IN THE AUSTRALIAN COMPETITION TRIBUNAL  
AGL ENERGY LIMITED  

of 2014

RE:  PROPOSED ACQUISITION OF MACQUARIE GENERATION (A CORPORATION ESTABLISHED UNDER THE ENERGY SERVICES CORPORATIONS ACT 1995 (NSW))

This is the annexure marked "BAR 3" annexed to the statement of BRETT ALAN REDMAN dated 23 March 2014

Annexure BAR 3

[Form approved 01/08/2011]
Final Report of the Special Commission of Inquiry into the Electricity Transactions

With a recommendation under s. 10(3) of the Special Commissions of Inquiry Act 1983 that the report be made public

The Honourable Brian John Tamberlin QC
October 2011
Special Commission of Inquiry into the Electricity Transactions

31 October 2011

Her Excellency Professor Marie Bashir AC CVO
Governor of NSW
Office of the Governor of NSW
Macquarie Street
SYDNEY NSW 2000

Your Excellency

Special Commission of Inquiry into the Electricity Transactions

I was appointed by Letters Patent issued on 29 April 2011 under the Special Commissions of Inquiry Act 1983 to inquire into and report on all matters relating to the Electricity Transactions.

As part of the Inquiry, I presented an initial report on 31 August 2011.

I now provide a final report to you containing all relevant material but excluding confidential material. In relation to this report, I make a recommendation pursuant to s. 10(3) of the Special Commissions of Inquiry Act 1983 that the report be made public.

I have separately provided to you a second report which contains a recommendation that the whole of that report not be made public.

Yours faithfully

[Signature]

The Honourable Brian John Tamberlin QC
Commissioner
Special Commission of Inquiry into Electricity Transactions
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Preface

1 This report follows a lengthy inquiry into transactions whereby certain electricity assets of the State of New South Wales were sold in mid December 2010 and it also concerns future options available to further the public interest in the NSW electricity sector having regard to the outcome of these transactions.

2 I regard it as a privilege to have been asked to examine these important issues which impact so directly on the public interest of the citizens of this State.

3 I have been fortunate to have had the support and assistance of an outstanding diligent and dedicated team, without whose assistance this report would not have been possible.

4 I especially thank Christine Adamson SC (now Justice Adamson of the NSW Supreme Court) and Gail Furness SC for their invaluable contributions to every aspect of the conduct of the Inquiry including the preparation of this report and for their meticulous examination of the vast documentation and the clarification of a wide range of complex commercial, factual and legal issues which the subject matters of the inquiry have presented.

5 I also wish to thank David Kell of counsel for his comprehensive and detailed examination of many critical aspects throughout the Inquiry and the assistance of Henry El-Hage of counsel particularly at the early stages of the Inquiry.

6 Throughout the Inquiry I have received enormous assistance and cooperation from Clare Miller, who has been the Solicitor for the Inquiry and who for much of the Inquiry has also carried out the task of Executive Officer to the Inquiry. Her work in establishing the Inquiry, obtaining documents and liaising with numerous participants and witnesses has been efficient and exemplary. Without her fine work this report could not have been prepared within the time assigned.

7 The Inquiry has been greatly assisted by the legal work of Jessica Murty and the paralegals Julia Detheridge, Stephen Matulewicz and Daniel Bunozza.

8 I also acknowledge the efforts of Brad James, who was the Executive Officer for the early part of the Inquiry, for carrying out a complex and difficult task in obtaining premises and making administrative arrangements to enable the Inquiry to begin within an extremely short timeframe. I also thank Keith Atterton for his work for a period as Executive Officer.

9 I am grateful for the cooperation and efforts of the administrative staff Jessica Bowe and Tonette Leedham.

10 Finally, I express my thanks to all the persons and organisations named in the Appendices to this report who have co-operated with the Inquiry as participants or who have made submissions to the Inquiry.
Introduction and history

1 The electricity supply industry in Australia, including NSW, is comprised of sectors involving the generation, transmission, distribution and retail sale of electricity.

2 Electricity is generated by the power stations (the generators).

3 A transmission network consists of the large transmission towers and the wires that run between the power stations, underground cables, transformers, reactive power devices, and switching and monitoring equipment. It is sometimes referred to as the ‘towers and lines’ and transports electricity in NSW and the ACT from generators to distributors and, in a few cases, to major end users, such as aluminium smelters.

4 The distribution networks (the ‘poles and wires’) move electricity from transmission networks and along distribution lines to residential homes and businesses. Pole-top transformers reduce the voltage for safer use by end-users. The distribution networks consist of the poles, underground channels and wires that carry the electricity as well as substations, transformers and switching and monitoring equipment.

5 Electricity retailers purchase electricity in wholesale markets and package it with retail services for sale to customers. A number of electricity retailers are also retailers of gas.

6 Reform of the electricity industry was recommended in 1991 by the Industry Commission in order to improve efficiency and to increase competition. Throughout the 1990s disaggregation of various State owned energy utilities occurred in most States including NSW. In 1998, the National Electricity Market (NEM) commenced, which is a wholesale electricity market in which NSW and most other States participate.

7 NSW restructured the State owned Electricity Commission of NSW during the 1990s and separated the functions of generation and distribution. It corporatised the entities which carried out those functions with the aim of improving the level of efficiency and accountability of those enterprises.

8 The first proposal in NSW to sell the generation, retail and transmission assets was in 1997. At that time, it was thought that up to $22 billion might be raised. That proposal was rejected by the 1997 ALP State Conference.

9 In 2001, NSW Treasury released a discussion paper which proposed an initial form of gencntrader model involving the tendering of electricity trading functions of the State owned electricity generation and retail businesses to the private sector.

10 By this time, Victoria had sold its five generation companies, its distribution/retail businesses and transmission network. Together with State owned gas businesses which were also sold, the total purchase price was about $26 billion. Similarly, South Australia had disposed of its generation, distribution and transmission assets by way of long-term leases, and sold its retail assets, for about $5.3 billion (gross).
In May 2004, NSW Treasury released a consultation paper which proposed the separation of the "financially high-risk task of wholesale electricity trading, from the major task of producing and delivering reliable and affordable electricity", by tendering out to the private sector "the job, and the risk, of trading wholesale electricity". Under the proposal, generation traders would bid for the capacity of State owned generators into the NEM.

In 2004, a Green Paper was published by the NSW Government, stating the preference for new investment in generation capacity to be financed by the private sector. No White Paper issued.

In 2007, Professor Anthony Owen was commissioned by the NSW Government to inquire into, among other matters, the need and timing for new baseload generation. He recommended that the NSW Government divest itself of the retail arms of EnergyAustralia, Integral Energy and Country Energy and the generation businesses of Macquarie Generation, Delta Electricity and Eraring Energy, each of which was a State owned corporation. He predicted that by 2013/14 further baseload generation would be needed. If the Government continued to own most the of State's electricity industry, the investment needed over the next 10–15 years was up to $8 billion, the capital needed to enable the retail businesses to remain viable was up to $3 billion with a further $4 billion needed to retro-fit some existing power stations. He compared this to the State receiving about $26 billion for the assets if sold.

In May 2008, the Government gave notice of its intention to introduce a Bill in Parliament to:

Provide for the restructuring of part of the State's electricity industry by authorising and facilitating any of the following transfers of assets to the private sector:

(a) the lease of power stations of an electricity generator and the transfer of the rest of its business,
(b) the transfer of the retail business of an electricity distributor,
(c) the transfer by initial public offer of the business of an electricity generator (including power stations).

The Bill specifically provides that the distribution and transmission assets (the 'poles and wires') of an electricity distributor must remain in public ownership.

Following negotiations with the Opposition, in June 2008, the Government introduced a further Bill to provide for review by the Auditor-General in connection with the restructuring of the State's electricity industry. That Bill was passed. On 21 August 2008, the Auditor-General reported that, subject to certain matters identified for consideration by Treasury, nothing had come to his attention that caused him to believe that the Government's strategy for the transfer of assets to the private sector was not appropriate for maximising financial value for taxpayers.

On 28 August, the Opposition opposed the Bill, as did the Greens. The Bill was withdrawn in September 2008.
The gentrader option

In September 2008, the Government sought expert advice as to the options available to it to reform the sector as recommended by Professor Owen without special purpose legislation. It considered that it had to take action because on 28 August 2008, Standard & Poor’s had put New South Wales on credit watch and had revised their outlook to “negative” following the Opposition indicating that it would not support the Bill.

The Government was advised that the next best option, after sale or long-term lease, was the gentrader option; that is outsourcing the trading rights of the generators to the private sector. The Government was advised that this was a sub-optimal option and was clearly not as advantageous to the State as selling the generators outright. It was expected that the market appetite for gentrader rights would be less than for the generators and thus there may not be sufficient demand for the 12,500 megawatt capacity; that is the combined capacity of the State owned generators. It was also thought that a new entrant into the market, important in order to increase competition, would be unlikely under the gentrader option.

Conclusions about the gentrader option

The Inquiry is of the view that the decision to sell the gentrading rights was made in the knowledge that it was a sub-optimal solution. The best option, however, was not available, that is the sale or long-term lease of the generators under legislative authority. It accepts that some action was necessary to reform the electricity sector in light of the recommendations made by Professor Owen.

The Inquiry agrees with the view of Donald Challen, the expert it engaged to express opinions as to the Inquiry’s terms of reference. When asked whether there was any real alternative to the Government in choosing to sell the trading rights of the State owned generators he said: “The short answer to this question is that there [was] none.”

The sale process

In November 2008, the Government decided to proceed with an Energy Reform Strategy which consisted of four main elements:

a. the sale of the retail businesses;

b. the sale of development sites;

c. contracting out of Government owned generation (gentrader option); and

d. retention of Government ownership of the network and transmission infrastructure.

A Steering Committee was re-established, working groups formed, advisers appointed and work commenced. The advisers were from the fields of law, competition, finance, economics, accounting, tax, information technology, probity, engineering, environment, financial modelling, regulation and the energy market.
An international roadshow was conducted. The structure of the sale transaction was debated between the advisers and the Steering Committee and ultimately agreed. There were to be four gentrader bundles offered, Delta West comprising Mt Piper and Wallerawang power stations, Eraring comprising Eraring and Shoalhaven power stations, Macquarie Generation being Bayswater and Liddell and Delta Coastal comprising Vales Point B, Munmorah and Colongra. The transaction would be executed on a simultaneous basis; that is bidders were given the opportunity to bid for several assets within a particular timeframe.

The gentrader agreements were drafted and questions of the allocation of risk between the State as owner of the generators and the purchasers of the trading rights were debated and ultimately answered by Cabinet which accepted the advice of the Steering Committee. The details of the transactions appear later in this summary.

Expressions of interest were sought and evaluated by reference to criteria which had been determined in advance and approved by Cabinet. Eight bidders were approved. In the meantime, the bidder data rooms were being populated with data provided by the generators and retailers. Those data rooms were opened in early July 2010 and pre bid negotiations took place with the results being periodically conveyed to the Steering Committee.

The pro forma gentrader agreements were varied following negotiations and ultimately bespoke agreements were drafted. The relevant advisers ‘signed off’ to the Steering Committee that their terms were consistent with decisions of the Steering Committee and the Government as to the appropriate risk allocation.

The Auditor-General was involved in discussions concerning the principles and objectives of the agreements.

The retention value of the assets was determined before the bids were evaluated. Extensive modelling of the assumptions made was carried out.

The final bids were evaluated against pre-determined and agreed criteria. There were some post bid negotiations and the Government agreed with the recommendation of the Steering Committee as to which bids should be accepted.

**Conclusions about the sale process**

The Inquiry is of the view that:

a. the governance structure adopted;

b. the process by which the assets were offered to the market; and

c. the decision to sell the assets the subject of acceptable bids

were, in the circumstances of the then Opposition’s position not to support the legislation, the economic climate, the expert advice available to the Government and the uncertainty over carbon pricing, reasonable and appropriate.
Structure

31 The Inquiry concludes that the decision making structure employed was appropriate for the assets under sale and an orthodox and conventional method of achieving the objectives of the sale. The Steering Committee comprised qualified and experienced members from relevant areas of government and industry. The working groups were, also, appropriately constituted and covered the key issues.

32 The evidence reveals that, in respect of each significant decision which was made and on which there were potential alternative options, there was at least one contrador, or an adviser who was capable of reviewing the work of a proponent. In this way, the working groups and the Steering Committee had access to competing views in respect of matters calling for their recommendation or decision.

33 A probity advisor was appointed, and its representatives were visible to all involved and attended all relevant meetings. They prepared probity plans and briefed participants, received and resolved many declarations as to conflicts of interests and published a comprehensive report at the end of the process.

34 The probity advisers received no complaint about the process, which is some indication that no one had a legitimate grievance.

35 While the process took significantly longer than initially anticipated, the Inquiry does not consider that the length of time taken can be attributed to any one action or event. It clearly was a complex set of transactions which involved dozens of people contributing to decision making on a regular basis. The structure was established to enable or require the work of one expert to be critiqued by another. It was an unprecedented transaction in Treasury's experience in terms of its size, complexity and lack of legislative authorisation.

36 Mr Challen expressed the following view, with which the Inquiry agrees:

The transactions were implemented using a process which, in my view, meets best practice standards. The governance arrangements were robust, implementation was thorough and documentation appears generally to have been of a good standard.

Number of bundles

37 In relation to the decisions made concerning the number of bundles to be offered and the manner of sale, the Inquiry agrees with the view expressed by Mr Challen:

The Steering Committee gave [the packaging of the gentrader bundles] considerable attention and, in providing advice to Government to proceed with the four bundles, made a judgment call on the basis of the analysis and advice it received. I conclude that this element of the structure of the transaction was well executed. It is not possible to make a judgement about the impact on the outcome relative to the alternatives considered.

Risk allocation

38 In relation to the manner in which risk was allocated between the State and the gentrader, the Inquiry is persuaded by the view expressed by Professor Stephen Gray. As a director of SFG Consulting, he modelled and prepared
7 reports on six of the iterations of the gentrader agreements to demonstrate and assess the various risks associated with each version, and how those risks could properly be quantified. Professor Gray said:

One is not necessarily better than the other for the State, in that in those two different scenarios the amount that the gentrader bidder will be prepared to pay will of course be different. So what is being exchanged is additional upfront payment from the bidder for the gentrader contract versus a series of potential payouts from the State over the life of the contract.

Retention value

39 As the evidence before the Inquiry established, the retention value was determined before the bids were considered. This was not only a requirement imposed by the Auditor-General, but also a necessary aspect of value for money, to avoid the risk that the bids themselves could be permitted to influence the determination of retention value.

40 Mr Challen said:

The work of the Retention Value Working Group, and most particularly the model which was used to undertake the retention value calculations was subject to review and audit by Ernst & Young. Ernst & Young’s working papers reveal that a thorough and highly competent review of the retention value models was undertaken.

41 The Inquiry accepts Mr Challen’s opinion that the assessment of retention value of the retail businesses and the generators was in accordance with orthodox methodology and was conducted with appropriate rigour.

Compliance with laws and policies

42 The Inquiry is satisfied that there was compliance with applicable laws and policies during the sale process.

The outcome

Price

43 The price paid for each retail business sold was:

<table>
<thead>
<tr>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>Origin</td>
<td>1,300</td>
</tr>
<tr>
<td>EnergyAustralia</td>
<td>TRUenergy</td>
<td>1,486</td>
</tr>
<tr>
<td>Integral</td>
<td>Origin</td>
<td>1,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>3,786¹</td>
</tr>
</tbody>
</table>

¹ Excludes any purchase price adjustments relating to unbilled income and working capital.
The amounts paid for the Eraring and Delta West gentrader bundles were as follows:

<table>
<thead>
<tr>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eraring</td>
<td>Origin</td>
<td>960 - 1,158</td>
</tr>
<tr>
<td>Delta West</td>
<td>TRUenergy</td>
<td>540 - 600</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1,500 - 1,758</td>
</tr>
</tbody>
</table>

1 If tax deductibility charges are allowed by the ATO, the higher figure is payable.

The price paid for the development sites (which are included in the gross proceeds above) were:

<table>
<thead>
<tr>
<th>Development site</th>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marulan</td>
<td>EnergyAustralia</td>
<td>TRUenergy</td>
<td>6.4</td>
</tr>
<tr>
<td>Marulan</td>
<td>Delta</td>
<td>TRUenergy</td>
<td>8.6</td>
</tr>
<tr>
<td>Mount Piper Extension</td>
<td>Delta</td>
<td>TRUenergy</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>16.0</td>
</tr>
</tbody>
</table>

**Key terms of gentrader agreements**

The gentraders pay capacity charges to the generators (which continue to be owned by the State) in consideration for the exclusive right to trade the electricity output of the power stations. The gentrader is entitled to all revenue resulting from trading electricity in the NEM.

The gentrader agreements include monthly targets for availability for all generation units at each power station. These targets are based on ten years of historical data provided by the State owned generators and take into account outages. Separate targets are provided for peak, off-peak, weekend and super peak periods.

If the State owned generator defaults in its obligation to meet the availability targets, the gentrader is entitled to be paid Availability Liquidated Damages. Availability Liquidated Damages are also subject to a total annual cap and are not related to market trading exposures.

The State owned generator must pay an over generation charge when more electricity is generated than instructed by the gentrader.

The State owned generator is obliged to operate and maintain the power stations and the gentrader is responsible for the cost of capital improvements that the gentrader initiates.

The gentrader is obliged to pay the State owned generator the following charges:

- fixed charges, which are based on the estimated costs of operating and maintaining the power station and include associated capital expenditure. These charges are fixed and paid monthly over the term of the agreement and are escalated quarterly by reference to various factors;
b. variable charges, which are paid at a set rate per MWh for the electricity sent out each month. As with the fixed charges, these charges are escalated quarterly by reference to various factors; and

c. pass-through charges, which recoup costs for water, transmission connection, licence fees, rates and land taxes.

52 The gentrader is responsible for purchasing and supplying coal to the power stations and the State owned generator is obliged to manage the coal from receipt to burn.

53 The gentrader is responsible for carbon costs and is entitled to carbon benefits.

**Cobbaro coal mine**

54 In October 2010, the Government decided that a State entity would own and develop a mine at Cobbaro (between Mudgee and Dubbo), and that it would sell mined coal to the State owned generators at prices that reflected the estimated cost of production, rather than the price offered through a tender process. The effect of this was that if any of the gentrader agreements were entered into with the generators which were party to the Cobbaro coal supply agreements, the gentrader would get the benefit of coal at cost price.

55 The decision to develop Cobbaro increased the retention value of the generators since they had the benefit of the coal supply agreements for Cobbaro coal, the cost of which would affect their net profit in the future.

56 This decision was arrived at following a lengthy process which had begun in 2008. It represented a departure from the Government's policy of not owning coal mines (which had led to the sale of State owned coal mines in the late 1990s and early 2000s) in that it put in place a structure which would give the State owned generators and gentraders access to coal at a lower price than would have been available to them had they had to source such coal through a tender process.

57 The Inquiry's view is that it is too early to say either that the benefits from the investment made by the State in Cobbaro warranted the cost of the investment, or that they did not.

58 The Inquiry considers that each of the Government's major decisions relating to Cobbaro (to develop it in the first place; to reject the preferred tender; to take over the development itself with a view to eventual sale; and to enter into coal supply agreements with Origin and the generators) was justified by reference to the material available to it at the time of each decision. Whether each of the decisions will prove, when and if the mine is sold, to have been better than the alternatives with the benefit of hindsight is presently unknown. The time has not yet arrived when such a judgment can be made.

59 The principal benefit to the State afforded by the Cobbaro Coal Project is that the coal supply agreements with the State owned generators for Cobbaro coal, if performed, will ensure that the State owned generators (and the gentraders) will have access to coal to preserve their continued operation at a price which is unlikely to disturb their merit order in the NEM.
The importance of Cobbor to the coal-fired generators in NSW appears from the following passage from the Electricity Statement of Opportunities 2011, at 5-7:

Coal costs for all New South Wales generators (excluding Redbank) tend to converge after approximately 2020, due to Cobbor becoming the supplier for the majority of coal to all large New South Wales power stations.

**Value for money**

The State received gross proceeds from the transactions of $5.3 billion.

The retention value of all the transactions entered into was exceeded by the bid price, when all associated costs and liabilities were taken into account. When considered individually, the bid price for each of the Delta and Eraring bundle was less than the retention value of each bundle. The bid price for each retailer and each development site far exceeded the retention price for each.

If the retention value of the combination of assets sold to a particular bidder exceeds the bid price less any additional costs or liabilities incurred as a result of the sale, then the State will not obtain value for money by selling. However, if the retention value is less than the bid price less additional costs or liabilities incurred as a result of the sale, the State will obtain value for money. Of course, this is subject to the retention value being appropriately derived, which the Inquiry is satisfied it was.

There is a complexity that arises in relation to the gentrader agreements because what was sold (the gentrading rights) was different to what would have been retained, namely the generators. By contrast, the retail businesses as sold were identical to those which would have been retained. Therefore, while it is appropriate to compare the retention value for the retailers with the bid price for them, since there is a true comparison, the same cannot be said for the generators and the gentrading agreements.

The Inquiry concludes that, on the basis outlined in the report, the State received value for money from the electricity transactions, with the possible exception of Cobbor, which has been considered separately.

**Costs and benefits**

The State maintained its AAA rating after having been put on negative outlook in 2008 and achieved some measure of electricity reform. It is not, however, possible to say that the State would have lost its AAA rating if the transactions had not occurred, or if only the retail businesses and development sites had been sold and the generators retained. Furthermore, the electricity transactions were not the only matters germane to the deliberations of the rating agencies, which also had regard to the contents of the State budgets from time to time.

The State achieved a partial privatisation of the electricity sector, but did so in a way that resulted in the execution of binding, enforceable gentrader agreements for some, but not all, of its generators, which has substantially affected the market and restricted the range of future options.

The execution of the agreements has entrenched an option that deprived the State of the opportunity of achieving maximum value from those of its
generators that are subject to the gentrading agreements. Although the State (through the relevant State owned corporation) retains a right to transfer the generator to a third party, it may be difficult to encourage entities other than the corresponding gentrader to bid for it. This may make it difficult to create the requisite competitive tension to achieve good value for the generators that are subject to gentrading agreements.

69 The gentrader agreements are necessarily more complex than a sale or lease of the generators. The gentrader agreement requires a high degree of co-operation between the generator and the gentrader to make the relationship work effectively, which gives rise to an unquantifiable risk of disputes and litigation.

70 The benefits of the Eraring and Delta West gentrader agreements were that the State owned generators divested themselves of the following principal risks:

a. trading risk associated with participating in the NEM, which included consequential losses from outages arising from technical failure, or industrial action (which were uncapped, unless and to the extent to which, they could be hedged);

b. counterparty credit risk in relation to hedge contracts;

c. carbon price risk (since the whole of that risk is now borne by the gentrader);

d. fuel risk (since the gentrader is wholly responsible for the cost and volume of coal to fuel the generator); and

e. regulatory risk (principally associated with the cost of compliance with environmental laws).

71 The Inquiry accepts that the substitution of trading risk for the risk of a liability for Availability Liquidated Damages is beneficial for both fiscal and policy reasons. The fiscal reason is that the acquired risk is lower than the trading risk (although in any given year more may be paid in Availability Liquidated Damages than loss incurred through exposure to trading risk). The policy reason is that the measure of damages for breach of the covenant to provide a certain level of capacity is not referable to the spot price of electricity in the NEM at the time of breach. Thus, the Government has no incentive to invest in generation because its financial exposure is not connected to the spot price.

72 There are some provisions in the gentrader agreements that impose a liability on the State owned generator which do not need to be separately considered because they would have been incurred by the State owned generator, irrespective of the gentrader agreement. Such provisions include:

a. the liability for overgeneration charges;

b. the cost of auxiliary power requirements past a set limit;
c. the costs of remedial action to manage clinkering (the combustible residue, fused into an irregular lump, that remains after the combustion of coal); and

d. the cost of remediation of the site at the end of the generator’s useful life.

73 There were several benefits to the State of the sale of the retail businesses. The net figure, once deductions had been made from the bid price for costs and liabilities, was well in excess of the retention value.

74 The State, through its State owned corporations, is no longer exposed to the risks associated with the electricity retail business. These risks are considerable, and are substantially greater than those to which the State owned generators are exposed.

75 In relation to the development sites, the principal benefit to the State was that it received proceeds which were well in excess of their retention values. A further benefit from such sales is that they may encourage investment in generation (which was part of Professor Owen’s recommendation as to what was required), although the sale agreements themselves do not require the purchaser to develop the sites within any particular time or at all.

76 Mr Challen expressed the following opinion:

   If net proceeds was the only criterion for making the sell/don’t sell decision, the Government may not have proceeded to sell the Eraring and Delta West gentraders on the basis that the net proceeds from the bids did not exceed the retention values of those rights. However, net proceeds was not the only criterion and the decision to sell was fully justifiable by reference to the full set of objectives and the fact that, at the level of each bidder and overall for the collection of assets and rights, the net proceeds far exceeded the retention value.

   ... Bringing the full set of transactions together, and having regard to the material value in reducing State debt, preserving NSW’s AAA credit rating and incentivising the private sector to invest in electricity generation and retail, it is reasonable to conclude that the benefits of the transactions overall exceeded the costs and expected value of the new net risks.

77 The Inquiry agrees with Mr Challen’s conclusion.

**Did the Electricity Transactions meet the objectives?**

78 The previous Government’s objectives, together with the preamble, were as follows:

   The NSW Government ... has designed its Energy Industry Reform strategy... to ensure there is timely investment in the electricity sector, thereby delivering efficient and reliable power to the businesses and homes of New South Wales... Specifically the strategy is designed to achieve the following objectives...

   - Deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;
• Create an industry and commercial framework to encourage private investment into the NSW electricity sector and reduce the need for future public sector investment in retail and generation;

• Ensure NSW homes and businesses continue to be supplied with reliable electricity; and

• Place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt.

For the reasons given in the report, the Inquiry considers that the Electricity Transactions:

a. have delivered a more competitive retail electricity market in NSW;

b. have the potential to deliver a more competitive wholesale electricity market in NSW, although this will depend in part on the way in which any remaining State owned generators respond to passing on the carbon price, when imposed, to users of electricity;

c. have had the effect of encouraging some level of private investment in the NSW electricity sector, although it is too early to say whether this will be sufficient to obviate the need for public sector investment to meet demand in the future;

d. may not have had a material effect on ensuring that NSW users continue to be supplied with reliable electricity and were not a material cause of the increase in electricity prices which the retailers can now charge; and

e. in so far as they have reduced, but not removed, the Government’s exposure to electricity market risk and reduced the total State sector debt, NSW is in a stronger financial position.

The resignation of the directors

One consequence of the adoption of a non-legislative model was that the State owned corporations themselves would be required to execute the transaction documents. The Government sought and received advice from various quarters about this issue. The consensus was that, in the event that the boards would not voluntarily enter into the transactions, power was available under s. 20N of the State Owned Corporations Act 1989. That section provides as follows:

If the portfolio Minister wishes a statutory SOC to perform activities, or to cease to perform activities, or not to perform activities, in circumstances where the board considers that it is not in the commercial interests of the SOC to do so, that Minister with the approval of the Treasurer may, by written notice to the board, direct the SOC to do so in accordance with any requirements set out or referred to in the notice.

Thus, if a board decided that it was not in its commercial interests to enter into the transactions, it could inform the Treasurer (as the portfolio Minister) of that decision and then the Treasurer could direct the board to enter into the transactions. If so directed, the board is obliged to follow the direction.
The Government expected that when it came to the final decision making, the State owned corporations would have comparatively little time in which to reach a judgment about whether to proceed with the transactions. It was contemplated that the direction powers would have to be activated after receipt and evaluation of the bids, and any post-bid negotiation had been completed.

This process meant that the Government proceeded on the basis that there was no utility in disclosing the bids or the post-bid negotiations to the State owned corporations until after the proposed transactions with the successful bidders had been approved by the Government. There was also the consideration, from the bidders’ point of view, that they would be listed companies which would need to put their shares into a trading halt once the transaction had been approved in principle but the transaction documents had not been executed.

A protocol and memorandum were provided to each State owned corporation in mid 2009 which set out what each could expect by way of information sharing and timing. The events transpired as contemplated in those documents.

Hence, throughout 2010, each board received a number of briefings from the advisers concerning timetables, the transaction agreements, the key terms of the gentrader agreement and confirming the role of directors as set out in the earlier memorandum. For example, in March 2010, one of the advisers gave a briefing to the State owned corporations’ senior management, including chief executives and chief financial officers, on the key terms of the draft gentrader agreements including the regime for Availability Liquidated Damages.

By mid November 2010, the boards had received and, in some cases management had commented on, more than one version of the draft gentrader agreements and been advised as to the proposed changes to the gentrader agreements following feedback from bidders. They had received separate advices as to the validity of the anticipated s. 20N Direction. They had received drafts of the letters, approvals and directions expected to be received from the Government following its evaluation of the bids and decision as to the purchasers of each bundle. Each director and member of senior management received an indemnity from the State in respect of the transactions.

On 14 December 2010, after being informed of the successful bidder, the price and any changes to the agreements not previously disclosed, each board met to consider its response. In the afternoon, four directors of Delta Electricity and four directors of Eraring Energy resigned from their respective corporations.

While the reasons given to the Inquiry by the directors who resigned, differ in terms, the essence of the concerns of the resigning directors is similar. Each was satisfied as to the legality or lawfulness of what he or she was asked to do. Each believed that the transaction was not in the commercial interests of their respective corporations. Most saw their decision as having a moral or conscience dimension. Particular concerns expressed included the following:

a. the belief that the consideration to be paid for the trading rights was low;

b. the exposure of the corporation to Availability Liquidated Damages;
c. the haste with which they were expected to make their decision;

d. not being permitted access to their own expert advice as to the transactions;

e. not knowing of or participating in the negotiations with prospective bidders;

f. not being privy to the price for which other assets were sold;

g. whether the costs payable by the purchaser would cover the actual costs incurred; and

h. the workability of the gentrader model.

89 The Inquiry's view is that the sale was structured so as to deliver the objectives sought by the State for the benefit of the State as a whole and to respond to Professor Owen's recommendations. The State had engaged well qualified experts to advise it about the sale. By contrast, the decision to be taken by each director was in the context of the interests of Delta Electricity or Eraring Energy and not in the broader interests of the State of NSW.

90 Thus, the interests of each of the State owned corporations and that of the State were not identical and s. 20N permitted, in effect, the State to act other than in the commercial interests of a State owned corporation, providing certain criteria were met.

91 This was no fire-sale. While it can be appreciated that at least some of the directors wished to have greater involvement in the process and decision making, ultimately, it was a decision of the Government acting in the broader interests of the State as to the disposal of assets it owned. The advisers and the Steering Committee believed that adequate information was given to the State owned corporations; some of the directors of some of the State owned corporations disagreed. Although the provision of more information may have prevented some or all of the resignations which occurred on 14 December 2010, ultimately those resignations do not call into question the process the Energy Reform Project followed.

92 None of the resigning directors, the continuing State owned corporation directors or those advising the Government are at fault because of the resignations. There has been no breach of any identifiable law or duty.

**The new directors**

93 The appointment of the new directors was necessary if the transactions were to proceed. In the order of $200 million had been expended by the State to reach this stage. Millions of dollars had been spent by prospective bidders. The State's AAA rating may have been at risk. Some of the assets had received acceptable bids and in total those bids exceeded the retention value. Furthermore, the successful bidders were subject to a trading halt.

94 The Project Director, the Chair of the Steering Committee and the Chair of the Evaluation Committee were each appointed to either Delta Electricity or Eraring Energy. Another experienced director and Chair of other State owned corporations was appointed as Chair of Eraring Energy.
While, ideally, one would not appoint advisers to the Energy Reform Project to the board of the energy State owned corporations, in the circumstances which prevailed the appointments were lawfully and validly made and any subsequent conflict of interest was appropriately dealt with.

Future options

The generators

The Inquiry does not consider that the objectives of a competitive electricity market or reliability of supply are advanced by maintaining the status quo; that is continued State ownership of more than half of the State’s generation capacity or by the continuation of the gentrader agreements. However, to unravel the sales which have taken place would be costly and not in the interests of the State’s reputation.

The Inquiry finds that it is consistent with a competitive electricity market that the retail businesses and wholesale generation businesses be privatised. It accepts that the recommendations made by Professor Owen in his 2007 report were well-founded.

The sale of the generation trading rights was not expected to, and probably did not, achieve the consideration that the sale of the generators would have been expected to receive. It was a second best option. Accordingly, the sale of the remaining assets should not be structured so as to separate the trading rights from the generators. Further, for the State to adopt this option would be likely to reduce the prospect of attracting a new entrant.

The network businesses

Overall, the evidence before the Inquiry tends to support the view that privatisation of the network businesses would lead to efficiency gains over time. This would result in more effective capital investment, which should result in a reduction in the charges permitted to be levied for the business in the next regulatory period.

However, there is a lack of empirical evidence to support these views and a number of reviews are underway, the outcomes of which may affect the value of the businesses. Further, those involved in, and responsible for, the regulation of the network businesses, namely the Australian Energy Regulator and the Australian Energy Market Commission, have identified weaknesses in the current regulation of the network businesses.

It is expected that, if a rule change proposed by the Australian Energy Regulator (as detailed in the report) is made by the Australian Energy Market Commission, there will be a better means to establish whether networks are operating efficiently and a better basis on which to compare the relative efficiency of network businesses. Further, the outcome of a review being conducted of the reliability standards will assist in any comparative exercise as well as potentially affecting the value of the businesses. Finally, the Frameworks Review being carried out by Australian Energy Market Commission, may also affect the value of the businesses.

Each of the reviews referred to above will be completed in 2012.
103 In order to consider whether an asset should be sold or not, objectives need to be articulated and, if more than one, given weight and ranking. Possible objectives in relation to the network businesses include:

a. securing funds for use in other public enterprises;

b. encouraging private investment so as to reduce the need for public sector investment;

c. ensuring the reliable delivery of electricity; and

d. minimising the price of electricity, including by ensuring the efficient operations of the network businesses.

104 It is ultimately a question for Government which objectives it chooses and the rank and weight given to each. In the absence of accepted and clear benchmarks against which to consider the efficiency of the network businesses in public hands and in private ownership, any decision is necessarily a policy one.

105 Factors the Inquiry believes are relevant to take into account once those objectives have been determined by the Government, are the results of the three reviews referred to above. Their outcome may affect the value of the network businesses and hence the value to the State of them being retained in public hands and the acceptability of any bids for those assets.

106 If the dominant weight is given to the fiscal objective, then it would follow that the sale of the network businesses would achieve that objective. It would be prudent to await the outcome of the three reviews before valuing the assets to be sold. Similarly, if any other objective is adopted, alone or in combination, prudence would dictate the same process.

Recommendations

107 The Inquiry recommends that:

a. legislation be enacted to enable the Government to offer for sale or long term lease the Eraring and Delta West generators, which are subject to gentrading agreements and the Macquarie Generation and Delta Coastal generators;

b. the Government sell the development sites;

c. the Government sell the Cobbora mine;

d. the Government determines its objectives for the network businesses and in accordance with those, decides whether it will retain in public ownership or sell all or part of the network businesses; and

e. the State obtain expert advice as to the implementation, including timing of these recommendations, particularly in respect of the network businesses as the reviews referred to above are likely to affect value and are expected to be finalised in 2012.
Chapter 1  The Inquiry's Approach

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Commencement of the Inquiry

1.1 The Letters Patent establishing the Inquiry and its terms of reference were issued by the Governor on 29 April 2011. They are reproduced in Appendix 1.

Terms of reference

1.2 The Letters Patent made and issued under the Authority of the *Special Commissions of Inquiry Act 1983* appointed the Honourable Brian Tamberlin QC as Special Commissioner to inquire into and report on all matters relating to the Electricity Transactions (occurring both before and after entering into those transactions), including:

1. compliance with applicable laws, policies and practices;

2. the circumstances surrounding the resignation and appointment of directors of Eraring Energy (Eraring) and Delta Electricity (Delta) in December 2010;

3. the value for money achieved for the State compared to the retention value of the assets to the State;

4. the costs and benefits to the State of the Electricity Transactions, including potential risks and liabilities and the extent to which the transactions can deliver the stated objectives for entering into them; and

5. any other related matters.

1.3 Further, the Commissioner was to inquire into and report on options for future action that could be undertaken to further the public interest in a competitive NSW electricity sector, including options to:

1. address any issues identified in relation to the Electricity Transactions; and

2. promote competitive electricity prices and ensure reliability of supply.

1.4 ‘Electricity Transactions’ refers to:

a. the sale of the State-owned electricity retailers (EnergyAustralia, Integral Energy and Country Energy) by the NSW Government in 2010/11;

b. the sale of the electricity trading rights of the State-owned generators (Eraring and Delta West) by the NSW Government in 2010/11;

c. the Cobbora coal mine development;

d. the sale of the development sites suitable for power generation by the NSW Government, including at Marulan and Mt Piper in 2010/11; and

e. the proposed sale of the electricity trading rights of State-owned generators (Macquarie Generation and Delta Coastal) that was not completed by the NSW Government.

1.5 The initial report to the Governor of NSW was required, and delivered by 31 August 2011. This report was required on or by 31 October 2011.
1.6  On 23 May 2011, the Inquiry conducted a public sitting to announce its terms of reference and to outline the processes to be followed by the Inquiry, including the means by which it intended to inform itself.

Staff

1.7  Clare Miller was appointed as Solicitor to the Inquiry in early May. Ms Miller was seconded from NSW Crown Solicitor’s Office and was quarantined from that organisation for the duration of the Inquiry (as were all other staff who were seconded from NSW Crown Solicitor’s Office).

1.8  Christine Adamson SC, Gail Furness SC and David Kell were appointed as Counsel Assisting the Inquiry in early May 2011.

1.9  Henry El-Hage of Counsel and Jessica Murty (seconded from NSW Crown Solicitor’s Office) provided legal assistance to the Inquiry during its early stages. Brad James and Keith Atterton (both seconded from the Department of Attorney General and Justice) were the Inquiry’s Executive Officers for consecutive periods. Julia Detheridge, Stephen Matulewicz and Daniel Bunoza were seconded from NSW Crown Solicitor’s Office to provide paralegal assistance to the Inquiry. Tonette Leedham and Jessica Bowe were seconded from NSW Crown Solicitor’s Office to provide secretarial assistance.

Expert assistance

1.10  Professor Anthony Owen, who prepared the report for the NSW Government in 2007, was retained by the Inquiry to supplement and update his earlier report and express his opinion on future options. Professor Owen is the Director and Santos Chair of Energy and Resources at the School of Energy and Resources, University College London, Australia. Professor Owen’s report to the Inquiry, along with his curriculum vitae, is included at Appendix 12.

1.11  Donald Challen was retained by the Inquiry to provide a report on terms of reference three and four and opinion on future options. Mr Challen is an economist and was the Secretary to the Tasmanian Department of Treasury and Finance between 1993 and 2010. Mr Challen’s report to the Inquiry, along with his curriculum vitae, is included at Appendix 11.

1.12  The Inquiry invited a number of experts to opine on future options in an honorary capacity. Several persons accepted the Inquiry’s invitation and their considerable assistance to the Inquiry in providing written reports setting out their views is acknowledged and appreciated. The Inquiry received short reports on future options from the following:

a. the Australian Energy Market Commission;

b. Kate Farrar, Managing Director of QEnergy, a Queensland-owned and operated electricity retailer;

c. Professor Hugh Outhred, Professorial Visiting Fellow in Energy Systems with the School of Electrical Engineering and Telecommunications, University of New South Wales; and
d. Greg Houston, Director of Nera Economic Consulting, and an economist with over 25 years experience in the economic analysis of markets.

**Advertising the Inquiry**


**Processes through which the Inquiry acquired information**

1.14 Shortly after the commencement of the Inquiry, letters were sent to 54 key agencies and individuals, inviting them to participate in the Inquiry and provide relevant information.

*Documents produced on summons*

1.15 Whilst some information was provided voluntarily, most information was produced in response to summons issued during the Inquiry. The Commissioner’s power to summons material is set out in the *Special Commissions of Inquiry Act*. In providing material pursuant to a summons, individuals and agencies were not excused from producing the information on the ground of privilege or on any other ground, including commercial-in-confidence.

1.16 The Inquiry issued 87 summonses to produce documents including to NSW Treasury, the Department of Premier and Cabinet, Delta, Eraring, Macquarie Generation, Ausgrid, Essential Energy, Endeavour Energy, the directors and former directors of Eraring and Delta, the advisers to the Electricity Reform Project and other individuals, corporate entities and Commonwealth and State Government agencies.

*Submissions*

1.17 The Inquiry invited submissions from interested parties. The Inquiry made it clear that submissions could be received on either a confidential or non-confidential basis.

1.18 The Inquiry received 32 submissions. Just under a third of the submissions were provided on the basis that their contents were to be kept confidential. One submission was anonymous.

1.19 The Inquiry continued to receive submissions until early October 2011.

1.20 A list of the names of the agencies, organisations and individuals who provided submissions is contained in Appendix 6.

*Private hearings*

1.21 Between 11 July 2011 and 28 September 2011 the Inquiry conducted private hearings obtaining evidence from 26 individuals. In addition to current and former Macquarie Generation, Delta and Eraring directors, advisers to the Energy Reform Project and former Ministers gave evidence.
A list of the individuals that gave evidence in private hearings is contained in Appendix 7.

These hearings were held in private because of the commercial in confidence nature of the terms of the Electricity Transactions. The reasons that these hearings were held in private are further addressed below.

Each person examined was summoned to do so. Directions under sections 7 and/or 8 of the *Special Commissions of Inquiry Act* were made which included preventing the publication of evidence given. From time to time, these directions were varied.

*Private meetings*

Between 10 May 2011 and 21 September 2011, private meetings were held with 37 individuals. A list of the individuals that participated in private meetings is contained in Appendix 8.

Each person taking part in such meetings was summoned to do so. Directions under sections 7 and/or 8 of the *Special Commissions of Inquiry Act* were made which included preventing the publication of evidence given. From time to time, these directions were varied.

*Visits*

A list of visits is contained in Appendix 9.

*Scope*

The Inquiry has not inquired into matters of federal legislation, largely because our focus has been on the Electricity Transactions the subject of the terms of reference rather than the legal framework within which the sector operates. In addition, the available time did not permit such inquiry.

*Confidentiality*

As referred to above, all hearings conducted by the Inquiry were in private apart from the first, which was of a preliminary nature.

There were several reasons for this, the force of which depended on the relevant term of reference.

The first four terms of reference concern compliance with laws, the circumstances surrounding the resignation and appointment of the directors of Eraring and Delta on 14 December 2010, whether the State obtained value for money as a result of the transactions and the costs and benefits of the transactions.

These terms of reference collectively required an examination and appreciation of the sale process that led to the Electricity Transactions and of the provisions of the contracts that comprised the Electricity Transactions.

Each of the participants in the sale process (including those who lodged expressions of interest and those who made bids, whether conditional or unconditional) did so on the basis that they were obliged to keep confidential
information provided by the State in the course of the sale process, the terms of
the various drafts of agreements prepared and the final executed agreements.

1.34 The Inquiry considers that public disclosure of confidential matters in the course
of public hearings would not only have undermined the confidentiality regime
which the State imposed, but would also undermine any confidence such
parties, and others, might have in those regimes in the future.

1.35 In addition, legal professional privilege attached to much of the legal advice
received by the participants in the Energy Reform Project.

1.36 The Inquiry was also concerned not to undermine competitive neutrality in
connection with the functions of the State owned corporations. The gentrader
agreements contain sensitive commercial information which, if disclosed, would
provide pricing and strategic information to the competitors of TRUenergy
Holdings Pty Limited (TRUenergy) and Origin Energy Limited (Origin) and also
their fuel suppliers.

1.37 It was submitted to the Inquiry (in support of the maintenance of the
confidentiality regime) that the impact of any such disclosure is heightened for
gentraders given the particular sensitivity of the National Electricity Market to
pricing and strategic bidding-related information.

1.38 The Inquiry accepts the force of the submissions made to the following effect:
the National Electricity Market is operated such that generators are required to
submit offers to the Australian Energy Market Operator for the supply of
electricity every 5 minutes. Offers made by generators broadly take into
account both the costs and technical constraints applicable to their power
stations during a relevant bidding period. The market is designed to encourage
offers at the generator’s short run marginal cost. Detailed knowledge of the
costs and technical and operational parameters in relation to the power stations
would enable competitors to predict, with a greater degree of accuracy, bidding
parameters. As such, there would be a competitive disadvantage if extracts
from the gentrader agreements were to be published. The disclosure of this
information may also reduce the competitive bidding tension in the National
Electricity Market and the NSW region in particular.

1.39 Whether the State obtained value for money from the Electricity Transactions
and the costs and benefits of such transactions depends on the terms of the
agreement and also the assessment of the retention value of the assets to the
State. The retention value is highly confidential and its disclosure has a
significant potential to affect any subsequent sales and also market confidence
in the Electricity Transactions.

1.40 Much of the evidence concerned matters which were the subject of
consideration by Cabinet. It is well recognised that the disclosure of documents
concerned with advice given to Ministers and Cabinet deliberations may be
damaging to the public interest.¹ Having regard to the conventions of Cabinet
confidentiality, references to particular meetings, decisions or Committees of
Cabinet are generally avoided.

¹ See Sankey v Whitlam (1978) 142 CLR 1 at 52 and NSW v Public Transport Ticketing Corporation [2011] NSWCA 60
at 45
1.41 The circumstances surrounding the appointment and resignation of directors touch and concern these matters. The matters that troubled the directors who resigned included the terms of the gentrader agreements and the risks to which Delta or Eraring would be subjected as a result of the transactions. Therefore, any consideration of why some directors resigned and some remained necessarily involves an examination of such matters.

1.42 Furthermore there was no real factual dispute to be resolved in the course of the inquiry into the circumstances surrounding the resignation and appointment of directors. The differences between the directors who resigned and those who remained on the one hand and the members of the Energy Reform Project team were differences of perspective. The members of the Energy Reform Project team were privy to more information than the directors of the State owned corporations and they considered the Electricity Transactions to be beneficial to the State as a whole. The directors were concerned about the effect the gentrader agreement would have on the post-transaction conduct of the business.

1.43 In these circumstances, the Inquiry considered that the public interests in competition in the National Electricity Market and maintaining the confidentiality regime which was in place for the Electricity Transactions outweighed the public interest in public hearings.

1.44 In respect of the term of reference requiring the Inquiry to investigate future options, the Inquiry’s reasons for not conducting hearings in public were different from those set out above. In respect of what should be done with the gentrader agreements and the remaining generators, there was no substantial difference in opinion. As set out in this report, the overwhelming consensus of opinion was that the State should sell, or grant long-leases over its generators.

1.45 In relation to the network businesses, each proponent articulated the relevant arguments and these have been addressed in the report. Ultimately, the question whether the State should sell the network businesses depends on the governing objective, and this is pre-eminently a matter for the Government.

Two reports

1.46 Section 10(3) of the Special Commissions of Inquiry Act permits a recommendation being made relating to the publication of the whole or any part of a report. For the reasons given above, much of the evidence considered and reported on by the Inquiry is confidential, either because of its commercially sensitive nature or by reference to Cabinet conventions.

1.47 Accordingly, the Inquiry has prepared two reports. The first contains all relevant material including confidential material. That report carries a recommendation that the whole of it not be published by the Government.

1.48 The second report contains a recommendation that the whole of it be published by the Government.

1.49 The vast majority of the second report (the public report) is identical to the first report (the confidential report). Thus, all recommendations, chapters dealing with the history of electricity reform in Australia, a summary of the terms of the
agreements entered into, the governance structure of the Energy Reform Project, the decisions made throughout the process, including as to timelines, adopting the gentrader model, the structure of the transaction and protections to employees, the reasons for the resignation of the directors, the manner in which the retention value was determined, the evaluation process, whether there was compliance with laws and policies and a discussion on future options appears in each report, along with this chapter. Further, the costs and benefits of the transactions, to the extent that they disclose commercial in confidence evidence or Cabinet decisions are expurgated so as to disclose only those matters which properly should be in the public domain.

Section 10(1)

1.50 The Inquiry is required, under s. 10(1) of the Special Commissions of Inquiry Act to report whether there is or was any evidence or sufficient evidence warranting the prosecution of a specified person for a specified offence. The Inquiry reports that there is or was no evidence warranting the prosecution of a specified person for a specified offence.

Expression of appreciation

1.51 The Inquiry wishes to thank all those who provided submissions, who participated in private hearings or private meetings, who produced documents or who otherwise provided assistance.
Chapter 2 Electricity and its reform in Australia

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Summary of the electricity market and regulation

2.1 Electricity is an important form of energy. The most common types of energy are electrical energy and heat energy. These types of energy are derived from primary energy sources such as fossil fuels (chemical energy), such as used in coal-fired or gas-fired generators, hydro (water) energy, solar energy, wind energy and wave energy. These energy sources can be utilised to form energy such as electricity or heat. Chemical energy, such as possessed by fossils fuels, is a form of potential energy.

2.2 Electricity is a secondary, rather than a primary energy source. It is produced by the conversion of other energy sources such as the chemical energy in coal or natural gas. The burning of fossil fuels produces heat that powers a generator which, in turn, creates electricity.

2.3 The great majority of the electricity produced in Australia continues to be generated from coal. The 2011 Electricity Statement of Opportunities reports that the fuel source mix of existing (installed) generation is as follows:

a. black coal: 42.2%;
b. natural gas: 18.0%;
c. hydro: 15.8%;
d. brown coal: 15.2%;
e. wind: 3.7%;
f. gas other: 2.7%;
g. liquid fuel: 1.6%; and
h. biomass: 0.8%.4

2.4 In broad terms, electricity is generated at a power station by burning coal or gas in a furnace that boils water and changes it to steam. That steam is then forced, under great pressure, through a large turbine containing multiple blades. When the steam is forced through the turbine, the blades begin to spin causing the turbine shaft to rotate at high speed. The turbine is connected to a generator consisting of a huge coil of conducting wire, which is surrounded by large, powerful magnets. Electricity is generated when the wire coils are rapidly rotated in a strong magnetic field.

2.5 After passing through the turbine, the steam is condensed and returned to the boiler to be heated again.

2.6 To be useful, once generated, the electricity at a power station must be transported to businesses and residential homes for ultimate use by a consumer. Although the process effectively occurs instantaneously (when a

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3 Fossil fuels, such as coal, oil and gas, are so named because they have been formed from the organic remains of prehistoric plants and animals.

consumer switches on an appliance and power is transmitted from a power station), a series of important steps underpin the process.

2.7 First, a transformer, known as a step-up transformer, converts the electricity produced at the generation plant from low to high voltage to enable its efficient transport on the transmission system. The voltage is effectively the ‘push’ that propels the electricity on its journey along the transmission lines. The increased voltage provides a bigger ‘push’, which can be in the order of up to 500,000 volts.

2.8 Secondly, the electricity then travels along the high voltage transmission network, along heavy cables suspended between very large towers.

2.9 Thirdly, when the electricity arrives at the geographical location where it is required, such as a city or town, the voltage has to be reduced. This is done by a substation transformer, a step down transformer which converts the high voltage electricity to low voltage electricity that is suitable for distribution to consumers.

2.10 Fourthly, distribution lines then carry the lower voltage electricity to consumers who access it through power outlets in factories, offices and residential homes. Before the electricity enters a residential home, the voltage is reduced once more by a smaller pole-top, step down transformer to 240 volts.

*Measuring electricity*

2.11 The rate at which energy is produced by a system or process is called power. Electrical power is measured in watts (W). The number of watts indicates the rate at which an appliance, such as a kettle, converts electricity to another form of energy, such as heat or light. It is a measure of power. A watt represents the production of one joule of energy per second.

2.12 A thousand watts is a kilowatt (KW). One megawatt (MW) is equal to one million watts.⁵ The capacity of a power station to generate electricity is typically measured in terms of megawatts. For example, the capacity of the Eraring power station, located on the shores of Lake Macquarie in NSW, is 2,660 MW.⁶ This means that the Eraring power station has the capacity to deliver 2,660 MW of electrical energy for every hour that it operates.

*Generators, network businesses and retailers*

2.13 The electricity supply industry in Australia, including NSW, is comprised of sectors involving the generation, transmission, distribution and retail sale of electricity.

*Generators*

2.14 In NSW, there are a number of electricity generators, both State owned and privately owned.

2.15 The largest electricity generation company, in terms of capacity, is Macquarie Generation, a State owned corporation which owns and operates coal-fired power stations at Bayswater (2,640 MW) and Liddell (2,000 MW).

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⁵ One gigawatt (GW) is equal to one thousand megawatts.
2.16 Delta Electricity (Delta), a State owned corporation, owns coal-fired power stations at Mt Piper (1,400 MW), Vales Point B (1,320 MW), Wallerawang (1,000 MW) and Munmorah (600 MW), and a gas-fired power station at Colongra (724 MW). As a consequence of the Electricity Transactions, the output of the power stations at Mt Piper and Wallerawang became subject to long-term gentrader arrangements with TRUenergy Holdings Pty Limited (TRUenergy), although Delta continues to own the power stations. TRUenergy is a wholly owned subsidiary of the CLP Group, which is listed on the Hong Kong Stock Exchange. CLP operates a vertically integrated electricity generation, transmission, distribution and retail business in Hong Kong.

2.17 Eraring Energy (Eraring), a State owned corporation, owns power stations at Eraring (2640 MW) (coal) and Shoalhaven (240 MW) (hydro). As a consequence of the Electricity Transactions, the output of these power stations became subject to long-term gentrader arrangements with Origin, although Eraring continues to own the power stations. Origin is a top 20 ASX listed company involved in gas exploration and production, power generation and energy retailing.

2.18 Smaller generation facilities are owned by other market participants including Snowy Hydro\(^7\) (owned by the NSW, Victorian and Commonwealth governments in differing proportions), Origin, TRUenergy, Redbank and Infigen.

**Transmission networks**

2.19 TransGrid, a NSW State owned corporation, is the owner, operator and manager of the NSW high voltage network, sometimes referred to as the 'towers and lines' that transports electricity in NSW and the ACT from generators to distributors and, in a few cases, to major end users, such as aluminium smelters.

2.20 A transmission network consists of the large transmission towers and the wires that run between them, underground cables, transformers, reactive power devices, and switching and monitoring equipment.

2.21 TransGrid’s network also connects to networks in Queensland and Victoria, thus playing an important role in the National Electricity Market (NEM).

2.22 TransGrid’s network includes over 12,600 kilometres of high voltage overhead transmission line and over 45 kilometres of underground cable throughout NSW. It also includes 91 substations and switching stations, 63 connection points to generators, 358 distributor and direct customer points and 6 interconnectors to the Victorian and Queensland transmission networks.

2.23 Outside of NSW, the other electricity transmission network owners involved in the NEM are SP AusNet (Victoria), ElectraNet (South Australia), Powerlink Queensland (Queensland) and Transend (Tasmania). The Victorian and South Australian companies are privately-owned. The Queensland and Tasmanian entities remain State owned.

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\(^7\) Snowy Hydro power stations comprise Tumut (2116 MW), Blowering (70 MW), Guthega (60 MW) and Murray (1500 MW).
2.24 To mitigate the risk of monopoly pricing, transmission networks within the NEM are regulated. The Australian Energy Regulator (AER) is the regulator. Under the National Electricity Rules, regulated transmission businesses within the NEM must periodically apply to the AER for assessment of their revenue. The revenue proposals must be consistent with submission guidelines developed by the AER under the National Electricity Rules.

2.25 Revenue determinations made by the AER factor in the need for increases in investment by transmission service providers and the replacement of ageing assets. The determinations can also allow networks to comply with more stringent network performance, reliability and security requirements. The AER's regulatory approach is to determine a revenue cap for each transmission business, which sets out the maximum revenue that the business can earn during the relevant regulatory period (usually five years).

**Distribution networks**

2.26 The distribution networks (the 'poles and wires') move electricity from transmission networks and along distribution lines to residential homes and businesses. Pole-top transformers reduce the voltage for safer use by such end-users. The distribution networks consist of the poles, underground channels and wires that carry the electricity as well as substations, transformers and switching and monitoring equipment.

2.27 There is approximately 750,000 kilometres of distribution infrastructure in the NEM.

2.28 In NSW there are three State owned corporations that own and operate distribution networks in different geographical areas, namely Ausgrid, Essential Energy and Endeavour Energy.

2.29 The Ausgrid electricity distribution network provides power to 1.6 million homes and businesses throughout Sydney, the Hunter and the Central Coast. The distribution network is made up of over 200 large electricity substations, 500,000 power poles, 30,000 small distribution substations and nearly 50,000 kilometres of below and above ground cables.

2.30 Essential Energy's distribution network spans a diverse geographical area in country and regional NSW and includes over 200,000 kilometres of power lines, 1.4 million power poles and 135,000 distribution substations.

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8 The National Electricity Rules detail the procedures and processes for NEM operations, network connection and access, power system security, pricing for network services in the NEM and national transmission planning. The National Electricity Rules are made pursuant to the National Electricity Law, which is contained in a schedule to the National Electricity (South Australia) Act 1998 (SA) and which is applied in NSW by the National Electricity (New South Wales) Act 1997, ss. 6 and 7.

9 National Electricity Law, Chap. 6A.

10 Subject to and in accordance with the National Electricity Rules, a transmission service provider must provide access to prescribed and negotiated transmission services with the meaning of the Rules: National Electricity Rules, cl. 6A.1.3.


14 AER, State of the Energy Market, 2009, p. 155. And a further 100,000 kilometres in Western Australia and the Northern Territory.

15 In March 2011 EnergyAustralia changed its name to Ausgrid after its retail business was sold to TRUenergy, including the EnergyAustralia brand name.

16 In March 2011 Country changed its name to Essential Energy after its retail business was sold to Origin, including the Country brand name.

17 In about February 2011 Integral changed its name to Endeavour Energy after its retail business was sold to Origin, including the Integral brand name.
2.31 Endeavour Energy’s distribution network spans Sydney’s Greater West, the Illawarra, the Blue Mountains and the Southern Highlands. It comprises over 33,000 kilometres of overhead power lines and underground cables, 170 major substations, 315,000 power poles and 28,000 smaller substations.

2.32 Within the NEM but outside of NSW, the electricity distribution networks in Victoria and South Australia are privately owned or leased. The distribution networks in Queensland and Tasmania remain State owned.

2.33 In Australia (including NSW), the electricity distributors provide the infrastructure that permits electricity to be transported to end-users comprising businesses and residential homes. However, the electricity distributors do not sell electricity direct to the end-user. Rather, licensed electricity retailers sell the electricity to the end-user, with the price bundled to reflect costs for electricity generation, transmission and distribution services.

2.34 To manage the risk of monopoly pricing and to ensure the reliability, security and safety of the power system, electricity distributions networks in the NEM are regulated under the National Electricity Law and the National Electricity Rules. Since January 2008, the AER has been the body responsible for the economic regulation of electricity distribution networks.

2.35 The AER has described its regulatory approach to distribution networks as involving the setting of a ceiling on the revenue or the prices that a distribution business can earn or charge during the relevant regulatory period, typically five years. In its April 2009 determination, the AER applied a price cap to NSW distribution networks, which placed a ceiling on the prices of distribution services during the respective regulatory periods.18

2.36 The regulatory system in place for transmission and distribution network businesses has now been operating for a significant period of time and industry participants are relatively familiar with the system. That said, the regulatory system is continually evolving. As stated in the Garnaut Climate Change Review Update Paper eight:

The regulatory framework governing transmitters and distributors in Australia is the product of a long reform process. It is also a work in progress. The goal of network regulation is to restrict the ability of network providers to extract monopoly rents, while maintaining appropriate incentives for meeting demand for services, efficiency, reliability and innovation. The ideal is for the regulated network provider to behave as if it were a player in a competitive industry. This is easier said than done.19

**Retailers**

2.37 Electricity retailers purchase electricity in wholesale markets and package it with retail services for sale to customers. A number of electricity retailers are also retailers of gas.

2.38 There is a degree of vertical integration within Australian electricity markets, including NSW, with ownership links between retailing and generation interests,

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and regulators applying 'ring-fencing' arrangements to ensure operational separation of the businesses.\textsuperscript{20}

2.39 As at June 2010 there were 27 licensed electricity retailers in NSW.\textsuperscript{21} Eleven of these retailers supplied electricity to residential and/or small business customers.\textsuperscript{22}

2.40 Within the NEM, there is an increasingly significant private sector presence in the retailing of electricity. All NEM jurisdictions except for Tasmania have introduced full retail contestability (FRC) for electricity. This permits a customer to enter into a contract with their retailer of choice. NSW has had FRC since January 2002.

2.41 State and Territory governments are largely responsible for regulating retail electricity markets. As at July 2010 retail price cap regulation for electricity services applied in all jurisdictions except Victoria.

2.42 In NSW, the Independent Pricing and Regulatory Tribunal (IPART) oversees regulation in the retail electricity (and gas) sector. The role of IPART is considered further below.

2.43 Australian governments have agreed to phase out the continued use of retail price caps for electricity where effective competition can be demonstrated.\textsuperscript{23} The Australian Energy Market Commission (AEMC) has the task of assessing the effectiveness of retail competition in each jurisdiction and advising on ways to remove retail price caps. However, the final decision is left to the relevant State or Territory government.\textsuperscript{24}

2.44 Australian governments have also agreed to transfer regulatory functions for electricity retail markets to a national framework to be administered by the AEMC and the AER.\textsuperscript{25} However, States and Territories will retain responsibility for control of regulated retail prices. This aspect is considered further below.

\textit{Contribution of generation, transmission and distribution costs to retail prices}

2.45 The electricity bills paid by retail customers reflect the costs of the generation, transmission, distribution and retailing of the electricity.

2.46 Generally, wholesale energy costs account for about 37% - 45% of retail bills, with network tariffs accounting for about 43% - 51%. Retailer operating costs account for about 4% - 8%, while retail margins account for about 3% - 5%.\textsuperscript{26}

2.47 In NSW the typical small customer electricity bill is comprised of wholesale energy costs (37%), network costs (51%), retail operating costs (6%) and retail margin (5%).\textsuperscript{27}

\textsuperscript{21} The Electricity Supply Act 1995 and the Electricity Supply (General) Regulation 2001 contain provisions detailing obligations on licensees.
\textsuperscript{22} AER, State of the Energy Market, 2010, p. 94.
\textsuperscript{24} AER, State of the Energy Market, 2010, pp. 96-97. The AEMC has yet to submit a report in respect of NSW.
\textsuperscript{26} AER, State of the Energy Market, 2010, p. 98.
The National Electricity Market (NEM)

2.48 A defining feature of the electricity industry in Australia has been the introduction and development of the NEM.

2.49 The NEM is a wholesale market through which generators sell electricity. The main customers are energy retailers, who bundle electricity with network services for sale to residential and commercial end-users. The NEM includes NSW, Victoria, Queensland, South Australia, Tasmania and the ACT. The NEM operations are based in five regions that largely follow State boundaries. The five regions are physically linked by an interconnected transmission network.

2.50 The NEM is the world’s longest interconnected power system, extending over a distance of around 5,000 kilometres from far north Queensland to western South Australia. More than $10 billion of electricity is traded annually in the NEM to meet the demand of more than 8 million end-use consumers.

2.51 The NEM includes around 200 large generators, five State based transmission networks (linked by cross-border interconnectors) and 13 major distribution networks that supply electricity to end-users. The infrastructure assets within the NEM are variously owned and operated by State government and private sector companies.

2.52 The NEM began operating in December 1998 and then covered NSW, Victoria, Queensland, South Australia and the ACT. Tasmania joined the NEM in 2005.

2.53 By facilitating electricity trade among the five regions, the NEM promotes efficient generator use. It permits NSW to obtain electricity from other States at times of high demand. Since commencement of the NEM, NSW, South Australia and Tasmania has each been a net importer of electricity, whereas Victoria and Queensland has each been a net exporter. NSW relies on local baseload generation but has limited peaking capacity at time of high demand. Baseload generation provides a relatively constant, steady and reliable stream of energy and generally comes from coal-fired plants. It produces electricity at the lowest variable cost.

2.54 The price signals in the wholesale and forward markets for electricity are also important drivers for new generation investment in the NEM. Tightening supply conditions, as evidenced by higher spot and futures prices, may entice increased investment in generation capacity, which assists in ensuring the security of long-term power supply.

2.55 By contrast, low spot prices and futures prices may attract new retailer competitors and energy-intensive industries to the regional market to take advantage of the lower power supply costs.

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2.56 The development and introduction of the NEM was an important component of a broader process of significant structural reform of the electricity industry in Australia that began in about the early 1990s.

2.57 In May 1991, the Industry Commission released an influential report recommending significant structural reform of the electricity industry.\textsuperscript{30} The Industry Commission pointed to significant inefficiencies arising from the lack of competition in the industry. The Industry Commission recommended urgent reform including separating the ownership of generation, transmission and distribution functions and corporatising, and then privatising, State owned entities involved in generation and distribution.

2.58 Throughout the 1990s, and within each of the different States, disaggregation of the various State owned vertically integrated monopolistic utilities was undertaken. This was followed by corporatisation (and, in some States, privatisation) of the separated businesses. This aspect is detailed further below.

2.59 The Special Premier’s Conference of July 1991 agreed to establish a National Grid Management Council to develop plans for a national electricity grid.\textsuperscript{31} The National Grid Management Council (NGMC) was subsequently established.

2.60 Council of Australian Governments’ (COAG) electricity reform agenda was complemented by, and aligned with, the broader national competition policy agenda that arose from the Hilmer Report on National Competition Policy. The Hilmer Inquiry, chaired by Professor Fred Hilmer, was established by the Prime Minister in October 1992 to undertake an independent inquiry into a national competition policy following agreement by Australian governments on the need for such a policy.

2.61 The Hilmer Report recommended the implementation of a national competition policy for Australia.\textsuperscript{32} Among other things, the Hilmer Report advocated:

a. competitive neutrality principles be applied so that State owned businesses would not enjoy unfair advantages when competing with private businesses;

b. ensuring access by market participants to significant infrastructure (‘essential facilities’, such as an electricity transmission grid) on fair and reasonable terms;

c. removing the immunity of government-owned businesses from the \textit{Trade Practices Act 1974 (Cth)}; and

d. restructuring public sector monopolies so as to separate regulatory and commercial functions, and to separate natural monopolies and potentially


\textsuperscript{32} The Independent Committee of Inquiry into Competition Policy in Australia (Professor Frederick Hilmer, Chair), \textit{National Competition Policy}; August 1993, Australian Government Publishing Service, Canberra (the Hilmer Report).
competitive activities, with potentially competitive activities being separated into a number of smaller, independent business units.

2.62 In April 1995, COAG agreed on a National Competition Policy (NCP) for Australia, which adopted in broad terms much of the recommendations of the Hilmer Report. Three inter-governmental agreements underpinned the NCP, namely the Competition Principles Agreement; the Conduct Code Agreement; and the Agreement to Implement the National Competition Policy and related reforms (which included reform commitments in respect of the electricity industry). National Competition Payments from the Commonwealth Government would be linked to, among other things, progress in reforming the electricity sector.

2.63 On 9 May 1996, NSW, Victoria, South Australia, Queensland and the ACT entered into the National Electricity Market Legislation Agreement, pursuant to which each jurisdiction agreed to enact a National Electricity Law with South Australia as the lead jurisdiction. All jurisdictions co-operated in the drafting of the relevant bill. The National Electricity (South Australia) Act 1996 (SA) was passed by the South Australian Parliament in June 1996. The National Electricity Law was set out as a schedule to that Act.

2.64 Section 7 of the National Electricity Law provides:

The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to —

(a) price, quality, safety, reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system.

2.65 In May 1997 the NSW Parliament passed the National Electricity (New South Wales) Act 1997, which applied the National Electricity Law as a law of NSW. Comparable legislation was also introduced in the other participating jurisdictions.

2.66 In NSW an interim wholesale electricity market commenced operation in May 1996. On 4 May 1997, and pending the introduction of the NEM, harmonised wholesale trading in electricity commenced between NSW, Victoria and the ACT. The NEM commenced operations in December 1998.

**How the NEM works: the basics**

2.67 The electricity produced by the generators in the NEM is sold through a central dispatch process that is managed by the Australian Energy Market Operator (AEMO) in accordance with the National Electricity Law and the National Electricity Rules and in conjunction with regulatory agencies.

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35 National Electricity (New South Wales) Act 1997, s. 6.
36 National Electricity (Victoria) Act 1997 (Vic); Electricity - National Scheme (Queensland) Act 1997 (Qld); Electricity (National Scheme) Act 1997 (ACT).
2.68 The National Electricity Law prescribes AEMO’s functions. The National Electricity Rules, made under the National Electricity Law, detail the procedures and processes for NEM operations, network connection and access, power system security, pricing for network services in the NEM and national transmission planning.

2.69 The NEM operates as a wholesale spot market. The market features a (virtual) electricity pool that has no physical location and which is, in effect, a set of procedures that AEMO manages. AEMO aggregates and dispatches supply bids to meet demand in real time. The NEM dispatch processes are underpinned by highly sophisticated information technology systems.

2.70 In the NEM, each trading day starts at 4.00 am. Each trading interval is a half hour period starting on the hour or half hour. Each dispatch interval is a five minute interval.

2.71 Generators in the NEM offer to supply the market, by notification to AEMO, with specific quantities of electricity at particular prices for each half hour of the day. These bids are required to be provided to AEMO by 12.30 pm on the preceding day. Each generator must submit offers in ten choices of (increasing) prices (price bands). Generators may submit re-bids until about five minutes prior to dispatch, by which they can change the volume, but not the price, in the offer.

2.72 Based on the offers submitted by the various generators, AEMO determines the generators required to supply electricity based on the cheapest generator bids first and then progressively for the more expensive bids until enough electricity is dispatched to meet demand. Using sophisticated dispatch software, AEMO dispatches generation to meet demand in a process occurring at five minute intervals. The dispatch price for each five minute interval is the offer price of the highest (marginal) priced MW of generation that is needed to be dispatched to meet demand.

2.73 A wholesale spot price is determined for each half hour period (trading interval) based on the average of the five minute dispatch prices. This wholesale spot price is the price that all generators receive for their electricity supplied during that half hour period. It is also the price that purchasers pay to AEMO for the electricity used in that period. The wholesale spot price can change every half hour.

2.74 Daily demand peaks, reflective of increased domestic and commercial activity, typically occur between about 7.00 am and 9.00 am and 4.00 pm and 6.00 pm. Demand can also significantly increase during periods of very high temperatures.

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37 A spot market is, effectively, a commodities market in which the relevant product is sold for cash at current prices and delivered immediately.

38 AEMO, An Introduction to Australia’s National Electricity Market, July 2010, p. 10. In addition, the National Electricity Rules provide for default bids, which are standing bids that apply where no daily bid has been made.
2.75 The relevant process of the scheduling of NEM generators and calculation of the half-hourly spot price is explained in the following diagram and commentary produced by AEMO:

Source: AEMO, An Introduction to Australia’s National Electricity Market July 2010 p 11.

2.76 The market determines a separate spot price for each region. While there can be significant price alignment between the regions, variations may occur when a cross-border interconnector becomes congested (for example at times of peak demand or during maintenance of the interconnector) and inter-regional trade is restricted.

2.77 The National Electricity Rules set a maximum spot price. This is known as the Market Price Cap or the Value of Lost Load (VoLL). The cap is currently $12,500 per MWh. Generators are not permitted to bid into the market above this price.

2.78 The National Electricity Rules also set a floor spot price, known as the Market Floor Price. The floor price is currently set at -$1,000 per MWh.

2.79 In addition, the National Electricity Rules include provision for administered price capping which effectively provides a safety net to protect electricity trading during periods of sustained extreme high prices that might cause financial stress. If triggered, the administered pricing provisions, implemented by AEMO, provide for capping of prices until they return to lower levels.

**Reliability and security of supply**

2.80 AEMO is required to operate the power system to ensure that standards of reliability and security are maintained. The AEMC Reliability Panel sets the power system security and reliability standards for the NEM. Reliability is concerned with the continuity of electricity supply to market customers.

2.81 The NEM reliability standard is formulated in terms of the amount of energy at risk of not being delivered to customers owing to a lack of available generating capacity, such as might arise from generation failure or unexpected demand spikes (the unserved energy). Under the NEM reliability standard, the maximum permissible unserved energy, or the maximum allowable level of electricity at risk of not being supplied to customers, is set at 0.002% of the

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39 National Electricity Rules, cl. 3.9.4. It is also known as the Value of Lost Load (VoLL).
40 On 1 July 2010 the cap increased to $12,500 per MWh from $10,000 per MWh. From 1 July 2012 the cap will be determined by reference to a formula that permits adjustment for increases in the Consumer Price Index (CPI): National Electricity Rules, cl. 3.9.4.
41 National Electricity Rules, cl. 3.9.6.
annual energy consumption for the region for that financial year.\textsuperscript{43} AEMO operations are directed at ensuring that the standard is met. Insufficient generation capacity to meet consumer demand has occurred only on relatively rare occasions, one instance arising in the context of a heatwave in Victoria and South Australia in January 2009.

2.82 In most instances, market forces ensure that supply and demand are kept in balance in the NEM. Under the National Electricity Rules, however, AEMO is empowered to use a variety of measures to restore supply and demand balance in extraordinary circumstances where a supply shortfall may threaten system security or reliability of supply. These tools include the power to direct generators into production where a supply shortfall is predicted and generators have withheld part of their capacity from the market.

2.83 AEMO also has power, in specified circumstances directed at reducing demand, to instruct market participants (distribution and transmission companies) to shed some customer load (load shedding). This involves, in effect, a deliberate switching off of electrical supply to parts of the electricity network (and thus some customers) based on the need to reduce demands very quickly to an acceptable level, and thus avoid the risk of a more complete shutdown of the electricity network.

2.84 In certain circumstances, AEMO can also resort to ‘reserve trading’ which involves AEMO tendering for contracts for electricity beyond those factored into AEMO usual forecasting processes.

\textit{Electricity derivatives}

2.85 To manage the risks and uncertainties inherent in fluctuations in the spot price, which can vary between -$1,000 per MWh to $12,500 per MWh, generators and purchasers (typically electricity retailers) commonly enter into financial contracts (derivatives)\textsuperscript{44} that lock in agreed arrangements relating to pricing for electricity they intend to produce or purchase in the future.

2.86 The derivatives include swaps or hedge contracts, options and futures contracts. These arrangements do not give rise to the physical delivery of electricity.

2.87 Electricity financial markets are subject to regulatory oversight, with the principal agency being the Australian Securities and Investments Commission (ASIC).\textsuperscript{45}

\textbf{The Australian Energy Market Operator (AEMO)}

2.88 AEMO manages the NEM and the retail and wholesale gas markets of eastern and southern Australia.

2.89 Aspects of the role undertaken by AEMO have been discussed above. In respect of the NEM, AEMO’s primary responsibility is to balance the supply and demand of electricity by arranging for the dispatching of the generation necessary to meet demand.

\textsuperscript{43} AEMC Reliability Panel, NEM Reliability Standard - Generation and Bulk Supply, December 2009.

\textsuperscript{44} The financial contracts are called ‘derivatives’ because they derive their value from an underlying asset – relevantly, electricity traded in the NEM.

\textsuperscript{45} The regulatory framework includes the Financial Services Reform Act 2001 (Cth) and Corporations Act 2001 (Cth).
2.90 AEMO's responsibilities include management of the NEM, overseeing reliability and security of the NEM, ensuring adequate supply reserve to meet reliability standards, directing generators to increase production during periods of supply shortfall, instruction of load shedding to rebalance supply and demand and protect power system operations, electricity emergency management, and national transmission planning of the electricity transmission grid.

Industry regulators

2.91 There are a number of regulators who play varying roles in the electricity industry. Some of these aspects have already been discussed above.

The Australian Energy Regulator (AER)

2.92 The AER is an independent statutory authority that is administratively part of the Australian Competition and Consumer Commission (ACCC). The AER regulates the wholesale electricity market.

2.93 The AER is responsible for the economic regulation of the electricity transmission and distribution networks in the NEM under the National Electricity Law and National Electricity Rules, and for compliance monitoring and enforcement of the National Electricity Law and National Electricity Rules. As part of its responsibilities, the AER undertakes monitoring of the electricity wholesale market.

2.94 The AER is also responsible for the economic regulation of gas transmission and distribution networks and enforcing the National Gas Law and National Gas Rules in all jurisdictions except Western Australia.

2.95 The AER monitors activity in the electricity spot market (in the NEM) and screens for non-compliance with the National Electricity Rules. It reports weekly on wholesale and forward market activity. It also reports on extreme price events in the NEM and conducts intensive investigations if warranted.

The Australian Energy Market Commission (AEMC)

2.96 The AEMC is an independent, national body that is responsible for rule making and market development in respect of the NEM under the National Electricity Law.

The Australian Competition and Consumer Commission (ACCC)

2.97 The ACCC has responsibility for various functions that can impact on aspects of the electricity industry including:

a. enforcement of completion laws and authorisation of anticompetitive conduct;

b. enforcement of consumer protection and fair trading laws;

c. access regulation under Part IIIA of the Competition and Consumer Act 2010 (Cth); and

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46 Competition and Consumer Act 2010 (Cth), s. 44AE.
47 See National Electricity Law, s. 15.
48 See Memorandum of Understanding (MoU) dated 2 July 2009 between the AEMC, the AER and the ACCC, pp. 3-4.
49 See National Electricity Law, s. 29. The AEMC is also responsible for access to natural gas pipelines and broad elements of natural gas markets under the National Gas Law.
d. price monitoring under Part VIIA of the same Act.

The Independent Pricing and Regulatory Tribunal (IPART)

2.98 The IPART is the independent economic regulator for NSW. IPART oversees regulation in the electricity, gas, water and transport industries in NSW and undertakes other tasks referred to it by the NSW Government. Under the Electricity Supply Act 1995, IPART makes recommendations, monitors compliance and reports in relation to electricity licences.

2.99 In this respect, the Electricity Supply Act 1995 establishes a regime for the licensing of the distribution and supply of electricity by retailers in NSW.

2.100 Pursuant to the Electricity Supply Act 1995, IPART is responsible for setting regulated retail tariffs for electricity and regulated retail charges, which apply in respect of households and small businesses.

2.101 Customers who are not on the standard supply contract but have entered into a negotiated (market) contract with an electricity retailer pay unregulated, market-based prices. However, these market-based prices are influenced by changes in the regulated price.

IPART and the Greenhouse Gas Reduction Scheme

2.102 In addition to the above functions, IPART administers the Greenhouse Gas Reduction Scheme (also known as GGAS) and the associated register of abatement certificates.

2.103 The Greenhouse Gas Reduction Scheme requires NSW electricity retailers and certain other parties (collectively referred to as "benchmark participants")\(^{50}\) to meet mandatory targets for reducing or offsetting the emission of greenhouse gases from the production of electricity they supply or use. The Act sets a State greenhouse gas benchmark expressed in tonnes of carbon dioxide equivalent per capita.\(^{51}\)

IPART and the Energy Savings Scheme

2.104 IPART also administers the Energy Savings Scheme (ESS). The ESS is a mandatory energy efficiency scheme which commenced in NSW on 1 July 2009.

2.105 The ESS is designed to encourage energy efficiency by rewarding companies that undertaken eligible projects that reduce electricity consumption or improve the efficiency of energy use. Mandatory participants in the ESS include electricity retailers and certain other parties (such as generators who supply direct to a customer). They are required to meet individual energy savings targets based on the size of their share of the electricity market.

The forthcoming national energy retail law

2.106 As indicated above, as the next major step in the national energy reform process, Australian governments have agreed to transfer regulatory functions

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\(^{50}\) Benchmark participants include electricity generators to the extent prescribed in the Electricity Supply (General) Regulation 2001, cl. 73B.

\(^{51}\) Electricity Supply Act 1995, s. 97B. Under the Act, the benchmark figure progressively dropped from 2003 to 2007 and then remains at 7.27 tonnes from 2007 to 2021.
for electricity retail markets to a national framework to be administered by the AEMC and the AER.\textsuperscript{52}

2.107 The National Energy Customer Framework (NECF) was agreed by COAG as part of the Australian Energy Market Agreement (AEMA).\textsuperscript{53} The NECF involves the harmonisation of State based regulatory frameworks for the retail energy market and energy distribution sector. There will be a single set of applicable national rules. However, exempted from the NECF process is retail price regulation and community service obligations.

2.108 Retailers operating in the national electricity and gas markets will need only one licence, issued by the AER, and will be subject to one consistent set of rules across the participating jurisdictions.

2.109 On 10 December 2010 the Ministerial Council on Energy (MCE) agreed to work towards a target commencement date of 1 July 2012.

2.110 The NECF includes a package of laws comprising the National Energy Retail Law, the National Energy Retail Rules and the National Energy Retail Regulations. These law, rules and regulation have been developed in a process involving extensive consultation by the MCE.

2.111 In March 2011 the South Australian Parliament, as lead jurisdiction for the reform process, passed the National Energy Retail Law (South Australia) Act 2011. The National Energy Retail Law is included in the schedule to the Act. Other participating jurisdictions, including NSW, will be expected to pass complementary legislation consistent with the target commencement date.

2.112 In respect of retail price regulation in NSW, the NSW Government has previously committed to the continuation of electricity and gas retail price regulation for small customers until at least 30 June 2013 or beyond, until the NSW Government is satisfied that there is sufficient competition in the NSW retail energy market.

Proposed price on carbon emissions

2.113 On 10 July 2011 the Commonwealth Government published its policy document on climate change and clean energy entitled *Securing a clean energy future: the Australian Government’s climate change plan*.\textsuperscript{54} A key aspect of the policy is to introduce a carbon price into the Australian economy to create a financial incentive to reduce carbon pollution.

2.114 The policy is designed to change Australia’s electricity generation sector by encouraging investment in renewable energy, such as wind and solar power, and the use of cleaner fuels like natural gas.

2.115 On 13 September 2011 the Commonwealth Government introduced into the House of Representatives a package of legislation designed to implement the

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\textsuperscript{52} Australian Energy Market Agreement 2004 (as amended), cl. 14.11. In respect of the regulatory role of the AER, see AER, *Statement of approach: compliance with the National Energy Retail Law, Retail Rules and Retail Regulations*, July 2011, ACCC, Canberra.


\textsuperscript{54} Australian Government, *Securing a clean energy future: the Australian Government’s clean energy plan*, 2011, CanPrint Communications Pty Ltd, Canberra.
policy set out in Securing a clean energy future: the Australian Government’s climate change plan. The package comprises 18 bills, including three key bills namely:

a. the Clean Energy Bill 2011 (Cth) which establishes the carbon price mechanism;

b. the Clean Energy Regulator Bill 2011 (Cth) which establishes a regulatory body to administer the mechanism; and

c. the Climate Change Authority Bill 2011 (Cth) which establishes a new Authority to advise the Commonwealth Government on the future design of the carbon price mechanism.

2.116 The Explanatory Memorandum to the Clean Energy Bill 2011 (Cth) records that Australia’s carbon pollution represents 1.5% of global emissions of greenhouse gases making Australia one of the top 20 polluting countries in the world. Further, Australia is identified as producing more carbon per head of population than any developed country, including the USA. 55

2.117 The Explanatory Memorandum further states that electricity generation is Australia’s largest source of carbon pollution (responsible for just over a third of Australia’s total carbon pollution), reflecting the availability of relatively cheap and abundant coal. 56

2.118 The package of Bills would implement the Commonwealth Government’s policy to place a price on carbon and to move to an emissions trading scheme by 2015. The Bills provide for a fixed carbon price for 3 years starting at $23 per tonne of carbon pollution from 1 July 2012 and rising by 2.5% per annum in real terms. The proposed legislation would also provide that the carbon price would be paid by liable entities which have facilities that emit 25,000 tonnes or more of carbon pollution per year. Once the carbon price would transition to a fully flexible price under an emissions trading scheme, with the price determined by the market.

The proposed legislation would establish the Clean Energy Regulator which would work with liable entities to ensure compliance with the carbon price mechanism, including by educating and advising entities regarding compliance.

2.120 The package would also establish the Climate Change Authority as an independent statutory body to, among other things, review the carbon pricing mechanism and to provide expert advice to the Government on progress towards meeting targets.

2.121 The package also includes provision for assistance to support employment in emissions-intensive trade exposed industries. The carbon price would also be accompanied by a household assistance package to offset the impact on the cost of living for those identified as being in need of help.

2.122 In addition to the introduction of a carbon price, the package would include further measures to support innovation and investment in clean energy

56 Clean Energy Bill 2011 (Cth), Explanatory Note, p. 10.
technologies. Thus, a commercially-oriented Clean Energy Finance Corporation would be established to drive innovation through commercial investments in clean energy technologies by loans, loan guarantees and equity investments. Further, a new statutory body, the Australian Renewable Energy Agency would be established to administer some $3.2 billion in Government support for research, development and demonstration of new renewable energy technologies.

2.123 The package would also provide for the establishment of an Energy Security Fund aimed at ensuring a smooth transition of the energy market and to maintain secure energy supplies. The Energy Security Fund would comprise two elements. First, an allocation of free carbon units and cash payments to strongly affected coal-fired electricity generators conditional upon such generators publishing Clean Energy Investment Plans showing how they would reduce their pollution and by meeting power system reliability standards. Secondly, the Commonwealth Government will seek to negotiate the close of around 2,000 MW of highly polluting coal-fired generation capacity by 2020.

Reform of electricity industries in other States

Victoria

2.124 The Kennett Liberal-National Government, elected in October 1992 with an economic reform agenda, led Australia in the privatisation of the electricity industry. The Kennett Government privatised the generation, distribution and retail arms of the industry in Victoria in the 1990s.

2.125 Prior to the 1990s the State Electricity Commission of Victoria (SECV), a State owned monopoly, controlled the generation, transmission and supply of electricity in Victoria. In 1993, as a precursor to corporatisation and eventual privatisation, the SECV was restructured into three internal businesses, relating to generation, transmission and distribution/retail respectively.

2.126 In October 1994, following detailed consideration of the preferred operating framework, the SECV businesses were disaggregated into a number of entities, which were each corporatised. The entities comprised five generation companies; a transmission company, Power Net Victoria (PNV) which owned and maintained the high voltage grid and connected generators, distributors and large customers to the grid; five regionally based distribution and retail businesses; and Victoria Power Exchange which was in charge of operating the wholesale electricity market and maintaining system security.

2.127 The Office of the Regulator General was also established as an independent statutory authority to oversee the electricity sector.

2.128 From 1995 onwards, the Kennett Government sold the corporatised businesses to the private sector. The distribution/retail businesses were privatised first, in late 1995. The five businesses were sold to separate purchasers, largely foreign-based.

58 Its functions were subsequently taken over by the Essential Services Commission of Victoria.
59 United Energy was sold for $1.553 million in August 1995 to a consortium comprising Utilicorp, AMP Society and Axiom. Solaris Power was sold for $950 million in October 1995 to AGL and Energy Initiatives. Eastern Energy was
2.129 The five electricity generation companies were sold from 1996 to 1999, with the three brown coal-fired generators sold in 1996 and 1997. The transmission network (PNV) was also sold in late 1997.

2.130 Victoria also introduced a graduated process of competition and choice of supplier for business and residential customers, not limited to designated geographical regions. Since January 2002 all residential and small business customers have been able to choose their electricity supplier.

2.131 Currently, the AER is responsible for regulating the distribution and transmission of electricity and the wholesale electricity market. The Essential Services Commission of Victoria (ESC) is responsible for regulating retail businesses in Victoria.

Assessments of Victorian privatisation program

2.132 At least in terms of its direct financial return to the State government, the Victorian electricity reform program may be regarded as the most successful in Australia.

2.133 The privatisation of the 12 electricity businesses in Victoria between 1995 and 1997 achieved a reported total purchase price of $19.7 billion. In addition, four State owned gas businesses were sold in 1999 for $6.3 billion. The Victorian privatisation program thus raised a total of $26 billion, which was used to pay off State debt. The ratio of debt to GDP fell from 26.7% in June 1995 to 3.1% by June 2000.

2.134 In 2001 Access Economics reported that privatisation of the electricity sector in Victoria had brought substantial benefits to the energy sector, Victorian consumers, the State budget and the wider Victorian economy.

2.135 In respect of the impact of the privatisation program on the State budget, Access Economics concluded that, in terms of savings in interest payments, on a conservative analysis the State budget was some $230 million better off in 1999-2000 than if privatisation had not taken place. The reduction in State debt also provided the Government with significantly increased fiscal flexibility. Access Economics also reported that privatisation had brought with it lower

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Yallourn Energy was sold for $2,426 million in May 1996 to a consortium comprising PowerGen, Itochu, AMP society, Axiom and Hastings Fund Management. Hazelwood was sold for $2,257 million in August 1996 to a consortium comprising National Power, Destec, PacificCorp, Commonwealth Funds Management and CBA. Loy Yang B was sold for $84 million on 1 April 1997 to Edison Mission Energy. Loy Yang A was sold for $4,746 million on 22 April 1997 to a consortium comprising CMS Energy, NRG Energy Inc, Infrastructure Trust of Australia, Macquarie Bank, ANZ Securities, and UniSuper. The gas-fired generator (Ecogen) was sold for $361 million in March 1999 to AES Corporation. The hydro generator (Southern Hydro) was sold for $391 million in November 1997 to Infratil: Access Economics Report, p. 21. Note that Loy Yang B had previously been the subject of a partial privatisation: Consumer Law Centre Victoria, Electricity Reform in Victoria: Outcomes for consumers, February 2006, p. 5. For more recent developments, see Yeats, C. "Loy Yang B debt heads for the scrap heap", Sydney Morning Herald, 28 July 2010.

PowerNet Victoria was sold for $1,025 million in October 1997 to GPU: Access Economics Report, p. 21.
prices for energy consumers, improvements in the reliability of supply and fewer disconnections of residential and small business electricity customers.

2.136 In August 2001 the Institute of Public Affairs (IPA) reported that the privatisation of the Victorian electricity sector had reduced public debt, freed up public capital, reduced final prices, led to increased productivity of capital and labour, and improved system reliability.

2.137 The IPA said that one of the major benefits to Victoria arose from being the first mover in privatisation. When the assets were sold, there was significant uncertainty regarding valuation and risk profile in light of the fact that the NEM had yet to commence. As events transpired, the purchasers overvalued the assets to the ultimate benefit of the Victorian tax payer. In respect of the sale of the electricity distribution businesses, the IPA quoted the Victorian Auditor-General as stating that "... the proceeds of the $6.2 billion received by the State from the sale of the (electricity distribution) businesses net assets compared favourably with the valuations of $3.9 billion."

2.138 The IPA warned, however, that,

It is unlikely that this situation will be repeated if NSW or Queensland sell their generation assets. The recent sales in SA are evidence that buyers are more cautious and have a better understanding of the electricity market.

2.139 In February 2006 the Consumer Law Centre Victoria (CLCV) published a report focused on consumer outcomes from the Victorian electricity reform. In respect of electricity prices, the report found that the price benefits associated with the reforms including the introduction of full retail competition had not been equitably distributed across all consumer groups, with domestic consumers experiencing only a slight decrease in electricity prices compared to industrial consumers.

2.140 In terms of quality outcomes, the CLCV reported that, based on most quality of electricity supply measures, reform had resulted in improvements for consumers, although the benefits were not uniform across all consumer groups (with consumers in rural and regional areas not having received the same degree of quality improvements as metropolitan consumers). In terms of public accountability following reform, the CLCV reported that, overall, Victorian consumers had benefited from enhanced public accountability mechanisms associated with the reform process, including the establishment of an independent economic regulator (the ESC) and other measures.

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66 With the average retail price for residential customers falling by 8.9% in real terms from 1995 to 2000, and the average retail price for business customers (other than bulk customers) falling by 11.4% in real terms: Access Economics Report pp. 25-27.
67 Access Economics Report, p. 3.
70 IPA Report, p. 5.
71 Consumer Law Centre Victoria, Electricity Reform in Victoria: Outcomes for consumers, February 2006 (the CLCV Report).
72 CLCV Report, p. i.
73 CLCV Report, p. ii.
74 CLCV Report, p. ii.
South Australia

2.141 In the late 1990s South Australia privatised its electricity industry. In contrast to Victoria, South Australia disposed of its generation, transmission and distribution assets by way of long-term leases (but sold its retail business).

2.142 In January 1997, the State owned vertically integrated monopolistic electricity provider, the Electricity Trust of South Australia (ETSA), was split into two separate entities. The two entities were SA Generation Corporation (trading as Optima Energy), which controlled the State owned generators, and ESTA Corporation, which controlled the State’s distribution and transmission assets.

