

Envestra Limited
Managing Director's Address
27 October, 2010 Annual General Meeting

Ladies and Gentlemen

Long history as a reliable transporter of natural gas

The Annual Report theme this year highlights Envestra's long history, with its precedent companies in South Australia, Queensland and Victoria dating back to the mid-19th Century. Our gas business has been around for a long time, offering customers a reliable and cost effective energy supply over many decades. Our future, and that of our customers, depends on the continuation of our long-term investment in extending and upgrading the gas networks. That requires returns to shareholders to be reliable and attractive if capital to finance such expansion is to be forthcoming.

Our performance in 2009-10 was steady, with financial outcomes much in line with our expectations. The underlying Profit after Tax of \$36.3 million was marginally up on 2008-09, and network operations continued the consistent pattern of recent years. We were thus able to fund our business effectively, with some \$43 million invested by shareholders via the Company's Dividend Reinvestment Plan and \$554 million of new debt capital raised.

There are important changes occurring in our industry with some considerable challenges. I will outline some of these developments and explain where Envestra sits with them, particularly in relation to our strategy for the future.

Growth in the natural gas industry in Australia

Even a casual observer over the past year will have seen many articles, or announcements, of massive developments to occur in the Australian natural gas industry, largely associated with proposed liquefied natural gas (LNG) developments based on coal seam methane projects in the eastern States, or offshore natural gas fields in the West.

These developments, some proposed, some already proceeding, follow what has been a "game-playing" industry change in the United States over recent years, where we have seen a massive increase in US domestic natural gas supply capability as a result of both coal seam methane and shale rock gas extraction developments.

The Australian industry is also dealing with major gas supply changes, with LNG exports destined to more than double in the next 6 to 7 years, primarily based on coal seam gas supplies.

These developments will require huge investments, both in LNG infrastructure and in pipelines to transport the gas to the processing plants.

As well as these challenges for the industry, we are seeing substantial investment demands estimated by the esaa to exceed \$70 billion for both gas and electricity network owners over the next 5 years to fund the replacement of ageing assets, to address the expansion requirements, and to re-finance existing debt facilities.

Envestra's position in the face of this industry growth

Envestra was ASX listed in 1997 with a deliberate strategy to occupy a particular niche in the gas supply chain, being the transportation of gas in a regulated environment.

This strategy was and is, consistent with our targeted low cost of capital, and our investors' requirements, whether equity or bond investors, who are generally seeking low risk, consistent annual returns.

We intend to maintain this strategy, and therefore Envestra will not be significantly exposed to the benefits, nor the risks, associated with the forthcoming growth in the Australian upstream gas sector.

However, the expanded infrastructure requirements associated with ageing assets, population growth and changing household gas usage patterns is Envestra's core business and we intend to participate in these opportunities so long as regulatory outcomes justify such expenditure.

Carbon emissions and government policies

Natural gas is increasingly recognised as the link to a significantly carbon free energy solution that may evolve towards the middle of this century.

However, even with an Emissions Trading System, carbon tax or compulsory renewables targets, the long-life nature of energy investments, and the long lead times for new developments will mean that natural gas will play an increasing role in substituting for higher carbon emitting energy sources over the course of the next 20 years and beyond.

We expect that these developments will largely affect electricity generation, with various coal fired plants expected to be progressively substituted for natural gas. Envestra will not be greatly affected by this move.

Those developments, together with the rising penetration through Government decree of costlier renewables (particularly windfarms and solar) will increase electricity costs.

Whilst natural gas prices may also increase as a result of LNG developments and increasing gas network renewal costs, they are unlikely to be at a rate of increase expected in the electricity sector, and therefore, retail gas prices will become even more competitive with those of electricity.

Envestra's strategic direction

Envestra is a natural gas transporter, with long-term revenue growth dependent on network expansion, rather than volume growth. Whilst we are affected by volume outcomes in the midst of 5-yearly regulatory periods, longer term revenue growth is dependent on network (or regulatory asset base) expansion. These opportunities will mainly emerge through the construction of major housing subdivisions in Victoria and South Australia and to a lesser extent in Queensland.

Volume growth will be relatively modest, as indeed it has been in recent years due to warming weather patterns, improving energy efficiency standards, public energy conservation awareness and the increasing penetration of Government sponsored solar hot water. However, this is not expected to have a significant impact on revenue growth due to the structure of the regulatory regime which allows tariffs to increase to compensate for changes in consumption patterns.

Whilst growth by acquisition has not been a feature of Envestra since we bought the Victorian business in 1999, we have, over many years, examined a number of gas pipeline and network opportunities. However, in the "heady days" of the financial markets up to 2008, we were not prepared to pay prices others apparently considered reasonable for these assets. Markets have changed, and continuing our prudent approach to acquisition evaluation, we were able to announce yesterday that Envestra had been successful in acquiring Country Energy's Gas Networks. The business is largely centred in Wagga Wagga, but with operations in a number of regional towns in southern New South Wales.

The acquisition adds around 3 to 4% to Group revenues (\$14 million), assets (1,225 km of pipe) and customers (26,000), it is a business with sound growth prospects in an area adjacent to our existing operation in Albury. As a result, we expect to be able to generate synergies and more efficiently develop the local gas markets.

