

## BABCOCK & BROWN POWER

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### ASX Release

9 May 2007

### INDUSTRY PRESENTATION: CEDA

Please see attached presentation made today by Babcock & Brown Power (ASX: BBP) Chief Executive Officer, Mr Paul Simshauser at an event arranged by the Committee for Economic Development of Australia.

### ENDS

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#### About Babcock & Brown Power Limited

Babcock and Brown Power (ASX: BBP) is a power generation business, with assets diversified by geographic location, fuel source, customers, contract types and operating mode. Its aim is to grow returns to its securityholders through optimisation of its existing power generation business and the addition of further power assets via a combination of new construction and strategic acquisitions.

The initial portfolio has interests in seven operating power stations and one power station under construction and due for completion in late 2008. The portfolio has a total electricity generation capacity of approximately 2,900 MW. Babcock & Brown has been developing, operating and acquiring the generation portfolio over a period of 10 years. Four of the power stations have been co-developed by Babcock & Brown from green field development opportunities and four have been acquired from other operators.

## Portfolio Summary

Power station	Location	Equity interest (%)	Fuel	Operations Start Date	Capacity (MW)	Operating Mode	Offtake
<b>Operating power stations</b>							
Braemar	Queensland	85% <sup>1</sup>	Gas	September 2006	455MW	Intermediate	Energex/Market
Oakey	Queensland	50%	Gas	January 2000	286MW	Peak	Enertrade
Redbank	NSW	100%	Coal	April 2001	135MW	Base load	EnergyAustralia
Ecogen (Jeeralang)	Victoria	73%	Gas	1980	449MW	Peak	TRUenergy
Ecogen (Newport)	Victoria	73%	Gas	1980	510MW	Peak	
Flinders (Playford)	South Australia	100%	Coal	1960-1964	240MW	Intermediate	Various/Market
Flinders (Northern)	South Australia	100%	Coal	1985	527MW	Base load	Various/Market
<b>Under construction</b>							
NewGen Kwinana	Western Australia	70% <sup>1</sup>	Gas	late 2008 (projected)	320MW	Base load	Synergy
<b>Total of operating and under construction</b>					<b>2,922MW<sup>2</sup></b>		
<b>Contracted power offtake</b>							
Osborne contracts	South Australia	100%	Gas/cogeneration		180MW	Base load	Various/Market

<sup>1</sup> Direct and indirect equity interest.

<sup>2</sup> BBP's equity interest in the assets is equivalent to 2,350MW.

For further information please visit our website: [www.bbpower.com](http://www.bbpower.com)

# On Emissions Trading

## CEDA

### 9 May 2007

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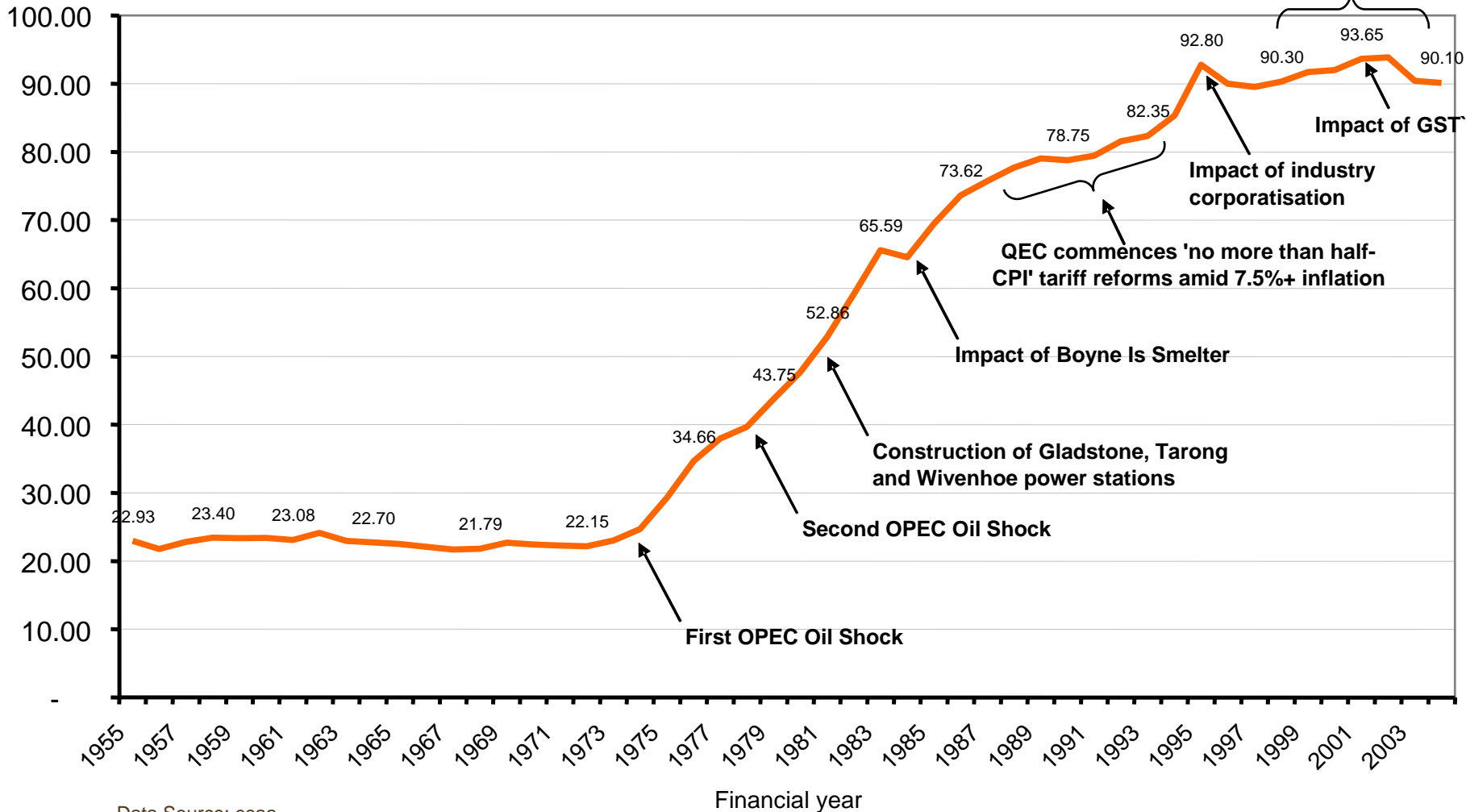
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## Emissions Trading – the quick overview

