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Industry View
In-Line

Chemicals

Carbon Credits: Rhodia Main Beneficiary Near Term

Opportunities in N₂O and HFC. The EU scheme only credits CO₂ reductions. The Clean Development Mechanism (CDM) scheme covers all five greenhouse gases. Rhodia (N₂O) is the main beneficiary of the CDM scheme of our coverage universe. Yara could benefit if the EU scheme includes N₂O from 2008.

Rhodia (RHA) the biggest chemical beneficiary of the Kyoto regime. We estimate that Rhodia's carbon credits could be worth up to €100 million per annum of additional cash flow for a minimal investment.

Yara could be a beneficiary after 2008 if the EU decides to include N₂O reduction targets within its Emission Trading Scheme scheme.

Limited opportunity for other chemical names. The Kyoto Protocol on climate change, and measures taken under it to reduce greenhouse gases, have a limited impact on the European chemical sector. This is mainly because the industry is not the most energy-intensive and has limited scope to cut CO₂ emissions.

Limited scope for the industry to reduce CO₂ significantly. The European industry has already done much to reduce emissions. It has invested in on-site energy and will continue to raise self-sufficiency to offset fears of a further spike-up in grid prices. It is widely recognised that significant further reductions in CO₂ can only be achieved through plant closures.

Unease in the chemical industry over the impact on competitiveness of Kyoto. Although the impact of Phase I has been limited, the industry fears a tougher regime after 2008. This may speed up the trend of targeting investment to the developing world.

GICS Sector: Materials

Strategists' Recommended Weight
MSCI Europe Weight

10.5%
6.5%

COMPANIES FEATURED

Air Liquide (AIRP.PA, €162.1)	Underweight
Akzo Nobel (AKZO.AS, €38.66)	Equal-weight
BASF (BASF.DE, €61.9)	Overweight
Bayer (BAYG.DE, €34.4)	Overweight
BOC (BOC.L, £11.70)	Equal-weight
Ciba SC (CIBN.Vx, SFr83.3)	Overweight
Clariant (CLN.Vx, SFr19.00)	Equal-weight
Croda (CRDA.L, £4.53)	Overweight
Degussa (DGXG.DE, €42.5)	NAV
DSM (DSMN.AS, €35.1)	Equal-weight
ICI (ICI.L, £3.51)	Overweight
Johnson Matthey (JMAT.L, £13.97)	Equal-weight
Kemira (KRA1V.HE, €13.95)	Underweight
Lanxess (LXSG.DE, €25.7)	Overweight-V
Linde (LING.DE, €64.9)	Equal-weight
Lonza (LONN.VX, SFr82.5)	Underweight
Rhodia (RHA.PA, €1.96)	Overweight-V
Solvay (SOLBt.BR, €93.0)	Equal-weight
Syngenta (SYNN.Vx, SFr165.9)	Overweight
Victrex (VCT.L, £7.54)	Equal-weight
Yara (YAR.OL, NK96.3)	Underweight
Yule Catto (YULC.L, £2.55)	Overweight

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This report follows a request from a group of asset managers working with the United Nations to analyse the environmental, social and governance issues that may be material for company performance and to then identify potential impact on company valuations.

The United Nations Environment Programme Finance Initiative (UNEP FI) works closely with 160 financial institutions worldwide, to develop and promote linkages between the environment, sustainability and financial performance.

UNEP FI Asset Management Working Group (AMWG) explores the association between environmental, social, and governance considerations and investment decision-making. Asset Managers that have participated in this project have combined mandates of 1.7 trillion USD.

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Investment Case

Phase I of the carbon credit regime has little impact on the European chemical industry with the exception of Rhodia, whose fortunes are likely to be transformed by it.

Near-term risks limited

There is still a risk that the Kyoto Protocol is not extended after 2012; near term the risk is limited. Companies allocated carbon certificates can monetise them now. As the market is designed to be 'net short', the price of certificates is likely to be underpinned.

Big opportunity in the 48% of the world not committed to reducing gases

Indeed, the possibility is that the scheme could well be extended past 2012. Furthermore, there is still a possibility that the US, which generates 20% of the world's greenhouse gases, will sign up. If this happened it would deepen and broaden the market. In addition, developing economies, such as China and India, which currently have no reduction targets and account for 14% of the world's carbon emissions, could also become more active within the scheme. In this scenario, the opportunity for companies reducing emissions would grow significantly.

European chemical industry not significantly affected

Within the limits of the current scheme, and within the terms of the Phase I period, the chemical industry is not significantly affected. This is because it is a smallish producer of CO₂, relative to other industries. The industry worries that the impact could be greater in Phase II. The current allocation of certificates does not penalise the industry, but it is a disincentive to add capacity in Europe. The likely longer-term impact is a hastening of the shift of investment overseas.

