Collaboration and coordination – forging a pathway to net zero

Sustainable finance series

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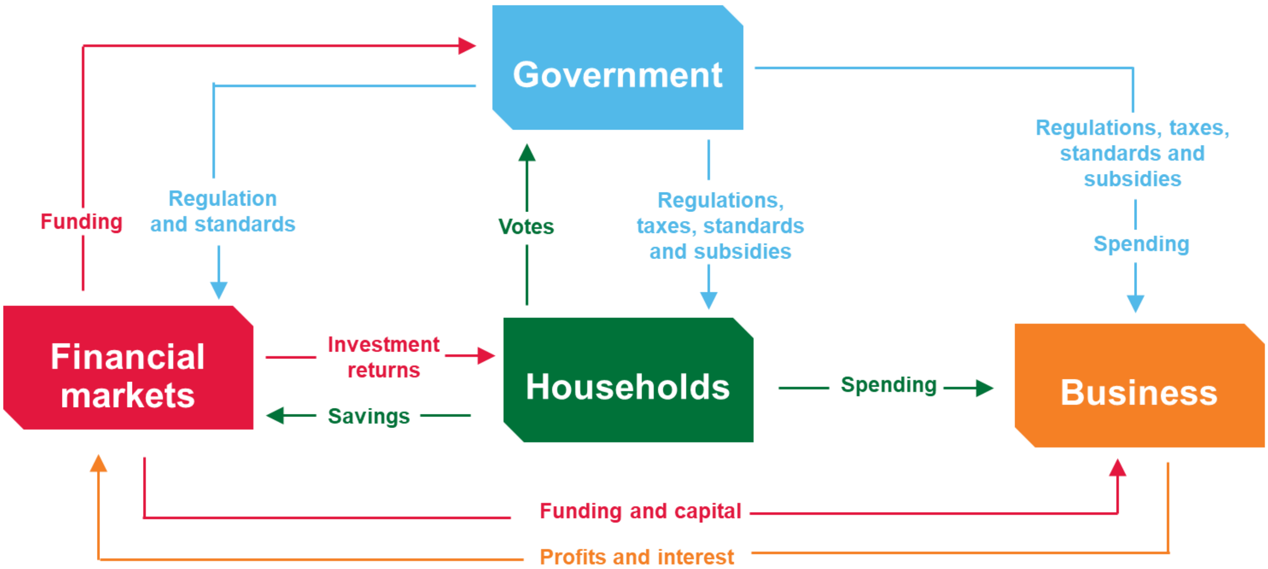
A joined-up approach to net zero

In November 2021, the United Nations Climate Change Conference (COP26) highlighted that, to prevent catastrophic climate change, governments, investors and businesses increasingly recognise that the world will need to achieve net-zero carbon emissions (NZE).

Key to this was an acknowledgement that governments must move from simply aspiring to move to NZE by 2050 to planning a pathway. Achieving this goal will require businesses, investors and governments to collaborate, given that another major takeaway from COP26 is that tried-and-tested models for evaluating emissions reduction, and at scale, are so far limited.

Common ground is growing between the targets that governments are introducing, with the investment community and businesses. Even so, there is still considerable scope to align these sectors more effectively. The complex interaction across these groups is outlined in Chart 1. This highlights that a lot more communication between all parties will be required, as well as a willingness to be flexible and respond to changing conditions when they occur.

Chart 1: Sector alignment



Source: TCorp

TCorp is seeing practices emerge for aligning government, the financial sector and business in the pursuit of net zero. From COP26 and other recent initiatives, there are some key examples and considerations for policy, to accelerate the transition to net zero through a coordinated approach.

Below are 3 key considerations for a joined-up approach:

1. **Financial sector: direct investments that deliver genuine impact**

   Turning the large sums committed to net zero into direct investment – in infrastructure or other physical assets that are net zero, or in financial portfolios that are structured to achieve emissions reduction.

2. **Business: setting, leveraging and delivering on commitments**
   Putting standards and reporting around self-starting pledges into action, working within mandates and incentives.

3. **Government: an expanded scope for action**
   Going beyond pledges to detailed and comprehensive net zero strategies, with a carbon emissions reduction pathway.

