

The clean energy future plan: an investor's perspective

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insights



Key points

- Securing a Clean Energy Future - The Australian Government's Climate Change Plan was announced on Sunday, 10 July 2011 – generally referred to as the Clean Energy Future Plan (CEFP).
- The CEFP maintains many core elements of the previously proposed Carbon Pollution Reduction Scheme (CPRS).
- There are some exceptions in terms of household and industry assistance, and various uncertainties remain that could change during the Parliamentary process.
- In terms of company-specific impacts, the main drivers relate to companies' ability to pass on the carbon price to customers, abatement opportunities and free permits. Our initial analysis indicates most companies would not be significantly impacted by the carbon price in the short term.

The CEFP versus the old plan and market expectations

Looking at the details of the CEFP, the initial fixed carbon price of \$23 / tCO₂e was in line with our expectations as was the transition to an emissions trading scheme (ETS) in 2015. Moreover, the compensation for emissions-intensive trade-exposed (EITE) industries of 94.5% based on the industry average baseline, and the 66% level for moderate emitters was as expected, and as initially contemplated under the CPRS. Measured against the industry average baseline, efficient companies will receive more free permits while less efficient producers will receive less, creating an incentive for companies to reduce carbon dioxide (CO₂) emissions intensity.

EITEs as defined under the proposed CEFP include aluminium smelting, steel manufacture, alumina refining, zinc smelting, cement and lime production, flat glass manufacturing as well as most pulp and paper production. Moderate emitters are expected to include industry sectors

such as plastics, chemical manufacturing, ethanol and tissue paper. Compensation rates will gradually decline with a decay rate of 1.3% p.a. which is in line with expectations.

The Government proposes further reviews by the Productivity Commission in 2014-15, which could see adjustments to the decay rate after the first six years. The Productivity Commission will be required to give at least three years notice to industry to change to a new decay rate. In terms of Governance, a Climate Change Authority (CCA) is to be established to advise on pollution caps and progress toward meeting targets as the carbon pricing mechanism transitions to a floating price in 2015. At this time both an upper price cap as well as a price floor will be introduced. Under the CPRS only a price cap was proposed. From 2015, companies will also be able to purchase eligible international offsets to assist in meeting their compliance requirements.

There were no major surprises in terms of the sector coverage of the plan compared to CPRS. The plan exempts petrol for an indefinite period for households, small businesses and agriculture, fisheries and forestry. Under the CPRS petrol was exempt for three years.

It is proposed that \$300 million be set aside for additional transitional assistance for the steel industry (in addition to the EITE 94.5% compensation level), via the Steel Transformation Plan. Coal miners will also receive an extra compensation package worth approximately \$1.3 billion, slightly below that proposed under the CPRS. The liquefied natural gas (LNG) sector will receive 66% compensation reduced by 1.3% p.a. (similar to the CPRS) but assistance will be capped on the downside at a minimum of 50% compensation. In regards to LNG, there had been calls for 100% compensation ahead of the announcement, particularly due to the high number of planned projects in the pipeline.

Industry and company-specific issues

Carbon reporting and disclosure among listed Australian companies varies. However, the Carbon Disclosure Project

(CDP) and National Greenhouse and Energy Reporting (NGER) Act facilitate analysis. Key issues relate to the ability of companies to pass on carbon costs to clients and end consumers, abatement opportunities and industry specific assistance. The ability to pass through costs depends on industry structure as well as globalisation of pricing. Electricity generators will be impacted differently depending on their portfolios. Renewable energy assets may benefit while emissions intensive assets (for example, brown coal) will be negatively impacted.

Overall, initial analysis shows the carbon price, and its proposed application, is not expected to result in a significant impact on value for most listed companies. Exceptions relate more to an inability to pass on rising costs and / or exclusion from, or only partial, transitional assistance.

Note that the impact on revenue or profits also depends on where a company is in the cycle - the percentage impact on profits can be different at the peak of the cycle, compared to the bottom.

