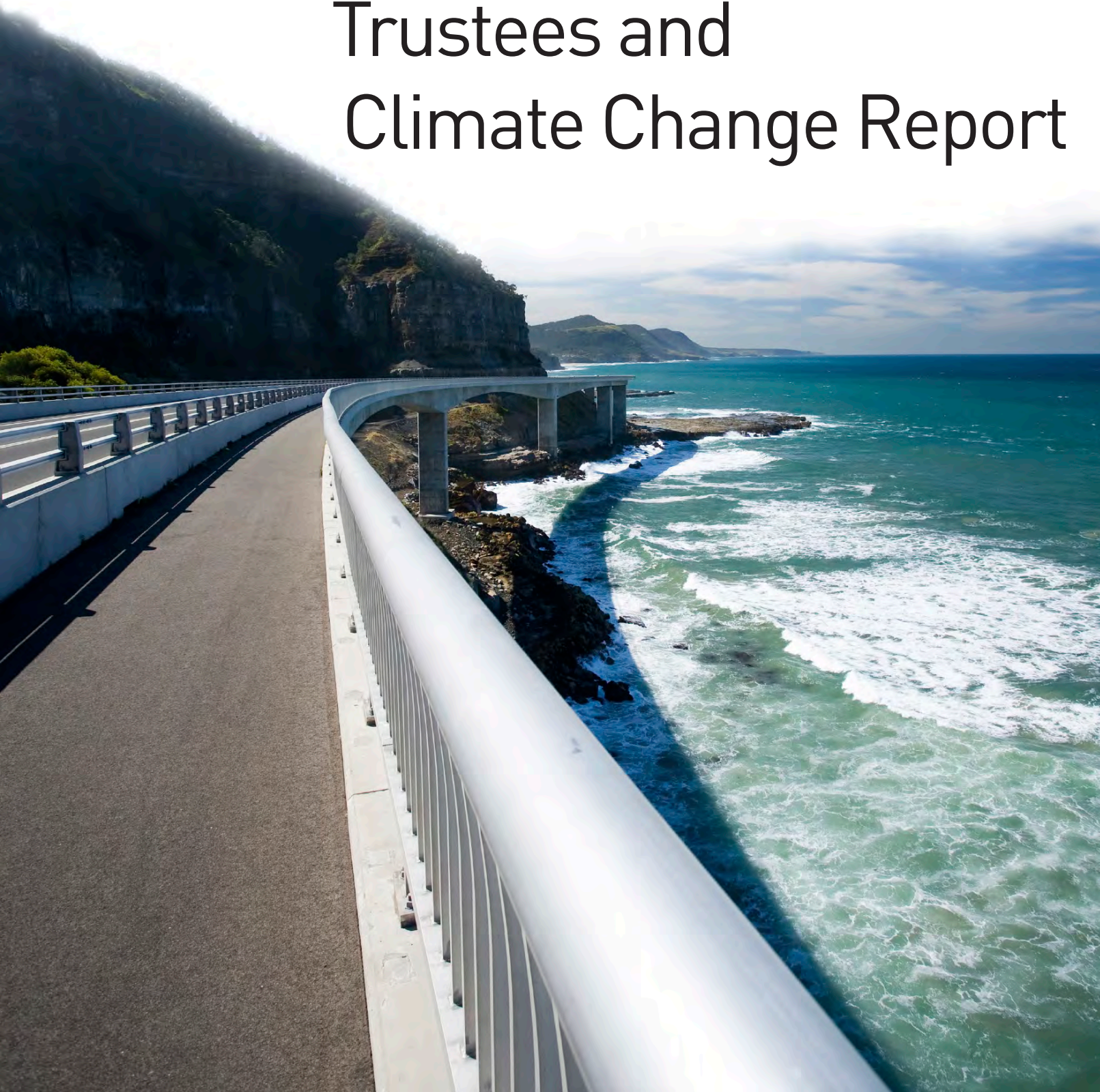


Superannuation Trustees and Climate Change Report



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Preface

This report is very timely. I hope and believe it will be read widely and acted upon. For this reason, it is a great honour to be invited to write an introductory comment. Some years ago I invented a humorous assertion which is not very funny but is intended to illustrate an important point that is relevant in this context.

Destruction of the world through unmitigated climate change is ... against the regulations!

Naturally, for this comment to become widely accepted there may have to be some progressive interpretation of the existing regulations. But now at least, we can all be clear, something needs to be done. It is no longer acceptable for governments, directors of corporations or superannuation trustees, to state that the problem of human-induced climate change is too complex or uncertain for action.

Law has been developed to protect people. History has been recorded for us to learn from. Winston Churchill called World War 2 "the entirely avoidable war".

Across many countries the war memorials state the sound observation: "Lest we forget". What the war memorials teach us, and what we have a duty to accept, is that we must never neglect our duty to protect ourselves and our children from whatever future disaster may threaten to come.

Over 12 years working on human-induced climate change I have become very seriously concerned about the impact of this phenomenon on our security. We may run our nations - bizarrely - without a balance sheet, but nobody would deny our economies are 100% owned subsidiaries of the environment.

My organisation, the Carbon Disclosure Project, has the privilege to collect data for 655 large investors with total assets equivalent to the GDP of the world. In response to this financial authority, over 2,300 of the world's largest corporations last year reported their greenhouse gas emissions, water use and strategies on climate change to us, and you can see all this data free of charge at www.cdproject.net

But many corporations and even asset managers who analyse the data wonder: what are the views of asset owners? It is the superannuation trustees who now need to enter the debate. At the very least, investment managers and investment consultants need to be asked to look at these issues.

This report provides a thoughtful, concise and brilliant invitation to welcome the vital contribution of superannuation trustees. Millions of citizens and their retirement nest eggs depend on the care and attention of these trustees. And on the issue of climate change, now more than ever.

Paul Dickinson
Executive Chair
Carbon Disclosure Project

Executive summary

Australia has one of the largest compulsory superannuation sectors in the world, giving the country's superannuation funds a unique ability to influence the financial market through their investment pool.

The future impact of climate change on economies and financial markets has been widely recognised, posing both risks and opportunities to investments. Superannuation funds are particularly vulnerable to climate change risk, due to the long term nature of their investments.

This was first addressed by the UNEP commissioned report *A legal framework for the integration of environmental, social and governance issues into institutional investment* (Freshfields Report) published in 2005, which concluded that the consideration of climate change risk in investment analysis is “clearly permissible and is arguably required in all jurisdictions”.¹ This was further reinforced by the subsequent UNEP commissioned report *Fiduciary Responsibility* (Fiduciary II Report) in 2009.² This analysis builds on these earlier reports with an emphasis on the Australian context, although its findings have a broad application to superannuation funds in other jurisdictions.

