

More than hot air: Carbon trading – a market solution

Conventional wisdom suggests that environmental problems are best dealt with by government regulation. However, there are alternatives that may prove to be more efficient and better for the environment. In this edition we take a closer look at one such alternative – carbon trading.



Public versus Private – how to best solve environmental problems?

In everyday life, the price of a good usually determines how much we want it. This is true for most goods, but for some goods – such as ‘public goods’ – this price mechanism does not work. Public goods – such as the environment and public utilities such as water – can be used by everyone and have no substitute. This means that people with free, or relatively inexpensive, access to public goods tend to exploit them. For example, in the case of the environment, this exploitation usually leads to over-pollution.

Conventional wisdom suggests that the best method to deal with environmental problems, such as pollution, is through government regulation. However, by giving ‘public’ goods ‘private’ characteristics (i.e. exclusive use through ownership) the problem of exploitation can be overcome. Carbon trading is an excellent example of how, with the right incentives and market rules, individuals and business can take the initiative to find the best ways to solve the challenge of climate change.

What is carbon trading?

The most common system of carbon trading involves capping the amount of greenhouse gas emissions allowed from certain industries. Companies within these industries are then granted an ‘emissions allocation’ – Carbon Certificates – and are able to ‘trade’ this

allocation with other companies. Through this process of buying and selling certificates, carbon is given a price.

Benefits

While market mechanisms do not replace the need for regulation on some environmental issues (e.g. controlling the use or emission of some substances or protecting endangered ecosystems), the use of a carbon trading system to address climate change does have a number of benefits, including:

- A **reduction in the overall cost** of meeting emissions reduction targets such as those specified in the Kyoto Protocol – companies with emission ‘surpluses’ sell these to companies who would have otherwise incurred higher costs through other emissions reduction activities (such as buying new equipment);
- A **more accurate price for carbon** as the market becomes more liquid and active; and
- The **opportunity to generate income** – through the selling of these surpluses – from activities that previously attracted no additional revenue such as investment in emissions reduction, renewable energy generation and greenhouse-friendly fuels.

AMP Capital’s role

Being pro-active (and provocative), AMP Capital’s Dr Ian Woods recently wrote a paper titled ‘Emissions Trading and the Australian Aluminium Industry’. Dr Woods’ paper considers the potential impact of greenhouse gas emissions trading schemes on the Australian aluminium industry. Ian found that there is no single impact on the industry and that the impacts on companies involved with refining and smelting may be overstated. This suggests that opposition to such schemes from affected companies needs to be considered in light of the broader environmental, social and economic benefits that such schemes provide in addressing climate change.

While it is clear that carbon trading is not the cure-all to environmental problems in Australia, it is a step in the right direction that we believe will help both the environment and minimise costs to the business world.

Dr Woods’ paper ‘Emissions Trading and the Australian Aluminium Industry’ will soon be available on our website www.ampcapital.com.au under ‘Research and Position Papers’.

Stock story

Sigma: in fine health

In 1912 a Melbourne pharmacist E.H. Leete formed a company to package drugs that could only be sold by shareholders. That company today is Sigma, a pharmaceutical and healthcare manufacturer that has become Australia's largest maker of antibiotics.

On the pharmaceuticals side, Sigma has also become Australia's biggest maker of medicines for Australian and international companies, as well as selling branded and licensed products. In recent years, the company has benefited from the robust growth of the pharmaceutical industry, an expansion driven by technology, the declining costs of medicine and a favourable regulatory environment.

On the healthcare side, Sigma is the wholesaler and distributor of prescription and over-the-counter products to 3,500 chemists in Australia, including its own Amcal and Guardian chains and the Herron brand of headache tablets.

Our Sustainable Funds team regard access to affordable healthcare, including pharmaceuticals, as one of the key requirements for the world shift to a sustainable future. Sigma is helping to facilitate this access in Australia. The team also looks at a company's financials before it invests and likes what it sees with Sigma. They expect the company to grow strongly thanks to cost cutting in its distribution operations and it is also well positioned to win more drug manufacturing contracts.