A summary by sector

Below is a summary of the anticipated impact of the proposed CEFP on various sectors.

Retailers: costs are expected to increase as a result of electricity prices and the planned removal of the diesel fuel rebate from 2014 (see Transport sector, below) as well as other costs passed on through the supply-chain. Food retailers will likely pass on carbon costs to consumers. In terms of discretionary retail, the issue is not so much the carbon price itself, but rather, uncertain effects (such as psychological factors) from the impost of a carbon price.

The Government has announced generous household assistance, particularly for low income households. Federal Treasury modelling claims nine out of ten households will receive compensation and four million households will be better off, as a result of two rounds of tax cuts (2012 and 2015), and welfare assistance. This is expected to cover price increases as a result of the carbon price for low income households and pensioners. The reform includes tripling the income tax-free threshold from \$6,000 to \$18,200.

Given perceived complexity of the household assistance measures and conflicting views in media about the financial impact on households, discretionary spending could continue to remain subdued. Discretionary retailers will be unlikely to obtain any short-term relief as a result of the CEFP, at least until 2012. There could be further issues for retailers due to wealthy households, who drive retail sales, being negatively impacted. In addition, there is a possible risk that inflation forecasts related to the carbon price (0.7% p.a.) are on the low side, which could lead to higher interest rates.

Transport: separate legislation will create an effective price on some business transport emissions. Excise duties for airlines will be increased to reflect the carbon price. Airlines will therefore face higher costs for domestic flights. The majority of these additional costs will likely be passed on to consumers in a similar fashion to jet fuel price surcharges.

As a result, financial implications for airlines will largely depend on price elasticity.

Some commentators have identified airlines the most affected by the carbon price. However, we believe the price elasticity is fairly low, both for business and leisure travel, meaning airlines should not be significantly impacted. That said, it is noted that air travel is highly cyclical and partly linked to discretionary spending.

Fuel for motorists will be excluded indefinitely, while heavy road transport vehicles (above 4.5 tonnes) are planned to have excise reductions removed in 2014, meaning they will effectively be paying a carbon price. This was not universally agreed upon by all parties in the negotiations leading up to the announcement on 10 July, adding some uncertainty to its final adoption.

To put a perspective on the potential impact of this fuel impost, a barrel of oil including refining emits approximately 0.45 tCO₂e per barrel. A carbon price of \$23 tCO₂e adds about \$10 per barrel to the cost of oil. Road freighters would likely pass on the cost to their customers.

Large off-road vehicles, such as those typically used in the mining industry, will have their excise duties removed in 2012. Companies linked to the mining industry, such as coal haulers, will likely pass on carbon costs to their mining customers. Mining support companies could be impacted by lower volumes should coal miners cut production to reduce emissions.

Mining: most mining companies, including coal miners, will not be covered by the EITE assistance. However, many mining companies don't have emission-intensive processing. Major miners are also geographically highly - diversified, resulting in less exposure to Australian emissions. The claw-back of excise reductions for off-road vehicles will increase the cost base to various degrees for miners.

For coal miners, the carbon price is expected to add \$1.80 per tonne to the cost of mining coal. While coal mining fugitive emissions are included in the scheme, for most mines the carbon cost is expected to be small. The Government suggests about \$1.40 per tonne at a \$23 carbon price. The coal mining industry will also receive \$1.3 billion in compensation (slightly lower than proposed under the CPRS), which will aid transition for the most emissions-intensive, so called "gassy" mines. These will receive up to 80% compensation over six years. This applies to mines emitting at least 0.1 tonne of CO₂ based on 2008-09 and 2007-08 emissions. It will not apply to new mines.

Steel: in addition to the EITE assistance, the \$300 million dollar additional assistance package limits the impact on steel companies, which had been expected to be among the worst affected by the carbon price due to high emissions intensity. The \$300m will apply to manufacturers producing more than 500,000 tonnes of crude carbon steel in 2009-10. Listed Australian steel manufacturers are therefore expected to receive significant support.

