New book: Corporate Responses to Climate Change

January 2009

The recently published book, **Corporate Responses to Climate Change: Achieving Emissions Reductions Through Regulation, Self-regulation and Economic Incentives**, edited by Rory Sullivan, Insight's Head of Responsible Investment, examines current business practice and performance on climate change, in the light of the dramatic changes in the regulatory and policy environment over the last five years. The book focuses particular attention on the drivers for action, with a series of case studies analysing how regulation, corporate self-regulation, non-governmental organisation campaigns and stakeholder expectations have influenced corporate action on climate change. This article presents some of the key findings from the book and canvasses the implications for Insight's work on climate change.

The state of play

Research published earlier this year by Insight Investment (see our report **Taking the Temperature**) suggested that most large European companies have established the governance and management systems they need to manage their greenhouse gas emissions. Despite this progress, relatively little attention seems to have been paid to the implications of climate change for corporate strategy. For example, our research indicated that, with the exception of a few leadership companies, most companies expect their total greenhouse gas emissions to increase, and the vast majority of companies perceive climate change as having minimal impact on their business models. Our research suggested that very few companies are searching for 'transformational initiatives' that will allow them to deliver step change reductions in their own greenhouse gas emissions or in the emissions associated with their supply chains.

What are the drivers for action?

Various factors – cost reductions (e.g. energy, transport, waste disposal, raw materials), new business opportunities (e.g. innovation), improved brand and reputation, and stakeholder pressures (from investors, NGOs, employees, etc.) – have encouraged companies to take action to reduce their greenhouse gas emissions. However, the clear message from the case studies presented in the book is that regulation has been the single most important driver for action. The EU Emissions Trading Scheme (EU ETS), in particular, has played a catalytic role in putting climate change on the corporate agenda. The EU ETS has demonstrated that – notwithstanding the over-allocation of greenhouse gas emissions in Phase 1 of the scheme that saw the carbon price drop to virtually zero – governments are prepared to take decisive action to reduce greenhouse gas emissions across the economy, and that European policymakers will countenance

a carbon price of at least 30 €/tonne with some degree of equanimity. Yet, despite the EU ETS and the variety of other policy measures (in areas such as renewable energy and energy efficiency) that have been adopted, it is clear that the policy measures to date have not been sufficient to stimulate the step changes required in corporate performance if we are to move to a 'low carbon' economy.

There are a number of points to note in this regard. First, there are many gaps in the existing climate change policy framework. As the case studies in the book – which cover sectors from electricity generation to transport to financial services – evidence, emissions trading clearly cannot address all greenhouse gas emissions or motivate all companies to take action. An effective policy response to climate change will require the deployment of a range of policy instruments (command and control instruments such as product standards, taxes and other economic instruments, information-based approaches such as product labelling and voluntary approaches), targeted at specific sectors and focusing on different corporate motivations. The development of a comprehensive suite of policy instruments and policy approaches is, as yet, still in its early stages.

Second, even in sectors such as power generation, emissions trading is not a panacea. Ultimately, the effectiveness of emissions trading (in terms of the reduction in greenhouse gas emissions achieved) depends on the cap that is set and the amount of emissions reductions that are to be delivered through offsetting as opposed to direct emissions reductions actions. However, the existence of a price signal and a cap is not enough. Factors such as the duration of the price signal and policy certainty (discussed further below) are of critical importance. In relation to duration, many companies have decided to wait and see how climate change policy evolves before committing large amounts of capital to new projects.

Furthermore, while the case for using market-based instruments is well known and increasingly accepted by governments, such instruments are typically effective over the medium to long term; in the short term, demand for greenhouse gas emitting activities such as electricity generation and transport tends to be relatively inelastic, with supply linked to sunk capital costs in existing infrastructure.

Third, the policy and market conditions faced by firms remain highly complex and uncertain. The uncertainties in climate change policy include the level of government support for action on climate change, in particular given concerns about energy security and wider industrial competitiveness, the targets that are to be met and how these are to be allocated between firms, the policy instruments that are used, and the duration of climate change policy instruments. One of the most important conclusions from this book is that in the face of policy uncertainty, companies prefer to wait for clarity. The reality is that reducing emissions is likely to require significant irreversible investment by the private sector and the profitability of such investments is highly sensitive to climate change policy. Whether firms will invest depends on whether they will take governments at their word; faced with the political demands of elections will governments renege on their promises to maintain carbon taxes or EU ETS, or will they maintain commitments to limit the number of permits allocated under emissions trading schemes? The recent debates within the EU (where significant concessions were granted to Eastern European power generators and to heavy industry) and the relative lack of progress at the United Nations Climate Change Conference in Poznań in December 2008 demonstrate the challenges faced by governments of trying to maintain progress on this agenda while responding to changing economic conditions and protecting national interests.

