

AGL EnergyPrimary Credit Analyst: Mark Legge, Melbourne 61-3-9631-2041; mark_legge@standardandpoors.com
Secondary Credit Analyst: Ian Greer, Melbourne (61) 3-9631-2032; ian_greer@standardandpoors.comMajor Rating FactorsRationaleOutlook: StableBusiness DescriptionBusiness Risk ProfileFinancial Risk ProfilePeer Comparison**Corporate Credit Rating**

BBB/Stable/--

Business risk profile:

Satisfactory

Financial risk profile:

Intermediate

Debt maturities:

A\$1.5 billion term facility of 1-, 3-, and 5-year tranches, and an A\$0.5 billion 3-year revolver.

Collateralization:

AGL Energy's bank debt is unsecured, and supported by a negative pledge.

Bank lines:

AGL Energy has A\$2.0 billion of syndicated facilities to support A\$1.5 billion of assumed debt on demerger, and around A\$500 million undrawn and available for general corporate purposes. AGL Energy also has 3- and 5-year bank lines supporting A\$300 million in bank guarantees.

Outstanding Rating(s)**AGL Hydro Partnership**

Corporate Credit Rating

BBB/Stable/--

Corporate Credit Rating History

Oct. 20, 2006

BBB

Major Rating Factors**Strengths:**

- Vertically integrated nature of businesses;
- Solid market position of electricity and gas-retailing business;
- Moderate financial ratio minimum target; and
- Conservative dividend policy.

Weaknesses:

- Exposure to merchant risk;
- Sovereign risk associated with Papua New Guinea Gas Project investment; and
- Aggressive growth strategy.

Rationale

The long-term corporate credit rating on AGL Energy (AGLE) reflects the vertically integrated nature of its businesses, solid market position in electricity and gas marketing, and moderate financial metric target. These strengths are offset by the company's exposure to merchant risk, aggressive growth appetite, and sovereign risk associated with the PNG gas pipeline investment.

The risks associated with exposure to merchant risk are mitigated somewhat by AGLE's moderate level of vertical integration. AGLE's Victorian-based peaking hydro assets, together with the Hallett and Somerton gas-fired power stations, allow AGLE to internally hedge about 80% of its peak load. The small, complex, and weather-sensitive nature of its wholly owned AGL Hydro Partnership means Standard & Poor's will need to see several years of successful integration of this acquisition with AGLE's retail operations before ascribing material benefit to the company's business position.

AGLE's electricity and gas-retailing operations have sound market positions. As Australia's largest energy retailer, AGLE is able to reduce unit costs to a greater extent than some of the smaller participants. Moreover, as the largest provider of dual-fuel contracts, AGLE's competitive position is enhanced because these customers are less likely to churn. Demand for electricity and gas retail products is expected to remain solid over the coming years.

AGLE's public commitment to manage its debt levels so as to and maintain funds from operations (FFO) to interest coverage above 5x over the medium term, is supportive of credit quality. Importantly though, this policy will need to be adhered to for a continuing rating benefit to be ascribed. In the face of 2,200 megawatts (MW) of generation developments under consideration, Standard & Poor's expects AGLE will fund any emerging transactions consistent with this policy. AGLE's capitalization will be such that its FFO-interest cover target is anticipated to be comfortably exceeded in the first year of operations. Moreover, AGLE's dividend policy, of paying out 60% of net profit after tax, is seen as conservative.

AGLE's credit profile is weakened by its aggressive growth strategy. The anticipated rapid development of generation projects means AGLE will face the challenge of dealing with substantial (and perhaps multiple) construction, integration, and funding risks in the short-to-medium term. While the generation projects may provide further vertical integration benefits, such developments will need to show a track record of successful operation before any benefit to AGLE's business profile will be ascribed.

AGL announced on Aug. 13, 2006, that front-end engineering and design on the Australian component of the PNG pipeline had been scaled back. If the development of the Australian segment of the PNG gas pipeline proceeds, Standard & Poor's expects AGLE's ownership in the project and its exposure to construction risk to be minor. At the same time, Standard & Poor's expects AGLE would fund a material portion of its involvement with equity. The investment in the PNG Gas Project and proposed gas offtake agreement (should the PNG Pipeline Project proceed) exposes the company to the high level of sovereign risk associated with the Independent State of Papua New Guinea (PNG; 'B/Stable/B' foreign currency ratings and 'B+/Stable/B' local currency ratings). If the PNG offtake agreement proceeds and were to account for a material portion of the company's gas portfolio, AGLE's financial metrics would have to be strengthened for the 'BBB' rating to be retained.

