that are delivered by the electricity. The reason why it is important to make that distinction is that depending on the type of end-use technology that we use we might use more electricity or less electricity to achieve the same purpose. Something that is reasonably well-known there is in lighting where the so-called old-fashioned incandescent lights use a lot more electricity to achieve a given lighting level than, say, fluorescent lights.

The Hon. GREG DONNELLY: In terms of the way in which you have broken down the complex technology of the electricity industry, what do you say is the proper role or the appropriate role of government in those four areas?

Professor OUTHRED: Firstly, may I say I have advised various State governments in Australia, the Australian Federal Government and overseas governments on matters of this kind and the way I respond to the question is not to be specific about who should do what but more to say that if you want to, for example, set up a State-owned industry or the State wants to play an active role in the industry, then these are the issues you need to consider. On the other hand, if you want to have a fully privately operated industry, which is also possible, then you need to consider those issues, because different issues arose in each case, basically because the relationship between government, or governance more generally, and the industry changes depending on how actively government is involved, as we see in this case, for example, through the question of the Cobbora mine.

The Hon. GREG DONNELLY: What about the hybrid situation which lies in the middle there where you have both State involvement and private enterprise? How does that model work?

Professor OUTHRED: The easiest function to remove government from is generation because we now can set up sufficient competition amongst generation to achieve the kind of outcomes that privately owned industries or industries with private ownership can achieve where they both make a profit and still deliver something that is in the public good. That is basically what you are trying to achieve when you have private

industry: you are allowing people to make a profit but only by doing something that delivers some long-term public good. The poles and wires, the network businesses, because they are much closer to what we call monopolies, if you are going to retain anything in public ownership then that is the correct place to focus.

The question of retailing has become an open question again because traditionally we just regarded it as an interface between the supply-and-demand side of the industry, which is what we now have. But, looking forward into the future, we are going to have to pay much more attention to efficient and providential use of electricity, partly because of rising electricity prices, partly because of climate change issues and other things, and the present structure of the industry does not provide enough support for end-users to make the really good decisions about how to use energy that they will need to make in the future.

At the moment our industry structure is not designed in the way that we need it to be designed for the future rather than the past. In that transition it is really redesigning the retailer role that is the critical issue. Just as I said there is an option value about retaining assets, there is actually an option value in retaining retailers in New South Wales because then you can create a new form of retailer that is actually more focused on delivery of efficient and prudential energy use.

The Hon. GREG DONNELLY: But surely government regulation has a role through law or regulation in terms of influencing customer behaviour in the use of electricity?

Professor OUTHRED: That is correct. It is not only the end users but also those who provide electricity to them. The end users are not really in a position to make independent decisions. The typical residential end user does not have the expertise to make those decisions without support. Where will they get that support? It is more of an active role than just government regulation. Who will take on that active role? At the moment we kind of ask retailers to do it. However, quite frankly, it is not in the retailer's best interests once it is privatised. It is a profit-making entity and it will tend to make most profit by selling more electricity.

The Hon. GREG DONNELLY: I refer to your evidence where you talked about the real option theory. Can you provide any examples to the Committee where the real option theory has been used in practice in terms of making some assessment of a transaction such as the one we are considering? Can you provide examples of where that theory has been specifically applied and produced some—

Professor OUTHRED: It is widely used in private industry. First, to the best of my knowledge, it is not so commonly used in this type of public assessment. I think that is one of the problems here. We are seeing a lagging process in the way that the Treasurer is approaching this. Secondly, as an example not so much of a specific calculation but how to approach the problem, the National Transmission Network Development Plan that I alluded to earlier produced by the Australian Energy Market Operator [AEMO], is a good illustration of the way in which the broad uncertainties can be approached and dealt with on a scenario basis. Scenario-type studies are the basis of the application of real option theory.

However, because the AEMO is an advisory body and not a decision-maker it does not go to the final step of saying how we choose among these options. It is stopping at the point of trying to illuminate what might happen rather than choosing a particular path. In terms of private companies actually choosing which project to invest in and which to reject, I doubt that there are many that do not use this technique.

The Hon. GREG DONNELLY: I want to revisit your evidence about the issue of vacating of baseload power stations. Please correct me if I have misunderstood you. I got the impression that, in effect, for a sovereign State or Territory in the context of the national market there is really no interest by the State or Territory in having generators within their borders. If I understand your evidence correctly, generators will just pop up, so to speak; in other words, market forces will result in the creation of baseload generators. Is that your evidence?

Professor OUTHRED: It is a little more complex than that when you observe what governments do in practice. Most governments have regional development policies, other concepts about utilising resources within their state borders and so on, which mean that they still retain a legitimate interest in related matters. So they do have an interest in seeing large projects going to regional areas. But in deciding whether to give preference to a project of that type, they should not be thinking about that purely as an electricity generation project.

If they were thinking about the project purely from the point of view of electricity generation, they should be entirely indifferent about where it is located through the national electricity market as far as so-called

baseload generation is concerned, except for the concern about the possibility of the transmission lines being somehow interrupted or broken. That happens very occasionally due to bushfires and the like. Under those circumstances, the normal strategy is to rely on local peaking capacity and other emergency procedures. In other words, the location of the baseload power station is not regarded as the most critical matter.

The Hon. GREG DONNELLY: But it is an important matter.

Professor OUTHRED: Yes. It is certainly a complex story and governments have the right to take a broad view of it. But if they are purely thinking about a power station as a producer of electricity and if they are being hard-headed in the way that the Treasury officials suggested they are hard-headed then they should not be concerned; they should be indifferent as to location. They should be more concerned about finding the cheapest possible electricity because all New South Wales electricity customers would benefit from a lower price. It should be always a natural inclination to look for a low price for electricity because it is an essential good for nearly all economic and residential activities.

The Hon. GREG DONNELLY: Can you help me to understand what is your position having examined the scenario we are looking at and in making your submission? What do you say is the role of government in the electricity industry?

Professor OUTHRED: As I said, this is a matter of social choice. Suppose I suddenly became Premier and decided I wanted to impose my views on the rest of society, as I said my concern would not be then so much who owned what but how we organised it so we got the best outcomes for society.

The Hon. GREG DONNELLY: But in your mind the ownership issue is not critical.

Professor OUTHRED: No. I believe that as long as we undertake the processes and establish everything in a correctly functioning way then we can have an electricity industry that is largely privately owned or largely publicly owned.

The Hon. GREG DONNELLY: But also a mix?

Professor OUTHRED: Yes, absolutely; and anything in between. However, in each case you have to address the issues that then arise. For example, I started my career as an employee of what was then the Electricity Commission of New South Wales. My first job was as an employee of a publicly owned electricity generation and transmission entity. I had no objection to that; I took the job. But in terms of the organisational arrangements at the time, they clearly needed some work and things have been done since then.

The Hon. GREG PEARCE: You were selected by the Committee as an independent expert to give evidence. It would be very helpful for us to have your CV.

Professor OUTHRED: I am happy to provide that.

CHAIR: Please attach that to your submission. If you took any questions on notice, you have seven days in which to respond. Thank you for your attendance and your assistance to the Committee. It is appreciated.

(The witness withdrew)

The Committee adjourned at 12.55 p.m.