Big winners: HFC and N₂O producers

Kyoto mandates six greenhouse gases: carbon dioxide (CO₂), nitrous oxide (N₂O) and hydrofluorocarbons (HFCs).

Certificates of Emission Reduction (CERs) include all of these gases but the EU scheme covers only CO₂. The developing world CDM scheme also covers other greenhouse gases.

Under the CDM scheme, Rhodia is a beneficiary because of the disproportionate weighting of N₂O (310x) and HFCs (140x-11,700x) in the scheme. Another factor is that, chemicals being an international business, the industry has a significant manufacturing presence in the US, which is not included within the scheme. Stocks that might benefit from the inclusion of the other four gases include Yara.

Not much scope for chemicals to reduce CO₂ in EU

Because the European chemical industry has already reduced emissions of carbon dioxide and nitrous oxide, there is little further reduction that can be achieved. According to CEFIC (European Chemical Industry Council), CO₂ emissions from fuel combustion have dropped by more than 40% per unit of chemicals output since 1980. It is widely recognised that significant further reductions in CO₂ can only be achieved through plant closures.

The chemical industry in Europe believes that the current carbon credit regime in Europe puts it at a disadvantage to international peers. Furthermore, it believes the regime unfairly penalises companies that invested heavily in CO₂ abatement prior to Kyoto.

Rhodia could see significant potential upside

Rhodia's Ulsan (South Korea) and Paulinia (Brazil) N₂O abatement projects should reduce emissions by 49,000 tonnes per annum. In the process, they should generate 13 million tonnes of carbon credits per annum for the company until at least 2012. At €6/tonne, we estimate these credits would generate €470 million of EBITDA (2007-12), or €0.32/share. At €20/tonne the value rises to €1.6 billion (or €1.08/share).

Our €2/share target price is based on a CER price of just €8. We estimate a value of the underlying business of €1.66 and a value of €0.34 for carbon credits. However, if the value of the CERs were to rise to €20 (where the EU credits are trading) our target price would rise to €2.74, implying potential upside of 40%. If the price of carbon were to rise to a theoretical value of €30 our target price would rise to €3.3, implying potential upside of 70% (Exhibit 1).

Exhibit 1

Rhodia: Potential Value of Carbon Credits 2006-12

Price (€/tonne)	Total €mn	Per share (€)
6	468	0.32
8	624	0.42
10	780	0.53
15	1,170	0.80
20	1,560	1.08
25	1,950	1.35
30	2,340	1.63

Note: Assumes 13mn tonnes per annum 2008-12
Source: Morgan Stanley Research estimates

We strongly believe that carbon credits should be included in the valuation of Rhodia, because they are material to the share price and they are 'real'. That is to say, Rhodia could

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sell them forward today in a liquid market, although there is a limited risk that they may not get approval.

Rhodia: base-case scenario of €2.00 is our target price

Our base-case scenario includes carbon credits out to 2012. We assume only 7 million tonnes in 2007 at €6 per tonne, which is the current price for which the company could sell non-approved CDMs forward. We assume 13 million tonnes at €8 per tonne from 2008 until 2012 and thereafter declining to zero. This is a big discount to the €22 current EU traded price. We assume that Rhodia manages to generate EBITDA margins of 12.7% in 2006, 15% in 2008 (the average for the European specialty chemical sector) falling to a mid-cycle level of 13% to perpetuity. We assume that Rhodia refinances in 2010 at 6.0% and pays no penalty. We also assume that Rhodia loses its case against Sanofi in 2006, and wins its US litigation.

Our €2.00 price target is based on an average of DCF residual income and sum-of-the-parts valuations. We estimate a DCF valuation of €1.79 (WACC of 7.3% and a long-term free cash growth rate of 1.40%). We estimate a residual income value of €2.66, based on the same metrics as the DCF. We estimate a sum of the parts based on 2006 comparables of €1.73. Included in our valuation is €1.014 billion in pension underfunding, but a write-back of €31 million of pension interest.

Bull-case scenario of €4.6

Our bull-case scenario includes carbon credits out to perpetuity at €20 per tonne, which is the current EU traded price for approved projects that have been validated. We assume that Rhodia manages to generate 15% EBITDA margins in 2008-10 (excluding carbon credits) and then achieves 14% EBITDA margins (excluding carbon credits) to perpetuity. We assume that Rhodia refinances in 2007 and manages to finance at 5.5% thereon. It pays a penalty of €170 million. We have assumed that Rhodia wins its case against Sanofi in 2006.

Bear-case scenario of negative €0.15

Our bear-case scenario excludes carbon credits. We assume that Rhodia manages to generate margins of just 10% EBITDA to perpetuity. We have assumed that the company cannot refinance and pays high yield coupons until maturity and then continues to pay a premium rate to perpetuity. We also assumed that Rhodia loses its case against Sanofi in 2006, and loses its US litigation.

