Investor Group on Climate Change

Opinion

21 September 2017

Policy uncertainty is blocking investment in low carbon assets, say investors | Emma Herd

This article first appeared in Renew Economy 21 September 2017

Australian institutional investors have a strong appetite for low carbon assets, but policy uncertainty and a lack of scalable deals are major barriers.

Institutional investors have a critical role to play in achieving the ambitious goals of the Paris Agreement. The IEA estimates that $75 trillion in low carbon investments and energy efficiency combined will be required to limit global warming to 2°C.

The challenges of transitioning to a net zero emissions economy will require an unprecedented level of capital investment and represent a massive market signal to the global economy.

So how are local investors thinking about scaling up investment?

In June 2017, the Investor Group on Climate Change (IGCC) surveyed Australian and New Zealand institutional investors representing over $328bn in assets under management to understand the low carbon investment landscape.

This included superannuation funds, asset managers and sovereign wealth funds. The results were then assessed further with 50 IGCC members in August to understand the implications.

Set out in a new report – Road to Return – the results provide interesting new insights into how investors are approaching low carbon opportunities and where they are active.

Investors have strong appetite for green investment

100% of investors surveyed stated that they intend to increase their green investment over the coming years, while 55% have already allocated funds across multiple markets and asset classes.

When looking at active markets, there was a clear preference for international over Australian markets as a capital destination. This is likely a reflection of the regulatory and policy uncertainty which plagues the Australian market.

Developed markets are preferred for existing investment, although emerging markets will be a trend to watch with an estimated US$23 trillion in potential investment opportunities in low carbon solutions between now and 2030, according to the IFC.

Real estate and fixed income dominated the investment landscape.

Real estate is a popular asset class in Australia offering clear and measurable environmental impacts and reasonably safe returns. Investor feedback suggests that strong activity has principally been driven by the ease of assessing energy efficiency and green investments in real estate, which has a long history in Australia through NABERS and Green Star as core frameworks.

Mandatory disclosure regulations at property lease and sale have also increased awareness of green credentials in this asset class.

This clearly demonstrates the way in which regulatory or policy signals and supporting frameworks can unlock low carbon investment when implemented effectively.

The large allocation to fixed income can be explained by the dramatic growth in green bonds. This looks set to continue with the latest Climate Bonds Initiative State of the Market 2017 report finding that US$895 billion in climate aligned bonds have now been issued globally, up from US$3bn in 2012.

Looking ahead, while real estate and fixed income growth will likely continue, listed equities and infrastructure were identified as strong areas of potential growth.

New investment products are rapidly being developed that go beyond carbon footprinting and assess the contribution of a company to the low carbon economy.

For example, FTSE Russell has released a data model which can track companies that generate green revenues. MSCI has also developed similar capabilities as part of its MSCI Global Environmental Index. As data quality improves, this trend will accelerate.

Barriers to growth

Policy uncertainty and and a lack of investable deals with appropriate risk adjusted returns were standout barriers to green investment. The two issues are clearly related.

Despite the recent surge in renewable energy investment, investment is still not coming through institutional investors. Superannuation funds are long term investors and need to understand the future policy landscape to appropriately price investments or assets held for long durations.

Yet, the Federal climate change and energy policy landscape provides no investment certainty.

Many of the technologies required to transition to a low carbon economy are also still evolving.

Therefore, investment opportunities may not be at a stage or scale that enable long term investors like super funds to obtain the right return for the risk of investing in new technologies.

Complicated commercial conditions bring added issues. Even a vanilla type solar project has detailed due diligence for all aspects, as well as the regulatory risk, market risk, counterparty risk and the commercial contracting components requiring detailed assessment.

Combined with policy uncertainty, good deals at scale are hard to find for institutional investors.

Defining green and setting targets

Despite the proliferation of low carbon investment frameworks and methodologies, the majority of investors still prefer to build their own approach to defining green investment.

This may be a reflection of the fact that current tools for defining green investment are more effective for a specific sector or product, rather than at the portfolio level.

We also found that investors generally prefer strategies that exclude or tilt away from high carbon intensive assets or investments, rather than targeting positive low carbon opportunities. This rules out the use of several methodologies and would drive the need to generate internal approaches for defining low carbon investment.

Investors also have no appetite to set public investment targets.

Feedback suggests that investors prefer to assess a deal on its individual merits and risk / return profile rather than setting explicit green growth targets.

It could also reflect the current preference to manage carbon risk across a portfolio or asset class rather than measuring specific opportunities for green investment. Some investors also highlighted the challenges of setting targets without any policy certainty.

Overall, despite all these challenges, there is widespread acknowledgement of the need to continue to continue to pursue low carbon investment opportunities to support the objectives set out in the Paris Agreement of limiting global warming to less than 2°C.

Investors have appetite for low carbon opportunities. Resolving the current regulatory impasse and getting the policy signals right would clearly unlock substantial new investment.

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