Liquidity

AGLE's liquidity is strong. There is no debt due in first 12 months of operations, and about A\$300 million of undrawn bank facilities.

Outlook: Stable

AGLE's stable outlook assumes the company will adhere to its policy of maintaining FFO interest cover above 5x over the medium term. The 'BBB' rating could withstand cash flow-interest coverages dropping below 5x if Standard & Poor's perceives the situation to be temporary and there is a strong likelihood of a substantial rebound in cash flow. The outlook also assumes that the funding of any new acquisition would involve a significant equity component consistent with maintaining the rating. Moreover, the outlook assumes that any involvement in the proposed PNG gas pipeline does not increase the company's risk profile. If this is not the case, the rating would come under pressure.

There is limited prospect for an improved rating in the short-to-medium term given the company's aggressive growth ambitions. An upgrade is unlikely in the medium-term and will only be considered when AGLE achieves a greater level of vertical integration, a sustained track record of robust operations, and very strong credit metrics.

Business Description

AGLE is a vertically integrated merchant energy company. On average, more than half of AGLE's earnings before interest, tax, depreciation, and amortization (EBITDA) is expected to be derived from its wholly owned electricity and retailing business. Its major businesses are:

- Energy retailing: Australia's largest energy utility, with 2.0 million gas accounts and 1.6 million electricity accounts;
- Power generation: 633 MW of Victorian-based hydro assets (100% owner of AGL Hydro Partnership), Hallett Power Station, Somerton Power Station, 32.5% investment in Loy Yang Power; and development of 180 MW Hallett Wind Farm;
- PNG Gas Project: 10% interest;
- Western Australian energy retailer and cogeneration joint venture, AlintaAGL: 33% interest;
- Other investments include: 50% of Elgas Ltd., Australia's largest distributor of liquefied petroleum gas; 50% of ActewAGL retail, the Australian Capital Territory network owner and retailer; 50% of Sydney Gas, the New South Wales gas field developer; and 50% interest in the Moranbah Gas Project in Queensland.

AGLE has been established as an aggressive growth vehicle, with a focus on increasing earnings per share. The strategy involves increasing the level of vertical integration through the development of generation capacity and procuring of equity investments in upstream gas projects, and increasing the size of its retail energy base to reduce unit costs. However, at this stage, the probabilities of particular projects proceeding, their likely cost, and timing, are unclear.

AGLE has a diverse ownership base.

Business Risk Profile

Regulation

The electricity retail price caps in Victoria and South Australia are a risk to AGLE's electricity retail margins, particularly in an environment of rising wholesale prices. Although AGLE mitigates an element of the risk through electricity hedging, the price caps could cause some degree of financial loss if the regulator in South Australia or the Minister for Energy Industries & Resources in Victoria do not provide for an appropriate risk-adjusted return. Regulation does not materially enhance or detract from AGLE's other businesses.

Markets

Energy consumption in the primary energy retail markets serviced by AGLE is expected to be sound, with growth of 2.0%-3.5% anticipated in the next few years. The primary energy markets served are the gas retail market in Sydney, the electricity and gas retail markets of Victoria, and the electricity retail markets of South Australia and the Australian Capital Territory. The company's focus on these markets and the particular product offerings generally reflect AGLE's incumbent position in these markets. AGLE has licenses to retail gas and electricity in all states along the eastern and southeastern seaboard of Australia.

The revenue received from AGLE's energy retailing customer base is reasonably balanced between relatively higher-margin residential and small business customers (mass market), and lower-margin industrial consumers. The high proportion of mass-market customers provides greater revenue stability, as demand is generally less affected by economic fluctuations than larger commercial and industrial customers (see tables 1 and 2).

Table 1

AGL Energy Retail Gas Customers and Revenue Profile, 2005

Segment	Customers		Gas sales		Gas revenue	
	(000s)	(%)	(PJ)	(%)	(mil. A\$)	(%)
Natural gas						
Residential and small business	1,336	99.9	62	36	812	61
Industrial and commercial	1	0.1	69	40	325	25
Wholesale	-	-	42	24	190	14
Total	1,337	100	173	100	1,327	100

PJ—Petajoules.