Risks

In addition to sensitivity to carbon credit values, risks include: sharp increases in raw material costs; a decline in industrial production; an inability to pass on higher prices; a decline in the automotive market; de-stocking in polyamide; a sharp increase in new capacity in nylon; a failure of the Kyoto Protocol; litigation against Rhodia by investors claiming c€150 million; a liquidity crisis if profitability slumps; and a sharper-than-forecast rise in capex.

What is the Kyoto Protocol all about?

Background

The Kyoto Protocol was conceived as a market-based mechanism, whereby developed countries reduce carbon emissions. Developing countries are incentivised to reduce emissions, without hampering growth, by selling credits to the developed world.

Details

Negotiated in 1997 in Japan, the Protocol became legally binding on February 16, 2005. As of August 2005, 153 states and regional economic integration organisations had ratified the Protocol. Only developed countries (Annex 1) are committed to reducing emissions.

Under the agreement, Annex 1 nations (excluding the US and Australia) are pledged to reduce Green House Gas Emissions (GHG), measured in tonnes of CO₂ equivalent, by 5.2% from 1990 levels in the five years from 2008 to 2012. The EU-15 (Exhibit 2), agreed to reduce CO₂ emissions by 8% under Kyoto, greater than the 6% agreed by Canada and Japan.

Exhibit 2

Annex I Emission Reduction Targets

Country/Region	Target (Difference to Baseline) 2008-12 (%)
EU-15	-8
Canada, Japan	-6
Russian Federation, Ukraine*	0
Total	-5.2

*Some Economies In Transition (EITs) have a baseline other than 1990.
Source: UNFCCC, Morgan Stanley Research

Of the Annex 1 nations, the EU-15, Canada and Japan are pledged to reduce emissions. Collectively they account for 52% of global emissions, excluding the US and Australia (non-Kyoto countries); see Exhibit 3).

Exhibit 3

Global Emissions by Country and Kyoto Status

Country	mt CO ₂	% of Total	Ratified Kyoto
United States	5,762	25.2	No
China	3,474	15.2	Yes
Russia	1,540	6.7	Yes
Japan	1,225	5.4	Yes
India	1,008	4.4	Yes
Germany	837	3.7	Yes
United Kingdom	558	2.4	Yes
Canada	521	2.3	Yes
Italy	447	2.0	Yes
Mexico	385	1.7	Yes
France	363	1.6	Yes
Ukraine	348	1.5	Yes
South Africa	345	1.5	Yes
Australia	332	1.5	No
Brazil	328	1.4	Yes
Other	5,357	24	
Total	22,830	100.0	

Source: World Resources Institute, 2003

The allocation of credits within each country (NAP)

Each country is given a target for greenhouse gas reduction and allocates its permits to individual companies through a National Allocation Plan (NAP).

Permits are issued to a level equal or below its target. There is clearly a political decision to be taken about where the burden of reduction falls, and the assignment of certificates is not yet complete in all countries.

If a country or company is incapable of meeting its target, it can buy permits from countries or companies that are under their targets. In Phase II, a country can only buy in 50% of its targeted reduction. The remainder has to be achieved domestically.

Europe has the greatest burden

The UK and Germany have agreed to significant reductions in emissions, with Germany committed to a 21% reduction (Exhibit 3). It had hoped for gains from closing coal-fired power plants in the former East Germany. It now seems likely to fall somewhat short of that. Spain, Greece, Portugal and Ireland are allowed to increase emissions. There are still some minor disputes within the EU, with Spain, Belgium and the UK appealing about various aspects of the allocation.

Exhibit 4

EU-15 Kyoto Targets

	% Reduction
Austria	-13
Belgium	-7.5
Denmark	-21
Finland	0
France	0
Germany	-21
Greece	+25
Ireland	+13
Italy	-6.5
Luxembourg	-28
Netherlands	-6
Portugal	+27
Spain	+15
Sweden	+4
UK	-12.5

Source: UN, Morgan Stanley Research

EU credits can be traded under the EU Emission Trading Scheme (ETS), which came into force in January 2005. The ETS is the largest company-level scheme for trading in emissions of CO₂. We estimate that Europe is short CO₂ by around 3-3.5%.

Under the EU scheme, CO₂ limits were imposed on installations in nine industrial sectors in 25 EU countries. Although chemicals were not directly covered within Phase I of the scheme, combustion installations > 20MW thermal input are covered, which includes many large chemical sites. The European chemical industry is represented by the Chemical Industries Association and CEFIC.

The number of allowances allocated to each installation for any given phase will be set down in the National Allocation Plan (NAP). An emission cap is set for all sites covered by the scheme. Details of the Phase II allocations have yet to be decided.