The financial impact on the Envestra Group is expected to be mildly accretive. About 40% of the funding for the acquisition will come from existing resources, with the remainder being provided by the Commonwealth Bank. Settlement of the transaction is expected to occur this Friday, 29 October, with operation of the business to be transferred to APA Asset Management over the course of the next 2 to 3 months.

Turning to other strategic issues, improving regulatory outcomes, particularly in respect to the rate of return (WACC) allowed by the AER to network owners is fundamental to Envestra undertaking an enhanced future investment program.

Also fundamental to achieving network growth is the ability to source capital, both equity and debt. A key strategy is therefore to reinforce Envestra's "investment grade" credit rating to facilitate on-going access to capital.

Regulatory context

We spent considerable resources during 2009-10 in preparing material for the Australian Energy Regulator to consider in its current review of the South Australian and Queensland Access Arrangements.

Envestra has just submitted its proposed Access Arrangements to the AER for both networks covering the period 1 July 2011 to 30 June 2016; submissions requiring an onerous 2,000 pages of evidentiary material to support our position.

The proposal envisages significant increases in tariffs, reflecting an investment program of around \$675 million over that time. The investment program is mainly aimed at replacing ageing pipelines in city centres, and in expanding the networks to new suburbs.

Much of the tariff increase arises from increased cost of capital that has occurred over the global financial crisis period and is still with us. The proposed return to shareholders is 13%, reflective of the current Envestra dividend yield plus a 2% growth allowance, and what we see as the cost of capital for similar investment grade companies.

Regulators over the past decade have had a record of gradually reducing shareholders' returns, either through reducing WACCs, choosing unrealistic future demand projections that serve to reduce tariffs, or disallowing claimed costs that are required to run the networks.

We are hopeful that the AER, in its first decision covering Envestra's networks, will recognise the importance of the long-term interests of consumers and agree to Access Arrangements that encourage investment and thereby underline the future reliability and efficiency of the gas networks in South Australia and Queensland.

Capital markets context

As mentioned earlier, Envestra floated in 1997 with a structure that was designed to align to the perceived demands of what was then the new regulatory system.

One feature of Envestra's structure was "outsourcing". This approach recognised the need for Envestra to maintain significant control over its future costs, but at the same time, exploit the economies of scale of an operator with a growing contractor business aligned to a larger corporate where overheads could be spread across various divisions. At the same time, the structure delivered the targeted low cost of capital that was expected to be available to the owner of a regulated network operating in a stable and transparent regulatory environment.

Another feature was the capital structure. The Company aimed to operate only as a network owner in the regulated niche of the gas supply chain, thereby allowing use of comparatively high debt levels that served to minimise our cost of capital.

In more recent years, the global financial crisis put pressure on many companies' financing arrangements.

Protection of our investment grade credit rating has always been a fundamental strategy for the Group. Indeed, we are aiming to improve our credit rating with S&P to BBB, which is the level that Moody's currently rates the Company.

We target the BBB level because this is two levels above a "non-investment grade" rating, and as such, we believe the Company will be better placed to access capital markets for new funds, and it is also likely to provide a lower overall long-term cost of capital to the Group.

The higher rating will also ensure Envestra has the financial strength to withstand any aberrant events that may arise in the future, thereby enhancing the reliability of future returns to shareholders and bond investors.

We estimate that with the higher level of cash retention that has occurred since the dividend was set at 5.5 cents per security in late 2008, together with improving revenues associated with regulatory outcomes, our S&P rating should be increased in or around 2012. Whilst this is a matter for S&P to determine, we believe, based on reasonable forecasts, that our credit metrics by then will be reflective of a BBB rated entity.

Any rating change will also be dependent on S&P's level of comfort with the regulatory regime operating in Australia, and more particularly, the perceptiveness of the decisions of the Australian Energy Regulator.

2009-10 achievements

The year has been marked by steady progress as we consolidated our recent financial re-structuring, sought to improve regulatory outcomes, continued a substantial capital expenditure program and actively participated in various capital market initiatives including issuing US\$150 million of what is the longest dated (17-year) debt by an Australian BBB issuer since the GFC began. In addition, important productivity reviews were completed such that we are now well placed to move forward over the coming years with a view to growing revenues and profits over the medium-term and longer.

Operations

Our networks continued to perform reliably during 2009-10 despite the difficulties associated with prolonged drought conditions, and towards year-end, with significant rainfalls in South Australia, Queensland and Victoria.

Operating costs rose by almost 8% over the previous year with most of the increase arising from the renewed marketing campaign and increased leak maintenance costs arising in part from the climatic conditions.

Whilst subject to careful oversight by Envestra Management, our operating activities are outsourced to APA who undertakes maintenance and capital project activities. APA continued to provide a high level of service with a safety record, both in respect to employee injuries, and in respect to public incidents, only being marred by relatively minor occurrences. However, there is room for improvement and this is a focus for both Envestra and APA during the current year.

I take this opportunity to record my appreciation of the effort put in by our employees and contractors during 2009-10 in ensuring our networks operated reliably and our commercial interests were successfully advanced.

Our Company is in a sound financial position and there are ongoing opportunities to expand our interests and improve financial performance. Whilst the future is very much dependent on the forthcoming determinations by the AER, I have some confidence that the long-term interests of gas consumers will be balanced appropriately with the need to ensure shareholders are adequately rewarded for the significant investments that need to be made in the coming years.

Thank you ladies and gentlemen. I'll now hand you back to our Chairman.