Financial sector: direct investments that deliver genuine impact

The financial sector has a key role in reducing greenhouse gases through its function of allocating capital, in terms of both price and quantity. There are 2 key avenues.

The first is through direct investment in green technologies needed for decarbonisation. This is needed most to scale-up and commercialise technologies – such as green steel, and extra-powerful batteries. Commercial demonstration projects, for example for green hydrogen, are expensive, necessary and need sufficient capital backing.

The second is that this emissions reduction drive can come through investment management. Managers want to see how their investment will help decarbonise the real economy, reflecting their own emissions reduction mandates and their clients' demands. This includes through the measurement of ESG (environmental, social and governance) impacts for asset selection and portfolio performance. It also involves transitioning away from high-carbon investments, actively engaging with companies on real emissions reductions and in some cases, investing in the carbon market.

This focus on emissions reduction is becoming even more mainstream. Increasingly, investors are shifting their portfolios to be consistent with NZEs. For example, the Glasgow Financial Alliance for Net Zero (GFANZ), announced at COP26, covers US$130tn in capital committed to net zero. GFANZ comprises many of the world's largest asset managers, including StateStreet Global Advisors, PIMCO, Amundi, Legal & General Investment Management, UBS Asset Management, Aviva Plc, Macquarie Group and Allianz Global Investors.

Importantly, GFANZ argues that governments also need to commit to stronger interim targets for emission reduction. As the Investor Group on Climate Change's, Erwin Jackson said:

"Ultimately, it's the short-term targets which will drive the immediate investment in existing technologies we have available. Everyone's focused on 2030 and rightly so, because that's what investors are demanding."

Consistent with this, QIC recently committed to a 50% reduction in carbon emissions in its infrastructure portfolios by 2030 and NZEs by 2040. Superannuation funds are also getting involved; AustralianSuper is targeting NZEs for its investment portfolio by 2050, along with HESTA. Similarly, Aware Super has the same 2050 NZE target, and aims to contribute to an economy-wide 45% reduction in emissions by 2030.

For governments that wish to benefit from this shift in the investor community it is not only important that they have a credible plan to shift to NZEs but also to articulate it in a way that satisfies investors' expectations. Of course, this observation applies equally to businesses.

Business: setting, leveraging and delivering on commitments

Businesses are also busily preparing for a NZE future. The *Australian Financial Review* reported that, of 1,000 senior managers recently surveyed by Ashurst across G20 countries, "almost every organisation" had a net zero emissions target or was developing one.

The Net Zero Tracker reported that 667 of the world's largest 2,000 publicly traded companies by revenue have committed to a NZE target. In the US this shift is reflected, for example, in the creation of the First Movers Coalition, an initiative run by the US State Department and the World

Economic Forum, which involves business heads from heavy industries who commit to buying low-carbon products and developing green supply chains by 2030.

As with investors, there is a range of reasons why businesses have committed to reducing emissions. These include pursuing profitable new markets or avoiding costly mistakes (such as being left with stranded assets), managing the company's reputation or simply complying with regulation.

Regulatory shifts can also boost the integrity and the transparency of what businesses are undertaking. The new International Sustainability Standards Board (ISSB), which will sit alongside the International Accounting Standards Board (IASB), is a potential major and meaningful framework for rolling out sustainability disclosures.

More consistent, transparent and relevant information will also, of course, enable investors to better distinguish those firms which are making substantive moves towards reducing emissions and those which are merely paying lip service to it. Additionally, this highlights the symbiotic relationship between investors and the firms and other organisations in which they invest.

Government: an expanded scope for action

Between 2017 and 2021, the proportion of global emissions covered by government net zero targets jumped more than 65 percentage points, to more than 70%.