Australia has one of the largest compulsory superannuation sectors in the world, giving the country's superannuation funds a unique ability to influence the financial market through their investment pool.³ This position of influence has prompted suggestions of mandatory sustainable reporting and investment for superannuation funds.⁴

In particular, it has also seen increased expectations that investors will disclose the way in which they manage risk and especially environmental, social and governance issues, including climate change risks, that may impact on investments. Through the Carbon Disclosure Project, we have seen significant commitment by companies to disclose their greenhouse gas emissions. Yet despite this there has been a general reluctance by asset managers and fund managers to disclose the climate associated risks of their investment portfolios.

1 Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005), UNEP FI Asset Management Working Group at 13. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

2 UNEP, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment* (2009), UNEP FI Asset Management Working Group.

3 In 2011 Australian pension funds total assets amounted to approximately US\$1,301 billion according to the Towers Watson *Global Pension Assets Study 2012* (January 2012).

4 See for example Finsia 2007, “Have Your Say” Industry Opinion Poll.

...trustees have a clear duty to consider climate change risks and relevant laws and policies in making investment decisions...

Some industry participants argue that this would present too high a risk, with government policy being the appropriate driver to sustainable investments in areas such as clean energy. Despite this, most surveys have shown that the majority of Australian trustees now believe that addressing climate change risk is part of their fiduciary duty.⁵ This is particularly important because given the risks and opportunities presented by climate change and the rapid introduction of carbon pricing regimes across multiple jurisdictions, including the Australian Carbon Pricing Mechanism, trustees have a clear duty to consider climate change risks and relevant laws and policies in making investment decisions where such matters prove to be material. To fail to do so would be negligent and a breach of their duties.

This analysis considers in detail the risks and opportunities posed by climate change, the difficulty of accessing information to quantify climate change risk, the fiduciary obligations of superannuation fund trustees as they relate to climate change and sustainability, and conclusions as to what trustees should be doing in response to climate change. While this analysis is presented in the context of the Australian legal regime, it has far wider implications for international investors, asset owners and fund managers.

5 The Climate Institute and Australian Institute of Superannuation Trustees, Asset Owners Disclosure Project (Australia) *Funds Survey Results*, 2011.

Introduction

Climate change poses both risks and opportunities to all investments. Superannuation funds are particularly at risk due to the long term nature of liabilities and investments. First addressed by the Freshfields Report, which concluded that the consideration of climate change risk in investment analysis is “clearly permissible and is arguably required in all jurisdictions”,⁶ and further developed by the Fiduciary II Report, this analysis seeks to build on these reports with an emphasis on the Australian context.

In February 2011, one of the largest advisors to institutional investors globally, Mercer, released a report (Mercer Report) on the implications of climate change on investments.⁷ In this report it was determined that the investment impact of climate change is driven by three main elements:

- technology impacts: the rate of progress and amount of investment into low carbon and energy efficient technology and the impact of stranded assets on long-term value, will determine investment gains;
- physical impacts: the extent to which the physical impacts of climate change will affect investments; and
- law and policy development: transparent, certain policy, as well as the anticipation of this policy, will be the key driver of the transition to a low carbon economy.

Each of these elements presents uncertainty to investments. However, climate change and the transition to a low carbon economy also presents considerable investment opportunities. Given that Australia has one of the largest compulsory superannuation sectors in the world, superannuation funds have a unique ability to influence the market through their investment pool, and steer industry towards reducing emissions. Due to this position of influence, it has been suggested that superannuation funds be mandated to report on and

⁶ Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005), UNEP FI Asset Management Working Group at 13. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

⁷ Climate Change Scenarios – Implications for Strategic Asset Allocation Public Report (2011), Mercer LLC Carbon Trust and International Finance Corporation, February 2011 (*Mercer Report*).

Investment in energy improvements, renewable energy, biofuels, nuclear energy and carbon capture and storage could expand by more than \$5 trillion to 2030.

invest a certain percentage of funds in “sustainable investments”.⁸ However, the industry position is that national climate change and energy policy is the key driver to investment in clean energy technologies.

At the very least, in light of the issues surrounding climate change there is a strong case for superannuation trustees to reappraise their asset allocation and stock selection processes to fulfil fiduciary obligations to members under the laws governing the management of superannuation investments.⁹ There is also a strong case for trustees to ensure that fund processes and policies can manage systemic risks such as climate change and that they evaluate their assets in the context of these new laws and policies. In light of increased globalisation, market connectivity and the lessons from the sub-prime crisis, trustees may also be obligated to re-examine incentives, advisers, active ownership policies and member communications.

This analysis considers the risks and opportunities posed by climate change, the difficulty of accessing information to quantify climate change risk, and the duties and obligations of superannuation fund trustees pertaining to climate change, and forms conclusions regarding what trustees should be doing in response to climate change.

In addition to the Mercer Report, the Freshfields Report and the Fiduciary II Report reference is also made to a report by UK organisation, Fair Pensions, *Protecting Our Best Interests – Rediscovering Fiduciary Obligation* (Fair Pensions Report). Released in March, 2011, this report discusses the inclusion of climate change risk into the fiduciary obligations imposed on the institutional managers of pension funds, comparable to Australia’s superannuation funds.

⁸ See for example Finsia 2007, “Have Your Say” Industry Opinion Poll.

⁹ It should be noted that *Superannuation Industry (Supervision) Act 1993* (Cth) and *Superannuation Industry (Supervision) Regulations 1994* (Cth) do not apply to all superannuation funds.





The legal landscape

Currently, the majority of superannuation funds in Australia do not incorporate climate change risk into their risk assessment process. Further, the majority of funds are not altering their investment strategy to hedge against climate change risk. Most funds are also failing to take advantage of the investment opportunities climate change presents.

According to the Asset Owner's Disclosure Project 2011 Survey (AODP Survey) "94% of funds do not calculate any portfolio-wide climate change risks." Of the funds surveyed, "72% have no methods in place to mitigate climate change related risks." Also of concern, "83% of funds don't know what portion of their portfolio is invested in high climate impact sectors and 67% of funds don't know what portion of their portfolio is invested in low-carbon investments."¹⁰

As well as funds potentially suffering financial loss by failing to consider and mitigate against climate change risk, fund trustees could also be exposing themselves to legal liability by failing in their statutory duties.

