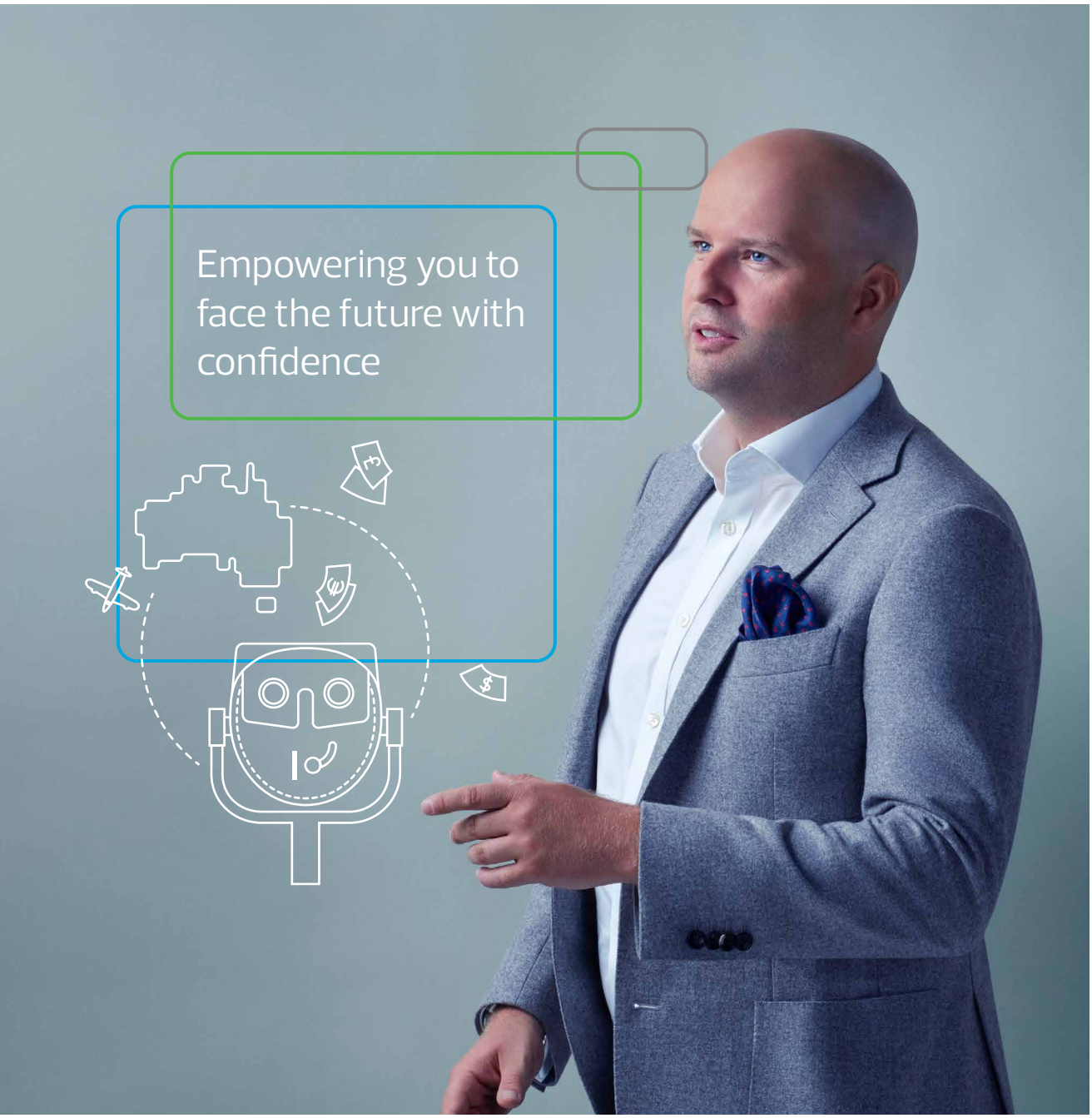