Canada — mainly voluntary reductions

Canada is implementing mainly voluntary measures. Official estimates suggest that the plan will reduce emissions by 250 Mt of CO₂ annually in 2008-12, but this might prove optimistic. Independent consultant Point Carbon estimates that reductions might total 40 Mt annually. The latest Canadian proposals are outlined in Project Green 2005. Key issues include voluntary reduction measures from the automobile industry, increased production of hybrid vehicles, voluntary citizen reduction of emissions, subsidies and tax breaks to

domestic companies and government investment in agriculture and forest carbon sinks.

Japan — mainly voluntary reductions

Japan's measures include broad guidelines, such as dissemination of ideas and technology to industry and the public. These are mostly voluntary with little or no mandatory measures for emission reduction. Point Carbon estimates the total effect of Japan's measures to be 33 million tonnes of annual CO₂ reduction, with a further 405 million tonnes coming from forestry measures.

Clean Development Mechanism (CDM)

Developing nations have no limits on CO₂ emissions but can invest in projects to reduce emissions. These projects generate credits that can be sold to developing nations through the Clean Development Mechanism (CDM) programme.

Projects under the CDM scheme are eligible for CERs. CERs are currently valid until the end of Phase II and can be used to cover shortfalls in the EU, Japan and Canada. Because there is currently no infrastructure for registering certificates they are not actively traded and prices of certificates sold have been at a discount to EU certificates.

Prior to UN approval, CERs can be pre-sold for €5-8 per tonne. The price rises to €12-15 for unilateral and registered projects where sellers take the bulk of the delivery risk. In the CER market, the price depends a great deal on the contractual structure of the project.

Within a year, and once certificates have been issued, the price should rise closer to the EU level of €21-22 per tonne we estimate.

We estimate that there are 445 million tonnes of new projects within the chemical industry that have already been submitted for approval. This includes the Rhodia N₂O projects and a number of large HFC23 projects in China (Exhibit 5).

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Exhibit 5

Chemical CDM Projects in the Approval Process

Country	Pollutant	Company	Co2 equiv. tonnes
2005-12			
India	HFC	Chemplast Sanmar	3,812
India	HFC	SRF	32,585
China	HFC	Changshu 3F Zhonghao New Materials	62,622
Russia	HFC	Russian chemical factories Chimprom	500
China	HFC	Juhua Fluoro-Chemical	34,772
China	HFC	Jiangsu Meilan Chemical	50,468
Mexico	HFC	Quimobasicos	26,233
China	HFC	Shandong Dongyue Chemical	55,610
India	HFC	Gujarat Fluorochemicals	27,134
South Korea	HFC	Ulsan	14,000
Egypt	N ₂ O	Abu Qir Fertilizers	9,961
Bulgaria	N ₂ O	Agropolychim	3,384
Romania	N ₂ O	Azomures	7,142
Chile	N ₂ O	Chile Nitrous Oxide Removal	4,080
Russia	N ₂ O	Akron	3,500
Korea	N ₂ O	Rhodia	57,190
Brazil	N ₂ O	Rhodia	35,766
Hungary	N ₂ O	Nitrogenmuvek Rt.	3,978
China	N ₂ O	Nanjing (NCIC)	4,635
India	N ₂ O	National fertilizers Limited	2,501
Bulgaria	N ₂ O	Neochim	1,249
Czech Republic	N ₂ O	Lovochemie	4,316
South Africa	N ₂ O	Omnia Fertilizer	0
Total			445,438

Source: UN, Morgan Stanley Research

Bottleneck currently for approvals under CDM

Rhodia was one of the first companies to file for approval for CDMs. The process is overseen by the UN. There are significant regulatory and infrastructure steps involved in CDM. These include a) methodology approval, which has only a 43% pass rate and a five- to six-month lead time; b) host country approval, largely dependent on political and bureaucratic processes in each country; and c) verification and production of certificates. In theory, the hurdle-rate for approval should progressively tighten as the scheme needs to remain net short to incentivise the market to reduce carbon.

Joint Implementation (JI)

As well as the CDM credits, producers in Annex 1 countries can apply for certificates under the Joint Implementation (JI) directive. Projects approved will generate Emission Reduction Units (ERU) but will only be available under Phase II from 2008 onwards.

UK — levy on energy supplied to businesses

The UK government introduced the Climate Change Levy in April 2001 as part of the overall measures towards meeting its Kyoto commitments. The levy is charged to UK businesses on energy supplied, although there are exemptions from the levy for energy-intensive industries, including the chemical

industry. Relevant chemical installations can obtain up to an 80% rebate from the levy in return for saving carbon through the reduction in energy used and by entering into a Climate Change Agreement with the DETR and the relevant trade association, CIABATA (Chemical Industries Association Broking & Trading Agency) for the chemical industry.

The UK government introduced the related UK Emissions Trading Scheme in April 2002. This provided companies with Climate Change Agreements with the option to meet their planned carbon emission reductions as well as the opportunity to realise the value of any carbon savings via carbon trading.