Climate change risk and opportunity

The three main elements of climate change risk – technology impacts, physical impacts and law and policy development – create additional layers of uncertainty for asset owners in managing their investment portfolio.¹¹ Climate change risk requires investors to consider more than mere volatility with respect to portfolio risk. Further considerations are possible carbon regulation scenarios, new potential sources of risks and how to measure and monitor those risks over time.¹²

For example, superannuation trustees need to consider a range of risks when considering any investments in the stationary energy sector. These include the price level and volatility of electricity, policy risk, the impact of obligations to reduce emissions, electricity demand, public attitudes and perceptions, macroeconomic factors (interest rates for example), political risks, capital and operating costs and maturity of technology.¹³

With respect to sustainable investments, including in clean energy technologies, law and policy development and technological maturity are particularly important considerations.

¹⁰ The Climate Institute and The Australian Institute of Superannuation Trustees, *Climate Change Investment Initiative: Asset Owners Disclosure Project: Funds Survey Results*, March 2011 at 8.

¹¹ Mercer Report at 4, 28.

¹² Mercer Report at 4.

¹³ Mercer Report at 4.

The cumulative economic cost of climate change impacts (with respect to the physical environment, health and food security) may be up to \$3.7 trillion to 2030.

Technology impacts

Technology impacts are significant to this discussion for two main reasons. Firstly, technology maturity is relevant due to the uncertainty regarding the viability and performance of some clean energy technologies.¹⁴ It is acknowledged that some clean energy technologies have had less success to date than other traditional energy technologies. However, those that have been successful have provided significant returns for investors.

The potential investment gains from low carbon and energy efficient technologies will depend upon the rate of progress of the individual technology and investment flows into that technology. As the technologies mature, their success and the subsequent investment gains should improve. Large investment inflows into these sectors are expected. For example, the Mercer Report predicts that additional cumulative investment in energy improvements, renewable energy, biofuels, nuclear energy and carbon capture and storage could expand by more than \$5 trillion to 2030.¹⁵

Trustees may also have to consider the rate at which externalities, such as carbon emissions, are likely to be repriced. This includes consideration of various carbon price scenarios that might impact the returns of investee companies, especially capital intensive ones with long term investments that generate the majority of emissions. A related issue is the impact stranded assets may have on the long term value of investments. Stranded assets, being those that would become unprofitable under certain scenarios, including where a price is placed on carbon, have the potential to result in considerable reductions in the long-term value of particular companies, but more significantly, entire sectors, ranging from traditional resources to pharmaceuticals.

It appears that, rather than a smooth transition via a global policy framework, the most likely carbon price scenario is the continued growth of country and regional schemes to a point where global integration is easier and assured. Under this scenario, carbon is likely to undergo rapid repricing as governments catch up from the years of non-cooperation. The impact on high carbon risk assets and their owners – pension and superannuation funds – is likely to be severe. Thus, trustees are obligated to consider the appropriate method of risk mitigation.

¹⁴ Mercer Report at 30.

¹⁵ Mercer Report at 30.



The insurance and mining industries factor in big climate events such as flooding in their respective decision making processes.

Physical impacts

The physical effects of climate change are far-reaching and include sea-level rise, ocean acidification, change in rainfall patterns and increased disaster risk, as weather events (including storms, floods, and droughts) increase in frequency and intensity.¹⁶ Further, extreme weather events caused by climate change, may lead to additional bush fires,¹⁷ whilst heavy rainfall and cyclones may lead to flooding.¹⁸ Such events have far-reaching flow-on effects for Australian and international business, including impacts on business supply chains, the supply of essential services, such as energy and water, and the future economic viability of particular regions.

The 2011 floods in Queensland, for example, not only had an impact on insurance earnings,¹⁹ but also reduced production for some miners²⁰ and forced up global coal prices, which has flow on effects for companies relying on cheap coal for profitability.²¹ The insurance and mining industries factor in big climate events such as flooding in their respective decision making processes. Regardless of whether these particular floods necessarily occurred as a direct result of climate change, science indicates that due to climate change, events like these will become more frequent and so, climate events are likely to have a greater effect on these industries. Further examples include:

- changing rainfall patterns altering agriculture yields and the ability of hydroelectric power stations to generate electricity, which again has flow-on effects for certain asset classes;
- an increased risk that infrastructure will be damaged or destroyed, even where building code compliance is designed to ensure that infrastructure or property is safe from destruction by extreme weather events. A report published by the Government of Victoria has found that “[t]he water, power, telecommunications, transport and building sectors are all at significant risk from climate change impacts” by 2030 (in the worst case scenario) or 2070 (in the best case scenario);²² and

16 *UNEP Year Book 2010: New Science and Developments in our Changing Environment*, Division of Early Warning and Assessment, United Nations Environment Programme, 2010 at 44.

17 For example see: <http://adl.brs.gov.au/forestsaustralia/facts/fire.html>

18 For example, see: <http://www.aph.gov.au/library/pubs/climatechange/theclimate/moreextreme.html>

19 Citigroup Global Markets, Equity Research, “Climate Change Risks and Opportunities: Learning from flood impacts on a wide range of Companies and Sectors,” 2/2/2011 at 14.

20 Citigroup Global Markets, Equity Research, “Climate Change Risks and Opportunities: Learning from flood impacts on a wide range of Companies and Sectors,” 2/2/2011 at 9.

21 Citigroup Global Markets, Equity Research, “Climate Change Risks and Opportunities: Learning from flood impacts on a wide range of Companies and Sectors,” 2/2/2011 at 3.

22 Victorian Government, “Climate Change and Infrastructure: Planning Ahead” 2010.

- interference with operating capacities and efficiencies due to interruptions in the supply of inputs such as energy, water or other resources, including human capital.

This may directly effect investments by impacting on the value of assets. The Mercer Report predicts that the cumulative economic cost of climate change impacts (with respect to the physical environment, health and food security) may be up to \$3.7 trillion to 2030.²³ In particular, health impacts and population migration risks are said to be underrated, as there is presently not sufficient evidence to draw sound conclusions on these impacts.²⁴

Law and policy development

Law and policy development risk refers to governments addressing climate change by introducing laws to require emitters of greenhouse gas emissions to cap, reduce or eliminate those emissions (i.e. putting a price on carbon emissions) or introducing subsidies, measures or policies in areas, such as renewable energy or energy efficiency, that will change business-as-usual behavior. Law and policy developments represent major risks for investors due to:

- the ability to create investor and investment uncertainty, where law and policy developments are in a state of flux;
- direct impacts on asset values; and
- the ability to drive disruptive technologies or to accelerate uptake in alternative technologies, as is being seen with renewable energy and energy efficiency.