2.143 In February 1998 the Government announced a significant reform and sale agenda that included electricity assets. The objectives of the reform process was to reduce State debt, minimise risks to the Government, deliver benefits to electricity customers through microeconomic reform and to enhance overall State economic activity.

2.144 As a prelude to privatisation, in October 1998 the State owned electricity assets were further restructured to create three generating companies, a single transmission company, a distribution company, a retail company, and a gas trading company. The Government contemplated a staged program of competitive bidding for the businesses.

2.145 The *Electricity Corporations (Restructuring and Disposal) Act 1999* (SA), passed by the South Australian Parliament in June 1999, provided the legal framework by which the Government’s asset disposal program could proceed.

2.146 In the 1999-2000 financial year, the Government disposed of the distribution and retail businesses: the distribution business (ETSA Utilities) by way of long-term lease, and the retail business (ETSA Power) by way of sale. The purchaser was a consortium comprising CKI Holdings and Hongkong Electric, with the retail business being immediately on-sold to AGL (SA).

2.147 In the same financial year, two of the three generation businesses (Optima Energy and Synergén) were disposed of by long-term leases, to TXU Australia and National Power, respectively. The leases of the generation assets were reported to be 100 year leases.

2.148 In the 2000-2001 financial year, the electricity privatisation program was completed, with the transfer to the private sector of the last of the generation businesses (Flinders Power, by way of long-term lease), the transmission business (ElectraNet SA, by long-term lease) and the sale of the gas trading business (Terra Gas Trader).

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75 Department of Treasury and Finance (SA), *Annual Report 1998-1999*, pp. 7 and 15. The three State owned generation companies were named Optima Energy, Flinders Power and Synergén. The transmission company was named ElectraNet SA. The distributions and retail businesses were named ETSA Utilities and ETSA Power, respectively. The gas trading company was named Terra Gas.


The total proceeds from the South Australian privatisation program was reported to be $5.3 billion (gross). Net proceeds were used to reduce State debt.  

From 1 January 2003 there has been full retail competition in the South Australian electricity industry, with electricity customers being able to choose their retailer. The Essential Services Commission of South Australia (ESCOSA) exercises regulatory powers including in respect of retail pricing.

Queensland

Like the process engaged in by other States, in the 1980s and 1990s the electricity industry in Queensland was gradually restructured, with a move away from the State owned vertically integrated monopoly towards disaggregation and the creation and corporatisation of separate trading companies.

Currently, there are three large State owned generation companies that compete and operate independently (namely, Tarong Energy, Stanwell and CS Energy) and several privately owned generators.

A State owned corporation, Powerlink Queensland, owns and maintains the high voltage transmission grid. Two State owned distribution companies, Energex and Ergon Energy, have an effective monopoly over the distribution network within their respective regions.

In early 2007 the Queensland Government finalised the sale of the electricity retailing and gas retailing businesses of Energex, the competitive retail business of Ergon Energy and Energex’s Allgas Energy natural gas distribution network. Origin purchased the electricity retailing business. AGL purchased the gas retailing business.

The Government stated that the retail businesses were sold to assist with the introduction of full retail competition for domestic and small business customers in Queensland from 1 July 2007. The Government announced that the sale of its energy retail and gas distribution businesses raised just over $3 billion.

The Government’s electricity distribution, transmission and generation assets were not sold as part of the 2007 privatisation reform.

Western Australia

In 1995 the State Energy Commission of Western Australia (SECSWA) was split into two entities: Western Power Corporation, which was given responsibility for electricity related functions, and AlintaGas, which was given responsibility for gas related functions.

Western Power became the State’s major generator, transmitter and retailer of electricity. From 1997 to 2006 the electricity market in Western Australia was gradually opened up to competition with new generators and retailers.

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79 See Electricity Act 1996 (SA) and Essential Services Commission Act 2002 (SA).
2.159 As part of the electricity reform process, in 2006 Western Power Corporation was disaggregated. Four separate State owned corporations were established, namely: Verve Energy (generator), Western Power (network service provider), Horizon Power (vertically integrated utility for supply outside the South West Interconnected System), and Synergy (retailer).

2.160 A wholesale electricity market became operational in 2006. Western Australia is not part of the NEM.

2.161 As part of the reform process, a number of measures were taken to mitigate the market power of the State owned generator (Verve Energy) and the State owned retailer (Synergy) and to encourage private sector participants. These measures included the placing of a generation capacity cap on Verve Energy (3,000 MW); a restriction on Verve Energy from retailing electricity until 2013; and a restriction on Synergy from generating electricity until 2013 (in each instance, extendable to 2016).  

2.162 In January 2011 the Economic Regulation Authority of Western Australia reported that the market power mitigation measures had been effective in assisting the introduction of new generation into Western Australia’s wholesale electricity market.  

_Tasmania_

2.163 The Tasmania electricity industry has been the subject of gradual reform since at least the 1990s. There has been no large-scale privatisation program as undertaken in Victoria and South Australia and the Tasmanian electricity industry continues to be largely characterised by public ownership.

2.164 The Tasmanian electricity market has unique features. Electricity supply is dominated by hydro generation and up to 60% of electricity demand comes from a small number of major industrial users.

2.165 Many of the developments in the reform process have related to the Hydro Electric Commission (HEC), the State’s previous monopoly electricity provider. In 1995 legislation removed the statutory monopoly on electricity generation previously enjoyed by the HEC.

2.166 In 1998 the HEC was disaggregated into three separate businesses, dealing with generation (Hydro Tasmania), transmission (Transend Networks) and distribution/retail (Aurora Energy).

2.167 In May 2005 Tasmania adopted arrangements for entering the NEM.

2.168 The Tasmanian Government has introduced retail competition for electricity customers in a phased manner similar to that undertaken in other States, but with full retail competition not yet achieved for households and small

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businesses. Customers who are not yet contestable continue to be supplied by the State owned retailer Aurora Energy.

The history of attempts at reforming the electricity industry in NSW

2.169 In the post-war economy, a lack of new investment in generation capacity in NSW resulted in serious power deficiencies and rationing. In a process akin to that undertaken in a number of other developed countries, in the early 1950s the State’s electricity industry was transformed to a centralised, monopolistic industry that performed its role with little public scrutiny.

2.170 The Electricity Commission Act 1950 established the Electricity Commission of NSW. The Commission (sometimes referred to as “Elcom”) was subject to the direction and control of the Minister. During the early 1950s the generation and transmission functions of various entities, including Sydney County Council and the Commissioner for Railways, were transferred to the Electricity Commission.

2.171 The advent of the Electricity Commission firmly entrenched the role of the State in the ownership and control of the electricity industry. This extended to the generation, transmission, distribution and retailing of electricity.

The Industry Commission report: 1991

2.172 In May 1991 the Industry Commission released Energy Generation and Distribution in which it recommended significant structural reform of the electricity industry. In the preface to its report, it said:

Governments and energy utilities agree that there is substantial scope for improving the efficiency of energy generation and distribution in Australia. The potential gains are large - in the order of $2.4 billion a year.

To increase competition and improve efficiency, the Commission recommends significant changes to the structure of the electricity and natural gas supply industries. This involves separating ownership of key functions in each industry and progressively selling much of the publicly owned generation and distribution assets. It would result in a considerable diminution in the dominant role traditionally played in Australia by publicly owned vertically integrated energy utilities.

Most public utilities reject structural change. However, without it, many of the current inefficiencies may become even more deeply entrenched, significant change might never emerge and the nation could suffer the ongoing handicap of electricity and gas industries which are not performing to their full potential.

The Commission considers that the process of structural reform needs to start now. This will require immediate action by governments.

2.173 The Industry Commission’s recommendations included:

a. increasing competition in the electricity supply industry by, first, notionally separating (‘ring fencing’) activities within two years and, secondly, fully separating activities as soon as possible thereafter including by:

84 ESIEP Paper, p. 34. The contestability timetable is tied to wholesale pricing outcomes in the generation sector.
i. separating the ownership of generation, transmission and distribution functions;

ii. breaking up existing publicly owned generating capacity to form a number of independent generating bodies;

iii. forming a public body to acquire and operate all transmission assets in New South Wales, Victoria, Queensland, South Australia and Tasmania;

iv. creating multiple distribution franchises in States where they did not currently exist; and

v. requiring all transmission and distribution bodies to provide open access;

b. corporatising, within 12 months, all public bodies engaged in electricity generation and the transmission and distribution of electricity to place them on a commercial basis, at arm's length from government; and

c. progressively selling publicly owned electricity generation and electricity and gas distribution assets to the private sector.  

2.174 In response to the Industry Commission report, the Special Premier's Conference of July 1991 decided that a national grid should be established. Subsequent meetings of the COAG progressed plans for the establishment of an interstate electricity transmission network.

2.175 In January 1992, the Electricity Commission of NSW was restructured into six business units (including three generating groups). In addition 25 distribution businesses were created. The Electricity Commission was renamed as Pacific Power. In May 1994, Pacific Power's network business was established as a separate legal entity.

2.176 In February 1995, the Electricity Transmission Authority (TransGrid) was separated from Pacific Power and formed as a separate statutory authority pursuant to the Electricity Transmission Authority Act 1994.  

2.177 In May 1995, the NSW Government issued its Electricity Reform Statement. A key proposed reform was to separate the functions of generation and transmission, which had previously been incorporated in a vertically-integrated and largely monopolistic structure.

2.178 An expert Working Group, chaired by Professor Hilmer, was established to advise the Government on whether and how Pacific Power might be disaggregated.

2.179 In relation to transmission, TransGrid would remain a separate entity. For an interim period, between when a NSW market was established and the

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86 TransGrid subsequently became a corporatised entity under the SOC Act in December 1998.

87 Then chairman of Pacific Power.
commencement of the anticipated national electricity market, TransGrid would perform market operation and settlement functions.

2.180 In relation to distribution and retail supply, the Government stated that the existing 25 electricity distributors would be amalgamated into a smaller number of distributors and restructured. The distributors would be corporatised and would operate under a commercial framework.

2.181 Each distributor would also have two subsidiary corporations, dealing separately with distribution network (wires) and retail supply (energy trading) operations. As retail competition developed, electricity consumers would be able to choose their energy supplier.

2.182 In August 1995 the Generation Reform Working Group, chaired by Professor Hilmer, recommended that:

a. Pacific Power be disaggregated;

b. a choice be made between two options for disaggregation; with the Working Group favouring the disaggregation of Pacific Power into three organisations comprising (i) Bayswater/Liddell power stations; (ii) Mt Piper, Wallerawang Vales Point and Munmorah; and (iii) Eraring; and

c. governance, management and financial structures consistent with real competition be established for each of the new generators. 88

2.183 The reforms to the electricity market undertaken by the NSW Government in the mid 1990s did not involve the transfer of any assets from public to private ownership. Rather, the NSW Government contended that the structure of the market, rather than the ownership of the assets, would drive efficiency improvements. 89

2.184 In October 1995 the 25 distribution businesses were amalgamated to form six companies. 90 Each company had a distribution business (the wires) and a retail supply business. In March 1996 the six distribution companies 91 were corporatised under the Energy Services Corporations Act 1995.

2.185 In March 1996 Pacific Power was further restructured to create two additional generating businesses as corporatised entities under the Energy Services Corporations Act 1995, namely First State Power 92 (subsequently named Delta

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90 By June 1996, the six companies were named EnergyAustralia, Integral Energy, NorthPower, Advance Energy, Energy South and Australian Inland Energy: NSW Electricity Reform Taskforce, Retail competition in electricity supply: policy paper, Treasury Research and Information Paper, TPP 96-1, June 1996, Appendix A.

91 Then named Energy South, Far West Energy, MetNorth Energy, MetSouth Energy, MidState Energy, and NorthPower Energy; see Energy Services Corporations Act 1995, schedule 1, part 2 (as enacted). These names of the entities, and in some cases their status, later changed. Thus, for example, MidState Energy subsequently traded under the name Advance Energy, Energy South was subsequently renamed Great Southern Energy and, in July 2001, was amalgamated with Advance Energy to become Country Energy. See also Energy Services Corporations (Dissolution of Energy Distributors) Regulation 2001. MetNorth Energy was subsequently renamed EnergyAustralia.

92 Which operated the Vales Point, Munmorah, Wallerawang and Mt Piper power stations.
Electricity) and Macquarie Generation.\textsuperscript{93} Pacific Power, as a corporatised entity,\textsuperscript{94} continued to operate the Eraring power station.\textsuperscript{95}

2.186 In March 1996 an interim state wholesale electricity market was introduced.\textsuperscript{96} The NSW wholesale market became fully operational in May 1996.

2.187 In October 1996 retail competition was introduced in NSW, to be phased in over a period of years. In May 1997 a limited interstate competitive market (known as NEM1) for NSW and Victoria commenced.

\textbf{The State Owned Corporations Act 1989}

2.188 An important contextual feature of the Electricity Transactions, and the resignation and appointment of directors of Delta and Eraring in December 2010, is that they involved the sale of State assets held by statutory State owned corporations (SOCs). Within this context, a proper understanding of the \textit{State Owned Corporations Act 1989} (the SOC Act), and the framework established by that Act, is critical.

2.189 The SOC Act is described, in the preamble, as being "An Act to provide for the establishment and operation of Government enterprises as State Owned Corporations." The SOC Act commenced operation on 22 September 1989.\textsuperscript{97}

2.190 The \textit{State Owned Corporations Bill} (the Bill) was introduced into the NSW Parliament in 1989 by the Greiner Government. The Bill provided the framework for the corporatisation of government owned enterprises. In the Second Reading Speech in the Legislative Assembly, the Hon. Nick Greiner, the then Premier and Treasurer, said:

> The main purpose of this bill is to establish a framework for the corporatization of selected government business enterprises. Corporatization is a strategy aimed at improving the level of efficiency and accountability in government business enterprises for the benefit of consumers and taxpayers. Public sector efficiency has become a vital issue for this State, as it has for governments around Australia and overseas.\textsuperscript{98}

2.191 The SOC Act did not itself corporatise any government owned enterprises. Rather, it provided the framework in which such corporatisation could occur. Such enterprises would become State owned corporations and subject to the provisions of the SOC Act, if by further legislation their name was included in a schedule to the SOC Act.

2.192 The principal objective of every State owned corporation was to “to be a successful business” and, in this respect, to operate at least as efficiently as any comparable business and to maximise the net worth of the State’s

\begin{itemize}
  \item \textsuperscript{93} Which operated the Bayswater and Liddell power stations.
  \item \textsuperscript{94} See \textit{Electricity Legislation Amendment Act 1995} which altered the title of the \textit{Electricity Commission Act 1950} to the \textit{Electricity (Pacific Power) Act 1950} and significantly amended the 1950 Act. The principal objectives of Pacific Power were to be a successful business, to exhibit a sense of social responsibility, and to conduct its operations in compliance with the principles of ecologically sustainable development: \textit{Electricity (Pacific Power) Act 1950}, s. 5A.
  \item \textsuperscript{95} Eraring was subsequently established by the \textit{Energy Services Corporations (Eraring Energy) Regulation 2000} and, in effect, was formed from Pacific Power’s remaining generation assets.
  \item \textsuperscript{96} See \textit{Electricity Supply Act 1993}; and NSW Electricity Reform Taskforce, \textit{The NSW electricity supply industry: Information paper on the transition to full retail competition}, Treasury Research and Information Paper, TRP 99-2, July 1996.
  \item \textsuperscript{97} SOC Act, s. 2; Government Gazette No. 97 of 22 September 1989, p. 7312. The Act was assented to on 15 September 1989.
  \item \textsuperscript{98} New South Wales, Legislative Council 1989, \textit{Debates}, 2 August 1989, p. 9139.
\end{itemize}
investment in the corporation (s. 8). To a large extent, the SOC Act reflects the principle of competitive neutrality — that State owned enterprises should compete on a "level playing field" with the private sector.

2.193 However, even if corporatised, the relevant business and assets would remain State owned. Recognising this, the Bill provided that Ministers as voting shareholders would have the final responsibility for setting commercial objectives and for appointing directors to the board of the business. However, an important aspect of the SOC Act was to be the explicit identification and separation of commercial and social objectives in a transparent manner. Thus, in the Second Reading Speech in the Legislative Council, the then Minister for Police and Emergency Services said:

Corporatization will facilitate the identification and separation of commercial and social objectives. It will require greater and more detailed accountability to Parliament. It will permit management to operate free from political intervention in matters relating solely to the commercial operations of the corporations. Any socially or politically motivated directions will be required to be explicit and thereby open to public scrutiny and comment.  \(^{\text{99}}\)

2.194 Corporatisation is different from privatisation. Privatisation involves the selling of State assets to the private sector. Although not an inevitable consequence, over time some corporatised State owned enterprises, previously governed by the SOC Act, have in fact been privatised. Examples include GrainCorp, the Government Insurance Office and the State Bank of NSW. Using the framework provided by the SOC Act, corporatisation has provided the means by which State owned enterprises can be placed on a more commercial footing and structured similarly to a private sector entity. This facilitates the future privatisation of the enterprise if considered desirable.

2.195 The SOC Act was amended by Parliament during the Carr Government in 1995.

2.196 Prior to the amendments, the SOC Act recognised only one class of SOCs, namely companies established under the relevant companies legislation \(^{\text{100}}\) but which were also named in the schedule to the SOC Act and governed by its provisions. At the time of the 1995 amendments, the two such existing SOCs were the Hunter Water Corporation and Sydney Water Corporation. After the 1995 amendments such SOCs were termed corporation SOCs.

2.197 The State Owned Corporations Amendment Act 1995 provided for the establishment of a new class of SOCs to be known as "statutory SOCs". Statutory SOCs are statutory corporations, not companies, but which share many characteristics of traditional companies such as having a board of directors, shareholders, and a memorandum and articles of association. Such statutory SOCs would be named in Sch. 5 to the SOC Act and be subject to the relevant provisions of the SOC Act.

2.198 The 1995 amendments also introduced provisions relating to written directions that can be given by the portfolio Minister to a statutory SOC in specified


\(^{\text{100}}\) At the time of the 1995 amendments to the SOC Act this was the Corporations Law.
circumstances. These provisions expanded upon the machinery that had existed under the SOC Act\(^{101}\) prior to the 1995 amendments.

2.199 Following the 1995 amendments, Part 3 of the SOC Act deals specifically with statutory SOCs (including their establishment, legal capacity and powers) while Part 2 deals specifically with corporation SOCs.\(^{102}\) Parts 1, 4 and 5 of the SOC Act contain general provisions applicable to both statutory SOCs and corporation SOCs.

2.200 The entities currently identified as statutory SOCs in Sch. 5 to the SOC Act include the State owned electricity generation companies Delta, Eraring and Macquarie Generation.

*Failed attempt at privatisation in NSW: 1997*

2.201 On 22 May 1997 the Treasurer, the Hon. Michael Egan MLC, released a proposal to privatise the NSW electricity industry in the form of a discussion paper entitled *A Plan for a Secure New South Wales*.\(^{103}\) The proposal would involve the sale of generation, transmission, distribution and retail assets.

2.202 Treasurer Egan said:

> The Government does not need to own the electricity industry to ensure that it achieves desirable economic and social outcomes.

> The market for electricity businesses is currently very strong and high prices being realised and is an opportunity that should not be missed.

> Selling the businesses means that the Government does not have to bear the increasing risk of continued ownership.\(^{104}\)

2.203 Treasurer Egan said that the proposal would raise up to $22 billion, which could be used to eliminate the entire public sector debt. This would generate net savings of about $500 million per year that could be used to fund government services and infrastructure for schools, hospitals and transport.\(^{105}\)

2.204 On 13 June 1997, and following concerns expressed in some quarters, the Government appointed an Inquiry chaired by Mr Bob Hogg\(^{106}\) to inquire into the proposed sale of electricity assets. On 28 August 1997 the report of the Hogg Inquiry was released\(^{107}\) and the majority view of the Committee was that the generation, distribution and retailing of electricity in NSW should be privatised.

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\(^{101}\) Section 11 of the SOC Act, as applicable prior to the 1995 amendments, had provided a power in the Minister to issue a written direction in relation to non-commercial activities in a form comparable to current version s. 20N of the Act following the 1995 amendments.

\(^{102}\) Except to the limited extent provided by s. 20G of the SOC Act, the Corporations Act 2001 (Cth) does not apply to a statutory SOC.

\(^{103}\) The discussion paper was prepared by Treasurer Egan for distribution to Pacific Power and electricity unions at a consultative meeting on 22 May 1997. The discussion paper was incorporated in Hansard on 27 May 1997: New South Wales, Legislative Council, Debates, 27 May 1997, p. 9156.

\(^{104}\) Treasurer Michael Egan, "A Plan for a Secure New South Wales", May 1997, see New South Wales, Legislative Council, Debates, 27 May 1997, p. 9156. Treasurer Egan further said: "The choice for government is whether it regulates and oversees this industry to secure good social and economic outcomes, or whether it owns the industry, thereby risking billions of dollars of taxpayers' money and commercial business enterprises, rather than investing those funds in social and economic services and facilities that are the core areas of government responsibility"; New South Wales, Legislative Council Debates, 27 May 1997, p. 9159.


\(^{106}\) Former ALP National Secretary.

\(^{107}\) Report of the Committee of Inquiry into Sale of the NSW Electricity Assets (Bob Hogg, Chair), August 1997.
The Hogg Inquiry reported that the financial gain to the State from the privatisation of the electricity industry would be very significant. By contrast, maintaining government ownership would lead to a decrease in industry competitiveness and the income stream that it provides for the State budget. It was not realistic to expect the Government to make further significant capital investment in the electricity industry. No government, faced with competing priorities, would choose to invest large amounts of capital in risky electricity ventures.

The Hogg Inquiry also reported that the time was right for the assets to be sold, with a number of ‘cashed up and ready’ buyers. A prompt sale would exploit the industry’s full potential. To delay privatisation meant that the sale value of the NSW businesses would decline if they failed to compete effectively in the forthcoming national electricity market.

The Premier and Treasurer were reported as adopting the recommendations of the Hogg Inquiry report.\(^{103}\)

The Carr-Egan proposal to privatise NSW electricity services was defeated at the October 1997 ALP State conference.\(^{109}\) Thereafter, the Carr Labor government did not advocate electricity privatisation as part of the 1999 election campaign.\(^{110}\)

Writing more than a decade later, former Premier Carr said of the events of 1997:

... the people who blocked electricity privatization in NSW when I and Michael Egan, then State Treasurer, proposed it in 1997 bear a terrible burden. A clean-cut sale of retail and generation would have sunk $30 to $35 billion into the State's budgets and its capital programs and delivered enormous benefit to workers and their families, the base of the Labor Party. But the party conference let them down badly, denying its own government the means to do even more than it was doing ... \(^{111}\)

**December 2004 Green Paper**

In December 2004 the NSW Government published a Green Paper entitled *Energy Directions for NSW*. While not advocating the privatisation of State owned assets, the Green Paper included a number of statements indicating the Government's strong desire for a greater role to be played by the private sector in the NSW electricity industry. Thus, in the Green Paper, the Government stated:

> The Government does not consider it appropriate to invest further capital in high risk commercial activities like electricity generation, when this capital and risk exposure can be provided by the private sector ... The Government is committed to retailing the electricity assets it currently owns. However, it would

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\(^{109}\) It was reported that, on the eve of the conference, the Premier accepted the inevitable and the proposed sale was not put to a vote. Rather, a compromise resolution was carried unanimously. The resolution acknowledged the overwhelming opposition to the electricity privatisation across the party, noted the Premier's express wish to revisit the issue but said that this could be done only after a broad party consensus had emerged; Australian Journal of Politics and History, June 1998, commentary on New South Wales: July–December 1997 (by David Clune).


\(^{111}\) "Thought lines with Bob Carr" (website and blog of former Premier Carr), "Electricity Privatisation", 15 December 2010.
prefer new investment in generation capacity to be financed by the private sector ... The NSW Government will investigate ways of moving the electricity trading risk exposure of its retail businesses to the private sector.\textsuperscript{112}

2.211 The 2004 Green Paper was reportedly published with the aim of developing an Energy Directions Statement White Paper in April 2005.\textsuperscript{113} However, a subsequent White Paper was not released.\textsuperscript{114}


\textsuperscript{114} Submission to the Owen Inquiry by Dr John Kaye MCL dated 2 July 2007, p. 1.
Chapter 3 The Owen Inquiry and the Electricity Industry Restructuring Bills

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Establishment of the Owen Inquiry: May 2007

3.1 On 9 May 2007 Premier Iemma announced the establishment of an Inquiry into electricity supply in New South Wales to be undertaken by Professor Anthony Owen. Professor Owen was then Professor of Energy Economics at the Curtin Business School, Curtin University of Technology, Perth.

3.2 Professor Owen was asked to:

a. review the need and timing for new baseload generation that maintains both security and competitively priced electricity;

b. examine the baseload options available to meet efficiently any emerging generation needs;

c. review the timing and feasibility of technologies and or measures available both nationally and internationally that reduced greenhouse gas emissions; and

d. determine the conditions needed to ensure investment in emerging generation, consistent with maintaining the State’s AAA credit rating.\textsuperscript{115}

3.3 In 2007, at the time of the Owen Inquiry, NSW’s baseload electricity was almost exclusively supplied by the State owned generators, Macquarie Generation, Delta and Eraring. In addition, the State operated three electricity businesses, EnergyAustralia, Country Energy (Country) and Integral Energy (Integral) had retail assets and also a monopoly on transmission and distribution of electricity in their respective areas.

The Owen Report: September 2007

3.4 The Owen Report was publicly released on 11 September 2007. Professor Owen’s key recommendation was in the following terms:

...I have determined that there is a need to be prepared for additional investment in baseload from 2013-14. Further, the most efficient means of providing for baseload is to improve the commercial and policy signals used by the private sector when investing in generation capacity in New South Wales. My key recommendation, therefore, is that the Government of New South Wales divests itself of all State ownership in both retail and generation.\textsuperscript{116}

3.5 Professor Owen made eight recommendations to the NSW Government:

a. divest the State of the retail arms of EnergyAustralia, Integral and Country;

b. divest the State of the generation businesses of Macquarie Generation, Delta and Eraring;

c. in the event that the Government does not wish to sell generation, then it should implement an appropriately structured long-term leasing of current generation assets. The State would retain ownership of the assets, with operational and commercial control by the private sector;

\textsuperscript{115} Inquiry into Electricity Supply in NSW (Professor Anthony D. Owen), September 2007 (the Owen Report), Chap. 1, p. 1.

\textsuperscript{116} The Owen Report, p. i.
d. actively monitor the progress of reforms to NSW planning, development approval and environmental licensing process to ensure that proposals for new generation capacity, and associated fuel supplies, are considered expeditiously, and in a cost-effective and predictable manner, without compromising the quality of environmental assessment;

e. support the planned review of the effectiveness of retail competition by the AEMC in 2010, and consider the removal of regulated retail price caps at that time, should the review find effective competition in the NSW retail market;

f. encourage the Commonwealth Government to bring forward the timetable for establishing a national emissions trading scheme. At a minimum the Commonwealth should resolve and announce:

i. the national greenhouse gas reduction target and short-term caps and associated penalties; and

ii. the basis for allocating emissions permits;

g. develop and implement clear and timely transitional rules for existing State based greenhouse gas and emission schemes to the national emissions trading scheme (in the event of its introduction); and

h. encourage and support energy efficiency initiatives where possible.\textsuperscript{117}

3.6 Professor Owen determined that forecast growth in electricity use indicated a need to provide about 91,000 GWh of electrical energy for NSW in 2013-14. This was about 10,500 GWh above the then current annual consumption and about equivalent to the yearly output of the Mt Piper power station. This expected gap could only partly be filled by means of increased energy efficiency, new renewable energy generation and increased output from existing generators.\textsuperscript{118} In addition, growing energy consumption in other States might reduce the amount of energy that could be imported from other States via interconnectors.

3.7 In terms of available technologies, Professor Owen concluded that most of the State's extra baseload energy needs would probably be met by coal-fired and/or gas-fired generation, as other technologies would be able to contribute only on a relatively small scale or would not mature until 2020 at the earliest.

3.8 Professor Owen also stated that, based on recent Australian experience, it could be expected to take up to six years to reach the stage of letting a contract for a new power station. This assessment had regard to the time usually taken in relation to such stages as feasibility, site selection, site purchase, environmental assessment and development approval, contract design and letting, and power station construction and commissioning.

3.9 Professor Owen reported that Government ownership of electricity businesses operating in the competitive sectors of the industry neither increased nor decreased the State’s ability to achieve price, social and environmental

\textsuperscript{117} The Owen Report, p. xlv.
\textsuperscript{118} The Owen Report, Chap. 1, pp. 7-9.
outcomes from the industry. However, if it were to remain an industry participant the State needed to be aware of the critical investment demands that would be placed upon it. Professor Owen said:

- Should the NSW Government choose to continue to own most of the State's electricity industry, the State will almost certainly have to both fund the next tranche of baseload generation in NSW and invest further in the State-owned energy corporations. There is no sustainable half-way house. If the State continues to own businesses operating in the competitive energy market, it needs to accept that these businesses will have to pursue business strategies and investments across the NEM that will allow them to be successful.

- Investment in baseload capacity is but one example of the type of investments that Government would need to fund. The cost of new investment in generation capacity in NSW over the next 10 to 15 years is expected to be in the vicinity of $7 billion to $8 billion.

- The Government-owned retail businesses will struggle to remain viable without significant additional capital to allow them to adopt a more vertically and horizontally integrated business model. The potential cost of doing so is in the range of $2 billion to $3 billion over the same period.

- Further... Government may be exposed to investing in the order of $3 billion to $4 billion over the next 15 years to retro-fit some existing power stations with carbon reduction technologies.\(^{119}\)

3.10 Professor Owen concluded that, compared to a 'retain and invest' approach, the State's net debt could be reduced by up to $26 billion in 2020 by the avoidance of the required investment in new generation, coupled with the proceeds of divestment of generation and retail. This would significantly improve the State's fiscal position and the Government's ability to meet its State Plan objectives. The State's business profile and credit rating would also benefit from the removal of 'high risk' generation and retail assets from its balance sheet.\(^{120}\)

3.11 Professor Owen did not advocate selling the 'poles and wires' of the State's electricity transmission and distribution networks.\(^{121}\)

3.12 As a result of the Owen Report, the Government commissioned Morgan Stanley, which had contributed to the Owen Report, to prepare a confidential paper outlining the options available, including structures for sale of electricity assets to implement the recommendations made by Professor Owen. Morgan Stanley recommended that the Government should divest itself of both retail and generation operations. The principal second or third best options included long-term lease of the generation stations and generator trader contracts. In relation to generator trader (otherwise known as gentrader) contracts, Morgan Stanley concluded that they were not a complete answer on new generation investment, value and risk transference objectives. It defined these contracts as "essentially the sale of dispatch rights from the power stations, with the Government retaining ownership and physical operation of the stations".\(^{122}\)

\(^{120}\) The Owen Report, Chap. 1, p. 13.
\(^{121}\) The Owen Report, Chap. 1, p. 14.
3.13 The gentrader contracts were not a new option. In December 2001, Treasury released a discussion paper titled *A Risk Management Proposal for New South Wales' Electricity Businesses*. The paper proposed an initial form of gentrader model involving the tendering of electricity trading functions of the Government owned electricity generation and retail businesses to the private sector.\(^\text{123}\)

3.14 In May 2004, having considered the comments provided in response to the 2001 discussion paper, Treasury released a consultation paper, also titled *A Risk Management Proposal for New South Wales' Electricity Businesses*. The consultation paper proposed the separation of the "financially high-risk task of wholesale electricity trading, from the major task of producing and delivering reliable and affordable electricity",\(^\text{124}\) by tendering out to the private sector "the job, and the risk, of trading wholesale electricity".\(^\text{125}\) Under the proposal, generation traders would bid the capacity of State owned generators into the NEM. An Agency Contract model was also proposed, transferring the responsibility for servicing and supplying customers on negotiated retail contracts from the State owned retailers to private retail managers.\(^\text{126}\)


3.15 On 10 December 2007 the Government accepted the key findings of the Owen Inquiry and outlined its Energy Reform Strategy. The Government relevantly announced that it would:

a. lease the State owned power generation stations on a long-term basis to the private sector, while keeping the assets in public ownership; and

b. sell electricity retail functions and development sites to the private sector.

3.16 The Government also announced the establishment of a Consultative Reference Group to test the impact of the proposed reforms against the ALP’s policy platform (the Unsworth Committee).

**Private member’s Bill introduced in February 2008**

3.17 On 27 February 2008 a private member’s Bill was introduced in the Legislative Council by Greens MLC Dr John Kaye. The *Energy Services Corporations Ownership (Parliamentary Powers Bill)* 2008 would prevent the sale, lease or other disposal of the main undertakings of an energy services corporation, or of any subsidiary, without a motion of approval being passed by both Houses of Parliament.

3.18 In the Second Reading Speech, also on 27 February 2008, Dr Kaye said that while the Greens were opposed to electricity privatisation, the Bill would not


stop privatisation; rather it would ensure that a carefully designed privatisation process would not escape the need for parliamentary scrutiny.\textsuperscript{127} The Bill subsequently lapsed in the Legislative Council on 14 May 2008.

3.19 A bill, in the same form, was introduced in the Legislative Assembly as a private member’s Bill by the Hon. Andrew Stoner, Leader of the Nationals, on 16 May 2008: the Energy Services Corporations Ownership (Parliamentary Powers) Bill 2008. On 19 June 2008 the Bill was negatived, when a motion that the Bill be agreed to in principle was defeated.\textsuperscript{128} The Bill did not proceed further.

### The Unsworth Committee Report

3.20 In March 2008 the Unsworth Committee submitted its report to Premier Iemma. The Committee reported that:

All of the Committee members, except the union representatives, agree that it is reasonable to conclude that the NSW Government’s strategy to secure the State’s future electricity supply meets the 12 criteria\textsuperscript{129} overall, subject to the Government addressing and implementing the recommendations contained in this Impact Statement. The strategy should proceed in the best interests of the citizens of New South Wales.\textsuperscript{130}

3.21 Following receipt of the report of the Unsworth Committee, on 10 April 2008 the Government announced an electricity safety net package of $272 million over five years.\textsuperscript{131} This included an increase in pensioner energy rebates over a five year period and the extension of electricity concessions to carers of young children and recipients of sickness benefits.

3.22 On 3 May 2008 the State Labor Party Conference voted against the Government’s proposed energy reforms.\textsuperscript{132}

3.23 On 8 May 2008 the then Leader of the Opposition, the Hon. Barry O’Farrell, announced that the Opposition supported in principle the Government’s proposed sale of the electricity assets, subject to certain conditions. Subsequently, there was correspondence between the Government and the Opposition and the Auditor-General to refine the content of these conditions.

3.24 The conditions related to:

a. the involvement of the Auditor-General;

b. the completion, release and adoption of a Rural Communities Impact Statement;

\textsuperscript{127} New South Wales, Legislative Council 2008, Debates, 27 February 2008, p. 5472.

\textsuperscript{128} New South Wales, Legislative Assembly 2008, Debates, 19 June 2008, p. 8931.

\textsuperscript{129} The 12 criteria in the ALP’s policy platform were detailed in the report and included the social utility of the public asset, the impact on regional areas, employment and the environment, the retention value of the enterprise measured against its sale value, and the existing competing demands on the NSW public sector and existing budgetary constraints.


\textsuperscript{131} See the response by Premier Iemma to question without notice from Mr Steve Whan: New South Wales, Legislative Assembly 2008, Debates, 10 April 2008, p. 6847.

\textsuperscript{132} The Sydney Morning Herald reported that “The Premier yesterday defied the unions by insisting the sale would go ahead after a humiliating 702-107 vote against privatisation at Labor’s State conference”. Clennell, A. and Robins, B. "Climbing to power: let’s talk turkey", Sydney Morning Herald, 5 May 2008.
c. a Parliamentary oversight committee to ensure improvements in the delivery of renewable energy;

d. retention of ‘poles and wires’ in public ownership; and

e. appropriate safety nets for pensioners, low income families and employees as determined by the Auditor-General.

The Electricity Industry Restructuring Bills 2008


3.26 The Explanatory Note identified the object and key features of the EIR Bill as follows:

The object of this Bill is to provide for the restructuring of part of the State’s electricity industry by authorising and facilitating any of the following transfers of assets to the private sector:

(a) the lease of power stations of an electricity generator and the transfer of the rest of its business,

(b) the transfer of the retail business of an electricity distributor,

(c) the transfer by initial public offer of the business of an electricity generator (including power stations).

The Bill specifically provides that the distribution and transmission assets (the ‘poles and wires’) of an electricity distributor must remain in public ownership.

3.27 Premier lemma noted that the EIR Bill followed the investigation and report by Professor Owen. The Premier described the EIR Bill as being designed “to secure our State’s future electricity supplies”. Premier lemma further said:

The transactions authorised by the Bills will avoid the need for New South Wales tax payers to provide capital of up to $15 billion for necessary investment in this part of the industry so that the Government can concentrate on investing in roads, trains, hospitals, schools and other essential infrastructure, including the network and transmission businesses, which it will continue to own and operate.

3.28 The EIR Bill also contained provisions designed to protect consumers and employees, including authorising the making of transfer payments to employees

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136 *Electricity Industry Restructuring Bill 2008*, Explanatory Note.
137 Cognate with the Bill was the *Community Infrastructure (Intergenerational) Fund Bill 2008*, which Premier lemma described as providing for a permanent fund into which the proceeds from the electricity transactions would be paid and which would be reinvested to generate ongoing income to replace the dividends previously received from the State owned generation and retail businesses. New South Wales, Legislative Assembly 2008, Debates, 14 June 2008, p. 8151.
of electricity generators and retailers as a consequence of the proposed restructuring.

3.29 On 19 June 2008, and following negotiations with the Opposition, the Government introduced a further Bill in the Legislative Assembly, relevant to the energy reform strategy, namely the Auditor-General (Supplementary Powers) Bill 2008. The Bill, if passed, would amend the Public Finance and Audit Act 1983 to provide for review by the Auditor-General in connection with the restructuring of the State’s electricity industry.

3.30 After passing the Legislative Assembly, and on the same day, 19 June 2008, the Bill was introduced in the Legislative Council. The Bill was passed by both houses of Parliament that day and was assented to on 23 June 2008.

3.31 On 26 June 2008 the Legislative Council adjourned for the winter recess until 23 September 2008. However, before adjourning, the Legislative Council agreed to a resolution providing for its possible early recall by the President, in the event that the Government wanted to advance its electricity restructuring program before sittings resumed.

3.32 On 21 August 2008 the Auditor-General provided his report to Parliament, entitled Oversight of Electricity Industry Restructuring, pursuant to s. 63G of the Public Finance and Audit Act 1983. The Auditor-General reported that, subject to certain matters identified for consideration by Treasury (discussed below), nothing had come to his attention that caused him to believe that the Government’s strategy for the transfer of assets to the private sector was not appropriate for maximising financial value for taxpayers.

3.33 The Auditor-General also concluded that the proposed employee protections were generally consistent with other privatisations and Government restructures, except for the employment guarantees. In respect of the latter, the proposed five year employment guarantee for certain generator employees was regarded as exceeding the guarantees in previous privatisations and restructures, which were generally for three years or less.

3.34 In his report, and to enhance the Government’s reform strategy, the Auditor-General raised certain matters for consideration by Treasury, including the use of simultaneous, rather than sequential, transactions for the sale of generation and retail assets; holding separate tenders for generation development sites; and determining a retention value and reserve price for each generator and retail asset prior to commencing each transaction.

3.35 On 22 August 2008, the day after the Auditor-General’s report was tabled in the Legislative Council, the President of the Legislative Council informed members that he had received a written request from Treasurer Costa (who was also Acting Leader of the Government in the Legislative Council), that the Legislative Council of NSW, Procedural Highlights no. 27: July to December 2008, p. 4.

138 Being the key provision introduced by the Auditor-General (Supplementary Powers) Act 2008.


Council be recalled. The President fixed Thursday, 28 August 2008 as the next sitting day.

3.36 On 28 August 2008 the Government introduced the Electricity Industry Restructuring Bill 2008 (No. 2) and the Electricity Industry Restructuring (Response to Auditor-General Report) Bill 2008 in the Legislative Council. These were relevantly similar to the EIR Bill, however, as the EIR Bill had not yet passed in the Legislative Assembly, the later Bill was marked No 2.

3.37 In the Second Reading Speech in the Legislative Council on 28 August 2008 Treasurer Costa (who was also the Minister for Infrastructure) said:

These bills are the most important pieces of economic reform contemplated in this State in a generation. Without them we face a very stark and unavoidable choice: either run unacceptable risks to the security of the power supply or divert taxpayer funds away from front-line services and vital infrastructure. Neither of those choices is desirable or necessary; and that is not political posturing but the advice of an independent expert inquiry headed by Professor Tony Owen that, 12 months ago, reported to the Government on the State energy needs. The warnings that the Owen report contained, in terms of a looming base load shortage by 2013-14 and the $15 billion cost pressure that would be placed on the State’s budget, cannot be ignored by a either a responsible Government or a responsible Opposition.

3.38 Treasurer Costa also said that the Government intended that the Bills be voted on in the Legislative Council before being introduced by the Premier and considered in the Legislative Assembly. He said further: “There is a simple reason for this: the investment community requires certainty.”

3.39 The cognate Bill, the Electricity Industry Restructuring (Response to Auditor-General Report) Bill 2008 was, as its name suggests, responsive to the report of the Auditor-General dated August 2008. Among other things, the Bill provided that the Government would be required to determine the retention value and reserve price of any State electricity assets before they were transferred to the private sector.

3.40 The Opposition opposed the Bills. The Leader of the Opposition in the Legislative Council, the Hon. Michael Gallacher, said:

The Government has had 13 years to get the important issue of this State’s future power generation right and ... it has got it wrong. The New South Wales Liberal-National Coalition will not support the lemma Government’s Electricity Industry Restructuring (Response to Auditor-General Report) Bill 2008 and the associated cognate bill. The Liberal-National Coalition does not take this decision [lightly].

3.41 Mr Gallacher further said that:

There are three key reasons for our dissatisfaction with this proposed electricity industry restructuring: the continued uncertainty surrounding the Commonwealth Government’s emission trading scheme; the current state of capital markets is not conducive to the sale of such a valuable asset; and the lemma Government’s history of financial and infrastructure delivery

143 Legislative Council of NSW, Procedural Highlights No. 27: July to December 2008, p. 4.
mismanagement and incompetence. Underpinning all three reasons is the fundamental issue of trust. The community does not believe that the Government can be trusted to get this privatisation right. The community does not believe that thelemma Government can be trusted to spend the proceeds of the sale in a transparent and honest manner. The community does not believe that the lemma Government can be trusted to put public interest ahead of the Labor Party's re-election plans.

By opposing this legislation the New South Wales Liberal-Nationalists Coalition will ensure that the people of the State are not betrayed.\textsuperscript{146}

3.42 The full text of Mr Gallacher's remarks in the Legislative Council on 28 August 2008 regarding the Bills can be found at Appendix 10.

3.43 Greens MLCs also indicated their intention to oppose the Bills.\textsuperscript{147} With the Bills facing defeat if voted upon, debate on the Bills was adjourned to September 2008. The adjourned debate was never resumed and the Bills were withdrawn on 23 September 2008.

3.44 Later that same day, 28 August 2008, in question time in the Legislative Assembly, Premier lemma responded to the events in the Upper House by stating that "The Leader of the Opposition knows that the Government's approach is right. Yet for five minutes of political advantage he has displayed all the principles of an economic vandal."\textsuperscript{148}

3.45 On 5 September 2008 Premier lemma resigned as leader of the NSW Labor Party and Premier. He was replaced by Premier Rees. The Hon. Eric Roozendaal MLC replaced Mr Costa as Treasurer.

3.46 On 24 September 2008, in response to a question without notice from Dr Kaye relating to the Government's electricity reform strategy, Treasurer Roozendaal told the Legislative Council that the Government accepted that Parliament had spoken on the issue. He said:

We accept that the people and the Parliament have spoken on this issue. We are currently assessing our options and developing a revised energy reform package that will ensure New South Wales has reliable and secure electricity supply while minimising the risk for the Government in future investments. The Government remains committed to withdrawing from the retail electricity market, where the three State-owned retailers already compete against numerous private companies. As we have always said, the distribution and transmission network businesses that are responsible for maintaining and upgrading the poles and wires will remain 100 per cent in Government ownership.\textsuperscript{149}

3.47 Following the failure to progress the \textit{Electricity Industry Restructuring Bill 2008} through Parliament in 2008, attention turned to the development of alternative reform measures including the gentrader model discussed below.


Chapter 4 Governance of the Energy Reform Project

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Governance structure for the Energy Reform Project

4.1 On 28 August 2008, the Government decided to proceed with the sale of electricity retail assets and development sites, which it had been advised could proceed without legislation.

The Steering Committee

4.2 In October 2008, the Government established a Steering Committee to report to the Minister for Finance to determine the optimal approach to implementing the decision made to sell the electricity retail assets and development sites and outsource the gentrading rights of the SOC generators, that is, Delta, Eraring and Macquarie Generation (the Energy Reform Project). Representatives from the Department of Water and Energy and Treasury were to co-chair the Steering Committee, with an additional Steering Committee member each from Treasury, the Department of Water and Energy and the Department of Premier and Cabinet, reporting to the Minister for Finance (at that time, Minister Tripodi). Ultimately, there was no co-chair arrangement. The discussion on the reasons for adopting the gentrader option appears in Chapter 5.

4.3 The Minister for Finance was the responsible Minister for the Energy Reform Project until November 2009, when the Treasurer became the responsible Minister. In November 2009, Minister Daley was appointed as Minister for Finance and thereafter remained one of the shareholding Ministers of the SOCs.

4.4 The Steering Committee reported and made recommendations to the Cabinet Committee, which from November 2008 had reporting arrangements with Cabinet.

4.5 The Steering Committee was responsible for all aspects of the administration of the Energy Reform Project. Matters of a policy or significant strategic nature were referred for decision to the Cabinet Committee but, by and large, the work of selling the assets and reporting to the Minister for Finance was the responsibility of the Steering Committee.

4.6 The work done by the Steering Committee included the following:

a. the sale process, strategy and timing in relation to the retail businesses and the gentrader rights associated with each of the generators;

b. the determination of retention value and reserve price;

c. liaison with the Auditor-General;

d. liaison with the ACCC; and

e. liaison with the SOCs (including the development of protocols for conducting the businesses during the period leading up to the execution of the transactions, which included a prohibition on the SOCs obtaining legal or financial advice without the consent of Treasury and a requirement that each SOC obtain the approval of the Steering Committee for any substantial transaction).
4.7 The permanent members of the Steering Committee were:

a. the Chair (John Pierce, the then Secretary of the Treasury from its inception until December 2008; then Michael Schur, the Secretary of the Treasury from March 2009 until October 2009; then Col Gellatly from October 2009 until early 2011);

b. representatives from Treasury (Kevin Cosgriff, a Deputy Secretary of Treasury, who was a member of the original Steering Committee when Mr Pierce was Chair and from December 2009 Richard Timbs, also a Deputy Secretary of Treasury);

c. representatives of the Department of Premier and Cabinet (initially Robyn Kruk, Director-General of that Department; then Vicki D'Adam, an Assistant Director-General of that Department from July 2009 to April 2010 and a Deputy Director-General of that Department from April 2010 to present); and

d. representatives of the Department of Water and Energy, which became the Department of Industry and Investment (initially Mark Duffy, Director-General of that Department; later Leisl Baumgartner, a Deputy Director-General of that Department; and subsequently Katharine Hole, Director of Energy Strategy and Reform of that Department, who had, before her appointment to the Steering Committee, attended meetings as an observer since 2008).

4.8 Mr Schur informed the Steering Committee at its meeting on 20 October 2009 that he considered that the major policy aspects of the projects had been accomplished and that the balance of the project would substantially comprise implementation. Mr Schur informed the Inquiry that he considered it to be appropriate to hand over the role of Chair in October 2009. He gave three reasons for his view.

4.9 First, he appreciated that the execution phase would be very time-consuming and demanding. A budget had been delivered in June 2009 and he considered that he needed to dedicate a significant amount of time to it.

4.10 Secondly, it had become apparent to him during the six months of his Chairmanship that being accountable to the Treasurer (as Secretary) on the one hand and reporting to the Minister for Finance (as Chair of the Steering Committee) on the other was problematic from time to time because it was not necessarily the case that the Treasurer and the Minister for Finance would take the same position on issues.

4.11 The third reason was that Mr Schur was not comfortable with being held accountable, as Chair, for the transaction, unless he had full authority and control over the transaction, which he did not since it was being controlled by the Minister for Finance (until November 2009), rather than the Treasurer. When, in November 2009, Treasurer Roozendaal took responsibility for the transaction, the Treasurer wanted to keep the then current governance arrangement in place, and retained Dr Gellatly as Chair, who then reported to the Treasurer rather than the Minister for Finance as had previously been the case when Mr Schur was Chair.
4.12 Mr Schur also informed the Inquiry that he considered that he left the Steering Committee with sound representation from Treasury. Mr Cosgriff had been on the Steering Committee since the outset and had a long involvement in the energy sector, and Mr Timbs, who had been appointed as a Deputy Secretary at Treasury in June 2009 after considerable experience with Macquarie Bank in transactions, was to be appointed in December 2009 as another Treasury representative on the Steering Committee.

4.13 When he was appointed Chair, Dr Gellatly had considerable experience in the public service. He was Director-General of the Department of Premier and Cabinet from June 1994 until March 1995 under Premier Fahey. He resumed that role from September 1996 and continued in that position until May 2007. Since his retirement from the public service, Dr Gellatly has been a director of various SOCs. He has also conducted inquiries for the Government on the use of ethanol and the State’s local government water supply. He was appointed as an administrator of the Wollongong City Council when the Council was dismissed in 2008.

4.14 Dr Gellatly informed the Inquiry that he saw his role as Chair as being to ensure that the Steering Committee’s deliberations were conducted on a proper basis, with sufficient advice. He did not see his role as requiring him to express any particular view on what he perceived would be the preferred outcome. He said that he never used his casting vote as Chair in any of the deliberations of the Steering Committee and that most decisions were the result of consensus. He summarised his view of the “usual role of chair” in the following way: “to facilitate the discussion to ensure that people get heard, that the process of decision-making is done in a dignified way, but that all the facts get put on the table and that everyone gets an opportunity to put their view”.

4.15 The Treasury representatives saw their role as being to ensure that decisions were made that were fiscally responsible and that adequate provision was made for any risks or contingent liabilities to which the State would be exposed by reason of entering into the transactions.

4.16 Ms D’Adam informed the Inquiry that she had, by reason of her experience as a long-term officer of the Department of Premier and Cabinet, an understanding of what decisions ought to be made by Cabinet (or a Cabinet committee) and what decisions could properly be made by officials or a Steering Committee. She considered her role to be to ensure that good governance prevailed and that the Steering Committee referred key decisions to the Cabinet Committee for its decision.

4.17 Ms Hole saw her Department’s primary function on the Steering Committee as being to look at matters concerning energy regulation and consumer protection. She informed the Inquiry that her Department was principally concerned with the retail businesses since these are the businesses that continue to be regulated by the State. However, the Department was also concerned with management of the risk associated with water licences to provide water to the SOC generators.

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150 Mr Cosgriff said to the Inquiry that when he joined Treasury in 2001 he ran a directorate that was called Resources and Policy which covered energy policy and energy markets. He continued in that role until 2006.
4.18 Observers from relevant departments and working groups were permitted to attend the meetings of the Steering Committee when required. From time to time the Treasurer, based on advice from the Steering Committee or from Treasury, submitted Minutes to the Cabinet Committee for its decision. The Steering Committee met weekly and considered reports from the various working groups which were pertinent at various stages of the transaction.

**Advisers**

4.19 A tender process was used to select most of the advisers to the Energy Reform Project. Government policy permitted consultants to be engaged without a tender process in circumstances of genuine confidentiality or genuine urgency. The Treasurer approved the direct engagement of Frontier Economics and solicitors, Freehills/Johnson Winter & Slattery. Others were appointed on an ad hoc basis, depending on their expertise and the roles they were required to undertake. The following principal advisers were appointed to perform the following roles:

a. Baker & McKenzie (lead legal advisers appointed on 24 December 2007 to provide all legal services associated with the implementation of the Government’s Energy Reform Strategy, including SOC vendor due diligence, with the exception of competition advice for which Gilbert & Tobin was appointed for a short period in early 2008);

b. Gilbert & Tobin (legal advisers appointed on 24 December 2007 to provide legal advice on ACCC issues; they ceased to act on 31 March 2008);

c. Freehills (legal advisers appointed on 28 May 2008 to advise regarding cross-border leases; they were subsequently engaged from 5 March 2009 to 28 February 2010 to provide legal advice on the gentrader strategy and develop the gentrader legal documents and associated schedules);

d. Johnson Winter & Slattery (legal advisers who were appointed on 5 March 2010, following the departure of Gary Maguire from Freehills to Johnson Winter & Slattery on 4 March 2010 to provide legal advice on the gentrader strategy and develop the gentrader legal documents and associated schedules);

e. Credit Suisse (joint lead financial advisers appointed on 24 December 2007);

f. Lazard (joint lead financial advisers appointed on 24 December 2007);

g. Frontier Economics (initially appointed on 24 December 2007 to give advice regarding the energy market and competition issues; subsequently also appointed to give advice on issues including the retail price determination process and IPART and the gentrader model);

h. Ernst & Young (appointed on 24 December 2007 to give accounting and tax advice; performed financial vendor due diligence for the SOCs; and also performed a financial model integrity review of the modelling used in the determination of retention values);

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i. KPMG (appointed on 14 February 2008 to provide Information Technology advice and assist with SOC vendor due diligence regarding Information Technology);

j. WorleyParsons (appointed on 31 March 2008 to provide engineering and environmental advice to the SOC generators and in respect of the development sites);

k. RSM Bird Cameron (appointed on 14 February 2008 to provide probity advice and conflict management); and

l. SFG Consulting (financial modelling consultants who were appointed on 1 June 2010 to provide financial modelling advice to determine some of the parameters of the gentrader agreements and to determine future working capital requirements and capital structures of the generators when operating under gentrader agreements).

4.20 Throughout the sale process the Steering Committee required the advisers to provide Scope of Works documents setting out the tasks requested of them and a budget for the tasks. The Steering Committee monitored the total expenditure of the Energy Reform Project.

4.21 The retainer of the financial advisers, Credit Suisse and Lazard, included a success fee based on the dollar value of the transactions. They were the only advisers whose remuneration included a success fee.

4.22 The individual and collective expertise of the advisers was considerable and included experience in transactions in the electricity sector and also on large scale privatisations.

4.23 Baker & McKenzie had acted for the State on the privatisation of the NSW coal mine portfolio in 2002 (known as the Powercoal sale). They acted for the State on the sale of Pacific Power International’s consulting business to Connell Wagner.

4.24 Chris Saxon of Baker & McKenzie had previously drafted a gentrader contract. Mr Maguire of Freehills (and later Johnson Winter & Slattery) had acted on a gentrader contract in Gladstone, Queensland.

4.25 Credit Suisse had advised the Victorian Government on a potential IPO of Snowy Hydro which did not proceed, as well as other substantial privatisations in areas other than electricity (such as QANTAS and Commonwealth Bank).

4.26 Andrew Leyden of Lazard had previously worked for Credit Suisse, with Campbell Lobb when they were advising the Victorian government on its electricity privatisation. In the course of that assignment he had come across the gentrader model.

4.27 Mr Shatter of RSM Bird Cameron had provided probity advice since 1993, including in relation to transactions, predominantly for infrastructure in public-private partnerships or purchases which are subject to Government procurement processes. RSM Bird Cameron is the market auditor for AEMO.
4.28 Frontier Economics had been involved in assisting the Queensland Government to have Queensland participate in the NEM. Danny Price of Frontier Economics informed the Inquiry that he was the progenitor of the gentrader model. He worked with Mr Maguire in Queensland gentrading agreements. Mr Price also worked on the Ecogen contract in Victoria, in which Mr Saxon was involved.

**The work of the probity advisers**

4.29 RSM Bird Cameron began work on the project in early 2008. Its first task was to establish a probity framework, within which probity briefings would occur, probity plans would be developed and implemented and key documents and processes would be reviewed by reference to probity principles.

4.30 The probity advisers presented the probity plans to the Auditor-General and, they informed the Inquiry, they accommodated any requests for amendment which he suggested.

4.31 RSM Bird Cameron provided briefings to every person associated with the Energy Reform Project, including the Premier, various Treasurers and Ministers who were in office during the process, the members of the Steering Committee, members of working groups, advisers, project officers and directors and staff of the SOCs. Every such person was required to sign a confidentiality undertaking and also a conflict of interest declaration. RSM Bird Cameron received in the order of 100 such declarations, which its representatives did not regard as unusual for a project of that size, which involved a significant number of people.

4.32 Representatives of RSM Bird Cameron informed the Inquiry that they concentrated particularly on confidentiality and conflict of interest when briefing the SOCs.

4.33 Representatives of RSM Bird Cameron attended every meeting of the Steering Committee (at which probity was on every agenda) and were permitted to attend any of the working group meetings. They concentrated on the Sales Process and Documentation Working Group because it was this group that essentially developed the structure of how the transaction was going to occur.

4.34 The probity advisers prepared a register of the more significant pieces of advice that were issued.

4.35 To the extent to which it fell within their brief, the probity advisers regarded the principle of value for money as requiring a competitive process, which would create competitive tension between bidders, each of whom was entitled to lodge a bid for the asset or assets in which the bidder was interested.

**The Working Groups**

4.36 Working groups and committees were established which reported to the Steering Committee. The names of and functions performed by individual working groups reflected the various aspects of the Energy Reform Project and included the following:
a. Gentrader Working Group (which, at the outset, included representatives from Treasury, the Department of Industry and Investment, Frontier Economics, Freehills (later Johnson Winter & Slattery) and later, in June 2010, was expanded to include representatives from the financial advisers and SFG Consulting);

b. Gentrader Separation Working Group (which was responsible for separating the generating activities from the trading activities of the SOC generators and which included representatives from Treasury, the financial advisers, KPMG, Ernst & Young, Baker & McKenzie and Delta);

c. Cobbora Working Group (which included representatives from Treasury, the three generator SOCs and the financial advisers);

d. Competition and Electricity Tariff Equalisation Fund (ETEF) Working Group (which included representatives from Treasury, the financial advisers, Baker & McKenzie, Frontier Economics and the Department of Premier and Cabinet);

e. Employee Issues Working Group (which included representatives from Treasury, the Department of Industry and Investment, the Department of Premier and Cabinet, the financial advisers, Baker & McKenzie and Ernst & Young);

f. Generation Employee Consultative Working Group (which included representatives from Treasury, the Department of Premier and Cabinet, the SOC generators, Unions NSW, the United Services Union, the Public Service Association, the Electrical Trades Union, the Construction, Forestry, Mining and Energy Union and the Association of Professional Engineers, Scientists & Managers, Australia);

g. Retail Employee Consultative Working Group (which included representatives from Treasury, the Department of Premier and Cabinet, the SOC retailers, Unions NSW, the United Services Union, the Public Service Association, the Electrical Trades Union and the Association of Professional Engineers, Scientists & Managers, Australia);

h. Sales Process and Documentation Working Group (which included representatives from Treasury, the financial advisers, Baker & McKenzie and RSM Bird Cameron, and later, from October 2010, Ernst & Young);

i. Retention Value Working Group (which included representatives from Treasury and the financial advisers);

j. Smelters Working Group (which included representatives from Treasury, the financial advisers and Baker & McKenzie);

k. Transaction Co-ordination Working Group (which was formed in June 2010 and which included representatives from Treasury, the financial advisers, Baker & McKenzie, Frontier Economics, Johnson Winter & Slattery and Ernst & Young);
l. Transition Working Group (which included representatives from Treasury, the Department of Water and Energy, the Department of Premier and Cabinet, Unions NSW and the United Services Union);

m. Vendor Due Diligence Committees for each of the SOCs and also the Development Sites (which included representatives from Treasury, the relevant SOC, the financial advisers, Ernst & Young, Baker & McKenzie, KPMG and WorleyParsons);

n. Evaluation Committee: Expressions of Interest (which included representatives from Treasury and the financial advisers); and

o. Evaluation Committee: Binding Bids (which included representatives from Treasury, the financial advisers and Baker & McKenzie).

4.37 The following table illustrates the governance structure of the Energy Reform Project.
Table: Governance structure of the Energy Reform Project

GOVERNMENT

RESPONSIBLE MINISTER (MINISTER FOR FINANCE THEN THE TREASURER)

STEERING COMMITTEE INCLUDING REPRESENTATIVES FROM TREASURY, DEPARTMENT OF PREMIER AND CABINET AND DEPARTMENT OF WATER AND ENERGY (WHICH LATER BECAME THE DEPARTMENT OF INDUSTRY AND INVESTMENT)

FINANCIAL ADVISERS

LEGAL ADVISERS

PROBITY ADVISER

ACCOUNTING AND TAX ADVISER

ENGINEERING AND ENVIRONMENTAL ADVISER

IT ADVISER

ENERGY MARKET ADVISER

FINANCIAL MODELLING ADVISER

GENTRADER WORKING GROUP

GENTRADER SEPARATION WORKING GROUP

COSSBOA WORKING GROUP

COMPETITION AND CSP WORKING GROUP

EMPLOYEE ISSUES WORKING GROUP

GENERATION EMPLOYEE CONSULTATIVE WORKING GROUP

RETAIL EMPLOYEE CONSULTATIVE WORKING GROUP

SALES PROCESS AND DOCUMENTATION WORKING GROUP

SMELTERS WORKING GROUP

TRANSACTION CO-ORIGATION WORKING GROUP

TRANSITION WORKING GROUP

VENDOR DUE DILIGENCE COMMITTEES

EVALUATION COMMITTEE: EXPRESSIONS OF INTEREST

EVALUATION COMMITTEE: BIDDING BIDS

RETENTION VALUE WORKING GROUP
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Deciding on the gentrader model

5.1 As noted in Chapter 4, on 28 August 2008, the Government decided to proceed with the sale of electricity retail assets and development sites, which it had been advised could proceed without legislation.

5.2 On 2 September 2008 the Treasurer reported that the failure to legislate was regarded by Standard & Poor’s as adversely affecting the State's credit rating. On 28 August 2008, Standard & Poor’s had put NSW on credit watch and had revised their outlook to “negative”.

5.3 Standard & Poor’s said:

[The sale of the assets was an important factor underpinning the ‘AAA’ rating because it provided flexibility to manage infrastructure priorities to maintain state competitiveness and satisfy electoral needs;

...the ratings may be downgraded one notch to AA+ if the government fails to re-prioritise its capital program.

5.4 The impact of the State’s inability to grant long-leases of the generators was twofold: first, it could not realise the value of the generators; and secondly, unless it could devise another solution, it would be required to fund substantial investment in electricity generation (as predicted by Professor Owen). Accordingly, the Government proceeded to consider non-legislative options which would fulfil the recommendations of the Owen report.

5.5 Credit Suisse and Lazard were asked to co-ordinate a report on the strategic options which remained available to the Government to sell the assets in accordance with its objectives. In their report dated October 2008, they considered the following options for proceeding without the need for enabling legislation:

a. public-private ownership or joint venture;

b. gentrader model;

c. long term power purchase agreement;

d. sale of retailers;

e. sale of development sites; and

f. public market listing or initial public offering (IPO).

5.6 The financial advisers identified two issues which they considered would be to the detriment of the State if the Government adopted the gentrader model:

a. the market appetite for gentrader could reasonably be expected to be less than that for a long-term lease of the generators and therefore there was a substantial risk that there would not be sufficient demand for 12,500 MW of capacity (the combined capacity of the SOC generators) and that all the gentrading agreements would not be entered into. It could be expected that the potential purchasers of the gentrading rights would be likely to be retailers, who already participated in the NEM, who would want generation
trading rights to hedge their market risk, rather than portfolio generators who might be interested if the generators were available for sale or long-lease. They considered that it was unlikely that there would be a new entrant if the gentrader model was adopted; and

b. there were difficulties associated with risk allocation and that one could not, under the gentrader model, fully pass the risk away from the State.

5.7 In 2007, Morgan Stanley had advised the Government that, when compared with the option of selling the assets, entering into generator trader contracts was far less attractive for similar reasons to those stated by the financial advisers in 2008.

5.8 On 31 October 2008, the Government agreed to a proposal which involved outsourcing the trading rights of the SOC generators to the private sector. The proposal was seen as a solution to the problem created by the withdrawal of legislation and as an alternative (though sub-optimal) way of implementing the Owen Report recommendations. The Government was advised that there had been recent informal discussions with key industry players evidencing "strong support for the generation trader proposal as well as a high level of interest in participation".

Views on the decision to proceed with the gentrader model

5.9 There was general consensus, in evidence given to the Inquiry, that it was not as advantageous for the State to sell the gentrading rights of the generators, as selling them outright or as had been proposed in the draft legislation granting long-term leases of the generators.

5.10 Both former Treasurer Roozendaal and former Minister Daley said to the Inquiry that the gentrader model was the next best option available to the State, in light of Professor Owen’s recommendations.

5.11 Former Treasurer Roozendaal told the Inquiry of the importance of the AAA rating to the State. He regarded it as a signal to business in terms of future investment as to the creditworthiness of the State. He said that it demonstrates how fiscally responsible the Government is in terms of the way it runs its $58 billion budget. He also adverted to the consequences for borrowing costs if there is a loss or downgrade on the credit rating.

5.12 Former Treasurer Roozendaal also said to the Inquiry that concern about maintaining the AAA rating was not the only reason for the adoption of the gentrader model. He gave two further reasons: first, that it was undesirable for the State (through its SOCs) to be engaging in a risky, volatile market such as electricity generation when they have to compete through the NEM with the private sector, and secondly, that because of the need identified by Professor Owen for investment in electricity generation it was “most desirable to shift the future responsibility of building future power generation to the private sector”. He said that if capital expenditure had to be made by the State, it would come at the cost of capital expenditure in other areas. He said that it was “a desired outcome for the people of NSW not to be liable for that future capital expenditure for generation and to get out of the business of generation.”
5.13 The Inquiry asked former Minister Daley whether, in so far as he was aware, any thought was given by the Government to putting the sale on hold and hoping that legislation could be passed in the future which would authorise their sale or long lease. He answered as follows:

No. It was such a rauous time for the Labor Party that we had well and truly, I think, arrived at the position where we knew that there was no chance of us getting the full transaction as we wanted it through the Parliament, and then we were still faced with this time line from Professor Owen's report that by 2013 or 2014 new baseload power stations would have to be built, and we were not in a position - we didn't want to be in a position where we had to find $15 billion to build power stations and to retrofit power stations, when the private sector could do it. That would not be a wise investment on the part of the Government. So we either did nothing, in which case, I think we would have been grossly derelict in our duty, or we proceeded with the next best option, which is what we did.

5.14 Former Minister Tripodi told the Inquiry that he formed the view that the gentrader model was feasible.

5.15 Mr Cosgriff said to the Inquiry that the implications of the withdrawal of the legislation were that the rating agencies assumed that the State's capital liability had increased by up to $15 billion (being the figure that Professor Owen had identified as being required for capital investment in generators and retailers). Mr Cosgriff said to the Inquiry that there was a general appreciation (shared by the Government and its advisers) that the gentrader option was very much the second-best, but that it was, once legislation had been withdrawn, the only available option.

5.16 Mr Price said to the Inquiry: "I don't want to shy away from the fact that the gentrader is, I think the term was, 'suboptimal'. It appealed to a much narrower audience. There is no doubt about that."

5.17 Mr Leyden and Mr Lobb said to the Inquiry that, of the options they had identified (which are referred to above), the gentrader option was the only one which fulfilled Professor Owen's recommendations.

5.18 Dr Gellatly was asked by the Inquiry what advice he would have given, had he been asked to advise the Government in September 2008 whether it should pursue the gentrader model or try to persuade Parliament at a later time to pass the requisite legislation to authorise a long-term lease of the generators. He said:

You know, that is a pretty big call, and that is because of the political realities about it. The Government ended up in gentrader because of the political situation with lemma and all that sort of stuff and the legislation. I think I wouldn't like to have put myself in the position where I was advising solely on that. In any of those big decisions like that, there needs to be a whole range of advice that goes in, the department, and there's the political aspect of it, the financial, economics and the electricity industry. I wouldn't have held myself out as being able to say 'Definitely do this' or 'Definitely do that', even in hindsight.

5.19 Mr Everett, the General Manager, and from July 2010 the Chief Executive, of Delta, said to the Inquiry that he made representations on behalf of Delta to Treasury to the effect that the gentrader model was "the wrong model". When
the model had previously been considered by the Government, Delta had sent two of its senior staff to Alberta to see what the experience there had been. He said that Delta’s view was that the gentrader model was likely to be productive of substantial legal disputes because it was difficult to capture within a legal document all of the activities that occur in a power station. He also considered there to be a poor allocation of risk in that he thought that the generators bore greater risk than the gentrader.

5.20 Mr Everett said to the Inquiry that Delta had made submissions to Treasury to the effect that one could write long term contracts between the generators and the retailers, which would effectively transfer value to the retailers and make the transaction simpler.

5.21 The Inquiry was told by representatives of TRUenergy that although its preference is to own and operate assets, its prior experience with a gentrader agreement in Victoria (known as the Ecogen contract) meant that it was familiar with the gentrading concept and was therefore “not put off when the gentrader model was announced by the New South Wales Government”.

5.22 Representatives of International Power (Australia) Pty Limited, a bidder for some of the assets, said to the Inquiry that it made representations in mid 2009 to the Treasurer and the Minister for Finance that the gentrader model was “high risk” and that there was a “high risk of failure”. It also told the Government that it was unlikely to attract a new entrant.

The Energy Reform Strategy

5.23 On 1 November 2008, the Premier announced that the Government would proceed with an Energy Reform Strategy which consisted of four main elements:

a. the sale of the retail businesses;

b. the sale of development sites;

c. contracting out of Government-owned generation; and

d. retention of Government ownership of the network and transmission infrastructure.

5.24 Work was done to refine the Energy Reform Strategy in the period until 5 March 2009, when the Government considered and approved the following key elements of the strategy:

a. a project implementation plan and transaction timetable, which provided for substantial completion of the transactions by the end of 2009, subject to market conditions;

b. for the majority of gentrader contracts at the power station level, a duration of 15 - 20 years; and

c. the adoption of a simultaneous or sequential sales process, or a hybrid of these.
5.25 The Government strategy paper, "Defining an Industry Framework", was published in March 2009 and set out the features of the gentrader model, including the risk allocation between generator and gentrader and the proposed key provisions of the gentrader contracts.

5.26 One of the terms included in the list of key provisions was the following: "Co-insurance: Each power station will have a co-insurance contract with every other power station to manage the firmness of risk of their gentrader contract."

5.27 The co-insurance proposal had been developed by Frontier Economics and propounded to the Government in late 2008 as a way of enhancing the gentrader model. Mr Price saw the co-insurance arrangement as a way of increasing competition in the market. He told the Inquiry:

To try and get a competitive market to try and encourage new entrants, one way of doing that was to break up the existing three generation portfolios, and they were big portfolios by National Electricity Market standards.

5.28 Mr Price explained:

Generators tend to try and manage their risk. Every time you have a contract in place, it increases the risk of something called unfunded difference payments; that is, if I have a financially firm contract and if I don't run in respect of that contract and the price goes above the strike price of the contract, I have to take money out of my pocket to fund a contract payment. It can send you broke very quickly. So one way that the generators - in fact it is the preferred way - manage this risk is by selling fewer contracts. But you can see immediately that selling fewer contracts creates an issue for revenue stability for any generator particularly a small generator that has just entered into the market. So if you want to break up these generators from three into five and you create this problem of each generator now withdrawing even more contracts from the market to try and manage these sorts of unfunded difference payment risks, what you will do is you will significantly reduce the supply of contracts to the market.

The effect on the SOCs of the lack of enabling legislation

5.29 One consequence of the adoption of a non-legislative model was that the SOCs themselves would be required to execute the transaction documents. The Government sought advice from a Queen's Counsel as to how best to effect this under the provisions of the SOC Act. The Queen's Counsel advised that, of the powers available to the Portfolio Minister, s. 20N was the more apposite, since, the alternative, s. 20P, required the Minister to be satisfied that there were exceptional circumstances and it was arguable that the circumstances would not meet this description. The process surrounding the giving of a s. 20N direction was later explained by Mr Saxon to the directors of each SOC at a meeting of each board. Chapter 9 discusses these provisions in more detail.

5.30 The Government expected that when it came to the final decision-making, the SOCs would have comparatively little time in which to reach a judgment about whether to proceed with the transactions. Without legislation, the Government was relying on the direction powers under the SOC Act. It was contemplated that the direction powers would have to be activated after receipt and evaluation of the bids, and any post-bid negotiation had been completed. These decisions would involve some matters which were germane to individual SOCs but others that would be irrelevant to the board of a particular SOC.
Once the bids had been evaluated and any post-bid negotiations had been conducted, it was expected that the Steering Committee would make recommendations to the Cabinet Committee, which would be the final arbiter of the process.

5.31 This process meant that the Government proceeded on the basis that there was no utility in disclosing the bids or the post-bid negotiations to the SOCs until after the proposed transactions with the successful bidders had been approved by the Cabinet Committee. There was also the consideration, from the bidders’ point of view, that they would be listed companies which would need to put their shares into a trading halt once the transaction had been approved in principle but the transaction documents had not been executed. There was a concern that the bidders would not stand behind their post-negotiation bids if the process was unduly extended.

5.32 The issues referred to above made it very unlikely that the boards of the SOCs would have much time to assess the transactions. Hence, the transaction strategy, as far as Mr Saxon was concerned, was to brief the boards of the SOCs as much as possible about the transactions, including the gentrader model, in advance of the final decision whether to execute the transactions. Mr Saxon identified the outstanding key integers of the transaction (to which the SOC boards would be privy when the transaction had been approved by the Government) as: the buyer, the price and whether there were any final changes to the contracts since the board was last briefed on the matter.

The period from 17 March 2009 to 30 November 2009

5.33 From the first meeting of the Steering Committee following the Government’s decision to implement the gentrader option, Michael Schur, the newly appointed Treasury Secretary, occupied the position of Chair.

5.34 Mr Schur told the Inquiry that there were four main tasks to be completed under the auspices of the Steering Committee while he was Chair:

- a. the re-establishment of the Steering Committee which had been in abeyance since August 2008; reassembling the working groups, and appointing Chairs; getting a realistic timeframe and putting in place a structure where the working groups could begin, on a weekly basis, to report to the Steering Committee on progress;

- b. re-engaging with the ACCC (whose clearance would be required for the eventual transactions);

- c. conducting the international roadshow in April-May 2009 to generate bidder interest and inform potential bidders of the proposed sale transaction; and

- d. finalising the strategy by making key decisions on matters including the following:

  i. the number of gentrader bundles;

  ii. how the transaction ought be executed (simultaneous, sequential); and

  iii. whether there should be an IPO, and if so:
whether the assets should be extracted from the trade sale, such that the trade sale and the IPO would run in parallel; or

whether the IPO should be a fallback option in case there were assets left over from the trade sale.

5.35 At the first meeting on 17 March 2009, the Steering Committee considered a report prepared by Credit Suisse dated 16 March 2009 which outlined the tasks which needed to be performed to implement the revised strategy, and the use, if any, that could be made of the tasks which had been done previously.

5.36 Because there was no change to the Government’s intention to sell the retail businesses, the work that had previously been done to prepare the businesses for sale needed only to be continued or updated.

5.37 However, the substantial change in sales strategy, from granting a long-term lease of the generators, to retaining ownership of the generators but transferring their generating capacity, occasioned significant additional work and meant that some of the work that had already been done regarding the leases of the generators was rendered futile.

The timeline

5.38 At its meeting on 17 March 2009 and subsequent meetings, the Steering Committee considered an implementation timeline and the risks to the then current timeline. Emissions trading was considered to be a risk since it was regarded as desirable that the emissions trading legislation, or imposition of a carbon price, had been passed before bids were required to be made. Uncertainty about that matter was thought to affect the price for which purchasers would bid for the gentrading contracts, and it was expected to lead to some discounting in value. The prospect of a carbon tax also had to be factored into the retention price of the generators, since it was to be expected that the carbon price would inevitably diminish their net profits, and accordingly their retention value.

5.39 In March 2009, the Steering Committee and those advising it expected that all transactions could be signed and approved by December 2009. There were draft timelines to this effect. That this expectation was misplaced was largely due to the time taken to draft the gentrader agreements and issues associated with the gentrader agreements. By June 2009 it became apparent that the finalisation of the terms of the gentrader contracts would take a considerable time and that there would be substantial work required to split Delta into Delta Coastal and Delta West.

The sales promotion

5.40 In April 2009, the Minister for Finance, and representatives of Treasury, the Department of Water and Energy and the financial advisers (Credit Suisse and Lazard) conducted presentations designed to interest potential purchasers in the Energy Reform Strategy. The purpose of the roadshow was expressed, by the financial advisers, to be to “demonstrate the Government’s commitment, build rapport with bidders, and raise awareness of the investment opportunity”.
5.41 Importantly, for the purposes of the recommendations made by Professor Owen, the Government emphasised in its promotion of the gentrader model that it intended to contract all of its electricity trading capacity to the private sector. The explanation of the gentrader model in the roadshow informed the audience that the gentrader would be required to make fixed capacity payments to the generator and pay for fuel and, in return, it would be able to trade the capacity of the generator and receive revenue from the NEM. The gentrader would be subject to the risks and rewards of the NEM and would be responsible for arranging its own hedge contracts (to offset those risks) and fuel supply contracts. The gentrader would also be responsible for any emissions permits required, including those in relation to greenhouse gas emissions. A graph was shown which depicted the relative emission intensity of the three SOC generators, and indicated that they compared favourably with brown coal from Victoria and South Australia, both of which have a higher greenhouse emission intensity than the black coal mined in NSW.

5.42 Those who saw the roadshow were informed that the Government had not yet decided:

a. how to package the gentraders (for example whether a gentrader contract would be offered in respect of each of the nine generators, or whether they would be offered by reference to the portfolio of each SOC generator, or in some other combination);

b. whether the transaction process would be sequential or simultaneous; and

c. whether the gentrader agreements would be offered in a combined process with the retail businesses.

5.43 The audience for the roadshow was informed that the Government would make those decisions by May 2009, invite Expressions of Interest in June-July 2009 and expected to complete the transactions by the end of 2009.

5.44 The team met with potential investors in Australia, South-East Asia, China, Japan, Korea, the Middle East, Europe, the United Kingdom, Canada and the United States. Detailed meeting notes were prepared of the 30 meetings with potential investors and letters were sent to each organisation with whom the team had met.

The structure of the sale transaction: simultaneous or sequential, the number of gentrader bundles

5.45 As at 17 March 2009, no decision had yet been made as to how the various assets (gentrader agreements, retail businesses and development sites) were to be offered for sale.

5.46 The principal decision to be made was whether the transactions were to be simultaneous or sequential. As its name implies, simultaneous transactions gave bidders the opportunity to bid for several assets within a particular timeframe. By contrast, sequential transactions involved the selling of one or more assets or bundles (for example, one gentrader and one retailer) at a time. The benefits of the former were thought to be that each bidder could work out the best combination of assets for its purposes, and (potentially) bid a higher
price for that privilege. However, the latter was thought to be substantially less complicated and would tend to produce greater bidder tension, particularly if the ‘best’ assets were offered first.

5.47 Under each alternative, it was proposed that there be an initial stage whereby prospective purchasers would submit Expressions of Interest. There would then be an evaluation of those Expressions of Interest to identify those persons who would be entitled to have access to the bidder data room, for the purposes of determining whether they wished to submit a bid, in what amount and on what conditions.

5.48 The need for a decision to be made on the structure of the sale was considered over a period by the Steering Committee and its advisers.

5.49 The Steering Committee held a full-day strategy meeting on 10 June 2009 at which it was intended that the information obtained from the market testing which had been done in the course of interviews with potential bidders and others, and responses received during the international roadshow, would assist the Committee to make decisions on the principal strategic decisions, including the following:

a. whether the sale ought be simultaneous, sequential, or a combination of both;

b. if the sale was sequential, what assets or combination ought be offered first;

c. whether the gentraders should be offered on a plant or portfolio basis (or any other basis);

d. whether retailers and gentraders should be packaged together and, if so, how;

e. how development sites should be offered (packaged with retailers or gentraders or separately); and

f. whether the process should incorporate an indicative bid (one-stage vs two-stage).

5.50 The advisers were required to prepare papers to be considered as part of the strategy meeting. In relation to issues, (a) and (b) above, Frontier Economics was required to prepare a paper. The principal arguments advanced for a simultaneous auction were:

a. the value to particular bidders of synergies between existing State owned assets depended on the bidder’s own attributes, which tended to be known only to the bidder. Therefore it made sense to leave as much freedom to bidders to determine the composition of the assets they wished to acquire;

b. the State was not in as good a position as the bidders to devise a configuration of assets that would elicit the highest price from each bidder; and
c. the price tension that would arise through a more traditional sequential sale process could be replicated through multi-round bidding whereby the results of the first round are revealed to other bidders before a subsequent round commences.

5.51 Lazard was required to prepare a paper which addressed the advantages of a sequential auction and which covered details of, and a rationale for, the order, sequence and packaging of the various retailers, gentrader contracts and development sites.

5.52 The principal arguments advanced by Lazard for a sequential sale were:

a. Lazard’s sale experience indicated that there was clear benefit in establishing a strong price signal by offering the ‘crown jewel’ assets first, since this would tend to engender confidence in the model to other bidders/market participants;

b. some potential bidders may have concerns with the simultaneous process, including the cost of conducting due diligence on all businesses before bidding or obtaining any price signals and the uncertainty about whether the highest bid would succeed (having regard to the Government’s objectives across all assets); and

c. it was consistent with the way in which the Victorian privatisation was conducted.

5.53 In this way there was, by design, a proponent for and a contradictor against each of the two main sale strategy options.

5.54 Treasury’s preference accorded with the advice given by Lazard. Mr Schur said to the Inquiry that his starting point was what was proposed to be done under the original transaction (long-lease of generators enabled by legislation, sale of retail businesses and development sites), which he described as being “a lot less complicated”. The original proposal was to sell EnergyAustralia together with a generator such as Macquarie Generation or Delta, followed by a trade sale of the assets that were not part of the IPO vehicle (which vehicle comprised Eraring and Integral). Mr Schur said that his reasoning was based on first principles: if this was the process that was adopted in a better economic environment with a less-complicated model, it should form the basis of the approach to be taken in a worse economic environment with a model that was more complicated because it included the gentrader agreements.

5.55 Mr Schur also preferred to give greater weight to the views of Lazard on this matter. He told the Inquiry: “My preference was to say let’s take market advice from a market consultancy and let’s take transaction execution advice from our financial advisers...”. He was also concerned that if there was going to be an IPO, the IPO assets needed to be extracted from the trade sale and transacted separately because there would be insufficient time before the election to have

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152 Mr Jackson, the managing director of Eraring, said to the Inquiry that in 2008, there was thought to be a good match between Eraring’s generation capacity and Integral’s customer size. A new vehicle was proposed which would combine the two entities and be subject to an IPO. In the six to nine months leading up to August 2008, a substantial amount of work was done to create a single entity. But when the legislation was withdrawn this work was undone and Eraring and Integral reverted to their original positions as two single, non-vertically integrated entities.
a trade sale, and then a subsequent IPO. He was also concerned that any IPO after a simultaneous process would be tainted with the stigma of a failed trade sale.

5.56 If a sequential sale process was followed, and initial asset sales did not result in a new entrant, Mr Schur regarded a subsequent IPO as the only way of guaranteeing a new entrant. He considered that the IPO should be conducted with Eraring and Integral because they were the assets thought to be of the least value and therefore the discount which occurs with IPOs would be less material than if more valuable assets were included. He said that it would be unlikely that Origin, AGL or TRUenergy would acquire an IPO asset and that it was more likely that a private equity firm would be interested in such an asset. Mr Schur also thought that if there was a sequential sale, with Macquarie Generation offered first, the market (including private equity firms) could gain confidence in the gentrader model if a listed company entered into the gentrader agreement.

5.57 Credit Suisse prepared a paper for consideration at the strategy meeting on the feasibility of an IPO of combined gentrader and electricity retailers. This option was considered only if it was thought likely that the ACCC would block some of the transactions, or there was likely to be insufficient bidder interest to auction all the electricity trading rights and retailers in a competitive way.

5.58 Mr Schur said that there was tension between market structure (which fell within the expertise of Frontier Economics) and transaction execution (which was within the expertise of the financial advisers). Mr Schur said to the Inquiry that this difference in perspective was also manifested in the issue of the number of gentrader bundles. As addressed in more detail below, Frontier Economics expressed a preference for five (on the grounds of market structure); whereas the financial advisers and Treasury expressed a preference for four on the grounds that it diminished the likelihood of stranded assets and was thought to provide better prospects of maintaining value for the State.

5.59 In relation to the issue of bundling, Lazard prepared a paper outlining what they considered to be the three practical alternatives. The alternatives were:

a. three bundles (by portfolio: Macquarie Generation (4700 MW), Delta (5000 MW) and Eraring (2940 MW));

b. four bundles (Macquarie Generation as a whole, Eraring as a whole and splitting Delta into Delta West (2400 MW) and Delta Coastal (2600 MW)); and

c. five bundles (as for four, but also splitting Macquarie Generation into Bayswater (2700 MW) on the one hand and Liddell (2000 MW) on the other).

5.60 Mr Leyden observed that bidders had expressed a preference for flexibility in what they could acquire and considered that some bidders would be put off by the size of portfolios (if they were sold purely by portfolio). Mr Leyden explained to the Inquiry that Lazard recommended that there be four gentrader bundles, rather than five. Treasury agreed and considered that there would be more competitive tension with four, rather than five. Furthermore, four bundles
would leave only one gentrader bundle that could not be hedged with a retail business, whereas five would leave two. Treasury was confident that the ACCC would grant merger clearance to four, as long as there was a new entrant. Frontier Economics preferred that there be five bundles. Mr Leyden said that there was “robust debate” about the number of gentrader bundles.

5.61 Following the Steering Committee’s strategy meeting on 10 June 2009, Lazard prepared a draft note dated 12 June 2009, which set out its recommendations regarding the sale process. Frontier Economics then prepared a document which set out its comments on Lazard’s document. In particular, the pros and cons of bundling the gentrader contracts were addressed.

5.62 Although Treasury and the financial advisers would have preferred a sequential rather than a simultaneous sale, none of the witnesses considered that one could say with any degree of certainty that the decision to sell the assets simultaneously affected the bids received.

5.63 Mr Cosgriff, who was persuaded by the arguments of the financial advisers that sequential sale was preferable, explained to the Inquiry that he thought that the closed auction simultaneous process was a “perfectly plausible and reasonable approach, particularly in a world where you have the fallback of doing an IPO so that you can deal with the new entry issue through the IPO”.

5.64 Mr Timbs told the Inquiry that for an IPO to be a legitimate fall-back option, it would have been necessary for there to be a completed trade sale process by June 2010 at the latest.

5.65 Some witnesses observed that, in the events that happened, the Government ended up with a sequential process since not all of the assets were sold. However, by the time the simultaneous process had ended, there was insufficient time to do an IPO before the election in March 2011. Mr Dimpfel observed that this may have affected the outcome, since it may have provided the opportunity to sell more assets, and also would, if successful, have achieved the objective of attracting a new entrant to the market.

5.66 Mr Dimpfel considered that the disparity between the timeline foreshadowed during the course of the roadshow (which envisaged execution of the transactions by the end of 2009) and what actually occurred, affected the credibility of the process on the way through, although (subject to the question of an IPO) he did not think that the delay and disparity affected the outcome or that there would have been any more bidders if the original timetable had been met.

5.67 In June 2009, the Steering Committee considered a number of papers prepared by its advisers on a transaction strategy which would involve a simultaneous auction whereby bidders would be eligible to qualify to participate in the auction process through a detailed (non-price) Expression of Interest. Bids for all assets would be invited at the same time and bids would be sealed envelope bids with confidential prices, so that an individual bidder would not know what other bidders were bidding. The Steering Committee considered options that would need to be implemented if all the assets were not sold at auction.
The Steering Committee requested that Credit Suisse prepare a paper for discussion on stranded asset risk and potential value discount, since Frontier Economics argued that a simultaneous transaction would avoid the value discount associated with the stranded asset risk in a sequential process. There was also concern that Origin, AGL and TRUenergy, retail businesses which might be interested in gentrading agreements to give them vertical integration, might neither want nor need the generation capacity of a whole SOC generator.

In a draft paper dated 3 July 2009 Credit Suisse argued that it would be better to get a single gentrader/retailer transaction executed that year, than delay the sale process by a further year because of the substantial further work required if the transactions were to be simultaneous. Credit Suisse argued that an imminent transaction of major assets would constitute a more convincing signal to the private sector that the Government had a firm intention to exit the electricity market, than would the delay occasioned by a simultaneous transaction.

Credit Suisse also prepared a paper, dated 3 July 2009, for consideration of the Steering Committee on steps which could be taken to encourage a new entrant. Credit Suisse used this opportunity to reiterate its concern that the complexity of a simultaneous transaction might discourage new entrants. It considered that the Government should announce an intention to conduct an IPO of Integral and Eraring at the end of the process to ensure that the objective of there being a new entrant would be met.

The Steering Committee considered that the Government should preserve the flexibility to conduct an IPO if it was necessary to ensure that all gentrader capacity was transferred to the private sector. Consideration was also given to what approach ought be adopted if all development sites were not sold. The Steering Committee considered that in that event, the Government ought maintain those development sites on the market and make them available to the private sector in the future.

Ultimately, the Government decided that the sale transactions would be conducted simultaneously: namely that all gentrader contracts, all retail businesses and all development sites would be offered for sale and that bids would be invited for whatever combination of assets the bidders choose to bid for. It also decided that five gentrader bundles would be offered, although this was subsequently revised to four, when the ACCC declined to authorise co-insurance. It reserved the right to offer particular assets as part of an IPO if the trade sale process did not fulfil the Government’s objectives.

Although Mr Schur’s preferences for a sequential sale and four rather than five bundles did not prevail at this stage, he told the Inquiry: “it is impossible to say for certain whether we would have got a very different outcome if we had done it differently.”

In September 2009, the Government agreed to proceed with the NSW Energy Reform Strategy in accordance with the approach detailed in a 47-page document, which was published in September 2009, entitled “Delivering the Strategy: approach to transactions and market structure”. The document disclosed:
a. the design of the gentrader contracts including the number and size and the risk allocation;

b. the retail businesses that would be sold and the transition services agreements that would be part of the transaction; and

c. the generation development sites that were to be offered for sale.

5.75 The document foreshadowed that Expressions of Interest would be invited from the end of September 2009 for about six weeks, following which time they would be assessed. It was envisaged that the bidder data rooms would be open for potential bidders from early February 2010.

The gentrader agreements

The Steering Committee and Gentrader Working Group

5.76 The gentrader model was, necessarily, substantially more complex than a long-term lease authorised by legislation would have been. It required consideration to be given, in the first instance by the Gentrader Working Group, then by the Steering Committee, followed by the Cabinet Committee, to the allocation of risks between the SOC and the gentrader. Consideration also needed to be given to the consideration payable under the gentrader contract, how and for what capacity it would be paid and what penalties, if any, would be provided for a failure to provide the promised capacity.

5.77 This, in turn, required technical due diligence on the capacity of each of the nine generators which would be subject to the gentrading arrangement so that a realistic assessment could be made for the purposes of the agreements. Given that the State envisaged that the generators would, after sale of their generating capacity, remain cost-recovery units, the Steering Committee thought it desirable that the operational expenditure (opex) and capital expenditure (capex) be forecast with sufficient accuracy so as not to leave the State exposed to a divergence between its actual costs and the periodic payments made by the gentrader which were designed to cover such costs.

5.78 The Steering Committee envisaged that the future fixed and variable costs of operations and maintenance as well as ‘stay in business’ capital expenditure would be defined in the gentrader agreements so that bidders would not need to have any insight into the existing or future cost structure of the generators.

5.79 It was necessary for a decision to be made whether there would be cost re-openers after a period (for example, five or ten years), or whether these charges would increase by reference to external indices. Treasury and the financial advisers favoured the former. Frontier Economics prepared a paper on this topic for the Gentrader Working Group in which it recommended the latter option. Frontier Economics’ recommendation was ultimately accepted by the Steering Committee and the Government.

5.80 Hedge and fuel contracts to which the SOCs were party also needed to be transferred to the gentrader as part of the transaction.