- Who will be included? Power Generators, <100 sites, >35% emissions
- Who should be included? As many industries as possible
- Who will be excluded? Trade-exposed industries (with some justification)
- When is it likely to start? No earlier than 2010
- What sort of scheme? Probably Cap and Trade
- What price should Carbon Trade at? \$16/t+ to make an impact
- What will the penalty (max) price be first up? Probably \$15/t
- Who will be near-term impacted? Electricity generators (sharp impact), domestic electricity consumers (moderate impact)
- Who will be long-run impacted? Electricity generators, industrial electricity consumers
- Any policy issues that have a “ticking device” attached? Yes – the vexed matter of permit allocation (Auction vs. Grandfather)

# 50-year history of electricity prices in Qld: from 1993, among the lowest electricity prices in the world

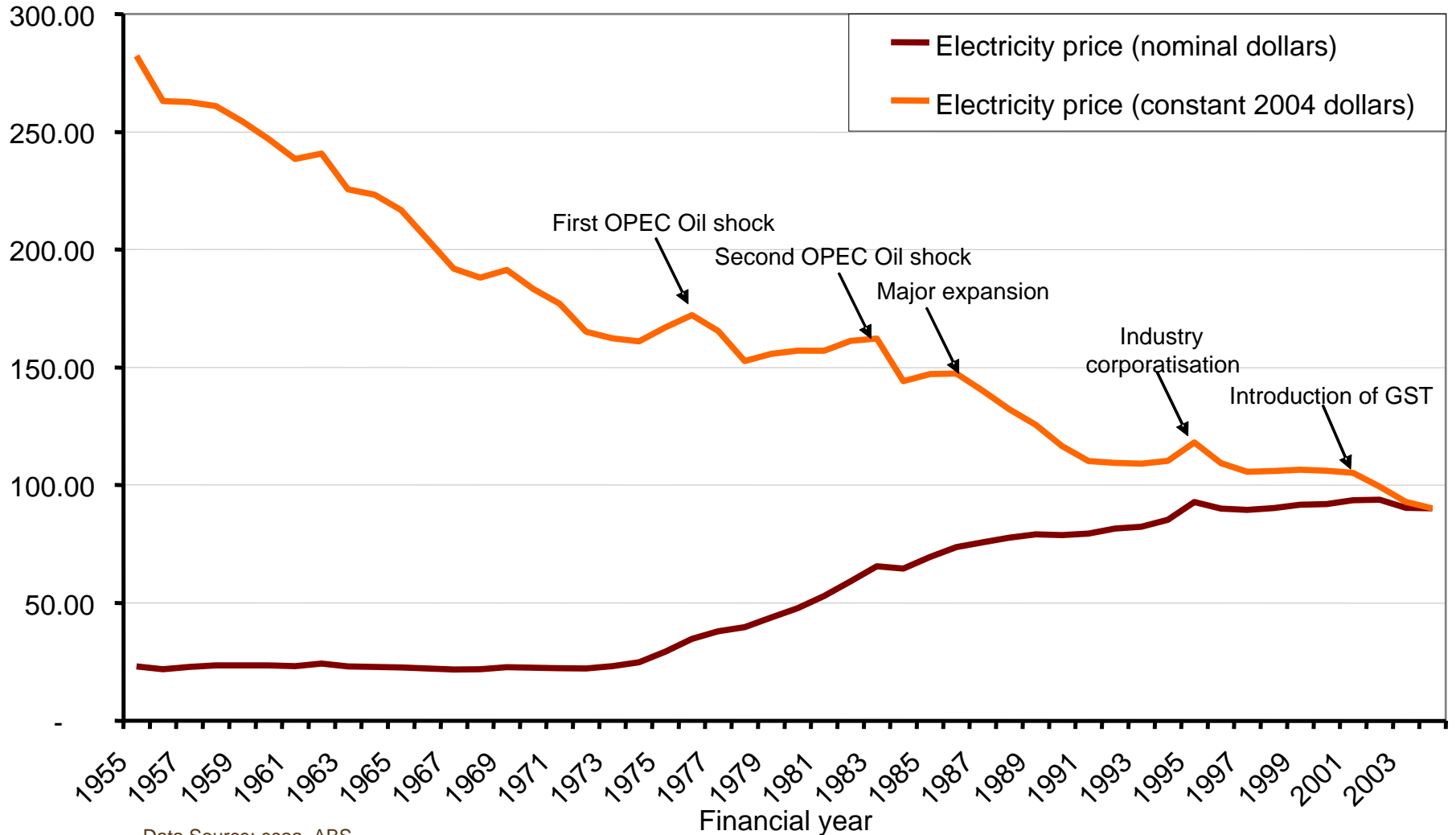
Electricity price (\$/MWh)