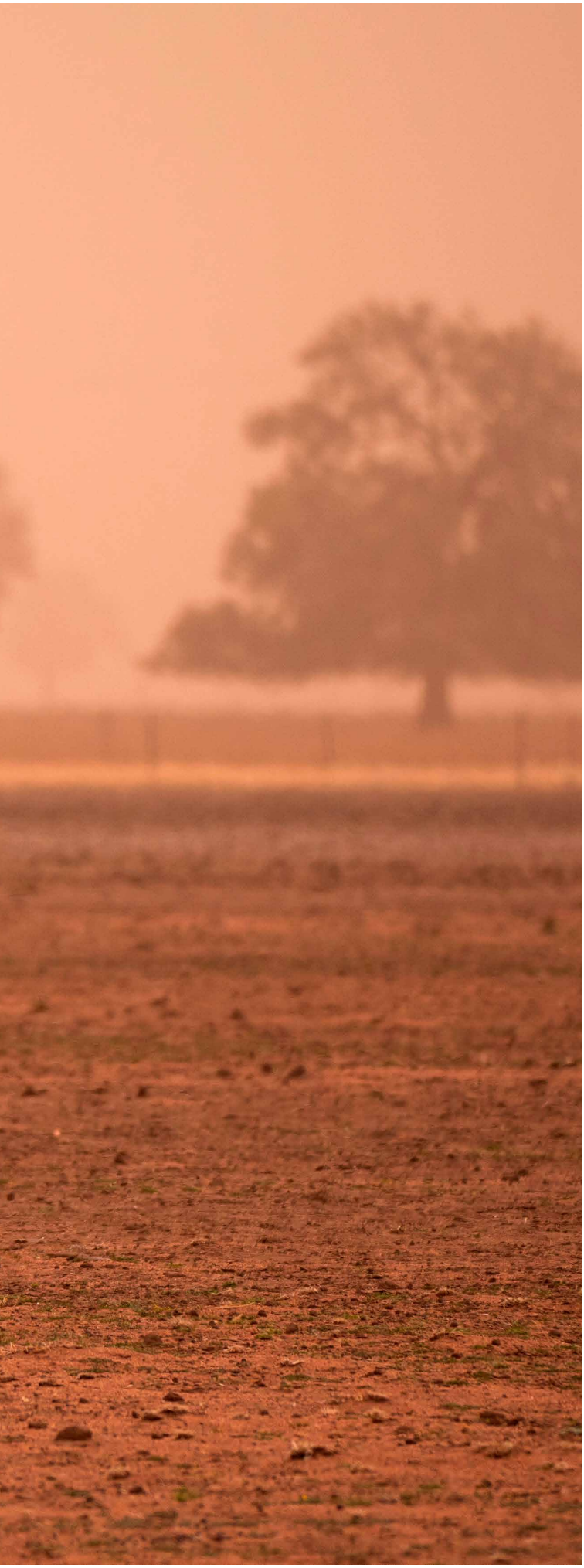


