

UBS Investment Research

Climate Change Update

Draft EU Directive, Renewable Energy

18 January 2008

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■ Proposed Directive – Promotion of the Use of Energy from Renewables

The Renewables directive will be announced on Jan 23rd with other proposals as follows: strengthening of the ETS; GHG emissions targets for non-ETS sectors; a legal framework for carbon capture & storage (CCS); & a revised code for environmental state aid. We review the existing draft Renewables proposal, noting that some things may change, but expecting the overall direction to be maintained.

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■ We Review the Renewables Draft Currently on the EU Website

The proposed Renewables Directive includes a binding target of a 20% share of renewable energy sources in energy consumption & a 10% binding minimum target for biofuels in transport by 2020, with individual country targets TBA. The scope is: renewables in the electricity, heating & cooling & transport sectors.

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■ Investment in Electricity Grid; GHG Impacts of Changes in Land Use

RequTs include investments in electr. grid as needed to support renewables; & significant verification & reporting for biofuels. We see **global relevance**.

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■ Positive for Renewables Stocks, but Execution and Valuation Also Key

Positive as this Directive is likely to be for renewables stocks, we think the market is also focusing on execution & valuation and this will continue. In utilities, we see EDP as the main benefactor of this target, given its renewables expansion plan & the possible IPO of its renewables arm (the CEO said in Nov. a decision will be made in 2008); & Fortum as defensive exposure. We also highlight some of the few Buy-rated stocks in renewables currently - Vestas & REC as well as FSLR & AMAT, in wind & solar, to this potential catalyst.

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Climate Change Catalyst event

At a 23rd January press conference¹ the EU will propose a package of legislation designed to fight climate change. The package will include legislative proposals as follows:

- A strengthening of the Emissions Trading System (EU ETS).
- National limits on greenhouse gas emissions for sectors not covered by the EU ETS, to be met by 2020.
- National targets for the share of renewable energy in each Member State's total energy consumption, to be reached by 2020.
- The safe and environmentally sound use of carbon capture and storage.
- A revision to the code governing state aid granted for environmental purposes.

[23rd January Press Release: ETS, sectoral GHG limits, renewables, CCS, state aid.](#)

[In this note we review the existing draft proposal for the Renewables Directive.](#)

Investment Implications for Renewables

We note that the UBS Utilities team believes the renewables target will be set at 20%, by 2020. The team comments “We think this goal will be hard to achieve and should be a stimulus for renewables”.

[Stocks to own in the context of the likely positive reaction to next Wednesday's press conference....](#)

In the context of recent underperformance, and the likelihood of a positive reaction to next Wednesday's press conference, we believe stocks to focus on are: utilities with a strong focus on renewables; and strongly positioned specialists in wind and solar, but, on balance, not biofuel. Stocks to own include EDP, Fortum, Vestas, and REC.

Furthermore, recent UBS publications suggest that this catalyst event may also be relevant to the global solar sector, since firms listed outside Europe have significant exposure to key countries such as Germany and Spain. Our Global Solar Co-ordinator, Stephen Chin, notes that the bulk of First Solar's (FSLR.O) sales are European (75% of the firm's 2007 sales to Germany²); and Applied Materials (AMAT.O), similarly, has several signed European contracts³.

¹

<http://europa.eu/rapid/pressReleasesAction.do?reference=AGENDA/08/2&format=HTML&aged=0&language=en&guiLanguage=en>

² First Solar Inc. Early Solar Market Leader With an Edge. Stephen Chin, Jagadish Iyer, Ahmar Zaman, 12 December 2007.

³ Applied Materials Inc. Analyst Meeting Likely Focuses on Solar. Stephen Chin, Jagadish Iyer, Ahmar Zaman, 14 January 2008.

Key Points in the Proposed Renewables Directive⁴

This note refers throughout to the existing draft, so some of the market implications discussed below may change. However, as the Directive's publication day (January 23rd) approaches, we think it worth indicating which points in the proposal stand out in our view. There may be changes but we believe the overall direction will be maintained. Key points are as follows:

- The EU regulatory approach for renewable energy is becoming gradually less "piecemeal": this Directive brings together renewable energy in the electricity, heating & cooling and transport sectors, as well as being released as part of a broader "package"⁵.
- Binding targets of a 20% share of renewable energy sources in energy consumption and a 10% binding minimum target for biofuels in transport by 2020.
- A key unknown (at this point) is how the 20% overall target will be translated into individual targets for each Member State. (Handelsblatt discusses some numbers – see below).
- Investment in electricity grid to support the development of renewable sources is required.
- Within the EU, "Guarantees of Origin" are to be transferable.
- The Directive includes requirements to quantify the greenhouse gas impact of changes in land use.
- Increased granularity in reporting for biofuels. The application of the "mass balance"⁶ system in biofuels implies a requirement for reporting, audit, and verification through the supply chain.