Data Source: esaa

# Over 50 years, prices have fallen in real terms escalation about 46% of CPI

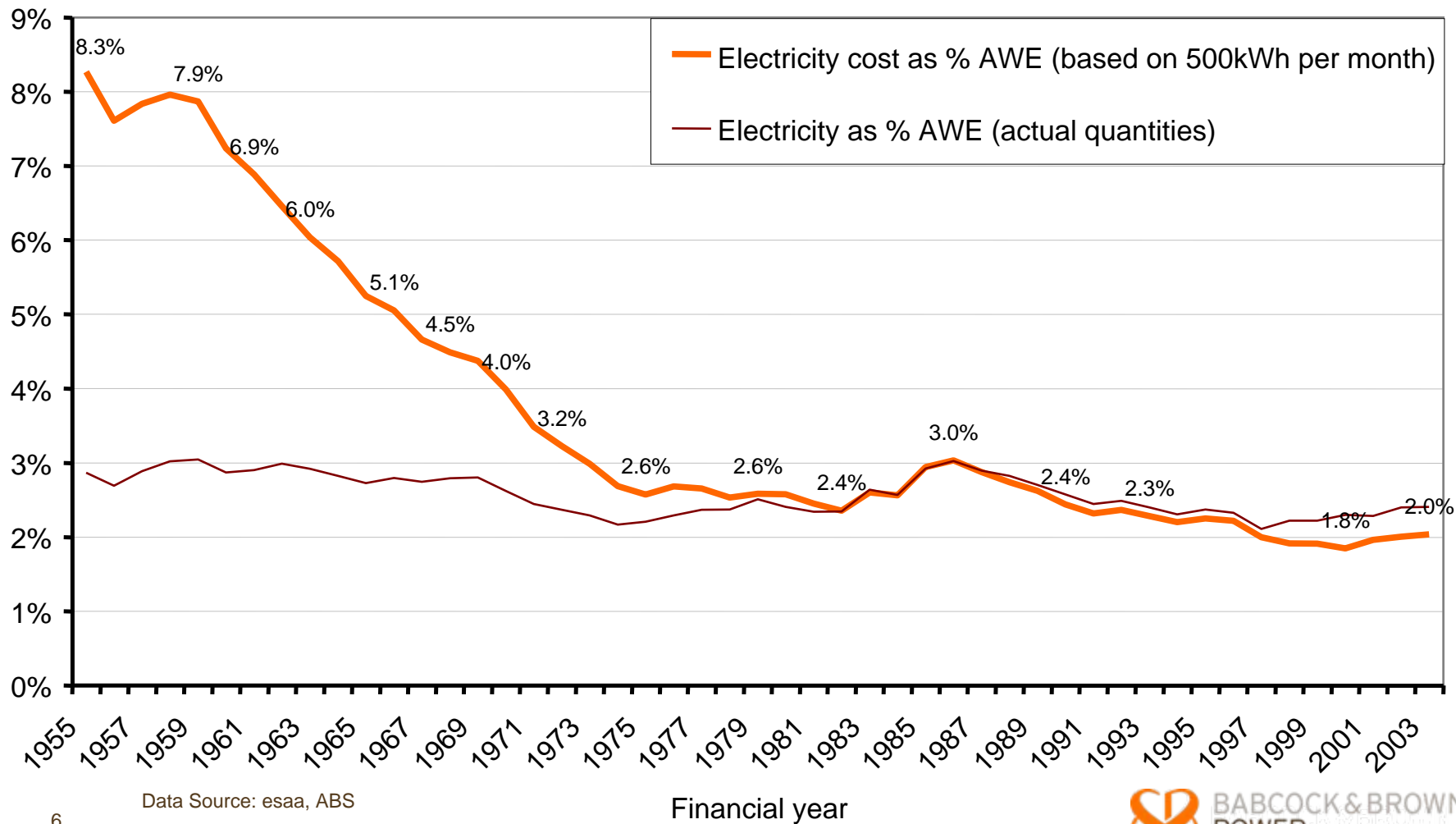
Electricity price  
(\$/MWh)



Data Source: esaa, ABS

# Despite ever rising demand (70% increase in 10 years by SEQld'ers) electricity has never been cheaper...

Electricity cost : AWE  
(%)