This is without doubt a material risk for investors as countries around the world begin to legislate regimes to limit emissions, imposing significant liabilities on business and changing asset values. To encourage private investment, transparent, long-lived policy is needed and in many jurisdictions is now being delivered. Of particular note are the significant developments in climate change law and policy that have taken place over the last decade with respect to carbon pricing. Figure 1 below shows the current stage of development of carbon pricing regimes around the world.

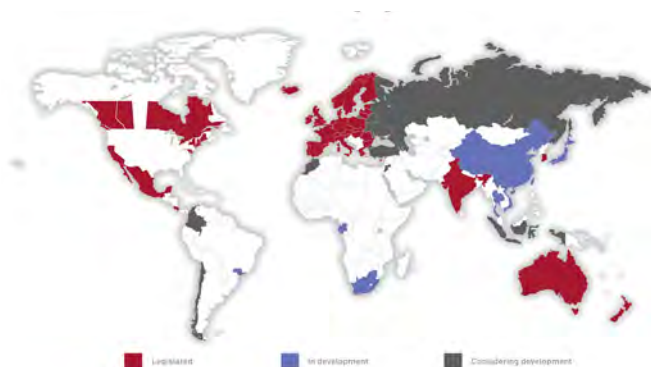


Figure 1
Carbon Pricing Regimes

²³ Mercer Report at 31.

²⁴ Mercer Report at 18.

The transition to a low carbon economy also presents new investment opportunities, such as new forms of energy and transport, new technologies, energy efficiency and energy storage.

For private investors to invest in sustainable investments, such as clean energy technologies, there is a need for the development of transparent, long-lived policy.²⁵ Countries that have attracted the most investment in sustainable investments are those that do in fact have transparent, long term policies in place and countries without appropriate policies have had more difficulty attracting investment.²⁶

Australia currently has state and national schemes subsidising renewable energy (the Renewable Energy Target). In addition, on 1 July 2012 the Australian Government's national carbon pricing scheme (the Carbon Pricing Mechanism) commenced operation. These schemes, coupled with the Carbon Farming Initiative and other policy developments in energy efficiency, create clear short, medium and long term goals in relation to climate change. They are aligned with other policy areas and create incentives for technology development.

The Global Investor Survey on Climate Change in 2010 concluded that national and regional climate and energy policy is the key driver behind climate change investment. The report bases this conclusion on a detailed comparison between the development of climate change policies and the integration of climate change considerations into investment analysis in the European Union, Australia and the United States.²⁷ Further, in March 2011, the results of the third annual survey conducted by the Climate Institute and the Australian Institute of Superannuation Trustees were released. Eighteen of Australia's largest super funds responded to the survey with more than "75% identifying lack of certainty around climate change policy as a barrier to sustainable investment in areas such as renewable energy."²⁸

Supporting this suggested causal link between policy and climate change investment, the Mercer Report predicts that the cost of carbon could increase by up to \$8 trillion from 2010 to 2030 depending upon the policy approach taken. The Mercer Report cites policy delay as a substantial additional carbon cost.²⁹

The transition to a low carbon economy also presents new investment opportunities, such as new forms of energy and transport, new technologies, energy efficiency and energy storage. Even the adverse effects of climate change may also themselves create new investment opportunities, such as the new opportunities

25 DB Climate Change Advisors 'Investing in Climate Change 2011 The Mega-Trend Continues: Exploring Risk and Return', February 2011 at 7.

26 Institutional Investors Group on Climate Change '2011 Global Investor Statement on Climate Change' 2011 at 2.

27 Institutional Investors Group on Climate Change, *Global Investor Survey on Climate Change, Annual Report on Actions and Progress 2010* at 40.

28 The Climate Institute and Australian Institute of Superannuation Trustees, *Asset Owners Disclosure Project (Australia) Funds Survey Results, 2011* at 7.

29 Mercer Report at 32.

for shipping and mining arising due to the melting ice caps, growth in demand for medication for treatment of tropical diseases due to increasing global temperatures and new alternatives to address climate related increases in resource and food prices.³⁰

However, with new opportunities come new risks. While climate change presents many new investment opportunities, it also poses potential risk to investments. The introduction of the Australian Government's Carbon Farming Initiative, for example, provides local investment opportunities in land based carbon sequestration and emissions reductions projects. But it is critical to understand such projects may also come with requirements that could affect asset values. For example, land based carbon sequestration projects impose new obligations on land owners and occupiers that can in some circumstances influence land value and the affect the priority rights of interest holders such as mortgagees.

Shifts in law and policy, such as the introduction of a carbon price, will have also directly impact asset values. In the Australian context, the commencement of the Carbon Pricing Mechanism has a number of effects on certain categories of assets. For example, various industries, such as steel and aluminium manufacturing, are provided assistance, in the form of free carbon units, to compensate them for the disadvantage otherwise faced due to their emissions intensive and trade exposed positions, which may be monetised by companies. However this assistance is to decrease over time. In addition, significant funds were also to be payed to a number of coal fired electricity generators in exchange for the closure of large carbon emitting facilities. While this programme has since been abandoned by the Australian Government, more than 3000 megawatts of coal-fired power generation capacity has been cut back or closed down due in part to the carbon price "driving up operating costs".³¹

These are all examples of how shifts in law and policy impact the value of assets, even in the short period in which the Carbon Pricing Mechanism has been operational in Australia, and cannot be ignored. Generally it is likely that companies acting now to adapt to climate change will be more profitable in the long-term. Sustainable asset investments could act as a hedge and improve overall portfolio resilience.³² Whether positive or negative, the consequences of climate change have the potential to affect the bottom line of many businesses and fundamentally change asset values and in-turn affect the rate of return for those funds that invest in such businesses.

30 Citigroup Global Markets, Equity Research, "Climate Change Risks and Opportunities: Learning from flood impacts on a wide range of Companies and Sectors," 2/2/2011 at 6.

31 Hepworth, Annabel and Pia Akerman, *Brown Out in Coal Power Squeeze*, The Australian, 17 October 2012.

32 Mercer Report at 15.



Access to Information

In accordance with the legislative requirements in Australia (set out below), trustees must evaluate, approximate and monitor risks and opportunities. They may do this by considering data supplied publicly by companies themselves, comparing competing companies, purchasing commercially available analysis of risk and requesting the informed advice of their asset managers.