Sigma posted a 49.3% lift in net profit to \$17.5 million for the six months to July 2003. In response to this result, along with strong free cash flow and reasonable debt, Sigma's shares have risen 59.1% per annum over the past three years and 61.2% over the past year.

Sigma is a good example of a company that acts in a socially responsible way and has richly rewarded its shareholders. However, while the business is sound, Sigma is trading on a current price earnings ratio of over 22 and, as such, is fully valued. Given this rich valuation, the AMP Capital Sustainable Funds team recently divested its holding of Sigma. Despite this, Sigma remains an excellent stock that AMP Capital wouldn't rule out holding in the future – at the right price.



Constructive engagement update

Our Sustainable Funds teams engage with companies to encourage better environmental and social performance. Companies with which we engage are not necessarily approved for investment in our Sustainable Future funds.

Australia

It has been a busy period of engagement for AMP Capital's Sustainable Funds team with members visiting companies on several continents.

Focusing on corporate governance

Michael Anderson (Director of Australian Equities and Head of Sustainable Funds) visited the California Public Employees' Retirement System (CalPERS) and discussed their approach to corporate governance. Michael also continued to be involved in industry issues, such as emerging company legislation and corporate governance.

Contributing to the sustainability agenda

Dr Ian Woods, on behalf of the other Australian signatories of the Carbon Disclosure Project (CDP), followed up the nine Australian companies who were approached to respond to the 2004 Carbon Disclosure Project questionnaire. This is the second year the CDP has asked a range of questions to companies to facilitate disclosure of investment-relevant information concerning their greenhouse gas emissions. Information on the project can be found at www.cdproject.net.

The team also continued to be involved in SRI industry initiatives including the United Nations Environment Programme (UNEP) SRI Advisory Committee, the Ethical Investment Association and discussions with Non Government Organisations (NGOs).

Michael Murray (Portfolio Manager/Analyst) spent three weeks with Grameen Bank in Bangladesh, a provider of finance to the poor in Bangladesh, as part of the St Vincent Fairfax Fellowship Program.

Meeting companies

Sarah Kim (Research Analyst) discussed Occupational Health and Safety (OHS) with Coca Cola Amatil's Yeo-Ju Bottling Plant in South Korea, who have implemented rigorous OHS policies in their management systems. Sarah also visited Novera Energy's Arpley Landfill Gas Power Plant in Warrington to discuss the current challenges they face as one of the largest landfill gas operations in the UK, producing over 46 megawatts of renewable energy. While in the UK, Sarah visited Sims Group's fridge recycling plant (photograph above), who are a world leader in the collection of ozone depleting substances from refrigerators.

Michael Anderson discussed climate change with Origin Energy including issues such as coal seam methane, the cost of carbon credits, energy assets and investment in renewable energy. Michael also met with John Fletcher, Managing Director of Coles Myer, regarding the success of their OHS Strategy, which involves linking managers bonuses to their OHS performance.

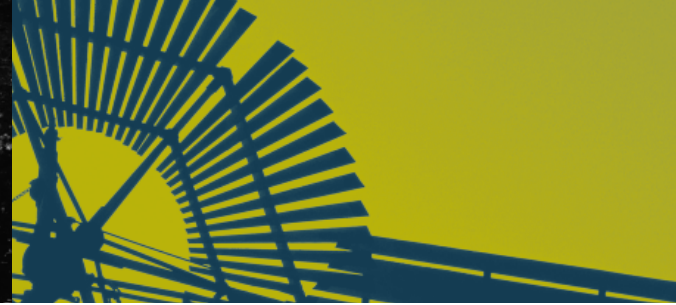
Dr Ian Woods met with Gasnet, a Victorian-based gas transmission pipeline network company, to discuss the systems which they have in place to manage the safety and integrity of their pipeline system, particularly the safety of employees and the community. Ian also visited the Baxter Group's landfill facilities in Melbourne. Baxter recently entered into a joint venture with Visy to develop resources and recycling facilities for their landfill sites in South East Melbourne. The sites currently have landfill gas collection systems in place to generate renewable energy.