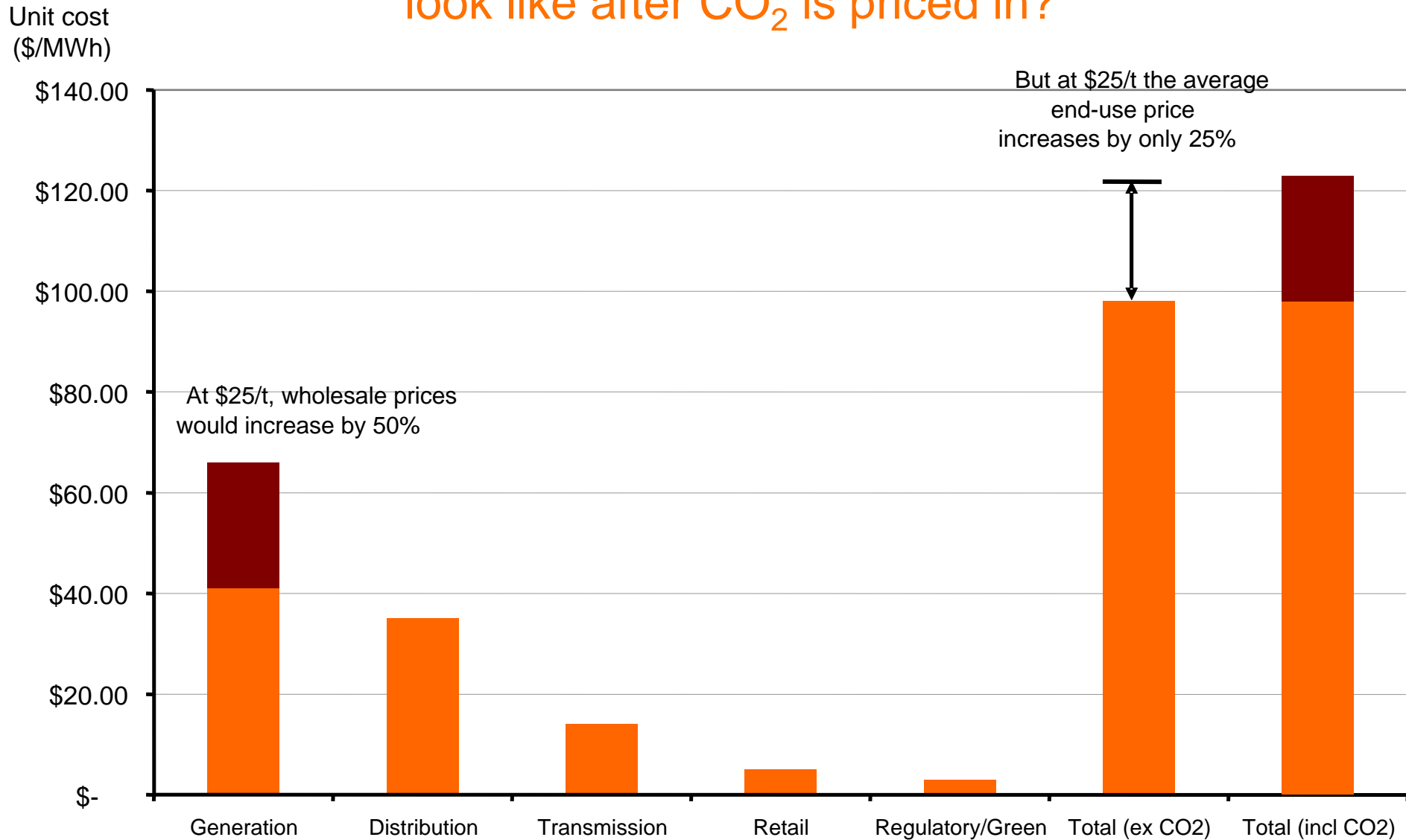


Data Source: esaa, ABS

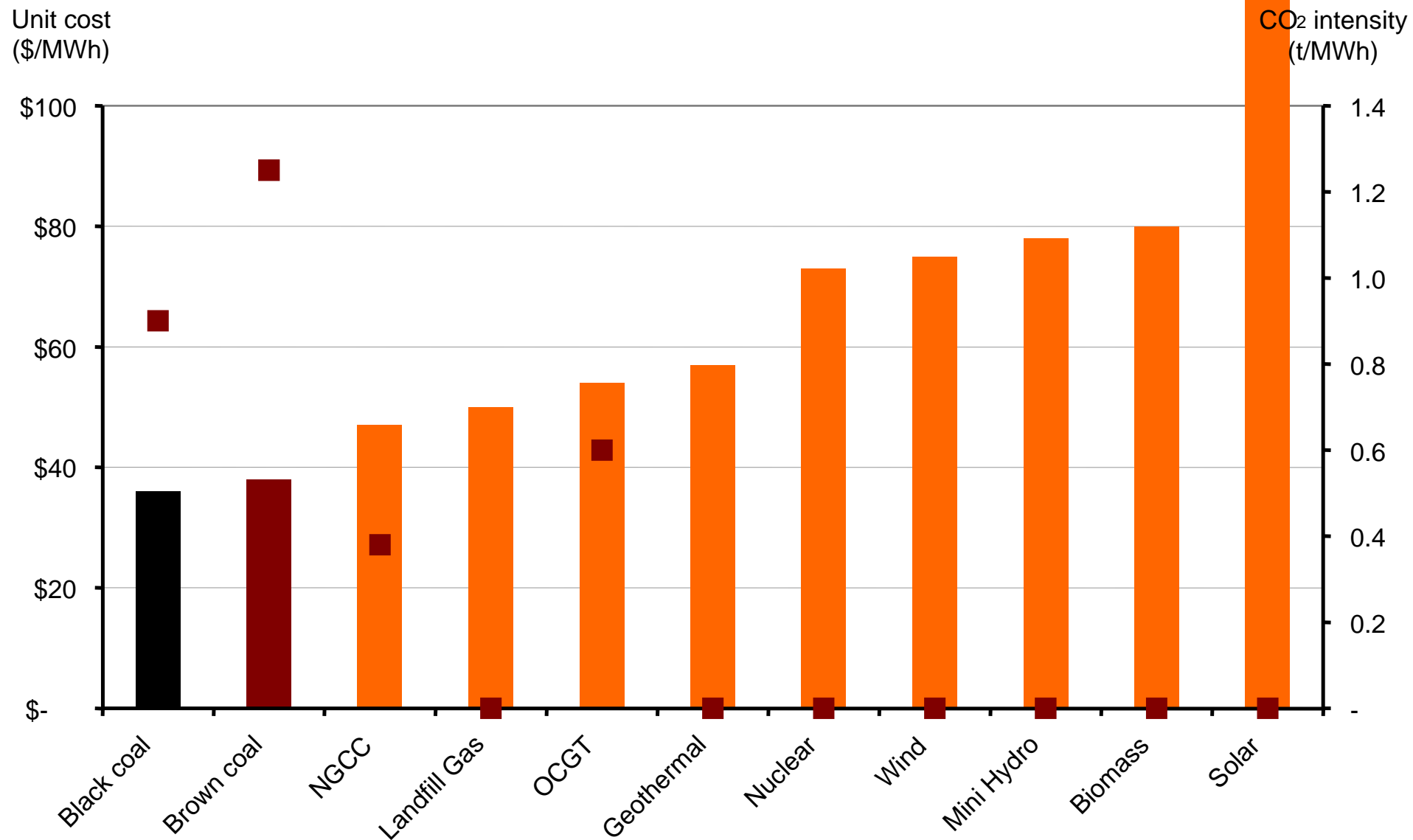
Financial year



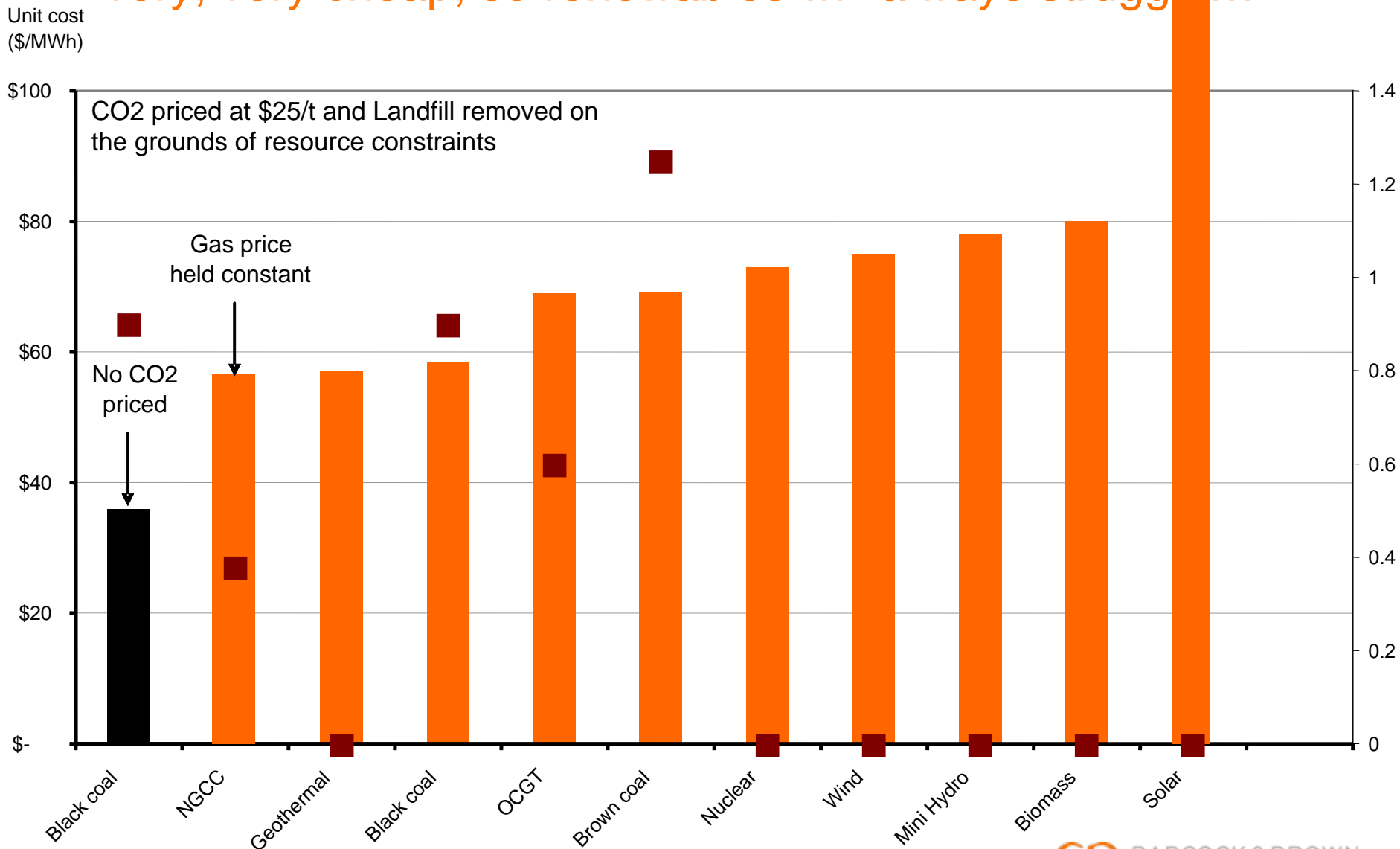
# So what makes up the cost of electricity, and what will it look like after CO<sub>2</sub> is priced in?