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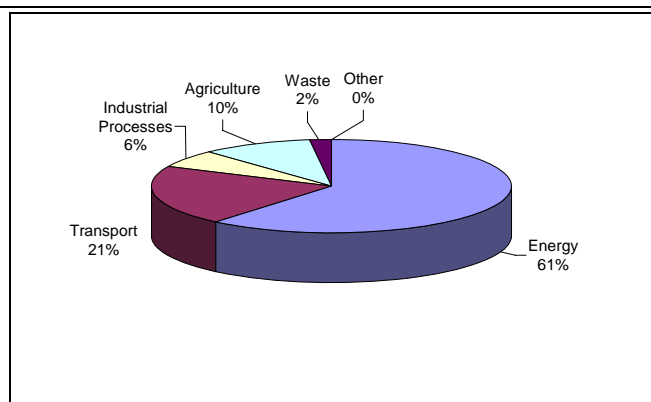
Impact on chemical companies

Focus on energy in Europe

82% of greenhouse gas emissions are estimated to be generated by the energy (61%) and transport (21%) industries (Exhibit 6). In Phase I, transport is not included in the scheme for political reasons.

Exhibit 6

Sources of Greenhouse Gas Emissions 2002



Source: UN, Morgan Stanley Research

Under the EU CO₂ reduction allocations, the biggest targeted reductions come from the energy sector. It is hoped that it can meet its targets by switching from coal to gas. However, this has a cost as gas is a more expensive fuel. Hence, European electricity generators might find it cheaper to buy carbon credits from the CDM scheme than switch entirely to gas.

Burning coal to generate electricity produces about one-third more CO₂ per unit of energy generated than burning gas. The theoretical synthetic price for a tonne of CO₂ is the cost differential between burning coal and switching to gas. At current price levels, that threshold is €35-40. The EU allowance at €21-22 is currently trading at a 40% discount to this price.

Other targets within the EU include combustion plants, oil refineries, coke ovens, iron and steel, cement, glass, lime, brick, ceramics, and pulp and paper plants. The chemical sector is not a targeted sector, although a few energy-intensive chemical sites are included among the 11,463 installations identified. These 11,463 sites account for around 46% of total EU CO₂ emissions and around 30% of all greenhouse gas emissions.

Chemicals not really affected in Phase I ...

Even though it is not significantly affected by Phase I of the carbon credit regime, the European chemical industry has lobbied against it. Chemical companies worry that it creates a competitive disadvantage for northern European-based plant versus North American and Asian peers (that is, countries not participating in the Kyoto agreement).

Another common complaint in the industry is that northern European CO₂ reduction targets are overly aggressive relative to southern Europe.

In addition, chemical companies believe that the scheme rewards the big polluters. European chemical companies made a big impact on reducing greenhouse gases in the nineties. Yet the carbon credits were allotted on the actual emission levels in 2003/04. This means that they have less room to improve processes and win carbon credits compared with companies that had previously invested less. The industry sees this as rewarding past 'bad behaviour'.

... but fear harder impact in Phase II

The chemical industry fears that Phase II (2008-12) of Kyoto could be more damaging if emission limits are further reduced.

Companies with many plants in many regions have to bring together all their plusses and minuses at the year-end to balance their books. An interesting example of how companies will cope is offered by Degussa's explanation of its own internal systems. It has established an internal reporting system along with an intra-group platform for the transfer of emissions certificates. With the aid of internal reporting, deviations between planned and actual emissions should be identified quickly to enable Degussa to take timely action. Via the internal transfer platform, units affected by the emissions trading regulations will first be able to exchange certificates internally, before turning to external trading partners.

BASF comments that the administrative charge associated with managing the carbon credits will result in additional costs of €1 million per annum.

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Timetable and implication for pricing

Phase I is an introductory phase

The scheme is split into two phases. Phase I runs from 2005 to 2007 and focuses only on CO₂ emissions. Phase II (2008-2012) will see a tightening of targets in line with the pledges agreed at Kyoto.

Allowances distributed for Phase I can be used in 2005, 2006 and 2007, but cannot be carried forward past 2007. In our view, it is likely that prices will spike up in 2007 as companies and countries have to balance books before the end-2007 deadline. Companies failing to comply are fined €40/tonne and still have to cover the carbon shortfall. Fines rise to €100/tonne in Phase II for non-compliance.

Phase II could be more stringent

Quotas will be reviewed in 2008. We think Phase II is likely to be more stringent with allowance allocations, and we forecast a significant rise in traded volumes as companies buy CO₂ units. So far, the burden of emission reductions within the EU has fallen on CO₂-intensive industries like power generation and cement. From 2008 new industries and new countries could be included. These might include curbing emissions from planes and ships, involving a fuel tax. Another option is to focus on CO₂-absorbing measures, such as halting deforestation. Agricultural soils could become a net 'carbon sink.' Farm practices that sequester carbon — no-till, vegetated buffers, withdrawal of cropland from production, reforestation, management of timberland, and abatement of methane from livestock waste — might all earn credits.

