

## Australia's Carbon Plan Offers Mixed Bag For Local Corporates

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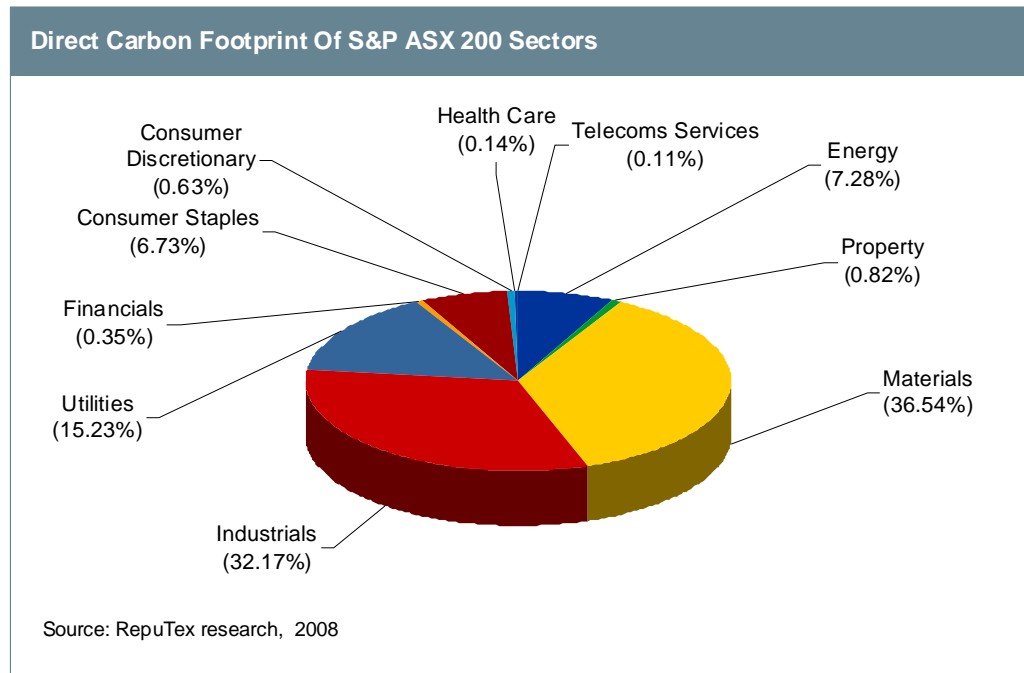
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Corporate Australia, already battling the repercussions of the deepening financial turmoil and related global economic downturn, is facing another challenge: navigating the introduction of a carbon trading system at home. Last month, the Australian government announced details of its so-called carbon pollution reduction scheme (CPRS), which proposes a price on carbon emissions from 2010. The credit implications for Australia's corporates are mixed. For the biggest emissions-intensive businesses—power plants, energy retailers, miners, and oil and gas producers—higher operating and compliance costs are inevitable (see chart 1). The CPRS may also weigh on the credit profiles and ratings of Australia's biggest carbon emitters.

Under the plan announced on Dec. 15, 2008, the government set a target to reduce carbon emissions by 5%–15% (from 2000 levels) by 2020, a lower reduction than its draft proposal, and lower than Europe's goal to cut greenhouse gases by 20% by 2020. The government also detailed the pricing on carbon when emissions trading starts in January 2010, including a maximum price of A\$40 per metric ton for the first five years of the scheme. To help compensate for the additional costs associated with the CPRS, the government has offered concessions to certain industries. For example, it plans to give A\$3.9 billion of free permits to coal-fired generators over the first five years of the system.

Although large carbon emitters have been preparing for the additional costs and other risks associated with a carbon system for some time, we believe that some companies are better placed than others to withstand the challenges, especially those with significant financial flexibility, low-cost operations, and diversified businesses. Marginal or single-product players are clearly more susceptible.

Chart 1



### **Utilities**

The government's policy measures and assistance for emission-intensive industries in its proposed CPRS should help alleviate the credit risks of the country's utilities sector over the next five years, especially for coal-fired generators and energy retailers. However, the longer term visibility of the government's policies for its CPRS remains limited because the policies are expected to further evolve beyond the first five-year period. Indeed, several variables and uncertainties, such as the possible magnitude of total carbon reductions by 2020 and the level of energy reserves, are likely to influence the investment decisions and ultimately the credit profile of the Australian utilities sector.

