



The current GHG landscape: Implications for business

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This paper provides a brief summary of the business implications of developments in the international greenhouse gas landscape. It considers the UN climate change negotiations and national regimes, as well as wider trends in the developments of clean technologies and the need for 'green' growth. The paper draws on recent client work and Irbaris staff involvement in the mid-year UN climate change negotiating session in Bonn.

1. KEY MESSAGES

With current low carbon prices, the apparent lack of progress in global climate or sustainability discussions, and the immediate economic challenges, it would be easy to assume that climate change and greenhouse gas (GHG) abatement are becoming less important.

In reality much is changing, and the likelihood of GHG mitigation issues being critically important for business in the longer term is slowly increasing. There are a number of key reasons for this, which are explored in more detail in this paper.

- 1. The outcomes of the UN climate change negotiations in Durban (COP17) increase the likelihood of significant longer term actions that will affect many businesses.** Although progress at this level is slow and much uncertainty remains, countries agreed to develop a new global climate change agreement with legal force to come into effect in 2020. This could potentially tighten mitigation targets, putting more pressure on companies to reduce emissions. It also has finance and technology implications.
- 2. Places as varied as Japan, Mexico, Australia, South Africa, California and Kazakhstan have developed or are developing domestic GHG tax or emission trading schemes.** Even China has committed to some form of GHG regulations in its next 5 year plan¹. A number of these countries are exploring linkages with each other's national GHG schemes, creating a patchwork of linked markets.
- 3. Regulations and consumer expectations in end-use markets could have a significant impact on the marketability of some high carbon content products.** Countries with GHG regulations, which produce higher cost low-carbon products, are increasingly discussing border tax adjustments for high-carbon imports, as well as local product standards and green procurement rules, which could all significantly change the potential market for high carbon content products.
- 4. The costs of clean technologies have been declining steeply and electricity from renewables is becoming cost competitive with fossil fuel electricity in some markets.** For example, in India it appears that building new coal-fired power stations is no longer attractive relative to investing in wind and solar for some major companies². Moreover, significant international funding and support is currently in place or proposed to deploy low carbon technologies at scale, particularly towards 2020.

2. CONTEXT

Developments in the climate change landscape should be viewed in context. There is an expectation that the next IPCC scientific assessments (due in 2014) will say that more, rather than less, ambitious targets are needed to avoid dangerous climate change. The UN climate negotiations have a work plan devoted to options to enhancing ambition, and the IEA³ recently announced that fossil-fuel CO₂ emissions are just below the threshold that scientists say is needed to limit the global temperature increase to 2 degrees. At the same time, there is a growing acceptance that climate change is already happening and that action needs to take place to adapt to it. Many governments are developing national adaptation strategies, adaptation is on an increasingly equal footing with mitigation in the UN negotiations, and a US court recently ruled that US Army Corps of Engineers⁴ could be liable for hundreds of millions of dollars in damages for failing to take adequate precautions against climate change in a major infrastructure project.

3. THE EVOLVING CLIMATE CHANGE LANDSCAPE

GHG regulation is developing at different levels: nationally and bilaterally, and globally. The UN climate change negotiations are the largest and most complex negotiations in the world and are focused on achieving GHG reductions and on how countries can respond to climate change to reduce its adverse impacts. Understanding the key outcomes of the Durban conference in December 2011, and the developments and expected policy direction at each level, is necessary for determining the implications of GHG policies for business.

3.1 Global developments

A key outcome of the Durban negotiations was to remove the traditional distinction between developed and developing countries, arguably marking a new paradigm for the climate change negotiations. Countries agreed to develop a new legal agreement, applicable to all countries, to come into effect in 2020 (the Durban Platform). Currently, developed countries have binding mitigation targets under the Kyoto Protocol, and developing countries may pledge non-binding mitigation targets. In 2020, this is likely to change as

all countries should have mitigation actions under one agreement. Some of the 'advanced developing countries' (e.g. BASIC countries) could have binding mitigation targets after 2020.

The UNFCCC process is no longer just an arena for governments and the private sector should exploit opportunities to be involved. Durban delivered a package that appeared comprehensive and ambitious; however, first hand observation of the atmosphere in the Bonn negotiating session in May suggested the countries are still mistrustful and deep divisions persist. Negotiations were hampered by procedural wrangling, reflecting the ambiguity in some of the terms agreed in Durban, and some fundamentally different views amongst the countries. Much has been left for countries to discuss at the next UN conference in Qatar in December 2012. Although much of the debate is buried in politics, there are key issues that will affect business that will need to be agreed within the next two or three years. Therefore the critical time for business influence is now.

Some examples of areas where business should engage include:

- ▶ **One global agreement:** Until Durban, mitigation targets have been required of developed countries but not developing. However, from 2020, all countries should be dealt with under one agreement and it is likely that 'advanced developing countries' will have mitigation requirements, which will impact companies in, or trading with, those countries.
- ▶ **Increasing mitigation ambition:** New mitigation options are being considered to reduce the 'ambition gap' between current emission reductions and those necessary to avoid dangerous climate change. In addition to potentially more stringent mitigation targets, new risks and opportunities could open up if targets apply to a wider range of emissions (e.g. from aviation/shipping and agriculture) and new market mechanisms (e.g. a sectoral mechanism) develop.
- ▶ **Continuation of the Kyoto Protocol:** At the next UN conference in Qatar, countries are expected to adopt a second commitment period to the Kyoto Protocol, thereby extending developed countries' binding emission reduction targets, and providing continuity for an international

emission trading mechanism. However, some countries have withdrawn (e.g. Japan and Canada) and key issues for the effectiveness of international emissions trading have still not been agreed, such as the length of the compliance period (2013 to 2017 or 2020) and eliminating the surplus of Kyoto Assigned Amount Units (or AAUs) which provides a significant loophole.