Table 2

AGL Energy Retail Electricity Customers and Revenue Profile, 2005

	Customers		Energy demand		Electricity revenue	
	(000s)	(%)	(GWh)	(%)	(mil. A\$)	(%)
Residential and small business	1,481	99.2	9,766	43.8	1,182.7	55.4
Industrial and commercial	12	0.8	12,513	56.2	954.0	44.6
Total	1,493	100	22,279	100	2,136.7	100

GWh—Gigawatt hours.

PNG Gas Project.

AGLE is exposed to PNG's high sovereign risk because of the company's effective 10% equity interest in the PNG Gas Project. PNG's foreign currency rating is 'B', with a stable outlook. However, the quality of the cash flow from the company's investment has been assessed as 'BB-', in line with Standard & Poor's transfer and convertibility risk (T&C) for PNG. The T&C risk assesses the possibility that a sovereign will place restrictions on its currency that limit the ability to freely exchange it for another currency or gold, or remit it to any resident or nonresident. The risk of disruptions to oil and (prospective) gas production is mitigated somewhat by: a historically robust production history, with only two days of interruptions since production began in 1992; the pipeline being buried; and the PNG government interest in the project. The

company's 10% interest is through an entitlement to reserves in the Kutubu (11.9%) and Gobe (66.7%) licences (see table 3). AGLE's share of oil, gas, and condensate reserves is about 110 million barrels of oil equivalent (75% gas and 25% oil). Gas is currently being re-injected into the oil fields to support oil production or for storage until the project proceeds.

Table 3

AGL Energy PNG Investment Field Reserves

Field	Reserve Life
Kutubu	2025
Moran	2025
SE Manada (under development)	2014
Gobe Main	2010
SE Gobe	2014

AGLE's rationale for its PNG Gas Project investment is to enhance the integration of its existing gas retail business. Incidental to this strategy will be an exposure to oil. It is not AGLE's strategy to become an explorer for oil and gas; Oil Search (not rated) will remain operator of all projects. The first four years is expected to account for 80% of the fields' production, with AGLE having prudently fully hedged its exposure to oil price fluctuations for that period.

Operations

AGL's most significant business risk relates to the challenge of effectively mitigating its retail base exposure to the potentially volatile wholesale electricity market. The acquisition of Southern Hydro (renamed AGL Hydro Partnership) in November 2005, combined with AGL's existing gas-fired Somerton (180 MW) and Hallett (150 MW) peaking plants, allows about 80% of the peak component of wholesale market risk to be internalized between its generation and retail business. Nevertheless, AGLE is still forced to rely on a forward contract market for a significant portion of its hedging, which, at times, cannot provide the cover required. The need to re-contract hedge positions as existing cover rolls off exposes the company not only to price and volume risk, but also to credit risk. Moreover, the retail price caps in AGLE's primary electricity market of Victoria exacerbate the financial consequences of inappropriate hedging.

The flexibility inherent in the 633 MW non-contracted capacity of the AGL Hydro generation portfolio will allow AGLE to create a partial internal hedge for its retail base. The reliable, fast-start, and low-capacity nature of AGL Hydro's Victoria hydro assets will provide AGLE with an ability to respond to peak price events. While irrigation requirements mean AGLE will not have full control over its water-supply releases on the Dartmouth and Eildon schemes (together representing more than half of non-contracted capacity), much of this risk is mitigated by the large regulation ponds that both schemes have downstream of the power plants.

AGLE operations will be fully diversified by its initial 33% stake in the Western Australian (WA) energy retail and cogeneration joint venture, AlintaAGL. The JV will have 540,000 gas customers, 1,000 electricity customers and 140 MW of cogeneration. The WA market is attractive due to prevailing retail energy margins of over 12%, which are higher than margins available in other Australian energy markets; strong growth profile; and the cap on government-owned generation. AGLE has the right to move to 50% ownership in three years and 100% ownership in five years.