International

Henderson Global Investors' SRI team (who manage the Sustainable Future International Share Fund) continued its programme of constructive engagement, carrying out SRI evaluations of 151 companies and meeting with 52 companies to discuss social responsibility, corporate governance and investment performance issues.

Focusing on corporate governance

For the past year Rob Lake (Head of SRI Engagement and Corporate Governance) has been a member of a government working party that is preparing guidelines for companies to help them determine issues that are 'material' for the purposes of reporting in the Operating and



Financial Review (The UK Accounting Standards Board's recommended reporting structure). This will include the impact of corporations on the environment and the wider community. The working party's final report together with further information is available at www.dti.gov.uk/cld/financialreview.htm.

Contributing to the sustainability agenda

Henderson Global Investors' SRI team presented at a workshop titled 'Investing in Sustainable Developments'. Bringing together practitioners from construction, property and investment, the workshop built on previous work conducted by the Sustainable Construction Task Force. Consensus was reached that, while the theoretical argument for sustainable development has been won, there remains a need to demonstrate how it can produce superior investment returns.

As a member of the Pharmaceutical Shareowners Group (PSG), the team participated in the second round of company engagement meetings, this time with Roche and Novartis. The framework developed by the PSG on pharmaceuticals and the public health crisis in emerging markets formed the basis for the discussions.

Meeting companies

Rob Lake joined BT on their Corporate Social Responsibility Leadership Panel. The team met with Hewlett Packard (HP), which proved to be extremely insightful and increased the team's understanding of HP's strategy on corporate responsibility. The team also met with Unilever to discuss the measurement of corporate responsibility performance.

Animal welfare

The team contributed to the debate on the ethics of research involving animals, organised by the Nuffield Council on Bioethics. The full submission can be found at www.henderson.com/global_includes/pdf/sri/Nuffield_Bioethics_Response_Dec_2003.pdf.

what's new?

Recently we conducted a study on how well Australian companies are applying the guidelines set out by the ASX Corporate Governance Council and IFSA. The analysis produced ratings for 1998 and 2003 among ASX200 and ASX100 companies (not including trusts) and used these ratings to examine trends in companies' compliance from 1998 to 2003.

A number of trends were identified through the analysis. Firstly, it was found that Australian companies are broadly compliant with approximately half of the principles outlined by the ASX Corporate Governance Council. Secondly, the number of companies complying with the ASX principles has more than doubled from 1998 to 2003. It was also found that ASX100 companies have adopted the ASX Governance principles to a greater extent than ex-100 companies. Importantly, we concluded that companies in Australia are becoming increasingly aware of their responsibilities to stakeholders.

A report summarising the findings can be found at www.ampcapital.com.au under 'Research and Position Papers'.

Profile

Helga Birden

Chair of Christian Centre for Socially Responsible Investment



1. Can you please give an overview of the Christian Centre for Socially Responsible Investment and your role within the organisation?

The Christian Centre for Socially Responsible Investment (CCSRI) encourages socially responsible investment by educating Christian investment groups, Fund Managers and superannuation funds about the importance of SRI as a credible investment style. We also advocate shareholder voting and activism on justice issues. My role is to work with our Board as Chairman to develop strategies for education and advocacy, linking to our overseas networks to ultimately influence corporations on environmental, community and ethical grounds. Faith based investors represent funds of between \$6-7 billion.

2. What has been the interest in SRI from your membership and the broader church community?

The interest in SRI among the CCSRI membership is strong, stable and has growth potential. There is a better understanding of the possible approaches to SRI such as using positive screens and sustainability indices for benchmarking.

We have noticed strong interest from Australian members invested in SRI funds in how their Managers are voting on issues arising in companies like NAB, Telstra, Woodside Petroleum, Westpac and ANZ (on ATMs at gaming venues), and BHP Billiton. Offshore faith investors in our global network have also had wins including ExxonMobil agreeing to report to shareholders on its treatment of HIVAids as a company issue and GAP detailing labour conditions in San Salvador.