In market terms, we believe these can be interpreted in the following way:

Investment Read-Throughs

Potential for Short Term Volatility

While it is clear that regulatory support for the renewables sector within the EU is strong, there is also scope for regulatory uncertainty at the country level as governments respond to individual country targets; however in the medium term, the transferability of Guarantees of Origin could introduce flexibility, offsetting such risks to some extent. In the short run, there may be some volatility in the

We review the existing draft proposal, noting that some things may change, but expecting the overall direction to be maintained.

Potentially a stimulus for renewables overall.....

...but with scope for some volatility too.

⁴ Source: the "Proposal for a Directive of the European Parliament and of the Council on the Promotion of the Use of Energy from Renewable Resources".

⁵ This includes proposals for the European Emissions Trading Scheme. See First Read: EU Emissions Trading. No free allocations – likely EU proposal. 9th January 2008. Per Lekander, Sarah Comper. Also EU Emissions Trading. ETS P3: Polluters have to pay – big time. Per Lekander, Sarah Comper, 13 December 2007.

⁶ The processor combines raw material from several sources, recording the % that is produced in a sustainable manner. This description stays with the consignment through the rest of the food chain (transport, and usage).

share prices of renewables firms in countries that have already invested heavily if their assigned targets surprise either way.

Comparing Chart 3 with Chart 4 below, share price trends in renewables changed in July along with broader market sentiment. Median performance for the stocks shown on these charts is +11% YOY as at January 17th, with Eurostoxx down by 5% over the same period. (Since July: median share price performance -14.3%, with Eurostoxx -13.7%).

Renewables Sector Trends

The UBS daily Spark (17th January) refers to an article in the Handelsblatt, suggesting that country targets for renewables will be set at 3 times the 2005 level (expressed as renewables as % total) for Germany; 1.5X for Austria, 2.3X for France and 1.3X for Sweden. If these numbers are correct, it would be reasonable to expect the January 23rd announcement to act as a boost for the renewables sector. It is the view of the UBS Utilities team that this will be the case.

Energy from renewable sources is defined as including “non-fossil” energy sources: wind, solar, geothermal, wave, tidal, hydropower, biomass, landfill gas, sewage treatment plant and biogases. In the short run we would expect the market to focus on the most investable sectors such as solar wind and biofuel. However, if the biofuel proposals appear in the Directive along the lines described here, we would expect the added sustainability criteria together with the auditing and reporting burden to increase costs in the short run (a negative), but potentially to reduce supply in the long run (a positive subject to what happens globally). Net net, any positive read through for alternatives is, in our view, likely to be muted for biofuels.

In stock market terms, the renewables theme is not only established, but the sector is maturing in the sense that the market is differentiating between models rather than simply following the positive regulatory trend. We see no reason for this directive to change this development. Whatever happens at the level of detail, we believe that for renewables, business fundamentals and multiples will increasingly matter, a process that is being accelerated by current market conditions. In the context of the potential boost for the sector from the content of the Directive, we might therefore expect a differential impact on different segments of the renewables sector.

