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8 April 2009

The Secretary
Senate Select Committee on Climate Policy
PO Box 6100
Parliament House
CANBERRA ACT 2600

By Email: economics.sen@aph.gov.au

Re: Senate Select Committee on Climate Policy

Thank you for the opportunity to make a submission in regard to Australia's policies for climate change.

InterGen (Australia) is owned by InterGen N.V. ("InterGen") and the China Hua Neng Group ("CHG"), and is a leading developer and operator of electricity generation facilities worldwide. As a privately owned investor and operator of power generation assets, InterGen (Australia) provides one of the best examples of international investor response to regulatory risk associated with the carbon policies.

Summary

InterGen (Australia) does not support the Carbon Pollution Reduction Scheme (CPRS) in its current form for the following reasons:

1. The allocation of transitional assistance to coal fired generators is not equitable in its allocation and has major implications for our profitability and future investments in Australia. There was a lack of consultation on this from the Green Paper to the White Paper.
2. The scheme has no introductory phase which is extremely risky for such major changes to the Australian economy and the complexities involved with implementation.
3. Deferred payment for permits is essential for those with natural carbon permit liabilities such as ourselves, as we do not have the working capital to fund this new cost.
4. It is extremely difficult to make long term investment decisions given the myriad of State and Federal based schemes.

Our submission concentrates on these issues as they are the most significant failings of the current carbon policies. Our global business is familiar with operating power assets in carbon regimes, such as the European Union and we are not opposed to climate change policies as such. If the points raised in our submission are addressed by the government we will support the policy.

Key Policy issues to be addressed to move to a low-emission economy:

1. Transition of the power generation sector
2. Investor confidence
3. Auction design
4. Streamlining of the multiple competing and confusing carbon policy measures

1. Transition of the power generation sector

The power generation sector is the single largest contributor to greenhouse gases and will represent about 50 per cent of the proposed CPRS coverage initially. Secure, reliable and competitively priced energy is integral to the effective functioning of all aspects of modern economies. It is therefore imperative that for any carbon regime to work the policy must 'get it right' for this sector. This means that the carbon policy must:

- Reduce emissions from this sector over time, but in parallel
- Ensure the continuity of supply of base load electricity to the economy.

The CPRS proposes a transitional assistance regime for the power generation industry that is in contrast to these two key objectives.

The generation sector will remit approximately 4 billion permits to the government between 2010 and 2030, but will receive only 130.7 million permits in compensation. More so, companies such as ours, under the proposed method for allocating compensation, will receive minimal or no compensation. As a result these companies, that will suffer significant loss of asset value, will be forced to impose significant risk premiums into any future investment decisions in Australia. This will make future investment in Australia unattractive to these companies when compared to investment opportunities available offshore. To put this into perspective, in the last year our company has begun construction of a state of the art gas facility in the Netherlands, purchased two gas plants in Mexico, and has a number of well advanced development projects in the UK, the Philippines and elsewhere. These markets are viewed as having substantially lower risk than the Australian market at present.

The Electricity Sector Adjustment Scheme (ESAS) is skewed toward compensation for the older, most emissions intensive station's nearest to decommissioning. The compensation methodology allocates compensation with no correlation to asset value loss or remaining asset life. While the black coal power stations are more efficient than the brown coal plants, the CPRS erodes a very large portion of the black coal power station asset value with the viability of a number of stations in question. It has sent an extremely adverse investment signal to the owners of the most efficient black coal plant in Australia. A scheme that compensates the least efficient plant in the market for loss, while providing little compensation for the cleanest coal fired technologies, damages the investment incentives and does not achieve the objectives of the policy.

By way of example, ACIL Tasman modelling shows brown coal generators are anticipated to receive around 75% of their asset value loss (compensation of \$3.4 billion compared with modelled loss of \$4.5 billion), whereas black coal stations are expected to only receive around 7% (compensation of \$440 million compared with modelled loss of \$5.9 billion)¹. For

¹ ACIL Tasman Briefing Note 6, 19 December 2008, Australia's Low Pollution Future – the CPRS white paper of December 2008.

our business we are expected to incur loss of asset value estimated in hundreds of millions of dollars, with little or no compensation expected to be received under ESAS. The Commonwealth Treasury's own modelling found the negative impacts on the generation sector to be significantly higher than the level of assistance proposed for the ESAS fund.

This poorly calibrated compensation regime has sent adverse investment signals to the owners of businesses such as ours, who have invested in the newest and cleanest black coal generation technology – the very businesses that have the skills and capability and which the government will be looking to as builders and funders of the next generation of power stations and clean coal technology projects.