Standard & Poor's Ratings Services believes that a combination of factors gives Australia's utilities some time to implement strategies to offset the inevitable decline in their asset values over time. These include the softer than expected trajectory of carbon reduction to 2020, the conditional but supportive assistance to coal-fired generators, and the compensation measures for households. What's more, provisions within the policy framework that enable affected companies to work closely with the energy market operator and regulators prior to the 2013 'gateway' bode well for avoidance of hasty and ill-informed longer term decisions. Even so, given that the CPRS will bring a structural change to the economy, the risks and costs associated with this change will likely influence the decisions of debt providers, and consequently, adversely affect the credit profile of coal-fired generators and energy retailers.

### **Generators: Viability and debt-refinancing challenges await rated coal-fired plants**

Although the near-term risks from the introduction of a tougher carbon plan have now been avoided, uncertainty surrounding the long-term future of coal-fired power generation remains intact. In particular, the CPRS and the improved competitiveness of gas-fired plants raise concerns about the long-term viability of coal-fired generators (especially brown-coal plants).

Standard & Poor's has public ratings on two Australian coal-fired generators affected by the CPRS: TRUenergy Holdings Pty Ltd. (BBB/Negative/—) and LoyVic Pty Ltd. (bank loans rated BBB/Stable). An early threat to the viability of these generators' two plants is likely to come from a sharper than expected end to the government's proposed assistance during the CPRS transition,

which may arise if Australia needs to comply with any new international obligations, or from accelerated investment in gas-fired base-load generators over the next few years to meet both the reserve requirements and growth in demand for power. Nevertheless, both plants are base-load generators and contribute so significantly to the state of Victoria's electricity output and the national electricity market (NEM) that an immediate loss of the two plants seems inconceivable. Moreover, the two plants, provided they operate stably, will benefit from the expected increase in electricity pool prices as a result of the CPRS. Also, LoyVic will benefit from a favorable hedge with Victoria for a substantial part of its plant output until 2014, with a potential to pass-through any carbon-related costs to the state.

In our opinion, the most immediate risk to the rated generators will be the debt refinancing due in the next one-to-two years, and the terms and conditions that lenders will seek to implement to protect themselves against potential erosion in asset values over the long term. The tenor of debt, pricing, terms and conditions, debt type (bullet versus amortizing), and level of liquidity maintained (committed undrawn lines) will have a bearing on the credit risks of the rated entities. As both TRUenergy and LoyVic have aggressive financial profiles, more stringent lending terms and conditions or covenants could place stress on the entities' respective credit profiles. TRUenergy has about AS\$950 million in bank debt due in August 2009 and a modest amount of working capital due in June 2009. However, LoyVic's AS\$1.2 billion bank-funded bullet facility is not due until 2012.

Unlike many other coal-fired generators, TRUenergy and LoyVic are part of a wider portfolio of investments of their ultimate owners in Australia. Consequently, the long-term growth strategy of their owners in Australia, possible new investments in "green" energy, or the bringing together of certain investments under the CPRS environment could have an influence on the credit profiles of TRUenergy and LoyVic. The position of these entities within the wider portfolio could mitigate the expected adverse impact of the CPRS on the merit order of these plants in the NEM and influence their hedging strategy.

***Retailers: Pass-through of generation costs will be vital***

The main CPRS-related challenge for the nation's electricity and gas retailers will be their ability to pass on the expected increase in energy costs to end users. Operating within the constraints of various state-based retail pricing regimes and regulators, combined with the aversion of regulators to implement substantial cost increases to date, the actual implementation of the policies within the government's carbon plan will be a critical element for the retailers. Small retailers that lack the economic size or physical assets to hedge their retail loads with their own physical generation are likely to be more vulnerable to an expected increase in electricity prices and limited duration of forward contracts.

Company growth strategies, particularly through participation in the expected privatization of the electricity retail assets in the state of New South Wales (NSW), will also be an important credit factor. The NSW energy retail market is among the least profitable in the NEM, with low margins and generally lower regulated increases in prices compared to other markets.