5.81 Discussion papers were prepared by members of the Gentrader Working Group, for consideration by the Steering Committee on various aspects to be
determined before the gentrader agreements could be finalised. Such papers included the following:

a. Frontier Economics prepared discussion papers on: interactions of generation facilities; coal contract allocations; water contract allocations; hedging contract allocations; contract firmness, co-insurance; contract payments; whether the capacity charges should be subject to re-openers, or whether their increase would be governed by external indices; the size of the contracts (how many generators would be offered together); the penalty regime; and the contract duration;

b. Lazard prepared a discussion paper on guarantees that would be given by the State to the SOC generator;

c. Treasury prepared a discussion paper on how non-market, non-scheduled generation\textsuperscript{153} would be treated; and

d. Freehills prepared a discussion paper on performance default and force majeure.

The gentrader agreements: the role of the solicitors

5.82 It is apparent from the evidence of Messrs Saxon and Maguire that during 2009 until about July there was little involvement by solicitors in the implementation of the gentrader model or the development of the gentrader agreements.

5.83 Mr Maguire said to the Inquiry that in about July 2009 he received instructions to prepare a paper on the contractual architecture of the gentrader agreement. He said that, commencing in about late July, there was "an intensive month of workshops" between himself, Treasury and Frontier Economics.

5.84 On 19 August 2009, Messrs Maguire and Price presented a paper entitled "Contractual Architecture of Gentrader Model" to the Steering Committee. They recommended that individual contracts be prepared for each of the nine power stations (Bayswater, Liddell, Mt Piper, Vales Point, Munmorah, Wallerawang, Eraring, Colongra and Shoalhaven). The paper envisaged the following seven types of agreements for each of the nine power stations:

a. gentrader contract (the centrepiece gentrader contract between the generator and the trader dealing with all necessary arrangements relating to the trading and operation of the power station for the term specified, other than for the supply of the primary fuel for the station);

b. coal/gas on-sale agreements;

c. stockpile agreements;

d. Cobbora coal supply option agreement (this envisaged giving the gentrader the option of a long term coal supply agreement from the proposed Cobbora coal resource for supply to the power station, rather than imposing a commitment on the gentrader to purchase certain quantities of coal);

\textsuperscript{153} This dealt with electricity which was generated by the SOC generator but which was not required to go into the pool for the NEM.
e. hedge agreements (a master hedge agreement or separate hedge agreements between the generator and the trader that mirror and were ‘back to back’ with the hedges that the generator had in place with electricity retailers or other third parties at the time of commencement of the gentrader contract);

f. shared services agreements; and

g. co-insurance arrangement (multilateral co-insurance agreement between all generators and all gentraders, which ultimately became redundant when the ACCC refused to grant its dispensation).

5.85 The authors of the paper (Messrs Price and Maguire) said that they planned to complete the gentrader contracts (with the exception of the Cobbora arrangements) by January 2010, if certain pre-conditions were met. This time limit was not achieved, although draft pro forma agreements had been prepared by November 2009 and further drafts were prepared throughout 2010. Mr Maguire told the Inquiry that from the time he produced a pro forma gentrader agreement in late November 2009 little progress was made, from his point of view, until April 2010 when the responses of the SOCs had been obtained, although he received comments from the financial advisers in January 2010.

5.86 In January 2010, Baker & McKenzie was given a copy of the pro forma gentrader agreement for the first time and asked to review the document. The review role which had been assigned to Baker & McKenzie included seeking the views from senior management of the three SOC generators. Seeking these views took several months.

Other strategic and policy decisions relating to the gentrader agreements

5.87 There were several policy and strategic decisions which needed to be made concerning the gentrader contracts. Typically, the Steering Committee received joint reports from Mr Maguire and Frontier Economics which set out the various options and made recommendations as to the preferred option.

5.88 This process occurred, for example, with the options for coal supply. A report dated 15 September 2009, entitled “Gentrader Model Coal Supply Options Report”, set out four options by which it was open to the Government to transfer responsibility for fuel procurement and associated fuel supply risk from the SOC generators to the gentrader purchasers.

5.89 There needed to be a mechanism whereby the rights, risks, benefits, and obligations under the coal supply agreements to which the SOC generators were party could be transferred to the gentraders. The following four options were identified:

a. novation option: novation of existing coal supply agreements from the generators to the gentraders so that the gentraders ‘stand in’ for the generators (which would require the consent of all suppliers);

b. back-to-back option (existing coal supply agreements would be mirrored in back-to-back coal supply agreements between the generator and the gentrader);
c. aggregate option (the SOC generator agrees to provide the gentrader with a specified tonnage of coal equal to the aggregate of that due to it under the existing coal supply agreement; the generator is responsible for managing the deliveries from the existing coal supply agreements); and

d. ‘Energy Sale Option’ (the SOC generator agrees to deliver to the gentrader a certain level of energy, the sum total of the coal provided under existing coal supply agreements, at a pre-determined price per unit of energy, $/GJ).

5.90 The authors of the report recommended the Energy Sale Option because the implementation difficulties were fewer than with the other options. At its meeting on 6 October 2009, the Steering Committee noted and accepted the recommendation of the Gentrader Working Group that the Energy Sale Option was to be preferred.

**Protections to SOC employees**

5.91 The Government had offered a range of protections to electricity retail employees. For those who were offered, and accepted, employment with the new retail owner, the Government had committed to: a transfer payment; maintenance of current superannuation arrangements; transfer or cashing out of accrued annual and long service leave arrangements; recognition of continuous service for calculation of future long service leave accruals; and transfer of sick leave entitlements. For those employees who did not transfer to the new owner, the Government had committed to affording such employees the right to remain with their existing employer (the SOC, who would perform transitional services while required and run the distribution and network business). The Employee Issues Working Group recommended, by a paper prepared for the Steering Committee dated 6 August 2009, that the same protections be afforded to displaced generation trading and fuel purchasing employees.

5.92 On 31 August 2009, the Government approved the package of employee entitlements for affected retail electricity and generator staff. Treasury supported the recommendations which resulted in the approvals, subject to an amendment that the proposed longer employment guarantee would apply only to the Energy Reform Project and not to other privatisations such as lotteries. An approval which incorporated the amendment was granted.

5.93 Ultimately, successful bidders were entitled, but not obliged, to make offers to SOC employees. If award employees accepted the bidders’ offer of employment, the bidder was required to provide:

- **a.** a five year employment guarantee;
- **b.** maintenance of current superannuation arrangements;
- **c.** election to transfer or cash out accrued annual or long service leave entitlements;
- **d.** recognition of continuous service for calculation of future long service leave accruals and to calculate sick leave provisions;
- **e.** transfer of sick leave balances;
f. a guarantee of conditions and rates of pay for five years;

g. an employment contract which incorporated changes in current SOC award or collective bargaining conditions and rates of pay changes;

h. union consultation if the bidder seeks to vary the contract within five years; and

i. a transfer payment of up to 30 weeks pay.

5.94 All SOC employees who were affected by the transactions, had the option of remaining with the SOC, in which case they were entitled to:

a. a guarantee of employment, conditions and rates of pay for five years;

b. a contract of employment for award employees that incorporated any changes to the SOC award or collective bargaining conditions and rates of pay changes;

c. the right to remain in their current or nearby location for the five year period; and

d. union consultation in relation to variations of contract or superannuation arrangements.

5.95 The effect of these entitlements was threefold:

a. there was a strong financial disincentive to the private sector making offers to employees who had worked for the SOCs (which made it unlikely that many offers for transfer of employment would be made);

b. although the retail staff of the SOCs would be required to perform the transitional services for the retail purchasers pursuant to the transition services agreement, they would not be required for those services after the roll-off of those agreements; and

c. because there was little overlap between the skills of staff required for the retail and network arms of the business, there were likely to be a substantial number of employees who had worked in the retail arm of the SOC business who could not be gainfully used in the network business but who would still be entitled to remuneration in accordance with the terms and conditions set out above. This would inevitably increase the costs of the network business.

The sale of the retail businesses

5.96 In June 2009 the Steering Committee took advice from Credit Suisse, Lazard and Ernst & Young as to the financial information pertinent to retail bidders, which should be included in the bidder data room (which did not, because of the delay occasioned by the gentrader agreements, occur until 1 July 2010). The Steering Committee approved a process whereby the Information Memorandum for each retail business was to include four years of historical financial for the periods financial year 2006-2009 inclusive. Ernst & Young was
to prepare a vendor due diligence report on these financials which would be included in the bidder data room.

5.97 The Steering Committee considered whether the forecasts to be included by the SOCs in the Information Memorandum for their retail business was to include common assumptions about future spot prices, regulated retail prices and the cost of hedging the retail load following the Electricity Tariff Equalisation Fund (ETEF) roll-off\(^{154}\) or whether it was preferable for each SOC to choose its own assumptions as to these matters. The Steering Committee accepted the advisers' recommendations that forecasts for the purposes of the Information Memoranda should be prepared on the basis of the common assumptions. Frontier Economics was modelling future NEM prices as part of their work on developing the gentrader contracts and it was expected that their modelling could be used to determine some of the common assumptions. It was proposed that Ernst & Young would prepare a vendor due diligence review of the forecasts, which would be limited in scope in that it would not express a view on the pool price forecasts made by Frontier Economics. The advisers regarded the forecast vendor due diligence as being of some assistance to bidders, but not something that they could rely upon, since bidders would have to form their own views on the forecasts.

5.98 Because of the decision to perform forecasts on the basis of common assumptions rather than assumptions devised by each SOC, SOC directors were informed that they (as distinct from management) would not be asked to sign off on or assist with the preparation of any Information Memoranda prepared as part of the project or sign off on any financial information that would be provided to bidders.

5.99 Later, on 9 November 2009, the Steering Committee was asked to note that the common assumptions relating to future spot prices, regulated retail prices and the ETEF roll-off may no longer be required and that it would be preferable for management to be responsible for the assumptions that formed the basis for the forecasts. It was noted that retail is largely a margin-driven business, so absolute pool and contract price forecasts (such as those prepared by Frontier Economics for the gentrader forecasts) were of less relevance. The Steering Committee accepted the recommendation made by the financial advisers that the common assumptions would be limited to ETEF cover, ownership (business as usual) and Consumer Price Index. However, as set out in the final version of the Retention Value Report, consistent market price assumptions were ultimately applied to the gentrader and retail valuations.

5.100 In mid-2009 the Regulation Working Group reported to the Steering Committee on the subject of retail electricity price regulation and recommended to the Steering Committee that retail electricity price regulation should be extended until 2013. This involved the Minister for Energy issuing new Terms of Reference to IPART for a new determination which would apply from 1 July 2010 (immediately after the expiry of the previous determination on 30 June

\(^{154}\) In NSW, SOC retailers and generators participate in the ETEF which is a fund which is designed to smooth out the volatility of wholesale electricity pool prices between generators and retailers, as well as allowing SOC retailers to manage wholesale purchase price risk for regulated customer load. Standard retail suppliers are required to contribute funds to ETEF when wholesale pool prices are below the benchmark price and entitled to withdraw funds from ETEF when prices are above the benchmark price. If there is not enough money in the ETEF to pay retailers, generators have to replenish the fund (the generators are reimbursed when retail suppliers make payments to the ETEF). The then NSW Government announced that the ETEF will be gradually phased out from 4 July 2010 to 30 June 2011.
2010) until 30 June 2013. The Steering Committee approved this approach on the basis that it would tend to enhance bidder certainty.

5.101 The Regulation Working Group also recommended to the Steering Committee that the retailer of last resort (RLOR) arrangements be transferred to new purchasers or retailers. RLOR arrangements apply if an electricity or gas retailer is no longer able to supply electricity or gas to its customers due to a ‘RLOR’ event (such as if its retail licence is cancelled or it is suspended from participating in the NEM). The RLOR scheme ensures continuity of supply to the customers of such retailers by transferring such customers to the standard retailer for the relevant network. The scheme did not, in terms, apply to the retail businesses conducted by the SOCs, but since such retail businesses were to be transferred to the private sector, the Regulation Working Group recommended to the Steering Committee that an amendment to the relevant regulation would remove an area of bidder uncertainty even though it was unlikely to have an effect on the bid prices.

5.102 The Regulation Working Group also drew matters to the attention of the Steering Committee including that the statutory rules in their current form required written consent of the customer before the customer was transferred to a new retailer. An amendment was made to the statutory rules on the recommendation of the Steering Committee that such written consent not be required for any customer transferred to a new retailer as part of any transfer the subject of the Energy Reform Project.

5.103 The structure of the agreements for the sale of the retail businesses was the subject of various memoranda from the Sale Process and Documentation Working Group to the Steering Committee.

Sale of the development sites

5.104 Towards the end of 2009, consideration was given to the preparation of sale documentation for the development sites. Reports were obtained from both the Development Sites Working Group and the Sale Process and Documentation Working Group as to the key commercial terms which should be included in such transaction documents. The due diligence and information memoranda were completed for six of the seven development sites before Christmas 2009. The bidder data rooms were opened and contained these documents together with other information. The seventh development site (the Munmorah site) was not included; however it was expected that such documents would be likely to be finalised by the end of February 2010.

Liaison with the ACCC

5.105 In September 2009, the Government lodged a Competition Memorandum with the ACCC.

Evaluation of Expressions of Interest

5.106 At its meeting on 1 September 2009, the Steering Committee considered a paper dated 28 August 2009 which had been prepared by the Sale Process and Documentation Working Group on the Expressions of Interest Evaluation Criteria and associated procedures. The Steering Committee approved the criteria (experience and capability; financial capacity; preparedness for bid process; corporate and social responsibility; and compliance with process
requirements) and information requirements. The Steering Committee noted that the Treasurer and Minister for Finance would be responsible for approving the final Expressions of Interest documents, including the advertisements, the request for Expressions of Interest, the investment flyer and the Expressions of Interest Process and Selection Plan (which would include the criteria, information requests and scoring method).

5.107 The investment flyer set out the Government’s objectives, the procedure for expressing an interest and gave an overview of the market and a description of the assets for sale. It also summarised the terms of the gentrader contracts and set out historical financial and operating statistics for the retailers and the generators. It enumerated the billable connections for the retailers and classified them into categories: for electricity, NSW regulated, NSW contracted and other States contracted and natural gas, the latter only in the cases of EnergyAustralia and Country, since Integral had no gas customers.

5.108 At its meeting on 22 September 2009, the Steering Committee approved a budget of $75,000 for advertising the Request for Expressions of Interest. The advertisement was published as follows:


c. *The Australian* - 2 October 2009;


e. *The Wall Street Journal* (US) - 30 September 2009; and


5.109 On 28 September 2009, the Government released the Request for Expressions of Interest, including the Investment Opportunity flyer. The documentation set out the Expressions of Interest process, timelines, information requirements and proposed confidentiality agreement (for those persons who met the criteria to execute before being permitted access to the bidder data rooms).

5.110 The Steering Committee, in October 2009, approved a document entitled "Process and Selection Plan for Evaluating Expressions of Interest".

5.111 The deadline for submitting questions or seeking clarification on the Request for Expressions of Interest was 4 November 2009. The deadline for submission of Expressions of Interest was 1 pm on 18 November 2009. The plan required each member of the Evaluation Panel to read each Expression of Interest. The Chair of the Panel was responsible for drafting the evaluation report, which was to be reviewed by the Proby Officer. The Steering Committee was responsible for reviewing, and approving the Evaluation Report which would then be provided to a Cabinet Committee for final approval. Parties, both successful and unsuccessful, would then be notified.
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1 December 2009 to 30 June 2010

Evaluation of Expressions of Interest

6.1 Ultimately, on 8 December 2009, the Steering Committee endorsed the final evaluation report on the Expressions of Interest and agreed to recommend to the Cabinet Committee that 27 parties be invited to participate in the bid process and gain access to the bidder data room.

6.2 After signing a confidentiality deed in December/January 2010, short-listed bidders were provided with a sale process letter which set out the time line envisaged for bidder due diligence, including the following key dates:

   a. retail data rooms and information memoranda by the end of January 2010;

   b. development sites visits and management presentations: February 2010; and

   c. binding bids for all assets by June 2010.

6.3 No dates were given for the gentrader data rooms but the June final bid date implied that the gentrader data rooms would be available by late March 2010.

6.4 However, it soon became apparent that the gentrader data rooms would not be open until at least the middle of 2010. Indeed, on 18 February 2010, the Government announced that it expected all transactions to be completed later in the year. In order to maintain bidder confidence in the sale process, the Steering Committee approved a letter to be sent to all short-listed bidders informing them that they would be contacted once more specific dates for the opening of the retailer and gentrader bidder data rooms were available.

6.5 The Expressions of Interest Evaluation Panel was called on again in 2010 to consider late expressions of interest by potential bidders who wished to be allowed access to the bidder data room. The same criteria were applied as had been applied in 2009 and a recommendation made to the Steering Committee as to whether the applicant ought be invited into the bid process, or declined access.

Finalisation of the sales strategy

6.6 In March 2010 the Steering Committee received a report from the joint lead financial advisers regarding the preparation for, and timing of, a potential IPO. The report concluded that the completion of an IPO prior to calendar year end was not feasible given the lack of time and that, to meet this timetable, the IPO would need to be launched before the outcome of the trade sale was known, which would be undesirable. Thus although the Government expressly reserved the right to conduct an IPO if the trade sale did not meet the Government's objectives, this did not ultimately occur.

6.7 Dr Gellatly told the inquiry that there was some preliminary work done on an IPO and that it was always envisaged that the IPO would involve one gentrader and one retailer. Although there had been some discussion about whether it was feasible to do an IPO with a single gentrader, Dr Gellatly's impression was that the general consensus was that it was not.
Consideration of the bid evaluation process

6.8 On 28 April 2010, the Steering Committee was provided with an overview in a draft paper of the proposed mechanics of the bid process. It agreed that the probity advisers should consider the bid process paper from a probity perspective and report to the Steering Committee. At the same time, Credit Suisse was asked to prepare a report listing policy issues from the bid process paper, which would be designed to facilitate discussion of which policy issues required approval from the Cabinet Committee and which could be determined by the Steering Committee itself.

6.9 Following discussion at the meeting of that report, the Steering Committee requested Credit Suisse to refine the list and distribute the final bid process paper. At the following meeting, on 19 May 2010, the final bid process paper was circulated and reviewed and endorsed by the Steering Committee.

6.10 It was proposed that there be an initial assessment of bids, irrespective of price, according to certain pre-determined mandatory threshold criteria. Bids that failed the test would not be further assessed by reference to the price offered.

6.11 On 23 June 2010, the Government approved the following mandatory threshold criteria which had been recommended by the Steering Committee:

a. experience and capability:

i. for retail assets, this requirement focussed on capacity to obtain a retail licence and compliance with consumer protection obligations. Instances of non-compliance were required to be disclosed where significant fines or other regulatory sanctions had been applied;

ii. for gencarrier assets, this requirement focussed on access to electricity trading and fuel procurement expertise. Instances of non-compliance with relevant market regulations were required to be disclosed where significant fines or other regulatory sanctions had been applied;

iii. for development sites, this requirement focussed on project development expertise and compliance. Instances of non-compliance with environmental regulations were required to be disclosed where significant fines or other regulatory sanctions had been applied; and

iv. information to demonstrate how any additional capacity was proposed to be acquired;

b. compliance with bid rules, including providing the requisite information, submitting the bid in its proper form, observing confidentiality, observing other probity requirements (including no conflicts of interest, no collusion with other bidders, no unauthorised contact with any SOC or State officials); and

c. compliance with applicable employee protocols.
Application to seek dispensation from the ACCC regarding the co-insurance arrangements

6.12 The application for dispensation in respect of co-insurance was lodged by Treasurer Rozendaal, on behalf of the generator SOCs, under cover of letter dated 27 November 2009.

6.13 The ACCC, in its draft determination of 25 March 2010, refused to authorise the co-insurance arrangement. The NSW Government submissions in response to the ACCC's draft determination were lodged on 19 April 2010 and on 29 April 2010. The ACCC made its final determination on 20 May 2010 and denied authorisation to the proposed co-insurance arrangement.

6.14 Subsequently, the number of gentrader bundles was reduced from five to four (Macquarie Generation, Eraring, Delta West and Delta Coastal). The effect of this reduction was that Macquarie Generation comprised a single bundle, rather than two.

Further development of the gentrader contracts

6.15 In December 2009, the Steering Committee considered a report from the Gentrader Working Group dated 21 December 2009 which set out a summary of the terms which were to be included in the gentrader contracts to deal with the allocation of risk between the SOC generator and the private gentrader. The annexure to the report set out the various contract terms which allocated risks and how this would impact on the value of the transactions. On 22 December 2009, the Steering Committee asked Treasury and the Department of Premier and Cabinet to undertake a review of the terms of the gentrader contract and report back to the Steering Committee. Until the gentrader contracts were finalised later in 2010, the policy positions to be taken by the State under the gentrader agreements were the subject of regular reports to the Steering Committee.

6.16 There was some concern that the Gentrader Working Group was not proceeding as quickly as had originally been envisaged. In February 2010, as a result of these concerns, Mr Yeadon was appointed Chair of the Gentrader Working Group.

6.17 Mr Yeadon had been a Member of Parliament from June 1990 until his resignation in 2007. He had been the Minister for Energy from 1999 until 2003. He was regarded by Dr Gellatly, among others, as being knowledgeable about the electricity market and having sufficient ability to understand the complexities of the gentrader model and oversee the implementation of the gentrader agreements. The Inquiry was told by both Mr Price and Mr Maguire that the liaison between the advisers and the Gentrader Working Group improved once Mr Yeadon was appointed Chair.

6.18 Mr Yeadon told the Inquiry that the schedules to the gentrading agreement contained highly complex specifications and material that was, by and large, not kept by the SOC generators themselves, either because they did not see the need for it or they did not require it to that level of detail and complexity. Therefore although the data was available in broad terms from the SOCs "there had to be a constant process of iteration to get that data and, more importantly,
to get it in the form that was required to go into the GTA schedules for the bidders to peruse”. Hence, the time taken.

6.19 Tim Baker, then General Manager, Marketing and Strategy, of Eraring, was responsible for providing the technical information required by the Gentrader Working Group to define the technical capability of each of the Eraring power stations. He said to the Inquiry that the period during which such information was provided was a “very demanding period”. In addition to providing technical information to be inserted into the schedules to the gentrader agreements, Mr Baker was also assisting Credit Suisse with the Investment Overview and WorleyParsons with the Independent Engineers Report. Later, towards mid 2010, Mr Baker assisted with bidder presentations and participated in the Q & A process which involved responses to technical questions.

6.20 Mr Baker informed the Inquiry that it was not until March 2010 that Eraring received a completed draft of the gentrader agreement.

6.21 Mr Skelton, formerly the Manager, Marketing and Trading, and now the Chief Executive, of Macquarie Generation, considered that Macquarie Generation “had a fair bit of involvement in reviewing [the draft gentrader agreements] from the perspective of how they would work from a trading perspective”. He considered, from reviewing the documents, that the gentrader agreements “had potential to be a workable arrangement”. He regarded the gentrader agreements as, in substance, outsourcing the trading function for which he was responsible. He explained to the Inquiry that there was a natural division between the generation and the trading functions of a generator and observed, in the case of Macquarie Generation, that they were physically quite remote from each other (an hour and a half’s drive away).

**Periodic payments**

6.22 The Gentrader Working Group was required to consider how payments under the gentrader agreements ought to be made. The gentrader bid process involved the bidders lodging bids for gentraders in which they ascribed a value to each gentrader contract (which reflected their assessment of the value of the net cash flows to the gentraders under the bidders’ electricity market assumptions and the terms of the gentrader contracts). These ‘value payments’ were described as a series of periodic payments rather than a single upfront payment. However, it was possible to structure a single upfront payment to reflect the present value of a series of future periodic payments to reduce the credit risk around future payments. The difficulty created if this were the only option was that it could impose a significant funding burden on the bidders, and could limit the field to those with strong balance sheets.

6.23 The alternatives posed by Lazard and Baker & McKenzie in a paper dated 16 March 2010 were the following:

a. up-front payments; or

b. vendor finance alternatives:
   
i. as underwriter; or

ii. as lender.
6.24 The Steering Committee, at its meeting on 31 March 2010, requested Treasury officials to engage with rating agencies on the potential underwriting approach and potential impacts for the State’s credit position. The Sale Process and Documentation Working Group investigated the effect of each option on the State’s credit position and reported to the Steering Committee by memorandum dated 18 May 2010. The Working Group reported that there was likely to be greater bidder interest in gentraders if flexible payment options were permitted. However, it noted that long-term deferred payment structures were likely to have material detrimental impacts on the State’s credit position.

6.25 SFG Consulting was retained by Treasury to model a stream of payments which would be equivalent to a single up-front bid to accommodate the possibility that some bidders would not be in a position to make a single up-front payment for generation capacity.

6.26 Eventually, this issue became hypothetical because each of the bidders for gentrader contracts was prepared to make an up-front payment.

**July 2010 to 15 November 2010**

*The opening of the bidder data rooms for retail businesses and gentrader contracts*

6.27 It was originally expected that the data rooms for the retail businesses would open in early 2010 and potential bidders expressed some disquiet when this date was deferred. However, the delay in the preparation of the pro forma gentrader agreement meant that the gentrader data room was not opened until 1 July 2010. The retail bidder data rooms opened at about the same time. The data room for the gentrader agreements was progressively populated after that date. On 1 July 2010, the pro forma gentrader agreement was available but the individual agreements for each power station were not placed in the bidder data rooms until sometime later.

6.28 On 1 September 2010 all individual power station gentrader agreements with the exception of Liddell, Bayswater, Munmorah and Shoalhaven were in the bidder data room.

6.29 It had been envisaged that the advisers, Johnson Winter & Slattery, Frontier Economics and SFG Consulting, would provide sign offs to the Steering Committee in respect of these agreements. However, because of the time constraints (including the bid closure date of 15 November 2010) and the need to populate the bidder data room with these bespoke agreements, the Steering Committee was advised by Mr Yeado, the Chair of the Gentrader Working Group, that, to the best of his knowledge, the bespoke gentrader agreements had been prepared in accordance with the risk allocation and other Cabinet Committee approvals. Accordingly, the Steering Committee endorsed the uploading of the bespoke agreements into the bidder data room and noted that subsequent sign offs would be provided by Johnson Winter & Slattery, Frontier Economics and SFG Consulting. Johnson Winter & Slattery ultimately did so in November and again in December 2010. Frontier Economics provided a ‘sign off’ in respect of the technical parameters in the agreements.
The further development of the gentrader contracts during this period

6.30 There were several decisions that needed to be made by the Steering Committee regarding the gentrader agreements. For example, the gentrader agreements provided for a total contract capacity (TCC), a contract availability factor (CAF) and a charging regime of penalties/bonuses around any shortfall/outperformance of the CAF. The Steering Committee approved the TCC for each power station based on recommendations of the Gentrader Working Group. The starting level of CAF for each power station was expressed in percentage terms, set in line with historical performance and diminished over time (to take account of the likelihood of diminished performance with ageing plant). There was to be a penalty for shortfall (known as Availability Liquidated Damages (ALDs)), but no bonus for providing a surplus. The Steering Committee determined, on the recommendation of the Gentrader Working Group, that no profit margin was to be built into any of the gentrader charges.

6.31 The risk to the State under the gentrader arrangements was modelled under various scenarios by Frontier Economics, with assistance from SFG Consulting. The simulation process used by SFG Consulting simulated availability rates and then led to a forecast of what the liquidated damages payments could be expected to be. The Inquiry was told by Professor Gray, of SFG Consulting, that Frontier Economics had extensive data on the outage rates for the generators on a unit-by-unit basis which became the basis for SFG Consulting’s simulation of what outage rates might be in the future.

6.32 Professor Gray told the Inquiry that he was provided with five or six iterations of the gentrader agreement, and was required to model each so that the Gentrader Working Group and the Steering Committee could consider the various risks associated with each version, and how those risks could properly be quantified. Professor Gray summed it up in the following terms:

One is not necessarily better than the other for the State, in that in those two different scenarios the amount that the gentrader bidder will be prepared to pay will of course be different. So what is being exchanged is additional upfront payment from the bidder for the gentrader contract versus a series of potential payouts from the State over the life of the contract.

6.33 Professor Gray identified as an example of this trade-off the decision not to make provision for bonus payments but to make provision for liquidated damages for not providing the availability covenanted for. He explained to the Inquiry that this would tend to increase the bid price because there is essentially an upside for bidders but no downside and the reverse for the State. His view was that there was no a priori reason to think that such a decision would create or destroy value, since it could reasonably be expected that such provisions would be accurately reflected in the bid price.

6.34 The consequence of the Steering Committee’s decision that there be no profit margin for the generator in costs charged under the gentrading agreements was that provision had to be made to manage the prospect of the generator not being able to meet its obligations in the future. SFG Consulting modelled the risk of there being a disparity between the actual costs incurred by the SOC generators and the charges payable by the gentrader (which depended on the volume and price of those costs). Having modelled various scenarios, SFG
Consulting then provided a range of results which were expressed by reference to percentiles.

**Communications with bidders: the request for binding bids**

6.35 Bidders were provided with the initial elements of the request for binding bids in September 2010. They were given an overview of the bid process, evaluation criteria for the bids, a description of the bid process (including information requirements) and instructions for submission. From September 2010 bidders had been given the opportunity to comment on the bid process. Their comments were considered and on 4 November 2010 the final elements of the Request For Binding Bids Instructions were communicated to bidders (once they had been approved by the Steering Committee).

6.36 The matters addressed in this document included lodgement details; details of the final balance sheet for each asset that would be used as a basis for the bids; request for a separate summary of material comment on the transaction documents; request for a sealed envelope containing all bid price information; clarification that bid prices should include the price attributable to fuel stock and fuel on-sale agreements; and bid terms and conditions and settled versions of the transaction documents, which bidders should mark up if they sought any amendment as part of their bids.

**Pre-bid negotiations**

6.37 After the bidder data rooms were opened for the retail businesses and the gentrader agreements in early July 2010, the bidders were given an opportunity to communicate their position on the qualitative terms of the transactions. All bidders were to be treated equally in this process in that they were all given the same period within which to provide comments and the same opportunity to negotiate agreements with the State. Furthermore, if the State was prepared to alter its policy or risk position, each bidder would be notified of the alteration.155

6.38 One of the purposes which this process was designed to serve was to ensure that there could be an assessment of bids on the basis of the bid price alone, since each bid would be made against transaction documents which were not materially different in terms of risk allocation. Baker & McKenzie were required to confirm that bid versions of the transaction documents were 'neutral' in order that this comparison could be made. They did so with respect to the gentrader transaction implementation deed and ancillary documents. Messrs Maguire and Price were required to do the same in respect of the gentrader agreements and did so, as set out above.

6.39 Negotiation teams comprised representatives from Credit Suisse, Lazard, Frontier Economics, Johnson Winter & Slattery and Baker & McKenzie. However, any reconsideration of the State's risk position was required to be reviewed by the Steering Committee, and, if it was contrary to a decision made by the Cabinet Committee, would be referred to it for review. The probity adviser was given the opportunity to be present for all negotiation sessions.

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155 This policy also applied to executed transactions in that if one successful bidder had negotiated terms which were more favourable to it, after execution of the transactions, the other successful bidder was given the opportunity to vary the transaction in accordance with the terms negotiated by the other, with a corresponding adjustment to price.
The Steering Committee was advised of concerns raised by bidders in the course of this process. Commonly this was done in the form of a table, which set out the current State position, the responses of particular bidders (which were given code names to conceal their identity) and a final column which, when the matter had been considered by it, set out the position to be adopted by the Steering Committee.

Retail agreements

6.41 In the case of the retail agreements, the Steering Committee considered a paper dated 6 September 2010 which had been prepared by Baker & McKenzie, which set out material amendments which had been made to the draft retail business transaction documents in light of bidders’ comments. Amendments were classed as material if they would, if accepted by the Steering Committee, change the structure of the transaction, the process or timing of completion, the risk allocation set out in the draft transaction document or the costs or potential liability of the SOCs. A further paper dated 11 October 2010 along the same lines was prepared for consideration by the Steering Committee and reflected further comments from bidders on the second draft of the retail business transaction documents.

6.42 Another example is provided by the pre-bid negotiations concerning the terms of the transition services agreements in relation to the retail businesses. These agreements were developed to provide purchasers with the full range of necessary transition services to operate a retail business while preparing to transition the business to operation by the purchaser. The principles applied were to provide continuity of service to customers and provide for fees under the transition services agreements which reflected the costs of providing those services.

6.43 Bidders made different requests for transition services leading to a difference in the cost of providing such services. Revised transition services agreements were drafted to reflect these arrangements. However, each agreement was assessed by Ernst & Young (which documented and summarised the changes for the benefit of the Steering Committee) as giving rise to a similar overall risk allocation for bidders which reflected changes to scope and costs.

6.44 On 22 October 2010, Baker & McKenzie advised the Steering Committee that they had prepared the final bid documents for the retail businesses and that they had been prepared in accordance with instructions and represented a materially equivalent risk and liability position.

6.45 This sign off meant that the Evaluation Committee could assess bids by reference to price because, on the assumption that the mandatory threshold criteria were met, the transaction documents to which the bids related were effectively equal, as far as the State was concerned. Mr Saxon explained to the Inquiry that, in these sort of large Government transactions, often time is of the essence and the limited time available to assess bids can be better spent if there is a “stable platform” where the bids are consistent across the bidders.
Development sites

6.46 In relation to the development sites, Baker & McKenzie provided a table of material bidder comments on the:

a. first draft of the sale agreements by memorandum dated 12 October 2010 for the Steering Committee; and

b. subsequent drafts by memorandum dated 27 October 2010 for the Steering Committee.

6.47 Baker & McKenzie prepared a 'sign off', similar to that referred to above in relation to the retail businesses, for the development sites.

The gentrader agreements

6.48 Mr Maguire and Frontier Economics were principally responsible for ascertaining bidder responses to the gentrader transaction documents. They prepared a narrative assessment of bidder mark-ups of the gentrader agreement documentation in October 2010 with recommendations as to whether the amendments ought be accepted for the consideration of the Steering Committee.

6.49 Baker & McKenzie provided a table of material bidder comments on the then current draft of the gentrader agreements by memorandum dated 12 October 2010 for the Steering Committee.

6.50 Because the bid closure date was imminent, there was insufficient time for Baker & McKenzie to review the further drafts of the gentrader agreements which had been prepared by Johnson Winter & Slattery following the consideration of the responses by the Steering Committee. According to Mr Saxon, the need to get the revised contracts to the bidders overrode the desirability of getting a second opinion on the contracts, so the revised contracts went straight into the bidder data rooms.

6.51 Hence the process with the gentrader agreements was different from that adopted with the balance of the agreements, where Baker & McKenzie was responsible for drafting the agreements and negotiating with bidders the overarching transaction agreement. Of the agreements relating to the gentrader arrangement, Baker & McKenzie was responsible for the Umbrella Implementation Deed and ancillary documents and Johnson Winter & Slattery and Frontier Economics were responsible for the balance of the agreements.

Bidder responses: examples

6.52 The State's responses to the bidders' comments were influenced not only by the risk allocation that had been decided upon, but also by matters of policy. For example, potential bidders for the gentrading agreements did not want the State's liability for Availability Liquidated Damages to be capped, but the State regarded it as important for there to be such a cap in order to achieve the objective recommended by Professor Owen. Uncapped Availability Liquidated Damages would expose the State to market risk, and therefore provide an incentive to build, for example, additional peaking plant to manage that risk. This would have the effect of bringing the State back into the electricity trading market and defeat the objective identified by Professor Owen.
Mr Leyden described to the Inquiry the resistance by potential bidders to the provisions which permitted assignment of the generators. Although the bidders pressed for pre-emptive rights to acquire the generators, this amendment was refused, on the basis that it was important to preserve flexibility for a future government to sell the generating assets to a party other than the corresponding gentrader. This consideration has ramifications for future options, which are considered in Chapter 13.

**Consideration of long term financial consequences of the Energy Reform Project**

6.54 Consideration was given by the Steering Committee to the costs and potential liabilities (capitalised and discounted to present value) which needed to be deducted from the proceeds of sale in order to measure the benefit (or detriment) to the State from the sale of its electricity assets and to make an appropriate comparison between the State’s financial position ‘before’ and ‘after’ the transactions.

6.55 Each of these matters was considered by the Steering Committee and expert advice was obtained in order to calculate the present value of the liabilities and costs that could be expected to be incurred over time.

**The gentrader agreements**

6.56 In November 2010, the Government accepted the advice of the Steering Committee that a fund would be required to cover the risks arising from the liability of the generators to pay Availability Liquidated Damages to the gentraders for outages and agreed to establish a fund. The underlying calculations to quantify the present value of the future liabilities were performed by SFG Consulting, at the request of Treasury. Regard was had in performing the calculations to the history of outages for each generator. SFG Consulting was retained because of its expertise in such modelling and its experience in the electricity market.

6.57 In addition to the contingent liability to pay Availability Liquidated Damages by reason of outages referred to above, the Steering Committee also identified other risks arising from the gentrader agreement which could give rise to Availability Liquidated Damages, which could not accurately be classified as outages. The two additional risks identified were:

a. major event risk (which would carry with it not only an obligation to pay Availability Liquidated Damages but also the requirement to undertake significant capital investment to bring the unit back to its agreed capacity, which may require additional funding from the Government); and

b. industrial relations (industrial action could bring the generator to a halt and could create a liability to pay Availability Liquidated Damages).\(^\text{156}\)

**Ancillary costs (stranded costs, dissynergy costs and other costs)**

6.58 The financial advisers worked with the SOC retailers concerning these costs which arose in part from the fact that the SOCs which had conducted the retail

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\(^\text{156}\) This risk ensued in that a liability to pay Availability Liquidated Damages arose at the Eraring Power Station when industrial action delayed boiler upgrades.
businesses also conducted network businesses. A five year employment guarantee had been made to employees of the retail businesses (who were not obliged to transfer to the purchasers' business, nor were the purchasers required to employ them). There were also various information technology costs which would be incurred by the SOCs after the transactions were completed. The SOCs provided information to the financial advisers as to their ancillary costs, estimates of future costs over the following five years and the assumptions on which those estimates were made. These categories of costs were expected to reduce the profit from the network businesses.

6.59 The transaction costs of the Energy Reform Project amounted to approximately $203 million.

**Determination of retention value**

6.60 The Auditor-General had recommended that the retention value be determined before the bids were evaluated and this was done. At its meeting on 17 March 2010, the Steering Committee was informed that Treasury would provide a plan for setting up a Retention Value Working Group. At about this time, a paper was prepared which concerned the methodology for determining of a retention value for the assets that were to be sold. The role of the working group was to direct and oversee the retention value work with the key deliverables being the development of a retention value methodology that was acceptable to the Auditor-General and the final calculation of the retention value for the NSW energy assets.

6.61 In June 2010, the probity adviser to the Steering Committee met with the Deputy Auditor-General to obtain his response to the updated probity plan. His comments were received and incorporated.

6.62 On 21 July 2010, the Retention Value Working Group advised the Steering Committee that Treasury and the financial advisers had engaged the Auditor-General to discuss the high level principles of gencor arrangement and the broad Government objectives with the transaction. The advisers noted that the retention value would still need to be calculated on the basis of Cobbora prices (since the gencor were to have access to coal at prices which were to be fixed under coal supply agreements with the Cobbora mine) and that Frontier Economics would need to provide electricity market prices on this basis.

6.63 The methodology adopted by the Working Group was the subject of memoranda to the Steering Committee for its consideration, and, if thought fit, approval from time to time. In substance, the retention valuation was a status quo valuation of the retailers, generators and development sites under continued Government ownership. Mr Timbs advised the Inquiry that this was a well-defined and accepted format for calculating retention value.

6.64 Expected equity cash flows to the Government were forecast and discounted back to present value at the valuation date under various market modelling scenarios. The hedge books were valued in a similar way.

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157 Memorandum from financial advisers to Steering Committee dated 8 December 2010.
158 The information provided by the SOCs together with a critique of the information was summarised in a memorandum from the financial advisers to the Steering Committee dated 29 November 2010.
6.65 Ernst & Young was engaged to do an integrity review of the financial advisers' model for future cash flows. This involved checking the logic of the formulae to ascertain whether there were any errors in the cells.

6.66 The determination of the retention value for the generators required a forecast to be made of electricity prices for the future. The Retention Value Working Group decided that it would use one consistent set of data supplied by Frontier Economics, rather than different assumptions for each power station, or portfolio.

6.67 There was some discussion by the members of the Retention Value Working Group of whether there should be an audit or review done on Frontier Economics modelling since the outputs from that modelling were significant inputs into the economic and financial models that were being used by Treasury and the financial advisers. In basic terms, the Frontier Economics modelling was being used to forecast electricity demand, and electricity price, which in turn affected the future income which would be earned by the generators if they were retained by the State.

6.68 Mr Price informed the Inquiry that two of three of its models (Whirlygig and Strike) had already been audited, albeit for a different purpose, by Professor Green and that its models were frequently used by persons in the electricity market, and were used by IPART in its determination of the price of electricity for small consumers. Frontier Economics did a large project for the AEMC to support its application for the Snowy Hydro area to be located in an expanded Victorian and New South Wales region.

6.69 Mr Price said to the Inquiry that the three models, Whirlygig, Spark and Strike, tended to be used in sequence, so that the output from Whirlygig is an input to Spark and the output of Spark is an input to Strike. Whirlygig principally models the supply and demand balance between various types of generation.

6.70 Spark, by contrast, replicates the way in which electricity is actually dispatched in the market. Mr Price told the Inquiry that Spark uses Nash Equilibrium: an equilibrium from which no generator would be motivated to move because if they were to try to do so they would not be dispatched because they would be out of the merit order, or if they try to undercut someone, they would retaliate. This produces a stable price for electricity (which is updated at short intervals of five minutes, or half an hour as the case may be) which can be used in forecasts. The model detects market power and its potential misuse.

6.71 Mr Price said that the third model, Strike, is a "portfolio optimisation" model. A generator trading in the spot market enters into hedging contracts to manage the volatility of these prices. What Strike does is tries to work out the optimal combination of these contracts and exposure to the spot market. The Strike model had also been used by Frontier Economics in the Energy Reform Project to separate the hedge contracts to which Delta was a party and allocate them between Delta West and Delta Coastal in a way that was optimal for each generation portfolio and which would equalise the risk associated with that contract position between the bidders.

6.72 Ultimately, the Retention Value Working Group did not require the Frontier Economics model to be audited or reviewed by a third party. Mr Timbs said to
the Inquiry that there were several people on the transaction who were sufficiently informed to know whether the inputs, assumptions and data in the models used by Frontier Economics were reasonable. The Retention Value Working Group reviewed the inputs and outputs of the Frontier Economics Model as to whether these were thought to be reasonable, and appended Frontier Economics’ report to the Retention Value Report.

6.73 Mr Timbs said that although there was a general appreciation that, when forecasting for long-term capital-intensive infrastructure assets, not all of the assumptions adopted in the determination of retention value would turn out to be correct, the approach adopted was to ensure that there was a sensible and sound basis for each assumption, and that the sensitivities of each assumption were adequately tested.

The gas price

6.74 One such assumption, which turned out to have a highly material effect on retention value, was the gas price.

6.75 The Inquiry was told that one of the key constraints in modelling future electricity prices is the new entrant cost for a new entry power station. The assumption made by electricity price modellers is generally that the new entrant will be a gas-fired power station, so the key variable is the gas price (since this fuels the new entrant’s power station). Indeed this assumption was borne out by the modelling undertaken by Frontier Economics. The higher the gas price, the higher the electricity price will be and vice versa. However, predicting gas prices has been made more difficult because the Liquid Nitrogen Gas developments in Queensland has created an expectation that there will be increasing pressure on gas prices, which will cause them to rise.

6.76 There was a debate within the Retention Value Working Group about the appropriate gas price to select for the purposes of modelling future electricity prices. On the one hand, Frontier Economics contended for the ACIL Tasman 2009 gas price but other members of the Retention Value Working Group (including representatives from Treasury) wanted to add $0.50 per GJ to that price, which had the effect of increasing electricity prices in the models and therefore increasing the retention value of each SOC generator. This was the only energy market assumption that was not determined by the modelling undertaken by Frontier Economics.

6.77 Although Treasury representatives considered the ACIL Tasman to be a reliable source for information such as the gas price, they considered that the gas market had moved since the ACIL Tasman work had been done in 2009 and that a reasonable case could be made for using a higher gas price. The difference the additional $0.50 made (from $5.50 to $6) was effectively to double the retention value of the generators.

6.78 Mr Timbs said that although the use of the ACIL Tasman 2009 gas price in determining the retention value could have been defended, he was more comfortable with using a more conservative assumption. He was conscious that, had the ACIL Tasman 2009 gas price been used, there would have been an opportunity for critics of the process to allege that the retention value had been suppressed, deliberately or otherwise, in order to make sure that the
transactions were effected. Mr Timbs considered that the analysis of retention value had to “have integrity and stack up”. Mr Cosgriff’s evidence to the Inquiry was to similar effect. He described the addition of $0.50 to the ACIL Tasman gas price as “a prudent thing to do” and said that he thought that making that adjustment “was an appropriate way of presenting that information to ministers and making a decision on retention value”.

6.79 Dr Gellatly considered that the difference in views about the appropriate gas price to use between Frontier Economics on the one hand and the SOC generators and Treasury on the other was that Frontier Economics were essentially economists who had a theoretical view of the world; whereas the SOC generators and Treasury had a more practical way of looking at the world. He saw both approaches as being professional and reflective of the positions of their proponents.

6.80 Mr Price told the Inquiry that had the gas price for which he contended been used in the determination of retention value, the bid prices for the gentrader agreements would have exceeded their retention values.

The Carbon Pollution Reduction Scheme (CPRS)

6.81 Other assumptions also made a substantial difference to the retention value, such as the CPRS. The base case used for retention value was CPRS 5% (5% drop on 2000 greenhouse gas emissions by 2020). The sensitivities of the CPRS were tested: a CPRS 15% led to a 60% drop in retention values of the generators. The base case of 5% was selected because it accorded with the Commonwealth Government’s then stated position on carbon.

Electricity demand

6.82 The Retention Value Working Group used the Medium Demand figures from the then current AEMO Electricity Statement of Opportunities. Mr Timbs described this as “the industry-recognised reference point”.

Discount rates

6.83 Different discount rates were used for the retail businesses from the generation businesses which reflected not only the different risks (generation being inherently riskier than retail) but also the consideration that the generation businesses had substantial debt; whereas, in respect of the retail businesses, it was assumed that the debt was referable to the distribution arm of the business and that the retail businesses were free of debt.

6.84 Mr Timbs explained to the Inquiry that the assessment of retention value for the generators was substantially more complicated than for the retail businesses because of the number of assumptions, the choice of which could dramatically affect the retention value.

6.85 The final version of the Retention Value Report was considered by the Government on 15 November 2010, the bid closure date. The probity advisers were concerned to, and did, ensure that the Retention Value Report had been prepared and approved before the bids were revealed and evaluated.

6.86 Those advising the Government, including Mr Schur, were aware that the retention value of the SOC generators could not be compared directly with the
bids for the gentrader agreements, since what was being sold (the trading rights to the generators) was different from what would have been retained (the generators themselves). In that sense, as Mr Schur explained to the Inquiry, "we weren’t necessarily comparing apples with apples when we were comparing retention values with bids received." Mr Timbs told the Inquiry: "it should not be a surprise that a gentrader bid is less than a retention value because it’s not the same thing".

6.87 Mr Timbs explained that the proper comparison against retention value is the bid price less any additional costs and/or liabilities that the Government will hold as a result of the gentrader contract and plus the value of the business that is retained. The sum of all these things is what needs to be compared with the retention value.

6.88 The value of the generators less trading rights was regarded by Mr Timbs, among others, as "undoubtedly positive" although it was not valued. Mr Timbs told the inquiry of the basis for his opinion: namely that the generators can probably contract at higher levels of capacity than they are obliged to under the gentrader contract. Furthermore, if the generators could become more cost effective, then there is the prospect that a margin could be earned on the charges payable under the gentrader agreement, which at present are sufficient, at best, to cover the generator’s costs.

6.89 The need to take into account the costs incurred and liabilities generated by the gentrading agreements in assessing the overall benefit or detriment of the sale was regarded by Treasury as particularly important since some of the decisions as to risk allocation in the gentrader agreement (as referred to more specifically above) were designed to increase the bid price, but to leave the State with a contingent liability. Availability Liquidated Damages and the absence of re-openers are two of the most obvious examples of this.

The consideration of the retention value proposed by the Steering Committee

6.90 The purposes of the proposal to Government were twofold: first, to gain approval for the retention value of the assets being sold; and secondly, to advise that a proportion of the proceeds would be required to:

a. discharge the generator debt (which amounted to $2.8 billion for all the generators);

b. provide for contingent liabilities; and

c. provide for costs (stranded costs from the retail businesses that largely arise from the offer of employment guarantee to retail staff).

6.91 The Government was also informed that some factors (which were difficult to quantify) had not been taken into account in the retention value calculation. Two factors were identified. The first was the option value of the development sites (their retention value was equivalent to their book value in the SOCs’ financial statements). The second was, potentially, more significant: the potential costs to the State, including the opportunity cost, of retaining the
assets in public ownership as a result of the future need to invest in new generation capacity and other areas.

6.92 The importance of the second factor arises from the stated reason for the sale of electricity assets. It will be recalled that the principal reason for the sale of electricity assets was Professor Owen's conclusion that, in order to encourage private investment in electricity generation, it was necessary for the State to divest itself of electricity assets. The Owen Report identified that investment in the electricity sector would be required as follows:

a. additional investment in generation of $7-$8 billion by 2020;

b. retail investment of $2-3 billion; and

c. carbon reduction technologies of $3-4 billion.

6.93 This second factor was identified as something which should be taken into account in a qualitative way in conjunction with the retention value when assessing the bids for electricity assets. Mr Schur said to the Inquiry that there were long discussions within Treasury about how this factor ought be taken into account in connection with retention value. Although the benefit of not owning the generation businesses (since one would be relieved of the obligation of investment in generation) was considerable to the State as a whole, it had nothing to do with the actual value of the SOC generators to the State. Mr Schur said that retaining the SOC generators in State hands:

> clearly has a very significant impact on the State's finances and in fact constrains the State in a very significant way from making investments in transport and schools and hospitals, et cetera, because of the way the rating agencies rate the State's credit rating.

6.94 In the events which happened, it was not necessary for this factor to be weighed in the balance, since the bids received for asset bundles exceeded the aggregate retention values for those assets.

### The process for evaluation of bids

6.95 In November 2010, the Government accepted the Steering Committee's recommendation that it approve the following further evaluation criteria, the first of which is quantitative and the balance of which are qualitative:

a. bid price and payment structure;

b. financial certainty (namely that the bid is not subject to finance);

c. completion certainty (unconditional bids, apart from ACCC approvals); and

d. ongoing risk to the State (changes to material terms which change the risk profile etc).

6.96 A detailed document entitled Bid Evaluation Plan was approved by the Cabinet Committee on 15 November 2010. The Plan was an internal confidential document which was to be complied with by all Government representatives and advisers involved in the bid process, including the Evaluation Committee.
A separate document, the Request for Final Binding Bids was also prepared that described the bid process to bidders.

6.97 The Bid Evaluation Plan set out the following:

a. a list of criteria against which bids would be assessed (comprising the criteria approved by the Government on 23 June 2010, together with the further mandatory criteria approved in November 2010);

b. a prescription of how the assessments would be made and recorded; and

c. a definition of the responsibilities of each participant in the evaluation process.

6.98 The key purposes of the bid evaluation process were said to be:

a. identify the combination of bids considered to be most likely to meet the objectives;

b. select and recommend to the Steering Committee preferred bidders for each asset or combination of assets; and

c. assist the Steering Committee and the Government to determine whether the objectives have been met and whether a second-phase bid process should be undertaken.

6.99 The Bid Evaluation Plan dealt with the sale process and in particular the criteria whereby it would be determined whether there would be a second phase of the bid process, including an IPO. The Government’s strong preference for all assets to be transacted during a first phase bid process was noted (this was likely to be a product of time, and the impending election).

6.100 Bidders were afforded considerable flexibility in that they were permitted to offer a single bid for a single asset, a single bid for a combination of assets (that is, a bid for one asset is contingent on the bid for another asset being successful), or multiple bids for single assets or combinations of assets. These rules allowed bidders to bid for vertically integrated combinations of assets (a retailer and a generator) or horizontally integrated assets (more than one retailer or more than one generator). Bidders were responsible for obtaining merger approval from the ACCC.

16 November to 13 December 2010

The Evaluation Committee and its interaction with the Treasurer

6.101 The Evaluation Committee, following the bid closure on 15 November 2010, proceeded to evaluate the bids, in accordance with the predetermined process set out in the Bid Evaluation Plan. The Committee, which was chaired by Mr Yeadon, concluded that, based on the bids received, it was possible neither to enter into transactions that would meet all of the Government’s objectives, nor to sell all of the assets. It observed that although some of the bids were capable of acceptance in the immediate future, others, being conditional, might require significantly more time before a transaction could be entered into. The
Committee sought guidance from the Steering Committee and the Treasurer regarding Government policy arising from the Energy Reform Strategy.

6.102 Generally speaking, the first-round bids for the retail businesses were above the retention values and the bids for the gentrading agreements were below the retention values for the generators. In the second round, Origin made a global undifferentiated bid for two retailers and single gentrader (Eraring) which had the effect that it was no longer possible to say that it offered less than the retention value for the Eraring gentrader.

6.103 In any event, the process that was adopted was to apply an aggregate. This meant that the bids received for the retail businesses were so in excess of the retention value, this made up the shortfall of the bids for the gentrading agreements. Two bidders, Origin and TRUenergy were successful. The 'rule of thumb' for retail businesses, being price per customer, was also applied and revealed that good prices had been achieved for the retail businesses. Mr Leyden told the Inquiry that he considered that the dollar per customer measure to be a more reliable indicator of value than earnings multiples for such a business.

6.104 Treasurer Roozendaal considered the policy issues and the proposed positions put to him. On 2 December 2010, he advised the Evaluation Committee that he accepted its recommendations. On 9 December 2010, Treasurer Roozendaal was informed that the ACCC had given merger clearance to the transactions proposed by the two main bidders and, in particular, that it would permit one bidder to buy two retail businesses. Once again, Treasurer Roozendaal accepted the recommendations put to him by the Steering Committee.

6.105 The Evaluation Committee confirmed in its Interim Bid Evaluation Report to the Steering Committee dated 13 December 2010 as follows:

Apart from providing advice in relation to the policy matters outlined above, the Treasurer had no detailed knowledge of Bids received and had no involvement in the evaluation of the Bids.

Post-bid negotiations

6.106 There were further discussions with bidders during this period about their marked-up versions of the agreements. The negotiations concerning the gentrader agreements were conducted, on behalf of the State, principally by Messrs Price and Maguire.

The payment structure

6.107 Consideration was given to the term under the gentrader agreement whereby the bidders would be entitled to lodge a deposit for future capacity charges or to elect to pre-pay future capacity charges. The view was taken that although both methods would enable the State to have access to the full capacity charges up-front (which it would then pay to the gentrader, with interest, as and when they fell due), there may be an advantage to bidders in adopting the deposit structure since it would give them greater flexibility. Baker & McKenzie, Ernst & Young and Treasury analysed the deposit structures proposed by the two successful bidders and made recommendations to the Steering Committee. Treasury's Fiscal Strategy Branch also contributed to the analysis in its
consideration of the impact of the deposit structure on NSW's key credit rating metrics.

The deductibility of capacity charges

6.108 Two of the bidders had sought private binding rulings from the Australian Taxation Office on the deductibility of capacity charges. The Australian Taxation Office declined to provide positive rulings and wrote to NSW Treasury to express their preliminary view, based on the information provided by the bidders, that the capacity charges were not deductible for income tax purposes on the basis that such amounts may be on capital account. Accordingly, the prices bid by 15 November 2010 reflected the non-deductibility of the capacity charges.

6.109 However, bidders were contacted on 26 November 2010 and requested to re-bid on the basis that the capacity charges were deductible. This resulted in bids being submitted on a further basis: that capacity charges were deductible. The State indicated its intention to obtain private binding rulings on behalf of the gentraders.

6.110 Ernst & Young arranged to meet with the Australian Taxation Office on 2 December 2010 in order to discuss what aspects of the gentrader structure were of most concern to them, with a view to making any final changes to the transaction documentation before signing.

6.111 The arrangements referred to above were the subject of a joint recommendation by the advisers and Treasury, which was accepted by the Steering Committee at its meeting on 1 December 2010.

The involvement of the ACCC

6.112 It was incumbent on the purchasers to obtain ACCC clearance for their acquisitions.

6.113 The ACCC gave its approval to the proposed acquisitions by Origin and AGL on 9 December 2010.

6.114 In its announcement, the ACCC said:

a. after extensive enquiries, the ACCC concluded that the acquisitions were unlikely to result in a substantial lessening of competition in any of the relevant markets;

b. the ACCC recognised that the acquirers would have high market shares in the retail electricity markets in NSW and Queensland, particularly if Origin purchased Integral and Country;

c. a key consideration was the level of competitive tension that would be likely to occur in the future with these acquisitions compared to the level of competition in the counterfactual where the three retailers were sold to separate acquirers;

d. in analysing the competition effects if Origin were to buy Country and Integral, the ACCC took into account the fact that EnergyAustralia would be acquired by a third party which was not AGL. The ACCC therefore
considered that Origin would face competition in electricity retailing from the acquirer of EnergyAustralia, smaller players, and AGL, which has a large gas customer base and expanding electricity customer base;

a. new entry to the retail market would be likely to preserve competitive tension in the retail markets; and

f. the aggregation of Origin’s Uranquity generator with the Eraring gentrader bundle would not be likely to enable it to exercise market power in the wholesale electricity market in NSW due to the presence of several competing generators in the market.

6.115 The ACCC’s Public Competition Assessment was published on 17 March 2011. The ACCC prepares such assessments in various defined circumstances. It gave as its reasons for the preparation of this assessment: “a merger is not opposed but raises important issues that the ACCC considers should be made public.” Although the scenario considered did not eventuate, in that AGL did not purchase any assets, the analysis is nonetheless instructive.159

6.116 The Evaluation Committee, in making its recommendations to the Steering Committee, which in turn recommended that the Government enter into the transactions, did not have the benefit of the Public Competition Assessment. However, it said in the Interim Bid Evaluation Report, on the basis of the ACCC’s announcement on 9 December 2010:

Based on the ACCC’s findings, the Evaluation Committee concluded that the Initial Transactions are consistent with the Government’s Objective of delivering a competitive retail and wholesale electricity market in NSW.

**Recommendations of the Evaluation Committee in the Interim Bid Evaluation Report**

6.117 It had been stipulated in the Bid Evaluation Plan that the aggregate of all bid prices for the individual transactions ought be assessed against the total retention values for the relevant assets, rather than on an individual asset-by-asset basis. The Evaluation Committee noted in its Interim Bid Evaluation Report that the total proceeds from the transactions were substantially above the mid-point of the retention value range.

6.118 The difficulties of valuation of the generators that confronted those who set the Government’s retention value, which arose from the uncertainties surrounding the future introduction of a carbon trading regime and future fuel prices, also confronted purchasers when attempting to determine an appropriate bid price for the gentrader agreements. It cannot have been unexpected that a different assessment of value would have been arrived at by the bidders than by the Government, particularly in circumstances where what the Government was valuing (the value of retaining the generators in their current configuration) and what the bidders were valuing (the value of the gentrading rights) were substantially different.

6.119 The Evaluation Committee commented on this disparity in the following terms:

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159 It can be found at www.accc.gov.au/content/index.phtml/itemId/981089.
Given the risk allocation in the gentrader contracts, assumptions regarding the future introduction of a carbon trading regime and future fuel prices are key valuation drivers. It is possible that bidders took a more conservative view regarding the impact of these risks compared to the assumptions used to derive the Retention Values. The Evaluation Committee sought to better understand this through clarification requests made to bidders; however, bidders did not provide sufficient detail to assess this issue.

6.120 The Evaluation Committee concluded that the transactions whereby Origin bought Integral, Country and the Eraring gentrader bundle and TRUenergy bought EnergyAustralia and the Delta West gentrader bundle were likely to be consistent with the Government's objective of optimising sale proceeds.

6.121 The Interim Bid Evaluation Report also contained a summary of each bid received, whether conforming or not, and measured each according to the mandatory threshold criteria. It also contained a detailed discussion of post-bid negotiations. It also contained a summary of material issues arising from the bidder mark-ups of the transaction documents.

6.122 Dr Gellatly said to the Inquiry that it had earlier been discussed that an IPO was feasible only if it comprised a retailer and a gentrader and that it was therefore necessary to consider whether it would be better to hold back one of the retailers (notwithstanding that the bid price exceeded the retention value) so that it would be available to be paired with an unsold gentrader. He did not consider there to be a "strong push" for this to occur.

6.123 In early December 2010, Mr Schur, Mr Timbs, Mr Cosgriff, Dr Gellatly, Mr Yeadon, representatives of Lazard and Credit Suisse (including the Regional Head of General Industrials and Energy Investment Banking in Hong Kong) met with the Treasurer at Parliament House to discuss the bids.

6.124 At the time of the meeting, there had been bids received for three retailers and two gentrader bundles which were considered to be attractive bids in terms of value. One issue discussed at the meeting was the market structure and in particular whether there should be a sale of two retailers to one company, namely Origin and the impact on market power.

6.125 In that context, Treasurer Roozendaal was considering whether to accept the offers on the table or to hold back the sale of a retailer. The costs associated with any decision to hold back the sale of a retailer for a second tranche of transactions was discussed.

6.126 The Treasurer asked the financial advisers for advice on:

a. the chances of a second tranche of transactions succeeding without a retailer being offered for sale;

b. the prospects of negotiating an acceptable sale of the remaining two gentraders with the un-accepted bidders; and

c. the prospects of success for an IPO which contained a gentrader alone.

6.127 Mr Lobb of Credit Suisse advised that:
a. the Government could do an IPO with a gentrader alone, without a retailer,\textsuperscript{160} and

b. as the Government had good bids for the retailers and an ACCC clearance, the Government should proceed to sell all three retailers and, if it did not sell all of the gentraders, do an IPO after the election.

6.128 A lengthy discussion took place during which Mr Cosgriff asked Mr Lobb whether, for the Treasurer’s benefit, he could confirm that the Government could do an IPO on a gentrader alone, as this was different from Credit Suisse’s previous advice. Mr Lobb confirmed that the Government could do so. Mr Timbs queried Credit Suisse’s advice.

6.129 The Treasurer indicated that he wished to consider the matter overnight. The next day, the Treasurer advised that he had decided to sell all of the retailers and two gentrader contracts.

6.130 Mr Price told the Inquiry that his view was that if everything could not be sold, it was better to sell nothing. Indeed he told the Inquiry that this was a fundamental premise behind his preference for the simultaneous sale (because if it were sequential one would not know until the last sale whether everything could be sold). He said that he expressed this view to Mr Yeaton, who responded by saying that the Government considered that it would be better to transact such sales as it could, in part, in order to engender market confidence in the gentrader agreements with a view to executing further such agreements later.

**The Government’s decision to enter into the transactions**

6.131 The collective view of the Steering Committee in light of the recommendations of the Evaluation Committee was that the three retailers and two gentrader agreements should be sold and nothing that could be sold ought be held back.

6.132 Former Treasurer Roozendaal explained to the Inquiry:

... on the advice of the transaction team and the steering committee, we took the view - “we”, the budget committee and myself took the view - that this was the first tranche of the transaction. At that point in time, there had been a lot of speculation that the gentrader agreements wouldn’t be accepted within the market, and clearly because we had binding bids - we had serious bids for two of the bundles to the value of over $5 billion, the market had accepted gentrader agreements. So we thought that was the first tranche, let’s go with that.

6.133 On 13 December 2010, the Government accepted the Steering Committee’s recommendation to transact with bidders TRUenergy, Origin and Infratil Energy Australia. The identity of the bidders was not disclosed to the Cabinet Committee but the assets for which they had successfully bid were disclosed.

6.134 The events of 14 December 2010 are dealt with in Chapter 9.

\textsuperscript{160} The Inquiry notes that Morgan Stanley, in its confidential report dated 24 September 2007, said that Macquarie Generation would be a suitable candidate for an IPO by itself. Whether it would be suitable as a stand-alone gentrader agreement was not considered by Morgan Stanley.
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The transactions

7.1 The following tables summarise details of the consideration received for the sale transactions entered into on 14 December 2010 when Origin purchased the gentrading rights from Eraring and TRUenergy purchased the gentrading rights from Delta West. Origin and TRUenergy are referred to as the gentraders.

7.2 The consideration paid for each retail business sold was:

<table>
<thead>
<tr>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>Origin</td>
<td>1,300</td>
</tr>
<tr>
<td>EnergyAustralia</td>
<td>TRUenergy</td>
<td>1,486</td>
</tr>
<tr>
<td>Integral</td>
<td>Origin</td>
<td>1,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>3,786</td>
</tr>
</tbody>
</table>

1 Excludes any purchase price adjustments relating to unbilled income and working capital.

7.3 The amounts paid for the Eraring and Delta West bundles were as follows:

<table>
<thead>
<tr>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eraring</td>
<td>Origin Energy</td>
<td>960 – 1,158</td>
</tr>
<tr>
<td>Delta West</td>
<td>TRUenergy</td>
<td>540 - 600</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1,500-1,758</td>
</tr>
</tbody>
</table>

1 If tax deductibility charges are allowed by the ATO, the higher figure is payable.
7.4 The constituent amounts that comprise the gross proceeds are set out in the table below:

<table>
<thead>
<tr>
<th>Gentrader Transaction Agreement</th>
<th>Eraring Bundle $2</th>
<th>Delta West Bundle $2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment for power stations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>856,000,000</td>
<td>-</td>
</tr>
<tr>
<td>Shoalhaven</td>
<td>11,080,000</td>
<td>-</td>
</tr>
<tr>
<td>Mount Piper</td>
<td>-</td>
<td>452,800,000</td>
</tr>
<tr>
<td>Wallerawang</td>
<td>-</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

| Fuel Stock Initial Payment†     | 70,000,000       | 76,000,000          |
| Ancillary Services              | 1                | -                   |
| Coal Supply                     | 1                | -                   |
| SRDA Adjustment†                | 830,000          | -                   |
| Hedge Book†                     | 22,000,000       | -                   |
| Transition Costs†               | 190,800          | 199,600             |
| Total (excl. tax contingent amount)† | 960,000,000     | 530,000,000         |
| Tax Contingent Payment†         | 198,000,000      | 60,000,000          |
| Total (incl. tax contingent amount)† | 1,158,000,000   | 590,000,000         |

1 Rounded number to next million dollars.
2 Costs are exclusive of any development site proceeds and any GST.

7.5 The consideration paid for the development sites (which are included in the gross proceeds above) were:

<table>
<thead>
<tr>
<th>Development site</th>
<th>Vendor</th>
<th>Purchaser</th>
<th>Gross proceeds $million (excluding GST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marulan</td>
<td>EnergyAustralia</td>
<td>TRUenergy</td>
<td>6.4</td>
</tr>
<tr>
<td>Marulan</td>
<td>Delta</td>
<td>TRUenergy</td>
<td>8.6</td>
</tr>
<tr>
<td>Mount Piper Extension</td>
<td>Delta</td>
<td>TRUenergy</td>
<td>1.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>16.0</td>
</tr>
</tbody>
</table>

7.6 The above proceeds include the stamp duty payable by the purchasers.

7.7 Treasury has advised that approximately $1.15 billion of the proceeds of the transactions has been used to retire $700 million of Eraring’s debt and $450 million of Delta’s debt.

The gentrader agreements: the respective rights and obligations of the parties

7.8 The gentraders pay capacity charges to the SOC generators (which continue to own the generators) in consideration for the exclusive right to trade the electricity output of the power stations. The gentrader is entitled to all revenue resulting from trading electricity in the NEM.

7.9 Capacity charges are levied in accordance with a predetermined schedule over the term of the agreement, which is the estimated remaining useful life of the
power station, which is set out in the table below by reference to each power station.

<table>
<thead>
<tr>
<th>Bundle</th>
<th>Commencement Date</th>
<th>Expiry</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eraring Bundle</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>27 February 2011</td>
<td>30 June 2032</td>
<td>22 years</td>
</tr>
<tr>
<td>Shoalhaven</td>
<td>27 February 2011</td>
<td>30 June 2038</td>
<td>28 years</td>
</tr>
<tr>
<td>Delta West Bundle</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mt Piper</td>
<td>1 March 2011</td>
<td>30 June 2043</td>
<td>33 years</td>
</tr>
<tr>
<td>Wallerawang</td>
<td>1 March 2011</td>
<td>30 June 2029</td>
<td>19 years</td>
</tr>
</tbody>
</table>

7.10 The gentrader agreements include monthly targets for availability for all generation units at each power station. These targets are based on ten years of historical data provided by the SOC generators and take into account outages. Separate targets are provided for peak, off-peak, weekend and super peak periods.

7.11 If the SOC generator defaults in its obligation to meet the availability targets, the gentrader is entitled to be paid Availability Liquidated Damages. Availability Liquidated Damages are also subject to a total annual cap and are not related to market trading exposures.

7.12 The SOC generator must pay an over generation charge when more electricity is generated than instructed by the gentrader. This charge is payable when the amount of electricity generated exceeds the instruction by more than 5 MWh.

7.13 The SOC generator is obliged to operate and maintain the power stations and the gentrader is responsible for the cost of capital improvements that the gentrader initiates. As referred to above, the SOC generator is obliged to provide capacity up to certain stipulated levels. The gentrader agreement provides for the capacity charges to be paid upfront by the gentrader and held by the Crown as a security deposit. The Crown pays interest to the gentrader at a rate of 5.2% per annum which is added to the initial deposit. The prepaid capacity charged and accrued interest is not immediately available to the SOC generator but is available to the Crown. It is released annually by the Crown to the SOC generator in accordance with the Capacity Charges Schedule.

7.14 The deposit deeds allow the Crown to pay the capacity charges to the SOC generators by accounting adjustments.

7.15 The gentrader is obliged to pay the SOC generator the following charges:

a. fixed charges, which are based on the estimated costs of operating and maintaining the power station and include associated capital expenditure. These charges are fixed and paid monthly over the term of the agreement and are escalated quarterly by a factor derived from the Wage Price, Producer Price and Consumer Price indices;

b. variable charges, which are paid at a set rate per MWh for the electricity sent out each month. As with the fixed charges, these charges are
escalated quarterly by a factor derived from the Wage Price, Producer Price and Consumer Price indices; and

c. pass-through charges, which recoup costs for water, transmission connection, licence fees, rates and land taxes.

7.16 The gentrader is responsible for purchasing and supplying coal to the power stations and the SOC generator is obliged to manage the coal from receipt to burn.

7.17 The gentrader is responsible for carbon costs and is entitled to carbon benefits.

The retail agreements: the respective rights and obligations of the parties

7.18 The retail agreements provide for an orthodox sale of the businesses. There is an associated transition services agreement for services to be provided by the SOC to the purchaser during the transition period for which the SOC is entitled to be paid. Such services include billing collections, debtor management and customer services including call centres and business information services.

7.19 The relevant transition periods for each retailer are as follows:

a. up to 25 months for Integral;

b. up to 36 months for EnergyAustralia; and

c. up to 43 months for Country.

Treasurer Roozendaal’s trip to New York

7.20 On 15 December 2010, the Treasurer left Australia and travelled to the United States of America, including New York. He was accompanied by his Chief of Staff and Mr Schur. The trip had been booked in November 2010, although it had been deferred for some days in order that the transactions could be executed prior to his departure. He returned to Australia on 24 December 2010.161

7.21 Treasurer Roozendaal was criticised, by sections of the media162 and political opponents,163 for leaving for overseas on 15 December 2010. The suggestion conveyed (expressly or by implication) was that the Treasurer had travelled to the USA in order to escape a backlash, and to avoid public scrutiny, relating to the sale of the electricity assets.

7.22 The purpose of the annual trip by the Treasurer to New York was to update the rating agency, Moody’s, on the NSW budget figures. The Treasurer and Mr Schur made a presentation to Moody’s which took about an hour and a half. They informed Moody’s of the impact of the electricity transactions on the State’s balance sheet, including the means by which the loss of dividend and tax equivalent income would be offset.

161 NSW Government, Department of Premier and Cabinet, Disclosure Log (DPC11/00423), Ministerial travel, Roozendaal, United States of America 15/12/2010 - 24/12/2012 (11 March 2011).
163 See the written statement of the Hon Andrew Stoner MP, Leader of the Nationals, dated 11 March 2011 and entitled “Roozendaal’s New York state of mind costs taxpayers tens of thousands”.

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7.23 Shortly after this presentation, Moody’s affirmed the State’s AAA rating.

7.24 On the basis of the evidence, the Inquiry concludes that Treasurer Rozendaal acted properly and consistently with the public interest in travelling to New York on 15 December 2010 to brief Moody’s on the State’s finances.

The proroguing of Parliament on 22 December 2010

7.25 Media reports on 20 December 2010 and the preceding weekend suggested that a Parliamentary committee was considering a self-referred inquiry into the electricity transactions of 14 December 2010 and the resignation of directors of Delta and Eraring.\(^{164}\)

7.26 On 22 December 2010 the Governor of NSW, acting, as she was obliged to do, on the advice of the Executive Council, prorogued both Houses of Parliament.

7.27 On 23 December 2010 the Parliamentary Committee met and resolved to conduct its proposed inquiry into the gentrader transactions. Advice was received from both the Crown Solicitor and the Clerk of the Parliament as to the effect of the prorogation on the Committee’s power to compel the attendance of witnesses and the availability of Parliamentary privilege (which would provide important protection to witnesses who might otherwise render themselves liable to claims for defamation of breaches of confidence or legal professional privilege). The advice was not consistent, and there was no binding precedent on which the Committee could rely.

7.28 The Committee conducted public hearings on 17, 18 and 24 January and 10 February 2011. Some of the witnesses called by the Committee had been privy to the detail of the electricity transactions. They included Premier Keneally, Treasurer Rozendaal, Mr Yeade, Mr Schur, Mr Timbs, Mr Cosgriff and Dr Gellatly. Others, such as Professor Outhred, Mr O’Farrell and Mr Baird were not aware of the detail of the transactions and had no means of finding out, except by the answers given by those witnesses in the first category. Because of the confidentiality of much of the detail of the transactions, although evidence was given as to the process followed and the result, in general terms, the Committee could not ascertain many of the significant matters which have been the subject of evidence before the present inquiry.

7.29 Treasurer Rozendaal said to the Committee, “Every inch of this transaction has been signposted, debated, analysed and scrutinised every step of the way for more than two years.”\(^{165}\) Our conclusions about the process appear in Chapter 12.

7.30 The Committee invited, and later summoned, the former directors of Delta and Eraring to give evidence. Each declined because of the uncertain legality of the

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Committee proceedings. It was accepted that there was just cause and reasonable excuse for their non-attendance by the Committee.166

7.31 The Committee ordered documents to be produced from the Premier, the Office of the Premier, the Department of Premier and Cabinet, the Treasurer, NSW Treasury, the NSW Electricity Reform Project Office, Eraring, Delta, and Macquarie Generation.167 Only non-privileged documents were produced.

7.32 On 23 February 2011 the Committee published its report.168 Its report is necessarily reflective of the limited nature of the information to which it was privy.

Further attempts to sell the remaining assets

7.33 Following the execution of the transaction for the three retail businesses, two gEntrader bundles and associated development sites, there remained two gEntrader bundles (Delta Coastal and Macquarie Generation) and two significant development sites (Tomago and Bayswater B).

7.34 By 21 December 2010, a further party had indicated an intention to lodge an expression of interest, which, if accepted, would entitle it to bid for the remaining assets. Discussions were continuing with three parties for the remaining two gEntrader bundles. There had also been discussions with TRUenergy about changes to the gEntrader agreement, which the Government had agreed to make. Consistent with its policy, Origin was also provided with a revised term sheet to give it the opportunity to consider whether it would prefer an agreement which incorporated those changes.

7.35 On 11 January 2011, a letter was sent to all bidders inviting bids for the remaining assets and setting out the process that would apply for submission of binding bids, the information requirements to be met by bidders, lodgement instructions and evaluation criteria which would be used to assess binding bids. These documents were based on the documents that had been used previously with consequential amendments to take account of the assets that were no longer for sale (having been the subject of transactions entered into in December 2010). The deadline for submission of binding bids was 31 January 2011, and the data rooms and a further Q&A process were available until 24 January 2011. The Government confirmed that it would accept binding bids which were conditional on ACCC approval, provided that the bidders could show that they had been in active dialogue with the ACCC and had used their best endeavours to respond to any request of the ACCC.

7.36 At its meeting on 12 January 2011, the Steering Committee considered further timelines which had been prepared by Treasury and the financial advisers for the sale of the remaining assets. The following key target dates were identified:

a. binding bids for the remaining unexecuted transactions, 31 January 2011;

b. execution of remaining unexecuted transactions, 16 February 2011;

166 Legislative Council of NSW, Procedural Highlights, Procedural Highlights no. 31, July to December 2010, p. 11; Legislative Council of NSW, General Purpose Standing Committee No. 1, Inquiry into the GEntrader Transactions, the Parliament, Sydney, p. 12.
167 Ibid.
168 Ibid, p. l.
c. completion of executed transactions, 28 February 2011; and

d. completion of remaining transactions, 28 February 2011.

7.37 On 1 February 2011, Premier Keneally announced that the Government would not proceed with any further privatisation of the State’s electricity assets.

7.38 At its meeting on 2 February 2011, the Steering Committee noted that no binding bids had been received by the expiry date of 31 January 2011. The financial advisers told the Committee that although bidders continued to express interest in the remaining assets, the bidders had expressed their concern given the Legislative Council Inquiry and identified a “reputational risk” in continuing to participate in the Energy Reform Project, having regard to that Inquiry.

7.39 The Steering Committee continued to oversee the tasks which were required to be performed prior to the completion of the transactions which had been executed on 14 December 2010; such completion was scheduled to occur by 1 March 2011. In the case of the retailers, these tasks were, in large measure, associated with ensuring a smooth handover of retail customers from the retail SOCs to the purchasers. In the case of the gentrader bundles, the pre-completion tasks included the following:

a. the gentraders becoming registered with AEMO as the generator for the relevant units;

b. completion of the coal stockpile surveys;

c. the gentraders putting in place the necessary insurance arrangements;

d. agreement concerning transition plans; and

e. transfer of hedge and other contracts.

7.40 Detailed completion check-lists were prepared with a view to completion on 1 March 2011. One such item was the need for a change in the Greenhouse Gas Reduction Scheme to permit the gentraders to apply for a permit to create greenhouse gas emissions.

**Further Directions**

7.41 In February 2011, Delta and Eraring were given a s. 20N Direction to maintain the employment conditions for award employees who were deemed affected employees and a separate Direction to maintain the employment conditions for contract employees who were deemed affected employees. Eraring was given an additional Direction in late February to execute the Share Transfer Agreement between Macquarie Generation, Delta, Eraring and Cobbora Holding Company Pty Limited.

**The Auditor-General’s Report**

7.42 At its meeting on 9 February 2011, the Steering Committee noted that Treasury would be provided with a draft of the Auditor-General’s report on the Energy
Reform Transactions for comment and that it was expected that the final report would be published on 25 February 2011.

7.43 Treasury made several comments on the Auditor-General’s draft report, some but not all of which were adopted by the Auditor-General in the published report. Mr Schur informed the Inquiry that Treasury would have preferred to have seen a table included in the report which set out what the key risks were before the transaction and what the risks were after the transaction. Treasury considered that such a table would have more effectively shown the change in the State’s risk profile as a result of the transactions.

7.44 In his evidence to the Inquiry Mr Schur instanced the following as material risks that had been reduced, to the State’s advantage, as a result of the transaction:

<table>
<thead>
<tr>
<th>Description of risk</th>
<th>Pre-transaction</th>
<th>Post-transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue risk</td>
<td>Volatile series of cash flows</td>
<td>Series of stable and fixed contractually determined payments</td>
</tr>
<tr>
<td>Carbon risk</td>
<td>State (through SOC generators)</td>
<td>Gentrader</td>
</tr>
<tr>
<td>Risk of unplanned outages</td>
<td>Unlimited</td>
<td>Capped</td>
</tr>
</tbody>
</table>
Chapter 8  The Cobbora Coal Project

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The Inquiry’s view of the Cobbora Coal Project ....................................... 126
The decision to develop Cobbarra

8.1 In October 2010, the Government decided that a State entity would own and develop a mine at Cobbarra (between Mudgee and Dubbo), and that it would sell mined coal to the SOC generators at prices that reflected the estimated cost of production, rather than the price offered through a tender process. The effect of this was that if any of the gentrader agreements were entered into with SOC generators which were party to the Cobbarra coal supply agreements, the gentrader would get the benefit of coal at cost price.

8.2 In addition, the decision to develop Cobbarra increased the retention value of the generators since they had the benefit of the coal supply agreements for Cobbarra coal, the cost of which would affect their net profit in the future.

8.3 This decision was arrived at following a lengthy process which had begun in 2008. It represented a departure from the Government’s policy of not owning coal mines (which had led to the sale of State owned coal mines in the late 1990s and early 2000s) in that it put in place a structure which would give the SOC generators and gentraders access to coal at a lower price than would have been available to them had they had to source such coal through the tender process.

8.4 In order to explain why this decision was made, it is necessary to outline the background to the development of what came to be known as the Cobbarra Coal Project.

The background to the development of Cobbarra

8.5 In the past, the SOC generators had been able to negotiate long-term coal supply agreements (usually for higher ash coal which was not suitable for export) at acceptable prices in the normal course of their business. These coal supply agreements insulated them from the vicissitudes of the international market price for coal. However, the increased export demand for coal (largely emanating from China) had inflated the local price. Even coal that had traditionally not been of a grade that was suitable for export (because of its high ash content) was being treated (washed) for export. Long-term coal supply agreements were not readily available to SOC generators, because the coal suppliers wanted to preserve their right to sell their supply for export, or at export prices.

8.6 Further, the SOC generators’ need to procure coal on the open market had the potential to place them at a competitive disadvantage to other coal-fired power generators in the NEM.

8.7 Indeed, according to ACIL Tasman Energy Market Modelling Data for the AEMO/DRET Energy White Paper dated 13 September 2010, most other generators outside NSW had dedicated coal mines which secured their fuel supply at well below export parity prices for a significant proportion of the estimated life of the power stations.

8.8 The situation in other regions of the NEM is as follows:
a. most Queensland power stations operate at mine-mouth (that is, mines that are owned by the generators that they supply) (owned or captive);

b. third party miners which transport coal to Queensland power stations do not face the same export parity pressure due to long term coal supply agreements, and inadequacies in export infrastructure in Brisbane;

c. all Victorian power stations operate at mine mouth (owned or captive) using brown coal which is much cheaper and not suitable for export; and

d. South Australian power stations own their coal supply mine as well as rail transport assets.

8.9 Thus, most other generators in the NEM were not facing the difficulties in procuring coal supply as were being encountered by the NSW generators.

8.10 The Inquiry was told that Cobbora was developed in part to overcome NSW’s coal supply issues.

8.11 Each of the SOC generators, as at 2008, would be short on coal in the future as coal contracts expired, although Eraring was in the worst position.

8.12 The Cobbora area was identified by the SOC generators as being suitable for the development of a large-scale open cut mine producing higher ash coal, which would fuel their generators. It was envisaged that a rail spur would be constructed which would be connected to existing rail lines to transport the coal to the SOC generators.

8.13 In July 2008, the Government determined a budget of $115 million over four years (of which $75 million was earmarked for land acquisition), which was to be shared between the three SOCs. The three SOC generators formed special purpose vehicles which together became an unincorporated joint venture (UJV).

8.14 Subsequently, on 9 March 2009, the Government authorised the UJV to apply for an exploration licence for Cobbora with a view to inviting tenders from the private sector to develop, construct and operate a privately owned mine within the base area of the exploration licence to supply coal to the SOC generators for 15 years.

8.15 The original Treasury forecast based on TCOrp models was that the mine development phase of the Cobbora Coal Project (from 2013 to 2017) was likely to cost a total of up to $1.5 billion (in 2009 dollars).
8.16 As at March 2009, the following timetable was envisaged for the Cobbora Coal Project:

<table>
<thead>
<tr>
<th>Milestone</th>
<th>Due date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mine Development Construction and Operations Contract - Invitation to Tender for Area</td>
<td>June 2009</td>
</tr>
<tr>
<td>Award of Mine Development Construction and Operations Contract</td>
<td>February 2010</td>
</tr>
<tr>
<td>Finalise environmental assessment</td>
<td>June 2010</td>
</tr>
<tr>
<td>Finalise land acquisition</td>
<td>June 2010</td>
</tr>
<tr>
<td>Lodge Part 3A Planning Application</td>
<td>June 2010</td>
</tr>
<tr>
<td>Development Approval granted</td>
<td>April 2011</td>
</tr>
<tr>
<td>Mining lease granted</td>
<td>April 2011</td>
</tr>
<tr>
<td>First coal produced</td>
<td>January 2013</td>
</tr>
</tbody>
</table>

8.17 During 2009 and 2010 the UJV progressed the project to a stage where most of the land required had been acquired, extensive drilling had been carried out and feasibility studies had been conducted.

8.18 The tender process which was conducted by the UJV resulted in a single complying tenderer. It nominated an ex-mine price for coal to be supplied to the SOC generators. There was concern by those involved in the Energy Reform Project that the tendered price was too high and would deleteriously affect the profitability of the SOC generators and potentially affect the merit order in the NEM (which meant that they would be later in the merit order than other participants. In other words, at a given level of demand, NSW generators would sell less electricity).

8.19 The concern was voiced by Frontier Economics in a report dated 11 June 2010 entitled “Review of Cobbora, Final Discussion note”, which described the tendered coal price as “exorbitant and ... dramatically higher than those faced by NEM competitors and the anticipated price when the process was commenced”. Frontier Economics warned that there would be no interest from the private sector in the gentrader contracts if the delivered price of thermal coal was in excess of $3/GJ. A critique of this report was performed by Ernst & Young.

8.20 A special Steering Committee meeting dedicated to Cobbora was held on 23 August 2010. Mr Dimpfel informed the Committee that bidders had expressed concern about the high price of Cobbora coal and the possible effect of such prices on the level of bids made by the gentraders through the NEM.

8.21 The Steering Committee obtained further advice on the appropriateness of the preferred tenderer’s price, including advice from the following:

- AMC Consultants, which was engaged to conduct a review of price to determine its reasonableness;

- Treasury representatives and the financial advisers who met with the preferred tenderer to determine the rate of return incorporated in their tender price (and to derive the cost of production) and reported that the
returns sought were substantially greater than the cost of capital. The financial advisers recommended against acceptance of the tender; and

c. the SOC generators, each of which recommended that the tender be accepted, in order to secure their coal supply.

8.22 In late August 2010, the Government decided not to accept the tender and referred back for the Steering Committee’s consideration the options available to the Government.

The four options

8.23 A report was prepared by the Cobbora Working Group which outlined four options:

a. further negotiations to secure an acceptable free-on-rail price from the preferred tenderer;

b. formally make Cobbora available for the future gentraders to develop the resource;

c. re-tender using substantially the same tender documents as previously; and

d. establish a Government owned organisation to develop the resource and enter into coal supply agreements with the SOC generators whereby the coal would be sold at a price that reflected the estimated cost of production.

8.24 The preferred tenderer’s offer for Cobbora had lapsed. The first option, therefore, was considered unlikely. The second option was rejected as not being feasible since it would depend on unknown vicissitudes. The third option was rejected since it was thought unlikely to produce a different outcome. The fourth option was ultimately the subject of a unanimous recommendation by the Steering Committee to the Cabinet Committee.

8.25 The reasoning for the preference for the fourth option was explored in the evidence before the Inquiry.

8.26 In his evidence to the Inquiry, Mr Dimpfel argued that where the Government owned both the mining asset (Cobbora) and the generators, there was a ‘zero sum game’. This dynamic would not alter when the gentrader agreements were sold because the price of coal in the coal supply agreements would affect the value of the gentrading rights. The benefit of coal at cost price in the Cobbora coal supply agreements would give rise to a higher bid price. Therefore there would be no effective ‘subsidy’ of coal, because the gentrader’s bid would have factored that into account.

8.27 Mr Schur explained to the Inquiry that his position, as Secretary of Treasury, was no different to the approach he would adopt for any large capital investment by the State. He saw Cobbora as a $1.5 billion investment about which he would have preferred to see detailed modelling. He said that the Treasury perspective was to analyse the relative risks: on the one hand, if the State accepted the preferred tender there was a risk that the value of the generators would be impaired because they would be locked into excessive coal prices; on the other hand, if the State refused the tender, it would be
obliged to develop and operate the mine itself and commit to supply coal to the SOC generators at a specified price and it would be exposed to the risk of there being insufficient revenue from the mine (or its eventual sale price) to recover its costs in full.

8.28 The Inquiry was told that, although neither of the two risks identified above could be precisely quantified, the ultimate assessment made was that the risk of impairing the value of the generators by accepting the preferred tender exceeded the risk of the State not recovering the costs of developing the mine.

8.29 Frontier Economics performed some modelling to quantify the impact of different coal prices on gentrader value and Government risk (of guaranteeing a firm coal price). On 20 September 2010, Frontier Economics made a presentation to the Steering Committee in which it concluded that:

a. a nominated delivered price was the point at which gentrader value and Government risk were appropriately balanced;

b. a higher coal price meant that the lower gentrader value outweighed the decrease in Government risk; and

c. a lower price exposed the Government to a higher risk but the gentrader value did not increase proportionally.

8.30 The delivered coal price comprised the following:

a. the ex-mine price;

b. the cost of rail spur access services to enable haulage from the mine delivery point to the main rail system;

c. royalties; and

d. the cost of transport from the place where the spur joined the main rail system to the power station.

8.31 Taking into account the Frontier Economics modelling referred to above, an acceptable mine price was derived, and, accordingly, it was the price that the Steering Committee recommended be stipulated in the coal supply agreements for Cobbora coal.

8.32 With or without the successful re-tendering of the Cobbora coal mine, the Government is left with a substantial price exposure. Treasury calculated that for every $0.10/GJ price difference, the State's gross exposure would be about $0.4 billion over the project life, or about $25 million per annum. If the price difference was of the order of $0.50 to $1.00/GJ, then the State's gross exposure could be of the order of $2 to $4 billion or about $125-$250 million per annum.

8.33 Treasury identified the following risks associated with the State's underwriting of the Cobbora Coal Project:

a. the cost of underwriting the price of coal may not be fully captured in a higher gentrader transaction value;
b. reduced fuel costs to some, but not all, NSW generators might not translate into lower power prices in NSW; and

c. these risks would apply irrespective of successful re-tendering.

8.34 The Steering Committee also recommended the establishment of a fund within TCorp from the sale proceeds to cover the following potential liabilities:

a. cost overruns;

b. the cost of procuring coal to perform the coal supply agreements if the mine was insufficiently developed by the time for performance of those agreements;

c. the effective cost of capital difference (between the Government which has a borrowing cost of 6% and the private sector which has an estimated cost of capital of 15%) which will give rise to an expectation from the private sector of a greater rate of return, which will mean that it there is a significant risk that the Government will make a loss on the resale; and

d. loss on the sale of the mine and rail spur assets upon transfer to the private sector which may not occur simultaneously.

8.35 Mr Schur described this fund to the Inquiry as an “insurance policy” against the risk of not recovering the costs already incurred. The bulk of the provision related to the third matter.

8.36 Subsequently, consideration was given to increasing the fund to take account of the possibility that the aggregate coal volume required by gentraders and SOC generators was 9 Mtpa (and not 11-11.5 Mtpa as previously envisaged). The figure of 9 Mtpa was the product of market modelling undertaken by Frontier Economics in late 2010 (which showed that that would be sufficient to meet the demand of Macquarie Generation, Eraring and Delta Coastal). The Steering Committee formally adopted the scaled back coal contract profile for Cobbora for the purpose of the Energy Reform Project and noted that this would necessitate an increase in the fund.

8.37 Ultimately, in October 2010, the Government accepted the unanimous recommendation of the Steering Committee and chose the fourth option, approved the proposed ex-mine price and the provision to be reserved from the sale proceeds. The draft coal supply agreements were placed in the gentrader bidder data rooms shortly thereafter.