The traditional approach to risk assessment by investment managers is primarily historical quantitative analysis. However, climate change risk assessment involves forward-looking inputs, and little research has been conducted which relates to the investment implications on a total-portfolio level.³³ This makes climate change risk relatively difficult to quantify, which was recognized as a key barrier to the inclusion of climate change risk in investment analysis across the seven jurisdictions covered by the Freshfields Report.³⁴ However, difficulty in quantifying the risk does not mean that trustees are relieved of their obligation to manage it. There is an increasing quantity and variety of public information available to super funds to assist in climate change risk assessment (for example, flood plain and coastal impact assessments), including from sources such as the Australian Department of Climate Change and Energy Efficiency, the Commonwealth Scientific and Industrial Research Organisation (CSIRO) and the Climate Institute and the Intergovernmental Panel on Climate Change

One source of information to assist in climate change risk assessment is the annual Carbon Disclosure Project. At present more than 70% of ASX-100 companies and around a quarter of former ASX-100 companies participate in the Carbon Disclosure Project which aims to “assist investors to understand companies’ carbon emissions and climate change exposures and how these may translate into investment outcomes.”³⁵ Further, the Carbon Disclosure Project rates companies on their understanding of business specific risks and opportunities and their own energy and emissions data management.³⁶ Mandatory participation in the Carbon Disclosure Project would improve access to information.

33 Mercer Report at 1 and 4.

34 Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005), UNEP FI Asset Management Working Group at 27. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

35 PWC, *Carbon Disclosure Project 2010 Australia and New Zealand Report*, Investor Group on Climate Change, 2010 at 22.

36 PWC, *Carbon Disclosure Project 2010 Australia and New Zealand Report*, Investor Group on Climate Change, 2010 at 19 and 22.

In addition, there are companies that can provide more detailed research to trustees, such as Standard & Poor's. In a recent report, Standard & Poor's found that "although more than a half of the surveyed respondents view the regulatory and physical risks of climate change as "serious"...only a minority of companies demonstrated a comprehensive understanding of those risks."³⁷

Investors are continuing to request more information from companies. With respect to climate change, investors are seeking details regarding the impacts of climate change and the way in which companies are preparing for a low carbon economy.³⁸ However, in 2010 a US survey found that it is uncommon for asset investors to refer to climate change risks and opportunities in investment analysis as nearly half of the fund managers surveyed said that investors do not ask them to consider corporate climate change risks.³⁹ While the Fiduciary II Report suggests that responsibility for the lack of climate change risks integration in investment analysis is at least partly due to the lack of engagement with the issue on the part of investment consultants.⁴⁰ Despite this, basic information about the risks and opportunities to individual companies is typically either publicly available or can be requested by the trustees. Trustees could require the companies to provide their own assessment of its climate change risk, require asset managers to perform company assessments themselves, acquire an independent assessment of the company's climate change risk, or at a very minimum consider the climate change risk of the sector generally.

So, despite the uncertainty with respect to the full economic consequences of climate change, there is considerable information available regarding the physical impacts of climate change. Although improvements to information availability can be made, data produced by sources such as those listed above can form the basis of climate change risk assessment, which should be introduced into ongoing strategic reviews by superannuation trustees.⁴¹

37 Standard & Poor's and Reputex, *Asia Pacific Corporate Carbon Exposure Survey*, October 2010.

38 PWC, *Carbon Disclosure Project 2010 Australia and New Zealand Report*, Investor Group on Climate Change, 2010, quoting Stephen Fitzgerald, and Simon Rothery, Co-Chief Executive Officers of Goldman Sachs at 7.

39 Spalding, Kirsten Snow, *Investors Analyse Climate Risk and Opportunities: A Survey of Asset Managers' Practices*, January 2010, Investor Network on Climate Risk, Sec 1:1.

40 UNEP, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment (2009)*, UNEP FI Asset Management Working Group at 32.

41 Mercer Report at 2.



The Governance of Superannuation Funds' Investment Activities in Australia

In Australia, the management of superannuation funds, including consideration of risk in investment decisions, is governed by the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (together the Superannuation Legislation), the purpose of which is to ensure the prudent and careful management of superannuation funds.⁴² It imposes requirements on trustees designed to ensure that all risks are adequately and prudently considered. As new risks are constantly emerging, trustees are compelled under the Act to constantly review and re-consider risks to the funds under their management. In recent years it has become apparent that climate change poses significant risks to many investments and, accordingly should now be considered and managed as part of the obligations imposed under the governing legislation.

Trustees are legally required to “have regard to” risks in their investment strategy and to exercise a degree of care skill and diligence in relation to all matters affecting the entity.⁴³ The legislation also mandates certain risk management procedures, requiring trustees to monitor and assess evolving risks and create a risk management plan.⁴⁴ These duties must be complied with and cannot be circumvented by disclosure. Equally, trustees cannot discharge these duties by following other funds, investors or conventions.

Certain provisions of the legislation seek to protect trustees from claims for losses in the absence of actual negligence.⁴⁵ This includes a defence if a person can establish that the investment was made in accordance with an investment strategy formulated under the legislation.⁴⁶ However, in the case of negligence, trustees are personally liable.

Trustee duties and obligations

The relevant duties and obligations on trustees and how they relate to climate change and sustainability, include:

- the duty of care, skill and diligence;
- the duty to prudently manage investment risks;
- the duty to consider the long-term perspective of investments; and
- the duty to diversify across a portfolio.

This analysis considers the applicability of the sole purpose test, and the consequences of contravention of these duties.

⁴² *Superannuation Investment (Supervision) Act 1993* (Cth), Objects.

⁴³ *Superannuation Investment (Supervision) Act 1993* (Cth), s 52.

⁴⁴ *Superannuation Investment (Supervision) Act 1993* (Cth), s 29P; *Superannuation Investment (Supervision) Regulation 1994* (Cth), r. 4.07B.

⁴⁵ *Superannuation Investment (Supervision) Act 1993* (Cth), s 55.

⁴⁶ For further discussion see Contravention of Trustees' Duties below.

Duty of care, skill and diligence

This duty of care, skill and diligence arises from the general law of trusts and provisions under the Superannuation Legislation which imply certain covenants into the trust instrument, binding the trustee. As mentioned above, trustees have a duty to perform trust business with a degree of care, skill and diligence that “an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.”⁴⁷ This applies to the entire decision making process, but is not an assessment of the particular decisions reached.