Standard & Poor's has public ratings on three major energy retailers in the NEM; AGL Energy (BBB/Stable/—), Origin Energy Ltd. (BBB+/Positive/A-2), and TRUenergy. With significant retail operations that provide an economic benefit, upstream assets to back retail demand during peak price periods, and a modest hedging strategy, the rated retailers can adapt to the CPRS regime provided the policy framework is implemented appropriately. Having recently strengthened their balance sheets through asset sales, Origin and AGL are likely to strengthen their upstream assets

and fuel supply position through acquisitions. However, TRUenergy is likely to face more challenges, with significant dependence on the company's coal-fired Yallourn plant. Although TRUenergy has limited retail presence outside of Victoria, the completion of its Tallawarra gas fired plant in NSW improves its growth options.

***Transmission and Distribution: Risks need to be managed delicately***

The direct implication of the CPRS on the country's poles and wires businesses is low; however, forecast capital expenditure for these businesses will be indirectly affected by the need to meet the expected increase in renewable energy projects. Hence, this could be a key credit factor for companies operating in this sector.

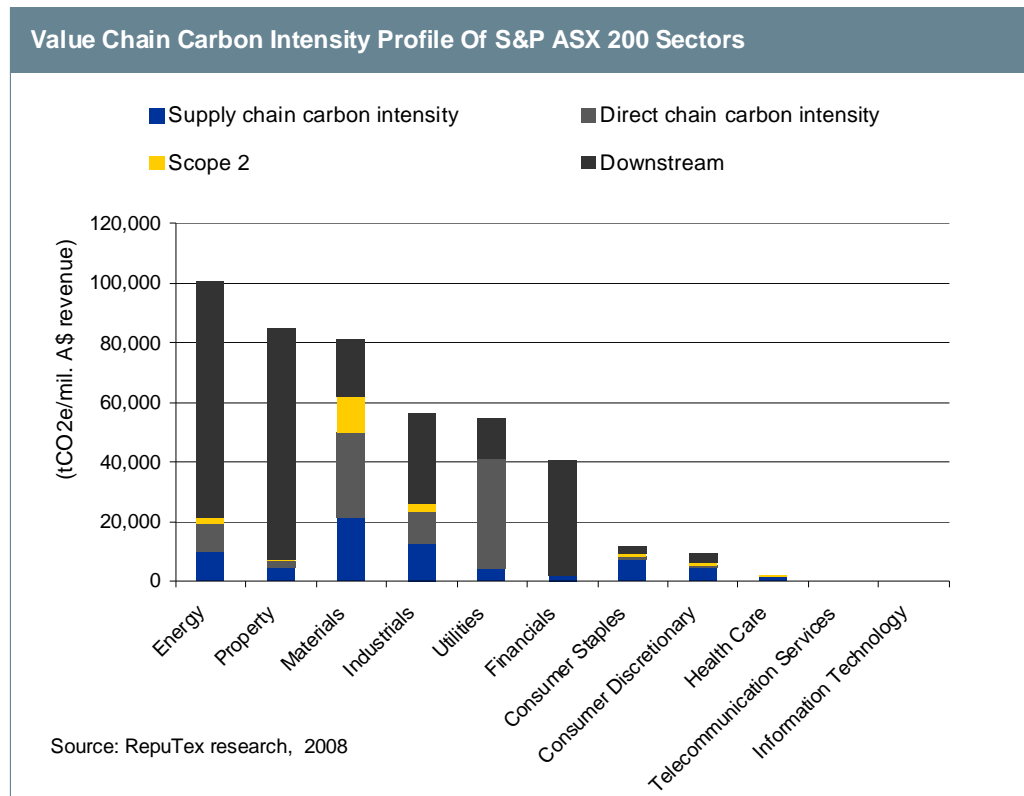
The CPRS and expanded national Renewable Energy Target (RET) should see increased investment in renewable energy and, consequently, substantial demand for new connections to load centers or the energy grid. Importantly, given the overlap of this demand with significant investment in asset renewal and the Australian Energy Regulator's review of the return on investments for the transmission and distribution entities, the financial risks will need to be managed more delicately to avoid any adverse effect on credit quality. If such new connections were to be undertaken on an unregulated basis, Standard & Poor's would see this as increasing the business risk of the entities. In contrast, the regulated nature of the new connections in itself may not reduce the credit risks, but the mechanism of the framework and how it reduces the risks will be important.

While we have seen wind farms connected from remote locations in the past, it has been on a relatively small scale. Most rated electricity transmission/distribution companies also have undertaken such investments prudently by ensuring: a) adequate security is in place, b) a funding approach that limits risk to lenders is adopted, c) asset bypass risk is limited, and d) above-average return on investment is achieved.

