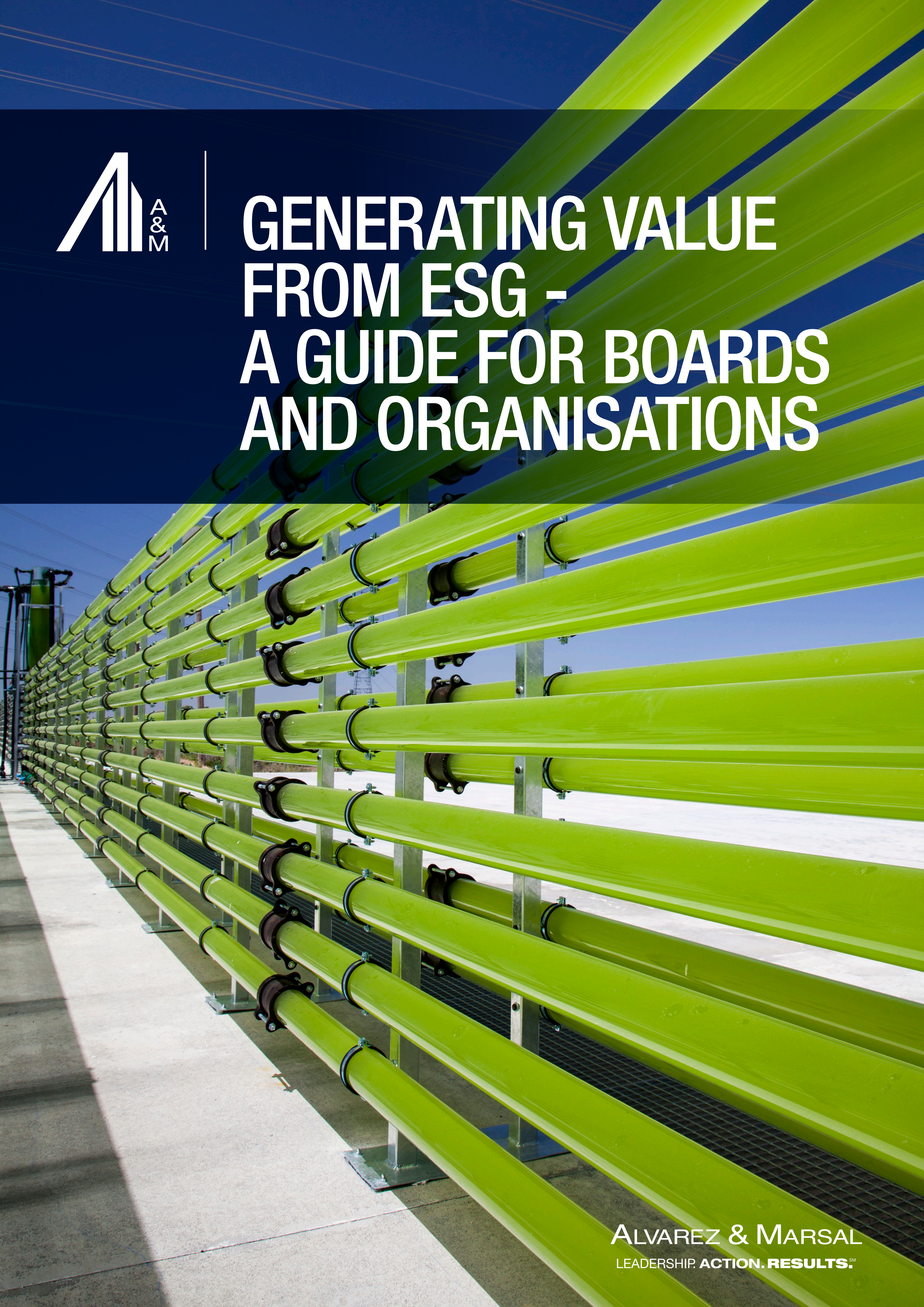


A&M

GENERATING VALUE FROM ESG - A GUIDE FOR BOARDS AND ORGANISATIONS

ALVAREZ & MARSAL

LEADERSHIP. ACTION. RESULTS.℠

GENERATING VALUE FROM ESG - A GUIDE FOR BOARDS AND ORGANISATIONS

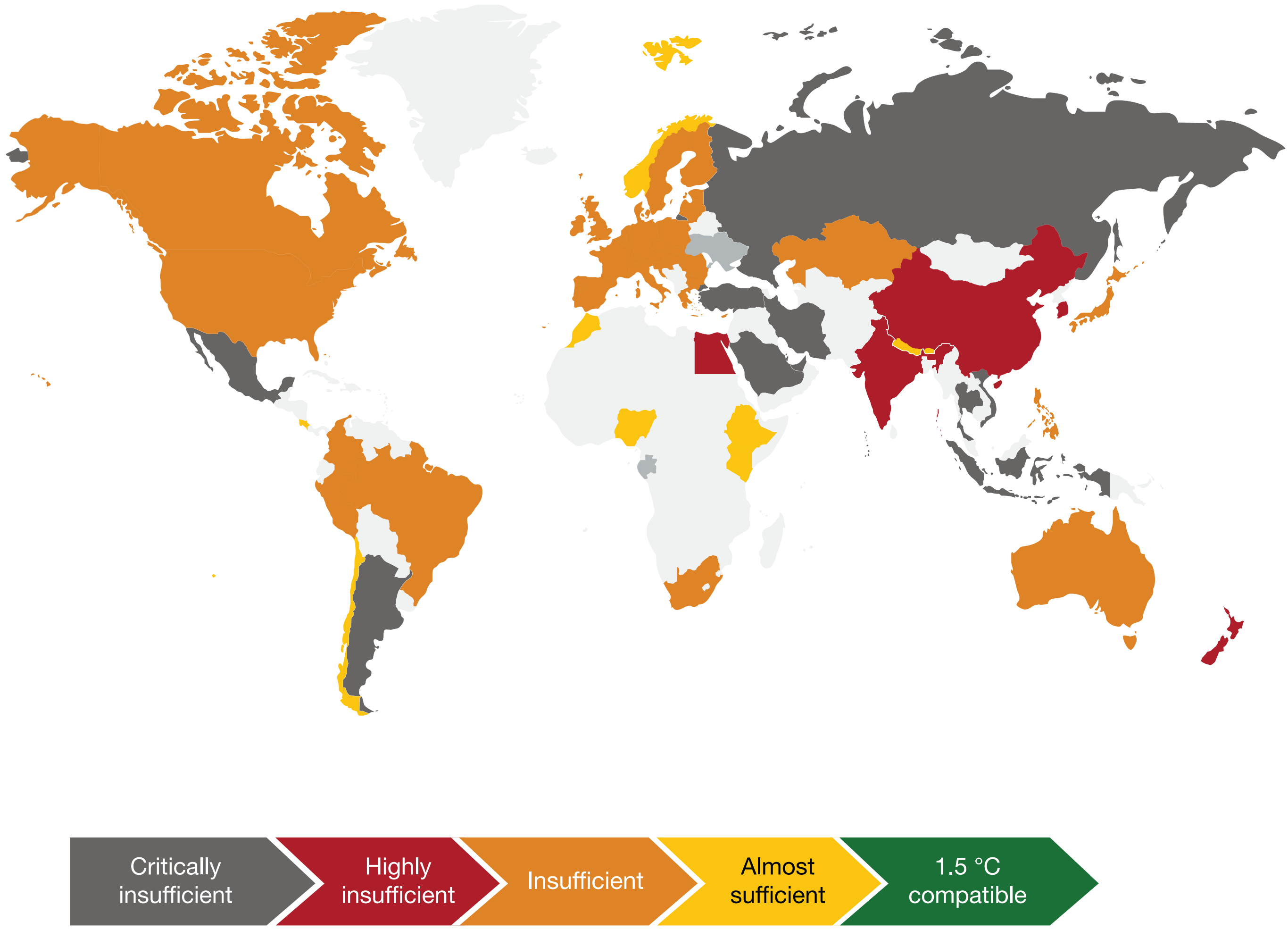
Company boards are under increasing pressure to address material Environmental, Social, and Governance (ESG) challenges, with a particular focus on decarbonising their operations.

This article delves into the challenges in governing the balance between commerciality versus compliance obligations; including the main challenges boards face, to ensure pragmatism triumphs over perfection and, how boards can come to terms with the degree of control they can exercise when effecting change and setting strategy.

Boards need to become comfortable looking to several other markets for ‘best practice’ in response to the decarbonisation challenge.