This duty is somewhat ambiguous, as only a court can definitively decide whether a trustee’s performance is satisfied, based on the full and specific circumstances of each individual case. However, it is clear that professional superannuation trustees are held to a higher standard, reflective of the power they command, and the importance of their role, which has been definitively stated in the courts.⁴⁸ This higher standard of care, skill and diligence is particularly important for such trustees as, not only are they professional trustees who invite reliance (by competing with each other for members), but reliance on a superannuation trustee is compulsory for many workers.

The courts view on this standard of care has not been static over time or within one particular jurisdiction. Unlike in the past, the law approves of prudent risk taking in order to avoid inflation.⁴⁹ However, the words of the legislation and the courts suggest that trustees must act with a very high standard of care, skill and diligence when taking investment risks: a very onerous duty.⁵⁰

Although the duty of care, skill and diligence does not specifically refer to the consideration of risk, it applies to all trustee functions and duties which include the consideration and management of risk. For example, in the case of a fund advertising a higher level of risk and potential reward, a breach of the duty may arise if the investment strategy did not consider investing, as a growth prospect, in companies that may benefit from climate opportunities, such as companies that in effect provide a hedge against climate change risk. A failure to even consider such companies may fall short of the standard of care, skill and diligence required of trustees, if not presently, than perhaps in the future as an increasing number of markets face climate regulation.

⁴⁷ *Superannuation Investment (Supervision) Act 1993* (Cth), s 52(2)(b).

⁴⁸ See e.g. *Auton v Australian Prudential Regulation Authority* [2005] AATA 32, at 57; *ASC v AS Nominees Ltd* (1995) 13 ACLC 1822, at 1831-1832

⁴⁹ For example, the statutory list of authorised trust investments was abolished and replaced by the “prudent person” test in NSW by the *Trustee Amendment (Discretionary Investments) Act 1997* (NSW).

⁵⁰ See e.g. *QLS Superannuation Pty Ltd; Australian Securities & Investments Commission v Parker* [2003] FCA 262 at [110].

Six per cent of funds participating in the Asset Owners Disclosure Project said that they did not believe “integrating climate change risks/opportunities into the investment policy/strategy [was] consistent with fiduciary duties and/or the sole purpose test”.⁵¹ In order to ensure funds satisfy their duty of care, skill and diligence, trustees should show they are open to consider all apparent risks and opportunities, including those arising from climate change and climate law and policy. They should integrate the capacity for climate change risks and opportunities to have profound financial consequences for members.

Duty to prudently manage investment risks

The duty to prudently manage investment risk arises from various provisions of the Superannuation Legislation,⁵² and, unlike the duty of care, skill and diligence, this duty is extensively described in the legislation.

First, trustees must have regard to certain risks in the investment strategy and second, trustees must oversee a risk assessment which includes reasonable “measures and procedures to be used to identify, monitor and manage the risks to the investment strategy relevant to the entity and the risks to the entity’s financial position.”⁵³ In addition, it is implied that trustees formulate an investment strategy that has “regard to the risk involved in making, holding and realising, and the likely return from the entity’s investments.”⁵⁴ This duty is procedural in nature, and must be performed to the high standards of skill, care and diligence described above. In order to fulfil this duty to the requisite standard in practice, some regard to climate change risk should be included in the investment strategy.

Consider, for example, a trustee considering a significant investment in coal mining. It has previously been noted that “coal specifically has become [a] broad investment risk” as a result of climate change risk.⁵⁵ This does not necessarily mean that a trustee will not invest in coal, however they should consider the long-term risks associated with such an investment and focus attention on investments on those coal companies that demonstrate greater emissions efficiency, less susceptibility to carbon pricing and actual weather events, and are exploring potential carbon capture and storage opportunities and those that recognise the impacts of the changing nature of energy

51 The Climate Institute and The Australian Institute of Superannuation Trustees, *Climate Change Investment Initiative: Asset Owners Disclosure Project: Funds Survey Results*, March 2010, at 2.4.

52 *Superannuation Investment (Supervision) Act 1993* (Cth), ss 52(2)(b), 52(2)(f)(i), 29P.

53 See *Superannuation Investment (Supervision) Act 1993* (Cth), ss 52(2)(f)(i) and 29P(2)(a).

54 *Superannuation Investment (Supervision) Act 1993* (Cth), s 52(2)(f)(i)

55 The Climate Institute, *Super Trustees Roundtable Meeting Summary*, Friday November 23rd, 2007, Session 3.

generation, as noted above with respect to the closure of coal-fired power generators. When choosing which company to invest in they will consider earnings-per-share, debt, and book value relative to share price. There may be three companies each with similar characteristics, however one may supply brown coal from flood-prone areas, another hard coking coal from a dry area, and another may not have accurate information on the emissions from their coal, or the flood risk to their mines. Clearly, the former is exposed to a high degree of climate change risk, which would be a relevant consideration for the trustee. To ensure that the requirements of the legislation are met, trustees should amend their investment strategies to require that information on climate change risk is sought and considered.

Provisions in the legislation outline the requirements of the risk management plan required for an Registrable Superannuation Entity license (which is granted by, and required for registration with, the Australian Prudential Regulation Authority (APRA)).⁵⁶ The risk management plan must “set out reasonable measures and procedures to be used to identify, monitor and manage the risks” to the investment strategy and financial position of the fund as well as any other operating risks.⁵⁷ In accordance with legislation, the risk management plan must set out and assess the likelihood and consequences of all relevant material risks, which are defined as, amongst others, a risk that has the potential, if realised, to adversely affect the interests of members.⁵⁸ APRA considers that a relevant material market risk is “the possibility of loss resulting from changes in market conditions,” and that monitoring must take into account “proposed and actual legislative amendments which may impact on the fund.”⁵⁹ Arguably, both primary and secondary climate change risk fulfil this definition and should be included in the risk assessment and subsequently assessed to the requisite standard of care, skill and diligence.

Duty to consider the long term prospect of investments

The duty to take a long term perspective arises from certain provisions requiring that regard be given to cash flow requirements,⁶⁰ and trustees’ functions be performed in the best interests of the beneficiaries.⁶¹

As recognized in the initial Freshfields Report, superannuation fund investments in particular are intended to yield significant cash flow in

⁵⁶ *Superannuation Investment (Supervision) Act 1993* (Cth), s 29P.

⁵⁷ *Superannuation Investment (Supervision) Act 1993* (Cth), s 29P(1), 29P(2).

