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What does the Paris climate change deal mean to investors?

ESG update

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"The impacts on Australia from the Paris agreement might be a) policy changes and b) change in demand for Australia's fossil fuel resources"

Overview

The 2015 UN Climate Change Conference was recently held in Paris and a global agreement was reached. The Agreement, which is expected to take effect in 2020, is the first comprehensive universal agreement (the previous treatment from 1997 only included developed countries including some that subsequently backed out) and it was approved by representatives of 195 countries which represent over 90% of the global greenhouse gas (GHG) emissions.

The key elements of the Agreement are:

- A target to keep global warming at 2 degrees celsius over pre-industrial revolution levels, alongside an aspirational goal to keep the temperature rises to 1.5 degrees.
- A goal of a CO2-neutral world sometime after 2050, but before 2100 – a long-term goal to peak GHG emissions as soon as possible.
- A commitment to review actions every five years, starting in 2023.

Global challenges

Given the ambitious timetable required for GHG emissions reductions, a key challenge remains to generate electricity to the approximately one billion people in the world that are currently without electricity without increasing GHG emissions. This means a long-term challenge for the viability of thermal coal.

According to the US National Oceanic and Atmospheric Administration, the average concentration of carbon dioxide in the atmosphere is currently 42% higher than it was before the industrial revolution. Also, the Intergovernmental Panel on Climate Change estimates that we have already burned half to two-thirds of the fossil fuel that can be used before it becomes very challenging to keep global warming below the 2-degrees target.[1]

What does it mean for Australia?

Under the current climate change policies, Australia has pledged to reduce GHG emissions by 26-28% by 2030 (on 2005 levels). However, even if this was met, Australia's GHG emissions per capita would remain relatively high compared to other G20 countries. Also, this objective is not particularly meaningful as it does not necessarily equate to a fall in actual GHG emissions (rather, it may relate to accounting changes related to carbon credits from the old Kyoto agreement).
The impacts on Australia from the Paris Agreement might be a) policy changes and b) change in demand for Australia's fossil fuel resources.

In regards to policy changes, the Agreement gives Australia increased flexibility, although at this point in time, it is difficult to forecast the specifics of such changes. We do not believe there will be any major policy changes before the next federal election. And, the impact from policy changes will depend on the fine print, as was the case with the 'carbon tax'. Nevertheless, two scenarios could be:

- Keep, but alter the incumbent 'Direct Action' policy? The policy includes an Emissions Reduction Fund to buy emissions through a reverse auction process on a voluntary basis. While Australia has a 26-28% target, there are few details on how this should be achieved and it could be challenging to achieve the target under the current policy mechanisms

or

- Move to a market-based mechanism? The world already has a number of emissions trading schemes on a national or regional basis, such as the EU and there are plans for additional schemes in the near future, e.g. in China. Australia's PM, Malcolm Turnbull has supported a market-based mechanism in the past and could be open to support such a move after 2017. In addition, Australia's Foreign Minister Julie Bishop has announced that Australia has signed up to the 'Paris Ministerial Declaration on Carbon Markets', which is designed to provide clarity on trading of international carbon credits after 2020.

What it does mean for investors?

In short, it is very early days, there is significant political uncertainty and, therefore, there are limited short-term impacts. However, the likely medium term impacts include:

- Policy changes that puts emission constraints on Australian industry. It is difficult to see significant emissions reductions without a change.
- Australia's electricity production will likely change due to a combination of policy changes and technology change, with potentially more government support for renewable energy and more pressure to close down coal-fired power stations.
- The demand for Australia's exports will likely change as the world cuts down on coal-fired electricity generation. The change will likely hit Australia's export of thermal coal harder than e.g. metallurgical coal, for which there are hardly any alternatives in steel production.
- Long-term investors, including super funds, will likely stress-test their portfolio against the 2-degree scenario and will try to reduce their carbon exposure over time.
- Banks might be reconsidering financing emissions-intensive industries (and refinancing loans could become more expensive).
- The policy includes an Emissions Reduction Fund to buy emissions through a reverse auction process on a voluntary basis. While Australia has a 26-28% target, there are few details on how this should be achieved and it could be challenging to achieve the target under the current policy mechanisms.

References

1. Climate Council, 2014. "Unpacking the IPCC Fifth Assessment Synthesis Report." Online, https://www.climatecouncil.org.au/ipccar5synthesisreport [Viewed 15 December 2015]

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