8.38 The proposed ex-mine price was designed to cover the NSW Government’s cost of funds, assuming 100% debt financing from TCorp with 6.1% interest rate and capital expenditure, production costs and stripping ratios (proportion of overburden/ waste rock to ore) similar to the preferred tenderer’s expectations as reflected in its unsuccessful tender for a 11 Mtpa mine, excluding UJV land purchase and preparation costs.

The Government’s intention to sell Cobbora

8.39 Following the Government’s approval, a transfer of shares from the UJV to Cobbora Holding Company Pty Limited, of which the Treasurer was to be the
sole shareholder, occurred on 21 December 2010. It was the Government's intention that the Cobbora Coal Project be transferred to the private sector as soon as reasonably possible. The Cobbora Coal Project was transferred to Cobbora Holding Company Pty Limited on 28 February 2011. Cobbora Holding Company Pty Limited has two wholly owned subsidiaries: Cobbora Coal Mine Pty Limited and Cobbora Rail Company Pty Limited.

8.40 Mr Lobb told the Inquiry that he considered there to be substantial value in the Cobbora Coal Project which could lead to its being sold at a price that would be sufficient for the State to recover its costs and provide some return. He reasoned that the Cobbora Coal Project would be attractive to a miner since the costs of production were met by the coal supply agreements with the SOC generators. The coal required to fulfill the demand in those agreements came from the base area of the mine. If any further development of the mine occurred a greater return might be expected which might make it an attractive commercial proposition.

8.41 The Inquiry was told on 15 September 2011 that Xenith Consulting Pty Limited had recently been engaged by the Cobbora Holding Company Pty Limited to provide assistance with the preparation of a business plan, which is expected to be completed in November 2011. As this plan post-dates the reporting date of this Inquiry, the Inquiry is not in a position to review the adequacy of the business plan.

8.42 The Inquiry has also been advised by Treasury, by letter dated 20 September 2011, that the Cobbora Holding Company Pty Limited is:

[A] fully functioning company and is progressing the project under the direction of acting Chief Executive Officer, Mr Steve Ireland. Mr Ireland provides project continuity as he was Acting CEO of the Cobbora Management Company whilst the project was managed by the Unincorporated Joint Venture.

The company is being resourced progressively with a number of positions successfully filled with suitably qualified individuals as employees or by way of secondment and recruitment to other positions is underway. In addition ... contractors have been engaged and are continuing to be engaged, to support key project activities such as the Environmental Approvals process and Infrastructure Project Management.

8.43 The Treasury document entitled “Review of Sales Transactions” provides the following information about the proposed business plan:

The mine plan is being designed to accommodate current contracted coal volume (up to 9.5 million tonnes per annum) with the first coal delivered in July 2015, plus up to approximately a further 25 per cent coal export sale volume.

The agreements relating to the Cobbora Coal Project

8.44 There are presently coal supply agreements dated 28 February 2011 between Cobbora Coal Mine Pty Limited and the following entities:

a. Macquarie Generation;

b. the Delta Coastal generators; and

c. Origin (which purchased the Eraring gentrader rights).
8.45 The coal supply agreements provide for the first delivery of coal to be made in July 2015.

8.46 The coal supply agreements limit the liability of Cobbora Coal Mine Pty Limited in respect of a breach of the term to supply coal to an annual cap (equivalent to a shortfall of a fraction of the total coal required to be supplied). This limitation operates to the benefit of the State in relation to the coal supply agreement with Origin and reduces the liability to which Cobbora Coal Mine Pty Limited would otherwise be exposed.

8.47 There are also rail spur access agreements between Cobbora Rail Company Pty Limited, Origin, Macquarie Generation and Delta Coastal.

8.48 Most of the costs budgeted for Cobbora ($1.5 billion) have yet to be incurred as the development has yet to reach the point where those costs will be incurred. As at 30 June 2011, the capitalised costs of the Cobbora Coal Project amounted to $130 million, which included:

a. land acquisitions: $92 million;

b. water licences: $5 million; and

c. mine development costs: $31 million.

8.49 The coal supply agreements affect the accounts of Cobbora Holding Company Pty Limited and also the State’s accounts (as shareholder of Cobbora Holding Company Pty Limited). Because the agreements were executed on 28 February 2011, their effect is recorded in the accounts for the financial year ended 30 June 2011.

8.50 The State has chosen to treat the effect of the agreements in a way that is more adverse to its accounts than has Cobbora Holding Company Pty Limited.

8.51 The issue arises whether Accounting Standard AASB 137 applies. This accounting standard requires, in certain circumstances, provision to be made for “onerous contracts”, which are defined as contracts “in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it”.

8.52 Based on the projected costs to be incurred in developing and operating Cobbora and the revenue to be generated from the concluded coal supply agreements referred to above, Ernst & Young calculated that the unavoidable costs of meeting each coal supply agreement exceeded the revenues.

8.53 It will be recalled that the ex-mine price was expected to cover the costs of production. It was, however, set at a time when it was expected that the total contracted coal quantity would be 11 Mtpa, not 9.5 Mtpa. Although the costs of producing 11 Mtpa are greater than for 9.5 Mtpa, they are not proportionally greater. The difference accounts for the disparity referred to above.

8.54 The coal supply agreement between Cobbora Holding Company Pty Limited and Origin is the only such contract with a non-State entity. Therefore it is the only contract for which provision is appropriate.
8.55 The project has the benefit of some concluded contracts but has future potential which is not yet the subject of concluded contracts. To attribute the full costs of the project to the revenue from concluded contracts gives a negative picture of the financial state of the company. The approach adopted by the State leaves out of account the residual capacity of Cobbora to produce more coal which would be available for coal supply agreements in the future with generators, or for export.

8.56 Cobbora Holding Company Pty Limited itself did not adopt that approach and did not apply AASB 137 in its treatment of the coal supply agreements. Its approach has met with the approval of the Auditor-General, who, as auditor, signed off on the accounts of Cobbora Holding Company Pty Limited for the year ended 30 June 2011 on that basis on 28 September 2011.

8.57 The Inquiry expresses no view about the appropriate accounting treatment of the coal supply agreement between Cobbora Holding Company Pty Limited and Origin. However, for the reasons given above, the Inquiry considers that the provision made in the State's accounts does not reflect the benefit conferred on the State by the Cobbora Coal Project.

Mr Challen's view of the Cobbora Coal Project

8.58 The expert engaged by the Inquiry to opine on terms of reference three and four, Mr Challen, is of the view that the benefits of the Cobbora Coal Project do not exceed its costs. His reasoning is based, in part, on the assumption that the preferred tenderer's price was a reasonable price that reflected a commercial rate of return. He then uses the Treasury analysis to determine that the price differential between the preferred tenderer price and the contracted price presents a shortfall over the proposed term of the coal supply agreements.

8.59 This calculation leads him to conclude that the Cobbora Coal Project will not achieve acceptable returns to compensate the State as owner for the risks inherent in the ownership and operation of the mine. Although Mr Challen refers to the advantages of the development (which cannot presently be quantified) he nonetheless concludes that the benefits, including unquantifiable benefits, of the Cobbora mine did not exceed its costs.

The Inquiry's view of the Cobbora Coal Project

8.60 As will be apparent from the following paragraphs, the Inquiry's view differs from that of Mr Challen because it considers that there is presently insufficient information to come to the view that the costs exceeded the benefits. However, the difference may simply be one of emphasis in that Mr Challen's assessment that the benefits do not demonstrably warrant the amount of, and risks associated with, the investment appears to underpin his conclusion that the benefits do not exceed the costs. The Inquiry's view is that it is too early to say either that the benefits from the investment made by the State in Cobbora warrant the cost of the investment, or that they did not.

8.61 As is set out in more detail below, the Inquiry considers that each of the Government's major decisions relating to Cobbora (to develop it in the first place; to reject the preferred tender; to take over the development itself with a view to eventual sale; and to enter into coal supply agreements with Origin and
the SOC generators) was justified by reference to the material available to it at
the time of each decision. Whether each of the decisions will prove, when and
if the mine is sold, to have been better than the alternatives with the benefit of
hindsight is presently unknown. The time has not yet arrived when such a
judgment can be made.

8.62 The principal benefit to the State afforded by the Cobbora Coal Project is that
the coal supply agreements with the SOC generators for Cobbora coal, if
performed, will ensure that the SOC generators (and the gentraders) will have
access to coal to preserve their continued operation at a price which is unlikely
to disturb their merit order in the NEM.

8.63 The importance of Cobbora to the coal-fired generators in NSW appears from
the following passage from the Electricity Statement of Opportunities 2011, at
5-7:

Coal costs for all New South Wales generators (excluding Redbank) tend to
converge after approximately 2020, due to Cobbora becoming the supplier for
the majority of coal to all large New South Wales power stations.

8.64 It is not possible to discern the value of this to the bidders for the Eraring
gentrader agreement (being the only gentrader agreement entered into which
carried with it the benefit of Cobbora coal supply agreements). Nor can one
know whether there would have been a bid for the Eraring gentrader without the
Cobbora coal supply agreements. However, it is reasonable to infer that the
Cobbora coal supply agreements had a positive effect on the value of the
Eraring gentrader agreement given its short coal supply.

8.65 In the Inquiry’s view, it would involve an unacceptable degree of speculation to
comment on whether the modelling performed by Frontier Economics in
September 2010 as to the effect of fixing the price at a particular level on the
value of the gentrader agreements was borne out by what happened. It is, in
the Inquiry’s view, too simplistic to say that because the retention price of the
Eraring generator was not exceeded by the bid price, Origin did not attribute
value to the Cobbora coal supply agreement. For reasons, which will be
expanded upon later, there is necessarily a disparity between the retention
value of the generators and the value of the gentrader agreement.

8.66 As will be seen from the discussion of future options in Chapter 13, the Inquiry
recommends the sale of the Cobbora coal mine and the associated
agreements. To a significant extent no useful prediction can be made as to the
success or otherwise of the Cobbora Coal Project unless and until it is sold. If
the sale price is sufficient to cover the Government’s costs of development and
the terms of the sale require the purchaser to provide coal to the SOC
generators or gentraders at the ex-mine price struck, then it could reasonably
be adjudged that the public obtained value for money. However, if the sale
price is insufficient to provide for these matters and there is a shortfall which the
State must make good, then it may be that such a judgment cannot be made.
Any ultimate assessment in time of overall value of the Cobbora project to the
State will need to also take into account the positive impact on the gentrader
bids and the impact on the profitability of the NSW generators resulting from
their contractual arrangements with Cobbora.
8.67 Having regard to the circumstances referred to above that the ex-mine price was designed to cover the cost of production of coal to the State, it is unlikely that it will be sufficient to cover the cost of production incurred by a commercial entity. The reason for this is that the State's borrowing cost is significantly less than the cost of capital to a commercial entity. Therefore, there is a real prospect that the State will not be able to sell Cobbora for a figure that is sufficient to reimburse it for its investment, if it has to rely only on the coal supply agreements to which any purchaser of Cobbora will be subject.

8.68 It will be recalled that a proposed provision in the State's accounts was suggested to take account of the real prospect that the eventual sale price of Cobbora will fall short of reimbursing the State for the investment it has made and the potential for construction and operating cost overruns.

8.69 As the narrative of facts discloses, the Government, in respect of Cobbora, faced two risks, the quantification of each of which involved a degree of speculation. The evidence does not provide a basis for an inference that the Government's decision to reject the preferred tender was not soundly based; nor does it provide a basis for an inference that the Government ought not have struck a price for the coal supply agreements which it considered reflected the cost of production of Cobbora coal.

8.70 There was some evidence before the Inquiry to the effect that the tender process which produced the preferred tender as the only contender was flawed and had been conducted in a way which may have been deleterious to the interest of obtaining the best price. However, the evidence was largely result-based (that is, because there was only one tender, the tender process cannot have been conducted well) or impressionistic (that is, it was bureaucratic because it was run by the UJV rather than by a separate State entity). In these circumstances, the Inquiry does not consider that any inference can be drawn about the Cobbora Coal Project tender process.

8.71 Furthermore, there would be little utility in coming to a conclusion about the tender process, when the result was that the single tender was not accepted and an alternative course of action was adopted.

8.72 The objectives set out for the Energy Reform Project were not expressed to include the Cobbora Coal Project. In these circumstances it is not apposite to apply them to it. For the reasons given above, the Cobbora Coal Project was undertaken in the first instance to assure adequate cost-effective coal supply to NSW generators to overcome the coal supply issues it was thought that they would face in the NEM when their current coal supply agreements came to an end. Whether it can fulfil this objective depends in large measure on whether the coal supply agreements can be performed in accordance with their terms.

8.73 However, the capacity of the NSW generators, or gentraders (in the case of Origin) to compete in the NEM also depends on extraneous factors, such as the carbon price, the ultimate quantum and effect of which on the merit order is presently unknown.
Chapter 9  Resignation and appointment of directors

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The State Owned Corporations Act 1989

9.1 An understanding of the SOC Act is necessary to appreciate the decisions being made by the SOCs on 14 December 2010. The framework for the SOC Act is set out in Chapter 2. This Chapter will consider its provisions in detail.

9.2 Section 20C provides that the assets, rights and liabilities of a State authority may be transferred to a statutory SOC in exchange for the issue of shares.

9.3 Section 20E sets out the principal objectives of every statutory SOC as follows:

(1) The principal objectives of every statutory SOC are:

(a) to be a successful business and, to this end:

(i) to operate at least as efficiently as any comparable businesses, and

(ii) to maximise the net worth of the State's investment in the SOC, and

(b) to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates, and

(c) where its activities affect the environment, to conduct its operations in compliance with the principles of ecologically sustainable development contained in section 6 (2) of the Protection of the Environment Administration Act 1991, and

(d) to exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates.

(2) Each of the principal objectives of a statutory SOC is of equal importance.

9.4 Consistent with the principle of competitive neutrality, a statutory SOC does not represent the State (except by express agreement with its voting shareholders), is not exempt from any State-imposed taxes or duties by reason of its status as a SOC and cannot render the State liable for any debts, liabilities or obligations incurred (SOC Act, s. 20F).

9.5 A statutory SOC has a share capital and shares as provided in its constitution.\(^{169}\) However, each statutory SOC has only two shareholders; the Treasurer and another Minister nominated by the Premier.\(^{170}\) These two Ministers are referred to in the SOC Act as the "voting shareholders".\(^{171}\)

9.6 Each statutory SOC has a board of directors. The directors are usually appointed by the Governor on the recommendation of the voting shareholders.\(^{172}\) In the case of a statutory SOC that is also an energy services corporation within the meaning of the Energy Services Corporation Act 1995 (the ESC Act), such as the State owned electricity generators Delta, Eraring

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\(^{169}\) SOC Act s. 20H(1).

\(^{170}\) SOC Act s. 20(5). The two shareholders have an equal number of shares and rights: s. 20H(4).

\(^{171}\) SOC Act s. 3(1).

\(^{172}\) SOC Act s. 20J.
and Macquarie Generation, the board of directors is appointed by the voting shareholders in accordance with Sch. 2, cl. 1(2) of the ESC Act.

9.7 The board of a statutory SOC is accountable to the voting shareholders as set out in Part 4 of the SOC Act and the constitution of the SOC.173

9.8 Each statutory SOC has a chief executive officer who, under the authority of the board, is responsible for the day-to-day management of the operations of the statutory SOC.174

9.9 Each statutory SOC must have a constitution and which must contain provisions specified in Sch. 6 of the SOC Act.175

9.10 Consistent with s. 20S of the SOC Act, a statutory SOC can declare and pay dividends to the voting shareholders. Such dividends are paid to the Treasurer on behalf of the State for payment into the Consolidated Fund. The statutory SOC must also from time to time pay to the Treasurer, for payment into the Consolidated Fund, tax-equivalents in accordance with s. 20T of the SOC Act.

Statutory SOCs are different from traditional corporations

9.11 Statutory SOCs, and the principal legislative regime that governs their operations, are different from traditional corporations. Significantly, statutory SOCs own and manage State assets. This fundamental matter is reflected in a number of provisions of the SOC Act.

9.12 The portfolio Minister is the Minister who has the duty to administer the foundation charter of a statutory SOC.176 The "foundation charter" is the Act or regulations by which the name of the SOC is inserted in Sch. 5 of the SOC Act (or some other Act specified by an Act as its foundation charter).177 In the case of the energy services SOCs, this is the ESC Act.

9.13 A statutory SOC can be subject to a written direction by the portfolio Minister requiring it to perform non-commercial activities in the circumstances specified in s. 20N of the SOC Act. This provision is considered further below.

9.14 Pursuant to s. 20O of the SOC Act, the portfolio Minister of a statutory SOC can, with the approval of the Treasurer, give written notice to the board of a statutory SOC that it must apply to the SOC, and any subsidiary companies, a specified public sector policy "if the portfolio Minister is satisfied that it is necessary to give the notification in the public interest."178

9.15 Pursuant to s. 20P of the SOC Act, the portfolio Minister of a statutory SOC may also, with the approval of the Treasurer, give a written direction to the board of a statutory SOC in relation to the SOC (and any subsidiaries) "if the portfolio Minister is satisfied that, because of exceptional circumstances, it is necessary to give the direction in the public interest."179 The board must ensure

173 SOC Act s. 20J(6); see also ESC Act Sch. 2, cl. 1(5).
174 SOC Act s. 20L.
175 SOC Act s. 20Q. In respect of a statutory SOC that is also an energy services corporation, see also ESC Act s.10, Sch. 2.
176 SOC Act s. 20L.
177 SOC Act s. 3(1).
178 SOC Act s. 200(1).
179 SOC Act s. 23P(1).
that the direction is carried out in relation to the SOC. 180 Before giving the direction, the portfolio Minister is required to consult with the board and to request the board to advise the portfolio Minister as to whether, in the board’s opinion, compliance with the direction would not be in the best interests of the SOC. 181 Section 20P also provides a mechanism for the statutory SOC to be reimbursed in respect of the net cost of complying with such a direction.

9.16 In respect of written directions given by a portfolio Minister under either s. 200 or s. 20P of the SOC Act, the portfolio Minister must cause a notice to be published in the Gazette setting out the reasons why the direction was given and why it is in the public interest that the direction be given. Such notice must be published within one month after the direction is given. 182 Copies of any such written direction and the notice in the Gazette are also required to be laid by a Minister before each House of Parliament. 183

9.17 Section 20Y prevents the sale of the main undertakings of a statutory SOC except with the prior written approval of the voting shareholders.

9.18 Furthermore, the board of directors of a SOC is accountable to the voting shareholders for the commercial performance of the corporation by written statements of corporate intent and the provision of annual and half yearly reports in accordance with Part 4 of the SOC Act.

9.19 Pursuant to s. 22 of the SOC Act, in respect of the financial year to which it relates the written statement of corporate intent must specify certain matters including the objectives of the SOC, its main undertakings, the nature and scope of the activities to be undertaken, the accounting policies to be applied, the applicable performance targets, and the kind of information to be provided to the voting shareholders by the SOC.

9.20 Pursuant to s. 29(1) of the SOC Act, the board of a SOC must supply to the voting shareholders such information relating to the affairs of the corporation as from time to time may be requested. Similarly, under s. 29(2) the board of a SOC must supply to the portfolio Minister such information relating to the affairs of the SOC as the Minister requests.

9.21 Section 33AA of the SOC Act provides that a board of a SOC has an obligation: to ensure that a public sector policy notified to the board is carried out; to ensure that a direction given to the board under s. 20P is carried out; and to supply information required of the board under s. 29. A director of a SOC does not incur any personal liability for compliance, or purported compliance, in good faith by the board with any such obligation: s. 33AA(3).

9.22 Further recognition of the special character of a SOC can be found in the statutory provisions relating to the duties of directors and officers of a statutory SOC. These duties are considered in greater detail in Chapter 10.

180 SOC Act s. 20P(2).
181 SOC Act s. 20P(3).
182 See SOC Act ss. 200(5) and (6), 20P(5) and (6).
183 SOC Act ss. 20(1) (a), (p), (q), (r). See also s. 27.
Section 20N of the SOC Act

9.23 Section 20N was introduced by the 1995 amendments to the SOC Act. In the present context, s. 20N is a key provision of the SOC Act. Section 20N(1) provides:

If the portfolio Minister wishes a statutory SOC to perform activities, or to cease to perform activities, or not to perform activities, in circumstances where the board considers that it is not in the commercial interests of the SOC to do so, that Minister with the approval of the Treasurer may, by written notice to the board, direct the SOC to do so in accordance with any requirements set out or referred to in the notice.

9.24 The SOC is required to comply with any such direction: s. 20N(2).

9.25 Section 20N(3) provides that the SOC is entitled to be reimbursed, from money advanced by the Treasurer or appropriated by Parliament for the purpose, amounts equal to:

(a) the net cost of performing any such activities, including the cost of capital, and

(b) the net cost of complying with a direction to cease to perform or not to perform any such activities.

9.26 The amounts and times of payment of those amounts are as agreed between the Treasurer and the SOC or (failing agreement) as determined by a suitably qualified person or persons nominated by the Premier.

9.27 The SOC may be reimbursed, from money advanced by the Treasurer or appropriated by Parliament for the purpose, amounts not exceeding the estimated net amount of revenue foregone through ceasing to perform or not performing any such activities, as determined by the Treasurer having regard to such factors as the Treasurer considers relevant in the circumstances.

9.28 Pursuant to s. 26(1)(j) of the SOC Act, a copy of any direction issued by a portfolio Minister under s. 20N is required to be laid, by a Minister, before each House of Parliament within 14 sitting days after the notice was given.

Knowledge of the Delta and Eraring boards prior to December 2010

9.29 From at least May 2009, each of the boards of Delta and Eraring had known that they would probably be called upon, at some time, to consider transaction documents relating to the Energy Reform Project and that, ultimately, they might receive a Direction under s. 20N of the SOC Act. In that month, the Chair of each board was provided with the Protocol for the Interaction of Government and the State Owned Electricity Businesses (the Protocol). Among other matters, the Protocol provided that the SOCs should not appoint external advisers in relation to the Energy Reform Project unless they received Treasury's prior consent. It noted that there may be exceptional circumstances in which it would be appropriate for a SOC to seek separate external advice, such as in relation to some issue identified in due diligence.
9.30 A memorandum from Baker & McKenzie dated 30 June 2009 was sent to each of the Delta and Eraring boards which summarised the information in the Protocol about the role that directors would be expected to play in the Energy Reform Project. The memorandum stated that, among other things, the directors of the businesses "will have a specific but limited role in relation to the Project, for which they will be indemnified". It stated:

The Protocol sets out in detail what Directors are expected to do, but this is to include:

- ensuring that management are made available and co-operate fully with the Steering Committee, the Task Force, other representatives of the Government in relation to the Project and otherwise perform the roles set out in the Protocol;

- ensuring that Project Representatives and advisers have access to management and information about the Business as necessary for the Project (including responding to questions, attending relevant meetings etc); and

- ensuring that all aspects of the Protocol are adhered to.

The Protocol also sets out what Directors will not be asked to do, including:

- signing-off on or actively assisting with the preparation of any information memorandum (IM) (including financial information such as forecasts) prepared as part of the Project;

- signing-off on or assisting with the preparation of any vendor due diligence data rooms;

- signing-off on or assisting with the preparation of any presentations to be given to bidders, bidder due diligence data rooms or any written responses to questions asked by bidders.

9.31 The memorandum further stated that there would be board briefings about the sale strategy, the timetable and a summary of the proposed key terms of the transaction documents.

9.32 At the conclusion of the bid process, the board of each business would be further briefed and provided with a final form of transaction documents and other details. The memorandum indicated that the board of each business would be requested by the Minister to consider, and if appropriate, sign the final form of agreements and that the board would be asked to "move quickly". The memorandum stated that "the State understands that it may be challenging for the directors of each business to sign these transaction documents..." because, among other things, the directors would neither have been involved in the negotiation of the documents nor have had the benefit of advice from their advisers.

9.33 The memorandum said: "...if the directors are ultimately unable to sign the transaction documents, it is expected that the NSW Government will use its direction powers as set out in the [SOC Act], particularly under section 20N of the Act."

9.34 The memorandum also provided reasons for the expectation that the involvement of the directors in the process would be minimal:
9.35 By August 2009, the boards had been provided with an amended Indemnity to cover the Energy Reform Project and any costs associated with an unsuccessful defence of civil proceedings bought against them personally. Each board had sought and received advice on the Indemnities.

9.36 Throughout 2010, each board received a number of briefings from the Energy Reform Project advisers concerning timetables, the transaction agreements, the key terms of the gentrader agreement and confirming the role of directors as set out in the earlier memorandum and indemnification. For example, in March 2010, Frontier Economics gave a briefing to the SOCs’ senior management, including chief executives and chief financial officers, on the key terms of the draft gentrader agreements including the regime for Availability Liquidated Damages. In September 2010, Delta sought and received Senior Counsel’s advice in relation to, among other matters, the scope of the Portfolio Minister’s power of direction under s. 20N of the SOC Act.

9.37 By mid November 2010, the boards had provided data to the various relevant Working Groups including Due Diligence, Retention Value and Gentrader. They had received and, in some cases management had commented on, more than one version of the draft gentrader agreements and been advised as to the proposed changes to the gentrader agreements following feedback from bidders. They had received separate advices from a Queen’s Counsel (QC) and Baker & McKenzie as to the validity of the anticipated s. 20N Direction. They had received drafts of the letters, approvals and directions expected to be received from the Government following its evaluation of the bids and decision as to the purchasers of each bundle.

**Deliberations by Delta**

*Delta board meeting on Friday, 10 December 2010*

9.38 On Friday, 10 December 2010, a Delta board meeting took place from about 7.30 am to 8.30 am.

9.39 The minutes of the meeting record that the directors received legal advice as to their duties as directors, which was later confirmed in writing.

9.40 The board noted that a number of warranties in respect of proposed transaction documents exposed Delta to commercial and legal risks. Delta management had sought to have these warranties amended or removed from the transaction documents, but the Government had determined that it would not do so as these were the form of warranties that the Government had negotiated with bidders.

9.41 The board considered that, in the circumstances, it would be appropriate for the directors before approving the transactions first to receive both a direction under s. 20N of the SOC Act from the Minister requiring Delta to execute the transaction agreements and a satisfactory legal opinion from Baker & McKenzie.
to the effect that such a direction was valid and that Delta was required to comply with it.

9.42 Mr Timbs said to the Inquiry that on Friday 10 December 2010, the Evaluation Committee had met with a view to making recommendations to the Cabinet Committee to consider over the weekend. He communicated with the Chairs of the SOCs in order to let them know that they would need to have board meetings on short notice. He said: "The reason we wanted to line them up straight away was we wanted as short as possible gap between completing the evaluations, making recommendations to the Government, getting decisions and signing contracts..."

**Delta board meeting on Sunday, 12 December 2010**

9.43 On Sunday, 12 December 2010, a further meeting of the Delta board took place from about 2.00 pm to 4.40 pm.

9.44 The meeting was advised that Delta management had reviewed and provided feedback on the transaction documents as they had been developed by the Government's advisers during the course of the due diligence and bidding process (but without being party to any discussion with bidders or knowing their identities). The board noted advice from management that Delta had not had the opportunity to carry out its own valuation of generation assets or development sites, had not been involved in the negotiation process, and that the structure of the transactions made it difficult to value the rights and assets offered for sale.

9.45 The directors considered reasons why the proposed gentrader and development site documents were not in Delta's commercial interests. It was noted that Delta did not expect to receive the final form of transaction documents until shortly before, or at, the board meeting at which the board would be expected to consider the documents and only then would Delta know which of the gentrader bundles or development site assets would be the subject of transactions, the amounts payable, the identity of the purchasers, and the precise terms of the transaction documents. The minutes further record that: "for these reasons alone, Delta management considers it could not be in Delta's commercial interest to sign and enter into the transaction documents as will be set out in the Minister's request without a sufficient opportunity to review and consider these matters".

9.46 The Delta board was concerned about the financial capacity of Delta to perform the gentrader contract. There was thought to be a risk of unforeseen costs that could not be recovered by Delta. In addition, availability obligations imposed on Delta under the gentrader agreements could expose Delta to significant financial penalties in the form of Availability Liquidated Damages.

9.47 The minutes recorded:

The Directors concluded that should a request be received from the Special Minister of State (as Portfolio Minister) substantially in the form as provided to Delta in draft form, then without adequate time to give careful and diligent consideration to the documents and their contents, the Board would be in a position where it would resolve that it is not in Delta's commercial interest to comply with the request. Should this occur, then Directors agree that the
Board's response to the Special Minister of State is to append the reasons for Delta's decision.

9.48 Delta had requested Baker & McKenzie to provide a written legal opinion in respect of the actual proposed direction and form of transaction documents that Delta would be required to sign (given that the QC's opinion had been provided in respect of gentrader transactions generally, rather than the specific documentation that would be before the board). It was noted that Baker & McKenzie had provided a draft opinion but that it was "heavily qualified by numerous assumptions and qualifications, not the least of which is that they assume the opinion of ...[the] QC is itself correct". Amendments had been sought to the opinion, only some of which had been made.

9.49 At the meeting, the Delta directors expressed significant disquiet about the proposed arrangements and the expected s. 20N Direction. The minutes record:

Directors expressed the moral dimension of these circumstances that, in the case of a valid direction to execute the Transaction documents, Delta will be entering into arrangements where risks are retained by the business without adequate mitigation arrangements due to the structure of the deal.

**Two Reports considered by Delta directors**

9.50 The first board paper advised directors that Delta expected shortly to receive a request from the Special Minister of State substantially in the form of a draft document attached requesting that Delta, among other things, perform the activities of executing the gentrader documents and development site documents specified in the request, and approval by Delta’s voting shareholders under s. 20Y of the SOC Act.

9.51 Among other things, the board paper advised as follows:

...based on Delta management's review of the various versions of [the Transaction] documents to date (and management expects that the final execution versions will be substantially consistent with the versions seen by them to date), management considers that there are extensive reasons why entering into these Documents would not be in Delta's commercial interests.

9.52 Attachments to the board paper listed reasons why the proposed transactions for the gentrader rights and the development sites would not be in Delta's commercial interests including:

a. gentrader documents:

i. Delta is currently a profit making entity. The gentrader payment arrangements, to the extent revealed, result in Delta being a cash cost recovery entity;

ii. Delta will be exposed to frequent monthly Availability Liquidated Damages payments;

iii. Delta has no knowledge of the assessed retention values for the trading rights and therefore cannot assess the adequacy of the transaction prices; and
iv. there are operational risks posed for Delta.

b. development site documents:

i. Delta does not know whether the sale prices are of reasonable value for the assets, nor what obligations or liabilities have been created for Delta;

ii. sale of the development sites diminishes Delta's ability to mitigate its carbon footprint in the future; and

iii. the indemnity for environmental liability for the Mt Piper Extension development site (an ex-mine site) is a material risk - and does not have a monetary cap, is not excluded by disclosure, and is unlimited in the type of contamination that may be claimed.

9.53 The board paper recommended that if a request was received from the Minister, the board should resolve that it was not in the commercial interests of Delta to comply with the request and that a letter in the form of a draft attached to the board report be sent by the Chairman to the Minister.

9.54 The second board paper recommended that, if the board was satisfied that Delta was obliged to comply with the Direction under s. 20N, the board should pass a resolution in a proposed form that included that the directors resolved to comply with the Direction and to authorise the execution of the relevant transaction documents.

9.55 The board paper also noted that, after some negotiation, the State had agreed to provide Delta with a guarantee of its obligations under the gentrader transaction documents.

Tuesday, 14 December 2010

9.56 On Tuesday, 14 December 2010, the Delta board formally met on six occasions. On the first four occasions, the board comprised of directors Harris, Phillips, Moait, Knight and Forward.

9.57 As seen below, at or immediately following the fourth board meeting (at 4.40 pm) the then directors, other than Mr Phillips, resigned from the board. At the following two board meetings on that day (which commenced at 9.30 pm and 10.10 pm, respectively) the Delta board comprised directors Dermody, Phillips and Yeadon, as well as the Managing Director, Mr Everett.

First Delta board meeting - commencing at 6.45 am

9.58 The first Delta board meeting on 14 December 2010 took place from about 6.45 am to 7.20 am.

9.59 A copy of the written advice as to directors' duties was tabled, together with the revised opinion from Baker & McKenzie.

9.60 The board also had available to it a package of documents that had been provided by Baker & McKenzie in a folder entitled "NSW Energy Reform Process - Delta Electricity - Board Meeting Documentation". The folder contained copies of the following documents:
a. the signed letter from the Special Minister of State to Delta dated 13 December 2010 requesting Delta to, among other things, enter into the gentrader and development site transactions and to execute specified transaction documents. The letter attached a copy of the Approval of Delta's shareholders dated 13 December 2010 given pursuant to ss. 20X and 20Y of the SOC Act;

b. a draft board resolution in relation to the request from the Special Minister of State;

c. an undated (but signed) letter from the Special Minister of State to Delta attaching an undated (but signed) s. 20N Direction from the Special Minister of State (with the approval of the Treasurer);^184

d. the Opinion of the QC dated 20 September 2010;

e. a supplementary memorandum of the QC dated 7 December 2010;^185

f. the (then unsigned) legal opinion of Baker & McKenzie dated 14 December 2010;

g. an advice from the Crown Solicitor regarding indemnities dated 9 December 2010;

h. a Baker & McKenzie memorandum regarding Delta development site transaction documents; and

i. a draft board resolution authorising Delta to enter into the transaction and execute transaction documents.

9.61 The board members also had available before them sets of the Delta gentrader sale transaction documentation and development sites transaction documentation.

9.62 The directors then discussed matters and reflected on the information provided at previous board meetings, including the meeting of 12 December 2010, which had indicated that the proposed transactions would not be in the commercial interests of Delta.

9.63 However, the directors noted that the information presently available excluded, among other things, the commercial terms and any changes to the documentation that Delta management had previously been provided and considered.

9.64 The directors considered that it would be appropriate to hear from the Energy Reform Taskforce and its advisers on the commercial terms associated with the transaction. The Chairman then declared the meeting closed at 7.20 am.

^184 In both cases, Hon. Eric Roozendaal, MLC.

^185 Which provided that a copy of his Opinion dated 20 September 2010 could be provided to, amongst others, Delta and Eraring as material to be considered (by them) in determining courses of action to be taken in relation to matters the subject of the Opinion.
Second Delta board meeting - commencing at 7.20 am

9.65 The second Delta board meeting on 14 December 2010 commenced at 7.20 am and continued until 9.35 am.

9.66 At the commencement of the meeting, the advisers to the Energy Reform Project, by invitation, joined the meeting. The advisers comprised the following people: Messrs Saxon and Holland (Baker & McKenzie), Dimpfel (Credit Suisse), Leyden and Quinn (Lazard) and Dermody, Yeadon, Smith, Park and Dr Gellatly (Energy Reform Group).

9.67 Dr Gellatly advised the board that the Government had approved the proposed transaction the previous day, 13 December 2010.

9.68 Two further documents were provided by the advisers and tabled at the meeting:

a. the commercial terms and conditions for sale of the Delta West gentrader and the Mt Piper Extension and Delta Marulan development sites; and

b. a summary of the material amendments to the bid version Delta West gentrader/transaction documents.

9.69 The minutes record that detailed discussion took place on each of the items in the summary of material amendments. Further discussion also took place between the directors and advisers. This took the form of the directors asking questions of the advisers and the advisers providing responses.

9.70 Among other things, the advisers were asked whether the retention values took into account average liquidated damages. The advisers responded that it was not appropriate to talk about individual asset retention values and that packages of retailer and gentrader contracts had been evaluated rather than single assets.

9.71 The advisers then left the meeting. The Delta directors conferred to discuss the information they had received "noting the haste expected from them for such a major transaction". The directors requested that a financial analysis be undertaken of the payment schedules to identify the split between the two western stations and the amounts to be paid. The directors agreed to meet at 2 pm to allow some time to assess the information presented by the advisers and for the financial analysis to be undertaken and further legal advice to be received.

9.72 The directors considered whether the price being paid by the bidder might be so low such that to continue in the process would be committing an illegal act and involve public misfeasance. The directors considered that it would be appropriate to take legal advice on the matter.

9.73 Five of Delta's directors, accompanied by the board's solicitor attended a conference with a Senior Counsel (SC) at around lunchtime. The SC was asked to advise whether public misfeasance or gross negligence might apply to the giving of the direction to the board. Subsequently, the Delta directors were satisfied that the matter did not involve public misfeasance or gross negligence.
Third Delta board meeting - commencing at 3.10 pm

9.74 The third Delta board meeting on 14 December 2010 took place from about 3.10 pm to 3.50 pm. The directors considered further questions to put to the advisers, and the advisers then joined the meeting.

9.75 Dr Gellatly outlined the evaluation process. The directors then put various questions to the advisers. In respect of liquidated damages, Dr Gellatly said that future liquidated damages would depend on how the plant was run. In respect of retention values, the advisers emphasised that the bids were presented as combined bids and therefore the Government looked at retention values by reference to the whole package.

9.76 In respect of the commerciality of the proposed arrangements with TRUenergy, Mr Timbs (Treasury) was asked whether he could give advice that the deal was commercial, from Delta’s perspective. The minutes record that: “Mr Timbs said that he could not give that advice. The analysis was not done on discrete elements, eg Delta West Gen Trader”.

9.77 The minutes further record:

The following question was put to the advisers. Is there anyone here that wants to put a view that the GenTrader deal is commercial?

Mr Timbs responded on behalf of everyone by [saying] that “I don’t think anyone here is putting forward that proposition”.

9.78 The advisers left the meeting. The directors then further discussed matters. The minutes record:

In the Directors view, the deal is clearly uncommercial but would not be so arbitrary and capricious to call into question the validity of any Direction. The options for Directors had now narrowed to either resignation or continuing with the process and sending a letter to the Minister in terms of the uncommercial nature of the Transaction.

9.79 The minutes record that the directors then expressed their views on the options as follows:

- Mr Phillips – clearly uncommercial but the appropriate process had been followed;
- Mr Knight – the Transaction has a smell and he is inclined to resign;
- Ms Moalt – indicated that she will resign;
- Mr Forward – indicated an inclination to resign;
- Mr Harris – in light of the other directors’ decisions and his own assessment of the deal, he would resign.

9.80 The directors agreed that the position of Chief Executive was different and that it was appropriate for Mr Everett to continue in his role and manage the business.

9.81 At this point in the meeting, the Delta directors noted that the Eraring board had requested informal discussions before the Delta board formally reached a decision. They were given legal advice that it was acceptable to meet, provided that there was no discussion of commercial terms. It is noted that Mr Bunyon's
evidence is that the meeting arose out of discussions between he and Mr Harris.

**Discussions between Delta and Eraring directors**

9.82 The evidence given to the Inquiry about these discussions appears later in this chapter.

**Fourth Delta Board meeting – commencing at 4.40 pm**

9.83 The fourth Delta Board meeting on 14 December 2010 took place from about 4.40 pm to 5.00 pm and followed the informal discussions that had taken place between the Delta and Eraring directors.

9.84 The Chairman, Mr Harris, asked the directors to state their position. The minutes record that:

Messrs Knight and Forward and Ms Moait confirmed their intention to resign from the Board of Delta Electricity. Mr Phillips indicated that he would remain. Mr Harris then confirmed that he too would resign.

9.85 The Chairman asked Dr Gellatly to join the meeting and told him about the decision of the four directors (including himself) to resign, effective immediately. The minutes record that: "Mr Harris explained that this was not a legal issue but a moral choice made by the Directors."

**Reasons for the decisions taken**

**Loftus Harris**

9.86 Mr Harris had been a director for just over three years, having been reappointed in October 2010. He was appointed Chair about seven weeks before his resignation. Prior to his initial appointment he had extensive experience in senior roles in the NSW public sector, most recently as Director-General of the Department of State and Regional Development, a position he had held for 10 years. He was familiar with the operation of SOCs, although Delta was the first SOC board to which he had been appointed.

9.87 Prior to mid December 2010, he had seen drafts of the documents which would be presented when the bidding process had been completed and the successful purchasers identified. He told the Inquiry that "they weren’t entirely unfamiliar".

9.88 While he was party to “corridor” discussions where the prospect of resigning was raised if the deal was “so bad”, he did not have the impression on 12 December 2010 that any of the directors were contemplating resignation. Resignation was only “fleetingly” on his mind prior to December.

9.89 He was conscious of a sense of “haste” which he put down to the impending election and that the transaction had "reached a point where ... companies had been urged to be involved, to take a position; simple commercial interests". The Government had to “get the transaction done".

9.90 Mr Harris attended the meeting with the Eraring directors during the course of that day, 14 December. He said that there was no talk about the "money that was on the table". However at some stage during the day he learned that
Eraring had received "$900 million or $1 billion or something", although he could not recall from whom or when. He told the Inquiry that he was not influenced at all by whether the Eraring directors proposed to resign.

9.91 He also attended the lunchtime conference with the SC, from whom he understood that if a director was minded to resign, he or she should do so before the board met to resolve whether the transaction was in Delta's commercial interests.

9.92 By the 4.40 pm meeting, Mr Harris said: "time was crawling all over us". There was no question of deferring the decision because there was an awareness that "this was going to go through. No matter what happened, no matter what anyone did, this was going to happen". During the course of 14 December 2010, following the disclosure of the price payable as well as the material amendments to the gentrader agreements, he took account of the following information in deciding to resign:

a. he considered the amount was low;

b. he considered the Availability Liquidated Damages contingency was "a pretty big figure";

c. as he did not know the price paid for the retailers, he was unable to assess the value as a whole to the Government;

d. he was concerned about what additional unexpected costs there might be, particularly given that the contract concerning Mt Piper ran until 2043;

e. the increase in hours for super peaks; and

f. as owners, Delta had an obligation to remEDIATE the power stations at the end of their term and there was no cap on that liability.

9.93 The minutes of the 4.40 pm meeting record: "Mr Harris informed Mr Gellatly of the four (4) Directors who were resigning, effective immediately. Mr Harris explained that this was not a legal issue but a moral choice made by the Directors."

9.94 Ultimately, Mr Harris resigned because he thought that it was not a good deal for Delta. He was asked whether he was concerned about his reputation if he complied with the Treasurer's request. He said:

Oh, yes. I think there's always that in the back of your mind in these things. I would like to think that I've spent a career with a reputation for trying to do the right thing. I always enjoyed public service. I felt that there was a value to it. And I felt this was not a good thing, so I resigned.

Sandra Moait

9.95 Ms Moait was appointed a director in September 2002. She has held senior positions within the trade union movement, including being Vice President of the ACTU and President of Unions NSW.

9.96 Ms Moait had drawn comfort from legal advice received over the months prior to December as well on 14 December that it was proper and reasonable for the
Minister to issue a s. 20N Direction. In addition, she was not influenced by the views expressed by any of the Eraring directors.

9.97 In deciding to resign, Ms Moait considered the following matters:

a. the workability of the gentrader model; the board had been advised of its operation in other jurisdictions and, to her, it appeared to be "fraught with difficulties";

b. she considered that the consideration was very low, based on the returns that Delta had made to Government and that it included the coal stockpile and the Availability Liquidated Damages;

c. the Availability Liquidated Damages;

d. Delta would become a cost recovery centre rather than a profit centre;

e. the lack of transparency of the negotiations in that Delta was not privy to them; and

f. the haste with which they were being asked to act, although she acknowledged that the speed was not a surprise to her given the information provided to the board in June 2009.

9.98 Ms Moait said:

I believed in the capacity of Delta to function well as an asset for the State Government. Until a decision was made to move away from coal-fired generation, I had always been impressed by the capacity of the executive of Delta and the staff of Delta to do a really good job, and I felt that it was losing a very valuable asset.

The Hon. Michael Knight AO

9.99 Mr Knight was appointed a director in March 2006. He had been a Member of Parliament between 1981 and 2001, and is best known for his work as Minister with responsibility for the 2000 Olympics. In his capacity as a Member he was a shareholding minister of Sydney Ports Corporation. After his retirement from Parliament, he served for a period as the Chairman of Sydney Gas Limited.

9.100 By 12 December 2010, he had formed the view that the board was being asked to 'rubber stamp' the decision made by the Government and that if the board indicated that they needed more time, the directors would be removed.

9.101 On 14 December 2010, Mr Knight considered the following factors:

a. that the super peak availability would lead to more exposure for Delta;

b. the exposure of Delta to Availability Liquidated Damages;

c. he considered that the consideration was "scandalously low" and was reduced by the Availability Liquidated Damages and the coal stockpile;

d. Delta would be liable for the shortfall between the gentrader's payments for the cost of maintenance and the actual cost of maintenance if the latter was
higher, which he was concerned it would be having regard to the ‘trimming’ the advisers had done on the maintenance schedules provided by Delta during the process;

e. that the advisers expressly declined to put forward the proposition that it was in Delta’s commercial interests to enter into the transaction; and

f. the transaction had a ‘smell’ by which he meant that it did not "look legitimate" based on the price and the haste with which it was conducted.

9.102 He met with the Eraring board, having sought and obtained advice that it was appropriate to do so as long as the details of the transactions were not discussed. He confirmed that prices were not discussed, although he recalled Mr Bunyon saying "something of the nature that maybe their deal wasn’t as bad as ours". He described the meeting as not one where people had well thought out positions and that he was not influenced by anything that occurred at that meeting when making his decision.

If people resigned, that was going to become [a] public issue. It’s an issue which clearly would hurt the Government – a range of high-profile people resigning from boards. It was almost unprecedented – I mean, there are probably some precedents, but in the modern climate it was a very, very big and momentous decision with lots of implications, not simply for the individuals involved. It had implications for those who remained. It had implications for the chief executives and the staff. It had implications for the Government’s public standing. You know, this was a very, very difficult decision that people were wrangling with, and it wasn’t like, ‘Do this or we will sack you.’ It was, ‘Do this and we will give you an indemnity and we will cover you and it is not your fault and you can tell everyone that it wasn’t your fault’, weighed against the moral issue of being involved in something which we all thought was pretty terrible.

And I don’t think there is any difference – well, certainly on the Delta board, and I suspect, because I didn’t discuss it with them, on the Eraring board: the only difference between those who stayed and those who went is the moral, tactical, strategic - whatever name you think is appropriate - decision to go or stay. Everybody thought it was awful. Nobody was talking about, ‘I want to stay because it is a good deal.’ Everyone was united in how bad the deal was.

Paul Forward

9.103 Mr Forward was appointed a director of Delta in March 2006, at the same time as Mr Knight. Like Mr Harris, he had held senior positions in the NSW public service including as Chief Executive of the Roads and Traffic Authority for six years.

9.104 By 12 December 2010 he had formed the view consistent with that expressed in the board paper of that date (see above). He was aware from the Chief Executive that the sacking of the directors was possible if they did not "go along with these arrangements" and that resigning was a possibility if "we felt it was so uncommercial and unacceptable to us". Having said that, it was not his intention to resign when leaving for the first board meeting in the early hours of 14 December 2010.

9.105 The various factors he took into account during the course of 14 December were as follows:
a. the liquidated damages were a lot larger than he had expected;

b. the schedule of payments revealed that very little funds were to be expended on Wallerawang, particularly in the latter years;

c. he considered that the amount was small given that it was to be reduced by the Availability Liquidated Damages, the coal supply at Mt Piper, the potential environmental risk at Mt Piper and the gap between the fixed and variable costs provided by Delta and the actual costs;

d. there was very limited time to consider the documents, a matter of hours, and he assumed that the proximity of the election meant the Government was keen to have the matter resolved;

e. he expected to be provided with a "benchmark case" or public sector comparator. He also expected to be privy to the modelling that had been carried out and to be told of the financial aspects of the other transactions and be provided with the "fuller picture". He thought that as the directors were experienced and trustworthy, and had signed confidentiality agreements, more information should have been available to them; and

f. he was concerned that Delta could be operating insolvent, notwithstanding the guarantee by the Treasurer.

9.106 Mr Forward met with the Eraring directors, having first obtained advice. While there was no discussion of the deal, he recalled Mr Bunyon saying that "We got a really bad deal, but you guys got a worse deal". Like his colleagues, he was unaffected by the intentions of the Eraring directors.

9.107 In short, Mr Forward resigned because of the deal, his lack of confidence in the evaluation process, the possibility for litigation with TRUenergy and possible insolvent trading.

I had had, I thought, a very productive time with Delta. These were very hard decisions to make. I thought it was a very competent management team and a very competent board that worked very well together. I was disappointed to have to leave that entity, but I wasn't prepared to tolerate what was going to be forced on us...

I make my living giving advice to companies on how to procure infrastructure projects, and whilst it wasn't top of mind at the time, I was embarrassed by this process. I was embarrassed by the potential sale of these assets at a very, very low, bargain-basement price, and I didn't want to be associated with that arrangement and particularly I didn't want to be associated with implementing those arrangements. I thought this was worst practice, not best practice.

Warren Phillips

9.108 Mr Phillips was first appointed to the Delta board in March 2000 and was the longest serving director. His other paid employment has been in the financial field, largely as a financial controller.

9.109 Prior to receiving details of the transactions on 14 December 2010, Mr Phillips held this view:
...if you go right back to the very first document we looked at, it was crystal clear from that information that Delta would move from a profit-making organisation to a cost-management organisation. When the board discussed these potential outcomes, it was clear that our original mandate was to generate electricity in a profitable, efficient manner and to deliver dividends to the State on a regular basis, and this was being changed, but our mandate hadn't changed. Therefore, it was not going to be commercial.

9.110 In his mind, there was no concern at the lawfulness of the direction anticipated to be received from the Government.

9.111 On 14 December 2010, Mr Phillips was influenced by the following matters:

   a. he considered that the amount being offered was low, but not so low as to be unreasonable;

   b. he considered the transaction from the point of view of his responsibility as a director of Delta, not as a citizen of NSW; and

   c. the reasons set out in the attachments to the board minutes referred to earlier in this chapter.

9.112 He was of the view that the board had received legal advice throughout the process and had carried out its duties as directors and could see no reason why the board should not proceed as requested.

9.113 He was present at the meeting with the Eraring directors and described the discussion as “one of those ‘do we both do it’ type conversations”. It ended with a view that a majority of board members from both boards would resign and that the respective Chairmen would advise Dr Gellatly. He recalled no discussion about the respective deals and their commercial terms.

I had been on the board since 2000, and I felt some concern for the staff, of which we had some 750, that I was well known by that group, and I felt that staying and showing support for the future, whatever that may be, was a good thing, and it would help our new chief executive get through a very difficult time, and I had a lot of affinity to the organisation and the people. I could not see any reason to walk away, but to carry out my duties and to help the business, which I have now done since that date, as best I can, and we are going through another interesting period with carbon tax, as well, which will be even more exciting.

Greg Everett

9.114 Mr Everett had worked in the electricity industry for over 25 years, initially with the Electricity Commission of NSW. He had worked for Delta before it became a SOC. He was appointed Chief Executive in July 2010.

9.115 Mr Everett was concerned about the role prescribed for the directors as set out in the Baker & McKenzie June 2009 memorandum and in subsequent discussions with the advisers. In his view, (which was shared by the other directors) the directors had a duty to ensure that the transactions occurred properly. "You can't abrogate your responsibility to management and advisers."

9.116 At the meeting held on 14 December 2010, Mr Everett said that all the directors agreed that resignation was not an option for him. In his view:
The role of chief executive is that you are much more hands-on with the business. You are really in that leadership role for 700 people you have in the business and you just don't - it is not just a resignation for a chief executive; it is almost an abandonment.

9.117 Mr Everett made notes during the course of 14 December 2010 including of the discussions with the Eraring directors. In those notes he records that "EE valuation not as bad as DE seems but not good and have legal questions". He said to the Inquiry:

I can't recall any discussion of price as I said before, apart from that we had seen that press release - well, Ray Madden, the corporate secretary, had seen a press release... there was no discussion here about the commercial aspects of the transaction. This is, you know, if people want to resign and they're taking a moral position and you think that others will be judged by it, well, it's probably appropriate to share that with them.

9.118 In relation to the 5 pm meeting at which four directors resigned, Mr Everett's notes record: "No discussion of transactions. A moral discussion."

First Delta reconstituted board meeting - commencing at 9.30 pm

9.119 The first meeting of the reconstituted Delta board on 14 December 2010 took place from about 9.30 pm to 10.00 pm. The board was now newly constituted and comprised John Dermody (as Chairman), Warren Phillips and Greg Everett (continuing directors) and Kim Yeadon.

9.120 It was noted that the board did not contain a Unions NSW nominated director but that Baker & McKenzie had advised that the board was duly constituted and able to perform its functions. Written advice was provided on this aspect consistent with an advice earlier provided to the Treasurer.166

9.121 The resignation letters of Messrs Harris, Knight, Forward and Ms Moait were tabled. New directors Messrs Dermody and Yeadon declared various roles that they had within the Energy Reform Group and advised that they had no direct pecuniary interest in the sale outcome. The minutes further record that both Mr Dermody and Mr Yeadon "articulated their duties owed to the Corporation".

9.122 The directors then considered the request from the Portfolio Minister dated 13 December 2010 for the board to enter into the transaction documents. As noted above, the letter attached an Approval from the voting shareholders to enter into the transaction documents.

9.123 The Delta board paper (discussed above) was also tabled. It contained a number of reasons why it was not in Delta's commercial interests to enter into the transaction documents. The directors also referred to the earlier discussions with the advisers (7.20 am and 3.10 pm) and the responses to questions asked.167 The minutes record that the directors spent time considering the reasons recorded in the board paper dated 13 December 2010 and also "confirmed that they were familiar with the issues".

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166 See Interpretation Act 1987, s. 52(1)(a) - relevantly providing that "any act or proceeding of a statutory body shall not be called into question merely because of... any vacancies in the membership of the body...".

167 Messrs Dermody and Yeadon were, fully aware of those discussions, having each participated in them in the role as one of the advisers.
9.124 The directors concluded that it was not in Delta’s commercial interest to enter into the transaction documents. The board then passed the following two resolutions:

1. In accordance with the Report of the Corporate Secretary dated 13 December 2010 and in light of:
   - the matters and documents noted in that report above; and
   - the matters discussed during the meeting,

   the Board RESOLVES that it is not in the commercial interests of Delta Electricity to comply with the request from the Hon Eric Roozendaal MLC, Special Minister of State and Portfolio Minister for Delta, to the Directors dated 13 December 2010;

2. That a letter in the form of Attachment E to the Report of the Corporate Secretary be sent by the chair of the meeting to the Special Minister of State.

9.125 The letter to the Portfolio Minister from the Delta Chairman advised that the board considered that it was not in Delta’s commercial interest to comply with the Minister’s request, including executing the gentrader documents and development site documents referred to in the Minister’s letter. The letter set out a number of reasons why the board considered that the proposed transaction was not in Delta’s commercial interest.

9.126 In respect of the proposed gentrader arrangements, the letter said:

Delta is currently a profit making entity. The GenTrader charging regime will, at best, result in revenue that will only cover cash costs.

9.127 The letter further said:

Delta’s generation assets are to be transacted by way of GenTrader contracts. These contracts provide Delta will be entitled to receive payments reflecting certain fixed and variable costs, but the arrangements apply in effect for the life of the relevant facility. There is a risk that unforeseen costs cannot be recovered by Delta. Secondly, the availability obligations imposed on Delta under the GenTrader Agreements may expose it to significant financial penalties in the form of availability liquidated damages.

9.128 In respect of the proposed development site transactions, the letter from the Chairman stated:

Sale of these sites diminishes Delta’s ability to mitigate its carbon footprint in the future.

- The indemnity for environmental liability for the Mt Piper Extension Site is significant in terms of the extent of the risk and financial exposure for costs.

Second Delta reconstituted board meeting - commencing at 10.10 pm

9.129 The second meeting of the reconstituted Delta board on 14 December 2010 took place from about 10.10 pm to 10.30 pm.

9.130 The principal purpose of the meeting was to consider the Direction under s. 20N(1) of the SOC Act received by Delta. The s. 20N Direction was dated
14 December 2010 and was attached to a covering letter of the same date. The Portfolio Minister, Treasurer Rozendaal, signed both the covering letter and the s. 20N Direction. The covering letter also attached a copy of the Approval of the voting shareholders pursuant to ss. 20X and 20Y of the SOC Act.

9.131 The covering letter made reference to the opinion of the QC regarding the validity of a direction under s. 20N. The letter relevantly stated:

As you will be aware, you have previously been provided with an opinion by ...[a] QC regarding the validity of a Direction under section 20N(1) in circumstances such as the present where you have resolved that you consider that it is not in the commercial interests of Delta Electricity to comply with my request to you as set out in my letter dated 13 December 2010. That opinion was provided to you on the basis that the Board could rely upon the opinions expressed ...

9.132 The letter also referred to the Deed of Indemnity between the Treasurer (on behalf of the State of NSW) and the directors and, in particular, the definition of "Transaction Process" in the Deed. In this respect, the letter from the Special Minister of State also stated:

I confirm that it is intended, and I acknowledge on behalf of the State, that the enclosed Direction under section 20N(1) comes within the definition of 'Transaction Process' for the purpose of the Deeds of Indemnity and accordingly, subject to the terms of the relevant Deed the indemnity given by the State will:

- cover you with regard to any acts by you as directors taken in compliance with the enclosed Direction; and

... This will include the execution as directors of any of the Transactions Documents contemplated by the Direction.

9.133 Among other things, the Direction under s. 20N directed Delta to perform specified activities including executing the gentrader documents and the development site documents (the 'Transaction Documents') listed in the schedules to the Direction.

9.134 At the Delta board meeting at 10.10 pm, a signed copy of the Baker & McKenzie opinion was tabled. The Guarantee from the State was also tabled, and it was noted that the Guarantee now contained a reference to s. 20U of the SOC Act.

9.135 The board passed a resolution to comply with the Direction under s. 20N. The resolution was in the following terms:

The Directors noted the Hon. Eric Rozendaal MLC, Special Minister of State and Portfolio Minister for Delta Electricity had provided a direction under section 20N(1) of the [SOC Act] dated 14 December 2010 in connection with, amongst other things, the entry by Delta Electricity into Gentrader Agreements in relation to the Wallerawang and Mount Piper power stations and the sale of the Marulan and Mount Piper Extension development sites (Direction).

The Directors noted that the transactions contemplated under the Direction have been approved under sections 20X and 20Y of the SOC Act and the
Directors also noted that under section 20N(2) of the SOC Act, Delta Electricity is required to comply with a direction under section 20N(1) of the SOC Act.

The Directors RESOLVED to comply with the Direction, and in particular to:

(a) authorise any two directors or a director and the company secretary to affix Delta’s seal and execute all deeds set out in Part A of Schedule 1 and Schedule 2 of the Direction; and

(b) appoint Greg Everett as authorised representative to execute all agreements set out in Part A of Schedule 1 and Schedule 2 of the Direction.

9.136 The board also resolved that the Chief Executive be authorised to accept the Guarantee on behalf of Delta.

Evidence of the new and continuing directors

Greg Everett and Warren Phillips

9.137 Following the resignation of the four directors, Mr Phillips and Mr Everett sought legal advice from Baker & McKenzie that two new directors could be appointed, that a union-nominated director was not necessary and that there was no legal impediment to Messrs Yeaton and Dermody being appointed. Baker & McKenzie advised that if a union-nominated director resigns and is not immediately replaced, that vacancy does not call into question any acts by the SOC while the vacancy exists. Further, it advised that there was no legal reason why members of the Steering Committee could not be appointed. The advice confirmed that a board must consist of at least four persons.

9.138 At the 9.30 pm meeting, and in relation to Messrs Dermody and Yeaton, Mr Everett told the Inquiry:

I had to explain, particularly to the new directors, what the transaction looked like from a director’s perspective as opposed to someone who was involved in the reform group... We actually went through [the] attachments and outlined why it was unsatisfactory from a director’s perspective. To be honest, I thought that there would be objections and there were none. They said, ‘yes, we can see from a director’s perspective that that is right’...

...I had explained to them the discussion that we had had with [a SC] because they had not been party to that, and that was a piece of information that was important for a director to understand. Really, that was the extent of it.

9.139 Mr Phillips said:

They made it very clear that while they were sitting on that board, they would only act in the interests of Delta, which I was delighted to hear, and so was Greg. I’m also a company secretary by qualification, so I wanted to make sure that they understood that while they were in that room, they had only responsibility for Delta and for nothing else.

They freely admitted, as board members of Delta, that it was not in the commercial interests of Delta to execute the documents. They understood that perfectly and had no objection to sending the letter with the attachment to the Treasurer.
Mr Everett was critical of the exclusion of the board and senior management from consultation concerning the gentrader agreements. He said to the Inquiry:

One of the points that was brought out by all three chief executives was that you need to involve the generators in this, and by trying to keep the most senior people out, you are constraining the supply of information that is coming into the formation of this gentrader agreement.

John Dermody

Mr Dermody was appointed the project director to the Energy Reform Project from 15 February 2010.

In relation to his appointment as director of Delta, he explained to the Inquiry:

I was at Baker & McKenzie when it happened... Then I was aware that Treasury were trying to find replacement directors, I happened to be there and I got nominated...

Well, I would rather have not been appointed as a director of Delta Electricity... For fairly obvious reasons; that I was the project director... I knew that it would become controversial because people working on the project were appointed to the board.

The decision to sell Delta’s trading rights, which is really what it is, is a fundamental change to the way in which Delta - or any other generator - had operated... When you put your hat on as a director of that organisation, it would never be in their commercial interests. That’s why we had anticipated, all the way along, that a direction would be necessary... you are taking away or selling their trading rights, which means that they now become an organisation that is really what we call a tolling operation. You’re taking away the big spikes, the big prices that you can make in electricity generation. With a few cold days... generators make a motza, because everyone has heaters and airconditioning on, et cetera... after the sale, belongs to the gentrader, not to the generator. Therefore, the generator is going to undertake a fundamental change in the way in which they operate. If you take away their rights to trade and just leave them with the right to keep on churning out electricity for a price, it will have a fundamental effect on their financials.

Mr Dermody agreed that, from his perspective as project director, he had been privy to the bid evaluation report, knowing what had transpired between the Government and the various bidders after the bid closure date, but put that out of his mind for the purposes of being a director of Delta.

In considering whether it was in Delta’s interests to enter into the transactions, he considered the management recommendation and the board paper.

He acknowledged that a potential conflict existed between his role as a director of Delta and as project director because not all of Delta’s assets had been transacted.

There was still the Delta Coastal bundle that may or may not be transacted in the future. So I could be sitting on the board of Delta dealing with that, and then, as project director, I’m also trying to sell that asset. So the major potential conflict was what was going to happen about the future sale of the assets.
At every steering committee meeting after my appointment, if any issue came up to do with Delta, no matter what it was, I made a declaration at the start of every meeting that I was the chair of Delta and requested anyone who may, in the course of conversation, talk about Delta to give me prior warning, so I could leave the room, and the minutes show that that happened on each and every occasion...

On the other side down at Delta, at any time the Electricity Transaction came up, then Mr Yeadon and I left the room, and the minutes and the records show that we did that.

9.146 Following the election, Mr Dermody indicated to the Government, on more than one occasion, that he and Mr Yeadon were willing to resign their positions as directors of Delta.

9.147 He resigned on 5 May 2011 when it became clear to him that he was likely to be "sacked in Question Time at Parliament". Reference to his sacking was made that day in Parliament, however, he said that he never received a letter saying that he had been sacked.

Kim Yeadon

9.148 Mr Yeadon was a key member of the Energy Reform Project. On 14 December 2010, he was at Baker & McKenzie as a member of the Energy Reform Project providing information to the boards. Mr Dermody called him and said:

...the Government was requesting that I and others on the transaction team, including himself, be appointed to the board in order to be able to deal with the business... I agreed to do that on the basis that it was legal. I did ask, "Is it legal for us to be there?", and the project director indicated that legal advice had either been sought or was being sought in relation to that question.

...the board meeting started around 10pm. I think, from memory... I think I rang in and they were convening. I must add, before that, I was also emailed, in PDF form, a range of documents...

It had been conveyed to me that there was legal advice that it was appropriate, or not illegal, for members of the steering committee to be appointed to the board.

...At some point, [John Dermody]... stated to me that they had legal advice to indicate that it was not illegal for the steering committee members. Notwithstanding that, we were not steering committee members, in any event, so the bar was even lower.

9.149 Mr Yeadon was of the view that he had a potential conflict of interest: "... because I had been working on the transaction for around a year and would have been emotionally invested in seeing the outcome of that transaction".

9.150 When asked by the Inquiry what he did to manage, mitigate or resolve that potential conflict of interest, he responded:

I affirmed to myself what my obligations were to Delta as a member of that board. I reviewed my role in the transaction as a gentrader chair and a bid evaluation committee chairman. I clearly distinguished out those two roles and the issues that went around them and therefore proceeded to deliberate as a member of the Delta board with those distinctions clearly in my mind.
9.151 At the suggestion of the probity officer, he resigned as Chair of the Evaluation Committee; however, he explained to the Inquiry that the decision to resign was a position that he had already arrived at personally.

So at the next and immediate bid evaluation committee meeting, I resigned as chair and indeed from the committee itself. There was still, yes, the possibility of negotiations with remaining bidders for the second round in my role as gentrader chair. However, circumstances conspired to the point that that did not come about.

...At every meeting of the steering committee and/or the transaction coordination committee, or indeed any other meeting, including the Cobbold working group, I made it clear that I was a director of Delta. If any issues came up in relation to Delta Coastal that had a potential conflict of interest, or not even Delta Coastal, just even a general conflict of it, if that was perceived in any way, I would leave the meeting, vacate the meeting, and would not participate.

9.152 He did not consider that he breached any duty of confidence he owed to the Energy Reform Project because he did not disclose any information to the other Delta directors which he had because of his Project role.

9.153 In relation to his resignation from the board of Delta, he said to the Inquiry:

I can't recall the precise day, but I was contacted by New South Wales Treasury to indicate that the Government was moving that afternoon to sack myself and John Darby from Delta Electricity... I was not happy about it because it's not good for your reputation to be sacked...

... I faxed [my resignation] off immediately. As far as I understand, although I have never been officially notified I assume that was accepted; but it was still put on the parliamentary record that I [was] dismissed.

9.154 He explained that he did not resign earlier because it was in the interests of Delta not to:

...it needs governance, and in order to have governance, it needs a board that's able to convene, which means the requisite number of directors under its constitution and under the Act. It is in the interests of the organisation to get the best directors possible. To leave time - a new Government had come into office at the end of March - I thought it was appropriate for them to have time to look around for the best available and appropriate directors, so I was happy to continue to serve until that occurred.

**Deliberations by Eraring**

*Prior to December 2010*

9.155 In October 2010, the Eraring board held a strategy conference to discuss, among other matters, the commercial risks, functional impact and structure of the gentrader agreements.

9.156 Following a conference on 21 October 2010 the Chairman of Eraring, Mr Bunyon, sent a letter to the Treasurer and the Minister for Finance (the shareholding Ministers), setting out concerns that the Eraring board had relating to the Energy Reform Project and the proposed gentrader arrangements. Mr Bunyon referred to a recent briefing by Baker & McKenzie that had provided
some details of the gentrading agreement. By the letter, the board raised the
following concerns relating to the gentrader arrangements:

a. due to the high target contract availability factor without the ability to offset
availability bonuses, Eraring will be exposed to liquidated damages
throughout the contract period which may be significant;

b. it is likely that Eraring would not be able to maintain solvency without
sufficient working capital to cover expenses and liquidated damages, and
accordingly would require a Government guarantee or a substantial
injection of capital;

c. Eraring will more than likely move from a dividend generating organisation
to an organisation where there is a probability of regular losses; and

d. Eraring will become a constrained organisation with no growth potential,
with no capability to invest and consequently will have difficulty retaining
and recruiting quality staff.

The events of 14 December 2010

Board meeting: 10.40 am

9.157 On Tuesday, 14 December 2010 the Eraring board first met at 10.40 am at the
offices of Baker & McKenzie. The following seven directors of Eraring were
present: Messrs Bunyon (Chairman), Bleach (by telephone), Maher, Priest,
Pritchard (by telephone), Vertigan (by telephone), and Jackson (Managing
Director). The board’s solicitor was, by invitation, also in attendance.

9.158 The following documents were tabled at the meeting:

a. letter dated 13 December 2010 from the Portfolio Minister (Treasurer
Roozendaal), requesting that Eraring enter into the transaction and execute
transaction documents. The letter attached a copy of the Approval of
Eraring’s Shareholders;

b. the Opinion from the QC dated 20 September 2010, and supplementary
opinion dated 7 December 2010;

c. advice from the Crown Solicitor dated 9 December 2010 on the terms of the
indemnities provided by the Treasurer to the directors and officers of Eraring
in respect of the transaction process;

d. a proposed form of Direction under s. 20N of the SOC Act;

e. an undated opinion from Baker & McKenzie on the proposed Direction
under s. 20N;

f. a set of the Eraring gentrader sale transaction documentation (the
‘Transaction Documents’);138 and

g. a transaction summary - Eraring Energy.

138 Note that, in contrast to the position with Delta, there was no development site transactions associated with Eraring.
The minutes record that the board discussed the tabled documents. Following this discussion, and by invitation, representatives from Treasury, Baker & McKenzie and Credit Suisse joined the meeting. The board was advised that:

The final version of the Generation Trading Agreements are largely consistent with previous versions provided to management, except for minor amendments such as extending payment terms from five business days to ten business days.

9.160 After the briefing, the representatives from Treasury, Baker & McKenzie and Credit Suisse left the meeting. The board was provided with legal advice in relation to directors' duties.

9.161 After discussion of the tabled documents and the briefing regarding their duties, the board resolved that:

a. management review the Transaction Documents and provide a briefing to the board later in the day on the material changes to the documentation from versions previously provided to management by Treasury; and

b. the Managing Director seek advice in relation to the Cobbora coal documentation.

9.162 The meeting was suspended at 12 noon.

Board meeting: 2.30 pm

9.163 At 2.30 pm director Bleach was now in attendance in person rather than by telephone and directors Maher and Vertigan were not in attendance.

9.164 The minutes record that management briefed the board on the Transaction Documents. The meeting was suspended at 3.15 pm.

Board meeting: 4.00 pm

9.165 At 4.00 pm all board members, with the exception of director Priest, were present, with directors Vertigan, Pritchard and Bleach by telephone.

9.166 The Managing Director briefed the board on advice received in relation to the Cobbora documents.

9.167 Representatives from Treasury, Baker & McKenzie and Credit Suisse re-joined the meeting. Dr Gellatly briefed the board on the review process for the gentrader bids and advised the board that the offer provided by Origin was conditional upon acquiring the Integral and Country retail businesses.

9.168 The representatives from Treasury, Baker & McKenzie and Credit Suisse and Eraring management left the meeting. The minutes record:

The meeting was suspended at this point while the Board met with the Board of Delta Electricity and [their solicitor].

The Boards of Eraring Energy and Delta Electricity discussed the transaction process and their position as Directors. [Their solicitor] briefed Directors on their duties. The Boards did not discuss the details of the transaction documents or the transaction details.
The Delta Electricity Directors and [their solicitor] then departed.

9.169 The Eraring board meeting was reconvened and director Maher rejoined the meeting by telephone.

9.170 The minutes record:

The Chairman and Directors Vertigan, Pritchard and Maher advised of their resignation from the Board of Eraring Energy effective immediately.

As a quorum was no longer present, the Board meeting was closed at 5:00pm.

9.171 Of the seven directors, four resigned including the Chairman. The Managing Director and two other directors, each appointed in 2010, remained.

Reasons for the decisions taken

Ross Bunyon

9.172 Mr Bunyon was appointed as Chairman of Eraring in 2000 and served in that position until his resignation on 14 December 2010. He had worked in the electricity industry for over 40 years, including as Chief Executive and Chairman of Pacific Power.

9.173 His decision to resign was made before meeting with the Delta board mid afternoon on 14 December. In relation to that meeting, it seems likely that Mr Bunyon made the suggestion to Mr Harris that a meeting of the boards of Delta and Eraring might be “a good idea”. However, by the time of the meeting he had “absolutely” decided to resign and he understood that each of the directors of Eraring was in a similar position, in that their individual decisions had been made prior to meeting with Delta.

9.174 During that meeting he formed the impression that the Delta valuation was very low, although he does not recall that the price was discussed or disclosed.

9.175 In deciding to resign, Mr Bunyon considered the following matters:

a. his belief that the price was low, particularly as it included the coal stockpile, the hedge book and the Shoalhaven Scheme; and

b. the prospect of Eraring facing liquidated damages.

9.176 Mr Bunyon said that during the course of the day:

I was becoming increasingly uneasy with the transaction, and it was occurring to me that after 40-odd years in the industry, I did not want to be associated with the transaction as it was now starting to appear...

[Did you have that view when you saw the $950 million and you knew of the risk exposure of Eraring, or was it the three matters that were included - the coal stockpile, the hedge book and the Shoalhaven - which really made the difference to you?]

I think the final difference was the inclusion of those other amounts [for the coal stockpile, the hedge book and Shoalhaven]. As I say, it was an increasing disquiet with the proceedings and the value, and it reached the point where I was able to articulate the fact that I was going to resign.
9.177 He considered the choice of whether to resign as a personal decision.

*Dean Pritchard*

9.178 Mr Pritchard was appointed in 2001 and remained a director until his resignation on 14 December 2010. He is and has been a company director, although not within the energy sector.

9.179 He was unhappy with the proposed transactions and the following comprises his reasons for resigning:

a. Eraring would become a very different organisation; "It would have, in my view, no life";

b. the risk of substantial damages and other penalties;

c. there would be little opportunity to be strategic; and

d. it was a very complex arrangement which meant that in terms of its execution, it would have considerable risk.

*Tony Maher*

9.180 Mr Maher was appointed a director of Eraring in October 2010 and attended his first meeting on 16 November 2010. He is the National President of the Construction, Forestry, Mining and Energy Union.

9.181 Initially, on 14 December 2010, Mr Maher considered abstaining because he could not form a view that it was or was not in the commercial interests of Eraring to enter into the transaction. The consideration meant nothing to him and he had not been briefed as to whether a certain figure would or would not be acceptable.

9.182 He attended that part of the meeting which took place at 4 pm on the telephone. He was advised that the Chairman and three others had resigned and "I was asked what my position would be and, without dwelling on it, I said I'd resign too".

9.183 He told the Inquiry that he was in a bit of a shock and even though he had only met Mr Bunyon a couple of times, he had a high regard for him. It was essentially a matter of solidarity for Mr Maher.

*Michael Vertigan*

9.184 Mr Vertigan was appointed a director of Eraring at the formation of the company in 2000. He had been the Secretary of the Department of Treasury and Finance in Victoria when the privatisation of the electricity assets occurred.

9.185 He, along with other directors, viewed the gentrader model as being suboptimal.

My reason for resigning, which I think I only really confronted at the time the documents were received on the 14th, and I was, of course, on a phone in Hobart for this meeting – I faced the situation whether I, as a professional company director, could continue in a process where I had satisfied myself that the result for the company of which I was a director, should the transaction go ahead, was a future in which it was likely to be unprofitable and certainly would
face solvency and liquidity issues. The question was: was that something I felt responsible in doing? And I concluded no. So that’s the reasoning and the rationale...

I should also add that my term expired 30 June, and I had been appointed just for an extra one year. It was clear that it was intended that I not be reappointed after 30 June, so that was the end of my time, in any event. So I had concluded that the latest point I would resign was the point at which the gentrader arrangements came into effect.

Peter Jackson

9.186 Mr Jackson was appointed to the board of Eraring in September 2006 when he became Managing Director. He had been in the electricity industry for some 40 years.

9.187 Mr Jackson had concerns about the gentrader model throughout 2009 and 2010. He was particularly concerned about the Availability Liquidated Damages in the context of Eraring upgrading its plant and not having any “good engineering history” on its performance. While he became aware that there was to be a ‘cap’ on those damages, and there were risks which Eraring bore under the then arrangements, it was able to manage those risks by operating in the NEM.

9.188 On 14 December 2010, he was first made aware that one of the directors was considering resignation. He then attended the meeting at which directors of Delta and Eraring were present. He recalls at that time being informed of the legal advice that Delta had obtained, that the direction was still ‘legal and binding’ notwithstanding that the value Delta had obtained was much less than expected. Individuals were then invited to comment and a number of directors indicated an intention to resign. Neither he nor Mr Everett was asked their intentions.

9.189 His thought processes following that meeting were as follows:

At that time, it was probably a feeling of loyalty and I had been frustrated through the process. I wasn’t comfortable that the transaction was a good deal for the State. And I respected very much the directors who had resigned, so I felt quite torn between - to resign is a statement...

The frustration was the lack of transparency and feedback from senior Treasury in relation to our concerns on the gentrader risks...

Ross [Bunyon] recognised - if I may, Ross and I had a long history. He shared with me his view that I should not resign. There was no question in his mind that I should not resign...

I recall he said, “Your role is to lead the organisation through these changes, not to resign. If you were to resign, it would be likely that you’d be quickly replaced in any case”.

Resignation was still on my mind for some hours after the closure of the board meeting, but I suppose, as the evening went on, I decided to stay and decided to define under what terms I would stay.

9.190 The terms were that he would abstain from voting on whether the transactions were in the commercial interests of Eraring so that his vote would not trigger the
transaction. Mr Jackson had no doubt that the transaction was not in the commercial interests of Eraring.

9.191 Mr Jackson then attended the 9.20 pm meeting with the new directors.

John Priest

9.192 Mr Priest was appointed in 2010 and attended his first board meeting on 20 April. His relevant experience was having been a director of Sydney Water for some ten years.

9.193 At his first board meeting, Mr Priest received a detailed presentation of the process that had taken place and the gentrader arrangement which was proposed. In addition, he was given information on the SOC Act, however, he was aware of s. 20N from his time with Sydney Water.

9.194 On 14 December 2010, when made aware of the consideration and other key terms of the agreements, he formed the view that while the price was not high, nor was it low. He gave reasons to the Inquiry for how he made the necessary calculations.

9.195 He believed that the transactions were not in the commercial interests of Eraring because there were structural issues, such as liquidated damages that could have caused insolvency. In addition, he was not in a position to decide that it was in its commercial interests.

9.196 Mr Priest said:

I wasn’t going to resign because from day one of being appointed to the board, I knew this transaction had complexities, wasn’t a conventional sale, and as a result, had lots of issues. So I decided that because I had joined the board knowing that - plus I also had a concern for the organisation following this, because going forward, as I intimated earlier, it’s actually quite a difficult thing to manage a company running itself to extinction, if you like, versus a company that’s trying to find its way forward and grow. The skill sets and pressures on the people are quite different.

Murray Bleach

9.197 Mr Bleach was appointed a director on 1 July 2010. He is and was a company director and had experience in privatisation of utilities, including electricity and infrastructure.

9.198 He was influenced by the following matters in considering the Electricity Transactions:

a. transferring the carbon risk to the buyer was a “great triumph”;

b. the coal price was increasing thus ongoing profitability was an issue;

c. the NSW electricity price was depressed compared to what Eraring valued it at; and

d. there was a residual component after the expiration of the contract.

I actually said part of this to the assembled mass - I said this bit, which was, “Gosh, I got appointed to this board knowing full well that we have this
privatisation process on, and the people who appointed me know I'm a privatisation specialist. I have a job to do in terms of conducting my director responsibilities. It would seem inappropriate for me to resign when what we're resigning about is the fact that we're going through a privatisation…'

The other reason was that - I didn't have legal advice on this, but I had something in my head that was saying if all these other guys are going to resign - and I didn't know at that stage whether John Priest was going to go, because he was at another meeting, and Peter, the CEO, was undecided, so that meant I was their last man standing, and I was thinking, gee, I thought there was a legal principle somewhere that said you can't just go and resign from a board without having a replacement. So I thought, do I have some legal responsibility to ensure that someone is going to take my spot? And I didn't. I didn't have anyone to take my spot.

9.199 He decided that it was not in Eraring's commercial interests to comply with the Portfolio Minister's request for reasons including that the board was unable to obtain its own financial or legal advice, the company was going to be left with no or little scope to make a profit, there would continually be issues with solvency and working capital and "it was going to be basically trying to minimise liquidated damages for its whole life". The absence of price reopeners was also a consideration.

**Board meeting: 9.20 pm**

9.200 The next Eraring board meeting commenced at 9.20 pm. The minutes record that the meeting concluded at 10.15 pm.

9.201 The board was now newly constituted and included two new directors, namely Jan McClelland (as Chair) and Dr Gellatly. In addition, Messrs Jackson, Priest and Bleach continued as directors.

9.202 As occurred at the fifth Delta board meeting on 14 December 2010, a question was raised as to whether the board was duly constituted with no union-nominated director having been appointed. Mr Saxon of Baker & McKenzie provided legal advice that, in the circumstances where a union-nominated director had resigned and not been replaced, the board vacancy did not call into question any acts of the SOC whilst the vacancy existed. Written advice on this aspect had been provided to the shareholding Ministers. A copy of the Baker & McKenzie advice was tabled.

9.203 Dr Gellatly declared his role as Chairman of the Steering Committee and advised that he had received legal advice that he had no conflict of interest.

9.204 Ms McClelland provided a brief description of her professional experience which included being the chair and director of a number of public, private and not for profit boards, a management consultant and a former CEO and senior executive in Government administration.\(^\text{169}\)

9.205 The minutes also state:

\(^{169}\)Ms McClelland is a former Director General of the NSW Department of Education and Training and a former Managing Director of the NSW TAFE Commission. In addition, she is a Fellow of the Australian Institute of Management, a Member of the Australian Institute of Company Directors and a Member of the Institute of Public Administration of Australia.
An explanation of the documents listed in Schedule 1 attached to the letter from the Special Minister of State, and which were available in paper form in the meeting room, was also provided to Board members.

9.206 The same documents as were tabled at the earlier meeting (described above) were also tabled at this meeting, save that the opinion from Baker & McKenzie was now dated 14 December 2010 and no proposed form of Direction under s. 20N (document number six) was tabled.

9.207 The board considered the tabled documents together with a briefing from Mr Jackson on behalf of management as to the documents. The minutes record:

After considering the tabled documents, a briefing from Mr Jackson on behalf of management as to the documents and after due consideration and discussion by the Board, the Board determined that it was not in the commercial interests of Eraring Energy to comply with the request from the Hon. Eric Roozendaal MLC, Special Minister of State and Portfolio Minister for Energy, to the directors dated 13 December 2010 for the following reasons:

(a) due to the time constraints, as required by the Special Minister of State and Portfolio Minister for Energy, for Energy to provide a response, the Board has not conducted a full and thorough due diligence on the transaction documents;

(b) Eraring Energy has not had the ability to carry out its own valuation of the generation trading rights for the Eraring Power Station and Shoalhaven Scheme. In any event, any valuation exercise would be challenging in light of factors such as uncertainty over any future carbon pricing scheme. Eraring Energy has not been able to review all bids received for Eraring Energy assets, nor negotiate directly with any bidder, including the proposed successful bidder. The structure of the transactions makes it difficult to value the rights being offered by Eraring Energy. For these reasons it is difficult for a Board to conclude that the consideration to be received is appropriate;

(c) the generation trading rights of Eraring are to be transacted by way of GenTrader contracts. These contracts provide that Eraring Energy will be entitled to receive payments reflecting certain fixed and variable costs, but the arrangements apply in effect for the life of the relevant facility. There is a risk that unforeseen costs will not be recovered by Eraring Energy. Secondly, the availability obligations imposed on Eraring Energy under the GenTrader Agreements, without the ability to recover significant availability bonuses, will most likely expose Eraring Energy to significant financial penalties in the form of availability liquidated damages. Eraring Energy will require sufficient working capital to cover expenses and liquidated damages. Specifically, the methodology of liquidated damages under the structure of the GenTrader Agreement (GTA) drives the business to be loss making in the long term;

(d) Eraring Energy has not formed the view that any of its generation trading rights should be transacted in the way contemplated by the Transaction Documents and has not engaged modelling advisers or been provided with any detailed modelling data and analysis to support this transaction, and as such is of the view that such a transaction is not in its commercial interests;
(e) as requested by NSW Treasury, the Board of Eraring Energy did not engage any specialist legal, accounting, or economic advisers to assist the Board during the Energy Reform Project; and

(f) at the request of the Due Diligence Committee organised for the Energy Reform Project, Eraring Energy Management have collated a list of outstanding issues with the Transaction Documents (referred to as the GTA Issues List) which has been provided to NSW Treasury and the consultants engaged for the Energy Reform Project. The vast majority of these issues have not been addressed in the Transaction Documents. These include:

- Target Availability and Total Contracted Capacity have been set at high risk levels. The modelling assumptions and analysis determined at these levels have not been made transparent. The targets are expected to result in significant liquidated damages in the long run [payable] by Eraring Energy;

- Availability Targets under the GTA will result in significant liquidated damages payable by Eraring Energy;

- the GTA permits the GenTrader to run generators at higher capacity factors than historic levels but provides no allowance for the impact on availability and outage time needed to make repairs;

- Eraring Energy retains a significant level of risk under the force majeure provisions of the GTA; and

- no price reopens on long term contracts requires the State to bear the risk of unforeseen events requiring additional outage expenditure.

After considering the tabled documents, the briefing from NSW Treasury and its advisers and the matters discussed at the meeting, it is RESOLVED that:

(1) it is not in the commercial interests of Eraring Energy to comply with the request from the Hon. Eric Roozendaal MLC, Special Minister of State and Portfolio Minister for Eraring Energy, to the Directors dated 13 December 2010; and

(2) that the Chair send a letter to the Special Minister of State and Portfolio Minister for Eraring Energy advising the Board’s decision and the reasons for the Board’s decision.

RESULT: Four in favour of Resolution No.1, Mr Jackson abstains.

Further board meeting

9.208 The meeting then adjourned and reconvened. Mr Saxon of Baker & McKenzie provided a Direction issued by the Portfolio Minister with the consent of the Treasurer under s. 20N of the SOC Act together with an Approval issued by the Shareholding Ministers under ss. 20X and 20Y.

9.209 The minutes record:

The Board noted that the Treasurer would not have had an opportunity to view the letter in Resolution No. 1 but was advised by Mr Saxon that nonetheless the Direction is valid and must be acted on by the Board as previously advised in document 4 above.
9.210 The reference to "document 4 above" was a reference to the letter from Baker & McKenzie dated 14 December 2010 which provided an opinion on s. 20N of the SOC Act.

9.211 Following receipt of the Direction, the directors resolved to comply with the Direction. No directors voted against the proposed resolution or abstained. The minutes record:

The Directors noted the Hon. Eric Roozendaal MLC, Special Minister of State and Portfolio Minister for Eraring Energy had provided a Direction under s. 20N(1) of the [SOC Act] dated 14 December 2010 in connection with, among other things, the entry by Eraring Energy into GenTrader Agreements in relation to the Eraring Power Station and the Shoalhaven Scheme (Direction).

The Directors noted that the transactions contemplated under the Direction have been approved by the voting shareholders under sections 20X and 20Y of the [SOC Act]. The Directors also noted that under section 20N(2) of the SOC Act, Eraring Energy is required to comply with a Direction under section 20N(1) of the SOC Act. Legal advice to this effect was confirmed by Mr Chris Saxon of Baker & McKenzie.

The Directors RESOLVED to comply with the Direction, and in particular to:

(a) authorise any two directors to affix Eraring Energy’s seal and execute all agreements and deeds set out in Part A of Schedule 1 of the Direction; or

(b) where it is not necessary to affix Eraring Energy’s seal, authorise any two Directors to execute all agreements and deeds set out in Part A of Schedule 1 of the Direction.

RESULT:

Five (5) Directors in favour of Resolution No. 2

It was agreed that Directors Bleach and Priest would be signatories to the deeds/agreements.

9.212 The Chair closed the meeting at 10.15 pm.

Evidence of the new directors

Jan McClelland

9.213 Ms McClelland, as set out earlier, was a management consultant and had been chair and a director of a number of boards. She had been a member of the board of the Waste Recycling and Processing Corporation from 2005 to January 2011.

9.214 On 14 December 2010 at about 5.45 pm, she received a message from Dr Gellatly. She returned his call.

He said to me that the Government had finalised or was in the process of finalising the sale of electricity but that, late that afternoon, a number of directors had resigned. They needed to appoint new directors to the boards to enable the process to proceed and he asked me if I would be interested and willing to be appointed to one of those boards to progress that process. He said he had to take another call, 'Think about it and I'll call you back'.

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9.215 She was familiar with the provisions of the SOC Act, but had not been involved in any process relating to s. 20N Directions.

Well, in thinking about it, in the process between his phoning back, I thought about it. Going back, as I said to you, it had been contemplated that I might be appointed to a State-owned electricity corporation and I had always been interested in that. The fact that Waste Services was being sold and my directorship there would come to an end very shortly, I had the time and the capacity to take on the role, and that was important.

9.216 Dr Gellatly called her back and:

I can't recall whether it was during that conversation or the one before when I spoke to Dr Gellatly, but I do recall that he said, 'You will be asked to consider whether it's not in the commercial interests of the company?' I recall saying, 'Why would that be?', because I knew Dr Gellatly was the chairman of the steering committee and I thought that was a rather strange way to be approaching things, and he said that that would be made clear at the meeting.

9.217 When she arrived at the offices of Baker & McKenzie, she asked Dr Gellatly about the resignation of the other directors and was told who had resigned. She did not speak with any of the directors who had resigned. She was briefed by some of the advisers about the nature of the gentrader agreements and transactions.

9.218 She became aware that:

From the point of view of Eraring, certainly they would be producing electricity, but their right to generate profits would be gone. They would be reliant on funding that was provided by Origin to meet their operating and known capital costs at the time. There were also to be targets set for production and, in the event of those targets not having been met, Eraring would be liable to pay damages - I think they were called liquidated damages.

9.219 She made notes during the briefing and, by reference to those notes and her recollection, said to the Inquiry that she was concerned about the capacity of Eraring to be able to meet those targets and that the responsibility for maintenance, industrial relations and disasters rested with Eraring.

I asked the question of both [Peter Jackson] and [John] Priest why the other directors had resigned... Everybody all seemed to be in a state of shock. That was my recollection of everybody whom I encountered.

9.220 It seems that the answers she was given involved speculation as to the motivations of others.

This is again where I am not exactly clear about the sequence, but at some stage - as I said before, Mr Saxon was coming in and out of the room. I think this might have actually occurred before I met with Mr Jackson and Mr Priest. I do recall saying to him, 'Why does this have to be done - dealt with tonight?' I recall that he said, 'Because Origin is closing trading at midnight'... I assumed from that that there were fairly serious consequences, commercial consequences, in not proceeding given that there had been a tendering process and a bid and negotiations had been concluded.

...Certainly I didn't have the history that the other directors had... I felt that I understood, however, what was being asked in terms of the nature of the transaction itself...
...But I also was looking beyond the 14th and to the needs of that organisation and its leadership. There was a void in the board. The board would need leadership. The organisation would need leadership in changing from being essentially a profit-making organisation to one that was focused on contract management, asset management, and they were areas that I was quite comfortable with and familiar with.

9.221 In terms of her understanding of her duties as a director, she said:

Certainly to act in good faith and have no conflict of interest, to do due diligence as best I could in the circumstances, to be familiar with what it was that I was being asked to deal with, and to ensure that I’d assessed the risk and that the decision I would make would be in the best interests of the company.

...I would have preferred more time. In my normal course of chairing and conducting my director’s responsibilities, I thoroughly prepare for any involvement, meetings that I have to deal with. I felt satisfied that I knew what I was being asked to do and that I understood the risk [to which Eraring would be subjected by entering into the transaction].

9.222 Mr Jackson articulated why the board determined that it was not in the commercial interests of Eraring to enter into the transaction and spoke to a document that was distributed to the board members, which was the basis for the minutes. Ms McClelland was persuaded by those points, which accorded with her own thoughts.

9.223 Ms McClelland ceased to be chair of Eraring on 12 May 2011, having been removed from the position by Treasurer Baird.

Col Gellatly

9.224 Dr Gellatly was the Chair of the Steering Committee and present in that capacity on 14 December 2010 at the various board meetings prior to the resignation of directors. He was asked by Treasurer Roozendaal to accept the appointment as director of Eraring and agreed to do so. The minutes record his declarations of interest and his abstentions.

9.225 He suggested that Ms McClelland be appointed as a director of Eraring because:

I had known Jan professionally for a long time in the public service when she was Director-General of Education. I knew in recent times she was a director of Waste Corporation; I think it was called, which I think actually finished that day. So I knew she had experience in state-owned corporations and was an experienced public servant and would I thought be able to do the duties required, so I asked her to come in.

Response to the directors’ actions

Reaction to the resignations

9.226 Mr Saxon says that, as far as he was concerned, resignation by the directors was not contemplated at any stage. The resignations came to him as a “complete surprise”.