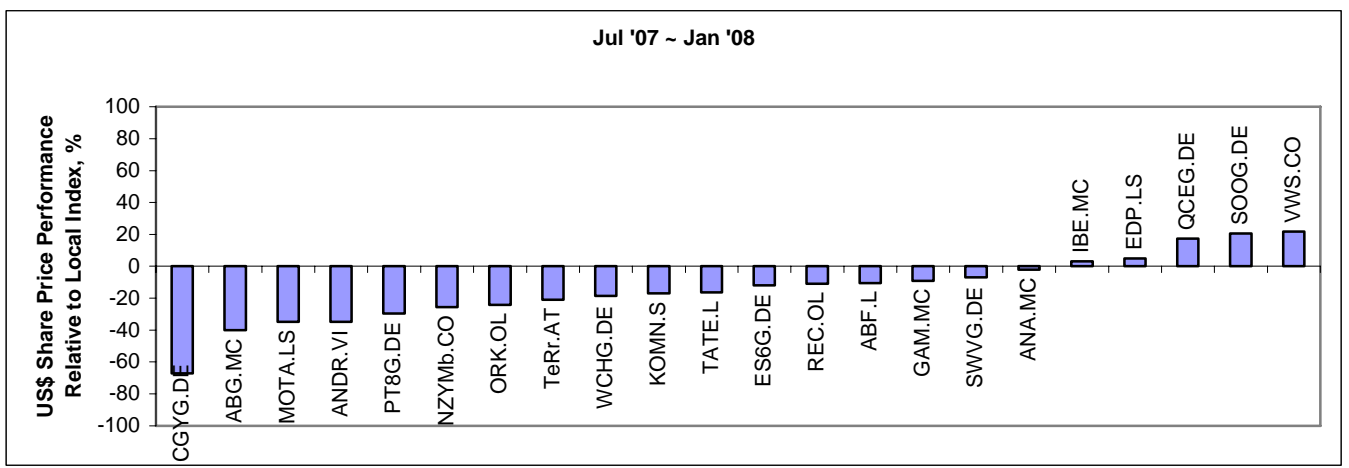
Since July, when market sentiment changed, renewables firms have mostly underperformed.

Handelsblatt suggests punchy targets for some countries

Sustainability proposals for biofuels: a positive in the long run but an added cost in the short run, with the sector already open to question.

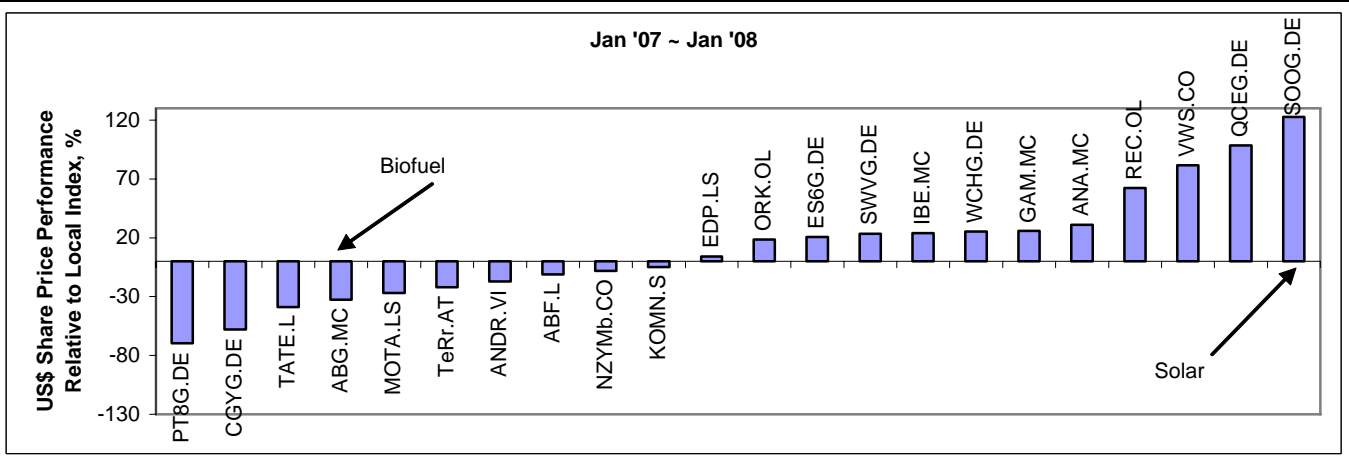
Positive though this Directive is likely to be for renewables, we think the market is also focusing on execution and valuation and this will not change.

Chart 1: European Alternative Energy Watch List Performance, July 2007~January 2008



Source: UBS

Chart 2: European Alternative Energy Watch List Performance, January 2007~January 2008



Source: UBS

Currently, UBS has very few Buy-rated stocks in alternative energy (or stocks exposed to it from a more diversified base), often because of the rich valuations. The UBS Utilities team comments: “We see EDP as the main benefactor of this target, given its renewables expansion plan and the possible IPO of its renewables arm”. Further to EDP we highlight the following Buy rated stocks having exposure to renewables (as utility or specialist): Fortum; Vestas Wind Systems; and REC.

Stocks to own in the context of the likely positive reaction to next Wednesday’s press conference: EDP, Fortum, Vestas, REC.

Furthermore, recent UBS publications suggest that this catalyst event may also be relevant to the global solar sector, since firms listed outside Europe have significant exposure to key countries such as Germany and Spain. Our Global Solar Co-ordinator, Stephen Chin, notes that the bulk of First Solar's (FSLR.O) sales are European (75% of the firm's 2007 sales to Germany⁷); and Applied Materials (AMAT.O), similarly, has several signed European contracts⁸.