Net shortfall means prices for carbon credits should rise

Based on our projections, we believe that EU-15, Canada, and Japan are unlikely to meet their Kyoto targets. We estimate a global Kyoto gap of around 300 million tonnes per annum, or 1.5 billion tonnes for the cumulative Kyoto period for all three geographies versus 280-310 million tonnes of CERs available over the Kyoto period, given current projects underway. We look for a steady ramp-up in trading volumes of CO₂ credits to 4.8 billion tonnes in 2008, compared with around 200 million tonnes in 2005.

Nitrous oxide: a big opportunity

Why nitrous oxide is opportunity

Kyoto currently mandates six greenhouse gases: carbon dioxide (CO₂), nitrous oxide (N₂O) and hydrofluorocarbons (HFCs). CERs include all of these gases but the EU scheme covers only CO₂ (Exhibit 7).

Exhibit 7

Six Major GHG with Rising Degrees of Potency

Greenhouse Gases	GWP
Carbon dioxide (CO ₂)	1
Methane (CH ₄)	21
Nitrous oxide (N ₂ O)	310
Hydrofluorocarbons (HFCs)	140 to 11,700
Perfluorocarbons (PFCs)	6,500 to 9,200
Sulphur hexafluoride (SF ₆)	23,900

GWP = Global Warming Potential: potency of gas to contribute to global warming, measured in carbon dioxide equivalent units.

Source: IPCC, Morgan Stanley Research

The large multiplier on HFCs and N₂O, coupled with the relative ease of abatement, means that there are significant opportunities for relevant companies operating in the developing world to earn sizeable credits under the CDM scheme. Every one unit of N₂O represents 310 units of CO₂. It is harder to reduce carbon dioxide while still generating a unit of energy. There are a number of N₂O projects underway, the highest profile of which is Rhodia's (Exhibit 8).

Emissions of nitrous oxide are mainly related to the manufacture of adipic and nitric acid used in the manufacture of ammonia for fertilisers. N₂O can be easily reduced in the manufacture of ammonia by one of a number of methods. One is installing a larger burning reactor in the manufacture of nitric acid (possible on newer plants). Another possibility is the catalytic cleaning of the tail gas from the nitric acid reactor. Only a minority of nitric acid plants world-wide operate with such high tail gas temperatures (> 400°C). The third option is catalytic decomposition of N₂O in the nitric acid burner.

The EU Commission is currently looking at whether N₂O should be in the EU emission trading system from 2008 and a decision is due by end 2006. It is possible that it will opt for a compromise, going for either a state-by-state inclusion or inclusion after 2012.

Exhibit 8

N₂O Reduction Projects

	Reduction (tonnes)	Stage	Country
Abu Qir Fertilizers	1,423	PDD	Egypt
Azomures	1,428	PDD	Romania
Paulinia	5,961	Submitted	Brazil
Nanjing (NCIC)	662	PDD	China
National Fertilizers	357	PDD	India
Neochim	156	PDD	Bulgaria
Lovochemie	539	Public validation	Czech
Rhodia Onsan	6,405	Submitted	Korea
TERRA	1,295	Public validation	UK

Source: UN, Morgan Stanley Research

HFCs are the sole fluorocarbons included in the basket of six gases decided in Kyoto. Projects in this area are mainly Chinese. The largest non-Chinese project is Ineos' project in India.

Impact on Companies

We consider our coverage universe and companies that are likely to see a significant impact from the legislation (only Ineos Fluor meets this criterion).

BASF

BASF has been assigned CO₂ certificates for 3 million tonnes per year at its Ludwigshafen site. Effective January 1, 2005, approximately 100,000 metric tons CO₂/year fewer certificates were assigned for BASF's plants in Ludwigshafen as a result of applying the reduction targets via compliance factors 1 and 2. Assuming a certificate price of €10 per tonne, this will result in additional expenses of €1 million (with the actual price for certificates this will be nearly twice as high as it was in January).

BASF has invested in its own electricity generation at Ludwigshafen to protect itself from the prospect of rising electricity prices. A new CHP plant was started up in mid-2005, taking self-sufficiency on the site from 15% to 65%.

Apart from in Germany, BASF is also affected by emissions trading in Spain (Tarragona), Belgium (Antwerp and Feluy), England (Seal Sands) and Denmark (Grenaa), although allocations in these countries have been delayed.

Rhodia — the main beneficiary

Rhodia is in the positive position of having two large adipic acid N₂O abatement projects within the CDM scheme. The two projects account for a net annualised 13 million tonnes per annum of carbon credits, split between its Ulsan (South Korea) and its Paulinia (Brazil) site. Both the Ulsan and Paulinia projects have been approved by the UNFCCC board.