9.227 Mr Lobb and Mr Dimpfel told the Inquiry, that they too were surprised at the resignations.
9.228 Mr Cosgriff told the Inquiry that he was “stunned they resigned”. He said:

They had been briefed about the process, they were asked to make quite a simple decision, which was they would take an instruction and that some of the more commercial members of the board exercised that. I do struggle, if I can be really frank, to understand the motivations here.

9.229 Former Treasurer Roozendaal said to the Inquiry that when he learned of the resignations, he was “extremely surprised” and “unhappy”. He said that during the course of the day he had had “absolutely no inkling” that there might be resignations. He reiterated that there was no warning given by the directors that any one of them was contemplating resignation, notwithstanding that he had been told that Dr Gellatly had spoken to the Chairs of each board on the previous evening.

9.230 Dr Gellatly told the Inquiry that he was still “bewildered why they resigned”. He added: “The only thing I can think of is that they thought there was something wrong with the transaction, but it was never defined to me what was wrong with it.”

9.231 When asked by the Inquiry whether he thought that there was anything the Government or the Steering Committee could have done differently to avoid the resignation of the directors, Dr Gellatly answered in the negative.

9.232 Dr Gellatly explained:

Everything we did along the way, we had lawyers, you know Baker & McKenzie’s opinion, Crown Solicitor’s. . . Even on the night of December 14, everything was documented, everything was done open in the sense of within the transaction and in the processes of the Government. . . I guess I found it annoying that the inference was that this was a dodgy deal done in the back rooms, where clearly it was not. You have seen there was a lot of work that went into it and the issue of that night and what happened and why we had to be appointed, because the Stock Exchanges were both on hold and there had been basically agreements and so on worked out, and the Government wanted to do the transaction.

Making the new appointments

9.233 In the late afternoon, on 14 December 2010, Baker & McKenzie reviewed the SOC Act and the Memorandum and Articles of Association of Eraring and Delta and advised Treasurer Roozendaal and his staff concerning the appointment of new directors. The review included consideration of whether the boards could be quorate without a union representative, in light of cl. 1(2)(b) in Sch. 2 of the Energy Services Corporation Act 1995 (which required there to be a union representative on each board). Baker & McKenzie advised the Government that the boards could make valid resolutions without such a representative being present if they were otherwise quorate.

9.234 Treasurer Roozendaal sought advice from Baker & McKenzie as to who could be appointed as replacement directors. Mr Saxon advised that he personally would be precluded. He advised that other persons involved in the process would not be precluded but ought to disclose any other role in which they relevantly acted at the board meeting. This advice was subsequently given in
writing later that night and expanded upon in a further written advice provided in January 2011.

9.235 Treasurer Roozendaal then suggested that Dr Gellatly and Messrs Yeadon and Dermody be appointed as directors. Dr Gellatly suggested that Ms McClelland be appointed for the reasons given earlier.

9.236 At about 5.45 pm Treasurer Roozendaal rang Minister Daley to inform him of what had occurred and the need to appoint new directors. He also informed him of the identity of the directors he proposed. Former Treasurer Roozendaal told the Inquiry that Minister Daley told him that he wanted legal advice on the issue of potential conflicts before the directors were appointed.

9.237 Mr Saxon was then asked to prepare the documentation to enable the appointments. Mr Saxon, at their request, also informed the Ministers of the discussions that had taken place with the board over the previous year or so.

9.238 Mr Saxon also warned them that there was a commercial risk if the transactions were not executed that day because the bidders could withdraw their offers, which would no longer be available for acceptance. Although the binding bids which had been made by the bid closure date were expressed to remain open for a period of 60 days, these bids had been superseded by subsequent negotiations and there was no obligation on the bidders to adhere to the offers they had made which were reflected in the transaction documents. He informed the shareholding Ministers that both of the purchasers were listed companies which had gone into trading halts on their respective exchanges on the morning of 14 December 2010 and would be very anxious not to extend their trading halts into a second or third day if they could possibly avoid it. He told the Ministers that the bidders had a strong expectation that the transactions would be executed on 14 December 2010.

9.239 On 22 December 2010 Baker & McKenzie provided a memorandum to Minister Daley and Treasurer Roozendaal summarising the verbal briefings given to them on 14 December 2010.

9.240 Former Treasurer Roozendaal explained to the Inquiry his reasons for replacing the directors who had resigned so that the boards of Delta and Eraring could act in the following terms:

We had a $5.3 billion transaction happening. We had two bidders that had put in bids in good faith. Those bids had been assessed by the bid evaluation team, by the project team, by the steering committee, by the budget committee of the Cabinet and approved... The Government saw this as a completion of a major economic reform, and suddenly, at the very last hurdle, we ran into an obstacle with these two boards not having a quorum. After some discussions we agreed we had to re-establish quorums to allow those boards to complete their responsibilities. We talked of who could possibly become directors and, in the end, to complete the transaction in the time frame in which it needed to be completed, we decided on those three [Dr Gellatly and Messrs Yeadon and Dermody] plus Jan McClelland.

9.241 Former Treasurer Roozendaal told the Inquiry that he did not think that it would have been appropriate to appoint a public servant; none of the persons he appointed to be directors were then public servants.
9.242 Former Minister Daley told the Inquiry that he required some “comfort” that what he was being asked to do was the correct thing to do as far as the Government’s decision to proceed with the energy transactions was concerned. He was also aware that as some directors had resigned there was “likely to be some controversy about that, or at least some inquiry at a later date” so he wanted legal advice that he was on a sound legal footing in appointing the replacement directors and a recommendation from Treasury that he sign the requisite documents. As both were forthcoming, he proceeded to sign the documents.

9.243 Former Minister Daley said that:

a. he considered that the actions of the resigning directors had “added nothing to the situation other than to leave those companies inquorate”;

b. he was aware that the successful bidders were in trading halts on their respective stock exchanges and that if the transactions did not conclude that evening there was a very real chance that they would withdraw the bids and the entire transaction would fall over; and

c. he considered that as a shareholding Minister, he had a duty to the Cabinet and to the Government to do what was reasonably required of him to complete those transactions, which was to appoint new directors so as to allow the boards to have a quorum to consider what they needed to do next.

9.244 The probity advisers were informed on 15 December 2010 that Messrs Yeadon and Dermody had been appointed to the board of Delta and Dr Gellatly had been appointed to the board of Eraring. The probity advisers considered that their appointments gave rise to a potential for conflict and recommended that Mr Yeadon stand down as chair of the Evaluation Committee, that each director make relevant declarations and that they resign their directorships as soon as practicable.

9.245 As discussed earlier in this Chapter, Baker & McKenzie advised on 14 December and provided further advice in January 2011, that, as a matter of law, they did not consider any potential conflict prevented them from being the members of the Energy Reform Project and being directors of the SOCs. They referred to any possible conflict as a technical one given that State of NSW owned Delta in that the voting shareholders held the shares on behalf of the State, the directors were accountable to the voting shareholders and the State was a party of those contracts between the new directors in their roles on the Energy Reform Project.

9.246 Notwithstanding that advice, the probity advisers considered that the transaction was so significant that no risk should be taken with public perception. Mr Shatter said:

We just didn’t think it looked appropriate. We thought it had a perception issue attached to it...the thing that always tends to hurt a project from a process perspective is people’s perception as to whether the project has been conducted in an upright and honest manner.

9.247 The Inquiry’s view on this matter is set out in Chapter 10.
Deliberations by the SOC retailers

**Knowledge of the SOC retailers prior to December 2010**

9.248 As with Delta and Eraring, from at least May 2009, the boards of EnergyAustralia, Country and Integral knew that they would probably be called upon, at some time, to consider transaction documents relating to the Energy Reform Project and the sale of the retail business. They also knew that, ultimately, they might receive a Direction under s. 20N of the SOC Act. In that month, the Chair of each board was provided with the Protocol for the Interaction of Government and the State Owned Electricity Businesses (the Protocol).

9.249 Over the following year and a half, the boards received briefings, from time to time, on aspects of the Energy Reform Project from Treasury and Treasury advisers, including Baker & McKenzie. Meetings were held from time to time, between management and Treasury officials and the responsible Minister. Legal advices as to the validity of the proposed Directions were provided as were draft Directions and associated documents.

**EnergyAustralia (now known as Ausgrid)**

9.250 On 14 December 2010 the board of EnergyAustralia met to consider documents relating to the proposed sale of its retail business and the Marulan development site. Immediately prior to the meeting, the Board received a set of papers from Baker & McKenzie. The board pack included a copy of a letter from the Portfolio Minister, Mr Roozendaal, to the board of EnergyAustralia requesting EnergyAustralia, among other things, to execute transaction documents relating to the sale of EnergyAustralia’s retail business and the Marulan development site.

9.251 The Baker & McKenzie board pack also contained:

a. a draft board resolution in relation to the request from the Special Minister of State;

b. a copy of an approval by the voting shareholders under ss. 20X and 20Y of the SOC Act;

c. a copy of a letter from the Portfolio Minister attaching an approval of the Treasurer and a proposed Direction under s. 20N of the SOC Act;

d. copies of the opinion of the QC dated 20 September 2010 and his memorandum dated 7 December 2010;

e. the advice from the Crown Solicitor dated 9 December 2010 regarding indemnities;

f. a draft board resolution authorising EnergyAustralia to enter into the transaction and execute transaction documents; and

g. a memorandum from Baker & McKenzie regarding the transaction documents.
9.252 The board was briefed by the advisers from the Energy Reform Project who joined the meeting.¹⁹⁰

9.253 The Chairman noted that the role of the board in connection with the project had been limited by the Protocol issued by the Government in May 2009 and specific instructions of the Steering Committee. In particular, the board:

a. had not undertaken work to ascertain the value of the retail business for the purposes of a sale;

b. had not been involved in the process of negotiating the transaction documents with the bidders; and

c. had not signed off on, or assisted in the preparation of, any vendor due diligence or bidder due diligence data rooms.

9.254 The board noted a number of issues arising out of the transaction documents which were not in the commercial interests of EnergyAustralia including:

a. EnergyAustralia would bear all costs associated with the performance of certain transitional obligations, which were not capped or recoverable from the purchaser;

b. there was ambiguity as to the precise nature and limit of the transition services that EnergyAustralia would be obliged to provide; and

c. the transaction documents resulted in EnergyAustralia being exposed to significant purchaser credit risk.

9.255 At 11.15 am the board unanimously resolved:

a. that it was unable to determine that the transaction documents were in the commercial interests of EnergyAustralia and as a consequence, noting the request for an immediate response, determined that entry into the transaction documents was not in the commercial interests of EnergyAustralia; and

b. that it was not in a position to comply with the request from the Special Minister of State.

9.256 One director asked that the meeting record their view that it was not in the commercial interests of EnergyAustralia to comply with the request from the Portfolio Minister because of the lack of information available to the board throughout the transaction and the overall lack of transparency in the sale process.

9.257 Baker & McKenzie then delivered a direction dated 14 December 2010 under s. 20N of the SOC Act from the Portfolio Minister, Mr Roozendaal, together with copies of the relevant approvals under ss. 20X and 20Y of the Act. The Direction required EnergyAustralia to execute transaction documents.

¹⁹⁰ In attendance were Dr Gellatly, Messrs Yeaton and Dermody together with Mr Birch of Treasury, Messrs Deeming and Dimpfel of Credit Suisse, Mr Leyden of Lazard and Messrs Saxon and Holland of Baker & McKenzie.
The directors noted the legal opinions provided to the effect that the directors of EnergyAustralia were required to comply with a direction under s. 20N. The Directors further noted that, under s. 20N(2) of the Act, EnergyAustralia is required to comply with a direction under s. 20N(1).

In these circumstances, the Directors resolved to comply with the Direction received under s. 20N(1) and in particular to:

a. authorise any two directors or a director and the company secretary to execute any agreements set out in Part A of Schedules 1 and 2 of the Direction; and


The directors noted the entitlement of a SOC under s. 20N(3) of the SOC Act to be reimbursed amounts equal to the cost of performing activities in compliance with a direction under s. 20N(1). The directors agreed that EnergyAustralia would continue to communicate with Treasury in relation to this aspect.

**Country Energy (now known as Essential Energy)**

On 14 December 2010, Country was provided with various transactions documents together with a memorandum regarding commercial terms for the sale of its retail business, including details of the purchaser, the consideration payable, and key amendments to the transaction documents.

Baker & McKenzie also provided the same board pack as given to EnergyAustralia and set out above.

The minutes record that the directors noted that, among other things, the directors had not had detailed involvement in the steps leading up to the finalisation of the transaction documents, had not been involved in negotiating the transaction documents, had not been in a position to undertake any independent valuation of Country’s retail business or the impact of the transaction documents on the remainder of Country’s business following the proposed transaction.

The board discussed the various legal duties applying to directors, the principal objectives and functions of an energy distributor under ss. 8 and 9 of the Energy Services Corporations Act 1995 and, further, that the transition services agreement provided for cost recovery only for Country and had the potential to result in the company having substantial stranded costs, which was not in its commercial interest.

The board further noted that Country had not been able to review all bids received for its assets or to negotiate directly with any bidder, including the successful bidder, and had not had the ability to carry out its own valuation of its retailing business.

In light of these various matters, the board resolved that it was not in the commercial interests of Country to comply with the request from the Portfolio Minister. The board meeting closed at 9.50 am.
9.267 A further special board meeting of Country took place on 14 December 2010. The minutes record that the board resolved that Country was able to pay all its debts as and when they became due and payable and that Country would not become insolvent by entering into the transaction documents or by acting so as to give effect to any transaction contemplated by the transaction documents.

9.268 The board further resolved that, acting pursuant to the s. 20N Direction and the obligation to comply with it pursuant to s. 20(2), the board approved the entry into and execution of each of the transaction documents. The board also resolved that any two directors, or one director and the company secretary, be authorised to execute and deliver the transaction documents. The documents were executed that day.

**Integral Energy (now known as Endeavour Energy)**

9.269 The board of Integral met at 10.00 am on 14 December 2010 and received the same documents as EnergyAustralia and Country.

9.270 The minutes record that the board discussed a number of issues relating to the ongoing solvency of Integral and was briefed by the Chief Financial Officer. Following discussion, and noting the entitlement under s. 20N(3) of the SOC Act to reimbursement of the net costs of complying with a direction under s. 20N(1), the board concluded that there was no reason to believe that Integral would become insolvent by entering into the proposed transaction.

9.271 Advisers to the Treasury joined the meeting by invitation.

9.272 The board considered the Portfolio Minister’s request. The board had regard to the following factors:

a. finalised transaction documents had been provided only at the board meeting that day;

b. Integral had not had the ability to carry out its own comprehensive valuation of its retail business, and had not been able to review in detail all bids received for its retail business or negotiate directly with any bidder;

c. consistent with the Protocol for the retail sale process, the directors had not engaged independent legal, financial or commercial advisers on the sale process;

d. the directors had received only a limited briefing at the meeting from the sale advisers on the bid outcomes; and

e. the directors had not received any understanding or undertaking from the shareholders as to how Integral’s stranded costs or other net costs would be met post sale.

9.273 The board resolved that it was unable to conclude whether or not complying with the Portfolio Minister’s request would be in the commercial interests of Integral, and therefore it was not in the commercial interest of Integral to comply with the request.
9.274 The board further resolved that should a direction be given by the Portfolio Minister under s. 20N of the SOC Act, in the same terms as the Minister’s request, the board authorised the Chairman and the Chief Executive Officer to execute the transaction documents.

9.275 The board noted that the transactions contemplated under any direction under s. 20N would be approved under ss. 20X and 20Y and that under s. 20N(2) the board was required to comply with a direction under s. 20N(1).

9.276 The transaction documents were executed following the meeting.

**Macquarie Generation**

9.277 On 28 January 2011, *The Australian Financial Review* (the AFR) published an article which was said to be an analysis of the Electricity Transactions and was headed “Policy Blackout Marked Power Debacle”.

9.278 Among other matters covered by the article, the following was said:

> A Director of that board [Macquarie Generation], who preferred not be named, provided a revealing account of the transaction process so far, which he said involved an appalling lack of attention to detail, almost no communication with the power companies and a frightening disregard for the protection of tax payers against ongoing financial risk related to the deal.

9.279 The unnamed director was quoted as having said “I have never before seen a more poorly handled transaction”.

9.280 The article referred to the Macquarie Generation’s Chairman and Chief Executive having had just one briefing from government advisers. It referred to the director as having said that Macquarie Generation’s management put in dozens of submissions to the Government’s transaction team outlining its concerns about the structure of the sale but never received any feedback. The article also reported that the company was never properly briefed on the process for penalty payments in the event of power outages and was also prohibited from obtaining its own legal advice.

9.281 The article came to the attention of the Inquiry because part of its content was quoted by Treasurer Baird in Parliament on 12 September 2011.

9.282 The Inquiry sought the views of the board of Macquarie Generation through its Managing Director and, separately questioned the director who was quoted as to his views.

9.283 The director in question was appointed a director of Macquarie Generation in July 2010, before which he had no dealings with Macquarie Generation. Other than the board papers for the month previous to his appointment, which he was given, he did not access or review any previous board papers.

9.284 He was briefed on the proposed Electricity Transactions when he first became a director, prior to that he was only aware of the project from reports in the media. He received no written material relevant to the Electricity Transactions when he was appointed a director.
9.285 The director spoke to a female journalist from the AFR on 27 January 2011. He told the Inquiry he answered questions on the basis that the conversation was off the record, that the information given was background only and were his personal views.

9.286 He informed the Inquiry that he expressed to the journalist his view that the transaction was one of the worst public policy transactions he had experienced because the level of communication with the board was poor and the board could not be certain that it would have the financial resources to meet any availability damages. He told the journalist that the management had put in dozens of submissions but did not say to her they had received no feedback. His concern was that there was only one meeting with the board.

9.287 He said he was not of the view, nor did he convey it to the journalist, that the process involved an appalling lack of attention to detail or a frightening disregard for the protection of tax payers against ongoing financial risk related to the deal.

9.288 The Managing Director of Macquarie Generation told the Inquiry that the company does not and did not hold a view that the Electricity Transactions were a poorly handled transaction or showed an appalling lack of attention to detail. He said that it was not the view of Macquarie Generation that the project showed a disregard for the protection of tax payers against ongoing financial risk. Further, it was not the position of the board that management put in dozens of submissions but never received any feedback.

9.289 It was the view of Macquarie Generation that the communication with it was not adequate. He told the Inquiry that management did make a number of submissions and they were concerned about a lack of response from the Energy Reform Group to some of those submissions. While there were informal discussions, they were not necessarily helpful formal responses on most of the issues. TheManaging Director of Macquarie Generation told the Inquiry that there were a number of letters written by Macquarie Generation raising concerns about how the liquidated damages regime would work.

9.290 It is clear from the material available to the Inquiry that Macquarie Generation did obtain its own legal advice in relation to directors’ duties and, further, the protocol that was issued by the government, which had been provided to Macquarie Generation, indicated that external legal advice could not be obtained unless prior consent was obtained by Treasury. The Inquiry understands that Macquarie Generation obtained such consent to obtain legal advice in relation to directors’ duties and the like.

9.291 Accordingly, the article in the AFR does not reflect the views of the board and management of Macquarie Generation. The Inquiry’s view of the sale process and outcome appears in Chapter 12.
Chapter 10 Compliance with laws and obligations on 14 December 2010

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The State Owned Corporations Act 1989

Comparative provisions to s. 20N in other jurisdictions

10.1 The key provisions of the SOC Act have been set out in Chapter 9. It is not unusual that such a piece of legislation exists or that s. 20N has been enacted. Provisions similar to s. 20N of the SOC Act are to be found in legislation governing State owned entities in other jurisdictions.

10.2 In Victoria the State Owned Enterprises Act 1992 relevantly provides that the principal objective of each State business corporation, governed by the Act, is to perform its functions for the public benefit by operating its business, or pursuing its undertaking, as efficiently as possible consistent with prudent commercial practice, and by maximising its contribution to the economy and well being of the State. However, akin to s. 20N of the SOC Act, s. 45 of the Victorian Act empowers the relevant Minister to issue directions to a State business corporation to perform non-commercial activities.

10.3 In the Northern Territory the Government Owned Corporations Act 2001 provides that the objectives of a Government owned corporation are to operate at least as efficiently as any comparable business and to maximise the sustainable return to the Territory on its investment in the corporation. Section 30 of the Northern Territory legislation empowers the portfolio Minister to give a direction to the board of a Government owned corporation if satisfied that it is in the public interest to do so and, relevantly, where the Minister has requested the board to advise the Minister whether, in its opinion, complying with the direction would not be in the best interests of the Government owned corporation.

Instances of use of s. 20N of the SOC Act

10.4 Since its introduction in 1995 s. 20N has been used on a number of occasions to require a statutory SOC to undertake specified non-commercial activities.

10.5 In order to put the events of 14 December 2010 in context, it is convenient to catalogue instances of use of s. 20N of the SOC Act in the period from 1995 to December 2010. They comprise the following:

a. Direction given to Freight Air Corporation dated 10 October 1996: The Hon Brian Langton MP, Minister for Transport, issued this direction requiring the Freight Rail Corporation to provide continuing transport assistance to charities that received assistance from Trackfast.

b. Direction given to Australian Inland Energy dated 18 December 1998: This direction concerned funding for the enhancement of the electricity supply in the Balranald area.

c. Direction given to Sydney Water Corporation dated 20 December 2002: The Hon. Kim Yeadon MP, Minister for Energy, issued this direction requiring

191 State Owned Enterprises Act 1992 (Vic), s. 18.
192 Government Owned Corporations Act 2001 (NT), s. 4.
193 In Queensland s. 115 of the Government Owned Corporations Act 1993 (Qld) empowers the shareholding Ministers of a government owned corporation to issue written directions if satisfied, because of exceptional circumstances, it is necessary to do so in the public interest. This provision is akin to s. 20P of the SOC Act.
194 A copy of the Direction was tabled in the Legislative Council on 7 April 1997.
195 A copy of the Direction was tabled in the Legislative Assembly on 2 February 1999.

Chapter 10

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Sydney Water Corporation to sell land owned by the corporation at Miranda incorporating requirements of:

i. mandatory development of the site as a three tier aged care development;

ii. the sale of the land being limited to 'not for profit' organisations; and

iii. incorporation of affordable accommodation in the development.196

d. Direction given to Hunter Water Corporation dated 2005:197 The Hon. Frank Sartor MP, Minister for Energy and Utilities, Portfolio Minister for the Hunter Water Corporation, issued this direction requiring the Hunter Water Corporation to acquire, manage, use and control certain Government owned land in the Lower Hunter to ensure that activities were undertaken to prepare the sites for future use and allow the Government’s aims for the sites to be met, until a new entity would be formed to take ultimate ownership and responsibility for the sites;198

e. Direction given to Sydney Water Corporation dated 24 September 2009: The Hon. Phillip Costa MP, Minister for Water, issued this direction requiring Sydney Water Corporation to extend the Hawkesbury Heights and Yellow Rock service area to include certain specified non-urban residential properties at Yellow Rock,199 and

f. Direction given to Delta Electricity dated 6 November 2010: The Hon. Paul Lynch MP, Minister for Energy, issued this direction requiring Delta to perform the activity of disclosing copies of Delta’s current contracts with Hydro Aluminium Kurri Kurri Pty Ltd to bidders for the Delta West gentrader bundle as part of the NSW Energy Reform Project.200

The Waste Recycling and Processing Corporation

10.6 The former Government sold its interest in the Waste Recycling and Processing Corporation (WSN) in December 2010. This transaction is included in the report as an illustration of how the process of privatising can occur when supported by legislation. Further, Ms McClelland was the chair of WSN at the time of its sale and thus is well placed to compare the outcome of each process.

10.7 WSN was established by the Waste Recycling and Processing Corporation Act 2001 (s. 4(1)) and was also a SOC under the SOC Act (see SOC Act, s. 20A(1)).

10.8 As a core part of its business, WSN provided waste management services to the greater Sydney area and beyond, including kerbside collection of waste and recyclables for a number of local councils, processing, recycling and recovery of resources from waste streams, and waste disposal.

196 A copy of the Direction was tabled in the Legislative Assembly on 8 May 2003.
197 No day or month was specified in the signed Direction.
198 A copy of the Direction was tabled in the Legislative Assembly on 20 October 2005.
199 A copy of the Direction was tabled in the Legislative Assembly on 27 October 2009.
200 A copy of the Direction was tabled in the Legislative Assembly on 10 November 2010.
10.9 In November 2008, as part of the 2008-2009 Mini-Budget, the Government foreshadowed the potential sale of WSN to the private sector.\footnote{NSW Treasury, *Mini-Budget 2008-2009*, Sydney, pp. 6-1, 6-3.}

10.10 In propounding the case for the sale of WSN, the Government said that there was no sound reason why the WSN waste business should remain in government ownership: WSN operated in an increasingly competitive market along with private sector operators; continued Government ownership would expose the Government, and thus NSW taxpayers, to ongoing commercial and financial risks; private sector participants were best able to meet the future investment needed in alternative waste technology facilities; the sale of WSN would address the existing conflict resulting from the Government being both owner and regulator of the business; and finally, sale proceeds could be used to retire public debt and thus strengthen the State’s financial position.\footnote{New South Wales, Legislative Assembly 2010, Agreement in Principle Debate, 16 March 2010, p. 21482.}

10.11 In March 2010, Parliament passed legislation to authorise and facilitate the transfer to the private sector of the assets, rights and liabilities of WSN. The Bill received bipartisan support.

10.12 The *Waste Recycling and Processing Corporation (Authorised Transaction) Act 2010* authorised the transfer to the private sector of any of the assets, rights and liabilities of WSN and provided the Government with flexibility as to the precise mechanics of the transfer, including whether it be by asset sale or share transfer. Power was conferred on the Treasurer (s. 12(2)) to give directions to WSN and the directors and other officers of WSN for the purposes of the transfer of WSN assets, rights and liabilities as authorised by the Act. Any such direction was required to be complied with (s. 12(2)). Such a direction did not require the approval of the voting shareholders or portfolio Minister of WSN (s. 12(5)).

10.13 Section 22 made clear that the provisions in the SOC Act did not in any way permit, restrict or otherwise limit the carrying out of the proposed sale transaction.

10.14 Post-enactment, there followed a Request for Expressions of Interest, then a number of parties were invited to submit indicative offers then binding offers.

10.15 On 14 December 2010 Treasurer Roozendaal announced the sale of WSN to the private sector, with the Government to receive $235 million in proceeds.\footnote{Eric Roozendaal, NSW Treasurer, Special Minister of State, Media Release, "Treasurer Roozendaal: $235 million in proceeds from successful WSN transaction", 14 December 2010, Sydney.}

*Experience of Jan McClelland with WSN*

10.16 Ms McClelland was a director of WSN from 2005 to January 2011. Ms McClelland’s experience with the sale of WSN may be contrasted with the process encountered by the directors of Delta and Eraring under the Energy Reform Project.

10.17 On 14 December 2010, Ms McClelland was on her way home from work, shortly before 5.45 pm, when she heard on the radio that WSN had been sold that day. Ms McClelland said that although WSN, like Eraring, was a SOC:
... its sale process was very different because the Government had passed legislation which essentially put the hands of the sale process entirely in the Treasury and, as a consequence of that, the board, unlike in this process, was somewhat removed. Although we were kept informed, we didn’t have a decision-making role in that process.

10.18 Ms McClelland said that when she first learned, on 14 December 2010, that the directors of Eraring had not been given the opportunity to carry out an independent valuation of the gentrading rights she was not surprised. Ms McClelland explained to the Inquiry:

It wasn’t surprising to me in a sense, because I had been through the sale process with Waste Services. As I said ..., that process had been handled very much at arms-length from the board. The board had been removed other than just being told that there was the bidding room and just various stages. We were not engaged in any of the modelling or any of the costings. In fact, that very day that I was driving home in the car and heard that it had actually happened on that day, so I was familiar with not being involved in the process, and in that sense, it didn’t seem odd.

What did seem odd to me was that the board had such a strong role to play in the process. Hence the whole issue of directors leaving and resigning at the eleventh hour just made me reflect on the process and think, ‘This is rather odd.’

Directors’ duties

10.19 Directors of a statutory SOC are subject to duties and obligations arising both under the SOC Act, the Corporation’s constitution and the general law.

Duties under the SOC Act and Articles

10.20 Pursuant to the SOC Act and the respective Articles, the directors of Delta and Eraring were each subject to the following duties:

a. a duty to act honestly204 in the exercise of powers and discharge of functions as a director of the SOC;205

b. a duty, in the exercise of powers and the discharge of functions, to exercise the degree of care and diligence that a reasonable person in a like position in a statutory SOC would exercise in the statutory SOC’s circumstances;206

c. a duty not to make improper use of information acquired because of his or her position as a director of the SOC:

i. to gain, directly or indirectly, an advantage for himself or herself or for another person; or

204 In Marchesi v Barnes [1970] VR 434 Gowans J regarded the duty to ‘act honestly’ (Companies Act 1961, s. 124(1)) as referring to acting bona fide in the interests of the corporation.

205 SOC Act, Sch. 10, cl. 3(1); Articles, cl. 17.2(a). Under the pre-CLERP regime, the comparable provision (s. 232(2)) imposed an obligation on directors to act honestly. There was an unresolved debate between courts as to whether s. 232(2) was breached where the director was subjectively honest but the court considered the purpose to be improper. Consider Marchesi v Barnes [1970] VR 434 at 438 (Gowans J) and contrast Australian Growth Resources Corp Pty Ltd v Van Reesema (1988) 13 ACLR 261 at [272] (King CJ). The same debate applies under s. 181 of the Corporations Act 2001. In Australian Motor Finance Ltd ( Receivers and Managers appointed) v Angelieri (No 3) [2010] FCA 1431 at [51] Tracey J said that the weight of authority favours the stricter view that it must be shown that a director engaged deliberately in conduct which he or she knew was not in the best interests of the corporation or for a proper purpose.

206 SOC Act, Sch. 10, cl. 3(1), cl. 17.2(b) of the Articles provides: “In accordance with Schedule 10, clause 3(3) of the SOC Act, each Director, in the exercise of powers and discharge of functions, must exercise the degree of care and diligence that a reasonable person in a like position would exercise.”
ii. to cause detriment to the SOC; 207

d. a duty not to make improper use of his or her position as a director of the SOC:

i. to gain, directly or indirectly, an advantage for himself or herself or for another person; or

ii. to cause detriment to the SOC; 208

e. a duty to take all reasonable steps to prevent the statutory SOC from incurring a debt if the director has reasonable grounds to believe that:

i. the statutory SOC will not be able to pay all its debts as and when they become due; or

ii. as a result of incurring the debt, the statutory SOC will not be able to pay all its debts as and when they become due.

("duty to prevent insolvent trading")

10.21 The statutory duty to exercise care and skill in the exercise of powers and discharge of functions is, however, modified by reference to governmental considerations. Thus, cl. 3(9) of Sch. 10 provides that, in determining for the purpose of subcl. (3) the degree of care and diligence that a reasonable person in a like position in a statutory SOC would exercise in the circumstances of the statutory SOC concerned, regard must be had to:

a. the fact that the person is an officer of a statutory SOC;

b. the application of the SOC Act to the SOC; and

c. relevant matters required or permitted to be done under the SOC Act in relation to the SOC,

including any relevant directions, notifications or approvals given to the SOC by the SOC's voting shareholders or portfolio Minister.

10.22 The duties and liabilities of directors listed in cl. 3 of Sch. 10 are additional to, and do not limit, duties or liabilities of a director arising under the general law. 209 Thus, cl. 3(11) of Sch. 10 provides that:

This clause:

(a) is in addition to, and does not limit, any rule of law relating to the duty or liability of a person because of the person's office in relation to a corporation; and

(b) does not prevent civil proceedings being instituted for a breach of the duty or liability.

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207 SOC Act, Sch. 10, cl. 3(4); Articles, cl. 17.2(c).
208 SOC Act, Sch. 10, cl. 3(5); Articles, cl. 17.2(c).
209 SOC Act, Sch. 3, cl. 11.
Duties arising under the general law

10.23 Under the general law, a director is regarded as being in a fiduciary relationship with the corporation and is subject to fiduciary duties.\textsuperscript{210} Derived from principles of equity, duties of loyalty, both positive and negative, apply to directors.

10.24 The positive duties of loyalty of a corporation director include the duties:

a. to act in good faith in the interests of the corporation;

b. to act for proper corporate purposes; and

c. to give adequate consideration to matters for decision and to keep discretions unfettered.

10.25 Negative aspects of the obligations of loyalty include the requirement to avoid conflicts of interest of various kinds, including improper use of information and position.

10.26 Separate from the duty of loyalty, the directors of a corporation owe a duty of care to their corporation to exercise reasonable care and skill.\textsuperscript{211}

10.27 Under the general law, the courts have evidenced a general reluctance to review the merits of board decisions that were exercised in good faith and not for irrelevant purposes. This applies more so in the case of decisions relating to business matters rather than constitutional matters (such as a placement of shares). The business judgment rule, developed by the courts, forms part of the court’s assessment of whether an impugned director’s conduct is in breach of a general law duty, such as the duties of loyalty and of the duty to exercise care and skill.

10.28 Thus, the courts may intervene if the board decision is found to be one that no reasonable board could consider to be within the interests of the corporation, or that no reasonable board of directors could think to be substantially for a purpose for which the power was conferred. In such limited circumstances, the court may infer that the decision was not made in good faith for a purpose within the power.\textsuperscript{212}

Duty to act in good faith in the interests of the corporation

10.29 Breach of this duty more commonly arises in cases dealing with the affairs of small proprietary companies, where controlling shareholders have treated the corporation assets as their own, or have used the corporation to incur an obligation so as to provide a personal benefit for directors or shareholders.

10.30 The duty to act in "the interests of the corporation" contemplates having regard to the interests of the corporation as a whole. This includes having regard to the interests of shareholders, as the proprietors of the corporation, and, in an insolvency context, the interests of creditors.

\textsuperscript{210} See eg Hospital Products Ltd v United States Surgical Corp (1984) 156 CLR 41 at [68] per Gibbs CJ.


\textsuperscript{212} Consider Wade v New South Wales Rugby League Ltd (1965) 180 CLR 459 per Brennan J.
Duty to act for proper purposes

10.31 The duty to act for proper corporate purposes requires consideration of the nature of the power conferred, the conduct of the director(s) at issue and the making of a determination as to whether the director(s) can be said to have acted for an improper purpose.

10.32 The court must consider first, as a matter of law, the purposes for which the relevant power may or may not be exercised and, secondly, the purpose for which the power was in fact exercised in the instant case and whether that was a permitted purpose.

10.33 Many, but not all, of the decided cases on proper corporate purposes arise in the context of attempted corporation takeovers and the issuing of shares by directors.

10.34 In any particular case, difficult factual questions may arise as to the purpose for which a power was exercised by directors. The court has regard to the subjective reasons proffered by each director and also the circumstances surrounding the decision.\(^{213}\) The onus of proof, however, lies on the party alleging a misuse of power.

10.35 A director, or board, may have had multiple purposes (mixed motives) when exercising a particular power. In such a case, the impermissible purpose must have been a significant contributing cause to the conduct undertaken, although it need not have been the dominant motive.\(^{214}\)

Duty to exercise reasonable care and skill

10.36 The general law also recognises a duty on directors to exercise reasonable care and skill in the performance of their office.\(^{215}\) The duty arises at both common law\(^{216}\) and in equity,\(^{217}\) and the duties largely overlap.

10.37 In determining whether in a particular case a director has met the relevant standard of care and diligence, regard may be had to what an ordinary person with the knowledge and experience of that director might have been expected to have done in the circumstances if acting on his or her own behalf.\(^{218}\)

10.38 In considering whether a director has exercised a reasonable degree of care, courts have balanced the foreseeable risk of harm from the defendant's actions against the potential benefits to the corporation.\(^{219}\)

10.39 Directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the corporation.\(^{220}\) They also

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\(^{215}\) Permanent Building Society (in liq) v Wheeler (1994) 14 ACSR 109 at [158].

\(^{216}\) Derived from the common law of negligence. Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson (1995) 37 NSWLR 438. In addition, at least in the case of an executive (as opposed to non-executive) director, duties arising from express or implied terms of a contract of service will likely arise.

\(^{217}\) Permanent Building Society (in liq) v Wheeler (1994) 14 ACSR 109 at [158]; Daniels, above. The equitable obligation to exercise reasonable care and skill, although arising in equity, is not to be equated with a fiduciary duty.

\(^{218}\) Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd (2007) 63 ACSR 1 at [1429]. The test may require modification in the case of an executive director: Ingot at [1430].

\(^{219}\) Vines v ASIC (2008) 62 ACSR 1 at [814]-[815] per Ipp JA.

\(^{220}\) Daniels, above, at [864]; ASIC v Healey [2011] FCA 717 per Middleton J at [114] - [169].
need to have a reasonably informed opinion on the corporation's financial capacity, so that they can form an opinion about the corporation's solvency.\textsuperscript{221}

The Inquiry's view

10.40 The Articles of Delta and Eraring each contained a clause mandating compliance with any Direction under s. 20N. The Articles relevantly provided:

\begin{quote}
The Directors must ensure that any directions or notices given to the board by the Portfolio Minister under any of the following sections of the SOC Act
\end{quote}

\begin{itemize}
\item[(i)] section 20N - "Non-commercial activities";
\end{itemize}

... are carried out in relation to the Corporation and, as far as practicable, its subsidiaries in accordance with the terms of the notice or direction.\textsuperscript{222}

10.41 For present purposes, the four key events occurring on 14 December 2010 were:

\begin{itemize}
\item[a.] the resignation of the four directors from each of Delta and Eraring;
\item[b.] the appointments of the four new directors (two to Delta and two to Eraring);
\item[c.] the respective, reconstituted boards passing resolutions to the effect that compliance with the Portfolio Minister's request to execute transaction documents would not be in the corporation's commercial interest; and
\item[d.] the boards passing resolutions to comply with the s. 20N Direction issued by the Portfolio Minister and to execute the transaction documents.
\end{itemize}

The resigning directors

10.42 Neither the minutes of the respective board meetings nor the oral evidence before the Inquiry disclose any dishonesty by any of the resigning directors. Each director who resigned had previously, over a period of time including the months preceding December 2010, approached their work as directors carefully and diligently. No director acted improperly in respect of information or their position and none was involved in trading while the corporation was insolvent.

10.43 In addition, each of the resigning directors acted in good faith and for proper purposes. They had advice that once a direction under s. 20N was received, they would be obliged to comply with it. Resigning prior to the receipt of that direction and thus the obligation is neither improper nor an indication of bad faith.

10.44 In some cases, the resignation of a director may reflect an attempt to mask, or avoid, an anterior dereliction of duty, such as a failure to pay due attention to the affairs of the corporation. In the present case, there is no evidence to suggest that any of the resignations bear that character.

\textsuperscript{221} ASIC v Rich (2009) 75 ACSR 1 at [7203].

\textsuperscript{222} See cl. 29.5 of the Articles of both Delta and Eraring.
10.45 As can be seen from the evidence of each director, the decision to resign or remain was essentially a personal one and was variously described as a moral or conscience issue.

10.46 None of the directors was ultimately concerned about the legality of the actions they were being asked to carry out or the power of the Portfolio Minister to direct those actions. Legal advice to that effect had been forthcoming from various quarters. Each director appeared to respect the positions taken by colleagues and to be interested in the views of the directors of the competing SOCs. However, the resignations were not the result of consensus.

10.47 The directors who resigned appear to have done so on the basis that they did not want to be part of a process which they felt was foisted upon them, and of which they felt they were largely and deliberately kept ignorant. There was no question in each of their minds that the terms offered were uncommercial to the SOC in question.

The different positions of the directors and the Energy Reform Project

10.48 The sale was structured so as to deliver the objectives sought by the State for the benefit of the State as a whole and to respond to Professor Owen's recommendations. The State had engaged well qualified experts to advise it about the sale. By contrast, the decision to be taken by each director was in the context of the interests of Delta or Eraring and not in the broader interests of the State of NSW.

10.49 Thus, the interests of each of the SOCs and that of the State were not identical and s. 20N permitted, in effect, the State to act other than in the commercial interests of a SOC, providing certain criteria were met.

10.50 This was no fire-sale. There was a need for the transactions to be completed as quickly as possible for the reasons set out in Chapter 12. While it can be appreciated that at least some of the directors wished to have greater involvement in the process and decision making, ultimately, it was a decision of the Government acting in the broader interests of the State as to the disposal of assets it owned. The advisers and the Steering Committee believed that adequate information was given to the SOCs; some of the directors of some of the SOCs disagreed. Although the provision of more information may have prevented some or all of the resignations which occurred on 14 December 2010, ultimately those resignations do not call into question the process the Energy Reform Project followed.

10.51 None of the resigning directors, the continuing SOC directors or those advising the Government are at fault because of the resignations. There has been no breach of any identifiable law or duty.

10.52 The Inquiry's view of the governance structure adopted, the process by which the assets were offered to the market and the decision to sell the assets the subject of acceptable bids is set out in Chapter 12. For the reasons given in that Chapter, the Inquiry is of the view that those matters were, in the circumstances of the then Opposition's position not to vote in favour of the EIR Bills, the economic climate, the expert advice available to the Government and the uncertainty over carbon pricing, reasonable and appropriate. Further, the
decision to sell the gentrading rights was made in the knowledge that it was a sub-optimal solution. The best option, however, was not available, that is the use of legislation to sell or long-term lease the generators.

The Delta directors and the Delta request resolution

10.53 As detailed above, at the board meeting commencing at 9.30 pm on 14 December 2010, the reconstituted Delta board considered and resolved that to comply with the Portfolio Minister’s request dated 13 December 2010 including to execute the transaction documents ("the Minister’s Request") would not be in the commercial interests of Delta ("the Request Resolution").

10.54 The duty to exercise reasonable care and diligence in relation to the affairs of the corporation required the Delta directors to reach a properly informed view that the Minister’s Request was not in Delta’s commercial interests before being able to vote in favour of the Request Resolution.

10.55 To exercise their duty of reasonable care and diligence properly, the Delta directors needed to have an appreciation of the final form of the transaction documents, or at least to have considered the extent to which the final form of the documents differed from the earlier draft form documents that had been the subject of consideration by the Delta board.

10.56 The documents and evidence support the view that each of these aspects was satisfied.

10.57 In relation to the second point, the material before the board meeting at 7.20 am included the transaction documents and also a summary of the material changes to the transaction documents. The minutes also record that “Detailed discussion ... followed on each of the items in the summary of material amendments”. There then followed extensive questioning of the Government advisers in relation to the proposed transactions.

10.58 In relation to the first point, the Delta board had previously had access to management reports relating to the proposed form of the transaction documents and their expected effect in relation to Delta. These have been discussed in Chapter 9. The reports raised significant concerns about the proposed transactions and inferred that the proposed transactions would not be in Delta’s commercial interests.

10.59 A number of such reasons were recorded in the board papers circulated before 14 December 2010 and they are set out in Chapter 9. The two new directors, Messrs Dermody and Yeaton, had access to such information prior to the Request Resolution.

10.60 In addition, Messrs Phillips, Everett, Dermody and Yeaton had each been present at the briefing by the Government advisers and the questioning of the advisers earlier that day. As the minutes record, when asked whether any of the advisers was of the view that the gentrader deal was commercial, Mr Timbs responded on behalf of everyone by saying that “I don’t think anyone here is putting that proposition.”

10.61 In the circumstances, directors Phillips, Everett, Dermody and Yeaton could properly conclude, based on the information available to them, that the
proposed transaction contemplated by the Minister's Request was not in the commercial interests of Delta such that it would be appropriate to vote in favour of the Request Resolution.

10.62 It may also be accepted that the earlier provision to the Directors of a proposed form of s. 20N direction was itself a recognition, by the State and Treasury, that the proposed transactions could not fairly be regarded as in Delta's commercial interests.

The Eraring directors and the Eraring request resolution

10.63 At the Eraring board meeting commencing at 9.20 pm on 14 December 2010 the reconstituted Eraring board considered and resolved that to comply with the Portfolio Minister's request dated 13 December 2010 including to execute the transaction documents would not be in the commercial interests of Eraring ("the Eraring Request Resolution").

10.64 The minutes record the reasons given by the Eraring board in respect of the Eraring Request Resolution. The reasons are extensive. They include criticism of the obligations imposed by gentrader contracts, the significant liquidated damages likely to be payable by Eraring, and the methodology of the gentrader agreement which would drive the business to be loss making in the long term.

10.65 The process undertaken by the Eraring board on 14 December 2010 does not reveal any identifiable breach of directors' duty. Each of the continuing directors and Dr Gellatly had had significant exposure to the matters requiring consideration for many months.

10.66 While, prior to 14 December 2010, Ms McClelland had no substantive knowledge of the proposed gentrader arrangement and its expected effect on Eraring, she had relevant experience as Chair and director of boards including Chair of a SOC and an understanding of the SOC Act.

10.67 Having heard and considered Ms McClelland's evidence and having regard to her experience, the material available to her by way of papers and oral briefings set out in Chapter 9, the Inquiry concludes that Ms McClelland did not breach any identifiable duty and, in particular, exercised the degree of care and diligence that a reasonable person in a like position in a statutory SOC would exercise.

The Delta and Eraring directors and the s. 20N Direction

10.68 As detailed above, each reconstituted board met again on the evening of 14 December 2010 and considered the Direction received under s. 20N of the SOC Act. Their attention was drawn to the opinion regarding the validity of a direction under s. 20N and the advice of Baker & McKenzie to the effect that "the directors ... would be obliged to comply with the Direction ...".

10.69 Section 20N(2) of the SOC Act mandated compliance with a valid s. 20N Direction as did the Articles of each SOC.

10.70 Further, the Delta and Eraring directors had been provided with an Approval from the voting shareholders in respect of the proposed transactions pursuant to ss. 20X and 20Y of the SOC Act.
10.71 Moreover, cl. 3(9) of Sch. 10 to the SOC Act relevantly provides that in determining the "degree of care and diligence required of a director, regard must be had to, among other things, any relevant directions ... or approvals given by the Portfolio Minister or the SOC's voting shareholders."

10.72 In those circumstances, there is no basis on which to conclude that compliance by the Delta and Eraring boards with the s. 20N Direction, and the consequential resolution authorising the execution of the transaction documents, involved any breach of directors' duty. Rather, the Inquiry finds that the compliance by the Delta and Eraring boards with the s. 20N Direction was required by law and involved no breach of duty.

The meeting between the Delta and Eraring directors

10.73 The Delta and Eraring directors were each subject to obligations to their respective companies including duties to act in the interests of the corporation and not to make improper use of information obtained by reason of their position as a director.

10.74 As detailed in Chapter 9, the Delta and Eraring board members met with each other for some period of time in the afternoon of 14 December 2010. The Delta board minutes described these as being "informal discussions".

10.75 It would be a matter of concern, and a potential breach of duty as a director, if any of the Delta or Eraring board members had disclosed, to a board member of the other corporation, information that was obtained by that board member in his or her position as a director and which ought not to be disclosed. In the circumstances, this would include details regarding the commercial terms of the respective transactions.

10.76 The Inquiry is satisfied that the commercial terms were not discussed to an extent which involved an improper disclosure. It seems probable that Eraring was made aware that Delta was concerned at the low consideration being paid for the relevant assets. That does not constitute commercial terms. There was no evidence that any specific figures were provided or exchanged and the reference to 'low' is necessarily subjective and relative. The minutes of each meeting and the oral evidence to the Inquiry supports that conclusion.

Conflicts of interest

SOC Act provisions

10.77 The SOC Act and the Delta and Eraring Articles each contained provisions relating to interests by directors in matters to be considered by the board.

10.78 Clause 1 of Sch. 10 of the SOC Act imposes a general obligation on a director to disclose any interests in a matter being considered. Clause 1 of Sch. 10 provides:

(1) If a director of a statutory SOC has a direct or indirect interest in a matter being considered, or about to be considered, by the board, the director must disclose the nature of the interest to a meeting of the board as soon as practicable after the relevant facts come to the director's knowledge.

Maximum penalty: 100 penalty units.
(2) The disclosure must be recorded in the board's minutes.

10.79 Clause 19.1 of the Articles of each of Delta and Eraring is to similar effect.

10.80 Clause 3(5) of Sch. 10 imposes an obligation on a director of a statutory SOC not to make improper use of his or her position as a director for certain purposes:

(5) An officer of a statutory SOC must not make improper use of his or her position as an officer of the SOC:

(a) to gain, directly or indirectly, an advantage for himself or herself or another person, or

(b) to cause detriment to the SOC.

Maximum penalty: 500 penalty units or imprisonment for 5 years.

10.81 Clause 17.2(c) of the Articles of Delta and Eraring is relevantly in similar terms.

10.82 Clause 2 of Sch. 10 imposes restrictions on board participation by a director who has a material personal interest in a matter being considered by the board. Clause 2 of Sch. 10 provides:

(1) A director of a statutory SOC who has a material personal interest in a matter that is being considered by the board must not:

(a) vote on the matter, or

(b) vote on a proposed resolution (a related resolution) under subclause (2) in relation to the matter (whether in relation to the director or another director), or

(c) be present while the matter, or a related resolution, is being considered by the board, or

(d) otherwise take part in any decision of the board in relation to the matter or a related resolution.

Maximum penalty: 100 penalty units.

(2) Subclause (1) does not apply to the matter if the board has at any time passed a resolution that:

(a) specifies the director, the interest and the matter, and

(b) states that the directors voting for the resolution are satisfied that the interest should not disqualify the director from considering or voting on the matter.

(3) In determining whether a quorum is present at a meeting of the board during a consideration of such a matter by the board, only those directors are regarded as present who are entitled to vote on any motion that may be moved in relation to the matter.

(4) The voting shareholders may, by each signing consent to a proposed resolution, deal with a matter if the board cannot deal with it because of subclause (3).
10.83 Clause 19.4 of the Articles of Delta and Eraring is relevantly in similar terms, save for the addition that:

... (e) No act of the Corporation is invalid or voidable by reason only of a failure of a Director to comply with this Article 19.4.

10.84 Clause 19.5 of the Delta and Eraring Articles provided:

In accordance with Schedule 10, clause 1(2) of the SOC Act, any disclosure by a Director under this Article 19 must be recorded in the Minutes by the Secretary.

10.85 Clause 19.3 of the Delta and Eraring Articles dealt with a director’s interests in contracts with the corporation. Clause 19.3 provided:

A Director will not:

(a) be disqualified by virtue of holding the office of Director from contracting with the Corporation or any corporation in which the Corporation is a shareholder or is otherwise interested, either as vendor, purchaser or otherwise, and nor will any contract or arrangement entered into by or on behalf of the Corporation in which any Director is in any way interested be avoided; or

(b) be liable to account to the Corporation for any profit realised by the contract or arrangement by reason only of the Director holding that office or of the fiduciary relations established as a result of the Director holding that office,

provided that the Director discloses the nature of his or her interest to a meeting of the board as soon as practicable after the relevant facts come to the Director’s knowledge.

**General law duties**

10.86 As recognised under the general law, a director is in a fiduciary relationship with the corporation and is subject to fiduciary duties.

10.87 Generally speaking, the general law requires directors, as fiduciaries, to avoid placing themselves in a position where a personal interest or duty conflicts with duties owed to the corporation. However, the modern trend is that there must be "a real or substantial possibility of conflict" rather than an abstract or theoretical prospect of conflict.223

10.88 Where it arises, the personal interest that may conflict with a duty owed to the corporation is typically a pecuniary interest. However, statements in the authorities indicate that there can be a breach of duty of a director in not disclosing an outside non-pecuniary interest that is incompatible with the director’s duty owed to the corporation.224

10.89 Where a real or substantial possibility of conflict exists, the director may nonetheless be free to proceed if the director discloses the nature and extent of the interest to either the shareholders or the other directors, depending on

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223 Consider Hospital Products Ltd v United States Surgical Corp (1984) 156 CLR 41 at per Mason J, The Bell Group Ltd (in liq) v Westpac Banking Corporation (No. 9) (2008) 70 ACSR 1 at [4509], [4508] (Owen J). Note also Boardman v Phipps (1967) 2 AC 46 at [124].

224 The Bell Group Ltd (in liq) v Westpac Banking Corporation (No. 9) (2008) 70 ACSR 1 at [4509].
whether the corporation’s constitution requires disclosure to shareholders or other directors.

10.90 However, even if the director makes adequate disclosure of the interest, in some circumstances this will not be sufficient to satisfy the director’s fiduciary obligations. In extreme cases, there may be a positive obligation on the director to protect the corporation’s interests by taking steps to prevent the relevant transaction (in which the director is interested) from proceeding. 225

10.91 The courts generally accept that corporation directors may act as directors of more than one corporation, even when the companies are in competition with each other, provided that confidential information is not disclosed. 226 The mere acceptance of more than one fiduciary position is not, without more, indicative of a conflict of duties. However, in certain circumstances, in order to avoid a conflict the common director may be obliged to avoid voting on a transaction or taking part in negotiations. 227

10.92 In this area of the law, in particular, each case depends on its particular facts. 228

**Analogous Corporations Act provisions**

10.93 Under s. 191 of the Corporations Act 2001 (Cth) directors of companies to whom that Act applies have a statutory duty to give notice to other directors of any “material personal interest” in a matter that relates to the affairs of the corporation. The term “material personal interest” is not defined by the Corporations Act.

10.94 The Corporations Act, including s. 191, did not relevantly apply to Delta and Eraring. However, the expression “material personal interest” appears in cl. 2 of Sch. 10 of the SOC Act and cl. 19.4 of the Articles of Delta and Eraring (dealing with voting by interested directors). While paying proper regard to the differing statutory context, some assistance can be gained from authorities dealing with the concept of a “material personal interest” within the meaning of s. 191 of the Corporations Act.

10.95 In McGellin v Mount King Mining NL (1998) 144 FLR 288 at [304] Murray J said of the phrase “material personal interest” (in the statutory predecessor to s. 195(1) of the Corporations Act):

> 'Material' in this context, I think, means that the interest involves a relationship of some real substance to the matter under consideration or the contract or arrangement which is proposed. In that way the nature of the interest should be seen to have a capacity to influence the vote of the particular director upon the decision to be made, bearing in mind that both the article and the section are concerned with that aspect of a director's fiduciary duties which relates to the resolution of conflict of interest which must, of itself, be of a real or substantial kind. The interest with which both the article and the section are concerned should be of a kind as to give rise to a conflict of that character. If that test is met, it seems to me not to matter that the nature of the interest may be described as direct or indirect, or vested in interest or contingent. It is the

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226 Western Areas Exploration Pty Ltd v Streeter (No. 3) (2009) 73 ACSR 494; Riteway Express Pty Ltd v Clayton (1987) 10 NSWLR 326.
227 Jenkins v Enterprise Gold Mines NL (1992) 6 ACSR 539; Grand Enterprises Pty Ltd v Aurium Resources Ltd (2009) 72 ACSR 75 at [32].
228 Grand Enterprises Pty Ltd v Aurium Resources Ltd (2009) 72 ACSR 75 at [33].
substance of the interest, its nature and capacity to have an impact upon the ability of the director to discharge his or her fiduciary duty which will be important.

**The positions of the new directors**

10.96 Mr Dermody was project director of the Energy Reform Project. He described his role as being to carry out the Government's reform policy and to drive the project.\(^{229}\) This included hiring staff and providing advice. Mr Dermody reported to Dr Gellatly, who was chair of the Steering Committee of the Energy Reform Project. In his role as project director, Mr Dermody commonly attended meetings of the Steering Committee.

10.97 Mr Yeadon had been the chairman of the Gentrader Working and, as at December 2010, was the chairman of the Evaluation Committee. Mr Yeadon also attended meetings of the Steering Committee. Consistent with a recommendation by the probity adviser to the Energy Reform Project, Mr Yeadon resigned from this position following his appointment as a director of Delta.

10.98 Dr Gellatly had been chair of the Steering Committee of the Energy Reform Project from October 2009. In that role, he had overall responsibility for the Energy Reform Project, including to make critical decisions, manage and resolve emerging issues and risks for the Project, and to drive the Government's objectives to a successful outcome.\(^{230}\)

10.99 Each of Messrs Dermody, Yeadon and Dr Gellatly had been engaged to perform roles in the Energy Reform Project for which they were remunerated, in accordance with consultancy agreements. None of Messrs Dermody, Yeadon or Dr Gellatly was remunerated by reference to a 'success fee', or any equivalent contingency payment, based on the outcome of the proposed transactions. None stood to gain financially from the execution of transaction documents.

10.100 On 15 December 2010, each of Messrs Dermody, Yeadon and Dr Gellatly completed a Conflict of Interest Declaration in respect of their appointment as director or Chair of the SOCs.

10.101 Mr Dermody declared that when Chair of Delta he was to avoid discussion about Energy Reform Project matters and when project director he was to absent himself from discussions concerning Delta issues. He also declared he would take such other actions deemed appropriate in conjunction with the probity adviser.

10.102 Mr Yeadon declared that as a director of Delta he would absent himself from discussion of Energy Reform Project matters and deal with Delta’s usual business. When performing duties with the Energy Reform Project, he would absent himself from discussions regarding Delta matters. He also declared he

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\(^{229}\) In his consultancy agreement with the State, his role was described as being to: "project manage the Energy Reform Project through the sale preparation and execution phase until financial close reporting into the Chairman of the Energy Reform Steering Committee". Consultancy Agreement dated 21 April 2010 between the Treasurer (Mr Rozendaal MLC) and John Dermody and Associates Pty Ltd, Sch. 1, p. 10.

\(^{230}\) Consultancy Agreement dated 10 February 2010 between the Treasurer (on behalf of the State of NSW) and Col Gellatly & Associates Pty Ltd, p. 11.
would take such other actions deemed appropriate in conjunction with the 
probit adviser.

10.103 Dr Gellatly declared that when sitting as Eraring board member he would 
deliberate and vote based on the best interests of Eraring and declare an 
interest at the start of the meeting.

10.104 At the next Steering Committee meeting held after 14 December 2010, on 21 
December, Mr Yeadon was noted as an apology and it was noted that legal 
advise had been sought in relation to the appointment of the other 
directors/Chair. At the subsequent meetings on 5 January 2011, Mr Dermody 
disclosed his interest. At the next meeting held on 12 January, the probity 
advise noted that further advice was being sought and that Mr Yeadon was a 
director of Delta and he had requested that any Delta matter be announced in 
advance so that he could absent himself.

10.105 At the subsequent meetings, the probity advise noted the interests of each of 
those three, when they were present at the meeting.

10.106 The proposed transactions were effectively under the control of the Treasury 
and, ultimately, the NSW Government through Cabinet approval. Indeed, the 
Government had approved the proposed transactions the previous day, 
13 December 2010.

10.107 Clause 1 of Sch. 10 of the SOC Act, which is replicated in cl. 19.1 of the Articles 
of Delta and Eraring, was in very broad terms and required a director to 
disclose a direct or indirect interest in a matter to be considered by the board. 
Unlike cl. 2 of Sch. 10, cl. 1 did not utilise the more limited language of a 
director who had a "material personal interest" in a matter before the board.

10.108 Having regard to the terms of cl. 1 of Sch. 10 of the SOC Act, in the 
circumstances it was appropriate that Messrs Dermody and Yeadon disclose to 
the Delta board their respective roles in the Energy Reform Project. It was 
similarly appropriate that Dr Gellatly disclose his role in the Energy Reform 
Project to the Eraring board.

The Inquiry's view

10.109 It is necessary to consider whether, having disclosed their interests to the 
respective boards, Messrs Dermody and Yeadon (for Delta) and Dr Gellatly (for 
Eraring) were properly able to join in the two board resolutions on the evening 
of 14 December 2010.

10.110 This issue cannot properly be considered in the abstract because it is highly 
fact-dependent. At least four considerations are presently relevant.

10.111 First, the voting shareholders of each corporation (namely, the Treasurer and 
the Minister for Finance) were obviously aware of the roles that each of Messrs 
Dermody, Yeadon and Dr Gellatly played in the Energy Reform Project and had 
appointed each person as a director earlier that day.

10.112 Secondly, each of Messrs Dermody, Yeadon and Dr Gellatly was appointed a 
director of a statutory SOC. As a director of a statutory SOC, each was in a 
position relevantly different from a director of a typical commercial enterprise.
This is reflected in part in provisions of the SOC Act, including duties imposed on directors. For example, in considering questions of reasonable care and diligence of a director of a statutory SOC, the SOC Act provides that regard must be had to:

a. the fact that the person is an officer of a statutory SOC, and

b. the application of the SOC Act to the SOC, and

c. relevant matters required or permitted to be done under the SOC Act in relation to the SOC,

including any relevant directions, notifications or approvals given to the SOC by the SOC's voting shareholders or portfolio Minister.²³¹

10.113 Thirdly, the transactions to be entered into were effectively the State selling State owned assets held by a SOC of which the Treasurer and Minister for Finance were the shareholders. Each of the three had been appointed to the Energy Reform Project with the knowledge of the shareholders and by them to the boards.

10.114 Fourthly, the proposed transactions, being a central component of the Energy Reform Project, had been approved by the Government on 13 December 2010.

10.115 In the circumstances, Messrs Dermody and Yeadon are not open to criticism for having participated in the Delta board resolutions on 14 December 2010. The same conclusion may be reached in respect of Dr Gellatly and the Eraring board resolutions on 14 December 2010.

10.116 In terms of cl. 2 of Sch. 10 of the SOC Act, neither Messrs Dermody nor Yeadon could be said to have a "material personal interest" in a matter being considered by the Delta board such that they could not properly vote on the matters being considered by the board in the evening on 14 December 2010. A similar conclusion may be reached in respect of Dr Gellatly and the Eraring board. In this respect, none of the three directors had any pecuniary interest in the outcome of the proposed transactions. Moreover, for each director their role in the Energy Reform Project was not such as would be likely to have caused them to vote in any manner different in the two substantive board resolutions of 14 December 2010 than any other properly informed director of the statutory SOC.

10.117 Each of Messrs Dermody and Yeadon and Dr Gellatly acted appropriately in relation to any conflict which may have existed by virtue of their respective directorships. There can be little doubt that all on the Steering Committee were well aware of their appointments. Further, the Eraring assets had been sold and although Delta Coastal remained unsold, the work done relating to Delta Coastal over those few weeks, was not considerable.

10.118 The appointment of the new directors was necessary if the transactions were to proceed. In the order of $200 million had been expended by the State to reach this stage. Millions of dollars had been spent by prospective bidders. The

²³¹ SOC Act, Sch. 10, cl. 3(9).
State's AAA rating may have been at risk. Some of the assets had received acceptable bids and in total those bids exceeded the retention value. Furthermore, the successful bidders were subject to a trading halt.

10.119 While, ideally, one would not appoint advisers to the Energy Reform Project to the board of the energy State owned corporations, in the circumstances which prevailed the appointments were lawfully and validly made and any subsequent conflict of interest was appropriately dealt with.

Properly appointed directors

10.120 The Inquiry is satisfied that each director was properly appointed by reference to cl. 1(2) of Sch. 2 to the ESC Act and cls 14.2 and 15.2 of the Articles.

10.121 The Instrument of Appointment for each of Messrs Dermody and Yeaton and Dr Gelliaty was undated but signed by Treasurer Roozendaal and Minister Daley. The term of the appointments was specified as being 14 December 2010 to 14 December 2011. None of them was remunerated for his role.

10.122 The Instrument of Appointment for Ms Jan McClelland was undated but signed by the Treasurer and the Minister for Finance. The term of the appointment was specified as being 14 December 2010 to 14 December 2011. Ms McClelland was to be remunerated for her role in an annual amount specified in the instrument of appointment.

10.123 Mr Warren Phillips had been reappointed as a director of Delta from 1 September 2009 with his term scheduled to expire on 31 August 2012.

10.124 Mr Murray Bleach had been a director of Eraring from 1 July 2010 with his term scheduled to expire on 30 June 2013.

10.125 Mr John Priest had been a director of Eraring from 1 April 2010 with his term scheduled to expire on 31 March 2013.

No director nominated by Unions NSW

10.126 Clause 1(2) of Sch. 2 to the ESC Act required one director to be appointed, effectively, by recommendation of Unions NSW.

10.127 At the time of the Delta and Eraring board meetings in the evening of 14 December 2010, and following the resignations of directors earlier in the day, neither board contained what may termed, for ease of reference, a Unions NSW nominated director.

10.128 The Delta minutes record that Baker & McKenzie had advised that the board was duly constituted and able to perform its functions. Written advice was to be provided on this aspect consistent with an advice earlier provided to the Treasurer.

10.129 Section 52(1)(a) of the Interpretation Act 1987 is presently relevant. Section 52 is entitled “Proceedings of statutory bodies” and provided:

(1) Any act or proceeding of a statutory body shall not be called into question merely because of:

(a) any vacancies in the membership of the body,
(b) any defects in the appointment of any members of the body,

(c) any disqualifications of any members of the body,

(d) any minor irregularities in the manner in which any meetings of the body have been convened or conducted; or

(e) the presence or participation at any meetings of the body of any persons not entitled to be present or to participate at those meetings.

(2) This section applies to a statutory body in addition to, and without limiting the effect of, any provision of the Act by or under which the body is constituted.

10.130 By reason of the resignations of the Unions NSW nominated directors of each of Delta and Eraring earlier that day, there was a vacancy in the membership of the boards of each corporation. That vacancy could not be filled that day. Indeed, the process required by cl. 1(2) of Sch. 2 to the ESC Act (involving a recommendation to the voting shareholders from a selection committee) was such as might well take some period of time.

10.131 Parliament could not have intended that, in such circumstances, the board of an energy services corporation (such as Delta or Eraring) would effectively be powerless to act. Rather, s. 52(1)(a) of the Interpretation Act 1987 serves to ensure that the board of the statutory corporation is properly able to continue to function pending the filling of the vacancy.232

10.132 For the proper exercise of power, the board of such a statutory corporation must still proceed by way of a quorum in accordance with the relevant statutory requirements. This aspect is considered below.

**Duly convened board meetings**

10.133 The Inquiry is satisfied that each board meeting was duly convened, by reference to cl. 10 of Sch. 8, cl. 14 of Sch. 8(2) of the SOC Act and cls 20.1, 20.3, 20.4 and 20.6 of the Articles of each of Delta and Eraring.

10.134 The Inquiry infers from the fact that all the Delta and Eraring directors were present at the respective meetings on the evening of 14 December 2010 that notice of such meeting was given. Each of the Delta and Eraring board meetings on the evening of 14 December 2010 was duly convened.

**Quorum for board meetings**

10.135 Clause 20.2(a) of the Articles of each of Delta and Eraring relevantly provided that the quorum for a meeting of directors was three persons.233 This was

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232 Cf. by analogy, *Fishwick v Cleland* (1960) 106 CLR 186 at [9]:

"No authority was produced in which a deliberative assembly of such a kind has been held incompetent to perform its duties or exercise its powers because there were vacancies in its membership. To interpret s. 38(1) as making it imperative that the whole membership of the Council must be completely filled and that otherwise its powers are not exercisable would not only be contrary to the inferences to be drawn from the provisions for a quorum, for majority voting and for disqualification for interest; it would be contrary to the general and traditional understanding with respect to the constitution of deliberative legislative bodies. The fact that the vacancies were of the three elected members can make no difference. The objection that because they had resigned and the numbers were reduced to twenty-six the Council was incompetent to act is untenable."

233 Note that by reason of cls 20.2(a) and 20.2(d) of the Articles, Sch. 8, cl. 11 (which provided that the quorum for a meeting of the board is, subject to the constitution, a majority of the directors for the time being) did not relevantly apply to Delta or Eraring.
subject to the proviso that one or more of the persons needed to form the
quorum were not excluded from voting by having a material personal interest in
a matter being considered by the board pursuant to cl. 19.4 of the Articles.\footnote{234}

10.136 At the Delta board meetings in the evening of 14 December 2010 four directors
were present (namely, Messrs Dermody, Phillips, Yeadon and Everett).

10.137 At the Eraring board meeting in the evening of 14 December 2010 five directors
were present (namely Ms McClelland, Dr Gelliaty and Messrs Jackson, Bleach
and Priest).

10.138 There was a quorum for each of the Delta and Eraring board meetings in the
evening of 14 December 2010.

**Authority to execute transaction documents**

10.139 The resolution passed by the Delta directors at the meeting held on 14
December 2010 commencing at 10.10 pm relevantly stated that:

The Directors RESOLVED to comply with the [s. 20N] Direction, and in
particular to:

(a) authorise any two directors or a director and the corporation secretary to
affix Delta’s seal and execute all deeds set out in Part A of Schedule 1 and
Schedule 2 of the Direction; and

(b) appoint Greg Everett as authorised representative to execute all
agreements set out in Part A of Schedule 1 and Schedule 2 of the
Direction.

10.140 In the case of Delta, transaction documents that were required by the s. 20N
Direction to be executed at the execution date (ie 14 December 2010), in
contrast to on or before the completion date, were executed in accordance with
the authority recorded in the minutes. Thus, the two deeds were signed by
Greg Everett (director) and Raymond Madden (corporation secretary) with the
corporation seal affixed.\footnote{235} In respect of gentrader related agreements required
to be executed on 14 December 2010, Mr Everett signed for and on behalf of
Delta as its duly authorised representative and his signature was witnessed by
Mr Madden.

10.141 The resolution passed by the Eraring directors at the reconvened 125th board
meeting held on 14 December 2010 relevantly stated that:

The Directors RESOLVED to comply with the Direction, and in particular to:

(a) authorise any two directors to affix Eraring Energy’s seal and execute all
agreements and deeds set out in Part A of Schedule 1 of the Direction; or

(b) where it is not necessary to affix Eraring Energy’s seal, authorise any two
Directors to execute all agreements and deeds set out in Part A of
Schedule 1 of the Direction.

\footnote{234}{See also the SOC Act, Sch. 10, cl. 2(3).}

\footnote{235}{Clause 25.1(c) of the Delta Articles provided that every instrument to which the seal for the corporation is affixed will,
subject to the Articles, be signed by a director and countersigned by another director, the Secretary or some other
person appointed by the directors for that purpose.}
RESULT:

Five (5) Directors in favour of Resolution No. 2

It was agreed that Directors Bleach and Priest would be signatories to the deeds/agreements.

10.142 In the case of Eraring, those transaction documents that were deeds and were required by the s. 20N Direction to be executed on 14 December 2010 were executed in accordance with the authority recorded in the minutes. Thus, the two deeds were signed by John Priest and Murray Bleach (each being a director) with the corporation seal affixed.

10.143 However, the Fuel Stock Sale Agreement, which was the other document required by the s. 20N Direction to be executed at the execution date, was signed by Mr Priest and witnessed by Mr Bleach. This was in accordance with the format of the document, which contemplated the execution of the agreement on behalf of Eraring by its duly authorised representative, whose signature is witnessed. However, the authority conferred by the resolution recorded in the Eraring minutes contemplated that two directors would be required to be the signatories to any such agreement. The Inquiry does not consider that the validity of the agreement is affected.

Conclusion

10.144 The Inquiry concludes that all applicable laws were complied with and duties fulfilled on and in respect of the events on 14 December 2010.

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236 Being the Gentrador Transaction Implementation Deed, the Fuel Stock Sale Agreement, and the Umbrella Deed.
### Chapter 11 Compliance with laws, policies and practices

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11.1 In this chapter, the Inquiry sets out its findings in relation to term of reference one: compliance with applicable laws, policies and practices. The Inquiry took the following approach in interpreting this term of reference. Time was not spent on identifying all possible laws, policies and practices which may have had potential application during the three or so years in which the transactions were conceived and implemented. Instead, having regard to the extensive and independent expertise available to the Energy Reform Project, only those areas of law and policy which were material and significant have been considered. The Inquiry took the view that any practice which had not been embodied in a policy, guideline or memorandum was not sufficiently material and accordingly, consideration has not been given to such practices.

Compliance with laws

11.2 As can be seen from previous chapters, the Energy Reform Project began in late 2007 and continued until March 2011. Initially, advisers were appointed and work was done to achieve the long-term lease of the generators and sale of the retailers and development sites by use of a special purpose enactment. Following the failure to progress the Bills in August 2008, the strategy fundamentally changed. Instead of legislation underpinning the sales of assets, the strategy was to be achieved within the confines of the existing laws.

11.3 The transactions in relation to the gentrader agreements were complex and the legal issues which arose were numerous. The Energy Reform Project had available to it legal services from a number of firms, solicitors, Senior and Queen’s Counsel as well as the Crown Solicitor’s Office. The Protocol issued by the Government in January 2008 provided that the SOCs should not appoint external advisers unless they received Treasury’s prior consent. Mr Saxon informed the Inquiry that on each occasion an individual SOC sought approval to obtain separate legal advice, for example in relation to directors’ duties, they were given that approval.

11.4 In order to consider the question of compliance with laws, the Inquiry summoned all legal advices which had been provided to the Energy Reform Project and the SOCs. In addition, it questioned those involved in the Energy Reform Project as to their views in respect of compliance. From that material, the following emerged.

Energy Reform Project legal advisers

Baker & McKenzie

11.5 As set out in Chapter 4, the Energy Reform Project engaged Baker & McKenzie as its principal legal adviser on 24 December 2007 and that role continued until 31 March 2011.

11.6 Following the withdrawal of the Bills, Baker & McKenzie provided all legal services associated with the implementation of the Energy Reform Project with the exception of drafting the gentrader contracts. The areas on which Baker & McKenzie advised were wide ranging and included vendor due diligence, bills and legislation, the Cobbora Coal Project, indemnities for the SOCs, structure for the leases, shared services and separation issues, carbon pricing, development consents, competition issues, various matters about the development sites, regulatory matters, environmental matters, draft resolutions,
the appointment of directors and the operation of direction powers under the SOC legislation.

11.7 As is referred to in Chapter 6, they provided to the Steering Committee and working groups a number of sign-offs as to the preparation of the retail businesses final bid transaction documents and the process followed in relation to bidder negotiations and subsequent amendments to those documents. In addition, they provided two sign off letters in relation to the final bid transaction documents in connection with the sale of the development sites and several concerning the implementation of the gentrader transactions. They confirmed that those documents had been prepared in accordance with any instructions received from the Steering Committee and Treasury and they reflected the risk allocation approved by Government.

Crown Solicitor’s Office

11.8 The Crown Solicitor’s Office provided extensive legal advice to Treasury and the Steering Committee. Much of this advice was by way of reviewing the advice given to Treasury by Baker & McKenzie.

11.9 The key area of advice from the Crown Solicitor’s Office was in relation to employment matters and the need for legislation to effect the gentrader agreements after the failure of the Bill to pass in the Legislative Council in August 2008. The latter is discussed later in this chapter.

Gary Maguire, Johnson Winter & Slattery

11.10 Gary Maguire drafted the gentrader agreements and negotiated with bidders concerning those agreements. His experience is set out in Chapter 4.

11.11 As set out in Chapter 6, in November and again in December 2010, Johnson Winter & Slattery confirmed to the Steering Committee that they had prepared a number of drafts of a pro-forma generation trading agreement, as well as power station specific agreements, and bid versions of those agreements, and further, bespoke changes to those bid versions. The bid versions and the bespoke bidder changes to the gentrader and associated agreements had been prepared in accordance with any instructions received from the Gentrader Working Group and reflected the risk allocation approved by Government.

Others

11.12 Freehills were engaged from May 2008 until the end of the 2010 to advise the Energy Reform Project on the Mt Piper cross border lease.

11.13 Mallesons advised Treasury and the UJV in relation to Cobbora Coal Project.

State Owned Corporations

11.14 One or more of the SOCs retained their own lawyers to provide advice on various matters including directors’ duties, due diligence, general governance matters for the board, the NSW guarantee to the SOCs, the development sites, the power to issue directions under the SOC Act and coal supply agreements.
Conclusion

11.15 No information has come to the attention of the Inquiry to suggest that any of these legal advisers did anything other than identify all legal issues and properly advise the Energy Reform Project or the SOCs on each of them.

Key legal issues

11.16 There were two key issues for the Energy Reform Project about which legal advice was critical. First, whether legislation was needed to sell the retailers, development sites and gentrading rights of the three State owned generators. Secondly, whether the boards of the SOCs could be compelled to enter into the transactions, if they chose not enter into them.

Whether the electricity reforms could be achieved without legislation

11.17 Before drafting the Bills, which were ultimately withdrawn as they did not have the support of the then Opposition, the Energy Reform Project had the benefit of advice that it was preferable that the sale or long-term lease of a generator should be transacted by way of special purpose legislation. The reasons given included:

a. the certainty that it would provide the State and the private sector;

b. it would be the most efficient and flexible method;

c. it could deal with existing contractual and other rights and liabilities that were to be transferred or reserved; and

d. it would overcome any inconsistencies in any other State legislation.

11.18 The Government also received advice that, although there was no precedent in Australia for a transaction such as the long-term lease of generators to be implemented without legislation, there was no reason in principle why this could not be done.

11.19 Subsequent to the withdrawal of the Bills, the Energy Reform Project sought and obtained advice that:

a. the proposed sale of the retail businesses could be undertaken without enabling legislation subject to various provisos in relation to third party consents;

b. an IPO company could be established under existing legislation, although there was a ‘significant’ question as to whether the retail assets of Integral Energy could be disposed of as part of a then proposed IPO; and

c. the sale of the gentrader rights, retail businesses and development sites could be effected without special purpose legislation only if the Boards voluntarily entered into the necessary agreements or were directed to do so under the SOC Act.

Directions under the SOC Act

11.20 Related to whether legislation was required, was the power under the SOC Act to direct a board to enter into the transactions, assuming that one or more
boards declined to do so. The details of the relevant provisions have been set out in Chapter 9.

11.21 The Energy Reform Project received advice from a number of sources in this regard: There was some initial discussion as to which provision of the SOC Act provided the necessary power to direct the SOCs to enter into the transactions to sell the retailers, the development sites and the gentrading rights. Section 20P permitted a board to be directed in the public interest when there were exceptional circumstances present and s. 20N, as has been set out in Chapter 9, required the board to first have determined that the transactions were not in the commercial interests of the SOC. Ultimately, the consensus view was that s. 20N provided the necessary power, in combination with the operation of s. 20Y and, where applicable s. 20X.

11.22 That advice was provided to the SOCs as well as the advice that each of the directions issued to each of them on 14 December 2010 was valid and that each board was obliged to comply with the direction. That advice was correct.

**Conclusion**

11.23 The Inquiry obtained evidence from members of the Steering Committee, key advisers to the Energy Reform Project, responsible Ministers, as well directors of Eraring and Delta and their solicitor as to whether, to each of their knowledge, there had been compliance with all relevant laws during the process. No witness indicated that to his or her knowledge there had been any non-compliance.

11.24 The Inquiry accepts that, in December 2007, following receipt of the Owen Report, the prudent approach was to lay a Bill before a house of Parliament, in order to secure express legislative authority to enter into transactions contemplated by that Report.

11.25 After the withdrawal of the Bills, in September 2008, the Energy Reform Project was entitled to rely on the advice given that the new strategy could be effected without special purpose legislation.

11.26 Nothing has come to the attention of the Inquiry which calls into question any of the advices given or the adherence to those advices by any person involved in the Energy Reform Project.

**Compliance with policies**

11.27 The Inquiry invited the legal representatives for the State to identify the policies that those engaged in the Energy Reform Project had regard to and applied in undertaking that project. A large number of policies were identified. Those policies were reviewed by the Inquiry. In addition, each witness involved with the Energy Reform Project was asked their view of compliance with policies. All gave evidence that, to their knowledge, there had been compliance with policies of which they were aware.

11.28 The Inquiry concludes that, insofar as it has sufficient information to determine, there has been no material non-compliance with key policies relevant to the work of the Energy Reform Project. While many of the policies do not warrant
mention in this report, particularly those concerning wage, record management, formation of subsidiaries and accounting policies and the like, reference is made to the more significant policies below.

11.29 First, there were two key protocols prepared for the purposes of the Electricity Transactions. The first, titled “Protocol for the Interaction of Government and State-Owned Electricity Businesses”, was drafted prior to the legislation being withdrawn from the Legislative Council in September 2008. Annexed to it were approval requirements for decisions of State owned electricity businesses. Clause 2 of that annexure provided that to the extent of inconsistency with other policies in place within Treasury in relation to the operation of the businesses, that protocol would prevail. The businesses were defined as Country, Delta, EnergyAustralia, Eraring, Integral and Macquarie Generation.

11.30 That Protocol was supplemented by a memorandum from Baker & McKenzie which was prepared in June 2009. Its key provisions have been set out in Chapter 9, however, some repetition is necessary in the context of this chapter.

11.31 The memorandum was forwarded to each SOC board. It stated that it was intended to be supplemented by meetings between the SOC board and representatives of the Energy Reform Project. The limited role expected of directors and senior management was set out. The memorandum stated that the boards would be asked to “move quickly” in considering whether the board could approve the transaction documents and, if they could not, in complying with the terms of any direction made under s. 20N of the SOC Act.

11.32 The memorandum noted that it may be “challenging” for the directors to sign the transaction documents because they had not been involved in the negotiation, the preparation and circulation of information memoranda and vendor due diligence, among other matters. Further, they had not had the benefit of advice from their advisers about the documents or the proposed transaction more generally. The reasons for the government conducting the project in that way were set out.

11.33 This memorandum accurately predicted the events which followed. Thus, the boards were briefed throughout 2009 and 2010, they were required to move quickly and they found the process of considering whether to enter in to the transactions challenging. The Government did, for the reasons set out in Chapter 10, have sound reasons for proceeding as it did.

11.34 Secondly, the Government Information (Public Access) Act 2009, in broad terms, deals with authorising and encouraging the public release of government information by agencies. Section 27 requires agencies to keep a register of government contracts that record information about each government contract to which the agency is a party. A SOC is an ‘agency’ for the purposes of this section (see s. 4(1) and Sch. 4, cl. 2(1)(e)). However, a SOC is not required to include any information about or a copy of a government contract if the contract relates to activities engaged in by the SOC in a market in which it is in competition with any other person (s. 39). This provision supports our view that non disclosure of the gentrader and associated contracts does not invite any proper criticism.
Thirdly, Treasury had prepared internal guidelines for appointments to boards of SOCs. These guidelines, dated October 2003 required a standard approach to making such appointments - the identification and interview of new candidates, the briefings of shareholders and final act of appointment. In the Preface, the following was stated: "The Guidelines recognise that the Board appointment process usually requires sound and sensitive judgement rather than just simple adherence to specified activities completed in a strict order."

The appointment of the new directors on the evening of 14 December 2010 took place over a very short period of time. The usual procedure was not followed. However, for reasons given earlier, the Inquiry is of the view that the directors who were appointed were appropriately and suitably qualified for the appointment and the process by which they were appointed was lawful. In those circumstances, we consider that there has not been any non-compliance of substance or principle with this policy.

Finally, conventions in relation to Cabinet are relevant in considering whether there had been compliance with policies and practices. The Inquiry has been informed by the Department of Premier and Cabinet of the convention which holds that Cabinet is responsible for significant Government policies and decisions.

The Ministerial Handbook that was current at the relevant time provided the following guidance:

There is no legislative requirement as to which matters must be determined by Cabinet and which may be determined by the relevant Minister alone. By convention, however, matters which require the consideration of Cabinet include the following... New policies and significant or sensitive changes to existing policies [and] Policies and commitments (such as contracts) with a significant financial impact, or which may require additional funding...

The determination of whether a matter ought to be considered by Cabinet is ultimately made by the Premier and usually communicated through The Cabinet Office [now Department of Premier and Cabinet] which administers the setting of the Cabinet agenda.

On 10 November 2008 the Government endorsed this approach in respect of the Energy Reform Project. Decisions were appropriately made by either a Committee of Cabinet or by Cabinet, in accordance with convention.

The Inquiry was told that in accordance with well established procedures officers working on the Energy Reform Project were expected to comply with decisions of a Cabinet Committee and seek further directions from a Cabinet Committee when they proposed to undertake a new or different course to that previously considered. Where the Energy Reform Project team wished to alter the course which had previously been approved, those matters were brought to the attention of a Cabinet Committee.

Conclusion

The Inquiry is satisfied that there was no material non-compliance with any of the policies which it has identified or has been brought to its attention in the conduct of the Energy Reform Project.
Chapter 12 Value for money and costs and benefits

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12.1 In this chapter, the Inquiry sets out its findings in relation to key decisions made, processes followed, the outcome achieved and whether the State received value for money having regard to the costs and benefits, risks and liabilities of the Electricity Transactions.

Sale process

12.2 In June 1996, the Independent Commission Against Corruption (ICAC) published a Practical Guide to Corruption Prevention. Chapter 13 of ICAC’s Guide relates to the Disposal and Sale of Assets and contains guidelines for developing policies and procedures for the disposal of assets. The guidelines are as follows:

a. decisions to dispose of assets must be fully documented, based on objective, economic criteria and should be approved by senior management;

b. organisations should use appropriate methods to determine the value of surplus assets;

c. organisations should develop procedures which maximise the net return to the organisation;

d. organisations should use competitive processes to make sure that all disposals are conducted with integrity;

e. organisations that advertise surplus assets for public sale should make sure that the advertisements are appropriately placed to capture the anticipated market;

f. organisations should establish disposal criteria and make these available to all potential bidders;

g. organisations should make sure that all staff involved in the disposal process disclose any actual or potential conflicts of interests;

h. all staff involved in the disposal of assets should be made aware of, and have access to, the organisation’s disposal policies and procedures and be given appropriate training if necessary; and

i. organisations must periodically review the propriety and effectiveness of their disposal policies and procedures to make sure they are fraud and corruption proof.

12.3 Having regard to each of these guidelines the Inquiry concludes that, to the extent applicable, each of these guidelines were met for the reasons set out below.

12.4 The decision to sell the electricity assets was made by the Government and followed the receipt of a wide range of expert advice. The decision was well documented and made public. The manner in which the retention value of the assets was determined is set out below, and as will be evident, the Inquiry has concluded the process by which this was done and its timing was appropriate.
12.5 The decision-making structure was appropriate for the assets under sale and an orthodox and conventional method of achieving the objectives of the sale. The Steering Committee comprised qualified and experienced members from relevant areas of government. The working groups were, also, appropriately constituted and covered the key issues.

12.6 The evidence summarised in earlier chapters demonstrates that, in respect of each significant decision which was made, there was at least one contradictor, or an adviser who was capable of reviewing the work of a proponent. In this way, the working groups and the Steering Committee had access to competing views in respect of matters calling for their recommendation or decision. There were alternative available outcomes and the selection of one over the other was a matter of judgment, about which reasonable minds could differ.

12.7 A probity advisor, RSM Bird Cameron, was appointed, and its representatives were visible to all involved and attended all relevant meetings. RSM Bird Cameron prepared probity plans and briefed participants, received and resolved many declarations as to conflicts of interests and published a comprehensive report at the end of the process.

12.8 The probity advisers received no correspondence of any complaint, which is some indication that no one had a legitimate grievance with the process.

12.9 In their 2011 Final Probity Report on the Energy Reform Project, the probity advisers made a number of findings, including the following:

a. nothing came to their attention to indicate that the probity principle of fairness had not been maintained and, in particular, the steps taken by the legal advisers to facilitate the pre-bid negotiations followed by the legal advisers sign-off of the transaction documents provided a satisfactory process to ensure qualified bidders were treated fairly;

b. nothing had come to their attention to indicate that the probity principle of value for money had not been maintained;

c. nothing had come to their attention to indicate that the probity principles of accountability, transparency and consistency had not been maintained;

d. from their attendance and observations at Steering Committee and Evaluation Committee meetings, necessary declarations were made and recorded at the commencement of the respective meetings. When appropriate, Dr Gellatly and Messrs Yeadon and Dermody had excused themselves from meetings of the Evaluation Committee or Steering Committee; and

e. the probity advisers referred to some relatively inconsequential breaches of confidentiality and there is no finding that any of these breaches had any bearing on the outcome of the transactions.

12.10 The advertising of the proposed sale included an international road show and many meetings between advisers and potential and actual bidders. Data rooms were populated and discussions took place between potential bidders and the advisers as to the terms of the tender and retail agreements.
12.11 As is clear from the chronology set out earlier, the process took far longer than initially appreciated. Most witnesses were of the view that the time taken to draft the gentrader agreements was the key cause of any delay.

12.12 Mr Maguire, the solicitor retained to draft the gentrader agreements, considered the gentrader model to be a complex one. He had informed Treasury and the financial advisers in February or March 2009 that preparation of the agreements would take, if all went well, at least a year. He told the Inquiry that he thought that the timetables set were unrealistic because those involved (with the exception of him and Frontier Economics) did not appreciate the complexity of the gentrader agreements.

12.13 Mr Maguire told the Inquiry that although he submitted his curriculum vitae to the Government in late 2008, he was not instructed to commence substantive work in earnest on the agreements until July 2009, although he had earlier advised the Government (in February or March 2009) that the drafting, if all went well, would take in the order of one year.

12.14 Mr Price also explained to the Inquiry:

...there is no doubt that we [Frontier] played a role [in the slippage in the timetable]. It is a complex transaction. This is not the normal sort of transaction where you just get data for a due diligence. You are actually involved in a serious exercise in allocating risk between different parties. It is extremely difficult and quite technical because all of this had to be modelled and no-one had really done anything at this scale in this country before. So there is no doubt that we could have done things more efficiently, but for the most part we kept to our timetable.

12.15 Dr Gelatly considered that the delay in the preparation of the gentrading agreements and the uncertainty about the carbon price might have affected international bidders, who were not as familiar with the operation of the NEM as the incumbents.

12.16 Ms Hole saw the length of time taken to prepare the gentrader agreements as an inevitable consequence of the gentrader model.

12.17 She instanced the water licensing component, in which her Department was interested and said that it:

...required a very detailed understanding of the regulatory framework around the water licensing, what entitlements the generation businesses had and how you might want to manage the risks inherent in that.

12.18 The Inquiry does not consider that the length of time taken can be attributed to any one action or event. It clearly was a complex set of transactions which involved dozens of people contributing to decision making on a regular basis. The structure was established to enable or require the work of one expert to be critiqued by another. It was an unprecedented transaction in Treasury’s experience in terms of its size and complexity and without legislative authorisation.

12.19 However, the consequences of the time taken were adverse to the outcome at least in so far as it deprived the Government of the option of an IPO.
12.20 Mr Challen expressed the following view:

The transactions were implemented using a process which, in my view, meets best practice standards. The governance arrangements were robust, implementation was thorough and documentation appears generally to have been of a good standard.

Adoption of the gentrader model

12.21 The principal decision that was made in connection with the sale was to proceed with the gentrader model. At the time the legislation was withdrawn in September 2008, there were, at least hypothetically, a number of options open to the Government:

a. do nothing until legislation enabling the long-term leases of generators could be passed;

b. proceed with the sale of the retail businesses and development sites and defer doing anything with the generators until legislation could be passed;

c. proceed with the sale of the retail businesses and development sites and the long-term leases of the generators notwithstanding that the legislation had been withdrawn;

d. establish a joint venture structure whereby the SOCs and the private sector would operate the generators jointly; and

e. adopt the gentrader option.

12.22 The advantages and disadvantages of the various options were, to some extent, explored in the evidence, which has already been addressed.

12.23 The Inquiry’s view is that the first two options referred to above would have failed to heed Professor Owen’s warning of a need for investment in future electricity generation from 2013. Further, neither would be likely to secure the AAA rating.

12.24 In relation to the third option, there is and was some doubt as to whether the Government could do so in the absence of legislation.

12.25 The fourth option had the disadvantage that it would leave the State in a position where it remained subject to trading risk through its ownership of the generators and remain a presence in the market. This, according to Professor Owen, would be sufficient to deter private investment in future generation. Accordingly, one of the principal policy reasons for selling the generators, or their capacity, would not be achieved by this option.

12.26 The fifth option was, as the evidence demonstrates, very much a second-best option with the best option unavailable, that is without the benefit of legislation. Mr Challen, in his report, to the question of whether there were any alternatives in September 2008, said “The short answer to this question is that there [were] none.”
12.27 The other key decisions that were made by the Government in the course of the sale process were:

a. the number of gentrader bundles;

b. whether the sale ought be sequential or simultaneous; and

c. the risk allocation.

12.28 The Inquiry agrees with the view and reasoning expressed by Mr Challen in his report in this regard which appears in Appendix 11. In addition, the Inquiry considers that each decision by the Government was taken after a deal of deliberation and it was reasonably available to be made on the information to hand.

12.29 Mr Challen expressed the following view:

The Steering Committee gave [the packaging of the gentrader bundles] considerable attention and, in providing advice to Government to proceed with the four bundles, made a judgement call on the basis of the analysis and advice it received. I conclude that this element of the structure of the transaction was well executed. It is not possible to make a judgement about the impact on the outcome relative to the alternatives considered.