COP25 AND THE IMPLICATIONS FOR AUSTRALIAN BUSINESS

Objectives, outcome and implications of the COP25 agreement due to take effect in 2020

Climate change is fast becoming a central focus of international trade partnerships. There is a rising risk that countries will start taxing goods and services from countries which do not have a carbon pricing plan in place.



OVERVIEW

The 25th annual United Nations Framework Convention on Climate Change (UNFCCC) Conference of the Parties (COP25) took place in Madrid on 2–13 December 2019.

COP is central to the Paris Agreement target to limit the increase in the global average temperature to well below 2°C above pre-industrial levels and to limit the temperature increase to 1.5°C above pre-industrial levels.

With the Paris Agreement due to take effect in 2020 and the UN Emissions Gap Report 2019 warning that efforts to halt climate change have been inadequate so far, COP25 provided a rapidly-closing window of opportunity to galvanise the world into action.

COP25 OBJECTIVES

COP25 highlighted the global need to ramp up national targets to cut emissions at least 50% lower than under Paris Agreement pledges by 2030 before global warming passes the point of no return.

To help this, the meeting aimed to:

- incentivise countries to set tougher new and updated five-year national emission reduction plans, known as Nationally Determined Contributions (NDCs), for the 2020-25 period
- finalise Article 6 of the Paris Agreement – the so-called 'Paris Rulebook' – to establish credible, global rules around international carbon trading and green finance. Done effectively, these could help countries reduce the overall cost of meeting their NDCs through voluntary international cooperation

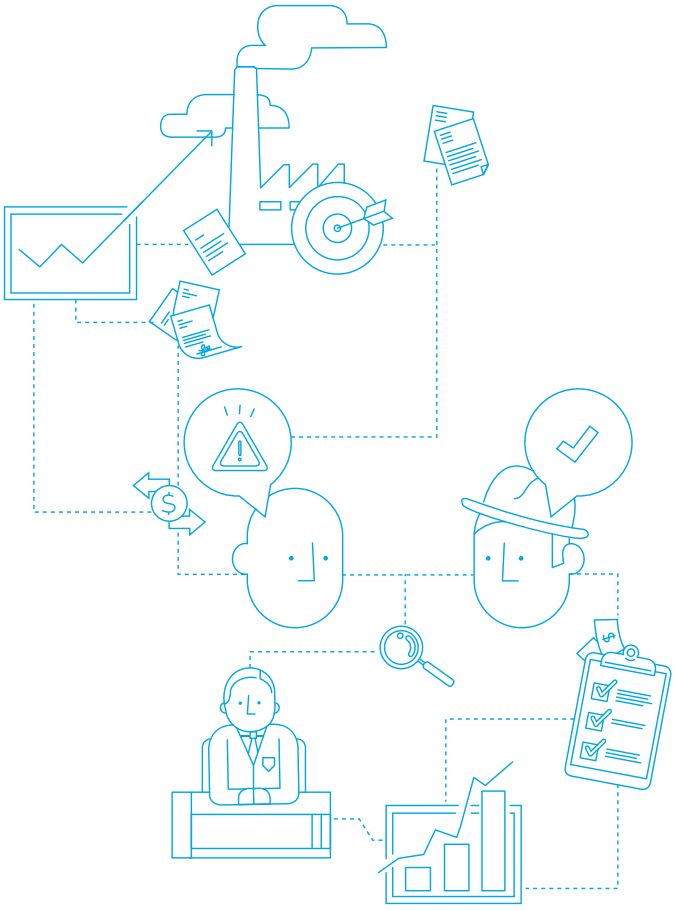
OUTCOME

While the majority of COP nations recognise the need to scale up their NDC targets, they refrained from signing off on Article 6 at COP25, an outcome the ICC said "fails to match the ambitions of business and other stakeholders".

This was because nations were reluctant to allow big-emitters Australia, Brazil and India to 'carry over' surplus carbon credits and quotas from the Kyoto Protocol (which ends in 2020) into the Paris Agreement (which takes force this year).

If Australia is allowed to carry over its Kyoto credits – mostly earned by counting earlier savings from reduced land clearing – it will be able to achieve more than half of its already-soft Paris Agreement target to cut emissions by 26-28% on 2005 levels by 2030 without having to make any further material reductions in emissions.

Rather than accept this arrangement, COP25 nations opted instead to push for resolution on Article 6 at COP26 which will be held in Glasgow, United Kingdom from 9-20 November 2020.



IMPLICATIONS

Despite Article 6 not being finalised, progress was made at COP25 in other areas. In particular, the UNFCCC noted that the meeting "succeeded in taking forward" crucial climate action work. This includes progress in areas such as adaptation, response, finance, climate action transparency, forests and agriculture, technology, capacity building, loss and damage, indigenous peoples, cities, oceans and gender.