⁵⁸ *Superannuation Investment (Supervision) Regulation 1994* (Cth), r. 4.07B(1)

⁵⁹ Australian Prudential Regulation Authority, *Superannuation Circular No.II.D.1: Managing Investment and Investment Choice*, March 2006 at 8.

⁶⁰ *Superannuation Investment (Supervision) Act 1993* (Cth), s 52(2)(f)(i).

⁶¹ *Superannuation Investment (Supervision) Act 1993* (Cth), s 52(2)(c).

the future.⁶² Thus, it is very important to take a long-term view of investments. Arguably, it is in the best interests of beneficiaries that superannuation funds not prioritise short-term profits over long-term growth and security. Although this does not of itself mandate the consideration of climate change, it is an important part of the duty to manage various aspects of investment risks, particularly as climate change risk is long-term in nature.

In the United Kingdom, however, consideration of the long-term prospects of investments is now mandatory. The Companies Act 2006 imposed new duties on company directors, requiring them to have regard to wider and long term consequences when making their decisions.⁶³ The Fair Pensions Report, argues that the new duties introduced under this legislation should be used as a model for similar amendments in the institutional investment context. The report states that this “enlightened fiduciary” model would necessitate a shift away from the current industry focus on short-term profit maximisation, and encourage sustainable, long-term investment.⁶⁴ This argument is supported by the Fiduciary II Report, which refers to the comments of Lord McKenzie in the House of Lords during the passage of the Pensions Bill in 2008 where he states that it is an “obligation on pension fund trustees” to ensure that “social, environmental or ethical considerations are taken into account” in their investment analysis.⁶⁵

Duty to diversify across portfolio

The legislation in Australia requires that an investment strategy must diversify the investments of a portfolio.⁶⁶ APRA holds the view that an example of diversification within an asset class would be “domestic and foreign equities”.⁶⁷

According to the AODP Survey, “only 17% of funds have a specific allocation to climate change related investments.”⁶⁸ This is in contrast to the position overseas. According to the Global Investor Survey on

62 Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005), UNEP FI Asset Management Working Group at 7. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

63 *Companies Act 2006* [UK] s 172.

64 FairPensions, *Protecting Our Best Interests – Rediscovering Fiduciary Obligation*, March, 2011 at 6. See also full discussion at Chapter 6.

65 UNEP, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment* (2009), UNEP FI Asset Management Working Group at 15.

66 *Superannuation Investment (Supervision) Act 1993* [Cth], s 52(2)(f)(iii).

67 Australian Prudential Regulation Authority, *Superannuation Circular No.II.D.1: Managing Investment and Investment Choice*, March 2006 at 9.

68 The Climate Institute and The Australian Institute of Superannuation Trustees, *Climate Change Investment Initiative: Asset Owners Disclosure Project: Funds Survey Results*, March 2011 at 9.

Climate Change, internationally more than 80% of asset managers and 57% of asset owners make specific reference to climate change risk in their investment policy.⁶⁹ Most respondents consider climate change to be a material investment risk and opportunity to the entire investment portfolio.

AODP Survey, “only 17% of funds have a specific allocation to climate change related investments”.

Deutsche Bank has argued that the climate change sector is already providing investment opportunities for active asset managers, however, such investment “requires understanding the supply and demand dynamics of traditional energy commodities such as natural gas, coal, oil as well as agricultural commodities.”⁷⁰ Once superannuation trustees have an understanding of how climate change will affect their investments, they should consider investing in sustainable assets which will perform well across the range of potential mitigation scenarios as a hedge.⁷¹

However, given the policy risk and technology risk involved, many investors are waiting until there is more certainty before investing in clean technology, due to the irreversible nature of investments. Given that there are a limited number of clean energy products and viable investments, it is arguable that there are insufficient options to hedge at the same levels of return for a given risk but the return sacrifice of the hedge needs to be considered with the benefits. However, the cost of any climate change hedging strategy would need to be considered in the context of the potential risk to the portfolio caused by any rapid repricing of risk that prevents a fund trading out of their exposed investments. As climate change risks and opportunities increase, this balance between the cost of hedging and portfolio stability in the event of a carbon repricing event is likely to change further.

Further, funds are maximizing their potential losses, should the primary and secondary consequences of climate change prove severe. Arguably, a carefully and prudently crafted investment strategy should already be seeking to hedge against such loss, a strategy which is necessary when any technology undergoes change. For example, it may be prudent for funds to balance large investments with high climate change risk, with smaller investments with high climate opportunities. At the very least, the duty to perform functions with skill, care and diligence suggests that an investment strategy satisfying the diversity requirement should in some way have regard to the diversity of climate change risk and opportunity, and as climate change risks and opportunities become more extreme.

69 Institutional Investors Group on Climate Change, *Global Investor Survey on Climate Change, Annual Report on Actions and Progress 2010* at 5.

70 Deutsche Bank Climate Change Advisors ‘Investing in Climate Change 2011 The Mega-Trend Continues: Exploring Risk and Return’, February 2011 at 7.

71 Mercer Report at 15.



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The sole purpose test

The sole purpose test requires that a fund is maintained solely for the benefit of its members.⁷² This legislative requirement has sparked some debate in the past about whether it is legal for funds to consider environmental, social and governance principles. It has been argued that the sole purpose test prohibits the integration of climate change risk into investment strategies.⁷³

In 2006 the Commonwealth Government's Parliamentary Joint Committee on Corporations and Financial Services found that "consideration of social and environmental responsibility is in fact so far bound up in long term financial success that a superannuation trustee would be closer to breaching the sole purpose test by ignoring corporate responsibility."⁷⁴ A similar view was expressed at the Superannuation Lawyers Conference on 27 February 2009 by Senator Nick Sherry (then Minister for Superannuation) who stated that "the consideration of environmental, social and governance factors is so critical to the long-term financial success of superannuation assets, [they] should be incorporated into the investment decision-making process of superannuation trustees".

However, at present, as the objective of superannuation trustees is to achieve financially acceptable risk-adjusted returns from investments, wider societal benefits are generally excluded from assessments, except to the extent that they impact on the investment returns (either positively or negatively).

The Freshfields Report, Fiduciary II Report and the Fair Pensions Report discuss the tendency of investors to invoke the duty to act for the benefit of beneficiaries as a barrier to their consideration of environmental, social and governance factors, including climate change, in their decision-making.⁷⁵ The reports both argue that acting in the best interests of beneficiaries does allow the consideration of environmental, social and governance factors both in terms of their potential to affect financial returns and offering non-financial benefits, such as better quality of life.⁷⁶

⁷² *Superannuation Investment (Supervision) Act 1993* (Cth), s 62.