12.30 In relation to whether the sale ought to have been sequential or simultaneous, the Inquiry notes the evidence that although Treasury and the financial advisers would have preferred a sequential process, none of the witnesses considered that one could say that the decision to sell the assets simultaneously affected the bids received. While it is arguable that the choice to conduct the sale simultaneously deprived the Government of an opportunity for an IPO, the contending businesses that were to comprise the assets to be sold pursuant to the IPO namely, Integral and Eraring, were sold through the simultaneous process. Accordingly, if the Government lost an opportunity it had no measurable value.

12.31 The terms of the gentrader agreements are set out in Chapter 7. It is clear from the events described earlier in this chapter that the risk allocation was arrived at after significant and robust debate, with the benefit of written papers and advocates for different views. We are persuaded by the view expressed by Professor Gray who said to the Inquiry that there were several iterations of the gentrader agreement. SFG Consulting modelled and prepared reports on six of the iterations to demonstrate and assess the various risks associated with each version, and how those risks could properly be quantified. The first such report was submitted on 15 October 2010 and the last on 15 December 2010. Professor Gray said:

One is not necessarily better than the other for the State, in that in those two different scenarios the amount that the gentrader bidder will be prepared to pay will of course be different. So what is being exchanged is additional upfront payment from the bidder for the gentrader contract versus a series of potential payouts from the State over the life of the contract.

12.32 Mr Cosgriff, who was persuaded by the arguments of the financial advisers that sequential sale was preferable, said to the Inquiry that he thought that the closed auction simultaneous process was a "perfectly plausible and reasonable
approach, particularly in a world where you have the fallback of doing an IPO so that you can deal with the new entry issue through the IPO.

12.33 Some witnesses observed that, in the events that happened, the Government ended up with a sequential process since not all of the assets were sold. However, by the time the simultaneous process had ended, there was insufficient time to do an IPO. Mr Dimpfel observed that the delays in the timeline meant that there was insufficient time to do an IPO after the trade sale and that this may have affected the outcome, since it may have provided the opportunity to sell more assets, and also would, if successful, have achieved the objective of attracting a new entrant to the market.

12.34 Mr Timbs told the Inquiry that for an IPO to be a legitimate fall-back option, it would have been necessary for there to be a completed trade sale process by June 2010.

12.35 Mr Lobb and Mr Dimpfel considered the fact it took longer than envisaged affected the credibility of the process although they did not think that the delay affected the outcome (apart from the fact that there could not be an IPO) or that there would have been any more bidders if the original timetable had been met.

Conclusion

12.36 The Inquiry is of the view that:

a. the governance structure adopted;

b. the process by which the assets were offered to the market; and

c. the decision to sell the assets the subject of acceptable bids;

were, in the circumstances of the then Opposition’s position not to vote in favour of the legislation, the economic climate, the expert advice available to the Government and the uncertainty over carbon pricing, reasonable and appropriate.

12.37 The decision to sell the gentrading rights was made in the knowledge that it was a sub-optimal solution. The best option, however, was not available, that is the sale or long-term lease of the generators under legislative authority.

Value for money

12.38 Terms of reference three and four provide as follows:

3. The value for money achieved for the State compared to the retention value of the assets to the State; [and]

4. The costs and benefits to the State of the Electricity Transactions, including potential risks and liabilities and the extent to which the transactions can deliver the stated objectives for entering into them;

12.39 The stated objectives (which were determined by the then Government in March 2009) were:
a. deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;

b. create an industry and commercial framework and environment to encourage private investment into the NSW electricity sector reducing the need for future public sector investment in retail and generations;

c. ensure NSW homes and businesses continue to be supplied with reliable electricity; and

d. place NSW in a strong financial position by optimising the sale value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt.

12.40 There are, essentially, two ways of determining whether the State achieved value for money as a result of the Electricity Transactions. One way is to take into account purely financial matters. The second is to take into account matters beyond simply financial considerations. The Inquiry proposes to address term of reference three by reference to financial matters and consider other matters which may be relevant to the overall benefit or detriment of the Electricity Transactions to the State in its consideration of term of reference four.

Value for money: the comparison required

12.41 If the retention value of the combination of assets sold to a particular bidder exceeds the bid price less any additional costs or liabilities incurred as a result of the sale, then the State will not obtain value for money by selling. However, if the retention value is less than the bid price less additional costs or liabilities incurred as a result of the sale, the State will obtain value for money. Of course, this is subject to the retention value being appropriately derived.

12.42 The costs and liabilities incurred by the State as a result of the sale affect the bid price and therefore they need to be taken into account in the quantitative comparison undertaken as part of term of reference three.

12.43 The effect was explained to the Inquiry by Professor Gray and is set out earlier in this chapter. Professor Gray did not see the different risk allocations (which included such matters as to whether there would be a bonus for over-capacity or liquidated damages for failure to provide warranted capacity) as producing or subtracting from value. He considered that, to the extent that the risk allocation favoured the gentrader, it would be likely to be reflected in a higher bid price.

12.44 The costs of the transaction itself are usually disregarded in this comparison since they have largely, if not completely, been incurred by the time the comparison is made and therefore ought not determine the decision whether to sell or retain assets. However, the costs of the transaction are relevant to the assessment of the overall benefit of the transaction (and therefore need to be considered by reference to term of reference four).
The determination of retention value

12.45 As the evidence before the Inquiry established, the retention value was determined before the bids were considered. This was not only a requirement imposed by the Auditor-General, but also a necessary aspect of value for money, to avoid the risk that the bids themselves could be permitted to influence the determination of retention value.

12.46 The retention value was determined immediately prior to the bid closure date because the retention values had to be current at the time of the transactions for a proper comparison to be made with bids.

12.47 The Auditor-General required, in his report of August 2008, that the retention value of the assets to be sold be calculated using consistent assumptions. This meant that, rather than use the SOC generators' own forecasts, the Retention Value Working Group was required to determine assumptions that would be appropriate for all of the SOC generators. Assumptions of that nature included coal prices, gas prices, energy demand, energy output, fixed and variable costs.

The retention value of the retail businesses

12.48 The retail businesses were valued by reference to five year cash flows, which were based on their five year plans, but which substituted consistent assumptions for the individual SOC retailer assumptions, and calculated a terminal value based on the forecast growth rate of those cashflows after five years.

12.49 There was some cross-checking of the retention values, which had been calculated by reference to the discounted cash flow method. Price/earnings ratios were derived for comparator companies and prices achieved per customer for recent sales were also analysed.

The retention value of the generators

The methodology of determining the retention value of the generators

12.50 The generation businesses were valued by reference to the cashflows to the Government of those businesses for the forecast life of the business, which were then discounted back to present value at an appropriate rate to reflect the risk of those cash flows.

12.51 The sensitivities of the retention value which were explored in the evidence before the Inquiry show the difficulties of determining the retention value of the SOC generators, and the substantial variations which alteration of particular inputs can produce.

12.52 As the particular gentrader model was almost unprecedented in Australia, there was a dearth of comparators. The Retention Value Working Group considered the use of comparators to be potentially misleading (except in the case of the Colongra gas-fired generator), given the changes to energy demand in recent years and the effect of the prospect of the carbon price. The Inquiry accepts, in the light of the evidence concerning the gentrader model and the loss of value which it inevitably produced, that this was a reasonable approach.
12.53 It came to our attention that, during the Inquiry, the current Treasurer and Treasury Secretary had sought expert opinion from an investment bank as to the value for money achieved by the transactions. The firm (which has requested not to be named) was provided with the retention value and the sale prices. Otherwise, it had access only to publicly available material. The report is, understandably, couched in highly qualified terms. It makes extensive use of data relating to other Electricity Transactions and concludes that the results of the transactions were not as good as the Electricity Transactions with which a comparison was sought to be made. The Inquiry does not consider the opinion to have any weight, having regard to the limited information to which its authors were privy and the lack of consideration of whether the transactions said comparable were indeed truly comparable.

12.54 The Retention Value Working Group checked the consistent assumptions adopted by Frontier Economics across all three SOC generators against the forecasts made by the SOC generators themselves. The models were run with the SOC generators forecasts to check the results against the results produced by the consistent assumptions.

12.55 The Inquiry did not detect, in the documentary material before it, or in the oral evidence, that there was any attempt by the Retention Value Working Group (whose recommendations were accepted by the Steering Committee and the Government) to manipulate the retention values of either the generators or the retailers. Indeed, the evidence established that the members of the Retention Value Working Group, and in particular the Treasury representatives, were at pains (at the time and in their evidence to the Inquiry) to ensure that each assumption could be defended on reasonable and conservative grounds. Mr Challen said:

> The work of the Retention Value Working Group, and most particularly the model which was used to undertake the retention value calculations was subject to review and audit by Ernst & Young. Ernst & Young's working papers reveal that a thorough and highly competent review of the retention value models was undertaken.

12.56 The Inquiry accepts Mr Challen’s opinion that the assessment of retention value of the retail businesses and the generators was in accordance with orthodox methodology and was conducted with appropriate rigour.

_Gentrader agreements: what would have been retained was different from what was sold_

12.57 There is a complexity that arises in relation to the gentrader agreements because what was sold (the gentrading rights) was different to what would have been retained, namely the generators. By contrast the retail businesses as sold were identical to those which would have been retained. Therefore, while it is appropriate to compare the retention value for the retailers with the bid price for them, since there is a true comparison, the same cannot be said for the generators and the gentrading agreements.

12.58 The evidence before the Inquiry establishes that it is incontrovertible that the generator is worth more than its trading capacity under a gentrader agreement. In these circumstances it would be unrealistic to expect the bid prices for the
gentrader agreements to equate to, or exceed, the retention prices of the generators.

12.59 Apart from the obvious point that there are fewer risks when one trades the capacity of a generator when one owns the generator (which could be expected to be reflected in a higher bid price for the generator), there are specific characteristics of the gentrader arrangement which mean that the ‘value’ of the generator is not fully realised in a gentrading agreement.

12.60 The matters that tend to diminish the value of the gentrading agreement, as opposed to the generator are as follows.238

a. the technical envelope specified in the gentrader contract is conservatively designed so as to minimise the generator’s exposure to the risk of unplanned outages and interruptions;

b. additional peak capacity is available in each of the power stations, but if it were used it would result in an additional risk to the plant. Unless otherwise negotiated, the gentrader has no access to this additional capacity (but the generator would have had such access, but for the gentrading agreement);

c. the gentrader does not have control over the way in which the generator is operated and therefore cannot reward generation employees for delivering good outcomes or reducing costs (whereas the generator could have done this, but for the gentrading arrangement);

d. the gentrader agreement provides for minimum fuel specifications. The effect of this is that the gentrader does not have the discretion to save money on fuel costs (by using lesser grade fuel) which would increase maintenance costs (by causing higher boiler erosion). Nor does it have the incentive to use better quality fuel so as to reduce maintenance costs, because the maintenance costs are incurred by the generator; and

e. because the Availability Liquidated Damages are capped, the gentraders are subject to risks (of unplanned outages and interruptions, which cause loss of opportunity to trade) which they do not ultimately control. This factor could reasonably be expected to lead to a reduction in the bid price, compared to the amount that the bidders would have been prepared to pay for the outright purchase, or long-term lease, of the generators.

12.61 The lack of a true comparator with respect to the generation retention value cannot be overcome by valuing the generator subject to the gentrading agreement since it was generally accepted by the witnesses who gave evidence to the inquiry that there was not necessarily an equivalence between the value of the generators on the one hand and the sum of the value of the gentrading agreements and the residual value of the generators that became subject to the gentrading agreements. The consensus was that separation of the trading and generating functions would result in an inevitable loss of value. In other words, the State could expect to realise more from the sale of a

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238 The Inquiry is indebted to the Treasury document (prepared in parallel to the Inquiry) entitled “Review of the Transactions” for this list, which provides a useful and succinct summary of matters which were otherwise the subject of evidence before the inquiry but which had not hitherto been collated in this way.
generator than it could expect to realise from both the sale of the gentrading agreement and the sale of a generator subject to a gentrading agreement.

12.62 No attempt was made to value the residual value of the generators that became subject to gentrading agreements, although Mr Timbs considered that it would undoubtedly be positive.

The deductions from the bid price referable to costs or the net present value of future risks and liabilities associated with the transactions

12.63 As referred to above, where the bid price exceeds the retention value, a further calculation is called for whereby the costs and present value of the risks and liabilities incurred by the State in the transaction are deducted from the bid price. These matters will be considered by reference to the gentrader agreements and retail businesses in turn.

12.64 Treasury has provided a document to the Inquiry, the most recent version of which is dated 14 September 2011, which sets out the net proceeds of the transactions and makes allowance for costs and liabilities (including future contingent liabilities, such as the liability for Availability Liquidated Damages). The Inquiry has no basis for concluding that this document is other than accurate on the basis of the information available.

12.65 In summary the document calculates the aggregated estimated net proceeds as follows:

<table>
<thead>
<tr>
<th>Purchaser</th>
<th>Range(^{239}) of aggregated estimated net proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRUenergy</td>
<td>$1,594-$1,680 million</td>
</tr>
<tr>
<td>Origin</td>
<td>$2,934-$3,178 million</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$4,528-$4,858 million</td>
</tr>
</tbody>
</table>

12.66 These figures exceed the retention value for the bundles of assets purchased. Accordingly, on that basis (which the Inquiry accepts to be correct), the State received value for money as a result of the Electricity Transactions.

12.67 The deductions from the bid price are considered in more detail below.

Deductions from bid price: the gentrader agreements

Liability for Availability Liquidated Damages for breach of the covenant to provide capacity

12.68 SFG Consulting was retained by the Energy Reform Project to assess the present value of the future contingent liability to pay Availability Liquidated Damages. SFG Consulting calculated the amount based on average estimate of aggregate penalties to 2039. The Review of Electricity Transactions document prepared by Treasury (in parallel to the Inquiry) describes the allowance made for this liability, for budgeting purposes of $119 million in relation to Eraring and $234 million in the case of Delta West in the following terms:

\(^{239}\) Whether the lower or higher figure is applicable depends on the outcome of the ATO ruling with respect to the deductibility of capacity charges and the ancillary costs (including stranded costs) that are ultimately incurred.
Amount based on average estimate of aggregate bonuses/penalties to 2039 as per SFG Report dated 15 December 2010. The potential ALD penalties are akin to the operating situation generators would have faced pre-transaction where any unavailability of plant would result in the generator being unable to dispatch and therefore have a negative impact on profitability through revenue losses arising from capacity being unavailable for trading in the market and losses on hedges where physical capacity is unavailable and the market price is greater than the hedge. As these risks had not been specifically taken account of in the retention valuation, they were included in the corresponding assessment of bid values.

12.69 There is no evidence or material before the Inquiry to indicate that these allowances are other than adequate.

__The risk that the covenanted monthly payments for fixed and variable costs will be insufficient to cover the actual costs__

12.70 The gentrader agreement imposes an obligation on the gentrader to make monthly payments referable to fixed and variable costs. The agreement itself defines the amount of such payments, which are subject to alteration based on five published indices (but are not subject to any re-openers by reference to any variation in actual costs). There is the potential for a disparity between the payments made to the generators on the one hand and the actual costs incurred by them on the other.

12.71 The risk of the disparity between covenanted payments and actual costs has been discounted to its present value (from projections to 2039) by SFG Consulting and Treasury, and taken into account as a deduction to the bid price to calculate the net benefit to the State.

12.72 There is, on the evidence and material before the Inquiry, no basis for calling into question the amount of the provision that was made for the net present value of this risk.

__Deductions from bid price: the retail agreements__

12.73 The costs to be borne by the network businesses once the SOC retailers had sold the retail arm of the business fall into two categories:

a. stranded costs, including employees costs; and

b. dissynergy costs.

12.74 The SOCs worked with Treasury and the financial advisers to determine an estimate of both categories of costs. These estimates continue to be revised as at the date of this report.

__Stranded costs__

12.75 As referred to in Chapter Five, the Government had made a commitment to employees of the SOC retailers.

12.76 These stranded costs associated with employees are temporary in that they do not extend beyond a five year period. To some extent the employees' costs are offset against the income received by the SOC retailer under the transition services agreement.
Dissynergy costs

12.77 Dissynergy costs are costs which were previously shared between the retail and network businesses of EnergyAustralia, Country and Integral but which, after the sale of the retail businesses, will need to be borne by the network businesses.

12.78 Some of the dissynergy costs will result in an increase to the network costs base in the future and can potentially be passed through via an AER determination either by seeking a re-opener to the current AER determination or seeking recovery under the next determination.

Value for money: Inquiry’s conclusion

12.79 Mr Challen expressed the following opinion:

If net proceeds was the only criterion for making the sell/don’t sell decision, the Government may not have proceeded to sell the Eraring and Delta West gentraders on the basis that the net proceeds from the bids did not exceed the retention values of those rights. However, net proceeds was not the only criterion and the decision to sell was fully justifiable by reference to the full set of objectives and the fact that, at the level of each bidder and overall for the collection of assets and rights, the net proceeds far exceeded the retention value.

... Bringing the full set of transactions together, and having regard to the material value in reducing State debt, preserving NSW’s AAA credit rating and incentivising the private sector to invest in electricity generation and retail, it is reasonable to conclude that the benefits of the transactions overall exceeded the costs and expected value of the new net risks.

12.80 The retention value of all the transactions entered into was exceeded by the bid price, when all associated costs and liabilities were taken into account. Accordingly, on the basis outlined above, the State received value for money from the Electricity Transactions, with the possible exception of Cobbora, which has been considered separately in Chapter 8.

Costs, benefits, risks and liabilities

The Electricity Transactions overall

12.81 The State received gross proceeds from the transactions of $5.3 billion.

12.82 The State maintained its AAA rating after having been put on negative outlook in 2008 and achieved some measure of electricity reform. It is not, however, possible to say that the State would have lost its AAA rating if the transactions had not occurred, or if only the retail businesses and development sites had been sold and the generators retained. Furthermore, the Electricity Transactions were not the only matters germane to the deliberations of the rating agencies, which also had regard to the contents of the State budgets from time to time.

12.83 The State achieved a partial privatisation of the electricity sector, but did so in a way that resulted in the execution of binding, enforceable gentrader agreements for some, but not all, of its generators, which has substantially affected the market and restricted the range of future options, as will be addressed below and later in this report.
12.84 Before the transactions were completed the State, through the six SOCs, had a natural hedge between the trading risks associated with the generators and the risks associated with the retail businesses. After the transactions, the State no longer has any natural hedge with a retail business for its remaining generators, Macquarie Generation and Delta Coastal. However, the benefits, such as they were of the apparent natural hedge, ought not be overstated. As each SOC operated independently and there was no (and could not be) co-ordinating oversight by the State of the risk position of each SOC, each SOC had to manage the risk through hedge contracts. Accordingly it was conceivable that a SOC retailer and a SOC generator could each be on the ‘wrong’ side of a hedge when the market moved.

12.85 Because of this effective isolation, the risk position of the State may not have materially increased by reason of the loss of any natural hedge, since the State could not act on information which could have enabled it to benefit from the natural hedge in any event.

12.86 In any event, the loss of any natural hedge is not nearly as material for the generators as it would have been for the retailers. This is because the market volatility risks faced by generators and retailers are highly asymmetric. Whilst the average pool price is in the order of $40 per MWh, prices can rise up to the Value of Lost Load (VoLL) $12,500 per MWh. The downside risk for unhedged generators is therefore less than $40 per MWh, while the downside risk for unhedged retailers is over 300 times this level. Peak NSW demand is in the order of 16,000 MW. Unhedged retail exposure to any significant portion of this demand when the market is at or near VoLL is financially unsustainable for any retailer. There is no equivalent risk for unhedged generators. The only way that a generator can face significant losses during high priced periods is if they have sold hedges or other instruments that are not backed by their available physical capacity.

12.87 Further, Macquarie Generation has a long-term contract with Tomago Aluminium Company, which operates as a hedge contract against the risks of trading in the NEM.

The costs, benefits, risks and liabilities of the gentrader agreements

12.88 The gentrader agreements changed the nature of the operation of Eraring and Delta West from energy market traders to asset managers.

12.89 The execution of the Delta West and Eraring gentrader agreements has had substantial effects on the electricity market in NSW. First, there is now an asymmetrical market, where the State retains more than half of the State’s generation capacity.

12.90 Secondly, the execution of the Delta West gentrader agreement (and the non-execution of the gentrader agreement in respect of Delta Coastal) means that Delta is a generator and trader in respect of Delta Coastal and a generator in respect of Delta West. The trading arm of Delta Coastal is in competition with TRUenergy (the counterparty to the gentrader agreement for Delta West) but Delta runs the generators for both. Further, as a result of the sale of the gentrader agreement for Delta West, Delta Coastal is, necessarily, a smaller generator than Delta was and therefore its capacity to cover plant outages in

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one power station by the capacity of other power stations is concomitantly reduced.

12.91 Thirdly, the execution of the agreements has entrenched an option that deprived the State of the opportunity of achieving maximum value from those of its generators that are subject to the gentrading agreements. Although the State (through the relevant SOC) retains a right to transfer the generator to a third party, it may be difficult to encourage entities other than the corresponding gentrader to bid for it. This may make it difficult to create the requisite competitive tension to achieve good value for the generators that are subject to gentrading agreements.

12.92 Fourthly, the gentrader agreements are necessarily more complex than a sale or lease of the generators. The gentrader agreement requires a high degree of cooperation between the generator and the gentrader to make the relationship work effectively, which gives rise to a unquantifiable risk of disputes and litigation.

12.93 In this sense, the fact that Macquarie Generation was not sold as part of the Energy Reform Project may be beneficial. It is the most valuable generator, with the largest capacity and its value has not been compromised by an associated gentrader agreement.

12.94 The benefits of the Eraring and Delta West gentrader agreements were that the SOC generators divested themselves of the following principal risks:

a. trading risk associated with participating in the NEM, which included consequential losses from outages arising from technical failure, or industrial action (which were uncapped, unless and to the extent to which, they could be hedged);

b. counterparty credit risk in relation to hedge contracts (except in so far as there was no assignment of such contracts and there are now back-to-back arrangements, which subjects the SOC to liability under the hedge contracts in the event of the gentrader’s insolvency);

c. carbon price risk (since the whole of that risk is now borne by the gentrader);

d. fuel risk (since the gentrader is wholly responsible for the cost and volume of coal to fuel the generator); and

e. regulatory risk (principally associated with the cost of compliance with environmental laws).

Trading risk v. Availability Liquidated Damages

12.95 The Inquiry accepts that the substitution of trading risk for the risk of a liability for Availability Liquidated Damages is beneficial for both fiscal and policy reasons. The fiscal reason is that the acquired risk is lower than the trading risk (although in any given year more may be paid in Availability Liquidated Damages than loss incurred through exposure to trading risk). The policy reason is that the measure of damages for breach of the covenant to provide a certain level of capacity is not referable to the spot price of electricity in the
NEM at the time of breach. Thus, the government has no incentive to invest in generation because its financial exposure is not connected to the spot price.

12.96 The Availability Liquidated Damages are fixed by reference to the present cost of building a new power station from which a range of hourly rates (Sx/MWh) referable to peak and off peak periods was derived. There was also provision for a higher rate of damages to be paid in certain periods known as "super-peak" periods, which the gentrader was required to nominate in advance. Although the damages for which the generator is liable in super-peak periods are significantly higher than for other periods, such damages are fixed and do not bear any proportional relationship to the spot price in the NEM. In addition, there is also a total annual cap on damages. In addition, there is also a total annual cap on damages.

Lack of re-openers on payments referable to fixed and variable charges

12.97 The SOC's which entered into gentrader agreements are exposed to the possibility that the actual fixed and variable costs would exceed the indexed payments made by the gentrader in relation to such costs. Although this exposure is properly classified as a risk, there are benefits that flow from the absence of re-openers.

12.98 Aside from the expectation that such a provision would result in higher bid prices, there was also a policy reason for it. If provision were made for re-openers, the gentrader would be privy to the cost structure of the generator in the course of any review. This is not the case under the gentrader agreement since the calculation of variations does not involve any analysis of actual costs. Thus the choice preserves the separation of operational matters (which are the responsibility of the generator) and trading decisions (which are the preserve of the gentrader).

12.99 Another policy reason for the choice of a gentrader agreement without re-openers for fixed and variable costs, is that the gentrader could argue, in the course of a review, that the costs ought be reduced on the basis that the generator was not being run efficiently. If this argument were accepted on a review, not only would the generator receive less in terms of the monthly payments, but also the residual value in the generator would be diminished.

12.100 Accordingly, the benefits of not having re-openers are as follows:

a. the gentrader is not privy to the cost structure of the generator;

b. by reason of this, another potential purchaser of the generator (other than the gentrader) will not be at a disadvantage by knowing less than the gentrader about the generator's cost structure; this may assist in creating competitive tension if the generator is offered for sale;

c. there is some potential for the SOC to cut costs to its own benefit (rather than to the gentrader's benefit); and

d. the lack of re-openers is likely to result in a higher bid price because it creates less uncertainty for the bidder.
12.101 The Inquiry considers these benefits to be a reasonable basis for the balance that was struck in the gentrader agreement, although it gave rise to the risk that has been identified.

Provisions in the gentrader agreements that do not materially alter the State’s risk

12.102 There are some provisions in the gentrader agreements that impose a liability on the SOC generator which do not need to be separately considered because they would have been incurred by the SOC generator, irrespective of the gentrader agreement. Such provisions include:

a. the liability for overgeneration charges;

b. the cost of auxiliary power requirements past a set limit;

c. the costs of remedial action to manage clinkering (the incombustible residue, fused into an irregular lump, that remains after the combustion of coal); and

d. the cost of remediation of the site at the end of the generator’s useful life.

The costs, benefits, risks and liabilities of the retail agreements

12.103 There were several benefits to the State of the sale of the retail businesses.

12.104 The net figure, once deductions had been made from the bid price for costs and liabilities, was well in excess of the retention value.

12.105 Furthermore, the sale of the retail businesses was consistent with an aim of the NEM, which envisaged privatisation (and indeed was the original reason for the splitting of the State electricity retailer into three separate businesses run by three separate SOCs).

12.106 There was some evidence before the Inquiry that tended to establish that competition in the retail market has been increased by the sale, which is addressed further below by reference to the objectives.

12.107 The State, through its SOCs, is no longer exposed to the risks associated with the electricity retail business. For the reasons given above these risks are considerable, and are substantially greater than those to which the SOC generators are exposed.

12.108 The State is exposed to a residual credit risk as a result of the retail agreements. Many of the contracts to which the SOC retailers were party were assigned to the purchaser. However, in some instances, the counterparty would not consent to the assignment of the contracts. In those instances, back-to-back arrangements were put in place with the purchaser. The effect of this is to make the SOC (which formerly owned the retail business) liable to the counterparty in the event of the retailer’s insolvency.

12.109 This risk is not regarded as particularly material as both purchasers have good credit ratings.
The costs, benefits, risks and liabilities of the sale of the development sites

12.110 The principal benefit to the State was that it received proceeds for the development sites which were well in excess of their retention values.

12.111 A further benefit from such sales is that they may encourage investment in generation (which was part of Professor Owen’s recommendation as to what was required), although the sale agreements themselves do not require the purchaser to develop the sites within any particular time or at all.

Did the Electricity Transactions meet the stated objectives?

Evidence concerning term of reference four

12.112 While the Inquiry has been assisted by the views of witnesses and Mr Challen, the conclusions expressed below represent the Inquiry’s view. In other parts of this report the material evidence of witnesses has been quoted or summarised. However, the Inquiry does not propose to do so in relation to this term of reference because, ultimately, it is a matter of judgment for the Inquiry whether the Electricity Transactions met the stated objectives.

The circumstances against which the results of the Electricity Transactions can be measured against the objectives

12.113 The electricity market has changed since the Owen Report, which has an impact on the extent to which what the NSW Government does can have an effect on the market and the fulfilment of its stated objectives. Furthermore the electricity market comprised by the NEM is a national market which covers Queensland, NSW, Victoria, South Australia and Tasmania. Although NSW has the greatest demand for electricity, it is not unaffected by the way in which the rest of the market operates.

12.114 The previous Government’s objectives, together with the preamble, were as follows:

The NSW Government ... has designed its Energy Industry Reform strategy... to ensure there is timely investment in the electricity sector, thereby delivering efficient and reliable power to the businesses and homes of New South Wales... Specifically the strategy is designed to achieve the following objectives...

- Deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;

- Create an industry and commercial framework to encourage private investment into the NSW electricity sector and reduce the need for future public sector investment in retail and generation;

- Ensure NSW homes and businesses continue to be supplied with reliable electricity; and

- Place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt.
12.115 The objective that is incorporated into the preamble is that timely investment in the electricity sector is required to deliver efficient and reliable power to users in NSW.

12.116 It is reasonable to infer that the "investment" referred to in the preamble is principally a reference to investment in generation, since retail does not require as significant a capital investment and is largely a margin-driven business. Furthermore the Owen Report is, as a matter of history, the basis for the strategy, and it was concerned with making recommendations to incline the private sector to invest in generation, so as to relieve the State of the obligation to make such investment. Efficiency and reliability were also referred to in the objectives and may be taken to import a qualitative element to the investment in generation.

12.117 The requirement that the investment be 'timely' arises by reason of the circumstance that there is a lead-time between the investment and the capacity of the new generation source to deliver power to the NEM. Accordingly the investment must occur before the further supply is required.

12.118 The Owen Report predicted a need for increased generation capacity in NSW from 2013. However the forecast growth which underpinned his report did not eventuate, in part because of the global financial crisis. Increased capacity will not, according to the 2011 Electricity Statement of Opportunities, be required until 2018-2019, due to a decrease in the maximum demand projections for the NSW region in the NEM.

12.119 The lead times for various generators differ, depending on the fuel for the generator. The Inquiry was told of the following indicative lead times:

   a. OCGT  3-5 years;
   b. CCGT  4-6 years;
   c. Wind  3-5 years; and
   d. Coal  More than 5 years.

12.120 The preamble to the objectives does not take account of reasons, other than continued government ownership of generators, which may have the effect of discouraging private sector investment in electricity generation. Of these, the principal one is the carbon price.

12.121 As referred to in Chapter 2, the Commonwealth Government announced its Clean Energy Future Plan.

12.122 The Inquiry was told that the fixing of the carbon price by the Commonwealth Government for an initial period (until 2018) increases uncertainty because it defers the time before which market certainty can be achieved such that investment in generation can be made with greater confidence.

12.123 For these reasons, even apart from the continued State ownership of Macquarie Generation and Delta Coastal, there may be a strong disincentive
for the private sector to invest in any substantial further generation, at least until such time as the carbon price has been determined by market forces.

The first aspect of the first objective: a competitive retail market

12.124 The objective appears to have been achieved in relation to the retail market. There are several reasons for this.

12.125 Prior to the Electricity Transactions there were other licensed retailers in NSW, including AGL, Origin and TRUenergy. However the retail market was dominated by the SOC retailers, which had a combined market share of 86%.

12.126 One of the hallmarks of a competitive market is that its participants make decisions for commercial reasons. Where the State itself or through its SOCs owns a business it may make decision for non-commercial reasons. This, of itself, can make the market in which it operates uncompetitive.

12.127 The State has the power to regulate retail electricity prices and to cap prices at low levels for political reasons. It may have been more inclined to exercise this power when it owned the retail businesses (since it would have been the subject of criticism if there were price rises for retail electricity). Its departure from all retail businesses means that, although it may continue to regulate retail electricity prices, its decision to do so will be unaffected by any ownership of retail businesses.

12.128 The cost structure of the retail businesses, when they were owned by the SOCs was different because they shared many of the costs of the network and transmission businesses (which were governed by the AER). Accordingly, the retail businesses may not have had the incentive, when in public hands, to cut costs in order to compete on price. There was also the possibility that the retail arm would be cross-subsidised by the network business, therefore unduly depressing the retail price of electricity. The State, as the owner of the SOCs, was in a position to influence this for political (non-commercial) reasons.

12.129 Although the three retail businesses run by the SOCs operated independently of each other, they did not engage in the type of conduct which is commonly associated with a competitive market. Consumer transfers between retailers is generally regarded as a measure of competition. The percentage of consumer transfers has been lower in NSW than in other regions of the NEM, where retail businesses have been privatised for some years. It can reasonably be inferred from this that the SOC retailers did not actively attempt to poach each other’s customers in the way that AGL announced that it would do (once it was clear that it would not be a purchaser of a NSW retail business).

12.130 Since the State owned all SOC retailers and generators, it could manage the risks, for example by making the ETEF available to its three retailers.

12.131 There are significant economies of scale available to retail customers that are not dependent on geographical location. Therefore, although AGL has a relatively smaller customer base in NSW, compared with Origin or TRUenergy,

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240 On 9 March 2011, AGL announced: “AGL today will launch its campaign to gain up to half a million new electricity customers in NSW. AGL is already winning new customers ‘organically’ in NSW at an annualised rate of more than 80,000, including more than 42,000 new customers in the six months to 31 December 2010.”
it is in a position to compete with them because of the size of its customer base elsewhere in the NEM.

12.132 A competitive market does not, of course, necessarily lead to a lower price for retail electricity. Indeed, if the network businesses did subsidise the retail businesses when they were in State hands, or the price regulation of the retail electricity market does not continue beyond 2013 (when the present IPART determination expires), there may be increases in retail prices of electricity to consumers by reason of these two matters alone.

*The second aspect of the first objective: a competitive wholesale market*

12.133 Whether the Electricity Transactions have achieved the objective of a competitive wholesale market is less clear than for the retail market. When the three SOC generators were each engaged in trading their capacity, they operated independently. Because they each bid into the NEM, they had to operate competitively because the NEM is a competitive market. Although they dominated the NSW region of the market, they were necessarily affected by prices in Queensland and Victoria because of the interconnectors between regions.

12.134 Nonetheless, diversity of ownership has unquestionably been increased. Prior to the Electricity Transactions, the Government generated, and had the capacity to trade 85% of electricity generation in NSW (through its ownership of Macquarie Generation, Delta, Eraring and its 58% share in Snowy Hydro).

12.135 There was, as between the three SOCs, a substantially level playing field. Their relative size, particularly in the case of Macquarie Generation and Delta, meant that they played a significant role in the NEM. Their bids were generally filled because, as coal-fired power generators, their variable costs were generally lower than other forms of generation.

12.136 After the transactions, there is now an asymmetry between, on the one hand, the SOC generators (Macquarie Generation and Delta Coastal), which do not have any vertical integration or any capacity to do so and Origin and TRUenergy, who have some measure of vertical integration because of their ownership of retail businesses and some measure of horizontal integration because they also operate other generators which trade in the NEM. It is not yet possible to say what effect this asymmetry will have, if any, on competition in the wholesale electricity market in the long-term.

12.137 The ACCC gave merger clearance to the proposed transactions on 9 December 2010. The test applied by the ACCC in granting merger clearance is a negative one: whether the proposed acquisition would not be likely to substantially lessen competition in the relevant market.

12.138 The ACCC considered that the aggregation of generation capacity arising from the proposed acquisition by Origin of one of the gentrader contracts (it ultimately bought Eraring) would not be likely to substantially lessen competition in the market for the wholesale supply of electricity in NSW and that its purchase of Country and Integral would not be likely to substantially lessen competition in the market for the retail supply of electricity either in NSW or Queensland. The counterfactual that the ACCC considered was the situation
that would apply if the assets were sold to other bidders, as distinct from the situation that would apply if the assets remained in the hands of the SOCs. Therefore, it did not need to address directly the extent to which competition was enhanced by the transactions (nor would this question have arisen by reason of the terms of the Trade Practices Act 1974 (Cth)).

12.139 Nonetheless one of the matters that inclined the ACCC to grant merger clearance for the sale of the Eraring gentrader agreement to Origin was that Macquarie Generation was to remain a SOC. On this basis the ACCC considered that the acquisition by Origin of one of the gentrader contracts would be unlikely to substantially increase the periods of time in which Origin’s generation output would be required to meet total demand in NSW. It noted in its Public Competition Assessment that:

Macquarie Generation will continue to be the largest generator in the region and therefore more likely to be in a position to be required to meet demand and materially influence the spot price than the other generators or gentraders.

12.140 Modelling conducted by Frontier Economics for the Energy Reform Project showed that the most competitive outcome was achieved when a new entrant purchased a gentrading bundle, alongside TRUenergy, Origin and AGL (it was assumed that each of these entities would bid successfully for a retail business). Correspondence between the ACCC and Baker & McKenzie dated 29 September 2010 indicated that the ACCC had not formed a view about the proposed acquisition of Macquarie Generation. Nonetheless the ACCC adverted to the fact that Macquarie Generation is the largest generator and already has some ability to influence prices. Although there is no new entrant, Macquarie Generation and Delta Coastal are in a position to compete with Eraring and Delta West and, given their independent operation, with each other.

12.141 In his report prepared for the Inquiry, Professor Owen has cautioned that there may be a temptation on the part of the State (which has the power to impose its political (non-commercial) will on the SOCs by a direction under s. 20N of the SOC Act) to impose politically motivated actions on the State generators that may distort the relevant market. He considers there to be a risk that State generators may be directed to absorb some of the carbon price, rather than pass it on in their bid price to the NEM, for non-commercial reasons. This would introduce a non-competitive element into the wholesale generation market. It is too early to say whether the risk foreshadowed by Professor Owen will ensue.

12.142 Prior to the transactions, the SOC generators operated competitively in the NEM. The Inquiry considers there to be some indication that the market is more competitive as a result of the transactions because it is more diversified than previously. However, it is not as competitive as it would have been had there been a new entrant. The circumstance that the State continues to own a substantial part of the State’s generation capacity means that there remains the potential for the market to be affected by non-commercial motives.
The second objective: creating a framework to encourage private sector investment in the electricity sector so as to reduce the need for public investment

12.143 In so far as investment is either required or desirable in the retail electricity sector, it is reasonable to assume that the sale of the retail businesses has created such a framework for private investment to occur.

12.144 Whether the transactions have created a framework which is more conducive to private sector investment in electricity generation is a more difficult question.

12.145 The first question is whether the Government's partial but unsuccessful attempt to sell its whole generation trading capacity makes the market more conducive to such investment.

12.146 There are also some indications from the terms of the bids themselves that the private sector was not deterred from investing in gentrader agreements even if some of the SOC generators retained their generation trading capacity. So much can be inferred from the circumstance that none of the bidders for the gentrader agreements placed a condition on its bid that it would only purchase a gentrader agreement if all gentrader agreements were sold. The Inquiry was, however, told that one bidder was reluctant to bid for a gentrader agreement unless it could be assured that another gentrader agreement (but not necessarily all) were sold. It can reasonably be inferred that the bidder wanted some external market acceptance of the gentrader agreement, rather than that it was concerned with continued SOC control of generation capacity.

12.147 Furthermore, while the upgrade to Unit two was completed before 14 December 2010, Origin has completed the upgrade of Units three and four (turbine only) of Eraring, which has increased its baseload capacity by 120 MW. It has commenced work on upgrading Unit one and four (boiler), which will increase its baseload capacity by a further 120 MW in 2012/2013. It expects that Unit one will be commissioned from January 2012 and Unit four from June 2012. This is the only recent instance in NSW of private sector investment in baseload power generation. This investment is a direct result of the Electricity Transactions.

12.148 The other projects which have been completed since 2010 in NSW are the construction of a wind farm at Gunning with a capacity of 47 MW and an upgrade of a hydro generator in Tumut by Snowy Hydro, which gives a further 300 MW of capacity. There was also a proposal by Woodlawn Wind Power to commission a wind farm by May 2011 with a capacity of 48 MW. These projects provide peaking power, rather than baseload power.

12.149 The Inquiry considers that there is, within the second objective, an unstated premise derived from the Owen Report: that if the Government sells its generation assets, it will encourage the private sector to invest in baseload electricity. In other words, it was thought that it was the State's continued ownership of generation assets (or at least the trading rights) that was effectively deterring private sector investment.

241 According to the 2011 Electricity Statement of Opportunities.
12.150 The Inquiry considers that it can reasonably be inferred from the benefits of vertical integration that the new retailers will ensure that they have sufficient capacity to insulate them from the pool prices in the NEM.

12.151 A document prepared by Treasury in parallel to the Inquiry entitled “Review of Electricity Transactions” sums up the relevant dynamic in the following terms, which the Inquiry accepts:

> It is likely that the sale of the retail businesses has ensured that adequate generation capacity will be available at peak times. The private sector retailers are unlikely to tolerate exposure to pool prices at times of generation shortages as the financial consequences (up to $12,500 per MWh) are too severe. The retailers will therefore ensure that they either own or have access to generating capacity that is adequate to meet their projected customer base.

However, there is no certainty that the generation capacity that they invest in will provide the cheapest possible electricity. In the absence of certainty over both the cost of carbon and the associated risks of being in continued competition with Government, the private sector is likely to invest in cheaper peaking plant in order to manage their risk. The higher discount rates associated with increased uncertainty will inevitably bias decisions towards solutions with lower upfront capital requirements, at the expense of higher marginal running costs. Based on the outcomes of the Owen Inquiry, the Government’s strategy was specifically designed to ensure adequate private sector investment in baseload generation.

12.152 As has been addressed above, there are other, more powerful factors which act to deter long-term investment: the effect of the global financial crisis and the carbon price. These factors may deprive the partial divesting by the State of its generation trading capacity of any real causative effect in encouraging private sector investment, at least in baseload capacity.

12.153 As Professor Owen has observed in his report to the Inquiry, the changes in the pattern of demand since his 2007 report was published indicate that additional investment will be for new peak and intermediate capacity, rather than baseload. The reason for this is that NSW is expected to experience only very minor energy shortfalls over the next decade, which means that there are limited needs for additional baseload generation.

12.154 The circumstances could change markedly, however, if any of the coal-fired power generators are retired earlier than planned which will create opportunities for replacement generation, which, because of the demand created, could be baseload.

12.155 In these circumstances, although the Inquiry is of the tentative view that the Electricity Transactions may have encouraged private sector investment to some extent, the effect may be marginal, particularly in circumstances where the largest generator, Macquarie Generation, is still publicly owned. It is too early to say whether investment by the private sector will be such as to obviate the need for public sector investment. It appears that there is a possibility that the private sector will, because of market uncertainty, continue to invest in peaking capacity, rather than baseload capacity which will have an overall tendency to increase electricity prices in the long-term.
The third objective: ensure NSW homes and businesses continue to be supplied with reliable electricity

12.156 Consumers in NSW are presently supplied with reliable electricity. As referred to above, this is likely to continue to be the case, based on present projections of future demand, until at least 2018-2019, at which point further generation capacity is likely to be required.

12.157 In terms of reliability, if further investment in generation capacity occurs then there will continue to be reliable supply (assuming, as is currently the case, adequate transmission and distribution networks). There is no reason to suppose that the demand for further capacity will not be met. However, for the reasons given above, it is unlikely to be met by baseload electricity (whether coal-fired or gas-fired), at least before 2018.

12.158 According to the IPART Electricity Determination published in June 2011, electricity prices that retailers can charge, increased by between 15.5% and 18.1%. The main reason given was the network and the renewable energy targets. Accordingly, the cost of electricity in the last six months of 2011 is less affordable. However, from the reasons given by IPART, we conclude that the Electricity Transactions did not have a material affect on the price of retail electricity.

The fourth objective: place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt

12.159 There are three aspects to this objective:

a. whether the sales value of public assets was optimised;
b. whether the State’s exposures to electricity market risk was reduced; and
c. whether the State’s public sector debt was reduced.

12.160 There is an assumption in the objective that each of these three matters, if achieved, will place NSW in a stronger financial position. The Inquiry accepts this assumption.\(^2\)

Whether the sales value of public assets was optimised

12.161 Whether the sales value of public assets was optimised depends in part on the time at which the question is asked.

12.162 The Inquiry accepts that, had NSW privatised its generators at an earlier time within the period of the last two decades, it is likely that it would have received greater proceeds. The privatisations of electricity assets in Victoria and South Australia during that period provide some evidence that a delay in privatisation

\(^2\) The Inquiry has taken into account, and been assisted by, the article written by John Pierce, when he was Treasury Secretary, “Fiscal Policy New South Wales Style”, in which the author makes the point that the sale of public assets for more than their retention value is insufficient of itself to strengthen the State’s financial position. What the proceeds are used for is also of fundamental importance. For example, a reduction in operating expenses (due to reduction in interest payable on State debt) can give additional capacity for expenses such as subsidies for infrastructure for public transport. A stronger balance sheet permits the State to borrow accordingly. As has elsewhere been addressed, the State has used some of the proceeds of sale to reduce the debt of Eraring and Delta. It is not yet know for what purpose the balance of the proceeds will be used.
has been to the detriment of NSW in that it has led to a substantial diminution of sale proceeds.

12.163 The Inquiry also accepts that had the proposed legislation to grant long-term leases of the generators been passed the proceeds for the generators would likely have been significantly greater. Further, it is likely that the bidder field would have been larger had the original proposal (long-term lease) been implemented.

12.164 Accordingly, for the purposes of its report, the Inquiry proposes to address whether the sales value of the retail businesses, the gentrader agreements and the development sites was optimised at the time of sale, without regard to any additional proceeds that might have been received from the sale or long-term lease of the generators, or a sale at an earlier time.

12.165 Furthermore, the Inquiry does not know whether a better result could have been achieved if the sale had been deferred for a period after December 2010. However, no inference could be drawn that the proposal to legislate for a carbon price would have produced a better result since, for the reasons given above, market uncertainty about the effect of the proposed carbon price is likely to continue until at least 2018.

12.166 The Inquiry’s view is that the best test of value at a particular point in time, is the price achieved at a well-publicised auction or sale by tender conducted with competitive tension in circumstances where the vendor due diligence has been sufficient to enable prospective purchasers to conduct due diligence on the assets available for sale.

12.167 It follows from the Inquiry’s view of the process conducted, the advice received and the manner of sale, that there is no basis for suggesting that the sale was conducted other than in a way that met the requirements set out above for a competitive sale.

12.168 Furthermore, the Inquiry does not consider that if the sale had been conducted differently (for example by open auction, rather than closed auction, or with a different number of gentrader bundles, or by IPO, or by offering the assets sequentially), a better result in terms of number of assets sold or proceeds received would have been achieved. The overwhelming weight of the evidence supports this view.

12.169 No doubt some bidders who were approached to make offers on the remaining assets after 14 December 2010 were deterred from doing so by the public opprobrium the transactions had (in the Inquiry’s view, unjustifiably) attracted by reason of the resignations of the directors, the proroguing of Parliament and the Legislative Council Inquiry.

12.170 The only asset that was sold in this period was the Bamarang development site, in respect of which there is no basis for suggesting that the sale proceeds were not optimised. The purchaser had initially placed a bid for this asset in the initial round of bids, and further negotiations resulted in a sale.
Whether the State’s exposure to electricity market risk was reduced by the Electricity Transactions

12.171 The State has substantially reduced its exposure to electricity market risk (which was, for the reasons given above, considerable) by selling the retail businesses.

12.172 By divesting itself of the Delta West and Eraring gentraders the State reduced its exposure to electricity market risk. This follows from the Inquiry’s view set out above that although the State has lost its natural hedge (arising from its ownership of generators and retail businesses), it had no real capacity to exploit the benefits of such a hedge, which was, accordingly, of little or no substantive benefit to it.

12.173 The State is still exposed to electricity market risk because of its continued ownership of Macquarie Generation and Delta Coastal, although its overall risk has been reduced by the transactions.

Whether the State has reduced its public sector debt by reason of the Electricity Transactions

12.174 The Inquiry has been advised by Treasury that, as at 14 September 2011, no part of the proceeds of the Electricity Transactions has been used to retire general government debt, but the Crown has retired $450 million of Delta’s, and $700 million of Eraring’s, existing debt from the proceeds. Accordingly, the Inquiry concludes that the State has reduced total state sector debt by reason of the Electricity Transactions.

12.175 Treasury has also advised the Inquiry that the remaining proceeds of the Electricity Transactions have been invested with T-Corp in short-term money market investments with an expected return of 6%, as no decision has yet been made by government as to the long-term use of the remaining proceeds. The 2011-2012 Budget has been prepared on the basis that the remaining proceeds will be used to retire debt.

Conclusions

12.176 For the reasons given above, the Inquiry considers that the Electricity Transactions:

a. have delivered a more competitive retail electricity market in NSW;

b. have the potential to deliver a more competitive wholesale electricity market in NSW, although this will depend in part on the way in which any remaining SOC generators respond to passing on the carbon price, when imposed, to users of electricity;

c. have had the effect of encouraging some level of private investment in the NSW electricity sector, although it is too early to say whether this will be sufficient to obviate the need for public sector investment to meet demand in the future;

d. may not have had a material effect on ensuring that NSW users continue to be supplied with reliable electricity and were not a material cause of the increase in electricity prices which the retailers can now charge; and
e. in so far as they have reduced, but not removed, the Government’s exposure to electricity market risk and reduced the total State sector debt, NSW is in a stronger financial position.
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Evidence and opinions about future options

13.1 The Inquiry sought views from various sources about future options for the electricity sector in NSW. These sources are set out below.

Written submissions

13.2 First, the Inquiry invited written submissions to be made on matters germane to its terms of reference. The invitation was published in newspapers and the Commissioner also issued the invitation at the public hearing on 23 May 2011. As Appendix 6 indicates, written submissions were received from many institutions, companies, SOCs, unions and individuals. The information, data and opinions contained in these written submissions have been of substantial assistance to the Inquiry.

Views sought from witnesses to the Inquiry

13.3 Secondly, the Inquiry sought the view of witnesses who included the following on future options:

a. members and former members of Parliament, including former Ministers;

b. Treasury officials;

c. a senior officer from the Department of Trade and Investment, Regional Infrastructure and Services;

d. a senior officer from the Department of Premier and Cabinet;

e. investment bankers who had been involved in previous electricity privatisations in other jurisdictions in Australia;

f. lawyers who had been involved in previous electricity privatisations in other jurisdictions in Australia;

g. an economist with experience in modelling;

h. representatives from the successful bidders, Origin and TRUenergy;

i. representatives from unsuccessful bidders, including AGL;

j. representatives from interested parties, who did not lodge binding bids;

k. representatives from each of the SOC retailers and generators, including the directors;

l. representatives of NSW unions; and

m. interested academics and consultants.

13.4 The witnesses who gave evidence to the Inquiry were invited, as distinct from required, to express a view about future options. Some of the witnesses, particularly those who were closely involved in the Electricity Transactions, had views about future options which they were prepared to express on the basis that their identity would be kept confidential. The Inquiry considers it to be important to respect that confidence.
13.5 The Inquiry, as Appendices 7 and 8 record, questioned witnesses whose collective knowledge about the electricity wholesale and retail market, network businesses, thermal coal market and electricity generation was comprehensive and impressive.

Assistance provided by the AEMC

13.6 Thirdly, the AEMC is obliged to pursue the National Electricity Objective, which is, as stated in the National Electricity Law: to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to:

a. price, quality, safety, reliability, and security of supply of electricity; and

b. the reliability, safety and security of the national electricity system.

13.7 Because of its objectives and its capacity to monitor the NEM, the AEMC was asked to provide its views to the Inquiry on future options, including whether the network businesses ought be privatised. The AEMC did so and its Chair and two of its Commissioners conferred with the Inquiry to address the views that it had provided.

Experts retained by the Inquiry

13.8 Fourthly, the Inquiry engaged Professor Owen and Mr Challen as consultants to the Inquiry. Their retainers included a request that they express an opinion about future options. Professor Owen was selected for this purpose because his 2007 Report was the basis on which the Government proceeded with the Electricity Transactions. As the author of the 2007 report, he is pre-eminently suitable to opine on what should occur now that some assets have been sold and others remain in Government hands.

13.9 Mr Challen was principally selected for his expertise which qualified him to express an opinion on terms of reference three and four. The Inquiry considers that his lengthy experience in Government, his work as an economist and his knowledge of governance of State owned corporations amply qualifies him to express a view about future options.

Experts invited by the Inquiry to express their views on an honorary basis

13.10 In addition to the sources referred to above, the Inquiry invited a number of experts to opine on future options in an honorary capacity. Several persons accepted the Inquiry’s invitation and their considerable assistance to the Inquiry in providing written reports setting out their views is acknowledged and appreciated.

13.11 The Inquiry received short reports on future options from the following:

a. Kate Farrar, Managing Director of QEnergy, which is a Queensland-owned and operated electricity retailer, which, in partnership with Arcadia Energy Pty Limited operates in the NEM;

b. Professor Hugh Outhred, Professorial Visiting Fellow in Energy Systems with the School of Electrical Engineering and Telecommunications, University of New South Wales; and
c. Greg Houston, director of Nera Economic Consulting, is an economist with over 25 years experience in the economic analysis of markets. He has been a member of the Expert Panel to advise the Ministerial Council on Energy on achieving harmonisation of the approach to the regulation of electricity and gas transmission and distribution infrastructure in Australia.

**The parameters set**

13.12 The experts were asked to give their opinions on the following future options, and also to identify any further options which were not included in the following list:

a. do nothing and maintain the status quo (Status quo option);

b. retain Macquarie Generation and Delta Coastal for the purpose of running them down and decommissioning them as generators (Run-down option);

c. undo the transactions (with or without legislation) (Unravel option);

d. continue with the sale process undertaken as part of the Energy Reform Project and:
   
i. offer for sale the trading rights associated with Macquarie Generation and Delta Coastal; and
   
ii. offer for sale each of the remaining development sites (Bayswater B, Munmorah and Tomago) for sale (Complete the Energy Reform Project option);

e. endeavour to renegotiate the generating agreements to reallocate risk (Renegotiation option);

f. sell the generators owned by Macquarie Generation and Delta Coastal (Partial generator/ trading option);

g. sell all the generators, including Delta West and Eraring (Generator option);

h. sell Cobbora coal mine (Cobbora option); and

i. sell the transmission and distribution network (Network businesses option).

13.13 The experts were informed that the options are not true alternatives, since there would appear to be no reason why, for example, the development sites could not be sold, even if the other options were not selected. Furthermore, if it were thought beneficial to sell the transmission and distribution network, this could occur in tandem with other options. The same can be said of the Cobbora option.

13.14 The experts were also told that the terms of reference oblige the Inquiry to consider the following objectives when reporting on future options: a competitive electricity sector including competitive prices and reliability of supply. Their opinion was sought on options which satisfy these objectives. However, the Inquiry considers there to be several other objectives which may
be relevant to future options, some of which include those adopted by the previous Government.

13.15 As indicated in Chapter 12, the previous Government's objectives were:

a. deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;

b. create an industry and commercial framework and environment to encourage private investment into the NSW electricity sector reducing the need for future public sector investment in retail and generation;

c. ensure NSW homes and businesses continue to be supplied with reliable electricity; and

d. place NSW in a strong financial position by optimising the sale value of public assets and reducing the Government's exposure to electricity market risk and reducing the State's public sector debt.

13.16 The Inquiry suggested to the experts from whom it received assistance the following further objectives which might be relevant to future options:

a. minimising post sale residual risk and liabilities to the Government;

b. maximising the likelihood of private sector investment in new generation capacity;

c. reducing emissions generally or to a particular level; and/or

d. encouraging renewable energy sources.

13.17 The reason the Inquiry drew the experts' attention to objectives in addition to those included in the terms of reference is it considers the choice and articulation of objectives to be a highly significant matter in the selection of future options. Indeed the objectives chosen determine, to some extent, the range of future options.

13.18 When it appreciated that the objectives contained in the terms of reference were likely to be more limited than those which would inform the Government in its deliberations concerning future options, the Inquiry met with the then Acting Secretary of the Treasury and the Director-General of the Department of Premier and Cabinet and, through them, invited the Government to stipulate additional objectives. The Inquiry was informed that no additional objectives would be provided. However, the Inquiry's assurance was sought that it did not consider itself limited to those objectives in the terms of reference. The Inquiry gave that assurance.

13.19 The Inquiry was, however, provided with a document, which the then Opposition used as part of its campaign for the March 2011 election, together with an accompanying press release dated 20 February 2011. The document, entitled "Plan for an Affordable & Sustainable Energy Industry" is dated February 2011.
13.20 The document contains the then Opposition's election promises including that the transmission and distribution networks will stay in public hands. It does not contain any statement of objectives, although there is comment concerning increases in electricity prices and promises for rebates for families and low income households. It proposed, against the background of continued public ownership of the network businesses, that the existing three distributors be merged into two: a metropolitan and regional electricity distribution network.

The range of options

13.21 As set out above, the Inquiry identified a range of options for the consideration of experts. The Inquiry proposes to set out the consequences of those options, followed by its view as to whether the option ought be implemented.

The status quo option

13.22 The assets that were sold comprise the three retail businesses, the Delta West and Eraring gentrader agreements and the Marulan, Mt Piper Extension and Bamarang development sites. The assets that remain unsold are Macquarie Generation and Delta Coastal gentrader rights, and the Bayswater B, Munmorah and Tomago development sites.

13.23 The status quo has two principal features, both of which are potentially unsatisfactory:

a. in respect of Eraring and Delta West, the State continues to own the generators and is party to gentrader agreements with Origin and TRUenergy respectively; and

b. in respect of Macquarie Generation and Delta Coastal, the State continues to own not only the generators but all the rights to trade the capacity of the generators.

13.24 To leave the status quo undisturbed has several significant consequences.

13.25 First, it entrenches the gentrader agreements which, as the Inquiry has concluded in the previous chapters, do not maximise the value of the generation capacity of the generators and give rise to the prospect of disputes as to their long term operation. The disadvantages of the gentrader model have already been addressed in this report.

13.26 Secondly, the State's continued ownership of Delta Coastal is problematic because Delta is presently operating the generator function and the trading function of Delta Coastal, but only the generator function of Delta West. Because it must generate the amount of electricity required by TRUenergy in respect of its Delta West generator, it is privy to information that would, if it were known to the operators of the trading function of Delta Coastal, be beneficial. In order to avoid any sharing of such knowledge, it is necessary for there to be Chinese walls between Delta West and Delta Coastal.

13.27 Thirdly, while Delta as a whole could conduct its generation business effectively and manage the risk to which it was exposed, including by entering into hedge contracts, the risk is increased for Delta Coastal since its size makes it more vulnerable to outages.
When Delta West and Delta Coastal operated as one, an outage at Mt Piper or Wallerawang (Delta West's power stations) could be covered by capacity from Vales Point or Munmorah (Delta Coastal's power stations). However, as a result of the transactions, Delta Coastal no longer has access to the capacity of the Delta West generators.

Of the two Delta Coastal power stations, Vales Point is the only one that is presently operational. Munmorah, which is due to be de-commissioned in 2014, consists of 4 x 300 MW units which were commissioned in the late 1960's. Units one and two were retired from service in around 1990 and Delta Coastal has been operating the remaining two units for relatively short periods of time at a reduced capacity. The costs of the standby capacity have resulted in Delta Coastal placing both units into storage.

Delta Coastal may be a useful adjunct to a retailer wanting increased access to generation capacity for the purposes of vertical integration. To require it to continue in its current form would be to consign it to compromised operation.

Fourthly, the status quo entrenches an asymmetrical market, in that part of the generation capacity is controlled by the private sector, but most of it is still owned and controlled by the State.

If Macquarie Generation and, to a lesser extent, Delta Coastal remain in State ownership this may not further the objective of a competitive market since SOCs may operate in a non-commercial way which does not further competition and may prove to be, as Professor Owen found that it was, a disincentive for private sector investment in generation, and particularly baseload generation.

If Macquarie Generation and Delta Coastal remain in State hands, then it will be the Government's decision whether they ought be decommissioned before the end of their technical lives with a view to diminishing greenhouse gas emissions to which they make a substantial contribution.

The Inquiry's view

It will be apparent from the above discussion of the consequences of the status quo that the Inquiry does not consider that the objectives of a competitive electricity market or reliability of supply are advanced by continued State ownership of more than half of the State's generation capacity or by the continuation of the gentrader agreements.

A competitive market requires price signals to be reliable indicators but Government's access to capital at a lower cost and preparedness to act for non-commercial reasons means that price signals sent by Government owned businesses may be misleading. For example, in a competitive market, a generator's efficient bid to the NEM represents the minimum price it is willing to receive in order to generate over the relevant time period and is equivalent to its variable costs, associated with fuel and other operating costs. However, as Professor Owen has warned, if a SOC generator absorbs the carbon price for non-commercial reasons to keep the price of electricity down, then its bid will not reflect its variable costs. This factor means that the presence of SOC
generators in a market where, as here, there are private sector generators makes the market less competitive.

13.36 Further, the private sector's concern that the State might act non-commercially has a tendency to discourage investment in generation. Ultimately, long term reliability of electricity supply depends on the private sector being prepared to invest in generation.

**Run-down option**

13.37 Presently, Bayswater and Liddell, the two generators owned by Macquarie Generation, have the lowest variable costs and the greatest capacity of any generation source in NSW. They supply a substantial proportion of the State's demand for baseload electricity. Vales Point and Munmorah, operated by Delta Coastal, have a higher variable cost than the Macquarie Generation generators but they, too, provide baseload electricity at a price that is less than the price at which gas-fired electricity generation is supplied to the NEM. If the demand can be met at any given point by coal-fired power generators then the spot price will reflect the lower variable cost, rather than the higher price which reflects the variable price of the gas-fired power generators.

13.38 There is, therefore, a significant potential disadvantage in running down Macquarie Generation or Delta Coastal before further baseload generation has been constructed to supply the demand which would be left unfulfilled were their combined capacity no longer available in the NEM.

13.39 The advantages of decommissioning relate principally to the reduction in greenhouse gas emissions which could be effected if the Macquarie Generation and Delta Coastal generators were no longer operational.

13.40 The Commonwealth Government, in its *Securing a clean energy future: the Australian Government's climate change plan* has indicated that up to 2,000 MW of generation will be invited to tender for closure by 2020. According to the 2011 Electricity Statement of Opportunities, the arrangement is to be negotiated during 2011-2012 and will take into account AEMO's views on energy security. The Commonwealth Government expects the closures to occur in the second half of the decade.

13.41 As coal-fired power generators, Macquarie Generation and Delta Coastal would both be eligible for tender. At Bayswater, Macquarie Generation has four units of 660 MW capacity each; at Liddell, it has four units of 500 MW capacity each. Delta Coastal operates Munmorah which has two units at 300 MW each (and will be decommissioned in any event in 2014) and two units at Vales Point of 660 MW each.

13.42 On the assumption that the Commonwealth would pay just compensation, which is principally measured by reference to market value, for such closure, there may be a fiscal benefit in such a course, particularly if no buyer can otherwise be found for the generators. However, much will depend on whether the electricity needs of NSW can be met by other, less greenhouse gas intensive, generators.
13.43 If the Government considered that reduction of greenhouse gases was an important objective, then it could put in a tender for closure of part of Macquarie Generation or the whole of Delta Coastal. That said, it is likely that the Commonwealth Government will prefer to pay for closure of one of the Victorian coal-fired power generators since they are fired by brown coal, which produces significantly more greenhouse gas emissions than does the black coal which fuels generators in NSW.

13.44 The option of tender for closure is included for completeness. Although it may fulfil the objective in the terms of reference of making the electricity market more competitive, since it would remove the SOC generators from the market, it may be detrimental to the objective of reliability of supply, because of the present contributions these generators make to the supply of electricity in NSW. It would also mean that the demand in NSW is likely to be filled by more expensive sources of generation than coal-fired generators and would, accordingly, have a tendency to increase electricity prices.

The unravelling option

The arguments for and against unravelling

13.45 Before the relative benefits and detriments of unravelling are considered by reference to particular transactions, it is important to specify what would be required to unravel the transactions. The State and its SOCs entered into legally binding agreements with third parties to sell the three retail businesses and some of the development sites and entered into gentrader agreements. It also caused a State owned entity to enter into a coal supply agreement with Origin for the supply of coal to the Eraring power stations. The agreements required the payment of substantial sums to the State, which have been received. Some of the proceeds have already been allocated by the Government to the repayment of debt of Eraring and Delta; the balance awaits further allocation. No contractual grounds have been shown which could justify the setting aside of the agreements.

13.46 Were the Government to unravel the agreements by legislation, this would almost certainly undermine future investment in the State generally and substantially damage the reputation of NSW. The private sector deals with Government on the basis that legally binding agreements entered into will continue to be honoured by successive Governments.

13.47 In addition, it would, as a matter of practical reality, be required to pay compensation to all purchasers of retail businesses, gentrader agreements and development sites.

13.48 It is against this background that the option of unravelling needs to be considered. Because of these matters, which affect not only the State’s potential liability for damages for breach of contract, but also its reputation for sovereign risk, the unravelling option does not involve the same balancing exercise as was required when the decision to privatise was made.

13.49 A decision to privatise involves a comparison between the benefits of State ownership of assets and the benefits of private sector ownership. But once
partial privatisation has been effected the question whether privatisation was a prudent and appropriate course for NSW has less force.

13.50 The real question is whether the disadvantages of unravelling, which the Inquiry finds to be considerable, are outweighed by the potential advantages of returning to the position the State electricity sector was in prior to the Electricity Transactions. In these circumstances there is no utility in unravelling unless one could be satisfied either that the electricity sector should not be privatised at all or that it would be beneficial for the State to be able to start again with the process of privatisation.

The Inquiry's view

13.51 The Inquiry has considered the written submissions to the effect that the electricity sector ought not be privatised. The Inquiry finds that it is consistent with a competitive electricity market that the retail businesses and wholesale generation businesses be privatised. It accepts that the recommendations made by Professor Owen in his 2007 report were well-founded. Furthermore, the detriments of unravelling are very considerable and would expose the State to substantial financial risk and risk to its reputation.

13.52 As appears in Chapter 12, the Inquiry has found that the sale process is not deserving of criticism. One does not and cannot know whether a better result would be achieved were the privatisation to be implemented now rather than when it was sought to be implemented by the previous Government.

13.53 As addressed in Chapter 12, the three retail businesses were sold at well in excess of their retention value and their sale has resulted in a more competitive retail market for electricity and meant that the State is no longer subject to the risks associated with the retail electricity market.

13.54 The development sites were also sold for a price in excess of their retention value, measured by reference to their book values. Furthermore, it would be inconsistent with a policy to encourage private investment in electricity generation for the State to unravel the sale of development sites, unless it has a firm intention to develop them itself.

13.55 The only part of the transaction in respect of which an argument could be made for unravelling are the gentrader agreements. The reasons for unravelling them are the same reasons they were always a second-best option to selling or granting a long-term lease of the generators, which have been addressed in Chapters 5 and 12.

13.56 Although unravelling the gentrader agreements would eradicate the asymmetry in the market, it would not enhance the objective of a competitive electricity market.

13.57 In light of the detriments that would arise from unravelling which are set out above, the Inquiry is not of the view that the gentrader agreements, ought be unravelled.
Complete the Energy Reform Project option

13.58 This option involves continuing with the sale process undertaken as part of the Energy Reform Project and offering the gentrading rights associated with Macquarie Generation and Delta Coastal and offering each of the remaining development sites, Bayswater B, Munmorah and Tomago, for sale.

13.59 The Inquiry can see no reason why the remaining development sites cannot continue to be offered for sale.

13.60 The advantage of the option that the gentrader rights associated with Macquarie Generation and Delta Coastal be sold is that it will not require legislative support. If gentrader agreements for Macquarie Generation and Delta Coastal are entered into, then the market will no longer be as asymmetrical since all of the generation capacity will be controlled by the private sector. Although the State will continue to own the generators, its exposure to financial risk will not be related to the spot price of electricity in the NEM, for the reasons given in Chapter 12.

13.61 The disadvantages of the option are that its probable effect is to reduce the possibility of there being a new entrant into the wholesale generation market. As has been addressed in Chapters 5 and 12, one of the principal disadvantages of the gentrader model is that it is unlikely to attract a portfolio generator into the market, since such generators prefer to own the power stations themselves. Therefore, for the State to adopt this option would be likely to reduce the prospect of attracting a new entrant.

13.62 There is a substantial risk that if the gentrader agreements for Macquarie Generation and Delta Coastal are offered for sale, the only bidders will be incumbent electricity retailers. In these circumstances, the ACCC may have no real option but to grant merger clearance, in the absence of a realistic counterfactual, that is, another bidder in the market whose bid, if accepted, would lead to a better market outcome. Therefore, there is a real prospect that the gains in competition that the Inquiry considers to have been achieved by the Electricity Transactions could be lost, at least partially, if the gentrader agreements are offered for sale.

13.63 Sale of the trading rights associated with Macquarie Generation and Delta Coastal to an incumbent would also be at odds with the objective of a competitive electricity sector, including competitive prices and reliability of supply.

The Inquiry’s view

13.64 Given the manifest disadvantages of the gentrader model, the Inquiry’s view is that the State ought not persevere with the gentrader option in relation to Macquarie Generation and Delta Coastal.

13.65 Much will depend on whether the State can enact legislation to effect the sale or long-term lease of the generators. On the assumption that legislation will be passed, then the option of selling the gentrader rights associated with Macquarie Generation and Delta Coastal ought not be preferred.
Renegotiation option

13.66 The consensus before the Inquiry and the Inquiry's view is that the gentrader model is suboptimal. Accordingly, any option that requires its continued operation is not favoured by the Inquiry.

Partial generator/ gentrader option

13.67 This option involves the State selling the generators owned by Macquarie Generation and Delta Coastal and retaining the generators owned by Eraring and Delta West.

13.68 It is possible that this option will transpire in any event if the following option, the generator option, is not successfully implemented. However, for the reasons which are expressed above, the Inquiry does not consider there to be any good purpose to be served by the State continuing to own generation assets in NSW. Accordingly, the Inquiry prefers the generator option, dealt with below over the partial generator/ gentrader option.

Generator option

13.69 This option involves the State offering for sale or long term lease:

a. the Macquarie Generation and Delta Coastal generators as generators; and

b. the Eraring and Delta West generators, which are subject to gentrading agreements.

13.70 Most of those whose opinion was requested and given expressed the view that the generators of Macquarie Generation and Delta Coastal should be sold and that the Eraring and Delta West generators, which are subject to gentrading agreements should be sold. In other words, the overwhelming consensus was that what the then Government proposed to do by legislation in 2008, ought be effected in the future.

The Inquiry's view

13.71 The Inquiry accepts the force of Professor Owen's 2007 report: namely that the best way of encouraging private investment in baseload electricity generation in NSW is for the State to divest itself of its generators, either by sale or long-term lease. Although intervening events, including the global financial crisis, the resultant slowing in demand for electricity and the introduction of the carbon price has postponed the date when such investment will be required, the basic premise remains good.

13.72 The Inquiry does not propose to address the detail of any implementation of the options which it has outlined in this chapter. Such implementation ought properly be the subject of expert advice at the time at which the option is sought to be implemented.

The Cobbora option

13.73 The Inquiry agrees with the consensus view that Cobbora ought be sold, if possible. Its development and operation by the State was, as the history narrated in Chapter 8 shows, not the preferred option but one that was taken
because the alternatives at the time were regarded as being less favourable to the public interest.

13.74 As discussed in Chapter 8, a business plan is being prepared for the development of Cobbora.

13.75 Because of the imminence of the delivery date for coal from Cobbora (July 2015) it is important that the desire to sell the resource does not impede its timely development. If the coal supply agreements with Cobbora Holding Company Pty Limited could not be performed in accordance with their terms, the State would be exposed to a liability in damages to Origin, and the cost of otherwise meeting the demand for coal of the SOC generators, Macquarie Generation and Delta Coastal, in the period of default.

13.76 The Inquiry accepts the evidence before it that there is presently adequate time for the development of Cobbora such that the Cobbora Holding Company Pty Limited will not be in default of the coal supply agreements.

The network businesses option

13.77 The transmission and distribution networks are natural monopolies since they are not subject to the constraints of competition. They do not affect competition in retail or wholesale generation markets.

13.78 The transmission and distribution networks affect the ultimate price of electricity, since their cost is incorporated by retailers into electricity prices. Such costs comprise a significant component of electricity bills. The December 2010 report of the NSW Electricity and Prices Inquiry chaired by Dr Tom Parry and Mark Duffy (the Parry Duffy Report) described the network as being "the biggest driver" of increases in electricity prices in NSW.243

13.79 The Parry Duffy Report found that costs associated with the distribution networks accounted for 40% of the average residential bill for consumers in NSW in 2010/11, while costs associated with the transmission networks were responsible for 8%.244 The Parry Duffy Report also stated that the distribution-related bill fraction was expected to rise to about 44% by 2012/13.245

13.80 Similarly, the Garnaut Climate Change Review Update 2011 titled “Transforming the electricity sector” found that network costs (transmission and distribution) in the NEM have risen dramatically since 2006, and that the high cost of capital investment required in electricity networks is the largest single cause of recent electricity price rises.246 Network prices are also expected to account for a significant portion of the increase in electricity prices in NSW in coming years.247

13.81 The question whether the network businesses ought be privatised caused the most significant division in views between the witnesses and others who expressed an opinion to the Inquiry.

244 The Parry Duffy Report, p. 12.
245 The Parry Duffy Report, p. 12.
246 Garnaut Climate Change Review, Update Paper eight: Transforming the electricity sector, 2011, p. 11.
The objectives

13.82 In order to consider whether an asset should be sold or not, objectives need to be articulated and, if more than one, given weight and ranking. Possible objectives relate to:

a. securing funds for use in other public enterprises (the fiscal objective);

b. encouraging private investment so as to reduce the need for public sector investment;

c. ensuring the reliable delivery of electricity; and

d. minimising the price of electricity including by ensuring the efficient operations of the network businesses (the price objective).

13.83 If the price objective is dominant questions arise whether the electricity and services currently provided by the transmission and distribution networks could be provided by the private sector at a lower cost than the cost at which they are presently provided, and, if so, whether the efficiencies will lead to a lower electricity price. Because it was not part of the previous Government's policy to privatise the network businesses, there is, as far as the Inquiry is aware, no Government analysis of the likely effect of such privatisation on the price of electricity. Nonetheless, there is considerable concern about the contribution made by the cost of the network businesses to the price of electricity.

13.84 If, however, the fiscal objective is dominant, then it may not matter whether the price of electricity will be reduced as a result of privatisation of transmission and distribution networks, since the public purpose to be fulfilled by the use of proceeds may be of greater concern and accorded greater priority.

How the revenue of network businesses is determined

13.85 The network businesses are regulated. Every five years the AER, the regulator, assesses the capital programmes and operating costs of each network business and determines the Weighted Average Cost of Capital (WCC). It then determines how much revenue the network businesses are permitted to collect from their customers over the ensuing five years. In addition to revenue determinations, the AER also assesses the proposals of network businesses on prudent discount applications, cost pass-throughs, revenue re-openers and contingent projects.

13.86 Although the AER determines the prices that the networking businesses can charge customers, the prices are influenced by management decisions made by the various network businesses and the efficiency of their capital expenditure. One witness told the Inquiry that the regulatory environment effectively encourages over-investment in capital because if the network business can persuade the AER that the capital investment is necessary for reasons of reliability and capital growth, the increased costs associated with it will be reflected in the charges that the business is permitted to levy.

13.87 This means that since customers in a particular area do not have a choice of network businesses, which makes them natural monopolies, the price paid by the customers reflects in part choices which the network businesses have made
about capital investment. If the businesses overspend on capital, this cost can, with the approval of the AER, be passed through to customers.

13.88 The AER considers itself to be compromised in its ability to set prices based on an objective assessment of the efficiency or the necessity of the expenditure proposed by electricity businesses. On 29 September 2011, it submitted a rule change proposal to the AEMC with a view to its being in a better position to make a more effective assessment of the costs proposed by the network businesses.

Whether a useful comparison can be made between publicly and privately owned network businesses

13.89 Within the NEM, the network businesses in NSW, Tasmania and Queensland are publicly owned. The network businesses in Victoria and South Australia have been privatised.

13.90 There are no uniform benchmarks which would enable a ready assessment to be made of the relative efficiencies of network businesses by reference to whether they are publicly or privately owned. This is, in part, because of the different ways in which such businesses are run and assessed, and in part because the reliability standards which govern the network businesses are determined by the respective States and are not standard throughout the NEM. A higher reliability standard will tend to increase the cost of supply of electricity and therefore cost is not the determinant of efficiency because the applicable standard may be different from that of the comparator.

13.91 The AER is currently developing the information needed to undertake such benchmarking in the context of revenue determinations.

13.92 There is considerable data, but no consensus on its effect, on the relative efficiencies of various network businesses throughout the NEM. Although it would have been of assistance to the Inquiry to have reliable comparisons between network businesses, the difficulties in making adjustments for the different operating environments for such businesses have meant that the task of devising reliable comparisons, even if potentially achievable has been beyond the timeframe of this Inquiry.

The evidence and submissions received

13.93 The Inquiry received a significant amount of evidence both oral and written and submissions in relation to future options regarding the NSW transmission and distribution networks. Much of the evidence and submissions came from persons with lengthy experience in the electricity sector, including directors and senior executives of industry participants and also the Energy Users Association of Australia.

13.94 Much of the evidence and submissions favoured the State exiting the ownership and operation of the State owned transmission and network businesses by selling the businesses to the private sector. The following arguments were advanced in favour of this option:

a. there are direct financial benefits from the sale of the network businesses;
b. the private sector is more efficient;

c. the State should not do things that the private sector is able to do; and

d. it is undesirable that the State occupy a position of market regulator and market participant.

13.95 The strengths and weakness of these arguments are addressed in more detail below.

13.96 Although there were experts and witnesses who were either in favour of, or against, privatisation of the network businesses, there were also several who saw no relevant benefit or detriment from the potential sale of such businesses, given their status as a highly regulated natural monopoly. The AEMC itself has no objections to privatisation of network businesses. It considers that electricity customers are no worse off, and may potentially be better off, as a result of such privatisation.

**The arguments in favour of a sale of the NSW transmission and distribution networks**

*Potential direct financial benefits from sale of network businesses*

13.97 Full privatisation of the transmission and distribution networks would enable the Government to significantly reduce its net financial liabilities and thus its net debt levels and could be used to fund infrastructure projects. It would also mean that the State would not have to fund future investment in the network businesses.

13.98 In addition to retiring State debt, the proceeds from the sale of the network businesses could be used to improve infrastructure in areas that need to be publicly funded because they cannot be run commercially, such as public transport and basic health care.

13.99 The price that might be received by the State should some or all of the network businesses be sold depends on a number of variables, including prevailing market conditions.

13.100 The sale proceeds were described by one witness as involving billions of dollars. In its submission to the Inquiry, Infrastructure Partnerships Australia, the nation’s peak infrastructure body, valued the NSW transmission and distribution networks as worth between $29.2 and $34.5 billion.

13.101 The Inquiry understands from Treasury that the network businesses are currently carrying approximately $15 billion in debt.

13.102 The weight to be attributed to the expected fiscal benefits arising from privatisation of the network businesses is a matter for Government policy. In the Inquiry’s view it would be open to Government to take the view that such fiscal and policy considerations justify the privatisation of the network businesses, in the event that the price bid by investors exceeds the retention value of the network businesses.
13.103 The Inquiry received evidence that there would probably be a significant demand from private purchasers, including superannuation funds for the transmission and distribution networks. The economic factors which have led to a diminished demand for investment in generation do not apply to assets, such as the network businesses, which are low risk and have a regulated return:

*Efficiency of the private sector*

13.104 A significant number of witnesses, including industry and financial experts, contended that the network businesses could be managed and operated more efficiently by the private sector and that this would lead to reduced electricity prices. The connection between efficient management and charges allowed to be made has already been addressed.

13.105 As discussed in Chapter 2, the Industry Commission, in its 1991 report on energy sector reform, identified the following key disciplines that apply to the private, but not the public, sector:

a. the ability of private shareholders to trade in the equity capital of the enterprise;

b. the requirement to compete for debt capital on commercial terms;

c. the exposure of investment and/or borrowing programs to continual monitoring by the capital and share markets;

d. the sanctions of takeover or merger for inferior performance arising from, say, the underutilisation of capital; and

e. the risk of insolvency.\(^{248}\)

13.106 The AEMC considered that the matters referred to above, and in particular the second, provide a strong basis for considering that privatisation of the network businesses would lead to a more efficient use of capital. It explained to the Inquiry that the public sector is relevantly concerned with the reliability of the networks and is relatively unconstrained in its use of capital for investment. The Government has access to cheaper capital because of its unique capacity to raise money through taxation. According to the AEMC this means that the Government will tend to spend more on capital investment since it does not place the same value on capital as its private counterparts and it is not as influenced by the returns on capital. Its focus and interest tends to be the delivery of services to electricity consumers. If the dividends to the State are reduced, then it is unlikely that there will be any immediate or quick response.

13.107 Therefore the expenditure on capital investment will continue and the public pays for it in two ways: through taxes that subsidise the cheaper cost of capital and through electricity prices since the cost of the networks is a major component in the price of electricity. In addition, the Inquiry was told by a witness from one of the SOC network businesses that there are cultural and institutional impediments that exist in publicly owned corporations that resist management attempts to improve the productivity of these organisations. Attention was drawn by one witness to the culture of union shadow management that acts as a strong retardant on the SOC’s ability to prosecute

effective efficiency and prudence. The Inquiry is not in a position to assess the reliability of such evidence and prefers to be guided by the fundamental differences in structure and incentives to which the AEMC has drawn its attention which are referred to in the text of this chapter.

13.108 The incentives that affect private sector investment are substantially different. Without Government’s unique ability to raise taxes to increase revenue, the private sector is subject to greater pressures to use capital efficiently. The management of network businesses which are privately-owned are affected by incentives which incline them to make their operating and capital expenditure more efficient, so that they can deliver a better return to shareholders. Private shareholders, if they are dissatisfied with the board, can change the composition of the board or sell their shares, which may affect the share price. One witness told the Inquiry of an incentive that is paid in Victoria (whose network businesses are fully privatised) to maintenance employees if the distribution runs all summer during peak demand periods without interruption.

13.109 Proponents of privatisation point to the potential for overinvestment of infrastructure by State owned network businesses, which derives from the different incentives referred to above. The Garnaut Climate Change Review Update 2011 described this concern as follows:

For state owned network service providers, there is an unfortunate confluence of incentives that may be leading to significant over investment and gold platting of network infrastructure. ... state government owners may have an incentive to over invest because of the low cost of borrowing and tax allowance arrangements. In addition, political concerns about reliability of the network, about the ramifications of any failures, may further reinforce these incentives.

The existing financial incentives for state owned network providers to over invest coupled with the political cost of any failure in the network managed by a state owned company, have the potential to overwhelm any countervailing incentives to minimise operational costs.

The comparison of costs between Victoria, where the network providers are in private hands, and New South Wales and Queensland, where the network providers are in state hands, is at the very least a compelling piece of evidence to support this contention. While there are likely to be genuine differences between the states that explain some of these divergences, it is unlikely that these differences explain the majority of these divergences.269

13.110 A number of witnesses and experts before the Inquiry also pointed to the Victorian experience as providing support for the future privatisation of the network businesses in NSW.

13.111 In a report dated May 2011, Australia’s Rising Electricity Prices and Declining Productivity: the Contribution of its Electricity Distributors (for the Energy Users Association of Australia) (the EUAA Report) Bruce Mountain pointed to the significant inefficiencies arising from over-investment by government owned distributors and recommended privatisation.

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13.112 The EUAA Report found that rising electricity prices in NSW and Queensland were attributable to rising inefficiency from over-investment and inefficient operation, particularly in respect of government owned distributors. It said:

- Distributors have incentives to over-invest because they are being allowed an excessive rate of return. This is particularly true for government-owned distributors since they have access to inexpensive state government funds, and these governments collect the dividends and income taxes on their distributors’ profits;

- The regulatory arrangement puts the AER at a disadvantage in eliminating inefficient expenditure because the onus of proof lies with the AER to prove that distributors have not proposed efficient expenditure, rather than with the distributors to prove to the AER that they have. This reverses the arrangement that applied when the jurisdictions regulated their distributors.

- The arrangements for appeal of AER decisions allow distributors to cherry-pick the decisions. Distributors have been able to obtain significantly higher prices as a result of appeals.

- The assets of government-owned distributors are valued nearly twice as highly per kilometre of network as those of privately-owned distributors.\(^{250}\)

13.113 The EUAA Report relied on research undertaken by Bruce Mountain and Stephen Littlechild in 2010\(^{251}\) as to the effect of government ownership of network businesses. A key aspect of that research was summarised in the EUAA Report as follows:

Ownership

Mountain and Littlechild (2010) suggested that a government that is also an investor, as the owner of a regulated company, and as the recipient of its tax revenues, has an additional (financial) interest in the profitability of that company. It is more receptive to a regulatory framework that continues to provide such revenue streams. It also has a financial interest in limiting the extent of regulatory power and discretion and how this is exercised, especially with respect to the severity of the price control.

If distributors are able to obtain profits above their cost of capital by expanding their regulated asset base, they can be expected to want to do this. Government-owned distributors have access to inexpensive capital through their state treasuries, and in addition these treasuries receive the dividends and the income tax on the profits that the distributors deliver. This provides a powerful incentive for government-owned distributors to favour an expansion of their regulated assets. Indeed, the NSW Treasury attributed the rapid growth in dividends and income tax from its distributors, to the rapid growth of their regulated assets.\(^{252}\)

13.114 The report to the Inquiry by Greg Houston of NERA Economic Consulting (the NERA report) considered that the comprehensive regulatory rules put in place by the AEMC, and administered by the AER, are capable of addressing any


\(^{252}\) The EUAA Report, p. vii.
public interest concerns arising from the monopolistic nature of the businesses. The NERA report found that:

Government ownership is simply not necessary to ensure ongoing security of supply or to promote the long term interests of consumers.

13.115 The NERA report also concluded that privatisation of the network businesses would offer potential benefits, in particular a sharper incentive to focus on maximising shareholder benefit by pursuing efficiency gains. Further, any such efficient gains would ultimately be shared with consumers in the form of reduced electricity prices. The NERA report stated:

...it follows that there is a strong ‘in principle’ reason to expect that privatisation will lead to lower prices for end customers of the poles and wires businesses than would otherwise be the case.

... There is little if any downside risk to consumers, since the well developed regulatory frameworks have been designed specifically to protect their long term interests. Indeed, this same framework is currently applied to privately owned networks in Victoria and South Australia. Moreover, there are conspicuous potential benefits arising from the greater incentives that private enterprises have to pursue efficiency improvements, which can ultimately be expected to translate into lower prices for customers.

13.116 The NERA report acknowledged that robust empirical evidence of the benefits of private ownership of electricity network businesses is difficult to come by:

Some assessments have been made of the performance of Victorian distribution businesses following their privatisation in the mid- to late-1990s. For example, in its latest revenue determination for the Victorian distributors the AER suggested that their operating and capital cost performance compared favourably to their publicly owned counterparts, including the NSW businesses. In 2001, Access Economics also prepared a report for TXU in which it concluded that:

“The bottom line is that privatisation has brought substantial benefits over the past decade to the energy sector, Victorian consumers, the state budget and the wider economy. While there are natural monopoly elements, the regulatory system balances consumer and private interests.”

13.117 In his expert report for the Inquiry, Professor Owen similarly pointed to the difficulties in comparing (or ‘benchmarking’) the experience of the network businesses in different states:

In Australia, the networks are vastly different with regard to both geographical factors and operating environments, which bring into question the precision of any benchmarking exercise. For example, whilst a number of studies have been produced that compare network costs in NSW with those in Victoria (and selected overseas networks), the conclusions tend to be rather vague and lacking in conviction.

13.118 In addition, the NERA report did not point to any compelling empirical evidence suggesting that privatisation of the Victorian network businesses had been

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detrimental in terms of efficiency performance or detrimental to electricity customers.

13.119 However, in respect of the transmission network, the Inquiry received documentary material from TransGrid which TransGrid said supported the view that TransGrid’s operating efficiency and service levels compared favourably by international standards and measured better than average compared with other Australian transmission network companies.

*The State should not do things that the private sector is able to do*

13.120 This contention depends on the proposition that it is preferable for State revenue and borrowing capacity to be used for projects and infrastructure which are not profit-making in a commercial sense, and therefore do not lend themselves to being run by the private sector.

13.121 The network businesses can be run, and are in parts of Australia, by the private sector. They are valuable and if the bid price for them exceeds their retention value, there is, given the regulation in place, no reason, according to this argument for the State to retain them.

*Removing conflict of interest with Government both as a market participant and an objective policy maker*

13.122 The Inquiry also received submissions to the effect that the sale of State owned electricity assets, including the network businesses, is desirable so as to enhance the ability of Government to play the role of objective policy maker. In the NSW context, this would also include the role that the NSW Government plays by virtue of its participation in the Ministerial Council on Energy and its influence on other COAG initiatives. A sale of the network businesses would avoid this potential conflict between the State’s role as market participant and policy maker.

13.123 This proposition was raised by the Inquiry with AEMC, which considered the argument to have little force in relation to the network businesses.

*Arguments against privatisation of the network businesses*

13.124 The Inquiry considers the principal arguments against privatisation to be as follows:

a. it is preferable for natural monopolies to remain in government hands where they can be more directly controlled so as to operate in the public interest;

b. the evidence in favour of privatisation is largely ideological and therefore no persuasive case has yet been made that the public would be better served by privatisation of the network businesses;

c. there are steps which could readily be taken, short of privatisation, to make the network businesses more efficient and therefore improve their performance.

13.125 These arguments are addressed in more detail below.
Natural monopolies ought remain in public ownership

13.126 The principal argument made against the privatisation of the network businesses was that, as natural monopolies, they should remain in government hands. Some witnesses instanced the privatisation of Telstra and of airports as being contrary to the public interest.

13.127 For example, in his submission to the Inquiry, Dr John Kaye MLC (Greens NSW) said:

The wires and poles businesses play a central economic and environmental role in the electricity industry and public ownership will be crucial to transforming the industry to a renewable energy base.

The roadblocks to the development of the federal government’s National Broadband Network were largely caused by the ill-thought-out Telstra privatisation that placed the copper communications network in private hands. The privatisation of a natural monopoly often leads to investment decision making and price setting practices that ignore the public benefit.

An analogous situation could develop in the NSW electricity industry if the wires and poles were sold. Reworking the networks to allow trading from both utility-scale and distributed renewable energy generation will involve a significant amount of change to the wires and poles businesses, that would be much more difficult if not impossible to achieve under private ownership.

Much of the current power price rises result from over investment in electricity transmission and distribution infrastructure. Private ownership would make this even harder to control.

13.128 A further witness pointed to the risk that private sector ownership of network assets might lead to owners not undertaking necessary maintenance and thus network assets breaking down.

The evidence is insufficient to establish that privatisation will benefit the public

13.129 Another principal argument against privatisation is that a case has not been made that private ownership will necessarily lead to lower prices, or more efficient network businesses. In these circumstances, according to the opponents to privatisation, there is no warrant for changing the status quo, since the State owned network businesses provide a reliable service and return adequate dividends to the State.

13.130 Given that the proponents of privatisation rely heavily on the fact that the network businesses are regulated, it is important to assess how effective such regulation is. As referred to above, the AER considers that its capacity to assess the efficiency of expenditure by network businesses is not sufficiently advanced by the rules in their current form. Furthermore, the AEMC does not consider present benchmarking to be adequate to make true comparisons between network businesses in different areas, and accordingly between privately owned and public sector network businesses.

The efficiency and performance of State owned network businesses can be improved without privatisation

13.131 Dr Kaye, among others, pointed to the need for improvement performance by the management of State owned network businesses:
It should be recognised however that the performance of the existing management of the four state-owned businesses has been less than acceptable. The past four years have been characterised by:

- a successful push for over-spending on infrastructure, resulting in a massive and mostly unnecessary price rise, substantial damage to the urban and natural environments, damage to demand management and energy efficiency and some infrastructure that badly under-utilised; and

- and the systematic discounting of opportunities for local distributed generation, demand management and energy efficiency as alternatives to investment in infrastructure.

The full benefits of public ownership of the wires and poles are being squandered by management's outdated thinking and their grab to build yet greater empires.

13.132 Another witness pointed to the potential for increased efficiencies, and competitive tensions, if the network SOCs contracted out services, including upgrading and maintenance. One entity submitted that it was desirable that the subcontracts be allocated for various regions and that private contractors be rewarded for innovation, costs savings and performance. It was also submitted that one of the Key Performance Indicators ought be performance against standard benchmarks that apply to the network businesses in NSW.

Reviews underway

13.133 The Inquiry has been told of various investigations and proposals that will be concluded within the next year which may enable a comparison to be made between privately and publicly owned network businesses on the basis of more reliable data.

The AER rule change proposal

13.134 The AER has stated that the National Electricity Rules need to be changed to protect consumers from paying more than they should for services. At an industry conference on 20 June 2011 its Chair, Andrew Reeves, said:

The AER has now almost completed a full round of resets under the current framework and we have undertaken a stock take of our experience. What we have found are a range of issues within the rules which restrict the regulator’s ability to make its own unbiased determination on efficient costs.