The black coal generation sector was not consulted on the compensation methodology adopted following the Green Paper. The methodology proposed in the Green Paper was discarded in favour of a totally different methodology in the White Paper without consultation with private investors such as ourselves.

Unless this flaw is amended to a scheme that reflects the true impact on asset value, the ability of companies to invest in the next generation of low-emission technologies will be limited to a small number of existing vertically integrated businesses that already have a large market share. Existing market participants that do not have access to gas reserves or new entrants will not be able to compete and will be likely to choose to spend their investment dollars overseas. The end result is an increase in market concentration, a reduction in competition and higher electricity prices for consumers and businesses, which in turn will negatively impact the growth of our economy.

The implementation of a modified, well designed compensation regime, that is commensurate with asset value loss, is a critical measure for ensuring investor confidence in the energy sector.

2. Investor confidence

At a time of great global economic uncertainty Australia needs a carbon policy that incentivises investment. Through our shareholders, we bring to Australia, major investors from Canada, China and India. The existing CPRS acts to stifle investment by private power generation companies such as ours.

To put the task ahead into context the future challenges for investment in the power generation industry, and the economy, include:

- The level of investment required in power generation over the period till 2020 ranges from \$13 billion to \$33 billion;
- That even in perfect markets there are considerable lead times of greater than five (5) years in developing and constructing power generation assets – and this is if current technologies are viable; and
- Due to the long life of these assets investment decisions are made over a 30 – 50 year time horizon.

To attract investment of this magnitude there is clearly a need to maintain investor confidence in this sector.

For companies such as ours project development dollars in Australia must compete for capital against opportunities available internationally. Capital is allocated to projects on the basis of financial returns over a risk adjusted threshold.

The loss of value, and potential stranding of new generation assets, unless adequately compensated via policy design, will change InterGen's assessment of regulatory risk in Australia, with flow on impacts to future long term investment decisions in Australia.

- InterGen seeks to invest in markets with predictable and stable regulation, or in its absence, in markets where such risks can be managed - for example through long term power purchase agreements.
- The Australian market has traditionally been viewed as one of predictable and stable wholesale electricity market regulation.
- In the absence of compensation for loss of profitability and value, the introduction of a carbon impost on existing long lived assets will lead to a re-rating of Australian market regulatory risk, and an increase in the risk adjusted threshold for assessing new projects in Australia.
- Such an adjustment is likely to strongly prejudice the commercialisation of projects in Australia relative to other countries.
- Any diminishing of investor confidence in the Australian market will place future investment in low emissions generation at risk, and/or increase electricity prices to compensate for higher risk premiums, with flow on impacts on the domestic economy.

2.1 An adverse investment signal has been sent to our international owners

- Our owners have sponsored investment of more than two (2) billion dollars in the newest and cleanest black coal generation technology plants. In fact, they have invested in two (2) of only (4) supercritical black coal-fired power stations in the country. These investments were made with a time horizon of 40-50 years. In return for this investment the CPRS scheme intends to implement a compensation regime that provides minimal or no compensation to companies such as ours, but instead compensates the oldest, least efficient plant in the market for loss, while deleteriously affecting the comparative advantage and investment incentives of those companies who were willing to bring the newest and cleanest generation technologies to the country - the very businesses that have the skills, capability and capital required to fund the next generation of power stations and clean coal technology projects.
- The myriad of State and Federal based schemes result in the risk premiums associated with the analysis of any development opportunities to be high.
- The unwillingness of the government to act on our concerns sends a signal that they consider the stranding of long-life assets as a result of a change in government policy, as an acceptable practice.

Carbon policy must deliver a scheme that provides certainty for investors through equitable distribution of compensation, and which replaces the many existing and proposed State and Commonwealth schemes so as to provide a clear carbon price trajectory on which future long-term investment decisions can be made.

3. Auction design

The design of the CPRS requires businesses to finance 100 per cent of their permit obligations from year one (1) of the scheme. This will become our businesses single biggest cost, be equivalent to almost 50 per cent of our existing total revenue, will cause significant cash flow issues and possibly put us in a position where we can not fulfil our debt covenants. Even though the Regulations to deal with this are yet to be released, businesses are expected to be in a position to manage it well in advance of 1 July 2010.

It is imperative that the design of the auction system allows deferred settlement for those industries, such as power generation, that will have a large genuine requirement to finance permits to cover their emissions. Without deferred settlement auctioning will:

- a) Significantly increase costs due to impact on cash flow;
- b) Impose significant new equity or debt funding requirements in a time of global financial distress, the cost and conditions attached with such funding is unknown; and

- c) Lead to significant market distortion as those less efficient facilities e.g. brown coal generation assets, that are issued with a substantial number of free permits will face much lower capital requirements compared to those assets that will be entitled to no or minimal free permits.