# Why don't we just go renewable? Cost & availability...



# When CO<sub>2</sub> is priced, it helps... But east-coast coals very, very cheap, so renewables will always struggle...

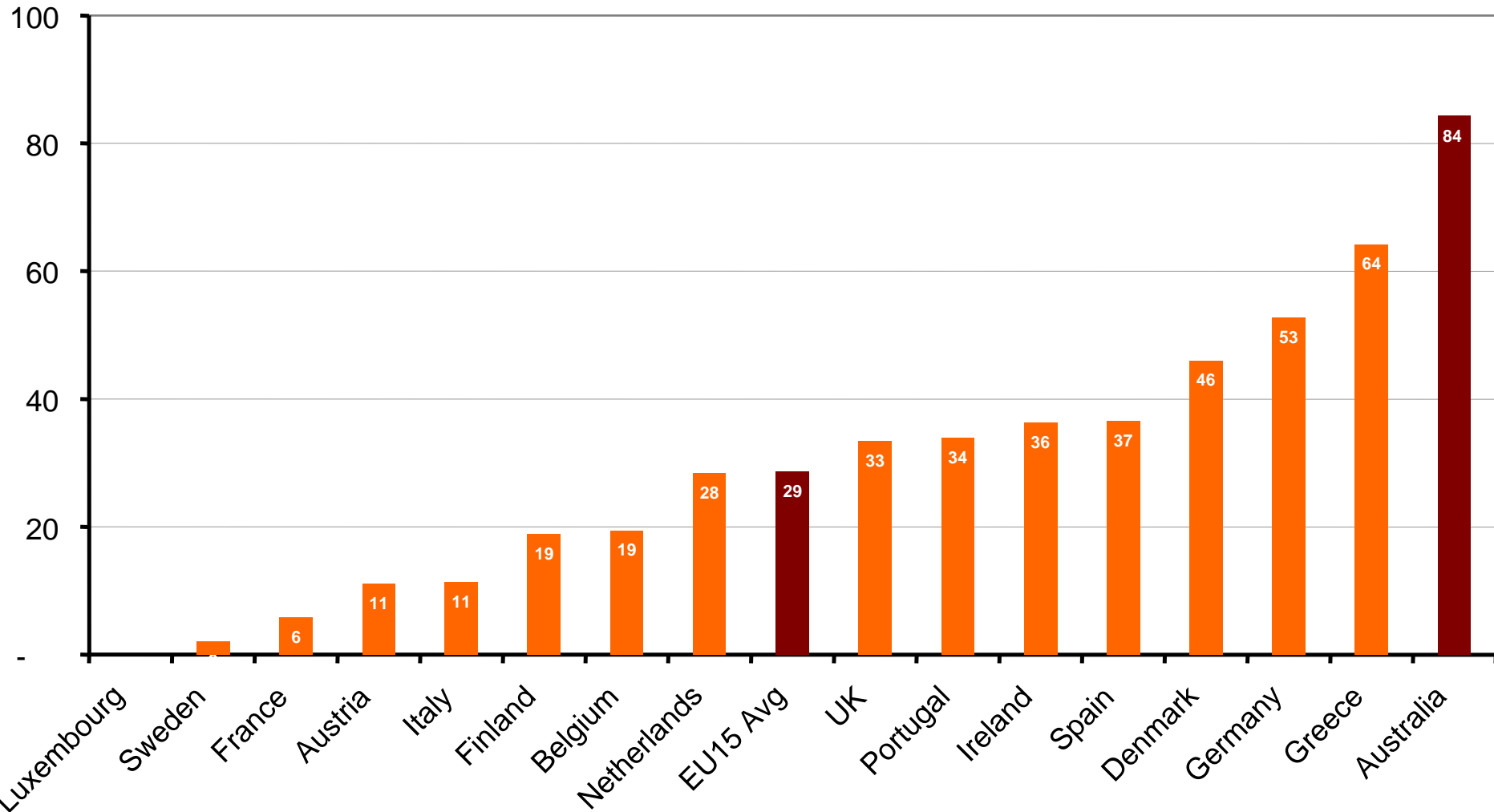


# GETTING EMISSIONS TRADING POLICY SETTINGS RIGHT

- Emissions trading, by way of auction allocation, necessarily brings about very substantial wealth transfers
- In the Euro-Zone, permits were “Grandfathered” (i.e. allocated for free) to power generators in order to minimise wealth transfers
- This led to so-called ‘windfall profits’ in the generation sector and hence the policy of Grandfathering has since become exceedingly unpopular with policy makers
- But it is important to examine EU15 results carefully, they don’t translate to Aust “neatly”:
  - In Germany, the Bundeskartellamt claimed that if *work-on rates* exceeded 25% then windfall gains existed because permits were allocated for free
  - In Germany, permits allocated (382mt) were greater than production (373mt) because policy makers included plant earmarked for closure in the allocation process
  - In Spain, the two dominant generators (80% market share) control all of the nuclear and hydro power, which constitutes 50% of energy... under such conditions, supra-normal profits would arise whether emissions were Grandfathered or Auctioned
  - In Europe, natural gas prices went from €3.05 to €5.70 (i.e. \$5/GJ to \$9/GJ) just as emissions trading was implemented
  - Windfall profits must be gauged against a suitable time dimension: If the economic (as opposed to technical) life of a generator reduces from 30 years down to 5-10 years, benchmark WACC returns rise from 11%pa to 23%pa
  - Coal in EU15: 28% market share. Coal in Australia: 85% market share. This is a very important difference -

