ESG INSIGHTS: TYNDALL'S REVIEW OF CARBON REGULATION.

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At Tyndall, our research is focused on discovering the long-term value of the companies we cover. Specifically, we look to forecast the cashflows from those companies and assess the sustainability and risk of those cashflows.

When it comes to companies with high carbon emissions there is a likelihood that regulation will lead to higher costs. To narrow down the impact of these costs, we make assumptions regarding future regulation. This paper outlines the direction regulators and countries are moving in, and how Tyndall is responding.

Climate regulation in Australia

While Australia is in line with other regions in its commitment to the Paris Agreement, in other areas Australia either lags or has less onerous requirements. While the industrial mix in Australia is markedly different from those other regions, rising political pressure will likely lead to moves by the government to close the gap.

A TIMELINE OF AUSTRALIAN CLIMATE REGULATION

Nov 2014

Australia's primary emission reduction policy came into force via the Carbon Farming Initiative Amendment Bill 2014, which established the Emissions Reduction Fund (ERF). The ERF is a voluntary scheme that aims to provide incentives for a range of organisations and individuals to adopt new practices and technologies to reduce their emissions. It offers Australian carbon credit units (ACCUs) to eligible activities, with one ACCU earned for each tonne of carbon dioxide equivalent (tCO2-e) stored or avoided. ACCUs can be sold to generate income, either to the government through a carbon abatement contract, or in the secondary market. This legislation followed the July 2014 repeal of the Carbon Price Mechanism. Eight 'carbon tax repeal' bills were passed by the Senate, making Australia the world's first nation to reverse action on climate change.

May 2015

The Renewable Energy (Electricity) Amendment Bill 2015 came into effect. This bill reduced the large-scale Renewable Energy Target from 41,000 GWh to 33,000 GWh of additional renewable electricity generation by 2020 (or 23.5% of the estimated electricity generation for 2020), with this level to be maintained until 2030 once achieved.

Aug 2015

Post-2020 emission reduction targets were announced: to reduce greenhouse gas emissions by 26-28% below 2005 levels by 2030.

Sep 2015

The 2030 Agenda for Sustainable Development was adopted by all United Nations Member States. i.e., the 17 Sustainable Development Goals (SDGs).

Oct 2015

The government announced a temperature commitment to keep global warming to 2 degrees Celsius compared to pre-industrial levels.

Dec 2015

The government announced a target of net zero emissions by 2100.

Apr 2016

Australia signs the Paris Agreement, a legally binding international treaty on climate change to limit global warming to well below 2 degrees Celsius compared to pre-industrial levels (but preferably to 1.5 degrees). The 194 signatory countries aim to reach global peaking of greenhouse gas emissions as soon as possible to achieve climate-neutrality by mid-century.

Jul 2016

The safeguard mechanism, part of the ERF, came into effect. This mechanism placed a legislated obligation on Australia's largest greenhouse gas emitters to keep net emissions below their emissions limit (or baseline). The safeguard mechanism operates under the framework of the National Greenhouse and Energy Reporting Scheme and applies to facilities with direct scope 1 emissions of more than 100,000 tonnes of carbon dioxide equivalent (tCO2-e) per annum. It mostly impacts mining, oil and gas extractors, manufacturers, electricity generators and the waste industry, covering approximately half of Australia's emissions. Safeguard facilities will be able to surrender ACCUs to offset emissions over their baseline.

The National Greenhouse and Energy Reporting (NGER) Scheme was established by the National Greenhouse and Energy Reporting Act 2007 (NGER Act). This is a single national framework for reporting and disseminating company information about greenhouse gas emissions, energy production, energy consumption and other information.

Nov 2016

The Paris Agreement became effective and was ratified in Australia.

Feb 2019

The ERF is rebadged as the Climate Solutions Fund, as part of the 'Climate Solutions Package'. This package provides an additional $2 billion over 15 years for carbon abatement programs, using the same process as the ERF.

Mar 2019

The safeguard mechanism is amended. Among other changes, the amendments simplify the process of allowing facilities to increase emissions in line with production.

Oct 2021

The Australian government commits to Net Zero emissions by 2050.

Jun 2022

The greenhouse gas emissions target for 2030 is increased from a 26-28% reduction to a 43% reduction (from 2005 levels).

Global comparisons of emissions targets

In the US, the target to reduce emissions by 26-28% by 2025 from 2005 levels was announced in Mar 2015. This appears to have influenced the Australian target, which was for an identical reduction but with a later (2030) target date.