Exhibit 9

Rhodia: N₂O Project Timelines

Ulsan

UNFCCC Filing	Q4 2005
Construction Starts	Q1 2006
Construction Finishes	Q3 2006
Plant Starts Up	Q4 2006
First CERs	Q1 2007

Paulinia

UNFCCC Filing	Q4 2005/Q1 2006
Construction Starts	Q2 2006
Construction Finishes	Q4 2006
Plant Starts Up	Q1 2007
First CERs	Q2 2007

Source: Company data, Morgan Stanley Research

Linde

Linde is not currently involved in carbon credits. It hasn't received any and it doesn't need to purchase any as the CO₂-emission of gas plants is below the threshold of the regulations.

Yara

Yara sells 100,000 tonnes of CO₂ per year from excess emission in its ammonia plant in Sluiskil, Netherlands. The other plants included in the EU emission trading scheme from 2005 to 2007 have allowances in line with their need (Le Havre, Ambès and Ferrara).

In 2004, Yara generated 30,200 tonnes of N₂O, equal to 9.4 million tonnes of CO₂. However, at the moment the EU scheme does not cover reductions in N₂O, although the CDR programme does.

Yara has invested more than €10 million in R&D focused on CO₂ reduction since the mid-1990s. The cost of installing and operating such technologies is in the range €1-€5 per tonne of CO₂ reduced.

DSM

DSM anticipates a small tradeable carbon surplus, not material to earnings. It has no projects underway in the developing world that could lead to additional credits. The recently-announced investment in antibiotics in India is a low emissions project. The same goes for the expansion of its caprolactam plant in Nanjing, China.

Akzo Nobel

Akzo Nobel has a 200,000 tonne surplus of CO₂ credits per annum, which it has sold. Eighty percent of the credits relate to the chemicals division, and relate largely to its cogen plants.

Kemira

Carbon credits are no longer a significant issue to Kemira because it has divested businesses with significant CO₂ emissions. Kemira regards the national allocation within the EU as unfair as Finland has a big reduction target even though it is a leader in energy efficiency and biofuel use.

Degussa

Degussa has 14 facilities that are included in the emissions trading scheme, plus between five and a maximum of nine further plants affected in other European countries, depending on how the area of applicability is defined. Overall, it is anticipated that its allocated certificates will be slightly below its emissions requirements.

Lanxess

Lanxess has only two power plants in EU that are included in the Kyoto carbon credit scheme. Management anticipates that in Phase I it will be credit neutral.

Ineos Fluor (no listed equity)

Ineos Fluor's manufacturing sites, in Japan, the UK and the US, all operate abatement technology, which contains and destroys fluorocarbon by-products, reducing potential emissions. These treatment units are also capable of handling other sources of fluorocarbon compounds.

Ineos Fluor has undertaken projects in the developing world through the CDM process. In South Korea, its Ulsan CDM project was started up in May 2004, with approval from Japan in July 2003 and South Korea in July 2004. It was the first CDM project to be approved in Korea. The project was registered by the CDM Executive Board in February 2005. This decision means the emission reductions already made can be verified and Certified Emission Reductions (CERs) issued by the CDM Executive Board.

Air Liquide

Air Liquide believes that it will benefit in the future from the significant future demand for oxygen, as a means of optimising the combustion process and reducing emissions of carbon dioxide and NOx. This has long been known and has led to a revolution in the glass and steel industries. However, there is a wider range of applications for oxygen in other industries.

Bayer

Bayer sees itself as having a balanced carbon position with no significant surplus or deficit on current assumptions. This would only change if it had to increase production in excess of currently announced plans.

BOC

None of BOC's facilities are covered within the terms of the ETS. It is looking at some projects in Australia within the JI initiative for Phase II but these are small.

Ciba Specialty Chemical

Six Ciba sites are listed in the EU CO₂ trading scheme. Since Ciba is not "energy-intensive", CO₂ emission costs are negligible in comparison to energy costs. Ciba estimates that it might be short net 1,000 certificates (€20,000 at current prices). Ciba has had internal discussions on whether it should apply for CDM certificates in emerging countries since it has several projects with alternative energy sources (for example, wind power in India). So far it has not applied

because of the complexity of the procedures. However, management is looking for opportunities in Asia.

Clariant

Clariant believes that it has a balanced position with respect to carbon credits. It comments that total emissions have been reduced continuously by increasing energy efficiency of processes and through disposals.

The largest carbon emissions come from power plants at its large production sites in Germany.

No CDM projects are in discussion yet. A pilot test has started using biofuel (Bagasse) for energy production in some sites in developing countries.

Croda

Croda has four installations with Climate Change Agreements. It comments that all four installations have complied with their agreements, meeting or exceeding targets for carbon-saving and retaining the full levy rebate.