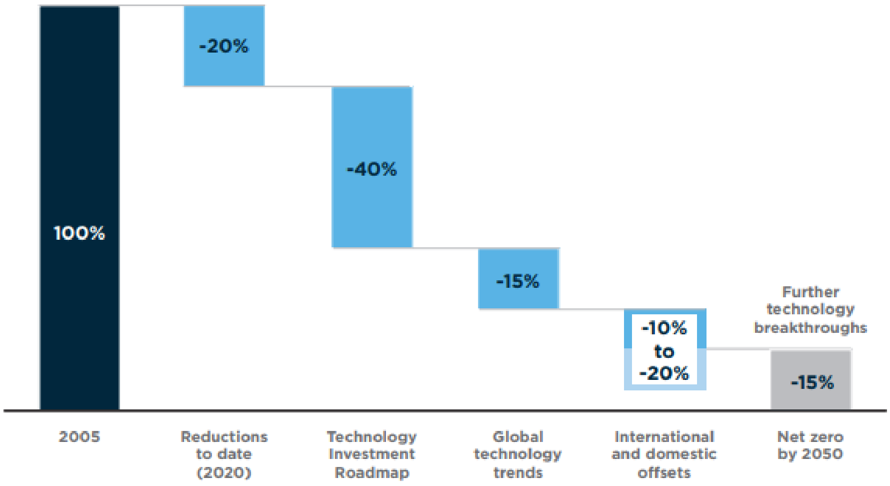
The scale of the transformation required to get to net zero, the dynamic interrelationships between sectors, as well as sequencing problems (i.e. people will be reluctant to purchase electric vehicles if there are few charging stations, but charging stations aren't profitable when there is little demand) potentially point to a role for government in driving an overarching net zero strategy in addition to simply setting a target. In such a strategy, government would set specific mandates, act as a significant investor and champion economic development, including skills-building.

The UK Government's Build Back Greener Strategy (2021) is a significant example of what this could look like. It sets a pathway to net zero that stipulates sector-specific targets, mandates and government commitments. Government is a major investor, committing £26bn, which is expected to be met with £90bn in private sector investment.

Reform to skills systems for the UK workforce is a key element of the strategy. Importantly, it also covers a dynamic path to net zero, meaning it is designed to adapt to new technologies, industry-level developments, costs reductions and the like as they emerge. An illustration: government is not wedded to, for example, low-carbon hydrogen, and if it does not materialise as expected, there will be changes made to the strategy along the way to compensate.

The Australian Government has adopted a different strategy. Having not committed to an interim target the government, as shown in the diagram below, relies heavily on technology that has yet to be developed. But as the IGCC noted, interim targets drive the investment that will ultimately deliver the technological breakthroughs required. This reliance on yet-to-be developed technology, alongside offsets, is a more uncertain path forward for NZE, when compared with coordinated, sector-specific strategies.

Chart 2: Priority technology contribution to meeting Australia's net zero by 2050 goal



Source: McKinsey and DISER analysis

Financial markets are reasonably good at understanding risk. And when investors accept more risk they also demand a higher return. Choosing to pursue a riskier path to NZE it is possible that investors may demand a premium when investing in Australian Government bonds. And this also could have repercussions for other Australian borrowers.

But while the Australian Government has eschewed interim targets and hopes that technology will solve the problem, Australia's state governments have been more proactive, committing themselves to a more ambitious path towards net zero. This observation highlights that it is possible that Australia could achieve a faster transition to net zero than sketched out in the Australian Government's plan. For this to be recognised by investors, however, it will require an extensive communication strategy with the investment community.

Conclusion

Getting to NZEs by 2050 will be achieved when governments, the financial sector and industry all play their part. This note highlights that the targets of governments as well as the investment and business communities are beginning to converge, although there is still ample room for further improvement. Moreover, greater coordination between these sectors could facilitate the shift of climate pledges into action.

The NSW Blueprint, for example, highlights how that could work. It notes that a brick factory in Tasmania is now able to produce carbon-free bricks. The NSW Government plans to alter building regulations so that new construction will need to be more energy efficient and this shift will likely increase demand for carbon-free bricks. With the Tasmanian company becoming more profitable, it should receive more support from investors and be able to obtain cheaper financing. This example shows how the targets of investors, businesses and governments can become self-reinforcing and accelerate the shift towards net zero.

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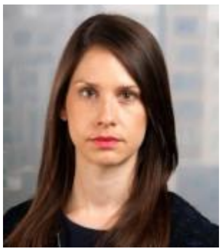

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