In the context of biofuel, we note that Abengoa has just been upgraded to Neutral - it has fallen in share price terms but the UBS analyst has reservations about the firm's large expansion plans in both bio fuel and solar, among other things⁹.

Infrastructure

Article 12 in the draft requires investment in electricity grid to support the development of renewable sources as required. We believe there is a structural need for investment in electricity infrastructure, as discussed in our climate change publications of 2007 in the context of energy efficiency. For instance, we quote: "Energy accounts for 70-80% of the GHG emissions that are believed to cause climate change. Switching to an alternative energy system is a long-term issue. However, we believe that energy efficiency – delivering the same or better solutions with reduced power consumption – offers a compelling short-term response, and that electrical-sector companies should be the main beneficiaries¹⁰". We view Article 12 as supportive of the case for energy infrastructure investment since the two policies (efficiency and renewables) can work in parallel.

Highlighted stocks: ABB (Buy), Siemens (Buy).

Changes to Land Use.....

We have noted with interest¹¹ the increasing prominence of changes to land use in the Bali discussions, as well as indications that environmental regulation in some developing countries appears to be tightening. For instance we highlight a recent note from the UBS paper team which states: "Indonesia has been a major source of global deforestation with potentially 50-80% of logging activity being illegal. The government is becoming more serious about cracking down on illegal logging, putting fibre supply at risk. One source projects a 70% drop in Indonesian pulp production in 2008 due to fibre availability. Indonesia is a major (low cost) exporter of pulp and uncoated free¹²". We view the presence of the environmental sustainability criteria in Article 13 as likely to confirm this trend.

Although the arrival of this proposal is not new news, it is possible that the announcements of country targets on January 23rd may read through to global solar firms.

We view Article 12 as supportive of the case for energy infrastructure investment since the two policies (efficiency and renewables) can work in parallel. Stocks: ABB and Siemens.

More stringent sustainability requirements for biofuel sources are arriving at the same time as a more general tightening of regulation identified elsewhere in UBS research – for instance by analyst Gail Glazerman.

⁷ First Solar Inc. Early Solar Market Leader With an Edge. Stephen Chin, Jagadish Iyer, Ahmar Zaman, 12 December 2007.

⁸ Applied Materials Inc. Analyst Meeting Likely Focuses on Solar. Stephen Chin, Jagadish Iyer, Ahmar Zaman, 14 January 2008.

⁹ Abengoa. Upgrading to Neutral (from Sell). Ignacio Carvajal Cebrian. 16 January 2008

¹⁰ Energy efficiency: A compelling short-term response to climate change. Christel Monot, 21 June 2007

¹¹ Climate Change Update: Bali Roadmap: Cooperative Action Beyond 2012. Julie Hudson, CFA. 17 December 2007.

¹² UBS Global I/O™: Paper & Forest Environmental Focus in Asia=Opportunities. Gail Glazerman, 16 January 2008.

A key point about the biofuel related requirements in this Directive is that they may have some significant indirect impacts on other sectors.

...and Audit and Verification

Assuming the Directive goes into effect we think this may provide an incentive for energy suppliers either to choose sustainable suppliers, or possibly, even, to own their biofuel sources on the basis that this may be the safest means of ensuring integrity. In the medium term, it is not impossible that this regulation could potentially constrain capacity growth by rendering biofuels not sustainably sourced non-valid for European usage. This of course depends on what happens globally speaking, too – a complex topic for another note.

Given the uncertainties surrounding bio-fuel currently (uncertainty about the balance between supply and demand; question marks about fuel-versus-food competition), it may be stating it too strongly to say that plantation firms following verifiable best practice would be well positioned to benefit from any long run increase in bio fuels use. However, considering that this regulation is appearing in the context of a broader trend, it does suggest that such firms are likely to be lower risk. It is therefore probably not going too far to suggest that consolidation and M&A might be triggered, by this regulation, amongst the providers of raw materials, on the basis of risk mitigation and security of supply.

UBS analyst Gaurang Bhatia recently commented: “The round table for sustainable palm oil (RSPO) has created non-binding guidelines and some companies are voluntarily undergoing a sustainability audit. We expect companies such as IOI, Sime Darby, KLK, Wilmar and Indofood Agri to be well positioned to qualify for this audit¹³”.