COP25 also showcased the wealth of climate action being undertaken by non-Party stakeholders and provided the opportunity for a host of business groups, activists and communities to underscore their support for global efforts to cut emissions in order to limit global warming. Standout announcements included:

- The European Commission's unveiling of its European Green Deal which includes determining by COP26 how the European Union plans to achieve net zero emissions
- Science Based Targets initiative (SBTi) announcing that 285 companies have now set climate targets aligned with the Paris Agreement and will target net-zero emissions by no later than 2050. To date, 19 Australian companies have signed up to SBTi including Origin Energy, Westpac, Bank Australia, Mahindra Automotive and Frasers Property
- Australia announcing its membership of the Leadership Group for Industry Transition which is helping heavy industries such as steel, cement, aluminium, aviation and shipping find a workable pathway to deliver on the Paris Agreement

OUTLOOK FOR AUSTRALIA

With time running out to halt significant global warming – and increasingly visible signs of the physical impacts of climate change on the nation and its economy – 2020 is set to be a pivotal year for Australian policy and business:

- Australia has until August 2020 to submit its revised NDC for the 2020-25 period to the UNFCCC Secretariat. It is hoped this will set far tougher targets for national emissions reductions than in the past
- During 2020, the Federal government has promised to review its Emissions Reduction Fund and also the Safeguard Mechanism. The latter covers over 250 carbon emitters and has the potential to evolve into a baseline and credit scheme, providing business with incentivises to invest in clean technologies
- By end-2020, the Federal government has pledged to develop a long-term national strategy for reducing emissions to net zero by 2050, a target endorsed by leading Australian businesses, state and territory governments.