It is imperative that auction design and settlement processes mitigate this cash imposition.

By way of example, InterGen Australia's Millmerran asset is due for refinancing in 2012 and Callide C in 2013. The financing structure that was set at the time of establishment does not have the capacity to accommodate the impact of the proposed uncompensated carbon impost. Financiers are now keenly monitoring the impact of the proposed CPRS on the company, and any adverse impacts may trigger provisions which could result in demands for earlier debt repayments or higher premiums for refinancing. To provide carbon certainty for our business for twelve (12) months and assuming a modest carbon cost of \$20/tCO_{2-e} this may require new equity (which could be otherwise applied for investment) or additional debt of around \$160 million for permit acquisition, which is equivalent to near half of total annual revenues for the business. Additionally, ongoing financing would also be required to fund ongoing permit acquisition.

4. Multiple competing and confusing carbon policy measures

An emissions trading scheme will be less effective if distorted by other interfering policy measures. **To get the support of major industry government must replace the myriad of other State and Federal based carbon schemes that are either in existence or proposed.** These additional schemes only act to:

- a) Distort the price signal that is central to an effective emissions trading scheme;
- b) Require investors to add into investment decisions additional risk premiums for future multiple policy changes the combined effect being unknown, and
- c) Increase the compliance and reporting burden on industry.

Examples of the carbon policies that stakeholders must analyse for their impact on their assets over the next 40 years, alone and in combination, for existing and future investment decisions, include: six (6) Carbon Pollution Reduction Bills, the Mandatory Renewable Energy Target, the Queensland Gas Scheme, the NSW Greenhouse Gas Abatement Scheme, the National Greenhouse and Energy Reporting Scheme, the Victorian Renewable Energy Target, the Energy Efficiencies Opportunity Act, the Generator Efficiency Standards, and the Greenhouse Challenge Plus.

The issues discussed above would be ameliorated if the Government abolished competing schemes and ensured the CPRS transitional design elements are correctly designed and implemented at the scheme's outset.

About InterGen (Australia)

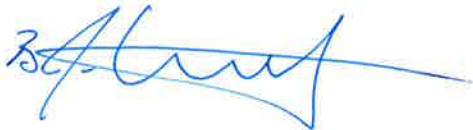
InterGen (Australia), as a privately owned investor and operator of power generation assets, provides one of the best examples of international investor response to regulatory risk associated with the Carbon Pollution Reduction Scheme.

InterGen (Australia) is owned by InterGen N.V. ("InterGen") and the China Hua Neng Group ("CHG"), and is a leading developer and operator of electricity generation facilities worldwide.

- InterGen currently owns 8,086 MW (6,252 net equity MW) in nine highly efficient natural gas-fired facilities, all of which utilize combined cycle generation technology, and three advanced technology, coal-fired facilities. CHG is China's leading power generation company and with over 90,000 MW of generation is the fourth largest generator in the world.

- Since the Company's inception in 1995, InterGen has developed, commissioned and operated over 20 different electric generation plants totalling over 16,000 MW of generation capacity in 10 different countries. InterGen both develops and acquires projects as owner, operator, and manager, and targets opportunities in developed markets. InterGen owns and operates four power generation facilities in Europe and has experienced the successes and challenges associated with the European Union's Emissions Trading Scheme.
- CHG has a diverse generation portfolio of gas, coal, nuclear, wind, hydro, and solar plants. Currently in partnership with CSIRO, CHG is also developing a carbon capture demonstration plant. CHG owns 60% of the Thermal Power Research Institute, the largest research body of its kind in China that amongst other projects is actively undertaking research into the advancement of power generation technology. CHG has completed or has under construction more than ten ultra-supercritical coal fired power stations in China.
- In Australia, InterGen has invested in some of the newest and most greenhouse efficient coal generation.
- InterGen (Australia) has a major interest in the Millmerran and Callide C black coal power projects, both of which utilise supercritical boiler technology. Accordingly it is differentiated from every other owner of coal fired generation in the National Electricity Market due to the young age of its facilities. At the time of InterGen's investment decision, the Australian Government was committed to meeting its international commitments through voluntary measures, and the introduction of a national emissions trading scheme was not under active consideration.

Yours sincerely



Brent Gunther
Managing Director
InterGen (Australia) Pty Ltd