Electricity generators: the most emissions intensive electricity generators may be progressively closed down and replaced with gas-fired units by 2020, with Government assisting with the shut-downs. The announcement on

10 July gave some clarity regarding this process. Under the CPRS the proposed assistance was to be \$7.3 billion in free permits. Under the CEFP, there is a \$5.5 billion package plus additional loan guarantees and a tender process for the closure of the most emissions intensive assets (for example, brown-coal generators) through the establishment of an Energy Security Fund. In a further boost for clean and renewable energy the Government has increased Australia's emissions reduction target for 2050 from 60% to 80%. The Government will also establish a \$10 billion Clean Energy Finance Corporation with 50% of the funding for the renewable energy sector and the remaining for 'clean energy' funding and consolidation of current renewable energy programs (\$3.2 billion).

In terms of company-specific impact, electricity generators need to be evaluated on the basis of their entire portfolios. Negative impacts from coal-fired power stations could be offset by higher electricity prices from less emissions-intensive or renewable energy. Higher generation costs will be offset by pass-through, higher electricity prices and higher value of relatively low emissions assets. As a result, some companies could actually be positively impacted.

Energy: the LNG sector will receive a minimum of 50% compensation (initially 66% reducing by 1.3% pa). The impact of the carbon price varies between different projects. Domestic gas is excluded from protection. As a result, companies with relatively higher exposure to domestic gas will likely be impacted more than those with oil or LNG production (protected by the scheme). Many companies in the LNG sector have locked in capital investments and there had been calls for 100% compensation ahead of the announcement on 10 July.

Construction: many construction companies should have most of their emissions covered under EITE industry assistance (cement, lime, flat glass and aluminium smelting). However, they also have indirect emissions. Many of these costs should be possible to pass through as construction companies often include such clauses in their contracts.

Agriculture: was excluded as expected. However, Kyoto compliant offsets from the Carbon Farming Initiative can be used under the CEFP. The package also included a number of other agricultural initiatives and measures, including a biodiversity fund (\$946 million over six years) and carbon farming futures (funding for research).

Property: The immediate and most significant impact of a carbon price on the management of office, industrial and shopping centres will be the increased cost of electricity. We anticipate the cost of operating base building energy to rise around 17% in the first year of carbon price implementation. Whether the impact of this hits the tenant or the landlord will

depend on the structure of the lease agreement. Where leases don't allow for full recovery of energy costs, you would expect landlords to eventually pass these on through increased rents over time, to reduce the impact on investment returns. A vast majority of AMP Capital's property portfolio leases are structured to allow for full recovery of energy costs, including the impact of a carbon price.

Increased costs to the tenant places increased pressure on management of real estate assets to reduce consumption of energy, and introduces the challenge to add new energy efficient technologies.

Other: there is expected to be a negligible, direct impact on insurance, diversified financials and banks. However, banks could be indirectly affected through lower demand for loans if the carbon pricing scheme has a negative impact on business sentiment. Industrial manufacturers and service companies that supply miners will likely pass on their carbon costs. However, fertiliser companies could find it difficult to pass through costs as they have low pricing power in a competitive international market. The impact on other sectors, such as packaging, healthcare, IT, gambling and telecom should be relatively limited.

Conclusion

In broad terms, the CEFP announced on Sunday, 10 July 2011, maintains many core elements of the previously proposed CPRS. However, there were a few notable changes in terms of household and industry assistance. Some uncertainties remain, particularly after 2015, relating to political factors, future Productivity Commission reviews and final allocation of industry assistance. More clarity is expected in the coming months as the package is refined. In the absence of conflicting information, we expect the package to be presented to Parliament as outlined in the announcement on 10 July. In terms of company-specific impacts, the main drivers relate to companies' ability to pass on the carbon price to customers, abatement opportunities and free permits. Initial analysis indicates most companies would not be significantly impacted by the carbon price in the short term.

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