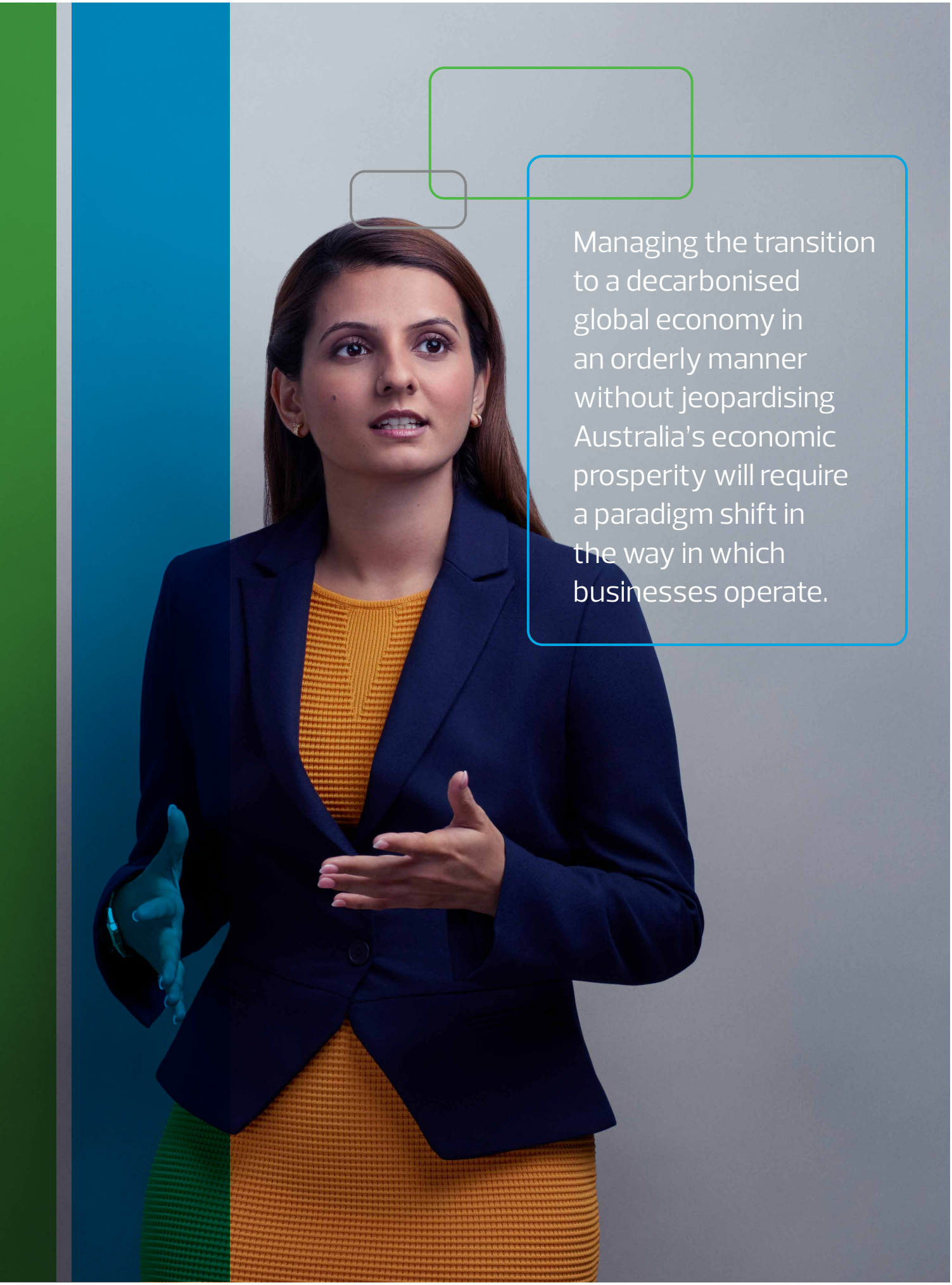
IMPACTS ON BUSINESS

The Australian economy is heavily reliant upon export revenue from energy-intensive, high-emitting industries such as coal, iron, aluminium and copper ores and concentrates, liquefied natural gas (LNG), gold, wheat, wool and beef.

While the transition to a decarbonised economy presents a particular challenge to such industries, buyers are already shifting their stance and there is a major risk that Australia will be left behind if it does not jump on board.

While there are undoubtedly costs and losses to be incurred in the energy transition, the costs of inaction on climate change vastly exceed the costs of action. Professor Ross Garnaut has noted that Australia's reliance on carryover credits to meet its international emissions reduction pledge will ultimately cost the Australian economy more than taking decisive climate action. The later action is taken, the costlier it will be for business, governments and society to achieve net zero emissions by 2050.

There are also substantial economic and development benefits to be gained from early and bold climate action. According to the UN's Intergovernmental Panel on Climate Change (IPCC), a fivefold investment in low-carbon energy technologies and energy efficiency will be needed by 2050 compared to 2015 levels if the 1.5C goal is to be met.

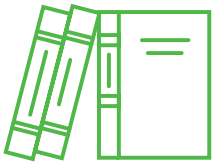


Managing the transition to a decarbonised global economy in an orderly manner without jeopardising Australia's economic prosperity will require a paradigm shift in the way in which businesses operate.

RISKS FOR AUSTRALIAN BUSINESS

FINANCING

Climate risk is galvanising lenders, insurers, pension funds and investors to ensure they are not exposed to stranded assets. Failure to act on climate risk and the energy transition could lead to an exodus of capital from high-emitting industries.



Learning

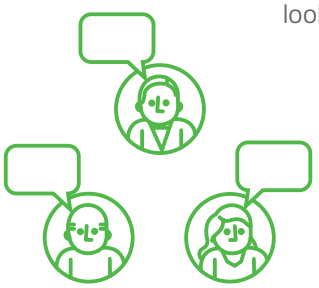
Locking Australian companies out of carbon trading learning is a significant disadvantage ahead of the emergence of a global emissions trading market. Being unable to trade carbon internationally reduces cooperative, cost-effective opportunities for pricing, trading and mitigating emissions by business.

brand

The reputation and actions of a business around climate change and emissions reduction is becoming a defining factor for customers and investors, with the potential to erode or add to brand value.

trade

Australia may end up at the back of the pack when it comes to negotiating favourable trade deals as major jurisdictions such as the EU, UK and China look to impose a carbon border tax on imports.



CUSTOMERS

The global, customer-driven push to develop a full inventory of product lifecycle emissions (Scope 1/2/3) means companies must focus their efforts across the entire supply chain for the best GHG reduction opportunities. Not doing this could see Australian products shunned by buyers.