AGLE's 32.5% stake in Loy Yang Power does not enhance its business position. Loy Yang Power owns the Loy Yang A power station and adjacent coal mine. AGLE plays no role in the bidding or hedging of Loy Yang A, thereby limiting any potential for an internal hedge of market risk to be established with its retail business. Nevertheless, the Loy Yang A investment does provide AGLE with a window into the base load market, as AGLE receives aggregate data on Loy Yang A trade volumes, prices, and level of contracting. Loy Yang A recently refinanced its debt and extended its debt-maturity profile (the next bullet is not due for five years), which resulted in improved margins and more favorable terms, conditions, and covenants. Nevertheless, continuing soft pool prices are hampering Loy Yang A's performance and there is unlikely to be significant cash flow from this investment in the short term.

AGLE has operational and maintenance risk for the Wattle Point wind farm despite not owning the asset. AGLE will have a 25-year offtake arrangement with the owner, Alinta Ltd., which involves the payment of a flat monthly offtake fee. AGLE will on-sell 75% of the output and renewable energy certificates generated to TRUenergy Pty. Ltd. (A-/Stable/--) under a contract expiring Dec. 31, 2009. It is anticipated that this arrangement will be the template going forward for AGLE's wind farm involvement, including the development currently being constructed at Hallett Wind Farm.

AGLE's energy trading group acts as a cost center, undertaking energy trading to minimize the cost of goods sold in supporting the company's retail activities. Margins on retail electricity contracts, particularly with large customers, are locked in under back-to-back hedge contracts. For its mass-market customers, hedging policy sets benchmarks that require the load to be fully hedged for the next 12 months, with hedging benchmark percentages progressively reducing over the following five years. AGL's hedging is achieved through the use of contracts-for-differences, more exotic financial derivative products, alliances with generators, and its own peaking plants. The utility maintains an extensive system of policies and procedures to control and monitor its centralized energy trading, including reporting requirements, delegation authority, credit limits, and wholesale risk parameters.

AGLE's existing gas supplies are considered robust; sourced from strong counterparties; long-term in nature; and Australian based. The company purchases its wholesale gas supply under long-term supply arrangements with Santos Ltd. (Santos; BBB+/Stable/A-2), BHP Billiton/Esso, Origin Energy Ltd. (BBB+/Stable/A-2), SydneyGas JV, and Moranbah CSM Gas Project. Santos sources gas from Queensland and the Cooper Basin in South Australia, while BHP/Esso sources gas from the Bass Basin in Victoria. The contracts remove future volume risk for AGL by securing gas supply for at least the next 13 years. If the PNG Gas Pipeline Project proceeds, AGL will sign a 20-year gas-supply agreement with the project's producers to purchase 1,500 petajoules (PJ) of gas over 20 years. The security of supply from PNG is seen as inferior to current gas sources given PNG's high sovereign risk. Moreover, given the uncertainty as to whether the PNG Gas Project will proceed, the risks associated with a gas offtake contract have not been factored into AGL's rating.

AGLE's gas portfolio has been further diversified by acquisitions in two coal seam methane JVs. The company has a half share in leases and exploration licenses for coal seam methane reserves as part of the Sydney Gas joint venture. The advantage of the venture is that the gas is sourced near AGL's gas retail base in New South Wales, meaning transmission tariffs are bypassed. AGL has a 10-year agreement to purchase 14.5 PJ of gas and is the operator of the asset. AGL also recently acquired a 50% stake in the Moranbah Gas JV operating agreement and associated gas sale contracts. The majority of proved and probable (2P) reserves are contracted (300 PJs out of 360 PJs) with Enertrade and Ergon Energy Corp. Ltd. (AA+/Stable/--) to 2020. AGL will take no exploration risk.

Competitive position

AGLE's strong position in the Australian energy retail market affords it a per-unit cost advantage over smaller participants. Furthermore, AGL's competitive position is enhanced as the largest dual-fuel retailer with 1.1 million customers; such customers have traditionally been shown to be less likely to churn. The competitive environment continues to be harsh, particularly in Victoria and South Australia, where churn levels are exceeding 20%. Despite this difficult environment, AGL has improved its retail margins (EBIT-to-sales margin) to 7.7% in fiscal 2006, from 6.6% the previous year.