Transferable Guarantees of Origin

We view this mechanism (Article 8) as likely to be key to the functioning of the renewables market in the EU, and believe that, at some stage, these Guarantees will change hands for a price (whether as part of a formal trading scheme, or informally, in other ways), therefore having the ability to generate cash flow, assets, and liabilities.

A few more details on the proposed directive follow. In particular we draw attention to the increasing granularity of biofuel regulation as part of a potentially significant long run trend. Specifically, in the medium term this may have some interesting knock-on effects. For instance “eco-asset” markets are active in the USA in particular, and also found in Brazil and Australia¹⁴. The infrastructure necessary to permit the required level of bio fuels reporting would, in our view, be potentially supportive of the development of eco-asset markets more generally.

“We expect companies such as IOI, Sime Darby, KLK, Wilmar and Indofood Agri to be well positioned to qualify for this audit”. Gaurang Bhatia, 16 Jan 2008.

The logistics necessary to permit the required level of bio fuels reporting would, in our view, be potentially supportive of the development of eco-asset markets more generally in Europe.

¹³ Plantation Sector. Limited impact of EU proposed ban on biodiesel. Gaurang Bhatia, Andreas Bokkenheuser, 16 January 2008.

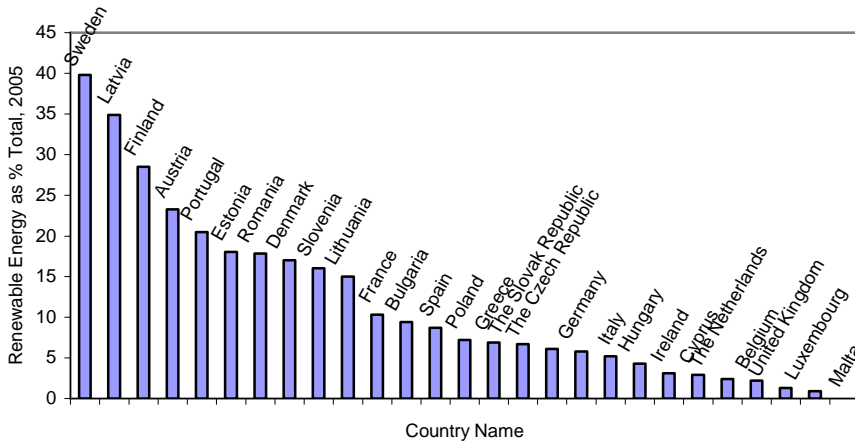
¹⁴ Alternative Alpha. Land – the long view. 4 July 2006. Julie Hudson. Also Alternative Alpha. Infrastructure - The long view. 17 November 2006.

Renewable Energy Legislation - Europe

“This Proposal for a Directive aims to establish an overall binding target of a 20% share of renewable energy sources in energy consumption and a 10% binding minimum target for biofuels in transport to be achieved by each Member State, as well as binding national targets by 2020 in line with the overall EU target of 20%”

By 2020: Renewables to be 20% of energy consumption; for transport, biofuels to be 10% of fuel mix.

Chart 3: Share of Energy From Renewables %, 2005



Source: EU Website

The UBS daily Spark (17th January) refers to an article in the Handelsblatt, suggesting that country targets for renewables will be set at 18% (5.8% in 2005) for Germany, 34% (23.3%) for Austria, 23% (10.3%) for France and 50% (39.8%) for Sweden.

Key Points in the Proposal

- Member states will be required to adopt a National Allocation Plan. The 20% target is to be translated into individual targets for each Member State, taking into account different starting points and local conditions.
- It covers renewable energy in three sectors: electricity, heating & cooling, and transport. Breaking this down slightly more, it covers energy from renewable sources within final electricity consumption; renewable energy for heating and cooling delivered to manufacturing industry, transport, households, services, agriculture, forestry and fisheries plus the consumption of district heating or cooling of renewable origin; and energy from renewable sources used in transport.