In several important respects, we have concerns about whether the current framework strikes an appropriate balance between the interests of network businesses and those of consumers. In broad terms, these concerns can be boiled down into three separate issues:

- first, we consider that the regulator should be able to make unbiased forecasts of efficient capital and operating expenditure

- second, there needs to be strong incentives for the firms to spend no more than is necessary and efficient, and to be sure that excessive expenditure is not rewarded

- lastly, there needs to be a process for setting the cost of capital that properly reflects the cost of funds, maintaining certainty for service providers that they are able to receive a commercial return on efficient
investment, while ensuring that consider is not paying for excessive returns.\textsuperscript{256}

13.135 The AER rule change proposal has been submitted to AEMC.

\textit{The AEMC Transmission Frameworks Review}

13.136 The AEMC is currently undertaking a review of the role and operation of transmission networks in the NEM, including approaches to network planning (the Transmission Frameworks Review). It was initiated by a direction issued to the AEMC by the Ministerial Council on Energy on 20 April 2010, and is expected to be completed by 2012.

13.137 The AEMC has described its review in the following terms:

A framework that promotes the efficient provision of transmission services to competitive and other regulated sectors of the National Electricity Market (NEM) will have a number of key characteristics. These include:

- Ensuring that the capacity in the existing transmission network is used as efficiently as possible with the costs faced by those parties that value using the network the most.
- Minimising the costs associated with managing the operation of the current network to meet system security, reliability and safety requirements.
- Timely investments in new infrastructure at locations that reflect expected future demand and generation capacity, by considering whether the benefits of investing outweigh the costs.

The operation of transmission networks and investment in new infrastructure requires an interaction between companies operating in a competitive market and regulated network service providers. Therefore, a robust framework requires that regulated networks have the right incentives to consider and meet the needs of users and generators in competitive markets. Equally, these users and generators should face appropriate incentives to ensure that overall costs are minimised. The facilitation of demand-side response and use of non-network solutions will also be important in ensuring overall efficiency.

These factors are of particular importance given the significant period of change being experienced in the NEM. Substantial investment in all stages of the electricity supply chain is required over the next decade in order to maintain secure and reliable electricity supplies. Policies aimed at addressing climate change concerns are expected to drive major new investment in renewable and low carbon generation. This is likely to have significant effects on the level and pattern of transmission investment in the long term, as well as leading to changes in network flows in operational timescales.\textsuperscript{256}

AEMC proposed review of distribution reliability standards

13.138 The AEMC has been in discussions with the Ministerial Council on Energy and the NSW Government about undertaking a review of the distribution reliability standards. Subject to finalisation of funding for the review, the AEMC expects to provide a final report on the NSW distribution reliability standards in 2012.


\textsuperscript{256} AEMC, Transmission Frameworks Review, Directions Paper, April 2011, p. 1.
June 2011 IPART Report

13.139 The Inquiry has also considered the June 2011 IPART report on changes in regulated electricity retail prices from 1 July 2011.257

13.140 The report made the following recommendations relating to network businesses:

1. The Australian Energy Market Commission should review the National Electricity Rules to address concerns that these rules may bias the Australian Energy Regulator’s decisions in favour of higher network prices and inefficient outcomes. The Rules need to be changed by the end of 2012 to ensure that these changes can be incorporated in the next regulatory determination;

2. The Ministerial Council on Energy should revise the merits review process in the National Electricity Law to provide a more balanced appeal process; and

3. The NSW Government should use its recently announced review to satisfy itself that the network licence conditions ensure that the current standards for network reliability and security align with customers’ willingness to pay and take steps to ensure that future changes to standards are subject to rigorous cost benefit analysis. This review needs to be completed by mid 2012 to ensure that it can be incorporated in the next regulatory determination.258

13.141 Professor Owen, in his report to the Inquiry, has referred to these, and other, weaknesses in the regulation of network businesses. He has also referred to the AEMC report on Total Factor Productivity, which proposes an alternative approach to measuring the investment and operational efficiency of the network businesses per unit of expenditure, than the current methodology used by AER to make revenue determinations. However any change of methodology will await the establishment of new data-reporting requirements to allow for initial trials.

The Inquiry’s view

13.142 Consistent with Professor Owen’s report and the NERA report, the Inquiry acknowledges that comparisons between the NSW and Victorian experiences should be approached with caution. There are difficulties in ensuring a true ‘like-with-like’ comparison and in assessing what would have happened if the Victorian businesses had not been privatised. Nevertheless, such indications as exist tend to suggest that the Victorian privatisation experience has been positive in terms of increased efficiency of the privatised businesses.

13.143 Overall, the evidence before the Inquiry tends to support the view that privatisation of the network businesses would lead to efficiency gains over time. This would result in more effective capital investment, which should result in a reduction in the charges permitted to be levied for the business in the next regulatory period.

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13.144 As referred to above, those involved in, and responsible for, the regulation of the network businesses, namely the AER and the AEMC, have identified weaknesses in the current regulation of the network businesses.

13.145 It is expected that, if the rule change proposed by the AER is made by the AEMC, there will be a better means to establish whether networks are operating efficiently and a better basis on which to compare the relative efficiency of network businesses. Further, the outcome of the review of the reliability standards will assist in any comparative exercise as well as potentially affecting the value of the businesses. Finally, the Frameworks Review also may affect the value of the businesses.

13.146 Each of the reviews referred to above is expected to be completed by mid 2012.

13.147 Possible objectives have been set out earlier in this chapter. It is ultimately a question for Government which objectives it chooses and the rank and weight given to each. In the absence of accepted and clear benchmarks against which to consider the efficiency of the network businesses in public hands and in private ownership, any decision is necessarily a policy one.

13.148 Factors the Inquiry believes are relevant to take into account once those objectives have been determined by the Government, are the results of the three reviews referred to above. Their outcome may affect the value of the network businesses and hence the value to the State of them being retained in public hands and the acceptability of any bids for those assets.

13.149 If the dominant weight is given to the fiscal objective, then it would follow that the sale of the network businesses would achieve that objective. It would be prudent to await the outcome of the three reviews before valuing the assets to be sold. Similarly, if any other objective is adopted, alone or in combination, prudence would dictate the same process.

Recommendations

13.150 The Inquiry recommends that:

a. legislation be enacted to enable the Government to offer for sale or long term lease the Eraring and Delta West generators, which are subject to gentrading agreements and the Macquarie Generation and Delta Coastal generators;

b. the Government sell the development sites;

c. the Government sell the Cobbora mine;

d. the Government determines its objectives for the network businesses and in accordance with those, decides whether it will retain in public ownership or sell all or part of the network businesses; and

e. the State obtain expert advice as to the implementation, including timing of these recommendations, particularly in respect of the network businesses as the reviews referred to above are likely to affect value and are expected to be finalised in 2012.
Appendices

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Appendix 1 Terms of Reference

New South Wales

ELIZABETH THE SECOND, by the Grace of God, Queen of Australia and Her other Realms and Territories, Head of the Commonwealth.

To the Honourable Justice Brian John Michael Tamberlin QC

By these Our Letters Patent, made and issued under the authority of the Special Commissions of Inquiry Act 1983, We hereby, with the advice of the Executive Council, authorise you as Commissioner to inquire into and report to Our Governor of the said State on all matters relating to the electricity transactions (occurring both before and after entering into those transactions), including:

1. compliance with applicable laws, policies and practices;
2. the circumstances surrounding the resignation and appointment of directors of Eraring Energy and Delta Electricity in December 2010;
3. the value for money achieved for the State compared to the retention value of the assets to the State;
4. the costs and benefits to the State of the electricity transactions, including potential risks and liabilities and the extent to which the transactions can deliver the stated objectives for entering into them; and
5. any other related matters.

AND FURTHER, WE authorise you to inquire into and report on options for future action that could be undertaken to further the public interest in a competitive NSW electricity sector, including options to:

1. address any issues identified in relation to the electricity transactions; and
2. promote competitive electricity prices and ensure reliability of supply.

AND hereby establish a Special Commission of Inquiry for that purpose. The Special Commission may be assisted by one or more experts on matters that the Commissioner considers require expert opinion.

AND OUR further will and pleasure is that you do, as expeditiously as possible, but in any case on or before 31 August 2011 deliver your initial report, and on or before 31 October 2011 deliver your final report covering all the matters hereto specified.

IN these Letters Patent “electricity transactions” refers to:

1. the sale of State-owned electricity retailers (EnergyAustralia, Integral Energy and Country Energy) by the NSW Government in 2010/11;
2. the sale of the electricity trading rights of State-owned generators (Eraring Energy and Delta West) by the NSW Government in 2010/11;
3. the Cobbrana coal mine development;
4. the sale of development sites suitable for power generation by the NSW Government, including at Marulan and Mt Piper in 2010/11; and
5. the proposed sale of the electricity trading rights of State-owned generators (Macquarie Generation and Delta Coastal) that was not completed by the NSW Government.
AND pursuant to s. 21 of the *Special Commissions of Inquiry Act 1983* it is hereby declared that sections 22, 23 and 24 shall apply to and in respect of the Special Commission the subject of these Our Letters Patent.

IN TESTIMONY WHEREOF, WE have caused these Our Letters to be made Patent and the Public Seal of Our State to be hereunto affixed.

WITNESS

The Honourable Justice Margaret Beazley AO
Administrator of the State of New South Wales in the Commonwealth of Australia.

Dated this 29 April 2011.

[Signature]
The Administrator's Command,

By the Administrator's

[Signature]
Premier
## Appendix 2 Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian Competition and Consumer Commission (ACCC)</td>
<td>A statutory authority established under the <em>Competition and Consumer Act 2010</em> (Cth) to ensure compliance with the Commonwealth’s competition, fair trading and consumer protection laws.</td>
</tr>
<tr>
<td>Australian Energy Market Commission (AEMC)</td>
<td>A national body established under the <em>Australian Energy Market Commission Establishment Act 2004</em> (SA) (applied in NSW by the <em>National Electricity (New South Wales) Act 1997</em>, ss. 6 and 7) with responsibility for rule making and market development in the NEM.</td>
</tr>
<tr>
<td>Australian Energy Market Operator (AEMO)</td>
<td>Manages the NEM, and the retail and wholesale gas markets of eastern and southern Australia. AEMO’s primary responsibility is to balance the supply and demand of electricity by arranging for the dispatching of the generation necessary to meet demand.</td>
</tr>
<tr>
<td>Australian Energy Regulator (AER)</td>
<td>A statutory authority established under the <em>Competition and Consumer Act 2010</em> (Cth) with responsibility for the economic regulation of the electricity transmission and distribution networks in the NEM under the National Electricity Law and National Electricity Rules.</td>
</tr>
<tr>
<td>Baseload</td>
<td>The amount of electricity required to meet the minimum demands of customers over a period.</td>
</tr>
<tr>
<td>Bayswater Power Station</td>
<td>A power station owned and operated by Macquarie Generation. It has a capacity of 2640 MW.</td>
</tr>
<tr>
<td>Cobbora Coal Project</td>
<td>Development of a mine at Cobbora between Mudgee and Dubbo to ensure supply of coal to SOC generators.</td>
</tr>
<tr>
<td>Colongra Power Station</td>
<td>A power station that was part of the Delta Coastal gentrader bundle and remains owned and operated by Delta. It has a capacity of 724 MW.</td>
</tr>
<tr>
<td>Competitive neutrality</td>
<td>The principle that Government business activities should not enjoy net competitive advantages over their private sector competitors by virtue of public sector ownership alone.</td>
</tr>
<tr>
<td>Council of Australian Governments (COAG)</td>
<td>Australia’s peak intergovernmental forum, comprising the Prime Minister, State Premiers, Territory Chief Ministers and the President of the Australian Local Government Association.</td>
</tr>
<tr>
<td>Development sites</td>
<td>Sites marketed for sale by the Government in 2010 for the development of new generation facilities, including Tomago, Bamarang, Marulan, Bayswater B and Mt Piper Extension.</td>
</tr>
<tr>
<td>Dissynergy costs</td>
<td>The costs apportioned to one or more business entities formed from the breakup of a previously consolidated business. For example, the corporate overheads previously shared by network and retail businesses.</td>
</tr>
<tr>
<td>Term</td>
<td>Meaning</td>
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</tbody>
</table>
| Electricity Transactions                  | As set out in the Inquiry's terms of reference, refers to:  
1. The sale of State owned electricity retailers (EnergyAustralia, Integral Energy and Country Energy) by the NSW Government in 2010/11;  
2. The sale of the electricity trading rights of State owned generators (Eraring and Delta West) by the NSW Government in 2010/11;  
3. The Cobbora coal mine development;  
4. The sale of the development sites suitable for power generation by the NSW Government, including at Manulon and Mt Piper in 2010/11; and  
5. The proposed sale of the electricity trading rights of State owned generators (Macquarie Generation and Delta Coastal) that was not completed by the NSW Government. |
| Energy Reform Project                     | The sale of the Government's electricity retailers, development sites and the trading rights for generators, managed through the Energy Reform Steering Committee. |
| Energy Reform Steering Committee          | Re-established in late 2008 to determine the optimal approach to outsourcing the generation trading rights. Members included representatives from NSW Treasury, the NSW Department of Energy and Water (which became Department of Industry and Investment), and the NSW Department of Premier and Cabinet. |
| Eraring Power Station                     | A power station for which the generation trading rights were sold as part of the Eraring gentrader bundle to Origin Energy Limited. It has a capacity of 2640 MW. |
| Former directors                         | The directors of Delta and Eraring who resigned on 14 December 2010, before the Electricity Transactions were executed.                 |
| Full retail contestability                | Where a customer may contract with an electricity retailer of their choice.                                                             |
| Future options                           | As set out in the Inquiry’s terms of reference, refers to action that could be undertaken to further the public interest in a competitive NSW electricity sector, including options to:  
1. Address any issues identified in relation to the Electricity Transactions; and  
2. Promote competitive electricity prices and ensure reliability of supply. |
<p>| Generator trader agreements              | Contracts for the sale of the rights to dispatch energy from power stations, with the State retaining ownership and control of the power stations. |
| Gentrader                                | A purchaser of the right to dispatch energy from SOC owned power stations.                                                              |
| Gentrader model                          | The sale of the right to trade electricity, while retaining public ownership and responsibility for operating electricity generators.  |
| Gentrader rights                         | The rights to dispatch energy from SOC owned power stations.                                                                          |
| Gigajoule (GJ)                           | A standard unit for the measurement of energy. One gigajoule is equal to one billion joules.                                             |
| Gigawatt (GW)                            | A standard unit for the measurement of power. One gigawatt is equal to one billion watts.                                              |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
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</thead>
<tbody>
<tr>
<td>Hedge</td>
<td>An investment strategy which reduces risk through investment in two businesses or financial products whose performance tends to cancel one another out.</td>
</tr>
<tr>
<td>Independent Pricing and Regulatory Tribunal (IPART)</td>
<td>A body established under the Independent Pricing and Regulatory Tribunal Act 1992 to oversee the regulation of the water, gas, electricity and public transport industries in NSW.</td>
</tr>
<tr>
<td>Initial public offering (IPO)</td>
<td>The first sale of stock by a formerly private company to the public.</td>
</tr>
<tr>
<td>Joule</td>
<td>A term used for the measurement of energy. One joule is equal to the energy expended in passing an electric current of one ampere through a resistance of one ohm for one second.</td>
</tr>
<tr>
<td>Liddell Power Station</td>
<td>A power station owned and operated by Macquarie Generation with a capacity of 2000 MW.</td>
</tr>
<tr>
<td>Megajoule (MJ)</td>
<td>A standard unit for the measurement of energy. One megajoule is equal to one million joules.</td>
</tr>
<tr>
<td>Megawatt (MW)</td>
<td>A standard unit for the measurement of power. One megawatt is equal to one million watts.</td>
</tr>
<tr>
<td>Megawatt Hour (MWh)</td>
<td>A standard unit for the measurement of energy. One megawatt hour is the power expended when one megawatt is applied constantly over the space of an hour.</td>
</tr>
<tr>
<td>Mt Piper Power Station</td>
<td>A power station for which the generation trading rights were sold as part of the Delta West gentrader bundle to TRUenergy. It has a capacity of 1400 MW.</td>
</tr>
<tr>
<td>Munmorah Power Station</td>
<td>A power station that was part of the Delta Coastal gentrader bundle and remains owned and operated by Delta. It has a capacity of 600 MW.</td>
</tr>
<tr>
<td>National Electricity Law</td>
<td>Refers to the Schedule to the National Electricity (South Australia) Act 1996 (SA). The National Electricity Law is applied in NSW by the National Electricity (New South Wales) Act 1997.</td>
</tr>
<tr>
<td>National Electricity Market (NEM)</td>
<td>A wholesale market through which power generators sell their output in NSW, Queensland, South Australia, Victoria and Tasmania.</td>
</tr>
<tr>
<td>National Electricity Rules</td>
<td>The rules made under the National Electricity Law.</td>
</tr>
<tr>
<td>Network businesses</td>
<td>Businesses that operate the distribution or transmission of electricity.</td>
</tr>
<tr>
<td>On-sale agreement</td>
<td>In the context of the sale of the SOC retailers, a variation on the pass-through agreement to accommodate a limited set of power purchase agreements that contain both retail and network elements and which cannot be transferred to the purchaser. See also pass-through agreement.</td>
</tr>
<tr>
<td>Owen Inquiry</td>
<td>Refers to the Inquiry into Electricity Supply in NSW conducted by Professor Anthony Owen, delivering its final report in September 2007.</td>
</tr>
<tr>
<td>Pass-through agreement (PSA)</td>
<td>In the context of the sale of the SOC retailers, an agreement under which a SOC passes through to its purchaser, the risk or benefit of any contract to which the SOC remains a legal counterparty until the contract can be transferred to the SOC's purchaser.</td>
</tr>
<tr>
<td>Term</td>
<td>Meaning</td>
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</tr>
<tr>
<td>Portfolio Minister</td>
<td>Refers to the Government Minister who, pursuant to s. 201 of the SOC Act, has the duty to administer the foundation charter of a SOC.</td>
</tr>
<tr>
<td>Price signal</td>
<td>A message sent to customers in the form of a price charged for a commodity. For example increasing prices during periods of shortage or increased commodity costs is a price signal to customers to reduce consumption.</td>
</tr>
<tr>
<td>Rail spur</td>
<td>A rail line which is used primarily for storing, loading and unloading rail cars.</td>
</tr>
<tr>
<td>Shoalhaven Power Station</td>
<td>A power station for which the generation trading rights were sold by Eraring as part of the Eraring generator bundle to Origin Energy Limited. It has a capacity of 240 MW.</td>
</tr>
<tr>
<td>SOC generator</td>
<td>Refers to the State owned generation companies, namely Delta, Eraring and Macquarie Generation.</td>
</tr>
<tr>
<td>SOC owned generator</td>
<td>Refers to those power generators owned by the SOCs, namely, Liddell and Bayswater (Macquarie Generation); Mt Piper and Wallerawang (Delta West); Vales Point, Munmorah and Colongra (Delta Coastal); and Eraring and Shoalhaven (Eraring).</td>
</tr>
<tr>
<td>SOC retailer</td>
<td>Refers to State owned electricity retailer companies, namely EnergyAustralia, Integral Energy and Country Energy.</td>
</tr>
<tr>
<td>Spot market</td>
<td>Effectively, a commodities market in which the relevant product is sold for cash at current prices and delivered immediately.</td>
</tr>
<tr>
<td>State owned corporation (SOC)</td>
<td>A corporation established under the State Owned Corporations Act 1989.</td>
</tr>
</tbody>
</table>
| Stated objectives                  | Refers to the objectives of the Energy Reform Strategy, namely, to:  
  1. deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;  
  2. create an industry and commercial framework to encourage private investment into the NSW electricity sector and reduce the need for future public sector investment in retail generation;  
  3. ensure NSW homes and businesses continue to be supplied with reliable electricity; and  
  4. place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government's exposure to electricity market risk and reducing the State's public sector debt. |
<p>| Statement of corporate intent      | A document which, pursuant to ss. 21 and 22 of the SOC Act, a SOC board is required to submit to its voting shareholders, and which sets out a number of matters, including the objectives and main undertakings of the SOC. |
| Statutory SOC                      | Established by the State Owned Corporations Amendment Act 1995.                                                                                                                                     |
| Steering Committee                 | See Energy Reform Steering Committee.                                                                                                                                                                |
| Stranded asset                     | An asset whose market value has become less than its book value because it has become obsolete ahead of completing its depreciation schedule.                                                           |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
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</thead>
<tbody>
<tr>
<td>Stranded cost</td>
<td>Cost incurred by a business which the business is not able to recoup due to market conditions brought about by regulatory change, technological advances or a combination of the two.</td>
</tr>
<tr>
<td>Summons</td>
<td>Refers to a summons issued by the Inquiry pursuant to s. 14 of the Special Commissions of Inquiry Act 1983.</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>The cost to the State of conducting the sale of assets, including advisers’ costs.</td>
</tr>
<tr>
<td>Transition Services Agreement (TSA)</td>
<td>In the context of the sale of the retailer SOCs, an agreement by which a SOC delivers to its purchaser those services which are necessary for the operation of the retail business to facilitate the ongoing operation of the retail business.</td>
</tr>
<tr>
<td>Unsworth Committee</td>
<td>The Energy Consultative Committee established by the NSW Government.</td>
</tr>
<tr>
<td>Vales Point Power Station</td>
<td>A power station that was part of the Delta Coastal gentrader bundle and remains owned and operated by Delta. It has a capacity of 1320 MW.</td>
</tr>
<tr>
<td>Wallerawang Power Station</td>
<td>A power station for which the generation trading rights were sold as part of the Delta West gentrader bundle to TRUenergy. It has a capacity of 1000 MW.</td>
</tr>
<tr>
<td>Watt (W)</td>
<td>A standard unit for the measurement of power. The equivalent of one joule per second.</td>
</tr>
</tbody>
</table>
## Appendix 3 Acronyms and Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACCC</td>
<td>Australian Competition and Consumer Commission</td>
</tr>
<tr>
<td>AEMC</td>
<td>Australian Energy Market Commission</td>
</tr>
<tr>
<td>AEMO</td>
<td>Australian Energy Market Operator</td>
</tr>
<tr>
<td>ALP</td>
<td>Australian Labor Party</td>
</tr>
<tr>
<td>AER</td>
<td>Australian Energy Regulator</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investment Commission</td>
</tr>
<tr>
<td>CAF</td>
<td>Contract Availability Factor</td>
</tr>
<tr>
<td>CCGT</td>
<td>Combined cycle gas turbine</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief executive officer</td>
</tr>
<tr>
<td>CLCV</td>
<td>Consumer Law Centre Victoria</td>
</tr>
<tr>
<td>COAG</td>
<td>Council of Australian Governments</td>
</tr>
<tr>
<td>CPRS</td>
<td>Carbon Pollution Reduction Scheme</td>
</tr>
<tr>
<td>EIR Bill</td>
<td>Electricity Industry Restructuring Bill</td>
</tr>
<tr>
<td>ESC</td>
<td>Essential Services Commission, Victoria</td>
</tr>
<tr>
<td>ESS</td>
<td>Energy Savings Scheme</td>
</tr>
<tr>
<td>ETEF</td>
<td>Electricity Tariff Equalisation Fund</td>
</tr>
<tr>
<td>ETSA</td>
<td>Electricity Trust of South Australia</td>
</tr>
<tr>
<td>FRC</td>
<td>Full retail contestability</td>
</tr>
<tr>
<td>GJ</td>
<td>Gigajoule</td>
</tr>
<tr>
<td>GW</td>
<td>Gigawatt</td>
</tr>
<tr>
<td>HEC</td>
<td>Hydro Electric Commission</td>
</tr>
<tr>
<td>ICAC</td>
<td>Independent Commission Against Corruption</td>
</tr>
<tr>
<td>IPA</td>
<td>Institute of Public Affairs</td>
</tr>
<tr>
<td>IPART</td>
<td>Independent Pricing and Regulatory Tribunal</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial public offering</td>
</tr>
<tr>
<td>KIW</td>
<td>Kilowatt</td>
</tr>
<tr>
<td>MCE</td>
<td>Ministerial Council on Energy</td>
</tr>
<tr>
<td>Mt</td>
<td>Million tonnes</td>
</tr>
<tr>
<td>Mtpa</td>
<td>Million tonnes per annum</td>
</tr>
<tr>
<td>MW</td>
<td>Megawatt</td>
</tr>
<tr>
<td>MWh</td>
<td>Megawatt hour</td>
</tr>
<tr>
<td>NECF</td>
<td>National Energy Customer Framework</td>
</tr>
<tr>
<td>NEM</td>
<td>National Electricity Market</td>
</tr>
<tr>
<td>OCGT</td>
<td>Open cycle gas turbine</td>
</tr>
<tr>
<td>PNV</td>
<td>Power Net Victoria</td>
</tr>
<tr>
<td>QC</td>
<td>Queen’s Counsel</td>
</tr>
<tr>
<td>ROLR</td>
<td>Retailer of Last Resort</td>
</tr>
<tr>
<td>SC</td>
<td>Senior Counsel</td>
</tr>
<tr>
<td>SECV</td>
<td>State Electricity Commission of Victoria</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Meaning</td>
</tr>
<tr>
<td>--------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>SECWA</td>
<td>State Energy Commission of Western Australia</td>
</tr>
<tr>
<td>SOC</td>
<td>State owned corporation</td>
</tr>
<tr>
<td>SOC Act</td>
<td>State Owned Corporations Act 1989</td>
</tr>
<tr>
<td>SOC Regulation</td>
<td>State Owned Corporations Regulation 2010</td>
</tr>
<tr>
<td>TCC</td>
<td>Total Contract Capacity</td>
</tr>
<tr>
<td>VoLL</td>
<td>Value of Lost Load</td>
</tr>
<tr>
<td>VPE</td>
<td>Victoria Power Exchange</td>
</tr>
<tr>
<td>W</td>
<td>Watt</td>
</tr>
<tr>
<td>WSN</td>
<td>Waste Recycling and Processing Corporation</td>
</tr>
</tbody>
</table>
## Appendix 4 Dramatis Personae

<table>
<thead>
<tr>
<th>Person</th>
<th>Background Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACIL Tasman Pty Ltd (ACIL Tasman)</td>
<td>Economic consultant.</td>
</tr>
<tr>
<td>AGL Energy Limited (AGL)</td>
<td>Energy company.</td>
</tr>
<tr>
<td>Ausgrid</td>
<td>On 2 March 2011, the name of EnergyAustralia’s electricity network operation was changed to Ausgrid by subreg. 3(2) of the Energy Services Corporations Amendment (Change of Name) Regulation 2011.</td>
</tr>
<tr>
<td>Baker, Tim</td>
<td>General Manager, Marketing and Strategy of Eraring during the Energy Reform Project.</td>
</tr>
<tr>
<td>Baumgartner, Liesl</td>
<td>Former Deputy Director-General of the Department of Water and Energy. Member of the Energy Reform Steering Committee from its inception to April 2010.</td>
</tr>
<tr>
<td>Bleach, Murray</td>
<td>Director of Eraring from 1 July 2010.</td>
</tr>
<tr>
<td>Bunyon, Ross</td>
<td>Chair and director of Eraring from 21 July 2000 to 14 December 2010.</td>
</tr>
<tr>
<td>Challen, Donald</td>
<td>Economist and Secretary of the Department of Treasury and Finance (Tasmania) from 1993 to 2010. Retained by the Inquiry to prepare an expert report.</td>
</tr>
<tr>
<td>Cobbora Holding Company Pty Limited</td>
<td>Created to manage the Cobbora Coal Project.</td>
</tr>
<tr>
<td>Cosgriff, Kevin</td>
<td>Deputy Secretary, Fiscal and Economic of NSW Treasury. Member of the Energy Reform Steering Committee from its inception.</td>
</tr>
<tr>
<td>Country Energy (Country)</td>
<td>Formed on 1 June 2001 from the merger of three regional energy businesses: Advance Energy, Great Southern Energy and NorthPower. It is a SOC under the SOC Act and the ESC Regulations. On 2 March 2011, the name of its electricity network operation was changed to Essential Energy by subreg. 3(1) of the Energy Services Corporations Amendment (Change of Name) Regulation 2011.</td>
</tr>
<tr>
<td>Credit Suisse (Australia) Ltd (Credit Suisse)</td>
<td>Joint lead financial adviser with Lazard to the Energy Reform Project from 24 December 2007.</td>
</tr>
<tr>
<td>D’Adam, Vicky</td>
<td>Assistant Director-General of the Department of Premier and Cabinet from July 2009 to April 2010 and Deputy Director-General of the Department of Premier and Cabinet from April 2010. Member of the Energy Reform Steering Committee from March 2009.</td>
</tr>
<tr>
<td>Daley, Michael</td>
<td>Minister for Finance from 17 November 2009 to 4 December 2010 and from 8 December 2010 to 28 March 2011. As Minister for Finance, he was the shareholding Minister of Delta and Eraring.</td>
</tr>
<tr>
<td>Person</td>
<td>Background Information</td>
</tr>
<tr>
<td>--------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Delta Electricity (Delta)</td>
<td>Established on 1 March 1996 as a SOC under the SOC Act, ESC Act and the Energy Services Corporations Act Amendment (Delta Electricity) Regulation 1996.</td>
</tr>
<tr>
<td>Department of Industry and Investment</td>
<td>See Department of Trade and Investment, Regional Infrastructure and Services.</td>
</tr>
<tr>
<td>Department of Trade and Investment, Regional Infrastructure and Services</td>
<td>For the relevant periods the NSW government department responsible for energy was: the Department of Water and Energy to July 2009; the Department of Industry and Investment from July 2009 to April 2011; and the Department of Trade and Investment, Regional Infrastructure and Services from April 2011.</td>
</tr>
<tr>
<td>Department of Water and Energy</td>
<td>See Department of Trade and Investment, Regional Infrastructure and Services.</td>
</tr>
<tr>
<td>Dermody, John</td>
<td>Project Director of the Energy Reform Project from 15 February 2010. Director and Chair of Delta from 14 December 2010 to 5 May 2011.</td>
</tr>
<tr>
<td>Dimpfel, Arne</td>
<td>Director of Credit Suisse.</td>
</tr>
<tr>
<td>Duffy, Mark</td>
<td>Former Director-General of the Department of Water and Energy. Co-chair of the NSW Electricity and Prices Inquiry and co-author (with Dr Tom Parry) of the resulting report published in December 2010, which is also known as the ‘Parry Duffy Report’.</td>
</tr>
<tr>
<td>Endeavour Energy</td>
<td>On 2 March 2011, the name of Integral Energy’s electricity network operation was changed to Endeavour Energy by subreg. 3(3) of the Energy Services Corporations Amendment (Change of Name) Regulation 2011.</td>
</tr>
<tr>
<td>EnergyAustralia</td>
<td>Established on 1 March 1996 as a SOC under the SOC Act and ESC Act. On 2 March 2011, the name of its electricity network operation was changed to Ausgrid by subreg. 3(2) of the Energy Services Corporations Amendment (Change of Name) Regulation 2011.</td>
</tr>
<tr>
<td>Eraring Energy (Eraring)</td>
<td>Established on 2 August 2000 as a SOC under the ESC Act, the SOC Act and the Energy Services Corporation (Eraring Energy) Regulation 2000.</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
<td>Tax and accounting adviser to the Energy Reform Project from 24 December 2007.</td>
</tr>
<tr>
<td>Essential Energy</td>
<td>On 2 March 2011, the name of Country Energy’s electricity network operation was changed to Essential Energy by subreg. 3(1) of the Energy Services Corporations Amendment (Change of Name) Regulation 2011.</td>
</tr>
<tr>
<td>Forward, Paul</td>
<td>Director of Delta from 20 March 2006 to 14 December 2010.</td>
</tr>
<tr>
<td>Frontier Economics Pty Ltd (Frontier Economics)</td>
<td>From 24 December 2007 adviser to the Energy Reform Project.</td>
</tr>
<tr>
<td>Person</td>
<td>Background information</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Gellatly, Dr Col</td>
<td>Chair of the Energy Reform Steering Committee from 27 October 2009 to early 2011. Director of Eraring from 14 December 2010 to 25 March 2011.</td>
</tr>
<tr>
<td>Gray, Professor Stephen</td>
<td>Professor in Finance at the University of Queensland. Director of SFG Consulting.</td>
</tr>
<tr>
<td>Harris, Loftus</td>
<td>Director of Delta from 1 October 2007 to 14 December 2010. Chair of Delta from late September 2010 to 14 December 2010.</td>
</tr>
<tr>
<td>Hoie, Katharine</td>
<td>Director, Energy Strategy and Reform of the Department of Industry and Investment (now Department of Trade and Investment, Regional Infrastructure and Services). Member of the Energy Reform Steering Committee from April 2009.</td>
</tr>
<tr>
<td>Houston, Greg</td>
<td>Economist and Director of Nera Economic Consulting.</td>
</tr>
<tr>
<td>Integral Energy (Integral)</td>
<td>Established on 1 March 1996 as a SOC under the SOC Act and ESC Act. On 2 March 2011, the name of its electricity network operations was changed to Endeavour Energy by subreg. 3(3) of the Energy Services Corporations Amendment (Change of Name) Regulation  2011.</td>
</tr>
<tr>
<td>International Power (Australia) Pty Ltd (International Power)</td>
<td>Retailer and generator of electricity.</td>
</tr>
<tr>
<td>Jackson, Peter</td>
<td>Managing Director of Eraring from 11 September 2006.</td>
</tr>
<tr>
<td>Kaye, Dr John</td>
<td>Member of the NSW Legislative Council from 24 March 2007.</td>
</tr>
<tr>
<td>Knight, Hon. Michael</td>
<td>Director of Delta from 20 March 2006 to 14 December 2010.</td>
</tr>
<tr>
<td>KPMG</td>
<td>Information technology adviser to the Energy Reform Project from 14 February 2009.</td>
</tr>
<tr>
<td>Kruk, Robyn</td>
<td>Director-General of the Department of Premier and Cabinet from 7 May 2007 to October 2008. Member of the Energy Reform Steering Committee from its inception to October 2008.</td>
</tr>
<tr>
<td>Lazard</td>
<td>Joint lead financial adviser with Credit Suisse to the Energy Reform Project from 24 December 2007.</td>
</tr>
<tr>
<td>Leyden, Andrew</td>
<td>Managing Director of the Corporate Advisory Melbourne division of Lazard.</td>
</tr>
<tr>
<td>Lobb, Campbell</td>
<td>Managing Director of Credit Suisse.</td>
</tr>
<tr>
<td>Macquarie Generation</td>
<td>Established on 1 March 1996 as a SOC under the SOC Act and ESC Act.</td>
</tr>
<tr>
<td>Madden, Raymond</td>
<td>Corporate Secretary of Delta</td>
</tr>
<tr>
<td>Maguire, Gary</td>
<td>Legal adviser to the Energy Reform Project.</td>
</tr>
<tr>
<td>Maher, Anthony</td>
<td>Director of Eraring from 18 October 2010 to 14 December 2010.</td>
</tr>
<tr>
<td>Person</td>
<td>Background Information</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>McClelland, Jan</td>
<td>Director and Chair of Eraring from 14 December 2010 to 12 May 2011.</td>
</tr>
<tr>
<td>Moid, Sandra</td>
<td>Director of Delta from 18 September 2002 to 14 December 2010.</td>
</tr>
<tr>
<td>Morgan Stanley Australia</td>
<td>Commissioned by the NSW Government to provide a report on the options available to the Government to implement Professor Owen’s recommendations.</td>
</tr>
<tr>
<td>Limited (Morgan Stanley)</td>
<td></td>
</tr>
<tr>
<td>Nera Economic Consulting</td>
<td>Provided an expert report to the inquiry on future options.</td>
</tr>
<tr>
<td>Outhred, Professor Hugh</td>
<td>Professoral Visiting Fellow in Energy Systems, School of Electrical Engineering and Telecommunications, University of New South Wales. Provided an expert report to the inquiry on future options.</td>
</tr>
<tr>
<td>(Origin)</td>
<td></td>
</tr>
<tr>
<td>Owen, Professor Anthony</td>
<td>Author of the Owen Inquiry Report. Retained by the inquiry to prepare an update report on future options.</td>
</tr>
<tr>
<td>Pierce, John</td>
<td>Secretary of NSW Treasury until early 2009. Chair of the Energy Reform Steering Committee from its inception to March 2009. Currently Chairman of the AEMC.</td>
</tr>
<tr>
<td>Priest, John</td>
<td>Founder and Managing Director of Frontier Economics.</td>
</tr>
<tr>
<td>Pritchard, Dean</td>
<td>Director of Eraring from 1 April 2010.</td>
</tr>
<tr>
<td>Roozendaal, Hon. Eric</td>
<td>Treasurer from 8 September 2008 to 4 December 2009 and from 8 December 2009 to 28 March 2011. From November 2009 he was the responsible Minister for the Energy Reform Project.</td>
</tr>
<tr>
<td>RSM Bird Cameron</td>
<td>Probity adviser to the Energy Reform Project from 14 February 2008.</td>
</tr>
<tr>
<td>Schur, Michael</td>
<td>Secretary of NSW Treasury from March 2009 to 28 April 2011. Chair of the Energy Reform Steering Committee from March 2009 to October 2009.</td>
</tr>
<tr>
<td>SFG Consulting Pty Ltd (SFG Consulting)</td>
<td>Financial modelling adviser to the Energy Reform Project from 1 June 2010.</td>
</tr>
<tr>
<td>Shatter, Michael</td>
<td>Director of the Melbourne Assurance and Advisory Services division of RSM Bird Cameron.</td>
</tr>
<tr>
<td>Skelton, Russell</td>
<td>Chief Executive Officer and Managing Director of Macquarie Generation.</td>
</tr>
<tr>
<td>Timbs, Richard</td>
<td>Deputy Secretary, Commercial Management Directorate of NSW Treasury from June 2009. Member of the Energy Reform Steering Committee from December 2009.</td>
</tr>
<tr>
<td>Person</td>
<td>Background information</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Tripodi, Hon. Joseph</td>
<td>Minister for Finance from 8 September 2008 to 17 November 2009. From November 2008 to November 2009 he was the responsible Minister for the Energy Reform Project.</td>
</tr>
<tr>
<td>TRUenergy Holdings Pty Limited (TRUenergy)</td>
<td>Acquired the gentrading rights for Delta West (Mt Piper and Wallerawang Power Stations), the retail arm of EnergyAustralia and the development sites at Marulan (from EnergyAustralia and Delta) and at Mt Piper Extension (from Delta).</td>
</tr>
<tr>
<td>Vertigan, Michael</td>
<td>Director of Eraring from 21 July 2000 to 14 December 2010.</td>
</tr>
<tr>
<td>WorleyParsons Services Pty Ltd (WorleyParsons)</td>
<td>Engineering and environmental advisor to the Energy Reform Project from 31 March 2008.</td>
</tr>
</tbody>
</table>
Appendix 5  List of Relevant Legislation

**NSW Acts**
- Auditor-General (Supplementary Powers) Act 2008
- Electricity Legislation Amendment Act 1995
- Electricity Supply Act 1995
- Electricity Transmission Authority Act 1994
- Energy Services Corporations Act 1995 (ESC Act)
- Government Information (Public Access) Act 2009
- Interpretation Act 1987
- National Electricity (New South Wales) Act 1997
- Public Finance and Audit Act 1983
- Special Commissions of Inquiry Act 1983
- State Owned Corporations Act 1989 (SOC Act)
- State Owned Corporations Amendment Act 1995
- Waste Recycling and Processing Corporation (Authorised Transaction) Act 2010
- Waste Recycling and Processing Corporation Act 2001

**NSW Subordinate Legislation: Rules and Regulations**
- Energy Services Corporations Act Amendment (Delta Electricity) Regulation 1996
- Energy Services Corporations (Eraring Energy) Regulation 2000
- Energy Services Corporations (Dissolution of Energy Distributors) Regulation 2001
- Electricity Supply (General) Regulation 2001

**Commonwealth Acts**
- Competition Policy Reform Act 1995 (Cth)
- Competition and Consumer Act 2010 (Cth)
- Corporations Act 2001 (Cth)
- Financial Services Reform Act 2001 (Cth)
- Trade Practices Act 1974 (Cth)
### Other States and Territories Acts

- Electricity Act 1996 (SA)
- Electricity Corporations Act 2005 (WA)
- Electricity Corporations (Restructuring and Disposal) Act 1999 (SA)
- Electricity (National Scheme) Act 1997 (ACT)
- Electricity - National Scheme (Queensland) Act 1997 (Qld)
- Essential Services Commission Act 2000 (SA)
- Government Owned Corporations Act 1993 (Qld)
- Government Owned Corporations Act 2001 (NT)
- National Electricity (South Australia) Act 1996 (SA)
- National Electricity (Victoria) Act 1997 (Vic)
- National Energy Retail Law (South Australia) Act 2011 (SA)
- State Owned Enterprises Act 1992 (Vic)

### Other States and Territories Subordinate Legislation: Rules and Regulations

- National Electricity (South Australia) Regulations 1998 (SA)
- National Energy Retail Rules (SA)

### Intergovernmental Agreements

- Australian Energy Market Agreement 2004
- National Energy Customer Framework 2011
## Appendix 6 Written Submissions

<table>
<thead>
<tr>
<th>Person or Organisation</th>
<th>Date of Submission</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Anonymous</td>
<td>6 July 2011</td>
</tr>
<tr>
<td>2. Armstrong, Kevin</td>
<td>11 June 2011</td>
</tr>
<tr>
<td>3. Ausgrid</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>4. Australian Alliance to Save Energy Limited</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>5. City of Sydney</td>
<td>16 June 2011</td>
</tr>
<tr>
<td>6. Confidential</td>
<td>12 July 2011</td>
</tr>
<tr>
<td>7. Confidential</td>
<td>7 October 2011</td>
</tr>
<tr>
<td>8. Delta Electricity</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>11. Eraring Energy</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>15. Institute for Sustainable Futures, University of Technology, Sydney</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>16. Kaye, Dr. John MP</td>
<td>23 September 2011</td>
</tr>
<tr>
<td>17. My Home Power Pty Limited</td>
<td>10 August 2011</td>
</tr>
<tr>
<td>20. NSW Business Chamber</td>
<td>29 June 2011</td>
</tr>
<tr>
<td>23. Outhred, Professor Hugh</td>
<td>6 July 2011</td>
</tr>
<tr>
<td>24. Public Interest Advocacy Centre Ltd (PIAC)</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>25. QIC Limited</td>
<td>11 October 2011</td>
</tr>
<tr>
<td>26. Rush, Martin, Mayor of Muswellbrook</td>
<td>17 October 2011</td>
</tr>
<tr>
<td>27. Taibot, Richard</td>
<td>1 June 2011</td>
</tr>
<tr>
<td>28. TRUenergy</td>
<td>17 June 2011</td>
</tr>
<tr>
<td>29. UGL Limited</td>
<td>16 September 2011</td>
</tr>
<tr>
<td>30. Unions NSW</td>
<td>21 June 2011</td>
</tr>
<tr>
<td>31. Walker, Professor Bob and Con Walker, Dr Betty</td>
<td>20 June 2011</td>
</tr>
<tr>
<td>32. Welch, Curtis</td>
<td>22 June 2011</td>
</tr>
</tbody>
</table>

The State of NSW declined an invitation to provide a written submission to the Inquiry. The Inquiry invited the Hon. Kristina Keneally to make a written submission to the Inquiry. Ms Keneally did not provide a submission.
## Appendix 7 Private Hearings

<table>
<thead>
<tr>
<th>Witnesses</th>
<th>Role in Electricity Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Loftus Harris</td>
<td>Director, Delta</td>
</tr>
<tr>
<td>2. Sandra Moat</td>
<td>Director, Delta</td>
</tr>
<tr>
<td>3. The Hon. Michael Knight</td>
<td>Director, Delta</td>
</tr>
<tr>
<td>4. Paul Forward</td>
<td>Director, Delta</td>
</tr>
<tr>
<td>5. Warren Phillips</td>
<td>Director, Delta</td>
</tr>
<tr>
<td>6. Greg Everell</td>
<td>Chief Executive and Director, Delta</td>
</tr>
<tr>
<td>7. John Dermody</td>
<td>Director, Delta, Project Director, Energy Reform Project</td>
</tr>
<tr>
<td>8. The Hon. Kim Yeadon</td>
<td>Director, Delta, Chair, Gentrader Working Group</td>
</tr>
<tr>
<td>9. Ross Bunyon</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>10. Dean Pritchard</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>11. Anthony Maher</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>12. John Priest</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>13. Michael Vertigan</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>14. Murray Bleach</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>15. Peter Jackson</td>
<td>Managing Director, Eraring</td>
</tr>
<tr>
<td>16. Jan McClelland</td>
<td>Director, Eraring</td>
</tr>
<tr>
<td>17. Dr Col Gellatly</td>
<td>Director, Eraring, Chair, Energy Reform Steering Committee</td>
</tr>
<tr>
<td>18. Russell Skelton</td>
<td>Chief Executive Officer and Managing Director, Macquarie Generation</td>
</tr>
<tr>
<td>19. Ronald Finlay</td>
<td>Director, Macquarie Generation</td>
</tr>
<tr>
<td>20. Danny Price</td>
<td>Frontier Economics</td>
</tr>
<tr>
<td>21. Andrew Leyden</td>
<td>Lazard</td>
</tr>
<tr>
<td>22. Campbell Lobb</td>
<td>Credit Suisse</td>
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<td>23. Arne Dimpfel</td>
<td>Credit Suisse</td>
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<tr>
<td>24. The Hon. Eric Roozendaal</td>
<td>NSW Treasurer</td>
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<tr>
<td>25. Michael Daley</td>
<td>Minister for Finance</td>
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<tr>
<td>26. The Hon. Joseph Tripodi</td>
<td>Minister for Finance</td>
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</table>
## Appendix 8 Private Meetings

<table>
<thead>
<tr>
<th>Attendees</th>
<th>Organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Chris Eccles</td>
<td>Department of Premier and Cabinet</td>
</tr>
<tr>
<td>3. Peter Achterstraat</td>
<td>The Audit Office of NSW</td>
</tr>
<tr>
<td>Tony Whitfield</td>
<td></td>
</tr>
<tr>
<td>4. Professor Anthony Owen</td>
<td>School of Energy and Resources, University College London, Australia.</td>
</tr>
<tr>
<td>5. Andrew Leyden</td>
<td>Lazard</td>
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<tr>
<td>6. Campbell Lobb</td>
<td>Credit Suisse</td>
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<tr>
<td>Arne Dimpfel</td>
<td></td>
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<tr>
<td>7. Graeme Browning</td>
<td>Ernst &amp; Young</td>
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<tr>
<td>8. Russell Skelton</td>
<td>Macquarie Generation</td>
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<tr>
<td>Peter Shields</td>
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<tr>
<td>Rob Cooper</td>
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<td>9. Michael Shatter</td>
<td>RSM Bird Cameron</td>
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<tr>
<td>Stephen Marks</td>
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<td>11. Paul Broad</td>
<td>Infrastructure NSW</td>
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<tr>
<td>12. Michael Schur</td>
<td>Former Secretary, NSW Treasury</td>
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<td>13. Richard Timbs</td>
<td>NSW Treasury</td>
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<td>14. Kevin Cosgriff</td>
<td>NSW Treasury</td>
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<tr>
<td>15. Professor Bob Walker and Dr Betty Con Walker</td>
<td>Academics and consultants</td>
</tr>
<tr>
<td>16. Professor Hugh Outhred</td>
<td>School of Electrical Engineering and Telecommunications, University of New South Wales</td>
</tr>
<tr>
<td>17. John Fitzgerald</td>
<td>AGL</td>
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<td>Paul Frazer</td>
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<td>18. Vicki D'Adam</td>
<td>Department of Premier and Cabinet</td>
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<tr>
<td>19. Mark Lennon</td>
<td>Unions NSW</td>
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<td>Mark Morey</td>
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<tr>
<td>20. Frank Calabria</td>
<td>Origin</td>
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<tr>
<td>22. Tim Baker</td>
<td>Eraring</td>
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<tr>
<td>23. Professor Stephen Gray</td>
<td>SFG Consulting Pty Ltd</td>
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<tr>
<td>24. Peter Limbers</td>
<td>Blake Dawson</td>
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<tr>
<td>25. Curtis Welch</td>
<td>Engaged to work on the Energy Reform Project</td>
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<tr>
<td>26. Ross Edwards</td>
<td>TRUenergy</td>
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<td>Mark Collette</td>
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<td>27. Vince Graham</td>
<td>Endeavour Energy</td>
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<td>Attendees</td>
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<tr>
<td>28. Russell Skelton</td>
<td>Macquarie Generation</td>
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<td>29. Tony Concannon</td>
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<td>30. Simon Harle</td>
<td>TPG Capital</td>
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<td>31. The Hon. Nick Greiner AC</td>
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<tr>
<td>32. Katharine Hole</td>
<td>Department of Trade and Investment, Regional</td>
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<td></td>
<td>Infrastructure and Services</td>
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<tr>
<td>33. Gary Maguire</td>
<td>Johnston Winter &amp; Slattery</td>
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<tr>
<td>Paul Kasmer</td>
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<td>Peter Rose</td>
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<tr>
<td>34. Trevor St Baker</td>
<td>ERM Power Limited</td>
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<tr>
<td>Andy Pittlik</td>
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<td>35. George Maltabarow</td>
<td>Ausgrid</td>
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<td>John Conde</td>
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<tr>
<td>Lisa Maffina</td>
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<td>36. Bruce Foy</td>
<td>TransGrid</td>
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<tr>
<td>Peter McIntyre</td>
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<td>John Hodgkinson</td>
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<td>Brian Spalding</td>
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<td>Neville Henderson</td>
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<td>Paul Smith</td>
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<td>Anne Pearson</td>
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Essential Energy and Infratil Energy Pty Ltd declined invitations to meet with the Inquiry.
## Appendix 9  Visits

<table>
<thead>
<tr>
<th>Date</th>
<th>Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 17 June 2011</td>
<td>Australian Energy Market Commission (AEMC), NSW</td>
</tr>
<tr>
<td>2. 23 June 2011</td>
<td>Macquarie Generation, Lambton, NSW</td>
</tr>
<tr>
<td></td>
<td>Bayswater Power Station, NSW</td>
</tr>
<tr>
<td>3. 15 August 2011</td>
<td>Infogen Energy Capital Wind Farm, Bungendore, ACT</td>
</tr>
<tr>
<td>4. 15 August 2011</td>
<td>Essential Energy Solar Farm, Queanbeyan, ACT</td>
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<tr>
<td>5. 16 August 2011</td>
<td>Snowy Hydro Discovery Centre, Cooma, NSW</td>
</tr>
<tr>
<td></td>
<td>Tumut 3 Power Station, Talbingo, NSW</td>
</tr>
<tr>
<td>6. 22 September 2011</td>
<td>Infogen, Sydney Offices, NSW</td>
</tr>
<tr>
<td>7. 4 October 2011</td>
<td>Snowy Hydro Limited, Sydney Offices, NSW</td>
</tr>
</tbody>
</table>
Appendix 10  Extract from Hansard, 28 August 2008 – the Hon. Michael Gallacher regarding Electricity Industry Restructuring Bills

Extract from New South Wales, Legislative Council 2008, Debates, 28 August 2008, pp. 9651-9654:

ELECTRICITY INDUSTRY RESTRUCTURING BILL 2008 (NO. 2)

ELECTRICITY INDUSTRY RESTRUCTURING (RESPONSE TO AUDITOR-GENERAL REPORT) BILL 2008

Second Reading

[Business resumed.]

The Hon. MICHAEL GALLACHER (Leader of the Opposition) [12.44 p.m.]: The Government has had 13 years to get the important issue of this State's future power generation right and, as members will shortly hear, it has got it wrong. The New South Wales Liberal-National Coalition will not support the lemma Government's Electricity Industry Restructuring (Response to Auditor-General Report) Bill and the associated cognate bill. The Liberal-National Coalition does not take this decision likely. There are three key reasons for our dissatisfaction with this proposed electricity industry restructuring: the continued uncertainty surrounding the Commonwealth Government's emission trading scheme; the current state of capital markets is not conducive to the sale of such a valuable asset; and the lemma Government's history of financial and infrastructure delivery mismanagement and incompetence. Underpinning all three reasons is the fundamental issue of trust. The community does not believe that the Government can be trusted to get this privatisation right. The community does not believe that the lemma Government can be trusted to spend the proceeds of the sale in a transparent and honest manner. The community also does not believe that the lemma Government can be trusted to put public interest ahead of the Labor Party's re-election plans.

The community's concerns are well founded. The 2007 State election did not deliver the lemma Government a mandate to embark upon the sale of this State's electricity assets. In fact, the lemma Government issued emphatic denials that any such sale would take place. The arrogant dismissal of concerns held by the Government's own members and its party, whilst contemptible, is not surprising. The Government's failure to put the question to the people of New South Wales demonstrates beyond any shadow of a doubt that this is a Government out of control, out of step and out of options. Mr lemma betrayed the trust when he refused to reveal his true plan about the future of electricity prior to the 2007 State election. By opposing this legislation the New South Wales Liberal-National Coalition will ensure that the people of the State are not betrayed.

The Treasurer's ever-shifting position on the privatisation of electricity portrays him as a political opportunist. As an executive member of the Labor Council he opposed
the privatisation of electricity. On 12 February 1998 as acting secretary of the council he moved the following executive recommendation:

That ... the Labor Council re-affirms its opposition to the Egan Electricity Privatisation Proposal.

At a Labor Council meeting on 21 October 1999, in his position as Secretary of that council, he moved the following executive recommendation:

That ... the Labor Council continue its campaign against contracting out of Government employees' work and jobs.

As well as opposing electricity privatisation the Treasurer has also spoken of the need to put social concerns above market fundamentalism. In his inaugural speech to this House in September 2001 he spoke of what he imagined as a better world:

While it is true that I respect the power of the market mechanism, I reject market fundamentalism, which places all market outcomes above social concerns ... Societies structured on markets that do not deliver social outcomes supported by the majority of the community are doomed to failure.

Perhaps the Treasurer should have considered his own advice before bringing this legislation to the Parliament. In addition to those sentiments in his inaugural speech, he said:

Barrie Unsworth advised me that this inaugural speech was an important speech because it provides a public benchmark to judge one's contribution to public life. I hope that at the end of my time in this House I will be judged as having contributed to prosperity, opportunity and fairness.

As I said earlier, the Treasurer is a recent public convert to the "privatisation at all costs" agenda. As late as before the last State election—in this House on 23 November 2006—the Treasurer said:

There is no energy crisis in New South Wales ... In fact, New South Wales has surplus energy.

A month out from the State election, on 20 February 2007, he was reported in the Australian Financial Review as saying:

There are no plans to sell our retail electricity businesses.

Yet here we are in an extraordinary sitting of this Parliament, having been recalled at great expense to the taxpayer, to pass legislation to privatise the electricity assets. That I stand shoulder to shoulder with my Coalition colleagues, the Nationals, and accuse the Government of betrayal is not political rhetoric. The Government's Ministers pledged that they would not sell our State's power in any restructure, but not 12 months later, in a backflip, they announced that they would. That is a betrayal. The Treasurer does not have a monopoly on opportunism when it comes to electricity privatisation. In the other place on 9 May 2007 the Premier said, when referring to the Owen review:

The Government goes into this review with an open mind, and only two things will be ruled out. The first is nuclear power. As I have stated previously, there will be no consideration whatsoever of nuclear energy for New South Wales.
Second, there will be no sale of electricity generation, transmission or distribution. On all other matters I am yet to be convinced and will await Professor Owen's expert advice.

The Premier even has been accused of lying to Unions NSW. In a Sydney Morning Herald article dated 25 May 2007 he was reported as stating in a letter to Unions NSW:

The privatisation of the State Government-owned energy companies is not on our agenda. In fact, the NSW Government's commitment to this sector is stronger than ever ... with record investment in new and upgraded electricity infrastructure.

I reiterate: This represents a betrayal of trust. It is a lack of trust that underpins the Coalition’s opposition to these bills. While such significant uncertainty surrounds the creation of the proposed emissions trading scheme, New South Wales’s taxpayers cannot be confident they are receiving full value for their assets. My colleague the Deputy Leader of the Opposition in this House, the Hon. Duncan Gay, will further outline our concerns regarding the Federal Government’s emissions trading scheme.

The great disappointment in all of this is that rather than engage in a constructive conversation with the Rudd Government, Michael Costa has wasted time threatening Labor rank and file and berating the Opposition. When the bills are rejected by this House, responsibility will fall squarely at the feet of the Treasurer. From the outset he misled the community, isolated his colleagues and politicised the process. The Treasurer has failed to show leadership. Leadership is about engaging the community in open dialogue, leadership is about asking the hard questions, and leadership is about inspiration and bringing people along on a journey toward a desired outcome. At no point has the Government engaged the New South Wales public in anything resembling leadership consultation. Conversely, it has betrayed and engaged in spin, and in this House it will pay a hefty price for its hubris.

The proposal to privatise electricity does not meet the public interest test. In so many ways Australia’s capital market conditions are not conducive to a positive outcome for the people of New South Wales. Since the release of the Owen report in 2007, Australian stock markets have fallen significantly. The Australian All Ordinaries fell almost 20 per cent, and the Australian utilities sector index fell almost 30 per cent. The impact of falling markets is clearly evident in the Hon. Michael Costa’s consistent downward revision of the value of the assets. In December 2007 the Treasurer described a $15 billion price tag as conservative. In June 2008, he estimated the price at “around $10 billion”. If a public company mysteriously lost $5 billion off the value of an asset in the space of six months, the Australian Securities and Investment Commission would declare an immediate audit. I point out that $5 billion is equivalent to the cost of 5,000 hospital beds or 130 new schools.

Importantly, the negative impact of capital markets will not be limited to initial public offerings; it will also affect trade sales. Market multiples will be used as a part of any basic valuation for a trade sale. Furthermore the global credit crunch makes it more difficult for companies to secure debt funding. My colleague in the other place the member for Manly estimates that the cost of underwriting $10 billion in current market conditions is $400 million more than at the same time last year.
The Iemma Government has spent the last week trying to make the future of its electricity plans all about the Opposition. The Treasurer has made numerous claims about why the Opposition should support the legislation—claims that simply do not stand up to scrutiny—and says that the Owen report found that $15 billion needs to be spent on electricity infrastructure. However, he is yet to explain why spending on electricity assets has been so neglected and why allegedly we need to come up with $15 billion by 2013. We reiterate that even as late as before the 2007 State election on 23 November 2006 the Treasurer stated in this House, "There is no energy crisis in New South Wales ... In fact, New South Wales has surplus energy."

Responsible government is about planning for the future and anticipating the need for the replacement and ongoing maintenance of assets, particularly major assets such as power stations, hospitals, schools and police stations. The Treasurer claims that the details of the Commonwealth’s emissions trading scheme will be clear by the end of the year, but what he does not point out is that, just as the New South Wales Government does not control its upper House, the Rudd Labor Government does not have control of the Senate. There is no way the Treasurer can be assured that legislation for the emissions trading scheme will be in place by the end of the year or that that legislation, even if it is amended or passed, will operate as intended.

The Treasurer also believes that financial market conditions, now or indeed at the end of the year, will be conducive to the sale of our State’s electricity assets. Nobody, not even the Treasurer, knows what the market conditions will be at the end of the year. What we know now is that since the release of the Owen report in September 2007, the Australian stock market has fallen significantly. As I have said, the Australian All Ordinaries fell by almost 20 per cent and the Australian utilities sector index fell by almost 30 per cent. International rating agency, Fitch Ratings, stated:

The final valuation of NSW’s coal-fired generation assets will be affected by the details of (the) carbon pollution reduction scheme (CPRS) due to be introduced in 2010. Uncertainty over how the CPRS will affect the electricity generator’s cashflows and of the present state of credit markets are likely to affect the value of proceeds.

It should never ever be forgotten that the only reason the Government faces defeat is that it has failed to secure the votes of its own caucus members. This predicament is entirely of the Government’s own making. The Coalition’s approach to electricity privatisation was never about ticking boxes or meeting deadlines. It has always been about what is in the best interests of the New South Wales community. Our approach to this legislation has not been about the father-knows-best politics of the Australian Labor Party. From the outset, it has been about doing what the people expect of us.

My colleagues in the other place each represent more than 40,000 voters in their respective electorates. The Leaders of the New South Wales Liberals-Nationalists involved each and every one of those 40,000 voters in formulating the Coalition’s final position. The Hon. Michael Costa and his leader cannot say the same. The Auditor-General’s Report and the Rural Community Impact Statement have played an important role in our decision. We also considered a range of factors, including external economic conditions and the current state of flux in the energy sector. The
process has involved wide consultation with groups ranging from business interests to energy sector employees and of course the general community.

Ultimately the Coalition decided that the Government cannot be trusted with the privatisation of electricity. Let me echo the words of the State’s Leader of the Opposition, Barry O’Farrell, who confirmed this morning that the New South Wales Liberals-Nationals will have an energy policy to put to the people of New South Wales before the next election. Our policy will include the principle of private sector involvement where it meets the public interest. It will consider the broadest range of methods that deliver to the public the best outcomes in electricity. What our electricity policy will not be is the singular agenda of an individual member of Parliament who is intent on rushing through a fire sale of the State’s most valuable asset.

Much has been said in the press concerning the effect that this decision will have on the Coalition’s relationship with the business community. Irrespective of what some business groups might think about the role of private enterprise in electricity generation, most members of the business community would agree that the Government cannot be trusted with even the most basic economic endeavours, let alone something as substantial as electricity privatisation. Ultimately, the key stakeholders in the proposed sale of the State’s electricity assets do not sit in New South Wales boardrooms; they sit in lounge rooms. They open a power bill every three months. They will watch as market forces, both external and internal, affect the retail price of power generation. Some of them will be renters, some will pay mortgages, some will have children, and some will live on a pension.

While the lemma Government decides how to divide the spoils of its sale across marginal constituencies, these people will decide what to cut from the family budget as the cost of living in New South Wales continues to increase. It should never be forgotten that if this legislation fails today it will be because the Labor Party has split. Two parties with conflicting agendas now run the New South Wales Government. I am proud to stand shoulder to shoulder with my Coalition colleagues The Nationals in condemnation of these bills and the manner in which they have been introduced. Today we oppose legislation that puts Morris lemmas and Michael Costa’s interests and quick-fix financial gains above the interests of the people of New South Wales. The Opposition opposes this legislation.
Appendix 11  Donald Challen’s Report

Report for the Special Commission of Inquiry into the Electricity Transactions

Background

1. The Honourable Brian Tamberlin QC has been appointed as Special Commissioner under the authority of the Special Commissions of Inquiry Act 1983 to inquire into and report on all matters relating to the electricity transactions. The electricity transactions refers to the sale in 2010-11 of the three retailer SOCs, the sale of the electricity trading rights of two of the generator SOCs, the sale of some power development sites and certain proposed transactions that did not proceed.

2. The Inquiry has retained me to provide advice in relation to certain of its terms of reference. My tasks relate particularly to the determination of the retention value to the State of the assets; whether, relative to the retention value, the State achieved value for money from the transactions; the costs and benefits, risks and liabilities of the transactions and the extent to which the transactions achieved their stated objectives.

3. A summary of my responses to the specific questions I was asked to address by the Inquiry are set out in paragraphs 194 to 206 below.

The transactions

4. The transactions are described in detail in the Final Report and need only be described briefly here for completeness.

5. The retail businesses of Energy Australia, Integral Energy and Country Energy were separated from the electricity and gas network businesses with which they had previously been integrated, and sold.

6. The generator SOCs were formed into four contract bundles with the intention of selling the physical dispatch and trading rights of the output of the SOCs. In the event, only two of the four contract bundles were sold – Eraring and Delta West. The purchasers of these contract bundles are described as the gentraders.

7. The State also owned seven development sites which had been identified for future electricity generation developments. These sites were offered for sale, though in the event only four of these development sites were sold – two at Marulan, the Mt Piper extension and Bamarang.

8. Initially, the State had intended to sell the Cobbora mine but, following a sale-by-tender process, determined not to proceed. Subsequently, it was decided to place the Cobbora mine into a new SOC which would sell coal to the gentraders on fixed contractual terms.

9. SOCs retained ownership of the power stations and are contractually obliged to operate and maintain them to make available particular levels of electricity output specified as
availability targets in the contracts. All of that output is made available to the gentraders who may sell it as they wish. If a SOC fails to meet the availability targets, liquidated damages (ALDs) are payable to the relevant gentrader. These ALDs are subject to annual maximum amounts.

10. All of the dispatch and trading rights to the electricity output of the power stations was transferred to the gentraders. They also had assigned to them the existing contracts for sale of output from the power stations (power purchase contracts or PPAs) and the existing financial derivative contracts which are used in part to manage the electricity market risk associated with operating power stations. Collectively, these contracts are called the hedge book, ownership of which passed to the gentraders.

11. The gentraders are responsible for supplying fuel to the power stations and meeting the cost of water used in the operation of the power stations. The Cobbora coal supply agreements have significantly mitigated the fuel supply risk to which the gentraders would otherwise have been exposed.

12. The gentraders make two forms of payment in return for the rights they have acquired. On a recurrent basis, for the period of the transactions (19 to 33 years depending on the power station), they pay to the SOCs contractually determined amounts to cover the fixed, variable and pass-through costs of operating and maintaining the power stations. They also pay pre-determined amounts to cover the capital expenditure required on the power stations.

13. The gentraders also pay annual capacity charges specifically for the dispatch and trading rights to the output of the power stations. These capacity charges have been paid in upfront amounts and represent the sale proceeds for the rights the gentraders have acquired. After retiring debt of the SOCs, the balance of these proceeds is available to the State.

**Information available**

14. My analysis and conclusions are based entirely on the documents available to me.

15. While I have been greatly assisted by the Counsel Assisting and staff of the Inquiry, I have not made any enquiry beyond that. Except where specifically stated, I have not independently verified any of the information provided to me.

**Process for implementing the transactions**

16. The transactions were implemented using a process which, in my view, meets best practice standards. The governance arrangements were robust, implementation was thorough and documentation appears generally to have been of a good standard. A Probity Adviser (RSM Bird Cameron) maintained oversight of compliance with five probity principles set out in the probity plan approved for the project. The five probity principles were fairness; accountability, transparency and consistency; confidentiality and security; dealing with conflicts of interest; and value for money. As would be expected for a project of its size and complexity, in the course of their engagement RSM Bird Cameron dealt with and satisfactorily resolved a number of probity issues. RSM Bird Cameron’s *Independent Final Probity Report: Request for Binding Bids* dated March 2011 after financial close of the recommended transactions, documents a
number of probity issues which arose in the course of the project. These include inadvertent release of information to an incorrect bidder by legal advisers; apparent leaks to the media on a couple of occasions by sources that were not identified; an accidental confidentiality breach by a bidder due to an incorrect email address being used; a bidder using information from an unauthorised source; and conflicts of interest arising from the appointment to the boards of the generator SOCs in December 2010 of three individuals working on the project and bid evaluations. While the last of these breaches was not good practice, none of the probity breaches are of great significance. Probity issues of this sort are not unexpected in a project of this scale and complexity. RSM Bird Cameron’s report is both thorough and comprehensive. It notes that all the probity issues that arose during the project were closed by the date of signing of their final report.

17. Expert advisers were engaged to assist the Steering Committee which took overall responsibility for the conduct of the transactions. Various working groups were established with responsibility for particular aspects of the transactions.

18. For present purposes, the two most important of the working groups were the Retention Value Working Group and the Evaluation Committee.

19. The Retention Value Working Group had responsibility for developing the methodology for determining the value of the companies, the assets and rights of which were for sale, on the assumption that those assets and rights remained in the ownership of the State.

20. The Evaluation Committee had responsibility for examining and evaluating the bids received against pre-agreed criteria, for negotiating contractual details and risk allocation with bidders, and making recommendations to the Steering Committee on which transactions should be recommended to the Government.

21. The Retention Value Working Group arranged its affairs so that its final report was available to the Steering Committee and the Budget Committee of Cabinet, prior to the consideration of the bids for the assets and rights. This is clearly good practice but it was also broadly consistent with recommendations made by the Auditor-General in his August 2008 report, *Oversight of Electricity Industry Restructuring*.

22. The bids were received on 15 November 2010. The Retention Value Working Group’s methodology was established in March 2010 and its final report specifying the retention values was signed off on 14 November 2010 (the *Retention Value Report*).

23. The Retention Value Working Group was assisted by the financial advisers to the project, Lazard Carnegie Wylie and Credit Suisse, and Frontier Economics. Frontier Economics undertook the energy market modelling which was necessary to establish the future revenue streams for the existing businesses on which the retention value methodology is founded.

24. The work of the Retention Value Working Group, and most particularly the model which was used to undertake the retention value calculations was subject to review and audit by Ernst & Young. Ernst & Young’s working papers reveal that a thorough and highly competent review of the retention value models was undertaken. Ernst & Young made many suggestions for correction, improvement and refinement of the spreadsheet.
models used to undertake the retention valuation calculations. All of these suggestions were adopted by the Retention Value Working Group. Ernst & Young provided separate reports for the generator SOCs' retention value financial model and the retail SOCs' retention value financial model. After noting that "The objective of the Model is to generate valuation outputs for the generation/three retail companies involved in the Project" Ernst & Young reported at the end of the process as follows:

Based on the work that we have performed, nothing has come to our attention to suggest that:

1) the key assumptions and input data set out in the Data Book have not been properly input into the Model;

2) the Model has not been constructed appropriately. in so far as its logical integrity and arithmetic is concerned, so as to materially achieve the objective described above after adjusting the base case assumptions and input data to reflect certain designated sensitivities... as set out in Appendix C;

3) the key provisions of specified extracts from certain Project Agreements and Financing Documents... have not been appropriately represented in the Model to the extent that they are material to the Model achieving its objective under the base case assumptions.

25. The Retention Value Report attached Ernst & Young's report as Appendix G.

26. Ernst & Young's work provides a high degree of assurance that the logic and arithmetic of the retention value calculations are correct. It also provides assurance that the external inputs to the model have been correctly taken into the model.

27. The remaining element in the process of developing the retention value estimates is the estimates of electricity output volume and price prepared by Frontier Economics under various scenarios developed by the Retention Value Working Group. While Ernst & Young have attested that the output of Frontier Economics' work has been correctly input into the retention value financial model, Frontier Economics' work itself, as an element of the retention value modelling, has not been subject to quite the same form of independent verification as the retention value financial model. However, various forms of assurance are available.

28. The members of the Retention Value Working Group and the expert advisers (particularly the senior staff of Lazard Carnegie Wylie) had considerable knowledge and expertise in the Australian energy market. This equipped them well to subject Frontier Economics' work and the output of Frontier Economics' energy market model to critical scrutiny. The evidence to the Inquiry (from Richard Timbs, who chaired the Retention Value Working Group) demonstrates that the Working Group's members and advisers did indeed subject Frontier Economics' work to critical scrutiny and that in one case in particular, pricing assumptions proposed by Frontier Economics were changed on the grounds that they were too conservative (in the sense of depressing the retention value estimates).

29. Each of the then existing SOCs had, of course, prepared and maintained detailed financial forecasts for their businesses. These provided a set of cash flows for five years or so consistent with the retention scenario. Because these forecasts had been prepared by each business independently, they were not (and could not have been expected to be) based on consistent assumptions or modelling. The potential for inconsistencies between the forecasts makes these SOC cash flows unsuitable for use in the retention valuation. In any event, the SOC forecasts were only available for a five year period;
insufficiently long for the valuation exercise. Consequently, the SOC cash flows could not be used directly for the Retention Value Working Group’s valuation. However, these SOC cash flow forecasts were available to the Retention Value Working Group and it is evident from the *Retention Value Report* that the Retention Value Working Group used these pre-existing cash flow forecasts to “sanity test” the cash flows for the early part of the period used in the retention valuation.

30. All these processes help build confidence that Frontier Economics’ assumptions, methodology and modelling produced reasonable results.

**Retention value methodology**

31. The Retention Value Working Group used a very standard methodology to establish the retention value of the companies, the assets and rights of which were for sale, on the assumption that those assets and rights remained in the ownership of the State. That methodology is described in detail in the *Retention Value Report*.

32. At the most basic level, the methodology is to form a retention value estimate by discounting the future cash flows from ownership.

33. In what follows, I describe the process used to establish cash flows for each of the generation and retail businesses. I separately describe the method used to develop the discount rates and I assess the reasonableness of the discount rates used in the valuations. In forming a judgement about the cash flows used in the valuation process, my remarks above about the centrality of the Frontier Economics work are very relevant. To paraphrase one finance industry sage, in any valuation exercise, the cash flows are a lot more important than the discount rate.

**Estimates of cash flows**

34. The approach is to form estimates of the net cash flows for each of the companies on a business as usual basis. These cash flows are on a pre-tax basis because the State as owner is not subject to tax. Although most NSW State-owned businesses are subject to the National Tax Equivalent Regime, this operates only to achieve competitive neutrality with privately-owned businesses, and the tax is paid to the state which is also the owner of the businesses.

35. In the case of the generators, net cash flows were established for each year through to the end of the life of each of the power stations. This reflects decisions that each of the SOC boards had made about the economic and technical life of their power station assets. The assets are assumed to have nil terminal value at the end of their economic life.

36. For the retailers which do not have a finite life, the approach used was to form net cash flows for a 5 year period. Beyond that period, the retail businesses are assumed to be in a steady state. Taking the year 5 cash flow as the starting point, the cash flows are projected forward in perpetuity, assuming they grow annually by a constant expected long-term growth rate. The present value of this stream of cash flows in perpetuity is then calculated as at the end of year 5. It is described as the terminal value and embodies the value of the retail business, assuming steady state operation, beyond year 5.
37. In addition to the net cash flows from operations, the retention valuation takes into consideration the cash flows arising from the business' hedge books (see paragraph 10). These are also valued year by year using the electricity price and volume scenarios modelled by Frontier Economics.

Discount rates

38. The discount rates are determined in a conventional way using the Capital Asset Pricing Model (CAPM). The application of the CAPM in determining the discount rates for the retention value calculation is described in Appendix A of the Retention Value Report. The application of the CAPM yields different discount rates for the generation businesses and the retail businesses because the risk characteristics of the cash flows from owning these businesses differ.

39. The application of the model requires three parameters – the risk-free rate of return, the market risk premium and the equity beta for the particular asset under consideration.

40. Consistent with standard practice, the then current yield on 10 year Australian Government bonds is used as a proxy for the risk-free rate of return.

41. As the Retention Value Report notes, “The market risk premium... represents the additional expected return over the risk-free rate that investors require to invest in equity securities as a whole to compensate them for the additional risk associated with investing in equities as opposed to assets on which a risk free rate of return is earned.” Noting that IPART concluded in its March 2010 review that a range of 5.5 to 6.5 per cent per annum is appropriate and that this range is consistent with usual Australian practice, the Retention Value Working Group opted to use [5.5 - 6.5] per annum for the market risk premium.

42. Establishing a value for the equity beta for each asset is a more difficult exercise and always involves judgement. The Retention Value Report notes:

Beta is a measure of the expected volatility of the returns on an investment relative to returns of the market as a whole... It is an ex-ante, rather than ex-post concept. The choice of the beta requires careful judgement and necessarily involves subjective assessment as it is subject to statistical measurement and estimation issues and a high degree of variation. Accordingly a common practice is to use industry betas based on averages as a technique for estimating a more reliable beta figure rather than placing reliance on the beta of any one particular comparable company. This requires a reasonably similar business profile of the companies as well as a sizeable number of industry peers.

43. After considering the available estimates of betas for reasonably comparable energy companies in Australia and a small number of similar overseas companies, the Retention Value Working Group settled on an equity beta for the retail businesses of [0.9 - 1.1]. By comparison, in its March 2010 determination, IPART concluded that 0.9 to 1.1 would be appropriate for both retailers and generators. In this light and the energy company comparisons, the retail business equity beta settled on by the Retention Value Working Group is reasonable.

44. For the generators, the Retention Value Working Group settled on a range of [0.9 - 1.1], somewhat higher than the range of 0.9 to 1.1 which IPART concluded was appropriate.

45. The Retention Value Working Group argues correctly that the generators remaining in State ownership, among other factors, are exposed to considerable delivery and pricing
risk associated with the Cobbora Coal Project, and technological risk associated with retrofitting to meet carbon reduction requirements. This suggests that equity betas somewhat higher than those accepted by IPART are appropriate for the retention valuation exercise.

46. There is always some room for argument about the chosen equity beta in an application of the CAPM. However, alternative judgements using the available comparators are not likely to shift the discount rate range down by more than say 2 percentage points at either end. To put this in perspective, this would increase the retention values of each of the generators by about 4.5%. Considered in the context of the transactions which proceeded, the total retention value of the businesses recommended for sale would have increased by about 1.6%. This is not material.

47. Accordingly, my view is that the range for the generation business equity beta settled on by the Retention Value Working Group is reasonable.

48. Under the CAPM, the discount rate (more precisely the cost of equity capital) is formed from:

\[
\text{Cost of Equity Capital} = \text{Risk-Free Rate of Return} + \text{Beta times Market Risk Premium}.
\]

49. Application of this formula yields discount rates in the range [---] for the generation businesses and [---] for the retail businesses.

50. Overall, my conclusion is that the ranges of discount rates used in the retention value analysis are appropriate and reasonable.

**Forming the retention valuations**

51. Having established net cash flows for each business (and terminal values for each of the retail businesses), a present value as at 28 February 2011 (the valuation date) is calculated by applying a discount rate. For the generation businesses, a stream of cash flows out for up to about 30 years (reflecting the life of the various items of generation plant) is discounted back to 28 February 2011. For the retail businesses, the cash flows for the first 5 years and the terminal value at the end of year 5 are discounted back to 28 February 2011.

52. As already explained, a range of discount rates (see paragraph 49) is applied reflecting the fact that some judgement is required in the application of the CAPM. Consequently the methodology yields a range of valuations for each of the operating businesses.

53. The development sites are valued using the current book values from the relevant owner business.

54. The resulting business valuations are aggregated into a so called sum-of-the-parts retention value which is shown in the *Retention Value Report* as a range for the retail assets, a range for the generation assets, a single value for the development sites and a range for the total.

55. When the retention values were later used in preparing the assessment of the bids and recommendations to Government for those transactions to be entered into, the sum-of-the-parts retention value was of little relevance because acceptable bids were not
forthcoming for all of the assets and rights offered for sale. However, the methodology made it a simple matter to extract the retention values for the assets and rights the subject of recommended transactions. This permitted a comparison of bid prices for individual assets and a comparison of total proceeds with the total retention value for the recommended transactions. These comparisons are contained in the Memorandum from the Evaluation Committee to the Steering Committee and Budget Committee of Cabinet circulated in December 2010.

Retention value assumptions

56. Any complex valuation exercise rests on a large number of assumptions about the values assigned to parameters. These parameters are the inputs to the valuation exercise. They are embedded in the financial model used to develop the valuation and, in this case, because market influences are so fundamental to the valuation, they are also embedded in the Frontier Economics modelling.

57. Standard methodology is to identify those assumptions which have a material impact on the final valuation and to prepare “sensitivities” which show how much the valuation changes in response to a specified change in the assumed parameter value.

58. One of those parameters has already been discussed, namely the discount rate used to bring future cash flows back to a present value. In each case, a range of values was established and a retention value range was calculated corresponding to the range of values for the discount rate parameter.

59. In the retention valuation of the generators, the parameters which materially affected the valuation were all market-related and had their impact through the Frontier Economics modelling work. These parameters were:

a. The overall demand for electricity in the NEM;

b. The carbon price applicable on the assumption that the Commonwealth Government’s then proposed CPRS was implemented; and

c. The fuel price available to (other) gas plant in the NEM.

60. The AEMO, which operates the NEM, annually prepares a Statement of Opportunities document which provides estimates of market demand in the NEM under various scenarios. The medium energy growth scenario from the 2010 Statement of Opportunities was used as the base case and sensitivities prepared for each of the 2010 Statement of Opportunities low and high growth scenarios.

61. At the time Frontier Economics and the Retention Value Working Group were developing their estimates, the expectation was that the Commonwealth Government would implement a CPRS which would target a reduction nationally in carbon emissions of 5%. This scheme formed the base case for the retention valuation exercise and Frontier Economics developed a time profile of carbon prices consistent with that assumption as inputs into its modelling.

62. Sensitivities were prepared on the assumption that the CPRS did not proceed; and an assumed CPRS which targeted a reduction in carbon emissions nationally of 15%.
63. The fuel price available to other gas plants in the NEM (hereafter the "gas price") was probably the most controversial of the assumptions. Frontier Economics' original advice dated March 2010 proposed using a gas price profile (together with other costs and operating parameters for other plant) taken from a report prepared by consultants ACIL in April 2009 for AEMO which was updated in 2010 in a report ACIL prepared for the Queensland Competition Authority on the basis that this was the most recent public source. The ACIL gas price profile (expressed in constant 2010 dollars) starts just below $5/GJ in 2013, rises sharply to nearly $7/GJ by 2015 and then increases gradually to about $8/GJ by 2028. Evidence to the Inquiry from Richard Timbs reveals that the gas price profile assumption was the subject of considerable debate and, contrary to the preference of Frontier Economics, the consensus of the Retention Value Working Group and its advisers was that the ACIL gas price was not current. The Retention Value Working Group ultimately opted to use as its base case gas price the ACIL profile plus $0.50/GJ.

64. Frontier Economics' later report of July 2011 makes it clear that their use of the ACIL profile plus $0.50/GJ is "as per instruction by the NSW Reform Unit".

65. A single gas sensitivity was prepared using the ACIL profile, that is, base case less $0.50/GJ.

66. The gas price assumption ultimately used in the retention valuation (ACIL profile plus $0.50/GJ) was conservative. It had the effect of boosting the retention value by almost 100% relative to the retention value based on the unadjusted ACIL gas price profile.

67. The fact that members of the Retention Value Working Group were prepared to adopt a gas price base case assumption that had this impact on the retention value supports a contention that serious and objective consideration was given to the most appropriate gas price. There is also support for their view in the Review of Frontier Report on Cobbora coal mine: Assessment of fuel resources in NSW energy market by Ernst & Young dated July 2010 which surveys a number of sources of information about future gas (and coal) prices.

68. I am inclined to the view therefore that the assumption was carefully chosen and appropriate.

69. The other assumptions which had a material effect on the retention valuation, for which sensitivities were prepared, were relatively uncontroversial. The NEM demand assumptions were based on the AEMO Statement of Opportunities – undoubtedly the most reliable, robust and authoritative source of such estimates. As such, the Statement of Opportunities is an obvious choice of source.

70. The CPRS/carbon price assumptions were sensibly based on the Commonwealth Government's very clear intentions of the time (albeit not realised) with a sensitivity based on no CPRS. While a 15% CPRS sensitivity was prepared it is unlikely that it was of great interest beyond revealing that as the national target within the CPRS increases above 5%, the impact on the retention value progressively lessens.

71. Three assumptions had a material effect on the retail business retention valuations:

a. The rate at which the customer base turns over, known as the churn rate;
b. The growth rate of revenues after the end of year 5 in the perpetual growth model used to estimate the terminal value; and

c. The gross margins available to the businesses beyond year 5 in the perpetual growth model used to estimate the terminal value.

72. The assumptions used for the churn rate and gross margins reflect historical experience and are reasonable. The assumed range of [30%] per annum for the growth rate of revenues is based on the anticipated growth rate for long-term price inflation in the Australian economy. This is also quite reasonable.

73. As noted above, there were a number of other assumptions, particularly in Frontier Economics' work which affect the retention valuation. The latter are identified in Frontier Economics' Modelling Assumptions, Framework and Results Working Note dated July 2011. The assumptions include the prices and volumes of existing coal supply contracts and spot market coal purchases, operating costs and technical efficiency parameters for the various power stations, and capital costs and operating parameters for new plant. The assumptions used are mainly based on historical experience, especially technical and cost parameters and contractual arrangements (for example for the delivered cost of coal to the power stations). The assumptions used are adequately justified and appear reasonable. None of them individually has a material effect on the retention valuation.

The retention valuation and sensitivities

74. As noted in paragraphs 31-55, the retention value methodology produces a valuation range (depending on the discount rate) for each of the generation assets and each of the retail assets. These are combined with the book values of the development sites to create a sum-of-the-parts retention value. This valuation is most easily found in the Memorandum from the Retention Value Working Group to Richard Timbs dated 14 November 2010 entitled Retention Values. This document also contains the results of the sensitivities described in paragraphs 74-82. The Appendix to this document provides the valuations and sensitivities for each of the individual generation and retail assets. The latter information is needed to form the retention values for the assets the subject of the recommended transactions, discussed further in paragraphs 83-99.

75. For confidentiality reasons, the retention valuations themselves will not be discussed here. What is worthy of note, however, is that the retail retention value varies per percentage point change in the discount rate by about [30%]; the generation retention value by about [30%] and the total by about [30%].

76. The retail valuation sensitivities reveal that the retail assets value is quite sensitive to the customer churn assumption, falling by 40% in response to a 2.5% reduction or rising by 32% in response to a 2.5% increase in customer churn. Similarly, the retail values are quite sensitive to changes in the gross margin available to the retail businesses in the period beyond year 5. Increasing the gross margin by 5%, increases the retail assets value by 35%, reducing the margin by 5%, reduces the value by 46%.

77. On the other hand, the retail valuations are relatively insensitive to the growth rate beyond year 5. A reduction of 1%, reduces the retail assets value by 13%, while increasing the growth rate by 1%, increases that value by 4%.
78. The generation asset values are all very sensitive to changes in the assumed values of the material parameters.

79. As already noted above, reducing the gas price (available to other generators in the NEM) by $0.50/GJ reduces the generation assets value by 53% (this is equivalent to the earlier statement that increasing the gas price from the ACIL estimate by $0.50/GJ increased the retention value of the generation assets by about 100%).

80. Relative to the 5% CPRS base case, the generation assets value increases by about 75% if there is no CPRS. A 15% CPRS reduces the generation assets value from the base case by 59%.

81. Finally, relative to the Statement of Opportunities medium demand base case, the generation assets value is 59% lower in the low demand scenario or 25% higher in the high demand scenario.

82. None of these results are surprising.

**Outcome of the transactions**

83. A key question is whether the State received value for money from the transactions which proceeded. This question has two dimensions. First, whether the transaction was structured and implemented so as to incentivise bidders to bid the best possible price available for the assets and rights. Secondly, whether the net proceeds received by the State exceeded the retention value of the assets and rights sold. In the event, neither of these questions is entirely straightforward to answer.

84. The first step in structuring the transaction was to determine which assets and rights were to be sold. The main issue which the Steering Committee tackled here was the way individual power stations were to be combined into gentrader bundles. While various options were considered, ultimately the Government approved the four bundles of Macquarie (4700MW), Eraring (2940MW), Delta West (2400MW) and Delta Coastal (2600MW). The other assets were straightforward as each of the retail businesses (after separating out distribution and transmission activities which remained in State ownership) and each of the development sites were sold as individual units.

85. The packaging of the gentrader bundles may well have had some impact on bidder appetite for the rights. The Steering Committee gave this matter considerable attention and, in providing advice to Government to proceed with the four bundles, made a judgement call on the basis of the analysis and advice it received. I conclude that this element of the structure of the transaction was well executed. It is not possible to make a judgement about the impact on the outcome relative to the alternatives considered.

86. In any event, this and other aspects of transaction structure pale into insignificance relative to the decision to offer gentrader rights as opposed to a conventional divestment of the physical assets. That decision was the most significant by far in impacting on the value for money received by the State.

87. In deciding to proceed with the gentrader transactions, the State effectively made a decision to exchange one set of risks for another. The State was relieved of the set of risks involved in participating in the wholesale electricity market. These risks are very significant and, of course, it was a specific objective of the Energy Reform Strategy to
reduce the State’s exposure to such risks. In eliminating exposure to these risks, however, the State accepted exposure to a new set of risks. The transactions were structured so that the operating and capital costs of the power stations would be recovered from the gentraders on a basis determined contractually at the outset of the transaction. The State therefore became exposed to the risk that the actual operating and capital costs incurred by the generator SOCs are greater than the amounts recovered from the gentraders. Given the long life of the transactions, these risks are considerable.

88. The other significant consequence of the decision by the State to proceed with the gentrader transactions was the loss of value of the option to conventionally divest the physical assets at some time in the future. This is significant because the complexity of the gentrader transactions means it is unlikely that bidders would price the rights purchased as keenly as they would in a clean conventional divestment of the physical assets.

89. Putting these issues aside, and accepting that gentrader rights were to be sold, the transaction was structured in a very conventional way, once the threshold question was settled of the way the assets and rights to be sold were bundled.

90. The approach to the transaction involved a preliminary road show to demonstrate the Government’s commitment to proceed and build rapport with bidders; widespread advertisement nationally and internationally of the opportunity; an expressions of interest process to pre-qualify bidders who were to be given access to the data room; vendor due diligence to ensure the Government was well informed about what it was selling, including inherent risks and contingent liabilities, as well as to provide data to bidders to assist them evaluate and value the assets; a binding bid process; structured evaluation of the bids against a pre-approved set of criteria; clarification questions of bidders; negotiation with bidders to fine tune their bids and adjust risk allocations; and finally a recommendation to Government to proceed with certain transactions. All of this is described in detail in Chapter 5 of the Final Report.

91. The prices bid by the three final and preferred bidders for the assets are set out in the Memorandum from the Evaluation Committee to the Steering Committee and Budget Committee of Cabinet entitled Evaluation Report Bid Price Information. These bid prices represent gross proceeds. A number of adjustments are necessary to arrive at the net proceeds which are shown in NSW Treasury’s Draft Response to the Auditor-General’s Electricity Sale Transactions Report dated 24 March 2011.

92. The most significant of these adjustments is to deduct the present value of the Availability Liquidated Damages. Estimates of the Availability Liquidated Damages are provided in the report by SFG Risk Analysis of Gentrader Contracts dated 15 December 2010. It is important to note that Availability Liquidated Damages are financial penalties for under-achieving the target generation for each generation plant specified in the gentrader agreements. The targets for each power station reflect an assessment of what is reasonably achievable given the operating characteristics and history of each plant. As such, the State through its SOCs is exposed to the same financial risks in the retention scenario. Consequently, the financial consequence of variation in availability is embedded in the generation retention values. For this reason, it is necessary to deduct the present value of the probable stream of Availability Liquidated Damages in arriving at net proceeds.
93. For completeness, I note that, in arriving at net proceeds, Treasury has deducted transaction costs which total $180 million and has apportioned them to each of the assets and rights sold. I suspect that, in the main, these transactions costs were sunk by the time the bids were lodged and the decision whether or not to sell was to be made. If I am correct, the transaction costs should have been omitted from the net proceeds calculation for the purposes of comparison with retention values. However, the amounts are not material to the assessment so I have not adjusted Treasury’s figures.

94. Treasury has provided a range of gross and net proceeds for each of the assets and rights which reflect the additional amount the buyers will pay if the gentraders receive a favourable Private Tax Ruling from the ATO confirming the tax deductibility of capacity charges. In the absence of advice that the probability of a favourable ruling is very high, my view is that the additional payment amount should be excluded from net proceeds for the purposes of the retention value comparison.

95. Table I shows the relevant figures for the net proceeds-retention value comparison. While the table provides detail at individual asset/right level, at least for the assets sold to Origin, the most appropriate comparison is undertaken for each bidder/buyer. It is evident from the Bid Evaluation Report dated 13 December 2010 that Origin’s interest was in purchasing the bundle of assets not individual assets. The documentation does not support the same conclusion for TRUenergy so it is possible the Government could have accepted TRUenergy’s bid for Energy Australia and the development sites but declined to sell the Delta West gentrader. In interpreting the table, the range shown in the retention value column relates to the range of discount rates chosen (refer to paragraphs 38-50).

96. It is clear from Table I that the net proceeds from the bundle of assets/rights sold to Origin significantly exceed their retention value. The same is true of the Bamarang development site sold to Infratil. In the case of the bundle of assets purchased by TRUenergy however, the margin by which net proceeds exceeds retention value is smaller and negative for the upper end of the discount rate range.

Overall, net proceeds exceed the mid-point of the retention value range by about
98. It is also apparent from Table 1 that the net proceeds from neither the Eraring nor the Delta West gentrader came anywhere close to their retention values. In part this reflects the complexity of operating under the gentrader structure relative to outright ownership of the generators and the loss of some tax benefits that would be available to owners of physical plant. It also no doubt reflects the difficulty on the part of bidders for these rights of valuing the revenue streams from coal generation assets given the uncertainty around a carbon trading regime, the high sensitivity to the market gas price and general NEM market conditions. The same uncertainties are encountered in the retention valuation exercise, starkly illustrated by the high sensitivity of the retention values to those key parameters.