Compliance

With emission mitigation and reduction efforts underway at a sub-national level, companies must increasingly navigate multi-layered regulations, adding to time and cost.

It is a matter of time before capital markets respond to the perceived or actual risk of investing in companies without credible plans for transitioning to a decarbonised economy. This could lead to a redistribution of capital – regardless of whether or not politicians are on board.

IMPLICATIONS

The delay in finalising Article 6 means another year has been lost in establishing credible, cooperative and global rules for carbon trading in markets central to Australian export industries.

While this appears to give Australia more time to prepare, it hinders business from early participation in global transition initiatives. In particular, it delays full and timely learning opportunities which ratchets up the **liability, litigation risk and cost** to Australian business.

This is why Article 6 has been backed by a number of Australian industry groups as "essential for the journey to and destination of net-zero emissions" because it provides an opportunity through **rules-based collaboration** to reduce the **cost** of transitioning to a low carbon global economy.

Trade risk

Climate change is fast becoming a central focus of international trade partnerships. This means there is a rising risk that countries or trading zones will start imposing sanctions or a border tax on goods or services coming from countries which do not have a carbon pricing plan in place.

This could negatively impact Australian exports from as early as 2021, exposing exporters to higher costs and making them uncompetitive compared to alternative suppliers.

Recent examples include:

- The World Trade Organisation floating the idea of taking "the design of climate change programmes and the pursuit of international cooperation in this field" into consideration when applying WTO rules
- The European Commission's European Green Deal which includes the ambition by 2021 to introduce a "proposal for a carbon border adjustment mechanism for selected sectors"
- The United Kingdom has outlined its ambition to achieve net zero greenhouse gas emissions by 2050, a factor which could impact Australian trade relations post-Brexit
- China is expected to announce more ambitious carbon plans this year with rumours that it may sign a trade deal with the EU

Similar efforts are under consideration across Asia – Australia's primary trading zone - and will likely gain in momentum as the urgency to cut emissions and limit global warming gathers pace. This ratchets up the risk for Australian exporters of coal, gold, ores and concentrates, lead and other commodities into its leading export markets.

Climate risk

There are significant implications for the financial sector from the physical and transitional risk associated with climate change, especially in Australia where some of the largest listed entitles are energy-intensive, high emitters.

Lenders, investors, insurance and superfunds are heavily exposed to the risk of investing in assets which may prove to be unsuitable for decarbonised future. As a result, they are stepping up scrutiny on individual sectors and companies to ascertain their exposure to climate change.

Driving this are recommendations on climate risk disclosure from the G20 Financial Stability Board's Task Force on

The concern and urgency around the risk of lending to, insuring and investing in what could become stranded assets is gaining pace in Australia as regulators and others grapple with the implications of climate risk on global capital markets.

Climate-Related Financial Disclosures (TCFD) and evolving guidance from the Reserve Bank of Australia, the Australian Securities & Investments Commission (ASIC), and the Australian Prudential Regulation Authority (APRA).

ESG risk

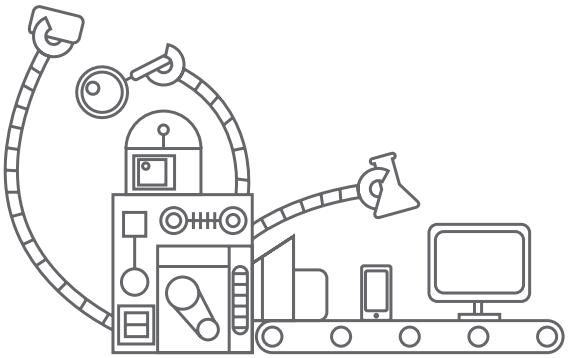
Environmental, Social and Governance (ESG) is now front-of-mind at corporate rating agencies such as Moody's and S&P Global Ratings which are also increasingly looking at the sovereign risk implications of climate change.