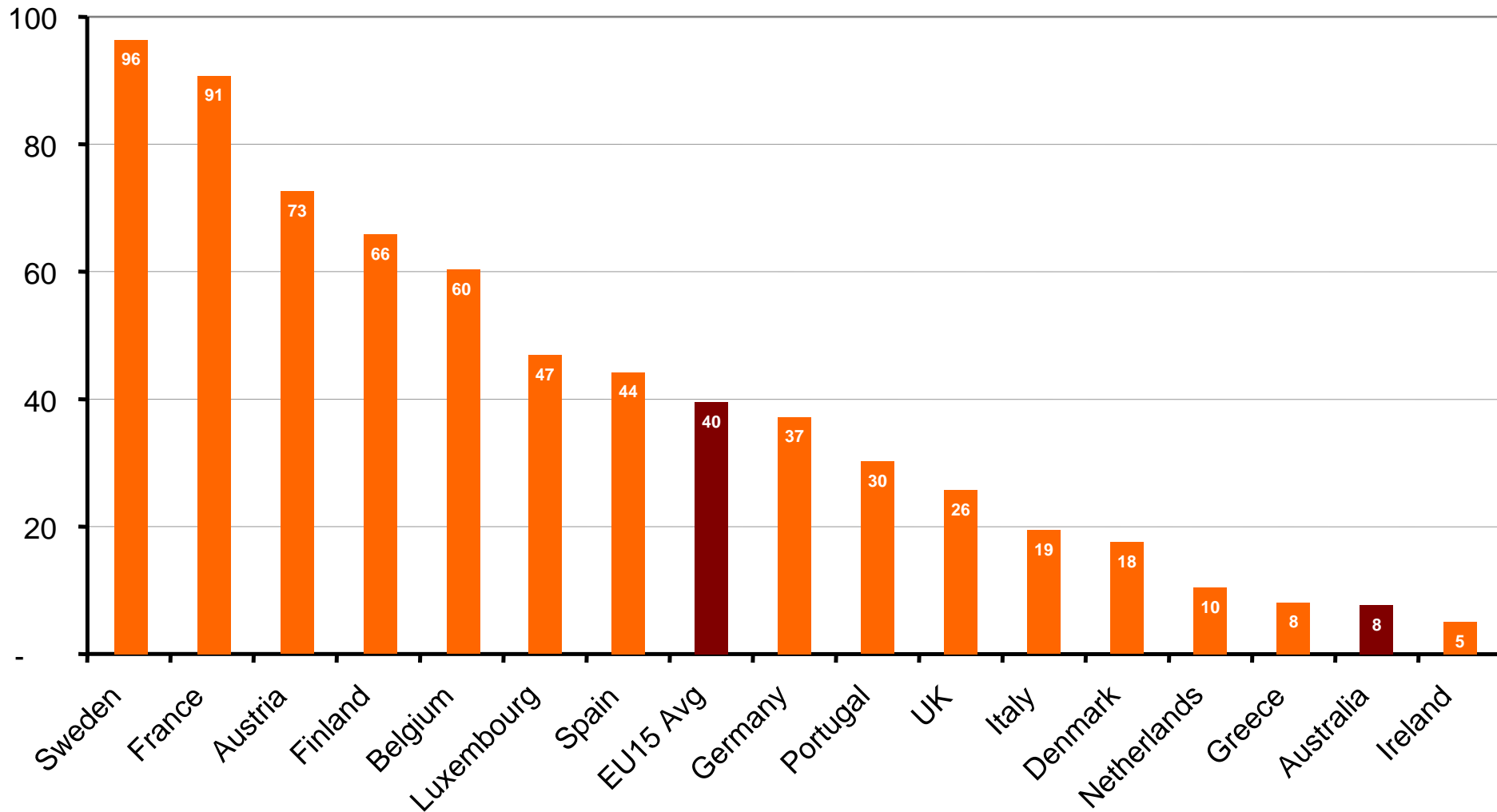
# Coal-fired generation: market share in the EU15

Market share of coal  
(%)



# Non-fossil generation: market share

Market share of non-fossils (%)



## Add-On Rates & Work-On Rates: who wears the cost?

- In theory, generators aim for a 100% *add-on rate* but in practice only 70% is likely due to technical limitations and fuel constraints
- Experience in the EU15 is that the *work-on rate* is around 60%
  - In Germany, 73% *work-on rate* in peak, 46% *work-on rate* in off-peak, avg: 60%
  - Netherlands, 39% *work-on rate* in peak, 55% *work-on rate* in off-peak, avg: 50%
  - Analysis stripped-out the gas price shock
- Forecast included in the NETT (2007) paper for the NEM: about 70%
- Simshauser & Doan for Victoria: at \$17.50/t, about 78% *work-on rate*
  - This has substantial implications for the brown coal generators \$10.2 billion investment
- If emissions trading is successful, the *work-on rate* will decline over time as new lower emission generators spend an increasing amount of time setting clearing prices in the combined commodity/emission market
- So what happens if adequate permits are not Grandfathered to the coal generators? Marginal generators will react in the spot market in a predictable manner.