NAPs

Electricity, heating & cooling, transport

- This proposed directive, if implemented, will supersede two others¹⁵ that address renewables use in electricity markets, and renewable fuels for transport. It is part of a “legislative package” that includes an update of Emissions Trading Scheme regulation – fully discussed by Per Lekander and Sarah Comper in recent publications¹⁶. Part of a broader package
- As currently drafted, the text only permits electricity generated outside the EU (and supplied to the EU) to “count” if it is net new capacity. It also appears to us that raw materials for biofuels are expected to come from a range of potential sources, including countries outside the EU. We would be surprised if this changed. Rules for energy sources outside the EU.
- Producers of renewable energy, or of heat /cooling produced from renewable resources, can ask the relevant Member State to issue a “Guarantee of Origin”, and these will be transferable between member states¹⁷. Guarantee of Origin
- Member states will maintain a registry of guarantees of origin (and produce an annual report).
- Member states are required (Article 12) to develop the necessary grid infrastructure to accommodate the delivery of electricity from renewable resources, and moreover, transmission system operators will be required (where operationally feasible) to give priority to energy from renewable sources. Electricity grid
- Article 13 states that biofuels must be environmentally sustainable: this means that they may not be sourced from land that had the following status as of January 2008. Sustainability
 - Forest undisturbed by human activity
 - Are designated for nature protection purposes
 - Wetlands
 - Forest¹⁸
 - Permanent grassland¹⁹

¹⁵ Directive 2001/77/EC (electricity produced from renewable resources with a target of 21% by 2010) and Directive 2003/30/EC (on the use of biofuels or other renewable fuels for transport with a target of 5.75% by 31st December 2010).

¹⁶ First Read: EU Emissions Trading. No free allocations – likely EU proposal. 9th January 2008. Per Lekander, Sarah Comper. Also EU Emissions Trading. ETS P3: Polluters have to pay – big time. Per Lekander, Sarah Comper, 13 December 2007.

¹⁷ Double counting will be avoided: for instance the same units of renewable energy cannot be taken into account in meeting an Renewable Obligation as well as being registered as a GO.

¹⁸ Land spanning one hectare with trees higher than 5 metres and canopy cover of more than 30% (or trees able to reach those thresholds).

¹⁹ Land under grassland vegetation and pasture use for at least 20 years.

- Biofuel suppliers will be required to show that environmental requirements have been met, implying the need for certification and audit.
- Article 15 sets out the calculation methodology for greenhouse gas emissions from the production and use of transport fuels. This includes emissions from:
 - extraction or cultivation;
 - carbon stock changes caused by land use change
 - processing
 - transport and distribution
 - fuel in use
 - carbon capture and sequestration
 - carbon capture and replacement
 - excess electricity.

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|-----------------------|-----------------|-----------------------|--------------------------|
| Buy | Buy | 55% | 39% |
| Neutral | Hold/Neutral | 36% | 36% |
| Sell | Sell | 8% | 20% |
| UBS Short-Term Rating | Rating Category | Coverage ³ | IB Services ⁴ |
| Buy | Buy | less than 1% | 25% |
| Sell | Sell | less than 1% | 50% |

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

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Source: UBS. Rating allocations are as of 31 December 2007.

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| UBS 12-Month Rating | Definition |
|-----------------------|---|
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| Company Name | Reuters | 12-mo rating | Short-term rating | Price | Price date |
|---|----------|---------------|-------------------|------------|-------------|
| ABB Ltd ^{4, 5, 13, 15, 16, 22} | ABBN.VX | Buy | N/A | CHF26.18 | 16 Jan 2008 |
| Abengoa ²⁰ | ABG.MC | Neutral (CBE) | N/A | €19.02 | 16 Jan 2008 |
| Applied Materials Inc. ^{8, 16} | AMAT.O | Buy | N/A | US\$17.42 | 16 Jan 2008 |
| Energias de Portugal ^{2a, 4, 16} | EDP.LS | Buy | N/A | €4.20 | 16 Jan 2008 |
| First Solar Inc ¹⁶ | FSLR.O | Buy | N/A | US\$181.56 | 16 Jan 2008 |
| Fortum ⁵ | FUM1V.HE | Buy | N/A | €27.93 | 16 Jan 2008 |
| Renewable Energy Corporation ^{2a, 4, 5, 20} | REC.OL | Buy (CBE) | N/A | NKr196.50 | 16 Jan 2008 |
| Siemens ^{2b, 4, 5, 14, 15, 16, 22} | SIEGn.DE | Buy | N/A | €94.94 | 16 Jan 2008 |
| Vestas Wind Systems ^{16, 20} | VWS.CO | Buy (CBE) | N/A | DKr429.00 | 16 Jan 2008 |

Source: UBS. All prices as of local market close.

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Additional Prices: Indofood Agri Resources, S\$2.45 (17 Jan 2008); IOI Corporation, RM8.20 (17 Jan 2008); KL Kepong, RM18.30 (17 Jan 2008); Sime Darby (M), RM12.10 (17 Jan 2008); Wilmar International Limited, S\$4.49 (17 Jan 2008); Source: UBS. All prices as of local market close.

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