Public pressure on companies is also stepping up with implications for products, services, supply chains and brand value. Further scrutiny can be expected in 2020 from the Australian Centre for Corporate Responsibility (ACCR), the Investor Group on Climate Change (IGCC), the UN Principles for Responsible Investment (UNPRI), Responsible Investment Association Australasia (RIAA), Market Forces and others.

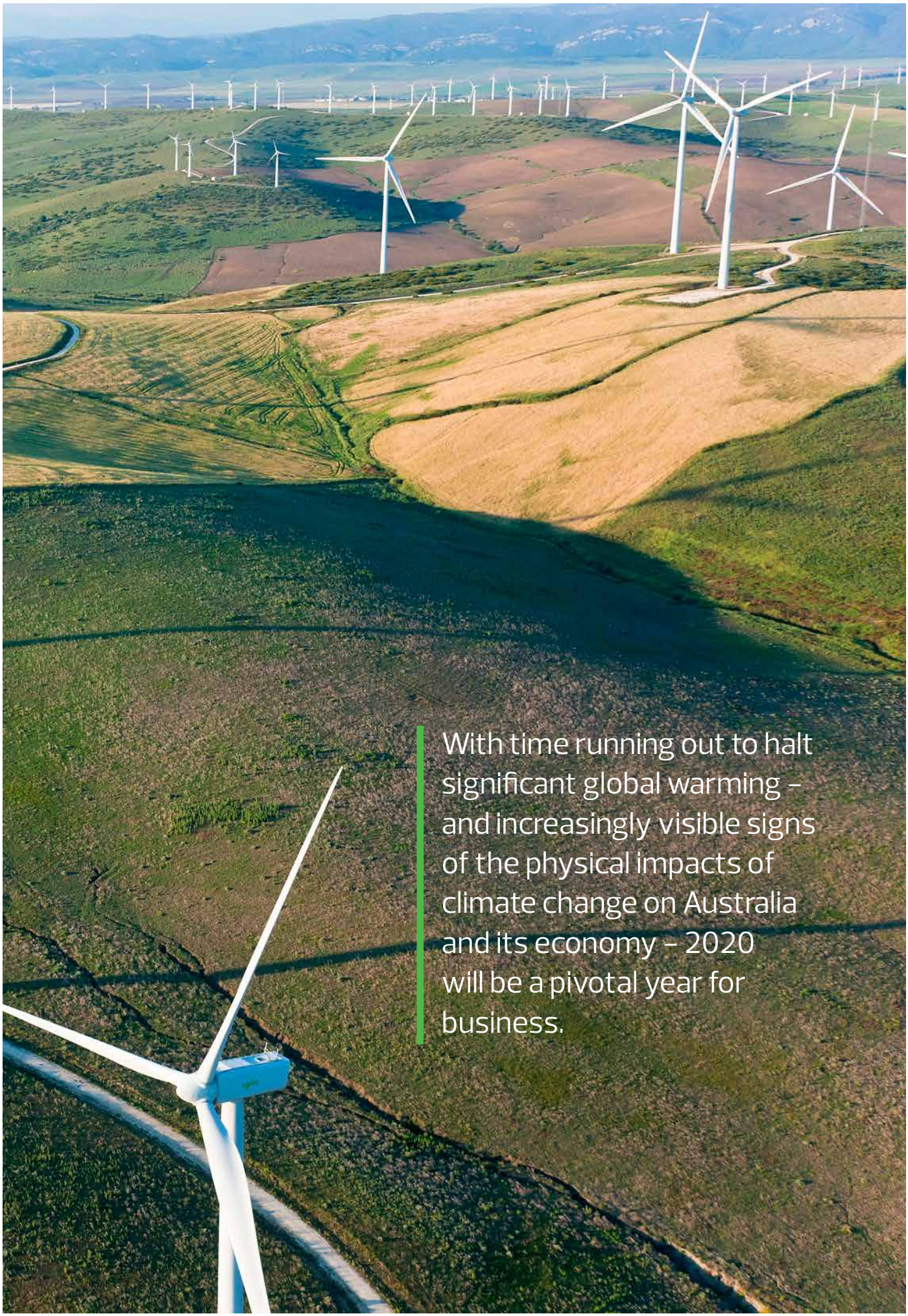
As UN Global Compact Network Australia has noted, "shareholders, investors and the broader community increasingly expect companies to not just provide goods and services and deliver strong economic returns, but to also take responsibility for the social and environmental implications of their actions".