***Other Corporate Sectors***

Given the nature of their activities, emissions-intensive trade-exposed industries (EITE) and airlines will be also strongly affected by the introduction of a CPRS. One of the main risks is that the increased direct and indirect expenses (see chart 2) associated with a cost on carbon may see Australian producers become less competitive than rivals who operate in offshore markets where there is no such cost. What's more, despite government concessions, some companies could potentially scrap or alter investments in new projects because of its rising cost structure. Corporates operating in the chemicals and packaging industries will also be somewhat affected by the CPRS, while companies operating in sectors such as consumer products and property are likely to be less affected.

Chart 2



**Trade-Exposed Corporates: Costs poised to spike, but preparation is underway**

As a result of the carbon penalty from direct emissions, operating costs for companies operating in emissions-intensive sectors, such as oil and gas, and mining and metals, will increase due to limited pass-through ability, given that they operate in a competitive global environment. In addition, higher input costs as a result of higher energy prices and other feedstock could also increase these companies' cost positions. For example, electricity (scope 2 carbon emissions) is a substantial individual cost in the production of aluminum. Also, exposure to upstream supply chain and direct costs are likely to be high for materials sectors. Additional costs could also arise through the need for preventative and remedial investments and changes to operating processes.

The implications for earnings depend mostly on the industry cycle and market structure. Standard & Poor's believes that companies would be in a better position to pass on the costs of the CPRS in a short market (boom cycle), but will face a huge challenge to do so in a market downturn. In other words, given the cyclical nature of the resources industry, the negative earnings implications could be magnified in a market downturn, but could be muted in a boom market.

Nevertheless, most of the companies we rate in the investment-grade spectrum would have some procedures already in place to help tackle the CPRS-related challenges. For example, some companies have installed data-collection systems to measure greenhouse-gas emissions inventory, or put in place an emissions-reduction plan or target. Elsewhere, some companies are undertaking activities to reduce emissions, including direct actions (energy-efficiency projects, greenhouse sinks, and management systems). Others are taking indirect or influencing actions, such as investments in abatement projects; for example, Woodside Petroleum Ltd. (A-/Stable/—) is investing in a carbon-sequestration plantation project in NSW and Western Australia, and Santos Ltd. (BBB+/Stable/A-2) is considering a carbon-storage project at Moomba in South Australia.

***Airlines***

Airlines, although emissions-intensive, are likely to fall below the threshold to be eligible for the government's assistance. Like the resources industry, however, airlines' operating costs will likely increase following the start of the CPRS. An airline's ability to pass on the additional costs to consumers will also depend on the state of the industry cycle. For example, price elasticity for airline tickets could be lower if the economy or personal disposal incomes are robust, enhancing the airlines' flexibility to pass on the carbon costs. In the current environment, where demand for air travel is under pressure, airlines will struggle to pass on the incremental costs to consumers. Nevertheless, airlines with a fleet of more fuel-efficient, newer aircraft should have competitive advantages over others. For example, the Airbus A380 aircraft will provide up to a 10% fuel reduction per passenger kilometer compared to the Boeing 747, while Boeing's 787 offers a 20% fuel reduction per passenger kilometer compared to the 767. Other measures could help airlines to reduce its carbon emissions. For example, Qantas Airways Ltd. (BBB+/Negative/A-2) and its subsidiary Jetstar have carbon offset programs that allow passengers to calculate and offset their share of flight emissions when making a booking. All contributions go toward Australian-based accredited abatement programs.

***Chemicals***

Chemicals manufacture can also be emissions-intensive, but is likely to fall below the threshold for assistance. The key impact of carbon trading for the chemicals industry will be through higher energy costs and feedstock prices, as well as emissions from the manufacturing process (see chart 2 – materials bar). The ability of chemical producers, such as Nufarm Ltd. (BBB-/Negative/—) and Orica Ltd. (BBB+/Stable/A-2), to pass on higher raw material and energy costs will be critically dependent on the point in the commodity cycle, as many end-users operate in cyclical industries such as mining and agribusiness. In the consumer products sector, the ability to pass on prices will depend on the magnitude of the increase in costs, residential property cycles, and the price elasticity of the various product types. Emissions of carbon and other chemicals will be a key area of focus, with investment in abatement technology likely to increase.

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