



22 October 2009

Speech to Contact Energy 2009 AGM David Baldwin, Managing Director

Good morning

Thank you Grant, and may I extend my own welcome to you all.

Over the next 20 or so minutes, I'd like to address two key questions that should interest shareholders most:

- (i) Why did Contact's profit fall by 30 per cent last year?
- (ii) What is being done to grow profits?

Along the way, my hope is that this presentation might also better inform you about the industry we are in.

As I travel around the country to meet with Contact's investors, it is abundantly clear to me that electricity is something that everyone thinks about – and often. The electricity bill is one of the two or three most significant accounts that people pay each month. And the electricity industry is one that most people have an opinion about.

However, it is also relatively poorly understood, and this may be in large part the fault of the leaders in the industry not properly communicating how it works – in a language that everyone can understand.

This is something I'm working on changing. It is Contact's goal to open up the industry in a way that makes it easier for people to understand.

So, over a cup of tea afterwards, you can let me know how I do today.

Before I begin addressing the two questions at the heart of this presentation, I'd like to set the context.

Explaining electricity

So how does the electricity industry work?

While the electricity market's machinations can be complex, at its heart the industry should not be too difficult to understand.

Very simply, electricity is generated at power stations across the country and fed into the transmission system where it is delivered to electricity demand centres. Local lines companies take the electricity off the transmission grid and deliver it to customers - industry, business and residential customers.

That's all relatively simple. The lesser-known part of the industry is the wholesale electricity market, which sits in between the generation of electricity and end consumers.

In essence, the wholesale market is used to set the price of wholesale electricity – much like other commodity markets such as beef, lamb and milk.

Electricity generators sell their power into the wholesale market and electricity retailers purchase the electricity they need to meet their customers' requirements from the market.

The price of wholesale electricity is set every five minutes, and can be volatile. The price can change quickly and significantly depending on what is happening across the electricity delivery system.

Although the wholesale electricity price changes every five minutes, it can also be significantly impacted over an extended period by the weather – primarily due to New Zealand's heavily reliance on rainfall to supply our hydro stations.

During wet periods when the New Zealand's hydro lakes are full, there is plenty of energy to supply the country. In general, this results in a low wholesale price.

In a dry period when the hydro lakes are low and the system is more reliant on the thermal generation fleet, such as Contact's gas-fired plants in Taranaki and Auckland, the wholesale price reflects the shortage of energy and is higher.

The winter of 2008 was a particularly dry period in New Zealand – one of the driest on record. If you look at what happened to the wholesale electricity price during that period it was between 25 and 40 cents per unit.

To get a sense of relativity, residential consumers pay around 21 cents per unit for their power at home. Of that 21 cents, around seven cents is the cost of the electricity, with the balance made up of the costs of transmission, distribution, levies and electricity retailing.

In the spring of 2008, the heavens opened and the country's hydro lakes were overflowing. You might recall seeing the pictures of water spilling across the South Island hydro dams late last year and into the early part of this year.

As a result, the wholesale electricity price in December 2008 was around three cents per unit.

So although the wholesale electricity market is behind the scenes for most of our customers and they are shielded from its fluctuations with fixed tariffs, it is very much at the centre of how we manage risks in our business – both to deliver price certainty for customers and returns for shareholders.

The importance of flexibility

One of Contact's main strengths has been the diversity and flexibility of our generation portfolio.

This flexibility has enabled Contact to switch between hydro and gas-fired generation as required, enabling the company to offset the impact the weather has had on the wholesale price of electricity.

When it was wet we could turn down the North Island gas-fired power stations and rely on the South Island hydro stations to meet demand across the country.

Similarly, when it was dry, our North Island power stations would make up for the lack of hydro and support the South Island in times of drought.

This flexibility has enabled Contact to maintain earnings regardless of volatility in hydrology and wholesale market conditions.

Two critical factors have been central to Contact's portfolio flexibility:

- A strong transmission system which enables hydro electricity to flow freely from the south to the north, and thermal electricity to flow from the north to the south
- Flexible gas-supply arrangements which enabled the amount of gas we use in our gas-fired plants to be varied up or down and, during a really wet year for example, to turn the gas supply off and shut our plants down for a while without penalty.

Over the years Contact has enjoyed both of these elements – a strong transmission system linking the North and the South Islands and highly flexible gas supply arrangements.

The loss of flexibility

Over the 2009 financial year, Contact was negatively impacted by the loss of this flexibility which had previously underpinned the company's strength.

A combination of severe transmission constraints, loss of gas supply flexibility and extreme weather restricted Contact's hydro generation and the company's ability to move electricity between the North and South Islands. These conditions resulted in a 20 per cent reduction to EBITDAF.