3. What trends do you see in the future in terms of investment activity from the church sector?

CCSRI works within a global investor and corporate responsibility network. The Churches are arguably the largest transnational in the world. Because of the grass roots nature of churches in the developing world, the conduct of companies in poorer communities will increasingly be assessed as 'material' to church sector investment portfolios that need to deliver sustainable returns.



Tracking the research

'Seeking out good corporate practice'

Your say

Some consider growing sugar cane to be damaging to the environment, while others consider it an 'Industry of the Future' when combined with ethanol production. I would like to know how AMP Capital's Sustainable Funds view this particular industry.

It is worth noting that our SRI research specialists are not aware of any particular listed company which is purely engaged in cane growing. CSR, however, is one company with significant interest in the downstream processing of cane.

The sugar cane growing industry, as with other agricultural industries, has some significant environmental issues to address. We share the concerns expressed by others about the impact on the Great Barrier Reef caused by sediment run-off and fertiliser use associated with sugar cane farming. In addition, we are somewhat sceptical of the widespread use of sugar cane for large-scale and economic ethanol production.

However, we do believe there is a role for other agricultural derived fuels. For example biodiesel, a fuel made from vegetable oils or animal fats, could supplement conventional diesel fuel. Biomass can also play a significant role in producing renewable energy (for more information see the recently released 'A Clean Energy Future for Australia' report by the WWF). Bagasse, a by-product in the sugar cane production process, is one potential source of biomass and its use to produce electricity is one area where the sugar industry can and does help in providing renewable energy and plays an 'Industry of the Future' role.

Our Sustainable Future Funds will only invest in agricultural companies if we believe they are satisfactorily managing their environmental issues by implementing proper management plans.

Australia

Company research – consumer discretionary, financials, energy and materials sectors

Much of the research this quarter was linked with the engagement program, site visits and the regular review of companies. Companies reviewed included Sims Group, Brambles, Newcrest Mining, BHP Billiton and Novera.

The research also involved more in-depth analysis of some of the companies in the energy, infrastructure, materials and media sector. Companies assessed included the Seven Network, FKP Limited, Austereo Group Limited, Envestra, Gasnet and Alcan.

There were a number of new listings on the market this quarter, which the team considered. Companies included Pacific Brands and Colorpak Packaging.

Proxy voting

Sarah Kim has put together a Proxy Voting Policy and Corporate Governance Position Paper that outlines what we consider best practice. The Position Paper will soon be available at www.ampcapital.com.au under 'Research and Position Papers'.

International

Banking survey

Henderson Global Investors' SRI team recently surveyed 37 banks from 11 European countries including the UK. The survey assessed how the banks conduct themselves regarding corporate standards, workplace practices, environmental management and relations with the wider society. The study revealed that approximately half the companies surveyed have made substantial progress with regard to their corporate responsibility strategy and their social, ethical and environmental risk management.

Mining industry review

Henderson Global Investors' SRI team (with help from AMP Capital's Sustainable Funds team) conducted a study of mining companies including AngloAmerican, BHP Billiton, Lonmin, Rio Tinto and Xstrata. The study examined the industry's performance on key sustainability issues such as waste disposal, pollution, social impacts, and health and safety. The early findings show that while most companies have developed formal policy statements and systems, there are wide divergences in performance. Fatalities, in 2002 for example, range from 47 at AngloAmerican, 13 at BHP Billiton and 6 at Rio Tinto (though, the size of the workforce and the type of mining vary considerably from company to company). A common thread emerging from the analysis is that it is still 'early days' for the industry as real improvements, such as sustained reductions in accident rates, will only be seen over longer periods.

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Sustainable Future Funds

The Sustainable Future Funds are a family of three SRI funds available to Australian investors: the Sustainable Future Australian Share Fund, Sustainable Future International Share Fund and Sustainable Future Balanced Growth Fund. The overall objective of these funds is to deliver superior returns to our clients by investing in companies that contribute to, benefit from and best adapt to the shift to an environmentally sustainable and socially responsible global economy.

Further information can be found on our website:

www.ampcapital.com.au or by contacting your adviser. Please note that you can subscribe to this newsletter on-line through our website.