Corporate governance in the transition to a low-carbon economy

Boards need to start thinking now about what the Government's moves to create a net zero carbon economy might mean for their organisations.

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The transition to a low-carbon economy will change the workplace as a result of firms being forced to adapt their competitive position. Business leaders must approach this issue as any other strategic threat and opportunity, or suffer the consequences.

From time to time, major new forces dramatically reshape the business world. Two examples from recent decades include globalisation and the IT revolution. The impact of climate change on businesses may rival both of these.

THE TRANSITION TO A LOW-CARBON FUTURE IN NEW ZEALAND

In the specific case of New Zealand, legislating for net zero emissions will introduce the impacts of a low-emission future forcibly into the economy.

The Emissions Trading Scheme (ETS), which is currently being reformed, may be complemented by other policies, such as those needed to achieve 100% renewable electricity by 2030. The Interim Climate Change Committee is already looking at options and the practicality of achieving this target.

The Productivity Commission says it clearly: "During the transition, action to mitigate emissions will require real and significant changes impacting on households, businesses, industries, cities and regions. A shift from the old economy to a new low-emission economy will be profound and widespread, transforming land use, the energy system, production methods and technology, regulatory frameworks and institutions, and businesses and political culture."

IMPLICATIONS OF THE TRANSITION ON FIRM COMPETITIVENESS

For each industry, the competitive landscape will be affected by the transition's four outcomes, described below.

1. Emissions reductions

New entrants that have lower regulatory costs to comply with emissions reduction requirements will be at a competitive advantage over incumbents.

Mechanisms used by governments to obligate industries to lower their emissions create a compliance cost. Emissions may have to be purchased for surrender under emissions trading schemes such as we have in New Zealand, but other mechanisms may also be introduced. This is especially likely in New Zealand, as the net zero emission legislation will set targets that are more ambitious than our obligations under the Paris Agreement.

Everyone will be faced with the reality of having to lower emissions somehow or pay the price.

2. Disruption to supply chains

There will be an increasing risk of disruption to supply chains as a result of climate change. This will affect firms' ability to substitute input materials.

There will be direct impacts, such as lower crop yields, damage to assets from more turbulent weather, or increasing restrictions on water use. There will also be indirect impacts resulting from companies' exposure to the emissions integrity of suppliers.

Businesses will have to be more vigilant – value chains can disrupt existing industries. But they can also create new industries, as the example of second-generation biofuels shows.

3. Changing consumer preferences

The nature of competitive rivalry in an industry will be determined by how well incumbents or new entrants manage to attract and sustain customer loyalty. In turn, customer loyalty will be driven by the way in which firms manage to adapt to changing consumer preferences. As society becomes more conscious of the effects of climate change, consumers will increasingly favour organisations that are responding to the low-emissions imperative.

4. Changing human capital requirements

During the transition, a firm's competitiveness will also be determined by its ability to attract specialist knowledge, either as a way to enter existing markets or to retain current market share.

The way we do jobs now will change and some roles being done today will be replaced by other roles. Obviously some of this change will be due to technology improving job productivity overall. However, the drive to reduce our environmental footprint will also create demand for skills that would not have occurred in the absence of the low-emissions imperative.

These skills could range from agricultural research into methane-reduction solutions to measuring the carbon impact of investment portfolios. Companies will need to be flexible to shift resources from less productive to more productive activities as employment and business opportunities change.

IMPLICATIONS FOR CORPORATE BOARDS

There are generally two ways in which a firm can respond to the transition: improve its operational effectiveness or change its business strategy (or both).

Ensuring operational effectiveness: Operational effectiveness refers to performing similar activities better than the industry rivals. Companies that produce more emissions than their rivals are operationally ineffective. As the world moves to lower emissions, every company will have to mitigate climate-related costs and risks in the value chain, in addition to those relating to their own operations. Getting the basics right for this will be a matter of operational effectiveness.

Changing business strategy: During the transition, some firms will find opportunities to improve their competitive positioning by creating new products or services, or by innovating in a way that creates a competitive advantage. This is a business strategy response that is different from simply improving operational effectiveness. For example, whereas an operational response to climate change for a logistics company would be using more efficient engines, a change in business strategy would involve delivering fewer distribution miles by bringing distribution centres closer to customers.

Approaches to dealing with climate change will differ across firms, depending on the particular business. However, all businesses will have to take some steps to manage their exposure to climate change in order to stay competitive.

CURRENT POSITION WITH REGARDS TO CLIMATE CHANGE

We know now that climate change effects on business models get little airtime around the board table. Based on the IoD Director Sentiment Survey 2018, 72% of directors either don't think it matters, or are blissfully unaware that they should be thinking about it.

A recent analysis of Deloitte Top 200 companies shows that only 31.2% include any climate change-related issues in their annual reports. That work also indicates that less than 5% of 365 public and private sector organisations reported they have established emission reductions targets.

Things are changing, however. Nearly 80 private sector CEOs in New Zealand have already taken a lead to measure emissions via the Climate Leaders Coalition. That is great leadership and a great start, but it is only a start.

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INTERNAL EMISSIONS REDUCTION TARGETS CAN SUPPORT TRANSFORMATION

If organisations are to factor climate change into their modus operandi, the critical thing they will have to do is measure their environmental footprint, set targets and monitor progress. It is often said that you can't manage what you don't measure.

Science-based emissions reduction targets allow companies to align their emissions profile with a trajectory compatible with the Paris Agreement. These targets can help companies become leaner and more efficient. In a world in which the price of raw materials is rising, this can increase the competitive advantage of firms. In New Zealand, nine companies have adopted such targets, but this may only be the start.

CONCLUSION

Directors will have to factor the regulatory cost of emissions reductions into decisions and strategy. Directors will have to face up to the implications of climate change to their supply chains. And there will be no escaping the impact on financial bottom lines if consumers vote with their feet when they see an organisation ignoring the issue. In the context of the future of work in a changing climate, businesses face two choices: step up or face the consequences – sooner or later.