An added risk is direct litigation regarding a failure of directors' duties around climate risk disclosure. Former High Court judge and royal commissioner Kenneth Hayne has previously warned that directors of companies could end up in court if they do not properly deal with climate risk.

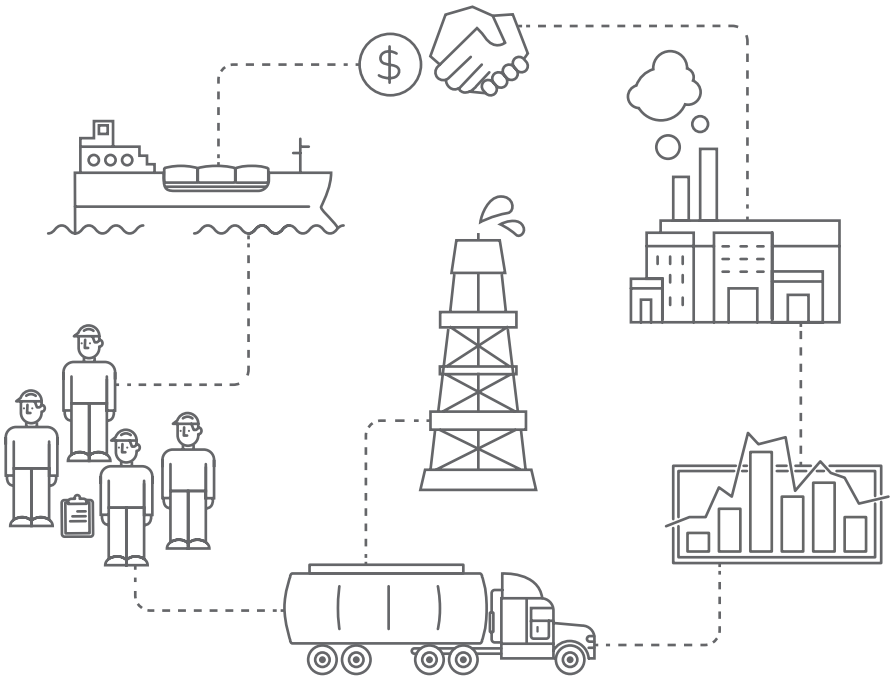
Underway this year, Mark McVeigh v Retail Employees Superannuation Trust (REST) could set a legal precedent as to how pension funds manage climate change-related financial risks.



Australia has not yet witnessed an exodus of capital from high-emitting sectors but the growth and interest in new technologies suited to net zero 2050 means this is likely inevitable as the global urgency to cut emissions intensifies.



With time running out to halt significant global warming – and increasingly visible signs of the physical impacts of climate change on Australia and its economy – 2020 will be a pivotal year for business.



CONCLUDING REMARKS

Ultimately, it is in the long term interests of Australian business to intimately participate in shaping and defining initiatives that help individually and collectively reduce emissions and limit global warming.

This requires early involvement in central mechanisms such as carbon trading which will enable businesses to trade offset emissions, leading on domestic emissions reduction policies through a scaled-up 2020-25 NDC.

Signalling to the international community that Australia will take the lead internationally to shape the transformation process is crucial. Not doing so risks negatively impacting Australia's standing in the international community which could ultimately cost business dear.

HOW RSM CAN ASSIST

RSM has the skills, knowledge and experience to support organisations in identifying and measuring the impact of climate risks, both in terms of financial reporting and on operational activities. Combined with our expertise in risk management, our dedicated Climate Change and Sustainability team are well versed in providing support to clients on mitigation, adaptation, and resilience building.

For more information, please visit this link.

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