- ▶ **Finance:** Countries have agreed to mobilise up to \$100bn each year by 2020, much of which will flow through a Green Climate Fund that is intended to serve as the central long-term financing body for climate action in developing countries. Sources of funding were not agreed in Durban, but much of it will have to come from the private sector. It is not clear how governments should incentivise business to do this. For example, whether public finance guarantees insurance or whether governments provide direct subsidies or grants to projects. As the Fund develops, potential opportunities for public-private partnerships and other forms of finance are likely to arise.
- ▶ **Technology transfer:** The climate negotiations are also debating issues support mitigation actions in developing countries, such as technology transfer. This is crucial for business but discussions are still at an early stage, so it is currently unclear what the real opportunities are (e.g. equipment, know-how, finance) and IP rights are likely to be a major stumbling block. Clarity could emerge in the next 12 months so monitoring progress could be valuable.
- ▶ **Adaptation:** There is increasing focus on this in the UN negotiations. Considerable funding and technology support are predicted to go to adaptation projects, particularly in least developing countries and Africa. This could benefit the private sector where it enhances a business' resilience, such as transport or infrastructure projects.

3.2 BILATERAL AND DOMESTIC DEVELOPMENTS

Business should also be aware of developments in domestic GHG regimes and bilateral agreements. Various countries or regions are developing taxes and emissions trading schemes (ETS), including Mexico, Kazakhstan, Australia, South Africa, China, and a number of states in the US. Various bilateral

discussions are already taking place between countries with either existing or planned ETS (e.g. the EU ETS is looking to make linkages, Australia is considering linking with the EU and New Zealand⁵, and California is linking with Quebec⁶). Such developments parallel the developments in global trade and the World Trade Organisation, where multilateralism has arguably floundered and trade has become dominated by bilateral agreements.

Where a country has a GHG regime that potentially increases costs of domestic lower carbon products, cheaper and high carbon imports from countries lacking adequate GHG regimes could make local products uncompetitive. These countries with regimes could introduce protectionist measures, such as border tax adjustments (BTAs) or similar entry barriers.

4. LOW CARBON INVESTMENT AND DEPLOYMENT

The desire for 'green growth' or 'sustainable development' may be a stronger driver for low carbon technology investment and deployment than constraints imposed by carbon costs. Significant cost reductions in certain renewable energy technologies (e.g. solar PV) mean that some of them are reaching grid parity with fossil fuel derived electricity in key markets. Investment in renewable energy at scale could create a virtuous circle of increased demand resulting in greater production volumes and lower costs.

As costs continue to fall, the number of markets where some clean energy technologies are becoming competitive without subsidies is increasing. In addition, the role of product or technology standards (e.g. the requirement for use of best available technologies) can apply in countries without formal carbon pricing schemes (e.g. the US) and can themselves be a significant driver of low carbon developments as well as create competitive opportunities and threats.

Changes in the relative economics of clean energy, coupled with the possibility that the risk rating of fossil fuel investments relative to clean energy investments could change, will further increase the attractiveness of cleantech investment and increase competition for fossil fuels.

5. IMPLICATIONS FOR BUSINESS

While much uncertainty around the future of GHG regulations remains, especially in terms of a global agreement, it would be wrong to conclude that there will not be a range of carbon pricing schemes and regulatory regimes across the globe.

A patchwork of different regulations (in combination with changes in the underlying economics of competing technologies) will create a complex web of opportunities and threats for businesses operating internationally.

The impact on investment choices and business performance will reflect a mix of technology, geography and end-market factors. For example:

- ▶ Companies need to understand which of their operating locations and supply chains' markets are planning to develop carbon taxes and/or ETS mechanisms in the next few years. These expected costs should be considered in discussions on the location of production facilities, distribution channels, and supply chain management systems.
- ▶ Companies investing in the more 'advanced developing countries' should be aware of the potential for binding mitigation targets under a new global agreement.
- ▶ Companies with assets that serve a closed domestic market may be less affected by the economic impact of GHG regulations than assets competing in international market or those exposed to border adjustments in key export markets.
- ▶ Changes in relative technology economics, especially if combined with favourable policies and easy access to finance, could significantly increase the attractiveness and reduce the risks of investment in clean technologies compared to conventional fossil fuel energy sources.

- ▶ The regulatory landscape within, and relations between, countries where a company intends to trade could change the competitive economics and/or the customer purchase criteria. The change in economics could be exacerbated if additional local regulations penalise high carbon products (such as low carbon fuel standards).

Substantial value will be created by those businesses with resilient and effective strategies to deal with a complex web of GHG regulations, markets and customer demands, especially relative to those companies that conclude the current uncertainty will result in no change from business as usual.

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Please contact [David Hampton](#) or [Kate Weinberg](#) for more information.



www.irbaris.com
info@irbaris.com

UNITED STATES
WASHINGTON DC
Irbaris (US) LLP

1875 Eye Street,
Washington, DC 20006
Office: +1 (202) 429-8424

UNITED KINGDOM
LONDON
Irbaris LLP

Centre Point, 103 New Oxford Street,
London, WC1A 1DD, England
Office: +44 (0) 20 3102 5455