A quarter-by-quarter look at the 2009 financial year illustrates exactly what happened.

In the first quarter, the South Island experienced one of the worst droughts on record.

At the same time, the absence of one of the two HVDC transmission cables which link the two islands prevented sufficient North Island thermal power from getting to the South Island. Contact's hydro generation was restricted by drought in the South Island and was unable to supplement the shortage with gas-fired generation in the north. This situation had a negative impact on Contact's performance in the quarter.

In the second quarter, the situation reversed and the South Island lakes filled to the point of overflowing. The transmission system then limited the amount of hydro power that could be shipped north, forcing 400 gigawatt hours of hydro energy – enough to power around 40,000 households for a year – to be spilled and wasted.

During the last two quarters of the year, the wet conditions continued. However, Contact's current gas supply contracts require us to pay for natural gas, even if we don't use it. So we were faced with a situation where the country had lots of hydro and low wholesale electricity prices but we were forced to pay for gas that we didn't want to use and which the market didn't need. The loss of the ability to turn off our gas plants and then use the gas later also had a significantly negative impact on Contact.

That's the story of what happened last year. I now want to focus on Contact's future.

Restoring flexibility

There are two key strategic challenges that must be addressed in order for Contact's earnings to revert back toward normal trends:

- Resolving the transmission constraints that now occur across the country
- Developing new sources of flexibility in Contact's portfolio, so the company can again perform well irrespective of the operating environment.

Transmission

After decades of underinvestment, Transpower, the State Owned Enterprise which owns and operates the national transmission system, will be investing billions of dollars over the coming years in strengthening the grid.

As we have seen over 2009, a strong transmission system is critical to the most effective and efficient operation of the electricity market, and to New Zealand's energy security.

One of the projects we watch particularly closely is the replacement of pole one of the HVDC – after the original pole one was unexpectedly removed from service in late 2007.

The replacement of pole one - known as pole three – is a critical part of the country's energy infrastructure and will be in operation by April 2012.

We're encouraged by Transpower's investment plan and we will do everything we can to help Transpower implement the grid upgrade projects that the country needs.

As I mentioned earlier, one of the challenges we faced last year – and one we still face today – is the fact that we have to pay for natural gas irrespective of whether or not we need or use it.

Restoring gas supply flexibility

We are making good progress in replacing the loss of gas flexibility.

We acquired the depleted Ahuroa gas field 18 months ago and, together with Origin Energy, started work on creating New Zealand's first underground gas storage facility.

The Ahuroa gas storage facility will provide a reservoir for Contact to store gas during periods in which we don't need it, such as across the summer or during a wet winter. This will enable us to operate our gas-fired power stations as they are needed and restore our ability to turn our gas plants off and instead store the gas underground without penalty.

In early October, we commissioned a new compressor on the Ahuroa site which is enabling us to inject gas into the reservoir at our target rate of around 40 terajoules per day.

Later this month we are also about to start drilling three new gas injection wells to enable us to inject more gas over the next nine months.

The Ahuroa project will cost around \$250 million and it's expected to be in operation by mid-2010. It's a vital part of restoring Contact's operational flexibility.

Generation flexibility

The second major initiative which will add important flexibility into Contact's portfolio is the \$250 million Stratford peaking project.

This is a plant that, unlike our existing gas-fired power stations, can go from cold to full output in less than 10 minutes. The plant will allow Contact to meet electricity demand requirements over peak periods or when the wholesale price increases for other reasons.

This project, together with the Ahuroa gas storage project, represents \$500 million of investment in critical energy infrastructure at a time when the country needs it most. These assets will restore valuable operational flexibility to Contact's portfolio and improve New Zealand's energy security.

Future generation developments

Looking further into the future, New Zealand will continue to need new sources of electricity generation to meeting growing demand. The need for new generation development will be particularly important as Genesis Energy's 1,000 megawatt coal-fired power station looks set to move to a reserve generation role over the coming years.

Contact's view is that renewables – particularly geothermal energy – will be the next source of new generation.

Right now Contact is building on its leading position as New Zealand's largest supplier of geothermal energy with the construction of the \$100 million Tauhara phase one power station at Taupo which is due for commissioning in the middle of 2010.

We are also planning the construction of the 250 megawatt Tauhara phase two geothermal power station and the 220 megawatt Te Mihi geothermal project which together represent up to a further approximately \$1.5 billion of investment in renewable energy.

As part of our strategy of securing generation options across a range of fuel sources, we have continued to explore potential new wind and hydro projects. This includes advancing consent applications for wind farms in the Waikato and Southern Hawke's Bay, and investigating a number of hydro options in Central Otago.