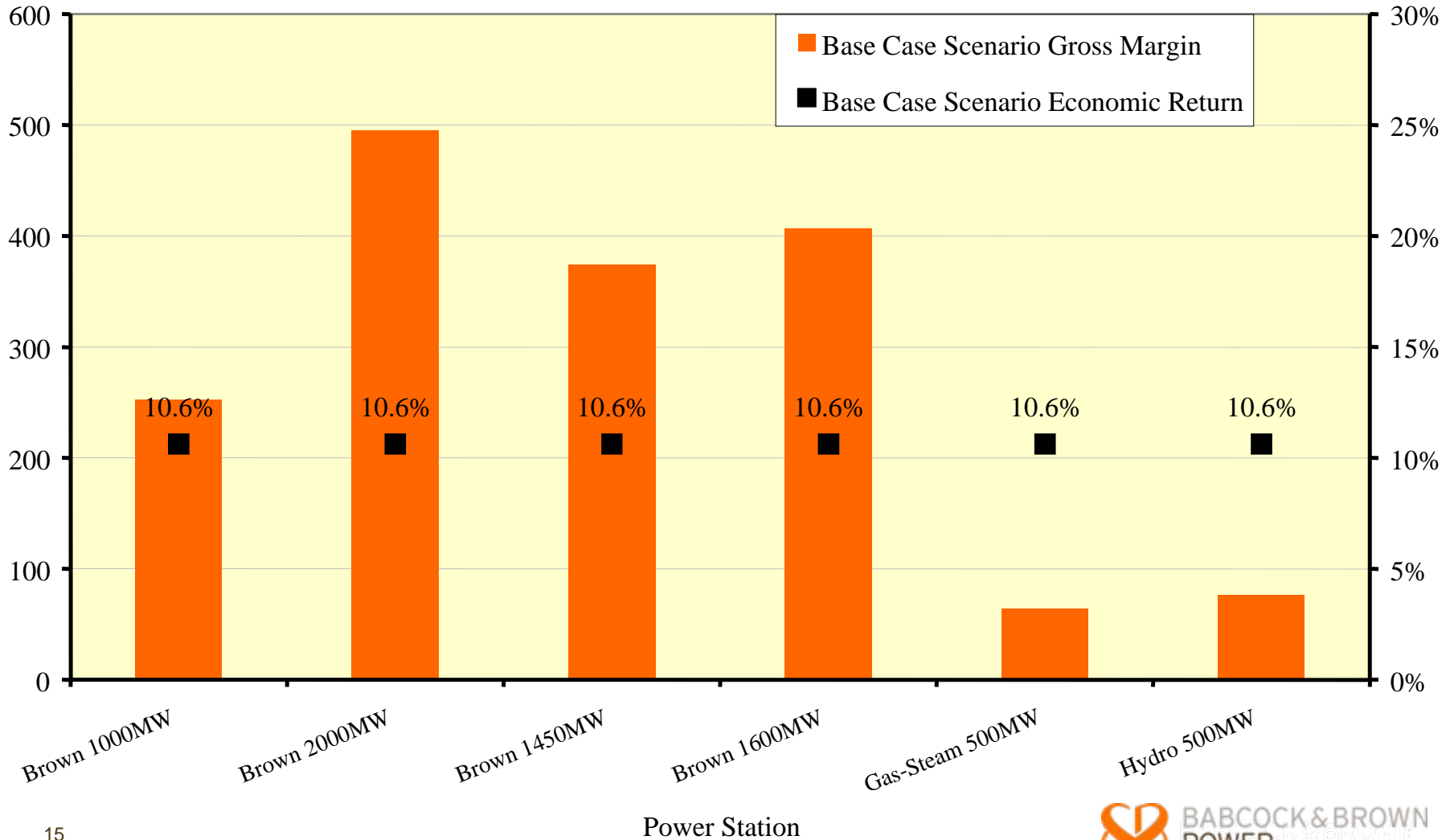
## The *Wounded-Bull Scenario*

- Marginal coal generators are likely to become *Wounded-Bulls* under an “all auctioned” scenario
- In Simshauser & Doan’s (2007) scenario, CO2 is priced at \$17.50 and all permits are auctioned
  - Brown Coal generator returns fall from about 11% to about 8%
  - Spot prices rises from \$34 to \$52
  - NGCC plant can enter and undercut the marginal coal producer
  - Marginal coal producer returns drop from about 7% to less than 4%
  - At this point the marginal producer would otherwise default on financial covenants, so...
  - Reverts to unwinding hedges and then withholds generating capacity to spike prices
  - Modelling results indicate that wholesale electricity prices rise from \$34, to \$52, to \$103/MWh (300% increase)
  - Marginal generator thus attempts to recover its otherwise stranded asset
  - All remaining generators extract supra-normal profits – more than would have been the case had all permits been allocated (resembles the current water-constrained environment, but in contrast, has been artificially manufactured)