Financial Risk Profile

Financial policy

AGLE's moderate financial policy is underpinned by its public commitment to manage its debt levels to ensure that, over the medium term, FFO interest cover is at least 5.0x. Moreover, the company's dividend payout policy, at 60% of net profit after tax, is considered conservative.

AGLE has a 25-year Power Purchase Agreement (PPA) for the 91 MW Wattle Point Wind Farm, which will be owned by Alinta Ltd. Standard & Poor's treats the PPA as debt-like in nature and includes the capacity payments in gross debt and interest expense calculations, respectively.

Profitability and cash flow protection

The quality of AGL's earnings and cash flow is considered modest, given the exposure of the company's operations to merchant risk. The projected capitalization of AGL is such that in 2007, FFO interest cover may approach 6.8x and FFO to debt may be around 28%. AGL is expected to have substantial funding requirements over coming years because of its aggressive growth strategy focused on expanding its generation capacity and upstream gas equity interests, and increasing its retail energy footprint. Despite this, Standard & Poor's expects AGL will abide by its financial policy of maintaining FFO interest cover above 5x over the medium term. As such, FFO to debt is expected to be around 30%. If the PNG offtake agreement proceeds, AGL's financial performance would have to be strengthened for the 'BBB' rating to be retained.

Liability management and capital structure

AGLE has been capitalized with a moderate debt burden, with gross debt (including the Wattle Point Wind Farm PPA) anticipated to be around A\$1.6 billion in fiscal 2007, equivalent to around 30% gearing (debt-to capital). AGLE's initial debt-maturity profile is reasonably short term in nature, with the expectation being that the company will have a mix of 1-, 3-, and 5-year term bank debt and a 3-year revolving facility. Nevertheless, Standard & Poor's expects the debt profile will be extended over the next few years.

Standard & Poor's anticipates AGLE will ensure that it establishes adequate financing facilities to cover bank guarantees related to its electricity (NEMMCO) and gas (Gascor) obligations, and have around A\$300 million in unused facilities for general liquidity purposes.

Financial flexibility

AGLE has moderate financing flexibility, and is expected to be able to readily access the debt and equity markets. While the company has the option to scale back dividends, Standard & Poor's does not consider a material reduction in dividends a likely option, given its stock will be widely held and dividend growth is important to shareholders. It is assumed that there will be an endorsed dividend reinvestment plan.

Peer Comparison

CLP Australia Holdings Pty Ltd. (A-/Stable/--) and New Zealand's Contact Energy Ltd. (BBB/Stable/A-2) have a greater level of vertical integration than AGLE due to the significant natural retail hedge provided to their generation businesses. On the other hand, Origin Energy has only modest non-contracted generation to internally hedge its retail operations compared with AGLE. CLP Australia's rating benefits from ownership support from its parent.

Table 4

Peer Comparison

	AGL Energy	Origin Energy	CLP Australia Holdings Pty Ltd.	Contact Energy Ltd.
Country	Australia	Australia	Australia	New Zealand
Corporate credit rating	BBB/Stable/- -	BBB+ /Stable/A- 2	A-/Stable/--	BBB/Stable/A- 2
Financial policy	Intermediate	Intermediate	Intermediate	Moderate
Year ended	2007E	2005	2005	2005**
Business type	Generation and retail	Upstream and retail	Generation and retail	Electricity generation
Financial statistics				
Gross revenue (mil. LC\$)	N.A.	4,860.6	1,592.1	984.1
EBITDA (mil. LC\$)	N.A.	938.9	122.4	363.8
Funds from operations (FFO) (mil. LC\$)	483.4	577.8	120.3	164.8
Total assets (mil. LC\$)	6270.3	8,014.7	5,187.7	4,374.3
Total debt (mil. LC\$)	1439.0*	2,830.3	1,951.5	1,085.9
Net debt (mil. LC\$)	1357.0*	2,742.5	1,948.7	1,047.7
FFO interest cover (x)	7	4.3	1.7	3.55
FFO/ total debt (%)	30.2	20.0	5.3	20.2
Total debt/total capital (%)	31.5	42.0	47.3	26.4
Net cash flow/capital expenditure (%)	113.3	100.5	(11.4)	91

E—Estimated. N.A.—Not available. *Not adjusted for PPA (Power Purchase Agreement) debt-like obligations. **Figures are for nine months. Accordingly, some ratios have been annualized.

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