Three Croda installations are affected by the EUETS. Two have been allocated carbon allowances as recorded within the National Allocation Plan. Some installations can fall within the remit of both the UK and EU schemes and Croda continue to monitor the complex relationship between these two schemes carefully.

Installations are allowed to opt out of the first phase of the EUETS on the grounds of equivalence of effort under the UK scheme. One Croda site has exercised this option and awaits confirmation from Environment Agency.

For its two remaining installations, through business changes and carbon-saving initiatives, Croda predicts a surplus of carbon credits within the first phase of the EUETS.

All Croda manufacturing installations have attained accreditation to ISO 14001. This includes the requirement for continual environmental improvement, including energy and carbon-saving. The use of energy per tonne of manufactured product has been monitored by Croda for many years. In 2004 the group achieved an improvement in energy efficiency for the third consecutive year. The reduction in normalised energy use was 10% over the previous year, and 34% since 2000.

Croda has selected Entec to carry out a Carbon Management Study in conjunction with the Carbon Trust and its Carbon Management Programme. The raw materials used by Croda

January 24, 2006

Chemicals

are primarily obtained from sustainable sources, so, as well as looking at existing carbon management arrangements, the study will also investigate opportunities. The development of Biofuels could offer Croda an opportunity to generate carbon credits. Croda is also looking at the installation of a wind turbine to generate electricity.

ICI

ICI is not a significant producer of CO₂. Its businesses are generally very low in energy intensity. It has no projects to reduce CO₂ either.

Johnson Matthey

Johnson Matthey believes that it will have a small surplus of credits. The company was involved in an initial pilot scheme.

Lonza

We are not aware of any significant positive or negative impact on Lonza from the carbon trading regime. Lonza does not have many large-scale energy-intensive manufacturing sites aside from Valais in Switzerland. The company has not commented on its position.

Solvay

As a major manufacturer of HCFCs, Solvay should be eligible for credits under the JI and CDM schemes. We are not aware that the company has filed any schemes under either programme. The company has made no comment.

Syngenta

Syngenta is not a direct beneficiary of carbon credits. However, it can aid its customers to win credits, which could boost its sales. Farmers can adapt techniques to prevent the release of carbon dioxide. A third party can aggregate carbon credits from many farmers and then sell on credits.

Farmers can plant more (plants absorb carbon dioxide), use 'no till' techniques (leaving the soil intact reduces the chance of soil oxidation and hence reduces carbon dioxide production) and prevent soil erosion.

Syngenta's products Paraquat and Touchdown reduce the need for tillage or the hand removal of weeds. Low tillage systems should continue to grow as reduced use of machinery reduces CO₂ emissions.

Victrex

The scheme does not apply to Victrex, since Victrex's site is below the minimum energy consumption threshold of 20 MW per annum.

Yule Catto

Yule Catto believes it will have a small surplus of carbon credits with a value in the tens of thousands of pounds. It does not believe this will be material to its earnings. It says it has an action plan to keep within the limits and build up a further surplus. The company does not see this as a material issue.

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(as of December 31, 2005)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	753	36%	272	40%	36%
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Total	2,078		680		

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Industry Coverage: Chemicals

Company (Ticker)	Rating (as of)	Price (01/20/2006)
Guillermo Peigneux		
Yara ASA (YAR.OL)	U (10/26/2005)	NKr 96.25
Michael Eastwood		
Air Liquide (AIRP.PA)	U (03/18/2002)	€162.10
BASF (BASF.DE)	O (03/18/2002)	€61.93
Ciba Specialty Chemicals (CIBN.VX)	O (05/27/2005)	SFr 83.25
DSM (DSMN.AS)	E (03/18/2002)	€35.07
Linde (LING.DE)	E (09/05/2003)	€64.90
Syngenta (SYNN.VX)	O (03/18/2002)	SFr 165.90
Paul R Walsh		
BOC (BOC.L)	E (02/08/2005)	1170p
Croda (CRDA.L)	O (01/26/2005)	453p
ICI (ICI.L)	O (04/05/2005)	352p
Johnson Matthey (JMAT.L)	E (09/18/2003)	1397p
Victrex (VCT.L)	E (01/26/2005)	754p
Yule Catto (YULC.L)	O (09/12/2005)	256p
Peter D Edwards		
Akzo Nobel (AKZO.AS)	E (03/18/2002)	€38.66
Bayer AG (BAYG.DE)	O (02/01/2005)	€34.42
Clariant (CLN.VX)	E (05/20/2005)	SFr 19.00
Degussa AG (DGXG.DE)	++	€42.50
Kemira (KRA1V.HE)	U (07/09/2004)	€13.95
LANXESS (LXSG.DE)	O-V (07/27/2005)	€25.67
Lonza (LONN.VX)	U (06/23/2005)	SFr 82.50
Rhodia (RHA.PA)	O (11/28/2005)	€1.96
Solvay (SOLBT.BR)	E (09/13/2002)	€93.00

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