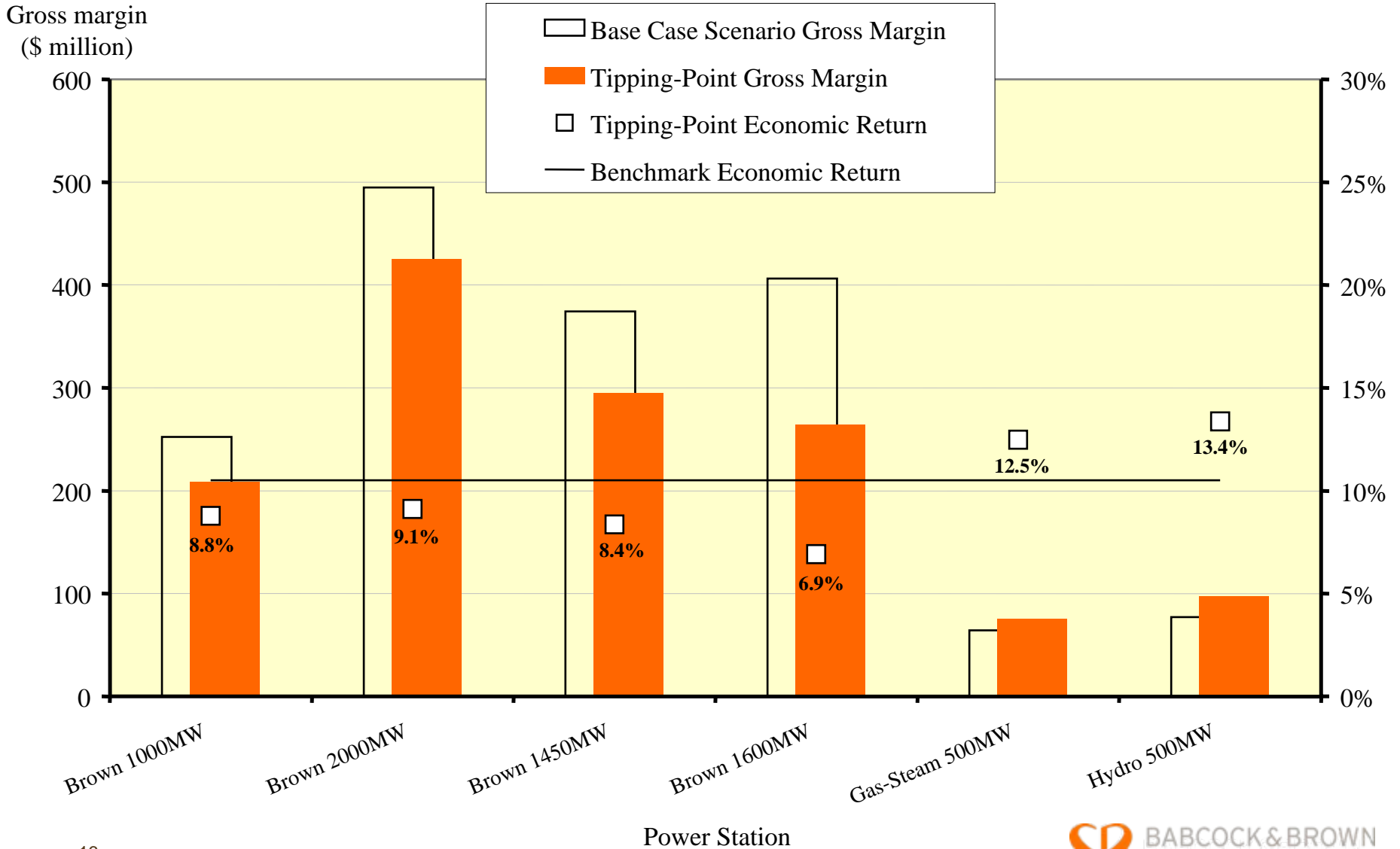


# Base Case Scenario

Gross margin  
(\$ million)

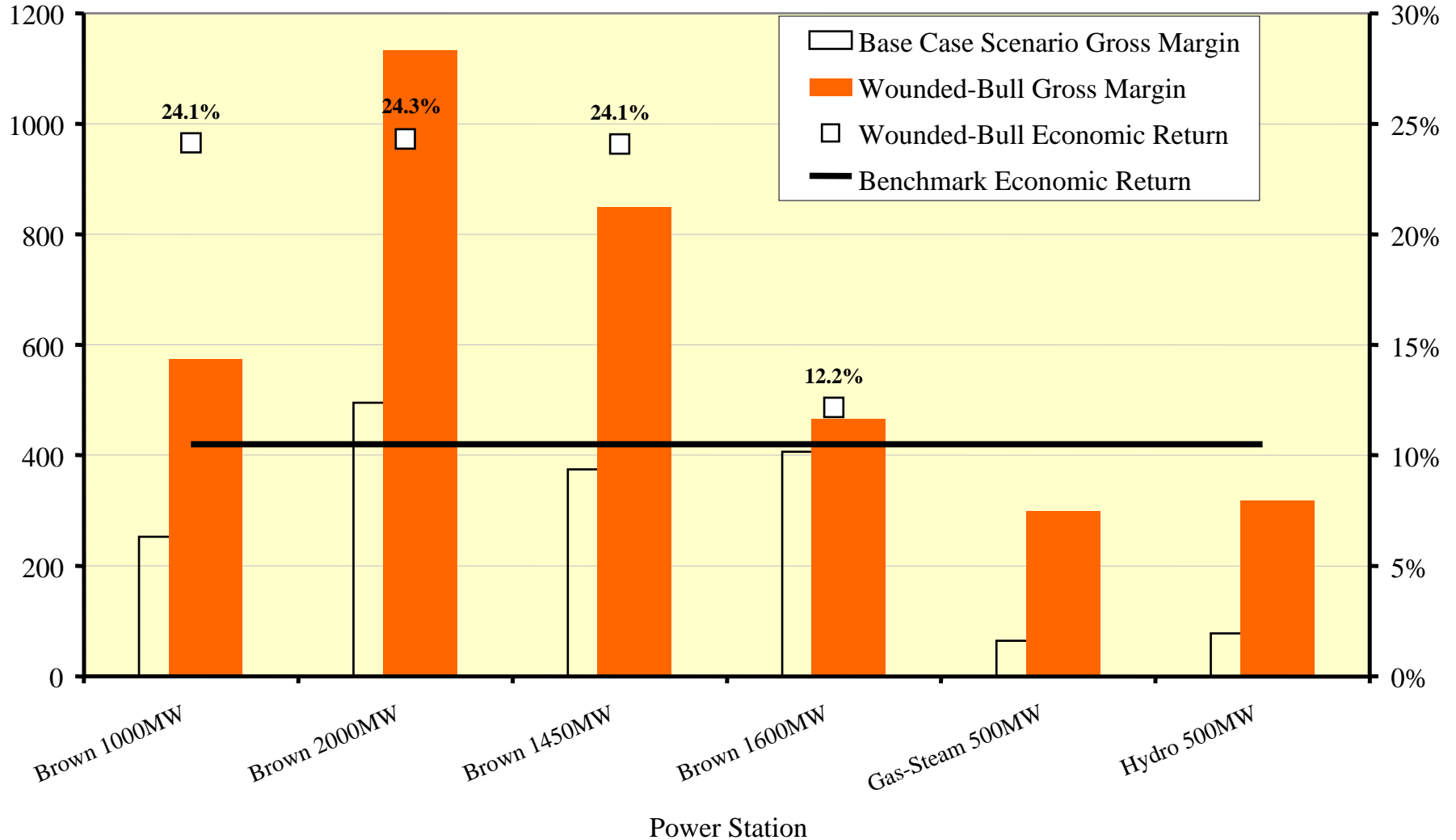


# Tipping-Point Scenario



# Wounded-Bull Scenario

Gross profit  
(\$ million)



# Conclusion

- For an industry that is naturally long GHG, emissions trading is a logical policy option and has the support from most in the power generation industry provided allocation policy deals with asset values
- Over the next 40 years, Australia's thermal plant stock will need a complete turnover, but the current class of coal technologies need a transitional glide path, and right now, 85% of power comes from coal
- This invariably means a careful policy of Grandfathered emission permits to ensure ongoing system security and electricity price stability over this lengthy transitional period
- As one of the bigger developers of new gas-fired generators, BBP sees no problem with incumbent coal generators being 'ushered' into the GHG world
- No generator wants to see the sustained price spikes through continuous economic withholding of capacity, but in the absence of Grandfathering, such an outcome is probably inevitable
- The longer term welfare implications of a *Wounded-Bull Scenario* far out-weight an overly generous allocation system to incumbent coal generators