⁷³ The Climate Institute and The Australian Institute of Superannuation Trustees, *Climate Change Investment Initiative: Asset Owners Disclosure Project: Funds Survey Results*, March 2010 at 2.4.

⁷⁴ Parliamentary Joint Committee on Corporations and Financial Services, *Corporation Responsibility: Managing Risk and Creating Value*, [Commonwealth of Australia, June 2006] at [5.16].

⁷⁵ Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005), UNEP FI Asset Management Working Group at 7. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf, UNEP, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment* (2009), UNEP FI Asset Management Working Group.

⁷⁶ *Fair Pensions, Protecting Our Best Interests – Rediscovering Fiduciary Obligation*, March, 2011 at Chapters 3 and 4.

However, the Fair Pensions Report recommends that the position, particularly in relation to non-financial benefits, be clarified via statutory amendment to the law in the United Kingdom.⁷⁷ Similar clarification may be needed within Australian as to what extent climate change factors should be regarded in investment decisions.

Contravention of Trustees' duties

In accordance with Australian legislation, a person who suffers loss or damage as a result of the conduct of another person in breach of certain implied covenants discussed above or the sole purpose test may be entitled to recover the amount of loss or damage from the person in breach.⁷⁸ Where the action is in relation to breach of an implied covenant, a defence to an action may be available where it can be established that the investment was made in accordance with an investment strategy, formulated with all relevant circumstances (as outlined in the statutory provisions) considered.⁷⁹ As described above, climate change risk seems to be a relevant circumstance for consideration. Therefore, this defence may only be available where climate change risk considerations are included in the investment strategy.

Conversely, this defence may also be relied upon by trustees who are concerned that, by investing in low carbon technologies as a hedging technique, they might be in breach of their duties under Australian legislation, so long as they have made the investment decision in accordance with an appropriate investment strategy.

Cultural and structural barriers

The superannuation industry in Australia, and indeed the growth of the pension industry in the major pension economies, has been rapid over the last 20 years. The growth in interconnectivity between markets, high frequency trading and the emergence of undiversifiable risks such as climate change that cross asset classes and sectors have created unique challenges for asset owners.

While the obligations outlined above exist, it is also important that trustees recognise that the rapid growth of the industry is leading to changing expectations regarding long-term sustainability and the way in which investments should be made. Trustees should adapt the way they apply the law to these changing circumstances and a defence that it has always been done this way or structurally from an industry perspective that is not possible is not acceptable.

⁷⁷ FairPensions, *Protecting Our Best Interests – Rediscovering Fiduciary Obligation*, March, 2011 at 53.

⁷⁸ *Superannuation Investment (Supervision) Act 1993* (Cth), s 55(3).

⁷⁹ See *Superannuation Investment (Supervision) Act 1993* (Cth), ss 55(5) and 52(2)(f).

This is especially so especially when there is increasing expectations from the community that investors will not only be more responsible for investment generally but will also take into account issues regarding the environmental, social and governance issues.

This is particularly the case given the sub-prime mortgage crisis and in light of disasters such as the 2010 BP Deepwater Horizon Oil Spill, where significant UK public pension fund investments were lost, £80 million for the public sector workers in Yorkshire alone⁸⁰. These sorts of expectations are also leading to calls for a more sustainable approach to capital investments as evidenced in the Generation Investment Management paper titled *A Manifesto for Sustainable Capitalism* by Al Gore and David Blood⁸¹, which calls for “sustainable capitalism: a framework that seeks to maximise long-term economic value by reforming markets to address real needs while integrating environmental, social and governance (ESG) metrics throughout the decision-making process”⁸².

Trustees should adapt the way the apply the law to these changing circumstances and a defence that it has always been done this way or structurally from an industry perspective that is not possible is not acceptable.

80 Matthew Elliott, Taxpayers' Allinace, *Pension Funds Sunk by BP Oil Spill Chaos*, This Money, 1 June 2010

81 Gore, Al and David Blood, *A Manifesto for Sustainable Capitalism: How Businesses can embrace environmental, social and governance metrics* (2010), available at: <http://www.generationim.com/media/pdf-wsj-manifesto-sustainable-capitalism-14-12-11.pdf>

82 Gore, Al and David Blood, *A Manifesto for Sustainable Capitalism: How Businesses can embrace environmental, social and governance metrics* (2010), pg. 1, available at: <http://www.generationim.com/media/pdf-wsj-manifesto-sustainable-capitalism-14-12-11.pdf>



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Conclusions

The stringent provisions of the Superannuation Legislation governing the management of risk require that trustees, or those to whom they delegate functions, take into account a broad range of risks when considering the merits of an investment. Climate change poses wide-ranging primary and secondary risks to investments. Failure to consider climate change risk as either part of risk management, or in an investment strategy, in the context of the legislation in Australia, may constitute a breach of trustees' duties.

The Superannuation Legislation is designed to ensure that trustees have regard to risk, and climate change is a major risk to investment value. Risks do evolve over time and as such the legislation must be applied over time in the context of such evolving risks as well as cultural and structural changes over time. In practice, this means that superannuation trustees should have evidence that they have genuinely considered climate change risks. The unquantifiable nature of the risk is no bar to its consideration. In order to avoid further uncertainty, it may be necessary to mandate consideration of climate change risk as part of the investment process of superannuation funds.

Further, given the unique ability of the superannuation industry to influence the market through their investment pool, it is arguable that it should be mandatory for superannuation funds to allocate a percentage of their investments to the sustainable sector. As superannuation funds are created and governed by statute, this could be mandated through an amendment to the Superannuation Legislation or its supporting regulations. Such a requirement has the potential to drive necessary development of the sustainability sector now to save costs in the future.

We are at the forefront of another such stage in the evolution of fiduciary responsibility and materiality. The concepts of fiduciary responsibility and materiality are not static concepts and have evolved over time in cycles. It is critical that trustees consider the impacts of climate change, including physical, technical and policy based impacts, on their investments in the knowledge that a failure to do so is likely to be a breach of their duties.

It is solely a matter of time before a trustee that fails to consider such impacts, which result in significant losses for the asset owners with respect to the investments they manage, will be forced to defend their actions in a litigious context. Incorporating a risk management approach that addresses climate change risk, will not only limit the risk of trustees being sued for negligence, but it will protect the investments over which trustees are only custodians.

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