Taking policy forward

There are no 'silver bullets' for the issues described above. The book, building on previous work conducted by Insight on policy uncertainty and investment decision making (**click here to view**) proposes a series of recommendations to policymakers to address the problems around policy uncertainty, suggesting that policymakers need to:

- **Avoid policy disconnects.** Perhaps the most critical need is to avoid a post-2012 hiatus in the international policy framework, i.e. by ensuring that some form of successor agreement to the Kyoto Protocol is negotiated and agreed as a priority.
- **Make it clear that emissions trading is an integral part of the policy framework for responding to climate change.** This will involve taking action to ensure the carbon markets and associated processes such as the Clean Development Mechanism continue to function, even if a formal international agreement has not been concluded.
- **Clearly communicate the post-2012 ambition even if the policy mechanisms remain unclear.** This should include the establishment of clear national and international greenhouse gas emission targets for 2020, as the EU has done, since a 10-15 year time horizon is the key timeframe in terms of companies' investment decision-making (in particular for large capital expenditures).
- **Explicitly consider competitiveness issues as an integral part of the design and implementation of these policy measures.** This will involve accepting that action on climate change will probably cost money, at least over the short and medium-term, and being clear about who will bear these costs.
- **Be clear about what other policy trade-offs need to be made.** For example, how will the goals of energy security (which may see coal as a key part of the solution) be reconciled with the need to significantly reduce greenhouse gas emissions? As another example, if the aviation sector is to

grow, does this mean that other sectors of the economy will need to deliver even greater reductions in emissions?

Finally, in order to compensate for policy risk, policymakers need to recognise that in order to incentivise investment in low emission technologies, the cost of emitting greenhouse gases may need to be substantially higher than expected under a normal discounted cash-flow analysis. A specific issue is that the EU ETS, on its own, is unlikely to stimulate major investments in lower CO_2 emitting forms of power generation unless prices move up significantly from the level of around €15/tonne of CO_2 prevailing in the markets in early 2009. The EU's proposals that some of the revenues raised from the EU ETS be explicitly allocated carbon capture and storage projects is (notwithstanding concerns about the adequacy of these funds) is an illustration of the approach that will be required.

Insight's priorities for 2009

In many ways, the material presented in the book is extremely encouraging: it demonstrates the significant actions that have been taken by companies to reduce their greenhouse gas emissions, and it provides important insights into the manner in which public policy needs to be designed to enable and encourage companies to make a substantive contribution to responding to climate change.

For Insight, the evidence presented in the book reinforces our belief that there is much more that needs to be done. We intend to maintain our focus on climate change as a key priority for 2009. We will be focusing our efforts in three areas:

- **Investment research:** The change in the US administration, as well as the continued appetite of governments in Europe, Australia and, increasingly, other countries (developed and developing) for policy action on climate change mean that climate change policy/regulation will continue to be a key driver of investment value, from both a risk (downside) and an opportunity (upside) perspective. We expect that the impacts of policy will become increasingly evident in sectors outside the 'usual suspects' of the electricity, renewable energy and heavy industrial sectors. We will also continue our **wider work on assessing the investment implications of adapting to climate change** and incorporating these findings into our investment analysis.
- **Engagement**: We will continue to engage with companies, in particular those with a significant regulatory exposure, to encourage them to adopt appropriate governance and management systems, to report on their greenhouse gas emissions performance and, most significantly, to set and deliver on greenhouse gas emission reduction targets.
- **Public policy**: In our view, 2009 – in particular, the United Nations Climate Change Conference to be held in Copenhagen at the end of the year – is a key year in the climate change policy debate. We are optimistic that by the end of the year we will have at least some clarity on the shape of the international framework that will succeed the Kyoto Protocol. We believe that investors have a critical role to play both in supporting policymakers as they seek to take effective action on climate change, and also in helping policymakers to design and implement measures that are economically efficient and that appropriate incentivise the large scale investments necessary to deliver the low carbon economy. We, therefore, intend to maintain our leading role in the public policy engagement activities of the Institutional Investors Group on Climate Change as the central aspect of our work in this area.

Produced by the Insight Responsible Investment Team

Web: http://www.insightinvestment.com/uk/responsibleinvestment/
Tel: 020 7321 1162

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06400-02-09