Our view is that new hydro projects will also need to feature in New Zealand's energy future.

To this end we have started a conversation with local communities on four options for hydro developments on the Clutha, with the aim of choosing a single option to develop further. While new large-scale hydro may not be required until the end of the next decade, we have deliberately taken a long-term approach to this process to allow full consultation with local communities and considered development of the right concept.

So you might well ask why Contact is not looking to build new baseload gas-fired stations to meet increasing demand?

The challenge for gas generation is that New Zealand's supply of gas is depleting.

By late next decade, New Zealand's domestic supply of gas is currently forecast to be less than demand.

The reality is that any source of new generation will cost more than the current sources of electricity.

Geothermal is clearly the most cost effective new energy source, which is why Contact is investing heavily in it.

Natural gas could be a cost effective option in the future, provided gas costs don't increase beyond today's price. If the country needs to import gas in the future then gas becomes more expensive than hydro or wind. Based on current information about available gas reserves we do not have sufficient confidence that there will be domestic sources to meet the requirements of a new gas fired station.

Pricing

The question you may be asking is how does this impact on how much we currently pay for energy?

If you break down the average retail electricity tariff into its component parts, the energy component is about seven cents per unit; less than a third of the total tariff.

The balance is made up of transmission costs, distribution costs, retail costs and retail margin.

As I've mentioned, the reality is that new forms of generation will cost more than existing generation and tariffs will need to increase to cover these costs, as well as other costs such as the investment in new transmission lines.

If there is to be the investment in new generation that the country needs, the costs of the new generation must be reflected in retail tariffs. This is why there continues to be upward pressure on retail tariffs and why prices will need to increase in the future.

Retail

Looking at our retail business, we have worked hard over the year to rebuild our relationships with customers and other stakeholders.

While in recent years we had been successfully building our retail customer base, following last year's AGM, customers made it clear that we were out of step with them.

In addition to the loss of customers associated with last year's AGM, the last 12 months have been characterised by intense and sustained competition for retail customers.

We have been intensely focused on rebuilding consumer trust and confidence, and winning customers through innovative offers such as our Dual Fuel product, a substantial online, ontime discount, and a two-winter price freeze in some regions.

After a period of customer losses – which peaked in February this year – consumers are again choosing Contact and we have returned to net customer growth in what is the most intensely competitive retail market New Zealand has seen for a decade.

Contact and the community

We have also worked hard to build our relationships with the communities in which we operate through initiatives such as community celebrations to mark the 50th anniversary of our Wairakei geothermal power station, opening our power stations to the public, and a number of sponsorships and partnerships that make a genuinely positive contribution in local communities.

To mark the milestone of 50 years of geothermal generation from Wairakei, Contact, in consultation with local iwi, has commissioned a large Maori sculpture to gift to the Taupo community.

The sculpture is a Waharoa, or spiritual entrance, through which acknowledgement and respect is given and received by Tangata Whenua and visitors.

The Waharoa will be blessed, unveiled and presented next month at the entrance to the Taupo War Memorial – a location selected by Tuwharetoa Kaumatua and endorsed by the local RSA – as a place to remember and reflect.

Health and safety

One of the disappointments for me as Managing Director was the company's health and safety performance over the last year.

While our health and safety performance was showing very good trends over the 2008 year, this performance slipped in 2009 – primarily as a result of the increased contractor activity we have around our sites.

This is an area in which we must do better, and is a key priority for this year. Early indicators over the first four months of this year are that the efforts we are placing on improving safety – particularly with our contractors – are starting to have an effect, with the year to date being without any significant safety incidents.

Conclusion

In conclusion, it's been a tough year for Contact, but we have addressed the challenges we face head on. We have continued to adapt while delivering value for shareholders and strengthening our capacity for future growth.

Our asset portfolio will mark several major milestones in 2010 with the completion of the Ahuroa gas storage facility, the Stratford peaking plant, and the Tauhara phase one geothermal power station. We're proud of these investments that will restore a level of portfolio flexibility, improve your company's ability to respond to different market conditions and make an important contribution to New Zealand's electricity supply.

In the year ahead we will also advance a range of other development options so that we can continue to deliver the right kinds of new generation, when the timing is right.

The year to 30 June 2009 has tested Contact's resilience, but this only underscores the imperative for our business strategy, and will strengthen our ability to perform over the long-term.

We are realistic about the challenges facing the sector, and are committed to playing our part in meeting them. We are looking forward to continuing to engage

constructively with all of the stakeholders in our business, and I thank you for joining us here today.

Thank you.