

Overview

JCP was reasonably certain of the policy surrounding the new Climate Change legislation, but the politics was more difficult to predict. JCP was confident the range of \$20 to \$25 a tonne of carbon, plus compensation and concessions for emissions intensive industries would be similar to the original CPRS. After certainty provided by the announcement we assume a flat \$23 a tonne from 2012 to 2015, then increasing by CPI plus 1.3%. The scheme details have been relatively consistent from the original CPRS.

Our relative certainty of the structure of the scheme was a result of extensive consultation with industry and government. Discussions included listed companies (ORG and AGK), non-listed (True Energy and International Power), the Department of Climate Change, Prime Minister and Opposition Leaders Offices, and JCP's proprietary Canberra contacts. The people designing the scheme within the Department of Climate Change have been more consistent in implementation methodology than the politicians voting on it.

The politics of the scheme were harder to predict with agreement needed from the three independents to pass through the lower House and Greens for the Senate. But given the consistent leaking of scheme details over the last three weeks, the politics looked far more certain.

Our base case scenario assumes scheme implementation on 30 June 2012, but we also have a scenario to reflect no or delayed implementation assuming lack of community support for the scheme leads to change in government. Our probability on this scenario is 10%.

Detail

As stated above, the scope of the tax was essentially as we expected, and the compensation to households and businesses is generous. Households on low incomes and families with children, plus pensioners will be the biggest beneficiaries of the household assistance package. The biggest losers will be those on high incomes.

The tax is likely to add 0.7% to inflation, however we would expect the RBA to look through this impact (given it is a one off, which is similar to the implementation of the GST), and would therefore expect little change to monetary policy as a result.

The carbon tax will be largely borne by a narrow number of companies and sectors. The most negatively impacted sectors are steel, aluminium, coal, building materials and transport, however companies within these emissions intensive trade-exposed industries have largely been insulated from the impact in the first 5 years through favourable assistance. Longer term, the key to earnings recovery for those companies/industries impacted by the tax is their ability to pass through emissions costs on to their customers, and ultimately to the end consumer, with limited impact on shareholder value. Overall, the impact on the JCP valuation universe is relatively minor, in the order of -0.5% to -1.0%. More specifically:

- **Miners** – Unlikely to be able to pass through the tax to their customers given Australian mining companies generally sit in the bottom half of the cost curve. As long term pricing is driven by the marginal cost producers, it is unlikely that the Australian mining industry will be able to pass on the higher costs from the carbon tax. However, we envisage little portfolio impact as most resource stocks have recently been sold off on macro issues such as European debt concerns, Chinese inflationary issues and a weakening US economy, and as such they are all presenting reasonably good value.
- **Steel** – Earnings negatively impacted and 94.5% compensation provided in year 1. JCP portfolios have no direct exposure to steel companies.
- **LNG** - Producers have been a beneficiary of the tax versus expectations, receiving a minimum effective assistance rate of 50% in relation to LNG production. Some marginal CSM producers will see lower returns. Oil Search will not be directly exposed, given its operations are entirely outside of Australia, which is a net positive for the JCP portfolios.
- **Coal** – Gassier coal mines will be receiving compensation for 80% of emissions above 0.1t CO₂. Our major exposure in the coal sector is to Whitehaven Coal (WHC). WHC will receive assistance given it's a gassy mine, however the assistance mechanisms do not apply to growth in production after 2009, which may impact WHC due to its Narrabri mine. We are still investigating this issue.
- **Airlines** – Pass through to the customers is the key here. The carbon tax is equivalent to approximately \$4 per passenger or a 2.0% fare increase for Qantas.
- **Transport** – Again, pass through to end customers is the key (TOL & AIO).
- **Building materials** – Companies with import competition will risk a lack of pass through ability, for example CSR's glass division.
- **ASX** - May benefit from 2015 from increased potential revenue if the trading of carbon permits/futures takes place on the ASX. We currently model this scenario for ASX.

Conclusion

In general, the JCP portfolios are well insulated from the impact of this tax, having low exposures across most of the negatively impacted sectors such as steel, aluminium, coal, building materials and transport. The construction of the portfolios has taken into account the impact of the tax through detailed bottom up analysis and forecasting, derived from the relative certainty of the structure of the scheme which was a result of extensive consultation with industry and government well prior to the announcement of the tax.

If you would like to discuss this in greater detail, please contact:



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