



Future Shock

Is business prepared for global warming?

The January 2006 AP6 climate pact focused on what industry can do to reduce its impact on global warming. But what of the impact of global warming on business, asks Richard Collins?

Business can relax about carbon now the Federal Government has cemented in a technology approach to reducing emissions, right? Well, no. While the government continues to resist either a tax or emissions trading scheme to put a price on carbon, the investment community is edging ever closer to its own valuation regime.

The debate around the “materiality” of environmental and governance issues to company valuation is not over yet, but a raft of reports last year from investment houses such as Merrill Lynch, Goldman Sachs and AMP Capital Investors underlined their growing interest in climate change.

“There is no question that 2005 will be seen as the watershed when the mainstream banking, insurance and investment worlds realised the scale of the commercial opportunities unfolding in the new carbon, clean-tech and sustainable natural resource market and, also, the legal risks of not being a leader in this area”, said Klaus Toepfer, head of the UN Environment Program. Of the suite of corporate social responsibility (CSR) issues in the mix, Phillips Fox’s Sean Lucy predicts climate change and carbon will be “the first to get monetised”.

Investors are beginning to seriously study the risks and opportunities presented by a world grappling with wilder weather shifting customer demands, rising energy costs and new regulatory responses.

“We can’t say when institutional investors will start shorting stocks because they think they are a (carbon) risk, but once one does others will quickly follow. Things could change in a week,” he said.

Australian’s public companies are, in the main, poorly placed to respond to such a challenge. AMP Capital Investors reviewed the climate change risk management strategies of the ASX 100 and called for urgent attention. Rob Bell, MD of the Australian arm of strategic value advisory firm Innovest, agrees. He told WME most well below best practice.

“Get below the top 20 and very few can give you an accurate picture about what they are spending on energy SMEs, white goods companies, manufacturers, the retail sector; they have all missed the message on carbon. A number of the larger companies have slipped under the carbon radar,” he said.

In the US, a fellow Kyoto Protocol skeptic, some leading businesses have quietly begun positioning themselves for a world after President George Bush. In December, BusinessWeek magazine reported that 24 of 30 US power company executives at a recent meeting with General Electric agreed mandatory curbs on greenhouse gases emissions were inevitable.

“If we stonewall this thing to five years out, all of a sudden the cost to us and ultimately to our consumers can be gigantic,” said James Rogers, CEO of the utility Cinergy.

Given the freewheeling nature of global capital, Australia would surely follow soon after. Analysts such as Bell and Baker and McKenzie’s Martijn Wilder warn that while others are learning the ropes of carbon management and trading – CO2 allowances worth 4.2 billion euros covering 4,000 companies changed hands last year in the EU – Australian industry remains in the slow lane.



Breaking the barriers

How close are institutional investors to making a call on carbon? Nobody is willing to take a stab. A Westpac report said most were at the “carbon price/value discovery” stage, but understanding the implications “has not yet penetrated mainstream financial analysis in a consistent manner”. Wilder, who authored a recent report with AMP Capital Investors called *A Guide for Company Analysts – Climate Change and Company Value*, said the picture in the investment sector was mixed.

“In the sale of Pacific Hydro, only two bidders valued in the carbon (credits), which the company said represented 25 per cent of the value,” he said. There are, however, early indications gearing up. In October the Institutional Investors Group on Climate Change (Australia and New Zealand) was launched, a spin off from UK partnership that aims to drive policy and awareness of carbon valuation and management.

Some of the other barriers are also starting to fall. A seminal legal brief by blue chip law firm Freshfields Bruckhaus Deringer overturned the conventional wisdom that fiduciaries cannot include CSR issues in investment decision-making. The 150-page paper, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, which includes Australian law, said “there is no duty to ‘maximise’ the return of individual investments, but instead a duty to implement an overall investment strategy that is rational and appropriate to the fund”.

Report author Paul Watchman noted: “Far from preventing the integration of (environment, social and governance) considerations, the law clearly permits and, in certain circumstances, requires that this be done.” Investment horizons and risk perspectives are also under scrutiny due to the growth of superannuation funds, the fourth largest pool of investable funds in the world. The Ethical Investment Association’s 5th Annual Benchmarking Survey found the large super funds were the single biggest driver of the 70 per cent growth in sustainable responsible investment in Australia in 2004/05 to \$7.7 billion.

“The balance of power in realigning,” said Innovest’s Bell. “So far the fund managers have been driving the super funds, most of which have been run by people from industry super backgrounds, such as teachers, with limited financial literacy. That is changing.”

No story on climate change can ignore the insurance sector, with Insurance Australia Group leading then pushing to put climate change on the public, political and business agenda. No surprise, given French insurer AXA has estimated about 20 per cent of global GDP is now affected by climatic events and says “climatic risk in numerous branches of industry is more important than the risk of interest rates or foreign exchange risk”.

Reporting and rhetoric

A further barrier that could crumble is reporting regimes, which are significantly underdeveloped in Australian companies. The Federal Government is currently pushing through the *Energy Efficiency Opportunities Bill*, which will require the country’s top 250 energy users to report on areas where they can boost energy efficiency.

And the IGCC, which represents funds of over \$155 billion through the likes of VicSuper, BT Financial Services and Babcock and Brown Environmental Investments, is coordinating the Carbon Disclosure Project survey of the carbon policies and performance of the ASX 100 and NZX 50.

However, there remains a gap between reporting carbon and actually valuing it. A WWF report out in late January said of the 39 global banks it studied, Bank of America and JP Morgan Chase were the only ones to go



beyond rhetoric in including climate change issues in their portfolio investments. The climate Change Working Group of the UNEP Finance Initiative identified four key hurdles; an unclear connection to financial performance and risk; uncertainty about the regulatory regime; limited data availability and assessment framework; and market complexity, cost and inability to confer competitive advantage.

How should companies respond?

There is no single response or template for mainstream industry as every company will be differently placed. Research by AMP Capital Investors into the potential exposure of the Australian aluminium industry to an emissions trading scheme found significantly differing risk profiles across the sector, with some companies exposed in percentage net profit terms nearly 10 times that of others.

Each company will need to develop its own strategy. BHP Billiton runs carbon pricing sensitivity analysis on all investment decisions with emissions over 100,000 tonnes of CO₂-e a year, and works up internal estimates of emissions in the use of its products to help prioritise risk areas. It surprised almost everyone last year when it undertook the first trade on the EU's emissions trading scheme and now staples credits from the scheme or the Kyoto Protocol's clean development mechanism to sales of coal into Europe. In similar vein, British Airways buys carbon credits and sells carbon-neutral tickets at a premium.

Westpac has developed a Sustainable Supply Chain Management Framework to, among other things, minimise its carbon impact and exposure upstream. It also seized an opportunity to establish the Westpac Environmental Markets Group, advising on issues such as trading Renewable Energy Certificates.

In New Zealand, retailer The Warehouse Group responded to the proposed carbon tax – which at NZ\$25 per tonne would have given it a tax bill of NZ\$675,000 for the year – by shifting transport from road to rail, introducing energy management software in its North Island distribution centre and increasing video conference. Bell says the pursuit of energy efficiency is probably the single most effective response for any company, particularly as it typically represents a bottom line saving as well.

Innovest lists eight key company specific factors to consider: greenhouse gas emissions-intensity of the sector; energy intensity, source mix and consumption patterns; compliance schedules and regulatory and tax liabilities for all production facilities; carbon intensity of product mix; "marginal abatement" cost structures; technology trajectory for a carbon constrained environment; risk management capability; and ability to identify and capture upside and revenue opportunities.

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