99. If net proceeds was the only criterion for making the sell/don’t sell decision, the Government may not have proceeded to sell the Eraring and Delta West gentraders on the basis that the net proceeds from the bids did not exceed the retention values of those rights. However, net proceeds was not the only criterion and the decision to sell was fully justifiable by reference to the full set of objectives and the fact that, at the level of each bidder and overall for the collection of assets and rights, the net proceeds far exceeded the retention value. This issue will be considered further in paragraphs 134-159 below:

**Benefits, costs, liabilities and risks**

100. Another perspective on the outcome is whether the benefits derived by the State by undertaking the transactions outweigh the costs and liabilities incurred together with the risks which are retained by the State. This issue is best considered separately for each of the main groups of transactions: sale of the gentrader rights, sale of the retail businesses, sale of the development sites and the Cobbora mine development.
Sale of the gentrader rights

101. Consideration is most complex for the sale of the gentrader rights. The main benefit-cost consequences that are specific to these transactions are encompassed in the net proceeds-retention value comparison. Thus, the retention value – a stream of revenue, net of operating and capital costs, from selling the output of the power stations and trading in the electricity market – has been exchanged for the net proceeds – an upfront amount to cover capacity payments net of the expected value of the Availability Liquidated Damages. Because a separate stream of contractual payments covers expected operating and capital costs, net proceeds is net of operating and capital costs and can therefore be compared directly to retention value (ignoring for the moment the possibility that actual operating and capital costs might differ from the contracted payments).

102. The State’s risk profile has changed. The State benefits because some risks have passed to the gentraders and some previously uncapped risks are now capped. Thus:

a. Electricity market price and volume exposure, trading risk, fuel price and availability risk, water supply price and availability risk, and carbon price risk have been passed to the gentraders; and

b. Uncapped availability risk – which is a form of electricity market risk – has been exchanged for Availability Liquidated Damages which are capped on an annual basis.

103. But the State has accepted some new risks:

a. The State is exposed to the risk that the gentrader contractual payments to cover operating and capital costs are insufficient to cover the actual costs incurred in meeting the plant availability requirements; and

b. The State is exposed to the risk that the complexity of the gentrader arrangements may give rise to future disputes and litigation, particularly if there is a break down in the high level of cooperation between the State and the gentraders needed for the arrangements to work effectively.

104. The State has accepted new costs:

a. Through the generator SOCs, the State is liable for the cost of managing the very complex contractual relationships with the gentraders.

105. These new costs cannot be readily quantified but they are real costs.

106. It is not easy to quantify the expected value of the modified and new risks. My view is that the risk is high that the gentrader contractual payments to cover operating and capital costs will be insufficient to cover the actual costs incurred in meeting the plant availability requirements. This risk has high likelihood in part because payments are based on a set of fixed indexation arrangements with no provisions for reopeners or resets to market at any time over the life of very long contracts. The magnitude of this
risk (its consequence) is also potentially large. Based on this reasoning, my judgement is that the expected value of the modified and new risks is material.

107. Since the net proceeds from the sale of the gentrader rights fell significantly short of the retention values, since there are new costs, and there are no material benefits or cost savings not encompassed by the net proceeds-retention value comparison, if the expected value of the modified and new risks is indeed material, there can be no doubt that the benefits of the sale of the gentrader rights fail to exceed their costs and risks, considering the gentrader transactions in isolation.

Sale of the retail businesses

108. Turning now to the sale of the retail businesses, there is little to take into account that is specific to the transactions that is not encompassed in the net proceeds-retention value comparison.

109. However, there is an additional benefit:

a. The State has withdrawn completely from electricity retailing which is likely to encourage new private sector participation and investment in this market.

110. The State has been relieved of the costs of managing its ownership of the retail businesses but has accepted some new costs:

a. Guarantees have been given to retailer SOC employees of employment continuity and entitlements to redundancies which would not have been necessary had the retail businesses continued in State ownership; and

b. The network businesses retained in State ownership are of smaller scale, after separation and sale of the retail businesses, which means the fixed costs of those remaining businesses must be spread over a smaller activity base and synergies will have been lost.

111. The State’s risk profile has again changed. Thus:

a. The State is completely relieved of its exposure to electricity market risk through the retailers; but

b. The State is exposed to a risk of stranded assets (particularly information technology assets) in the network businesses as the interim arrangements to provide services to the buyers of the retail business under Transition Services Agreements conclude; and

c. There is a risk that the contracted fees payable by the purchasers of the retail businesses under the Transition Services Agreements fall short of the actual costs of providing those services.

112. Net proceeds far exceed retention value for each of the retailers sold. In addition, the benefit of eliminating the State’s exposure to electricity market risk is considerable. Given that a number of the other costs and risks fall within the residual network businesses and can be managed there, the other benefits costs and risks are relatively small.
113. Consequently, it can be concluded with some confidence that, for the retail businesses, the benefits of the sale exceed the costs and risks by a considerable margin.

*Development sites*

114. The development sites are small in the scheme of things. While the net proceeds from the sale of those sites all exceed retention value, and in all but one case by a considerable margin, given that accounting book values were used to establish retention values, the net proceeds-retention value comparison is not as valuable in assessing costs and benefits as is the case for the sale of the gentrader rights or the retail businesses.

115. In selling the Mt Piper development site, the State has accepted an uncapped liability for the remediation of that site. While that might be thought of as a liability that needs to be reckoned among the costs attributed to the sale process, the remediation obligation existed when the site was in State ownership through a SOC. Consequently, that liability has not changed through the sale of the site and it should not be included as either a cost or a benefit.

116. The main benefit of selling the development sites is to send a strong signal that the State has removed itself as a potential developer of new generation capacity and thus to encourage private sector development of new generation capacity in NSW. The State could have attempted to achieve more certainty around those future generation developments, for example, by requiring the purchasers of the development sites to commit to generation developments within a particular period of time. Realistically, however, such commitments would have been very difficult to obtain and would likely have resulted in the value of the development sites being heavily marked down, and possibly failing to sell.

117. On balance, given that the key objective of the sale of the development sites has been achieved, it is safe to conclude that the benefits of these transactions exceed the costs.

*Cobborra mine development*

118. Finally, I turn to consider the benefits and costs embodied in the Cobborra mine development. Different considerations apply here because, unlike the other transactions, the Cobborra mine has not been sold. As such, the ownership risks all remain with the State.

119. The Cobborra Coal Project was initially developed by a joint venture owned by the pre-transactions generator SOCs. A tender was conducted to find a suitable private sector operator for the mine. Ultimately, the Government decided not to accept the proposal from the preferred tenderer (XXXXX). During the structuring phase of the other transactions in October 2010, it was decided to shift the Cobborra mine development into a newly-created SOC. This SOC has contracted with the gentraders as part of the overall arrangements for the sale of the gentrader rights. Contracts also exist between the Cobborra SOC and the SOC-owned generators still in State ownership (Delta Coastal and Macquarie). However, these transactions can be mainly ignored for the current purpose as, being between State-owned entities, they have no net effect.

120. The Cobborra transaction is of considerable benefit to the gentraders – it significantly reduces their volume and price risk in sourcing coal to fuel the power stations.
121. Cobbora is as yet still under development; it is not expected to produce coal to meet the State's obligations to the gentraders before 2015. Nevertheless, through the Cobbora SOC, the State is obliged to supply to the gentraders with coal from the mine at a fixed price of [REDACTED], escalated using a composite cost index.

122. The memorandum from the Retention Value Working Group to the Steering Committee dated 12 November 2010, entitled Retention Value - Methodology and Assumptions, reveals that the contracted price falls short by about [REDACTED] of the preferred bidder [REDACTED]'s price (indicative price of [REDACTED] capped at [REDACTED]). The Retention Value Working Group Report states that the contracted price “…is likely to approximate the cost of developing the mine under the [REDACTED] offer without any allowance for return on capital or margin for a third party miner.”

123. A commercial business case for the development of a project such as the Cobbora Mine would normally provide comfort that earnings from the operation of the mine (after meeting the capital and operating costs, and providing a margin on costs to compensate a third-party miner if one was involved) would be sufficient to provide the owner with a return on the capital devoted to the project, at a level sufficient to compensate for the risks inherent in it. It does not matter whether the owner is a private entity or the government through a SOC – any owner should receive a return on its capital commensurate with the risks inherent in the investment. Evidently then, at a price of [REDACTED], a business case for the Cobbora SOC would reveal that it could not achieve acceptable returns to compensate the State as owner for the risks inherent in the ownership and operation of the mine.

124. Some indication of the magnitude of the shortfall in acceptable returns can be inferred from a report prepared by Treasury in September 2010 which estimates that the gross exposure to the State from Cobbora is about [REDACTED] of price difference. Accepting the Retention Value Working Group view that the contracted price is consistent with developing the mine without any allowance for return on capital or operator margin, and assuming that the [REDACTED] price includes those allowances, the shortfall (net present value over the project life) is in the range [REDACTED].

125. The preliminary conclusion in considering the benefits and costs of the Cobbora development is therefore that a business case, had one existed, would have shown that the benefits of the development did not exceed its costs.

126. Some benefits cannot easily be quantified in a business case. For Cobbora, important benefits are the significant reduction in risk of coal supply to the SOC-owned generators (Delta Coastal and Macquarie) and the risk that those generators might become exposed to export parity prices for coal which are considerably higher than the Cobbora contracted price. This point is made very effectively in Delta Electricity’s Submission to the Special Commission of Inquiry. (As already noted, these benefits also apply to the gentraders. The State would have hoped to capture at least part of that benefit in the net proceeds of the sale of the gentrader rights.)

127. The State is exposed through the Cobbora transaction to certain risks:

a. The risk that delays in the development of the mine expose the State to damages for failing to meet coal supply obligations to the gentraders;
b. The risk that the contracted price falls short of actual future market prices for coal, the consequence of which is that the State has given away Cobbora mine value to the gentraders for inadequate compensation;

c. The risk that the ex-mine cost of coal from Cobbora will exceed the contracted price; and

d. The risk that the Cobbora SOC will not be able to acquire and maintain the skills and expertise to efficiently operate a large scale coal mine.

128. Some evidence is available for the magnitude of the first of this set of risks (the development risks). The Retail Value Report states that the Government had approved a contingency fund of $XXXX to manage the financial risks associated with the Cobbora development. In the Steering Committee minutes of 19 October 2010, however, it is stated that an additional $YYYY could be required above the $ZZZZ already approved by the Government.

129. Offsetting these risks is a considerable benefit, namely certainty for the Cobbora SOC of sale price and volume for its coal output. Given the uncertain future of carbon pricing arrangements and the impact those arrangements could have on demand for coal from any new mine and on the market price for coal in Australia, most mine developers would find such certainty very attractive; assuming of course that the contacted price is realistic. However, juxtaposing the contracted price relative to the price bid by $ZZZZ with the evidence of the Retention Value Report that Cobbora would not provide acceptable returns at the contracted price, it must be concluded that the contracted price is not realistic.

130. Consideration of the risks inherent in the Cobbora development and benefits which would not be captured in a business case does little to disturb the preliminary conclusion that the benefits do not outweigh the costs. That said, it needs to be recognised that at the time the decision was taken by the Government to take the development into full State ownership, it would have been seen as critical to a successful sale of the gentrader rights. Without it, those transactions may not have been completed, as potential buyers of the rights might well have regarded the fuel supply and price risk as too high. Also, as noted above, the Government would have hoped to be compensated for its Cobbora ownership risks through the net proceeds from the sale of the gentrader right. In the event, that did not occur. Nevertheless, I conclude that that the benefits of the Cobbora mine development did not exceed its costs.

The transactions overall

131. Some benefits and costs are not encompassed in the net proceeds-retention value comparisons and cannot be readily attributed to particular groups of transactions. Thus:

a. The State incurred transaction costs amounting to over $200 million;

b. The State received upfront cash payments for the assets and rights sold;
c. The availability of this cash permitted the State to retire about $1.15 billion of public sector debt; \[259\]

d. That action was ratings positive and will have contributed to the retention of NSW’s AAA credit rating (see paragraphs 158-159 for further discussion);

e. The State achieved significant reform after decades of frustration and failure; most particularly through the sale of the retail businesses;

f. The State’s withdrawal from dispatch and trading in the electricity market will significantly improve the incentives for private sector participation in the market and especially for future investment in generation; and

g. In choosing to proceed with the particular set of transactions, the State has foregone the opportunity to pursue certain other options (for instance an outright sale of the power stations backing the gentrader contracts) and has compromised certain other options (for instance, while it may well be possible to sell the generator SOCs at some time in the future, they may be relatively unattractive to buyers other than the relevant gentraders). These lost option values represent an (unquantifiable) cost of the transactions.

132. In summary, my answers to the question of whether the benefits exceed the costs and expected value of the new net risks for each of the components of the transactions are as follows:

- Gentrader rights – a strong no;
- Retail businesses – a strong yes;
- Development sites – a clear yes but they are small in the scheme of things;
- Cobbrora Mine development – a clear no but with uncertain magnitude; and
- Other considerations – a mixed bag – debt retirement, ratings impact, improved private sector incentives and the reform achievement are strongly positive but other matters are positive and small, or negative and magnitude unclear.

133. Bringing the full set of transactions together, and having regard to the material value in reducing State debt, preserving NSW’s AAA credit rating and incentivising the private sector to invest in electricity generation and retail, it is reasonable to conclude that the benefits of the transactions overall exceeded the costs and expected value of the new net risks.

**Did the transactions meet the Stated objectives?**

134. In its September 2009 New South Wales Energy Reform Strategy – Delivering the Strategy: approach to transactions and market structure, the Government set out the objectives for the transactions in the following way:

\[259\] Treasury has advised that approximately $1.15 billion of the proceeds of the transactions has been used to retire $700 million of Eraring’s debt and $450 million of Delta’s debt. No part of the proceeds of the electricity transactions has yet been used to retire general government debt.
a. Deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities;

b. Create an industry and commercial framework to encourage private investment into the NSW electricity sector and reduce the need for future public sector investment in retail and generation;

c. Ensure NSW homes and businesses continue to be supplied with reliable electricity; and

d. Place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt.

135. To what extent have these objectives been achieved, recognising that the transactions finally entered into were not all of those the Government would have wished to complete?

136. As the market existed prior to the transactions, there was already some competition in electricity retailing, though the retail market was dominated by the retailer SOCs. All of the retailer SOCs were sold. However, the businesses were purchased by two companies, Origin and TRUenergy which, according to the ACCC’s Public Competition Assessment of March 2011, were already in the NSW retail electricity (and gas) market but as relatively minor players. However, as Table 2 shows, these businesses have achieved a significant increase in the number of customers they retail to. The geographic spread of their retailing activities may also have increased. They have become the two biggest players in the NSW retail electricity market, though neither is dominant. The likely consequence is that the retail businesses now operating in NSW are stronger and more able to compete effectively with other retailers in the NSW market. Experience elsewhere suggests that the NSW retail market will develop more rapidly under the stronger competitive pressure and that product innovation will be more evident than previously.

137. As such, it is evident that the objective of delivering a competitive retail market has in all probability been achieved.
Table 2  NSW Retail Electricity Market Shares

<table>
<thead>
<tr>
<th>Retailer</th>
<th>Share (%)</th>
<th>Retailer</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy Australia</td>
<td>30-40</td>
<td>Origin</td>
<td>45-65</td>
</tr>
<tr>
<td>Country Energy</td>
<td>20-30</td>
<td>TRUenergy</td>
<td>30-45</td>
</tr>
<tr>
<td>Integral Energy</td>
<td>20-25</td>
<td>AGL</td>
<td>10-15</td>
</tr>
<tr>
<td>AGL</td>
<td>10-15</td>
<td>Others</td>
<td>0-5</td>
</tr>
<tr>
<td>Origin</td>
<td>5-10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TRUenergy</td>
<td>0-5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>0-5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ACCC Public Competition Assessment 17 March 2011 and Author’s estimates

Shading indicates NSW State-owned

138. NSW is a part of the NEM. The NEM is an exemplar of an effective competitive market. Through NSW locally-based generation, NSW’s central location geographically in the NEM, and through NSW’s interconnections with the Queensland and Victorian regions, NSW customers benefit from effective competition in the supply of electricity.

139. The gentrader bundles offered for sale by the Government included three of the largest generation portfolios in the NEM – Macquarie (11% of NEM capacity), Delta (10%) and Eraring (7%). Shifting the rights to dispatch and trade the output of Eraring and part of Delta (Delta West) into private hands may only have very marginally improved the degree of competition in the wholesale electricity market in NSW, if at all.

140. Table 3 shows that the effect of the transactions has been to leave a SOC-owned generator (Macquarie) as the largest player in the NSW generation market. Taking account of their owned generation and their rights under the gentrader agreements to dispatch and trade generation capacity, two privately owned businesses (Origin and TRUenergy) now rank next, while the rank order of the remaining players is unchanged.

141. Recognising that the wholesale electricity market was already subject to strong competition, unless all of the gentrader rights offered were sold, it is unlikely that there would be a significant impact on competition in that market.
Table 3  NSW Electricity Generation Market Shares

<table>
<thead>
<tr>
<th>Generator</th>
<th>Share (%)</th>
<th>Generator</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macquarie</td>
<td>27.1</td>
<td>Macquarie</td>
<td>27.1</td>
</tr>
<tr>
<td>Eraring</td>
<td>18.3</td>
<td>Origin</td>
<td>22.0</td>
</tr>
<tr>
<td>Delta Coastal</td>
<td>15.3</td>
<td>TRUenergy</td>
<td>16.2</td>
</tr>
<tr>
<td>Delta West</td>
<td>13.8</td>
<td>Delta Coastal</td>
<td>15.3</td>
</tr>
<tr>
<td>Snowy Hydro</td>
<td>11.3</td>
<td>Snowy Hydro</td>
<td>11.3</td>
</tr>
<tr>
<td>Origin</td>
<td>3.7</td>
<td>Others</td>
<td>8.1</td>
</tr>
<tr>
<td>TRUenergy</td>
<td>2.4</td>
<td>Others</td>
<td>8.1</td>
</tr>
<tr>
<td>Others</td>
<td>8.1</td>
<td>Others</td>
<td>8.1</td>
</tr>
</tbody>
</table>

Source: ACCC Public Competition Assessment 17 March 2011 and Author’s estimates
Shading indicates NSW State-owned

142. The other possibility is that the aggregation of rights to dispatch and trade generation capacity with that associated with existing assets of the buyers might lessen competition in the NSW electricity market. This arises by virtue of the possibility that a single entity through the bidding of its portfolio of generation capacity could control the electricity price in the NSW region in some circumstances. The ACCC considered this issue in detail in its Public Competition Assessment – AGL Energy Limited and Origin Energy Limited – proposed acquisitions of assets being sold as part of the New South Wales Energy Privatisation dated 17 March 2011. The ACCC concluded that “...the aggregation of generation capacity arising from the proposed acquisitions by AGL or Origin of one of the gentrader contracts would not be likely to substantially lessen competition in the market for the wholesale supply of electricity in New South Wales”.

143. The risk that competition in the NSW wholesale electricity market might lessen seems therefore rather slight. Equally, there is no reason to believe that competition might have improved as a result of the sale of the gentrader rights. Accordingly, it is difficult to conclude that the transactions met the objective of delivering a competitive wholesale electricity market in NSW – particularly as one existed already – there is no evidence to support either the conclusion that competition lessened or the conclusion that it improved.

144. The flip side of that point though bears on the assessment of the achievement of the second set of objectives. With NSW State-owned entities dominating not only electricity generation capacity in NSW but also the NEM, the risks for new entrant generators faced with the prospect of competing with these state-owned entities would have been severe to the point of daunting. Had the transactions proceeded as originally intended, there is little doubt that the incentives for new private sector investment in generation would have been greatly improved.

145. In the event, the dispatch and trading rights over only 42% of the generation capacity intended to be sold, were in fact sold. The incentives for private sector investment in new generation capacity may have improved marginally. However, it is clear that the Energy Reform Strategy objective of encouraging private generation capacity
investment in NSW and to reduce the need for future public sector investment in generation has not been achieved to any significant degree.

146. The picture as regards electricity retailing is much brighter. All of the retailer SOCs were sold. With those businesses now in private hands, the incentives for private sector investment in NSW electricity retailing have greatly improved. With this comes complete relief from the need for any NSW public sector responsibility for future investment in retail.

147. As such, the Energy Reform Strategy objective to create an industry and commercial framework to encourage private investment into the NSW electricity retail sector and reduce the need for future public sector investment in retail has been fully achieved.

148. The third objective of the Energy Reform Strategy was to ensure NSW homes and businesses continued to be supplied with reliable electricity. The key word in the statement of this objective is “continued” because NSW was previously supplied with reliable electricity. However, as the Owen Report highlighted, there were legitimate concerns that, without substantial investment, electricity supplies in the future might not be as reliable as that to which NSW consumers had become accustomed. With the increased prominence of strong private sector players (Origin and TRUenergy) in both the retail and gentrader markets, the prospects for future private sector investment have improved. While the impact on security of supply and reliability are very marginal, the objective of continuity in the reliability of the supply of electricity to NSW homes and businesses has been achieved.

149. The fourth and final objective of the Energy Reform Strategy was to place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt. This extent to which this objective has been achieved needs to be assessed by considering its constituent parts separately.

150. The first question to address is whether the sales value of public assets was optimised.

151. As regards the sale of the retailer SOCs, this question is fairly straightforward. As discussed in paragraphs 16-30, the conduct of the transactions leaves no reason for concern. There were sufficient serious bidders and competitive tension was maintained. Likewise, the structure of the transactions to sell the retail businesses was very straightforward and conventional. The prices received were well in excess of the retention values and all the evidence is that the prices achieved for the retail businesses were at least consistent with market benchmarks. The sales were “clean” leaving no unusual risks with the State or residual matters to manage.

152. Similarly, the development sites were sold for prices that were far in excess of their retention value and there is no reason to think that the prices received were not market realistic.

153. When it comes to the gentrader rights, the picture is more complex. Both sets of gentrader rights sold for well short of their retention values. Eraring was sold for about of retention value and Delta West for about of retention value. In addition, as discussed in paragraphs 101 to 108, the State has retained, directly and through the generator SOCs, considerable risk. While it is readily explicable that the proceeds of the
gentrader rights did not achieve retention value (see paragraph 88), the outcome does not support the conclusion that the sales value of these public assets (the gentrader rights) has been optimised. A necessary condition for that conclusion is that the net proceeds exceeded retention value; this condition was not met. It would also be necessary to see that the net proceeds from the sales of the gentrader rights exceeded retention value by an amount at least sufficient to compensate the State for the risks it has retained as an owner of power station operators. No assessment is available to assist with this question but it is academic in the current context as the necessary condition has not been satisfied.

154. The second question to address in considering the degree of achievement of the final Energy Reform Strategy objective is whether the Government’s exposure to electricity market risk has been reduced. The State is no longer an owner of any electricity retail business and thus is relieved of any exposure to the very considerable market risk that all electricity retailers accept and manage. The State also sold two sets of gentrader rights – Eraring and Delta West, accounting collectively for about 42% of the State’s previous generation capacity exposure to market risk.

155. There is an argument that prior to the transactions, the State’s ownership of most of electricity retail and generation in NSW gave it a natural market hedge which has been eroded by selling the retailers and failing to sell all the gentrader bundles. This argument would have strength were NSW not part of the NEM. Interconnection with other states and participation in the NEM means that the State was exposed to electricity market risks notwithstanding its ownership of both retailers and generators.

156. The effect of the completed transactions has been to significantly reduce the degree of direct electricity market exposure, albeit leaving the State-owned generators to mitigate their market risks through conventional means by contracting and purchasing financial hedges. The comparison of the level of exposure of the State to electricity market risk before and after the transactions could only be resolved by a significant simulation study which is not available. However, I am inclined to the view that there has been a material reduction in the electricity market risk the State is exposed to by virtue of its ownership of generation capacity.

157. Of course, in selling the gentrader rights, the State has not avoided ownership risks completely. Rather, it has exchanged one set of risks (electricity market) for another set of risks. As discussed in paragraphs 87 and 101 to 107, those risks are different but may also be challenging to manage and mitigate.

158. The third element of the final Energy Reform Strategy objective is whether the State’s public sector debt has reduced. This is quite straightforward. From the net proceeds of the transactions, $1.15 billion of debt was retired so this final element has been achieved. Peripheral to this is that, taking the transactions as a whole, the net proceeds exceeded retention value by nearly. This means that the private sector buyers have placed a higher value on the ownership of the assets and rights than the public sector. In selling the assets and rights, the State has foregone an income stream into the future from the ownership of those assets and rights. However, since the private sector buyers have placed a considerably higher value on them than did the public sector, it is clear

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260 Treasury has advised that approximately $1.15 billion of the proceeds of the transactions has been used to retire $700 million of Eraring’s debt and $450 million of Delta’s debt. No part of the proceeds of the electricity transactions has yet been used to retire general government debt.
that the divestment of the assets and rights and the retirement of debt with part of the proceeds is a superior outcome to the retention of the assets and rights. This being the case, it can be expected that, other things equal, the transactions would be a positive influence on NSW’s credit rating.

159. The only caveat to this conclusion would be if the ratings agencies concluded that the risks associated with ongoing ownership and operation of generation capacity now contracted to supporting the gentrader agreements exceed the risks associated with the previous ownership of retail and generation businesses. Notwithstanding that there are complex risks associated with the ongoing ownership and operation of the generation capacity, the fact that all the retail businesses were sold makes it nearly inconceivable the ratings agencies could draw such a conclusion.

**Alternative transaction models**

160. The Owen Report found that new generation would be required in NSW within the next decade. His conclusions have been confirmed subsequently in issues of the Electricity Statement of Opportunities by AEMO and its predecessor NEMMCO. The Owen Inquiry found that private sector investment would be the most efficient way to deliver new generation capacity but that the private sector would be unwilling to invest in new generation while generator and retailer SOCs dominated the NSW electricity market. Owen therefore recommended that the Government divest itself of all of its generator and retailer SOCs.

161. The then Government’s attempt to implement this strategy failed in August 2008 when the necessary legislation was withdrawn from Parliament when it became clear that it would not be passed by the Legislative Council.

162. The March 2009 *NSW Energy Reform Strategy* proposed an alternative to achieving the recommendation of the Owen Inquiry. This was to sell the retail businesses and the development sites, and divest the right to dispatch and trade the capacity of the SOC-owned generators, while maintaining ownership of the physical generators. The transactions which are the subject of the Inquiry’s terms of reference were designed to give effect to this strategy.

163. I now turn to consider the question of whether there were any alternatives, on the basis that an outright sale (or long-term lease) of the SOC-owned generators was impossible. In doing so, the test I have used is whether the objectives of the Energy Reform Strategy could have been met by some other means.

164. Given those objectives (which are set out in paragraph 134), the key question is whether there was some other means by which the Government could extract itself from involvement in generation and participation in the wholesale electricity market.

165. The short answer to this question is that there are none.

166. The businesses that are based on physical generation capacity (or indeed any other significant piece of plant) are best thought of as the right to receive the revenue streams that the operation of those businesses produces. With that right, comes the obligation to incur operating and capital costs. This is the reason that such businesses are typically
valued by discounting streams of cash flows – revenues net of operating and capital costs.

167. If the Government is to extract itself from generation and wholesale market participation, it must, at a minimum, pass the right to receive the revenues to another party.

168. Under a conventional divestment scenario, the right to receive revenues is passed to another party by selling the ownership of the physical assets, as well as the right to operate the plant. Of course, in this scenario, the new owner also accepts responsibility for the operating and capital costs – that comes with ownership.

169. Under the gentrader model, the right to receive revenues is passed to another party by selling the dispatch and trading rights to the capacity of the generation plant. Ownership of the plant itself does not change and the Government, through its owner SOCs, remains responsible for the operation of the plant, the operating and capital costs. Contractually, these costs are recovered from the gentrader but the responsibility remains with the SOCs and hence the Government. Most importantly, all the risks associated with operations and the risk that actual operating and capital costs will exceed the amounts contractually recovered from the gentraders lies with the SOCs and the Government.

170. Variations on the gentrader model could be conceived but they are exceedingly unlikely to do anything fundamentally different; which is to pass the right to receive the revenue from the operation of the generation plant to another party.

171. In coming to this conclusion, I draw confidence from the *Morgan Stanley Report to NSW Treasury* dated 24 September 2007. Morgan Stanley, who were advisers to the inquiry, anticipate the Owen Inquiry conclusion that “...to provide for the fullest set of investment incentives across the widest range of participants... Government should divest itself of both retail and generation operations, and avoid competing with the private sector.” Morgan Stanley then considered a wide range of alternatives to achieve this objective. In the event, they describe traditional divestment options through trade sales or IPOs, long-term leases of generation stations and gentrader type contracts, perhaps combined with a ban on new investment by State-owned generators. They came up with no other alternatives.

172. It is interesting to note Morgan Stanley’s summary conclusion in relation to the gentrader option: “Generator trader contracts... In and of themselves, a sale of such contracts is feasible, and has private sector precursors. However, these instruments are essentially hedging devices for retailers, and while they are a risk mitigant, do not provide a full substitute for generation. In particular, there was no interest from generator developers in purchasing such contracts. We think it unlikely that even if a sale of these contracts were [sic] pursued, that any more than a few thousand MW of capacity could be sold in conjunction with a sale of the retail businesses... The value of the contracts will inevitably suffer some discount to value based on the inefficient risk allocation... and tax leakage. In short, generation trader contracts are not a complete answer on new generation investment, value, and risk transference objectives”.

173. Juxtaposed against the outcome of the gentrader transactions – only 5340MW of the 12640MW of capacity sold, to buyers who are evidently keen to build their retail
businesses and were only minor players in generation, and at prices below retention value, Morgan Stanley’s advice was quite prophetic.

Other matters

174. The key recommendations of the Owen Inquiry remain as relevant and important today as they did in 2007. The 2009 Energy Reform Strategy and the transactions implemented in 2010 and early 2011 have achieved part of the Owen recommendation. The Government has completely extracted itself from the retail electricity market and has sold some generation development sites.

175. Had all the gentrader bundles been sold, the government’s involvement in the wholesale electricity market and its exposure to electricity market risk would have been substantially reduced, albeit at a high price in terms of the risks remaining with the Government. However, two of the gentrader bundles (Macquarie and Delta Coastal) were not sold; one of these (Macquarie) is the largest generator in the NEM.

176. While it may have forestalled damaging action by the ratings agencies by proceeding with the gentrader transactions when it did, it must also be recognised that in failing to divest all of the bundles, the Government has significantly compromised the desirable option of complete divestment in the future.

177. A perfectly viable strategy would have been to proceed with the divestment of the retail businesses and development sites, perhaps in conjunction with a credible commitment that State-owned businesses would not make any future new generation investments. Action in relation to the generation businesses could have been deferred for a future time when there was sufficient support in both Houses of the NSW Parliament to proceed with an outright sale of the physical generation plant. In my view, this would have been a preferable approach.

178. Having implemented the gentrader transactions, what options are available to achieve the Owen recommendation and the objectives of the Energy Reform Strategy?

179. Attempting another round of gentrader transactions is unlikely to bring success.

180. The best prospect would seem to be to build a community consensus and the support needed in Parliament to fully divest the State-owned generation assets with the objective of the Government fully quitting its involvement in the electricity industry. Of course the sale of the two gentrader bundles has compromised such a divestment. The physical plant backing the Eraring and Delta West gentrader agreements can now only be sold subject to those agreements and the risks to the plant operator they entail. While it is possible a third party may be interested in such a purchase, it is likely that the price bid for the assets will be severely marked down to reflect the difficulty of measuring and managing the risks for the operator embedded in the gentrader agreements. Those risks are most easily managed by the gentraders which makes them natural purchasers of the physical assets.

Delta and Eraring’s claims

181. Section 20N of the SOC Act makes provision (s. 20N(1)) for a State-owned corporation to be directed by the Portfolio Minister, with the approval of the Treasurer, to undertake
activities which the board of the SOC considers is not in its commercial interests to undertake. Having been so directed, the SOC is entitled (s. 20N(3)) to be reimbursed by the Treasurer for the net costs of undertaking those activities.

182. Delta and Eraring have both made claims under s. 20N for net costs they claim to have been imposed on them as a consequence of the Government’s direction to enter into the gentrader contracts and to divest themselves of their interests in the development sites and the Cobbora joint venture in favour of the new Cobbora SOC.

183. It is a legal question whether the Delta and Eraring claims fall within the ambit of s. 20N and the extent to which their claims should be paid, if they do fall within the ambit of that section. The legal issues are not within my brief.

184. The policy which s. 20N seeks to give effect to almost certainly would not have contemplated that section being used to “compensate” a SOC for a government decision the effect of which is to modify the scope of its core business. Those decisions are perfectly legitimate for shareholders to make. It is ultimately for the government, as shareholder, to decide what business they want their State-owned entities to be in.

185. The likelihood is that the policy intent of s. 20N was to achieve competitive neutrality in circumstances in which the government was seeking to have a SOC undertake some activity, peripheral to its main purpose. For instance, government may have had a social policy objective to provide rebates of electricity costs to low income families. One way of achieving this objective is to require retailer SOCs to pay such rebates on behalf of the government. To ensure the SOC is no worse off for having done so, and not put at a disadvantage relative to its competitors, the government reimburses the SOC for the costs of the rebates. Generally, such an arrangement would be established contractually. However, the availability of a provision such as s. 20N would ensure that the government could achieve its policy objective even if the board of the SOC was unwilling to cooperate. The reimbursement provisions are there to ensure that in directing the SOC the government does not breach its commitments under Council of Australian Government agreements to competitive neutrality.

186. In the SOC Act, s. 20N is under the heading “Non-commercial activities”. That and the Second Reading Speech from the State Owned Corporations Bill 1989 gives support to this interpretation. In introducing the Bill to Parliament, the Minister stated:

> In order to accommodate social or non-commercial objectives, the bill provides for specific agreements or social contracts to be negotiated between the Government and the relevant corporation. These contracts will be negotiated on an arm’s-length basis and will be specifically funded from Consolidated Revenue.

187. There is little doubt that, had the Government been giving effect to its Energy Reform Strategy legislatively, s. 20N would not have applied. However, for reasons that are well understood, the Government did not see a legislative solution as a viable option.

188. The Delta and Eraring claims under s. 20N are therefore an inevitable detriment in an approach to the implementation of the Energy Reform Strategy which is sub-optimal.

189. A desirable outcome would be for the Government to introduce, and the Parliament to pass, legislation which retrospectively overrides s. 20N in relation to the electricity transactions. This would eliminate a lot of pointless and costly activity which will be of no benefit to the NSW community.
190. In the event, if the government incurs the no doubt considerable cost involved in establishing the legitimacy of the claims and the amounts to be paid, and the payments are made, the consequence is likely to be a merry-go-round of payments.

191. The government will make appropriate payments to the SOCs which “reimburse” them for the net cost they have incurred. These payments may boost SOC revenues in the period in which the payments are made. The consequent increase in profit will boost tax equivalent liabilities and dividends via which the large part of the payments will return to the budget from whence they came. Indeed, in these circumstances, the government would have a strong argument to impose additional dividends to take back to the budget the entire amount of the payments in the form of tax equivalent payments and dividends. The net result would be a boost to profit for the SOC but no net cash effect. Alternatively, the government’s payment may be in a form which boosts its equity in the SOC (whether this occurs is an accounting question that cannot be answered in the abstract). In this scenario, the cash payment from government will “stick” with the SOC, boosting its balance sheet equity. The benefit to the Government will be equivalent – in the form of a boost to the value of the investment in the SOC among the assets on the Government’s balance sheet.

192. It is perfectly understandable that the SOC directors feel obliged to pursue this reimbursement. However, there is no community benefit in doing so and legislative intervention is the obvious and desirable solution.

193. Equally, the government as shareholder has a strong incentive to ensure that its SOCs are solvent entities with robust balance sheets. In the post-transactions world, this may require the Government to consider the financial viability of the SOCs and to take appropriate action if their viability is not assured. s. 20N is a clumsy way indeed to deal with such issues.

**Brief answers to the Inquiry’s questions**

194. To conclude, I provide a summary of my responses to the specific questions I was asked to address by the Inquiry.

195. I have examined the determination of the retention value for each of the assets/rights that were sold (which are referred to in A, B and D of the definition of Electricity Transactions), and found the methodology to be appropriate and broadly compliant with the requirements recommended by the Auditor-General. I found the assumptions used in the determination of the retention value to be appropriate and, where there is room for debate, the impact on the valuations not material. There are no matters which were not taken into account in determining the retention value which I consider ought to have been taken into account; and no matters which were taken into account in determining the retention value, which I consider ought not to have been taken into account.

196. I found that the State achieved value for money compared to the retention value of each of the assets/rights the sale of which is referred to in A (retailers) and D (development sites) of the definition of the Electricity Transactions but not in relation to B (generator trading rights). However, I found that the State achieved value for money compared to the retention value of the Electricity Transactions referred to in A, B and D of the definition, taken as a whole.
197. In paragraphs 181 to 193, I considered the claims for compensation which Delta and Eraring have made against the State arising from the gentrader transactions. I proposed that retrospective legislation be passed to put an end to these claims and argued that, should the claims proceed, there will be a net detriment to the State and no worthwhile benefit to Delta or Eraring.

198. I considered the costs incurred by, and liabilities imposed on, the State under the Electricity Transactions in paragraphs 100 to 133. I found that the benefits outweighed the costs and expected value of risks for the transactions referred to in A (retailers) and D (development sites) of the definition of Electricity Transactions; but not for those referred to in B (generator trading rights) or C (Cobbora coal mine development). However, I found that the benefits outweighed the costs and expected value of risks for the transactions taken as a whole.

199. In paragraphs 134 to 159, I considered whether the Electricity Transactions met the stated objectives. The first objective was “Deliver a competitive retail and wholesale electricity market in NSW to increase the potential for the sector to respond dynamically and innovatively to market forces and opportunities.” I found that the transactions achieved the objective of delivering a competitive retail market but did little to contribute to delivering a competitive wholesale electricity market in NSW, particularly as one existed already. I found no evidence to support either conclusion that competition lessened or improved in the NSW wholesale electricity market.

200. The second objective was “Create an industry and commercial framework to encourage private investment into the NSW electricity sector and reduce the need for future public sector investment in retail and generation.” As regards retail, I concluded this objective to be fully achieved. However, in relation to generation, I concluded that it has not been achieved to any significant degree.

201. The third objective was “Ensure NSW homes and businesses continue to be supplied with reliable electricity.” I concluded that although the impact on security of supply and reliability is very marginal, the objective of continuity in the reliability of the supply of electricity to NSW homes and businesses has been achieved.

202. The final objective of the Energy Reform Strategy was “Place NSW in a stronger financial position by optimising the sales value of public assets and reducing the Government’s exposure to electricity market risk and reducing the State’s public sector debt.” This has three distinct elements. As regards the first, I concluded that the sales value of the assets/rights sold was optimised as regards the retail businesses and development sites, but not for the generation trading rights. I concluded in respect of the second element that the Government’s exposure to electricity market risk has been reduced by eliminating its exposure through the State-owned retailers and materially reducing its electricity market risk exposure through its ownership of generation capacity.

203. The remaining element of the final Energy Reform Strategy objective is whether the State’s public sector debt has reduced. This objective has been clearly met and I concluded also that the outcome of the electricity transactions is ratings positive. Together this means that, in the words of the preface to the final Energy Reform Strategy objective, NSW is in a stronger financial position.
204. I was asked whether, on the assumption that the sale, or long-term lease, of the generators could not be effected (because Parliament refused to pass the necessary legislation), I considered that the gentrader model to have been a suitable alternative to the Owen recommendation. On the premise of the question, my answer is yes. However, as I argued in paragraphs 174 to 180, my view is that a better strategy would have been to delay action until it was possible to build a community and Parliamentary consensus that permitted the outright divestment of all the State-owned electricity assets. By choosing to proceed as it did, and failing to divest all the generation trading rights, the Government compromised the desirable option of complete divestment in the future.

205. I was asked specifically whether there is any reasonable basis for considering that the quantum of the bids that were accepted was not in excess of the sum of the retention values of the assets/rights covered by the bids. I found (see paragraph 98) that the bids accepted did not exceed the retention value for the Eraring and Delta West gentrader bundles.

206. Finally, I was asked whether there was any aspect of the Electricity Transactions which I encountered which leads me to consider that the assets/ rights that were sold, were sold for less than market price. I encountered nothing that leads me to that view.
CURRICULUM VITAE

DONALD W CHALLEN

September 2011

Professional Memberships

Fellow, Australian Institute of Company Directors

Fellow, CPA Australia

Fellow, Institute of Chartered Accountants in Australia

Fellow, Institute of Public Administration Australia

Member, Economic Society of Australia

Tertiary Education

University of Tasmania 1969
Bachelor of Economics

University of Tasmania 1970
Bachelor of Economics with Honours (First Class)

University of Tasmania 1976
Master of Economics

Employment History

March 1993 – October 2010
Secretary, Department of Treasury and Tasmania
Finance,

March 1991 - March 1993
Managing Director, Tasmanian Authority
Development

July 1986 - March 1991
Deputy Secretary (Economic and Financial Policy), Department of Treasury and Tasmania
Finance,

July 1984 - June 1986

January 1971 - June 1984
Economics Department, University of Reader in Economics (1984), Senior Tasmania (1978), Lecturer (1972), Tutor (1971)
### Current Board Memberships

<table>
<thead>
<tr>
<th>Role</th>
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<tr>
<td>Chairman from March 1993 to current</td>
<td>Tasmanian Public Finance Corporation</td>
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<tr>
<td>Director from March 1991 to current</td>
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<td>Chairman from December 2010 to current</td>
<td>Transend Networks Pty Ltd</td>
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<td>Chairman from December 2010 to current</td>
<td>Motor Accidents Insurance Board</td>
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<td>Trustee from November 2010 to current</td>
<td>Retirement Benefits Fund Board</td>
</tr>
<tr>
<td>Director from November 2010 to current</td>
<td>Tasmanian Symphony Orchestra Holdings Ltd and Tasmanian Symphony Orchestra Pty Ltd</td>
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<tr>
<td>Panel Member from January 2011</td>
<td>Independent Review of State Finances, to current (concluding February 2012)</td>
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### Former Board Memberships

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<td>Member 1999 to 2010</td>
<td>Financial Reporting Council, Australian Government</td>
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<td>Director from 1993 to 2007</td>
<td>Hydro-Electric Corporation, trading as “Hydro Tasmania”</td>
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<td>Member from 1999 to 2003</td>
<td>Basslink Development Board</td>
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<td>Chairman from 1993 to 2003</td>
<td>Tasmanian Gaming Commission</td>
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<tr>
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<td>Member from 1993 to 2004</td>
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<td>Chairman from 1993 to 1999</td>
<td>Tasmanian Government Insurance Board</td>
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<td>Director from 1993 to 1999</td>
<td>Trust Bank</td>
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<td>Chairman from 1993 to 1994</td>
<td>The Finance Trust of Tasmania Limited</td>
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<td>Director from 1991 to 1994</td>
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<tr>
<td>Managing Director from 1991 to 1993</td>
<td>Tasmanian Development Authority</td>
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<td>Director from 1987 to 1993</td>
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<td>Director from 1991 to 1993</td>
<td>Essential Oils of Tasmania Pty Ltd</td>
</tr>
<tr>
<td>Member from 1982 to 1983</td>
<td>University of Tasmania Council</td>
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<td></td>
<td>Member from 1987 to 1992</td>
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</tbody>
</table>
Publications

Books

Principles of Economics: Income, Wealth and Welfare in Australia
Melbourne: Longman-Cheshire, 1985
With A J Hagger, P Hardwick, B Khan and J Langmead

Unemployment and Inflation in the United Kingdom
London: Longman, 1984
With A J Hagger and P Hardwick

Macroeconometric Systems: Construction, Validation and Applications
London: Macmillan 1983
With A J Hagger

Unemployment and Inflation: Questions and Answers
Melbourne: Longman-Cheshire, 1982
With A J Hagger

Unemployment and Inflation: An Introduction to Macroeconomics
With A J Hagger

Modelling the Australian Economy
Melbourne: Longman-Cheshire 1979
With A J Hagger

Monographs

The Wages-Employment Relationship in Australian Macro-Econometric Models
Bureau of Labour Market Research, Monograph Series No 2
Australian Government Publishing Service, Canberra 1984

Australia: Econometric Model for Short-Term Prediction
With V W Fitzgerald and T Ike

Selected Published Papers


Appendix 12 Report of Professor Anthony Owen

REPORT TO
SPECIAL COMMISSION OF INQUIRY INTO ELECTRICITY TRANSACTIONS
from
Professor Anthony D Owen
Santos Chair of Energy Resources
UCL School of Energy and Resources, Australia
Adelaide, South Australia

Past developments affecting the demand and supply balance for electricity in NSW since publication of the Owen Inquiry and their implications for the Owen Inquiry's recommendations.

The Owen Inquiry Report was released on 11 September 2007. At the time of publication, the major issues identified as having a significant impact on future capacity requirements were the prospect of carbon pricing and its associated uncertainties, the impact of various State and Commonwealth energy efficiency initiatives, the availability of gas in Queensland and New South Wales, and the impact of higher retail prices resulting from the significant investment required to enhance the transmission and distribution networks within NSW. The major factors driving this latter requirement were:

- The need to meet load growth and rising peak demand;
- The need to replace ageing and obsolete assets; and
- The need to satisfy more rigorous licensing conditions for network security and reliability.

What was not anticipated was the Global Financial Crisis (GFC) which, following the collapse of Lehman Brothers in September 2008, led to stock markets collapsing and a serious shortage of liquidity in financial institutions around the world. The GFC had a number of significant impacts on the power sector in NSW (and, of course, in Australia and globally). One impact that was particularly evident was significant increases in risk premiums on all forms of debt. While Australian financial and economic conditions have remained relatively robust, the crisis has had ramifications for the energy sector. Coal fired generators
have raised concerns that tighter liquidity and more risk averse financial markets have made it more difficult to refinance debt. More generally, they argue that financial conditions have aggravated the risks they already face from the introduction of climate change policies. Financial conditions have also raised issues for new entrant generators, and might have delayed some new investment that would have increased competitive pressures on incumbents. Further, less finance has been available to develop renewable technologies such as for solar and geothermal generation. In addition, with regard to potential purchasers of NSW electricity generation assets, Babcock and Brown Power went into liquidation in 2009, a victim of the GFC (although a restructuring of their financial arrangements over an extended period of time ultimately lead to Babcock and Brown Power being resurrected as Alinta Energy).

On the demand side, the recession resulting from the GFC served to scale down future projections of power requirements, even in Australia that, technically at least, did not experience a recession. The Australian Energy Market Operator (AEMO) Electricity Statement of Opportunities (ESOO) 2011 notes, however, that the resulting recovery in electricity usage has been slow, and this is reflected in the relatively static demand for 2010 and 2011 as shown in Figure 1. In fact, demand has been flat for the past 5 years as a result of various energy efficiency schemes, higher levels of semi-scheduled and non-scheduled generation\(^1\), the GFC, and higher retail prices. Nevertheless, ESOO 2011 anticipates a return to growth averaging around 1.6 per cent per annum over the next decade (medium energy growth outlook), despite the fact that a price will be put on sector carbon emissions from 1 July 2012 a major part of which, if not all, will be passed through to consumers.

Figure 2 is analogous to Figure 1 (although the scales differ), but was produced 4 years earlier and was used by the Owen Inquiry as its basis for the short-term outlook for energy production in NSW.\(^2\)

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\(^1\) A scheduled generating unit has its output controlled by the Australian Energy Market Operator through the central dispatch process. A semi-scheduled generating unit has intermittent output, a total capacity of 30 MW or greater, and may have its output limited to prevent the violation of network constraint equations. A non-scheduled unit is not scheduled as part of the central dispatch process.

\(^2\) The difference between the two figures is that Figure 1 reflects total (native) energy whereas Figure 2 is scheduled energy. The differences are minor up to 2009-10, but thereafter they gradually increase from 2.2% to 8.3% by 2020-21 (information provided by Transgrid).
Figure 1: Comparison of actual NSW native energy with the previous and current projection (Medium Scenario)


Figure 2: Comparison of actual NSW scheduled energy with the previous and current projection (Medium Scenario)

According to ESOO 2011, NSW is expected to require additional generation investment by 2018-19, representing a two-year delay compared with ESOO 2010, which is primarily due to a decrease in the maximum demand projections for the region. When compared with ESOO 2007 projections contained in the Owen Report, the delay amounts to around five years. Even then, changes in patterns of demand indicate that the additional investment will be for new peak and intermediate capacity rather than baseload.

*Future developments likely to affect the demand and supply balance*

*Demand*

- Demographic and economic influences, key to which are:
  - Population growth, both as a driver of residential demand and as an indirect driver of gross domestic product;
  - Economic activity, at state, federal, and global levels;
  - Electricity intensity of the state economy, which reflects income level, industry structure, technology, energy prices, and climatic conditions;
  - Electricity prices; and
  - Technological change, such as more energy efficient appliances and the potential widespread adoption of technology “transformations” such as plug-in electric cars.

- Energy sector policy influences
  - Carbon pricing;
  - National renewable energy incentives and targets; and
  - Energy efficiency improvements of appliances and buildings, including mandated minimum energy efficiency standards.

- Weather and seasonal patterns of demand.
- Large industrial and mining projects.
Supply

While investments in the energy sector are all market-driven, investment opportunities can be more specifically identified as capacity-driven, energy-driven, or policy-driven, which recognises the different market signals that can govern investment decisions.

Capacity driven investment opportunities coincide with periods of supply scarcity, and include future supply and demand side investments to meet short periods of high regional demand or high electricity spot market prices. Investments of this type are needed to maintain system reliability in each region and to defer possible low reserve condition points.

Energy driven investment is generally motivated by the quantity of energy required over longer periods and the average electricity spot market price. At present, NSW is expected to experience only very minor energy shortfalls over the next decade, indicating limited opportunities for additional baseload generation in the state. However, the introduction of a carbon price may accelerate the rate of retirement of existing coal-fired capacity leading to opportunities for replacement generation.

Policy driven investments are motivated by government incentives and directives, such as the national Renewable Energy Target (RET), the Solar Flagships Program, and the Clean Energy Future Plan, and are designed to encourage investment in low-carbon technologies and fuels. In the short-term wind technology will be the main beneficiary, but other technologies such as geothermal, biomass, and solar thermal generation will begin entering the National Electricity Market (NEM) after 2015.

Carbon pricing

The Carbon Pollution Reduction Scheme (CPRS) was originally scheduled to be introduced in 2010. However in April 2010 it was postponed until after the end of the Kyoto compliance period (2012), but was abandoned shortly afterwards.

On 10 April 2011, the Commonwealth Government announced details of its Clean Energy Future Plan. It proposes to introduce a carbon tax scheme from 1 July 2012, with some measures taking effect earlier. The tax will target the nation’s biggest emitters of carbon dioxide by requiring them to pay a fixed price of $23 per tonne of emissions released into the
atmosphere. It is estimated that around 500 businesses will be affected initially. The fixed price will increase by 2.5% annually in line with real world inflation (effectively 5% nominal), over a three year period. There will be an unlimited number of single-year only permits available at the fixed price. After the third year, the carbon price will be determined by the market under an emissions trading scheme, based upon an emissions target that will be set from May 2014. Until 2018 floor and ceiling prices will be in place, thus removing the prospect of highly volatile market prices for emissions permits.

Consumer behaviour is expected to change in response to climate change policies. Such changes are likely to include an increase in energy conservation, demand side participation, and price transparency through smart meters and smart grids. As a result, the NEM’s demand profile is expected to change in response to these changing energy consumption patterns. In the longer term, adoption of electric vehicles may see convergence between the electricity and transport sectors, further changing patterns of demand.

**Electricity supply technology options for NSW, including increasing the capacity of the interconnectors**

**Technology options**
The Owen Report identified a number of technology options available to investors in generation in NSW. It noted that both coal and gas were in abundant supply in Eastern Australia, and thus technologies based upon these two fossil fuels were those most likely to be used for meeting additional (or replacement) baseload requirements. To meet the increasing requirement for peaking plant and for backing up intermittent technologies, such as wind, open cycle gas turbines or hydro power were the major mature technologies. Experience since the Report was issued appears to support these observations.

The recent trend of gas powered generation and wind generation comprising the majority of new generation investments (by capacity) is expected to continue for a number of years. Wind generation is mainly driven by the national RET scheme incentives, while a mix of combined-cycle gas turbine (CCGT) and open-cycle gas turbine (OCGT) generation is meeting increasing demand peaks that new wind generation cannot reliably supply.
Figures 3 and 4 give AEMO calculations for the long-run marginal cost (LRMC) of operation ($/MWh) for a range of available generation technologies for a given level of output. The former has a zero-rated carbon price. For the latter, a carbon price of $25/t CO2-e is built into the calculations.¹

Each technology has a distinct LRMC due to different capital and operating costs under identical finance arrangements. Thus OCGT technology, which has relatively low capital costs but relatively high operating costs when compared with CCGT or coal technologies, is the preferred technology for low-capacity-factor operation. However, as the capacity factor increases, its higher operating costs render it less cost-efficient than the other technologies.

From Figure 3, the relative cost-effectiveness of the technologies can be summarized as:

- OCGTs at capacity factors less than 20%;
- CCGT at capacity factors between 20% and 35%;
- Wind at capacity factors between 35% and 40% (with an assumed maximum capacity factor of 40%);
- CCGTs at capacity factors between 40% and 75%; and
- CCGTs, supercritical PC black coal, or brown coal at capacity factors above 75%.

In the presence of a $25/t ($50/t) CO2-e carbon price (Figure 4), the most cost-effective technologies are:

- OCGTs at capacity factors less than 15% (12%);
- CCGTs at capacity factors between 15% (12%) and 30% (25%);
- Wind at capacity factors between 30% (25%) and 40% (40%) (with an assumed maximum capacity factor of 40%); and
- CCGTs at capacity factors above 40% (40%).

The technologies which perform best across this range of carbon prices are OCGT, CCGT, and wind (which is not directly affected by carbon prices). This ranking is consistent with current investor activity.

¹ AEMO also provides details for a $50/t CO2-e carbon price.
Figure 3: Long-run marginal cost and the technology frontier with no carbon price

Source: AEMO, Electricity Statement of Opportunities 2011, ACCC.

Figure 4: Long-run marginal cost and the technology frontier with a $25/tonne CO2 carbon price

Source: AEMO, Electricity Statement of Opportunities 2011, ACCC.
The interconnectors

There are two types of interconnectors in the NEM: regulated and unregulated.

A regulated interconnector is an interconnector that has passed the Australian Energy Regulator (AER)-devised regulatory test. Transmission network service providers that own these interconnectors receive fixed annual revenue based on the value of the asset as set by the AER, regardless of actual usage. The revenue is collected as part of the network charges included in the accounts of electricity end-users. All but one interconnector operating in the NEM is regulated. They are:

- QNI - connecting Queensland and New South Wales
- Terranora - connecting Queensland and New South Wales
- VIC-NSW - connecting Victoria and New South Wales
- VIC-SA - connecting Victoria and South Australia
- Murraylink - connecting Victoria and South Australia.

An unregulated (or market) interconnector derives revenue by trading on the spot market. They do this by purchasing energy in a lower priced region and selling it to a higher priced region, or by selling the rights to revenue traded across the interconnector. Unregulated interconnectors are not required to undergo the regulatory test evaluation. The only unregulated interconnector currently operating in the NEM is Basslink, connecting Tasmania and Victoria.

Opportunities for expanding the capacity of interconnection between states will depend on the complementarities between the interconnecting regions both in terms of their demand and supply profiles. By allowing transfers of electricity across regions, an interconnection can, to some extent, be considered as a substitute for generation. As such, it could have implications for competition at the generation level, the timing and location of new generation capacity, the fuel mix, and system security and reliability. Thus prior to any extension of regulated interconnector capacity in the NEM, a comprehensive cost-benefit analysis would be required to ensure that this is indeed an efficient investment in terms of the cost of “system security and reliability” vis-à-vis alternative investment options. Any extension of unregulated interconnector capacity can be determined by market forces operating within the NEM.
Given the current hybrid private/state ownership position of generation, what are the costs and benefits of retaining the status quo? (Status quo option)

The Owen Report identified the potential for the NSW state-owned generators to invest for other than strictly commercial motives and therefore potentially to undermine the value of the assets of private generators. Prior to the establishment of the NEM, NSW Government investments in the state-owned generators were based upon forecasts of capacity requirements. The cost of over-investment could be clawed back from consumers in the form of higher tariffs. The NEM relies on price signals alone to generate investment in additional capacity. The cost of over-investment has to be borne by the generators themselves. There remains within the industry concerns that investments in baseload capacity may still be driven by capacity rather than market-based criteria if the state retains ownership of generation assets.

Further, there may also be the temptation to impose politically motivated environmental actions on the state generators that may distort the relevant market(s). For example, at present the state-owned generators will be liable for all carbon costs and the planned emissions trading scheme relating to their assets. This responsibility has been shifted to the gentraders under the energy reform arrangement. A danger that could threaten the integrity of the proposed carbon pricing scheme is that the state generators may be “encouraged” to absorb some of the carbon tax price pass-through for non-commercial reasons. Whilst this would reduce the level of dividend it pays to the NSW Government, it would be very appealing to the residents (i.e. voters) of NSW.

The implications for undoing the transactions and then:

- Revert to the state owned and operated generation model, but with assurances that there will be no further expansion of capacity financed by the state government or its electricity generation companies (Unravel option);
- Sell all of the generators (Generator option and the preferred Owen Inquiry option).
These two options are probably unacceptable on the basis of costs of compensation to the two gentraders and the indirect costs associated with the damage to the investment reputation of NSW.

Even if the damages were considered to be of an acceptable magnitude for the NSW Government, the first option simply reverts to a position that is financially undesirable for the state in the long-run. A government’s role is to provide services that cannot be efficiently supplied by the private sector. In general, this will involve the provision of services which the private sector cannot provide universally because the positive externalities are not built into the market price (e.g. public education, public health, etc.) or where security is involved (e.g. national defence, policing, etc.). Using government funds to invest in generation in a competitive marketplace would be at the expense of such investment (all of which probably carry higher rates of social return than investment in power generation plant). However, undertaking not to expand state-financed capacity essentially distorts the market since two major market entities (Macquarie Generation and Delta Coastal) will no longer be responding rationally to market-determined price signals.

To revert to the preferred outcome of the Owen Inquiry, the current gentraders would have to have their investments expanded to include the generation assets. In other words, re-negotiate the gentrader contracts to the equivalent of full ownership of the generation assets for Origin and TRUenergy. If this transaction could be achieved, then the sale of the remaining generators may be more appealing to potential investors than simply extending the gentrader concept through a process that has already resulted in no bids for the remaining two groups of assets.

**Sell the remaining two generators (Macquarie Generation and Delta Coastal (Partial generator/gentrader option)).**

Table 1 lists existing and committed scheduled and semi-scheduled generation in NSW. Excluding Munnorah, which is scheduled to shut down permanently in 2014, the five listed registered generators currently account for 97 per cent of the state’s registered generation capacity. The vast bulk of planned additions to capacity in NSW are scheduled wind and
OCGT, reflecting current renewable energy technology subsidies and high peaking prices respectively. Where higher capacity plant is required, CCGT is currently the preferred option.

It is technically feasible to invest in OCGT initially and then “close” the cycle when warranted by the market. Planned additions involving coal are currently limited to upgrades of existing plants, which is not surprising given the lack of urgency for additional baseload plant in NSW, uncertainties with regard to carbon pricing, confusion over the previous (Labor) Government’s power sector agenda, and tight capital markets.

Table 1: Existing and committed scheduled and semi-scheduled generation in NSW

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<tr>
<th>Registered Generator</th>
<th>Power stations</th>
<th>Registered capacity</th>
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<tr>
<td>Delta Electricity</td>
<td>Colongra (OCGT)</td>
<td>724 MW</td>
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<tr>
<td></td>
<td>Munmorah (Black coal)</td>
<td>600 MW</td>
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<td></td>
<td>Vales Point (Black coal)</td>
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<td>Macquarie Generation</td>
<td>Bayswater (Black coal)</td>
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<td></td>
<td>Hunter Valley (OCGT)</td>
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<td></td>
<td>Liddell (Black coal)</td>
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<td>Origin Energy</td>
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<td></td>
<td>Eraring (Black coal)</td>
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<td></td>
<td>Urankinty (OCGT)</td>
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<td>Snowy Hydro</td>
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<td>Guthaga</td>
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<td>Tumut 1, 2, &amp; 3</td>
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<td>TRUenergy</td>
<td>Mt Piper (Black coal)</td>
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<td></td>
<td>Tallawarra (CCGT)</td>
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<td>Wallenwang C (Black coal)</td>
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<td>Other</td>
<td>Gunnung (wind)</td>
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<td>Hume (hydro)</td>
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<td>Redbank (Coal tailings)</td>
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<td>Smithfield (CCGT)</td>
<td>160 MW</td>
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<td></td>
<td>Woodlawn (wind)</td>
<td>48 MW</td>
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</table>

Source: Adapted from ESOO (2011).

Prior to the gentrader transactions, TRUenergy and Origin Energy were relatively minor players in the NSW generation sector, each operating just one major CCGT power station at Tallawarra (460 MW registered capacity) and Uranquinty (664 MW), respectively. With the purchase of Delta West by TRUenergy and Eraring by Origin, they have both now become major generators in NSW, accounting for 18% and 23% of the state’s registered capacity (excluding Munmorah) respectively. The bulk of the remaining registered capacity is with the unsold generators, Macquarie Generation and Delta Coastal, and Snowy Hydro.
A possible model for selling the two generators would be similar to that for selling the gentrader rights for Macquarie Generation and Delta Coastal (see below).

_Sell the gentrading rights associated with Macquarie Generation and Delta Coastal, as well as the remaining development sites (Bayswater B, Munmorah, and Tomago) (Complete energy reform project option)._ 

Given that these gentrader rights and development sites did not sell at first attempt, then a revised second-round process is required that would appeal both to new bidders and successful first round bidders, subject to no single company gaining a dominant market position. Currently, if either Origin or TRUenergy were interested in purchasing gentrader rights for Macquarie Generation it would give them around 52% and 48% (respectively) of NSW registered capacity which would clearly be unacceptable levels of market share for the Australian Competition and Consumer Commission (ACCC). A disaggregated offering may well provide greater competitive pressures in the sale process.

A possible model, therefore, would be to offer gentrader arrangements for each of the three generation sites separately: Liddell, Bayswater, and Vales Point. Munmorah could be retained by the state, given it will close down in 2014. To limit the potential for market power, TRUenergy and Origin would not be permitted to buy more than one of these assets. Further restrictions on ownership may be necessary for new entrants.

The three development sites could also be sold separately, although with the condition that only power generation technologies with carbon footprints of less than (say) 500 kg CO2e/MWh be permitted (effectively banning current technology coal-fired plant).

_Recommendation_

The preferred option would be for Macquarie Generation and Delta Coastal to be sold, with the two gentrader contracts re-negotiated to give Origin and TRUenergy the equivalent of full ownership rights.
Renegotiate the gentrader agreements to reallocate risk (Renegotiation option), combined with either the Partial generator/gentrader option or the complete energy reform project option.

Risk is an inherent part of investment in power generation, but the gentrader model has split such risk between generator and trader. If the trader perceives that the risk it faces could have serious implications for its commercial viability, then this would present a good opportunity for the NSW Government to offer a full ownership option for the trader to replace the existing gentrader agreement. This would open the way for the full sale option.

Alternatively, the second round gentrader agreements could involve contracts that reallocate risk and therefore result in a successful outcome, with the resulting model being offered to the first round successful bidders as a replacement for their original agreements.

The impact of the above options on competition in the generation sector (i.e. which of these options are likely to reduce/increase competition and thus put upward/downward pressure on wholesale prices?)

In general, competition will be enhanced by an increase in the number of market participants, either located in NSW or exporting to NSW from neighbouring states through the interconnectors. However, the size distribution of the generators is important, as is the capacity of the interconnectors, to avoid market domination by one, or a few, major entities. For example, 40% of South Australia’s generation capacity is accounted for by AGL’s Torrens Island power station. Transmission limits on importing electricity from Victoria means that AGL Energy can, on days of high electricity demand, bid a significant portion of its capacity at prices around the market cap and drive up the spot price.

The two critical elements for enhancing competition within NSW, therefore, are:

- Ensure that no generator buys gentrader rights or outright ownership of the NSW state-owned generators sufficient to exercise significant market power; and
- Remove capacity constraints on the interconnectors, where it is commercially viable to do so.
In summary, competition can be enhanced by establishing a critical minimum number of independent "large" generators which, together with interstate generation via the interconnectors and numerous smaller generators, should deliver a competitive environment. This was an issue raised by Garnaut, who suggested a "Five Pillars" policy (similar to Australia's four pillars banking policy), whereby they could expand through merger and acquisition, except in relation to each other. Garnaut was referring to the NEM as a whole, but in principle it can also apply to the individual member states.

Conclusion

A competitive environment can ensure downward pressure on wholesale electricity prices. However, it is imperative that such an environment is not eroded over time through mergers and acquisitions. If Macquarie Generation and Delta Coastal are offered for sale or for gentrader arrangements the resulting impact on market power should be assessed in the context of the likely bidders. Ultimately, this is the responsibility of the Australian Competition and Consumer Commission.

The costs and benefits of selling the Cobbora coal mine, and implications for the above options.

As part of the Energy Reform Process, the NSW Government announced that the Cobbora open-cut coal mine was to proceed and would produce coal for all the current coal-fired electricity generating businesses at a discount on international prices. The government-managed mine is expected to have an annual output of 30 million tonnes and is scheduled to start production in 2013. From 1 July 2015, it is expected to supply the majority of coal to all large NSW power stations (excluding Redbank).

The base price of the coal to the state owned generators is going to be set at a level that reflects the estimated cost of production, and this benefit would flow on to the Gentraders. Figure 5 shows average prices for Australian thermal coal exports over the past decade.

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Whilst the extent of the implied subsidy for coal supplies from the Cobbora mine to the NSW power generators is difficult to calculate precisely, it will be very substantial when compared with recent international market prices for Australian coal of export quality. One consequence of this subsidy is that it will clearly offset the intent of carbon pricing and, consequently, will impede the introduction of low-carbon technologies into the NSW grid. However, it should also make the sale (or a gentrader arrangement) for Macquarie Generation and Delta Coastal more lucrative for the NSW government, given that the generation assets will have a guaranteed supply of fuel at known prices for the next 15 years of operations.\footnote{The gentraders are responsible for the acquisition of fuel.}

Certainly this would have been the case for the initial sale.

Figure 5: Average prices for Australian thermal coal exports (US$/GJ, free-on-board, Newcastle/Port Kembla)

Source: AEMO, *Electricity Statement of Opportunities 2011*, ACCC.
Whilst the NSW government’s intention of maximising the sale value of the generators through guaranteed long-term fuel supply contracts could be viewed as being financially prudent, nevertheless the coal is being provided at a price that does not reflect its opportunity cost (i.e. it is being subsidised). In a competitive electricity market this subsidy could, potentially, affect the merit order in the NEM in two ways:

1. It offsets the impact of a carbon price, thus making coal relatively cheaper for generation than other fossil fuels post-carbon tax; and
2. Since east-coast gas prices will shortly be exposed to world parity prices through LNG exports from the Queensland coal seam gas deposits, it provides coal with an unwarranted competitive advantage compared with gas generation technologies.

An estimate of the value of the coal subsidy can be made by calculating the volume and the corresponding value of coal that could enter the export market, with the latter then used to calculate a netback price to the mine gate. The difficulty with such an exercise is to determine a “representative” long-term contract price for Cobbora-quality coal upon which to base the calculations.

Conclusion

Subsidised coal prices translate into subsidised electricity prices. This situation is inefficient in two respects:

- It encourages coal-fired power generation at the expense of alternative fuels and technologies that are not subsidised; and
- It undermines the integrity of a carbon pricing policy.

Recommendation

The Cobbora mine should be sold and contracts for coal supplies for NSW coal-fired generators should be re-negotiated, either with the mine’s new owner or with other sources of coal supplies.

*The opportunity cost of a resource is the cost of the next highest valued alternative use of that resource.*
How future options could impact on system reliability.

Reliability refers to the continuity of electricity supply to end users and is a key performance indicator of customer service. The reliability standard for the NEM is determined by the Australian Energy Market Commission (AEMC) Reliability Panel. Currently it is that no more than 0.002 per cent of customer demand in each region, based upon a 10-year moving average, should be unserved by generation capacity in the region, allowing for demand-side capacity and import capacity from interconnectors. Supply interruptions in transmission and distribution networks are subject to different standards and regulatory arrangements.

AEMO publishes an annual Electricity Statement of Opportunities (ESOO), which presents the outlook for the NEM supply capacity and demand for the ensuing decade. The supply-demand outlook reflects the extent of growth, and opportunities for growth, in generation and demand-side investment. The reliability panel also recommends settings to ensure that the standard is met; these include:

- A spot market price cap, which is set at a sufficiently high level to stimulate the required investment in generation capacity to meet the standard. The cap currently stands at $12,500/MWh (but is now indexed according to the Producer Price Index, effective from 1 July 2012);
- A cumulative price threshold of $187,500/MWh (also indexed from 1 July 2012) over a rolling seven day period to limit the exposure of participants to extreme prices. An administrative cap of $300/MWh applies when the threshold is exceeded;
- A market floor price, set at -$1000/MWh; and
- Safety net mechanisms through which AEMO can manage a short term risk of unserved energy: which essentially involve contracting with generators for additional reserve capacity, or directing a generator to provide additional supply at the time of dispatch.

All regions of the NEM have consistently met the 0.002 per cent reliability standard, and generator capacity across all regions of the market is generally sufficient to meet peak demand and allow for an acceptable reserve margin.
Reliability in the NEM relies heavily on investor responses to price signals. The generation assets of the remaining state-owned generators in NSW are predominantly baseload and therefore reliability is more an issue of permitting the market to operate in response to appropriate price signals at the margin regarding timing, type, and capacity of investments in new generation plant. Resolving the current dilemma regarding disposal of the remaining state-owned generation assets should promote efficient and timely investment.

**Recommendation**

*Remove the uncertainty currently over-hanging the NSW sector of the NEM by selling the two remaining generators.*

**The impact of the above options on competition in the generation sector**

“It is difficult to conceive of an industry more susceptible to the exercise of unilateral market power than electricity. It possesses virtually all of the product characteristics that enhance the ability of suppliers to exercise unilateral market power.”

Market power refers to the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition. However, it is useful to make a distinction between having market power and the exercise of that market power. A generator is exercising market power when it alters its offers to the market in a manner that is deliberately designed to raise the wholesale market price. The exercise of market power leads to reduced output and loss of economic welfare.

It is possible to identify several reasons that support Wolak’s statement:

- The short-run price elasticity of demand for wholesale electricity is very low due to the limited scope for substitution (and, in the case of many consumers, capped price contracts do not expose them to the wholesale market in the short-run). Thus short-run response to wholesale price movements is very limited.
- The stock of generation assets is relatively fixed in the short-run; i.e. the short-run price elasticity of supply is relatively limited. Combining this attribute with the one

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above implies that during peak periods price can be very volatile in response to small changes in the supply-demand balance.

- Transmission and/or interconnector constraints may, from time to time, limit the ability of generators to compete thus giving the potential for localised market power.
- With relatively few major generators repeatedly bidding into the despatch process, a learning environment could lead to gaming decisions based upon tacit collusion.

The AER identifies the causes of all “events” where the wholesale price exceeds $5000/MWh. Such occurrences may be caused by a combination of unforeseen events, and it may then be possible for generators to take advantage of the ensuing market conditions. For example, in NSW on 7 December 2009 the AER reported that:⁸

*Extreme temperatures led to very high demand. Low cost electricity imports from Queensland and Victoria were constrained to manage congestion on the NSW transmission network. These factors, combined with plant outages, led to a very tight NSW market. A number of generators, including Delta Electricity, shifted capacity offers to higher price bands to take advantage of the tight market. Generators also rebid their plant ramp rates to prolong the impact, causing prices to stay above $300/MWh for 5.5 hours.*

The maximum price reached during this period was $9176/MWh. The AER described this period of high prices as featuring “an interplay of factors aggravated by opportunistic generator rebidding”.

Such “opportunistic” behaviour is address under Clause 3.8.22A of the National Electricity Rules: the ‘good faith bidding provision’.

3.8.22A Variation of offer, bid or rebid

(a) Scheduled Generators and Market Participants must make dispatch offers, dispatch bids and rebids in good faith.

(b) In clause 3.8.22A(a) a dispatch offer, dispatch bid or rebid is taken to be made in good faith if, at the time of making such an offer, bid or rebid, a Scheduled Generator or Market Participant has a genuine intention to

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honour that offer, bid or rebid, if the material conditions and circumstances
upon which the offer, bid or rebid were based remain unchanged until the
relevant dispatch interval.

(c) A Scheduled Generator or Market Participant may be taken to have
contravened clause 3.8.22A(a) notwithstanding that, after all the evidence
has been considered, the intention of the Scheduled Generator or Market
Participant is ascertainable only by inference from the conduct of the
Scheduled Generator or Market Participant, or of any other person, or
from relevant circumstances.”

Clause 3.8.22A is a ‘rebidding civil penalty provision’ as referred to in section 58 of the
National Electricity Law, a breach of which incurs a pecuniary penalty of an amount not
exceeding $1 million and $50,000 for every day during which a breach continues.

“Opportunistic bidding” by a NEM participant using its market power is not an unusual
occurrence, particularly on days of extreme temperatures.9 However, in this case the alleged
culprit was, in fact, a NSW state-owned generator.

In April 2011 the AEMC commenced public consultation on a rule change request from
Major Energy Users Inc (MEU) in relation to the potential exercise of market power by
generators in the NEM.

The MEU proposed that the AER declare generators that have market power during periods
of high demand as ‘dominant generators’. When regional demand exceeds the level at which a
generator has been declared a dominant generator, that generator would be required to offer
all of its available capacity for dispatch at a price not exceeding $300/MWh. Other generators
would be free to offer any price up to the current market cap of $12,500/MWh and all
dispatched generators would continue to be paid at the spot price for the relevant trading
interval.

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9 The spot price exceeded $5000/MWh in 95 trading intervals in 2009-10. The bulk of these were in South
Australia and NSW and “were associated typically with opportunistic generator bidding” (AER, State of the
The AEMC has extended the period for publication of the draft rule determination until 30 April 2012 and has outlined a three stage consultation process. Stage 2 is scheduled to commence in mid 2011 and includes consideration of:

- whether there is evidence of generators exercising market power in a manner that reduces efficiency

- whether such conduct would fall within the scope of the *Competition and Consumer Act 2010* (Cth) (CCA) (previously the *Trade Practices Act 1974* (Cth) (TPA)).

The MEU is concerned that when there is very high demand, large generators are able to cause the wholesale electricity spot price to rise more than it should by offering prices far exceeding their costs. The MEU states that this is a particular concern in South Australia but that it is also a potential problem in other regions.

The annual average spot price in the various NEM regions fluctuates from year to year, but the trend since 2001/02 is relatively flat except in South Australia, where the volume weighted average spot electricity price has increased from an average of $37.8/MWh in the years 2001/02 to 2005/06 to an average of $77.8/MWh over the period 2006/07 to 2009/10. Furthermore, the volume-weighted average spot electricity price in South Australia in 2009/10 of $82/MWh was more than double the average in all other regions of the NEM of $40.25/MWh.

As an empirical matter, the AER has concluded on a number of occasions that for certain trading intervals, the bidding strategies of large generators can have a significant impact on the spot price in a region. For example, the AER concluded that a contributing factor to high spot prices in New South Wales on 1 February 2011 was rebidding by Macquarie Generation and Eraring.

*The impact of lower/higher levels of vertical integration in the market that may result from adoption of some of the above options*

The question of whether low levels of vertical integration enhance market competitiveness is a vexed issue amongst energy economists. In the early years of electricity market
liberalisation. “ unbundling” the traditional state ownership, highly vertically integrated, model into its generation, transmission, distribution, and retailing components was considered vital for establishing a competitive market. However, following unbundling, market participants have sought to reduce their need for hedging using financial instruments by investing in both generation and retailing (and these companies are generally known as “gentailers”), thus providing a natural hedge against price volatility through, effectively, a limited form of vertical integration. To the extent that retail prices are not contestable or are capped, there is clearly no significant impact on price. However, full retail contestability is the stated goal of the Council of Australian Government’s Australian Energy Market Agreement (2006) to deregulate prices once competition is deemed effective (full retail contestability currently exists in all states of the NEM, accept Tasmania, but Victoria is the only state not to have price caps for small consumers) and thus the impact of the gentailer model on competition is an important consideration.

The electricity industry naturally tends towards vertical integration. Increased vertical integration between retailers and generators is evident, for example, in Australian states that have disaggregated and privatised their electricity assets through mergers and through direct investment by retailers in generation capacity.

Incentives for generators and retailers to vertically integrate to form ‘gentailers’ include physically hedging against pool market price risk, acquiring physical assets that provide collateral for financiers and NEM operators, and economies of scale. At least in theory, cost savings can be directly passed on to the consumer. However, there is a danger that a small number of vertically integrated gentailers could influence undue oligopoly power in the market (very similar to that of Australia’s commercial banks today). Extending the potential for inter-state trade through interconnectors could help to offset any potential abuse of market power.

The Gentrader arrangement actually created, or at least greatly enhanced, the presence of gentailers in NSW by packaging the gentrader rights with the retail arms of the former state owned corporations (SOCs). Origin and TRUenergy now dominate the retail electricity
market in NSW, with AGL the only significant, minor, market participant.\textsuperscript{10} Thus, if it wanted to achieve some degree of vertical integration in the NSW market, AGL would need to purchase either some significant generation assets or development sites. However, acquiring coal-based generation assets may be regarded as counter-cultural to AGL that promotes itself as being a leading producer of energy from renewable sources.\textsuperscript{11}

In the absence of interest from AGL, and assuming that any further investment in generation in NSW by either Origin or TRUenergy would be viewed as being unacceptable in terms of market power within the state, the assets of Macquarie Generation would have to appeal to a merchant generator without any sizeable retail sales base within the state to give it a degree of a natural price hedge.

\textit{The costs and benefits of selling the transmission and distribution networks.}\textsuperscript{12}

Electricity networks are highly capital intensive but incur declining marginal costs as output increases leading to a natural monopoly industry structure, where one company that serves the market would have a lower cost per customer than two or more companies. In the case of transmission and distribution networks, duplication of power lines would be required if another company entered the industry. This would clearly be an inefficient situation, since neither company would gain the full benefits of economies of scale.

Irrespective of whether ownership is private or public, regulation of transmission and distribution is regarded as essential in order to avoid market distortions and encourage the efficient allocation of resources. Privately owned companies would be expected to be more interested in maximising profit than their public counterparts, and would therefore be more

\textsuperscript{10} In fact, Origin, TRUenergy and AGL dominate the retail sector of the entire NEM. They are also major gas retailers, thus permitting cost savings through joint-administration and marketing.

\textsuperscript{11} Although AGL has 32.5\% of the ownership of brown coal generator Loy Yang A.

\textsuperscript{12} The transmission and distribution networks are discussed together, because they are both natural monopolies and therefore have many characteristics in common. However, they differ significantly in a number of respects. In particular, investments in transmission are generally episodic rather than continuous and come in discrete “lumps”. In the short term this produces an inability to recover costs until capacity reaches some threshold level. Thus efficient investment requires regulatory mandates and a regulatory cost allocation. Distribution lends itself more to an incremental approach.
responsive to regulatory incentives that rewarded improved efficiency through reductions in capital and operating expenditures. Although government-owned companies would not be indifferent to profit, they could be expected to place greater weight on non-pecuniary pressures from consumers, employees, politicians, the media, etc. This is likely to make them more cautious about reducing labour and other costs, and more sympathetic to increasing capital expenditure (which is often referred to as “goldplating” the network).

Currently, the transmission networks in Victoria and South Australia, and the three direct current network interconnectors (Directlink, Murraylink, and Basslink) are privately owned.

Victoria’s five distribution networks are also privately owned, while the South Australian network (ETSA Utilities) is leased to private interests. The ACT network has joint government and private ownership. All networks (transmission and distribution) in Queensland, New South Wales, and Tasmania are owned by governments.

The AER regulates all electricity networks in the NEM to manage the risk of monopoly pricing. The approach generally involves setting a ceiling on the revenues or prices that a network can earn or charge during a period, thus providing the network with an incentive to minimise costs through enhanced levels of efficiency. The ceiling is determined by a building-block methodology that accounts for a network’s efficient operating and maintenance expenditure, capital expenditure, asset depreciation costs and taxation liabilities, and a commercial return on capital.

The NSW Government subjects its network businesses to the commercial discipline of paying dividends and making tax equivalent payments in recognition of the opportunity cost associated with the Government’s equity investment in its businesses. These businesses effectively face similar costs as if they were a privately owned business, with the difference between government borrowing costs (with a AAA credit rating) and indicative private business borrowing costs (assumed as BBB+ for the calculations in Table 2), clawed back by the government in the form of a loan guarantee fee.
Table 2: NSW Budget: Revenue from State Owned Electricity Network Businesses ($m)

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<tr>
<td>Tax equivalent Payment</td>
<td>244</td>
<td>244</td>
<td>250</td>
<td>442</td>
<td>613</td>
<td>566</td>
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<tr>
<td>Government Guarantee fee</td>
<td>56</td>
<td>97</td>
<td>230</td>
<td>264</td>
<td>352</td>
<td>326</td>
</tr>
<tr>
<td>Total</td>
<td>726</td>
<td>821</td>
<td>942</td>
<td>1400</td>
<td>1888</td>
<td>1693</td>
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The significant increase in payments from 2011/12 reflects the increased allowable revenue available to the distribution businesses. Earnings from the network businesses are forecast to rise largely because the capital expenditure allowed by the AER increases the regulatory asset base from which a large proportion of the regulated revenue is derived through a return on capital. Thus, the NSW Government benefits, as any private owner would under the current regulatory framework, from increased expenditure by the network businesses and the subsequent higher prices paid by customers which generates a greater revenue stream for NSW Treasury commensurate with the cost of capital for the businesses.

This raises the question of the investment and operational efficiency per unit of expenditure on the transmission and distribution networks by government relative to private businesses. The AEMC has published a report on using a Total Factor Productivity (TFP) approach to regulating network revenues and prices.\(^\text{13}\) The approach measures how businesses use resources to produce output.\(^\text{14}\) It exposes regulated businesses to competitive pressures by linking revenues to industry performance rather than the cost structure of a particular business. The AEMC identified potential benefits of using this methodology over the current building block approach:

- A less information intensive methodology, with reduced regulatory costs;
- Reduced information asymmetry between regulated businesses and regulators; and
- Stronger performance incentives for regulated businesses.

However, there is a requirement for the establishment of new data-reporting requirements to allow for initial trials.

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\(^{13}\) AEMC, *Review into the use of total factor productivity for the determination of prices and revenues, draft report*, 2010.

\(^{14}\) More generally, TFP is the portion of output not explained by the amount of inputs used in production. As such, its level is determined by how efficiently and intensively the inputs are utilised in production.
The appropriateness of the building block methodology has also been questioned in a report into prices and productivity of electricity distributors in Australia commissioned by the Energy Users Association of Australia (EUAA). In addition to a number of regulatory reforms, one of its suggestions for improvement was for privatisation of distributors in NSW and Queensland. This conclusion was based upon a comparison of the efficiency of distributors in NSW, Queensland, Victoria, and South Australia, and “builds on and confirms influential research by Professor Stephen Littlechild and Bruce Mountain .... that pointed to government ownership, the regulatory framework and the conduct of regulation as the main causes of rising prices and declining productivity”.

Concerns over the current ownership and regulatory structure of the networks have also been expressed by Ross Garnaut who, in his “Key points”, observed “There is a prima facie case that weaknesses in the regulatory framework have led to overinvestment in networks and unnecessarily high prices for consumers”.

There is also the fundamental issue of whether a national (as defined by the geographic scope of the NEM) electricity market, should have a national transmission network as opposed to a fairly restricted form of inter-state trade operating in states that are largely concerned with intra-state trade.

Any assessment of the efficiency of the NSW transmission networks would require an investigation into whether costs per customer and permitted revenues reflect factors associated with regulation and ownership or industry structure, geographical factors and the operating environment. In general, such an analysis would rely on benchmarking; i.e. comparison of the network in question with the operating and capital expenditure of an “efficient” distributor. Having identified the efficient distributor, the task is then one of assessing whether the cost differences between the network in question and the benchmark are due to legitimate or uncontrollable cost factors. In Australia, the networks are vastly different with regard to both geographical factors and operating environments, which bring

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into question the precision of any benchmarking exercise. For example, whilst a number of studies have been produced that compare network costs in NSW with those in Victoria (and selected overseas networks), the conclusions tend to be rather vague and lacking in conviction.\textsuperscript{17}

There is a requirement for an assessment of the costs and benefits of privatising the network assets in NSW. This would address the question “Does the (anticipated) fall in costs (i.e. the benefits) resulting from privatisation warrant the cost of privatisation?” Whilst this question just expresses the obvious, actually calculating dollar values is far from straightforward. It is also important to address the distributional aspects of the question, in other words “who gains and who loses in the process of privatisation?”

Calculation of the net welfare benefits from privatisation involves an evaluation of the gains from efficiency that could be obtained as a result of privatisation plus the net benefits that would result from savings in investment expenditure on the networks, less the costs of privatisation. All values to be aggregated on a present value basis. In other words, an evaluation of the net benefits of the sale, as opposed to the retention of the assets, from a societal perspective.\textsuperscript{18}

\textit{Recommendation}

\textit{To undertake a study to assess the costs and benefits to the economy of NSW of selling the NSW transmission and distribution companies to the private sector.}

\textit{Eastern Australian Gas}

EnergyQuest estimates that proven and probable (2P) reserves of coal seam gas (CSG) in Eastern Australia (essentially just Queensland, with relatively small amounts in NSW)


\textsuperscript{18}Park Industrial, \textit{A Comparison of the Development of the Victorian and NSW Transmission Systems}, prepared for Transgrid, September 2011.

\textsuperscript{18}UHS group, \textit{Transmission Efficiency Review}, prepared for Transgrid, 8 May 2008.

\textsuperscript{18}This value could, of course, be negative.
currently amount to 35,246 PJ. To put this into context, it equates to approximately 40 per cent of Australia's total 2P gas reserves, the latter amount representing around 70 years of forward production at current rates. The vast bulk of production of CSG from Queensland is intended for export in the form of LNG and, currently, the four consortia involved are trying to lock in sufficient contracts to justify commencement of LNG production and export. If current plans come to fruition, it is reasonable to expect that domestic gas prices from the Queensland CSG resources for customers in Queensland and NSW will be heavily influenced by netback LNG export prices.

Initial LNG deliveries from BG Group's Queensland Curtis LNG are expected in 2014, with Santos's Gladstone LNG and Origin/ConocoPhillips's Australian Pacific LNG commencing the following year, and Arrow LNG project somewhat later. However, all projects still have major challenges to overcome, associated with the management of ramp-up gas, land access agreements, water treatment, and securing contracted gas volumes.

A large volume of ramp-up gas will be produced before the initial LNG trains are commissioned. This is expected to greatly exceed the volumes that the domestic market can absorb. This increased availability of CSG for domestic consumption may depress gas prices in Eastern Australia during the ramp-up period, but prices are likely to recover after the first LNG shipments occur.

However, uncertainties abound. The shale gas revolution is opening up opportunities in Asian countries for access to domestic sources of gas, as well as providing additional competitors in the international LNG market. There will also be competition from conventional LNG producers such as the North West Shelf, Algeria, Qatar, Indonesia and, a new entrant, Papua New Guinea. To the extent that these factors hold down international LNG prices, then domestic netback prices will be correspondingly lower.

Certainly there appears to be adequate supplies of gas to sustain an expansion of OCGT and CCGT power plants across Eastern Australia for many decades. The major uncertainty is the

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19 2P gas reserves represent the industry's expected volume of gas that can be produced and sold. It is general industry practice in Australia to contract based on 2P gas reserves volumes.
price at which domestic supplies will be made available if the industry becomes dominated by LNG export driven markets.

Conclusion
Switching from coal to gas for power generation will assist NSW (and Australia) in meeting national emissions reduction targets over the next couple of decades. However, market distortions resulting from subsidised coal for NSW power generators could inhibit this process. These subsidies cannot be defended on either commercial or energy security grounds given the availability of significant gas reserves in Eastern Australia.

19 September 2011
Appendix 13  Initial Report

Initial Report of the Special Commission of Inquiry into the Electricity Transactions

The Honourable Brian John Tamberlin QC
31 August 2011
Initial Report of the Special Commission of Inquiry into the Electricity Transactions

1.1 The terms of reference for the Special Commission of Inquiry into the Electricity Transactions are contained in Appendix 1 to this Initial Report.

1.2 Those terms of reference require an initial report by 31 August 2011 and a final report on or before 31 October 2011.

1.3 The Inquiry commenced on 29 April 2011 and by mid May, senior counsel and counsel were engaged and a solicitor to the Commission appointed. Premises were located and the necessary administrative arrangements were put in place. Administrative staff commenced work.


1.5 Twenty seven submissions have been received.

1.6 The Inquiry held a public hearing on 23 May 2011 at which leave was granted to the following parties to appear: Delta Electricity and a number of its current and former directors; Eraring Energy; the State of NSW, acting through the Department of Premier and Cabinet, NSW Treasury and the Department of Trade and Investment, Regional Infrastructure and Services; Ausgrid, formerly EnergyAustralia; Credit Suisse Australia Limited; Essential Energy, formerly Country Energy; Ms Jan McClelland, a former director of Eraring Energy; TRUenergy Pty Ltd; Mr Kimberly Yeadon and Mr John Dermody, former directors of Delta Electricity. Subsequently, other individuals and agencies have sought and been granted leave to appear before private hearings.

1.7 The Inquiry has established a website at www.lawlink.nsw.gov.au/sciet. All significant information concerning the progress of the Inquiry is placed on that website.

1.8 Shortly after the commencement of the Inquiry, letters were sent to 54 key agencies and individuals, inviting them to participate in the Inquiry and provide relevant information.

1.9 Eighty two summonses have been issued to a range of public sector and private sector bodies and individuals requiring the production of documents and information. Thus far, over 340 folders of documents and numerous CDs and USB flash drives have been produced and reviewed by the Inquiry. It is expected that there will be a need to summons further material.

1.10 The Inquiry has held private hearings with 20 people in relation to its first and second terms of reference. Those hearings have been held in private because of the commercial in confidence nature of the terms of the electricity transactions.
1.11 Meetings, which have been recorded and transcribed, have been held with over 35 individuals, many representing agencies and companies. Each person interviewed or examined has been summoned to do so. Directions under sections 7 and/or 8 of the Special Commission of Inquiry Act 1983 were made which included preventing the publication of evidence given.

1.12 In addition, the Inquiry has requested information from agencies and most of this has been provided, however, some remains outstanding.

1.13 On 17 June 2011, the Commissioner and Inquiry staff attended the offices of the Australian Energy Market Commission where a presentation as to the operation of the National Energy Market was made.

1.14 On 23 June 2011, the Commissioner and Inquiry staff visited Bayswater power station operated by Macquarie Generation and toured its trading room at Lambton.

1.15 On 15 and 16 August 2011, the Commissioner and Inquiry staff visited Capital Wind Farm, near Bungendore, a solar farm at Queanbeyan and Tumut 3 power station operated by Snowy Hydro Limited.

1.16 The Inquiry expects to complete the gathering of evidence in relation to the first two terms of reference shortly.

1.17 It has engaged an expert to provide assistance for the inquiring into and reporting on terms of reference three and four and expects this report in the near future.

1.18 The final two terms of reference concern reporting on options for the future action that could be taken to further the public interest in a competitive NSW electricity sector. The Inquiry has sought the views of many working within the electricity sector and has obtained the services of several experts to provide a short report on their views. In addition, Professor Owen, who prepared the report for the NSW Government in 2007, has been retained to supplement and update his earlier report and express his opinion on future options.

1.19 Given the volume of material sought and received and which remains outstanding, and the complexity of the transactions the subject of this Inquiry, no conclusions, findings or recommendations can be made at this time.

1.20 Final reports will be provided to the Governor on or before 31 October 2011 which will contain the conclusions, findings and recommendations of the Inquiry.