In April 2021, the US Government announced an emissions reduction target of 50-52% by 2030 (from 2005 levels). This is still more ambitious than the 43% target recently set by Australia.

In Europe, the current emissions target is for a 55% reduction from 1990 levels by 2030, or 51% from 2005. The UK has a 68% reduction target for 2030, from its 1990 base, equivalent to a 63% reduction from 2005. Again, these targets are greater than Australia's, but it could be argued they reflect the different industrial mix.

Australia's 43% reduction target was adopted with broad political support. While further reductions might be possible, the current carbon-intensive nature of Australia's power generation means that higher reduction targets may not be achievable.

Comparison of carbon markets

The Australian carbon credits scheme is voluntary, with demand driven by a corporate's own emission reduction targets. In the UK and the EU, a "cap and trade" system is used, whereby there is an absolute limit on greenhouse gas emissions for entities covered by the system. This cap is reduced over time to reduce total emissions. Within the system, carbon credits can be traded, allowing emissions reduction to be achieved by the lowest-cost alternative. The carbon credit price-setting mechanism also encourages investment in emission-reducing technology.

In the US there is a mixture of approaches, with government-imposed emission limits and cap and trade programs in states such as California, and voluntary or incentive-based markets in some other states.

Under a Labour government, it is increasingly likely that a more substantive approach will be introduced in Australia to reduce greenhouse gas emissions. This would permit closer management of total greenhouse gas emissions and provide a clearer signal of the cost of carbon emissions.

Reporting requirements

In Australia, Task Force on Climate-Related Financial Disclosures (TCFD) is presently not mandatory. However, Chris Bowen (Minister for Industry, Energy and Emissions Reduction of Australia) recently confirmed that climate reporting would become mandatory. Although further details have not yet been provided, since reporting requirements in other regions are higher, it is expected that reporting requirements in Australia will increase over time, including a requirement to report scope 3 emissions.

In contrast, in the UK TCFD was mandatory from April 2022 for the largest 1,300 firms. In Europe, the CSRD (Corporate Sustainability Reporting Directive) will come into effect in 2023. This includes TCFD reporting and broader sustainability disclosures, covering approximately 11,700 large companies including listed companies, banks, insurance companies and designated public interest entities.

In the US, the Securities Exchange Commission has proposed detailed climate reporting (the proposal is currently open for comment) including material climate impacts, GHG emissions and targets and transition plans. It would apply to companies that are required to file 10K reports as well as foreign private issuers. Large companies would need to comply as of fiscal year 2023 (filing year 2024) and small companies in fiscal year 2024. For scope 3 emissions, reporting would not be required until fiscal year 2025 but would for companies with 'material' scope 3 emissions.

How is Tyndall responding?

We expect the Labour government to increase regulation given Australia appears to lag behind global peers.

Specifically:

Australia's target for emission reductions from 2005 to 2030, which was recently increased to 43%, could be increased further to 50%. This would put Australia at the low end of the peer group and in the current bottom end of the US target range.

The implementation of a compulsory carbon credits scheme may be introduced. A tighter approach to allowable offsets is likely. Specific exemptions for industries that are in transition would offset the political sensitivity for those industries which may not be able to make the transition in the near term.

Reporting requirements will increase. TCFD reporting is likely to become mandatory once enough corporates demonstrate that it is achievable. Since Scope 3 remains difficult to calculate consistently, we do not expect this to become compulsory any time soon.

With a view that carbon emissions will face more restrictive regulation and reporting requirements are likely to increase, our research effort is focused on understanding whether companies are prepared for these outcomes and the likely impacts on future profitability. Engagement with corporates is vital to determine their ability to meet targets and the cost to adapt in the net zero transition period.

THE QUESTIONS WE ARE ASKING CORPORATES ARE:

- Are you prepared for more onerous carbon emissions regulation?
- What is the impact on profitability and the viability of operations resulting from heightened emission reductions targets or higher costs of offsets?
- What options are available to manage more demanding carbon emission regulations? Would any activities need to be curtailed, or could alternative processes emerge?

The responses to these questions, amongst others, enable us to better assess long-term cashflows and assess the risks to these cashflows under different scenarios.

Sources:

Department of Industry, Science, Energy and Resources, National Inventory Report 2020. Published May 2022.

European Environment Agency, Total EU greenhouse gas emissions, 1990-2016. Published 31 May 2018.

Department for Business, Energy & Industrial Strategy, Final UK greenhouse gas emissions national statistics 1990-2020. Published 1 February 2022

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