No countries are on track to meet national determined contributions…

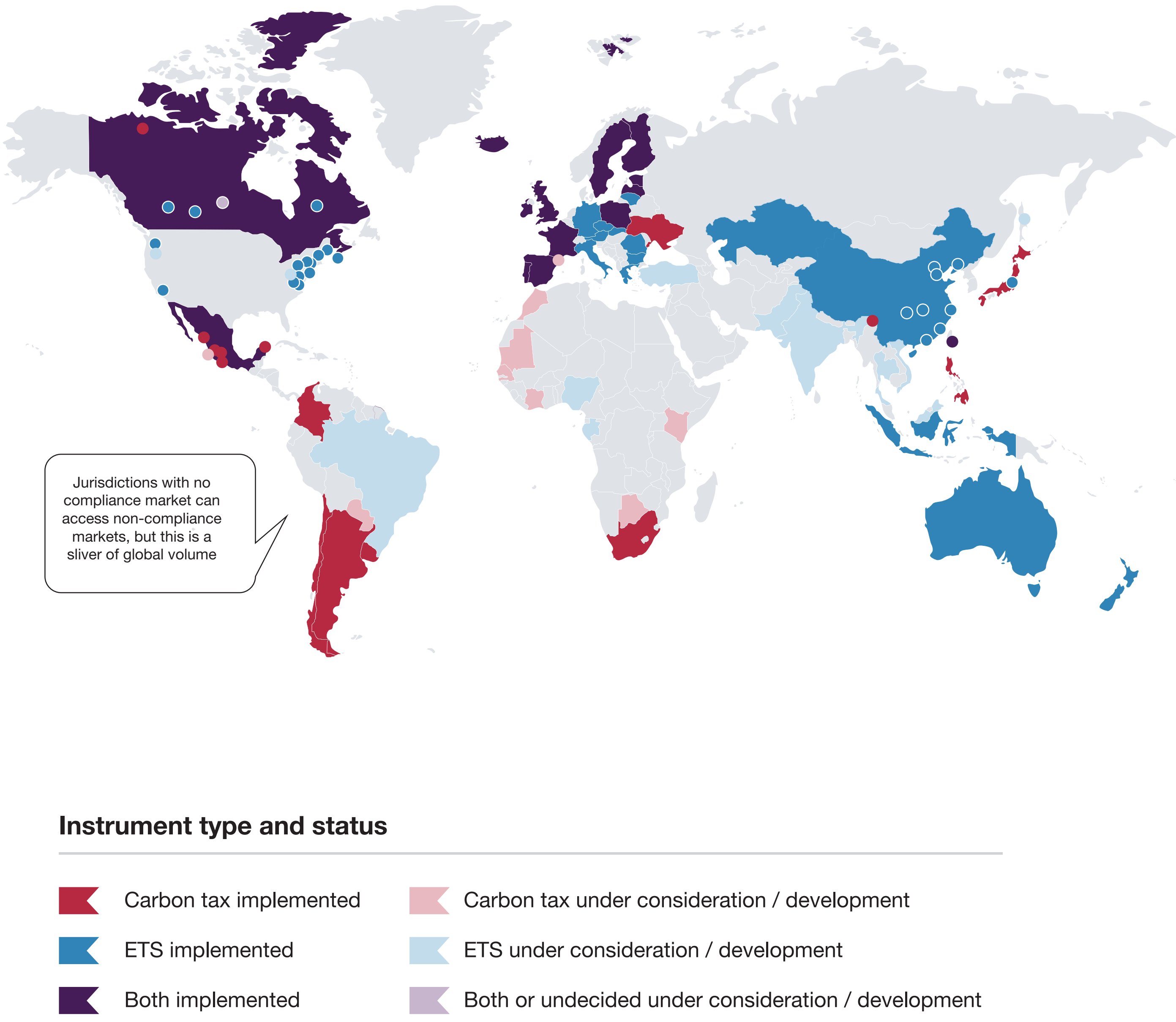
Progress against global national determined contributions (2024)



Sources: LSEG Carbon Market Year in Review 2023, S&P Global Commodity Insights, Bloomberg NEF, World Bank
1 Market value of compliance market; 2 The World Bank Dashboard

…despite increasing adoption of ETS and carbon tax schemes (ETS markets equate to ~US$950 Bn in annual trades[1])

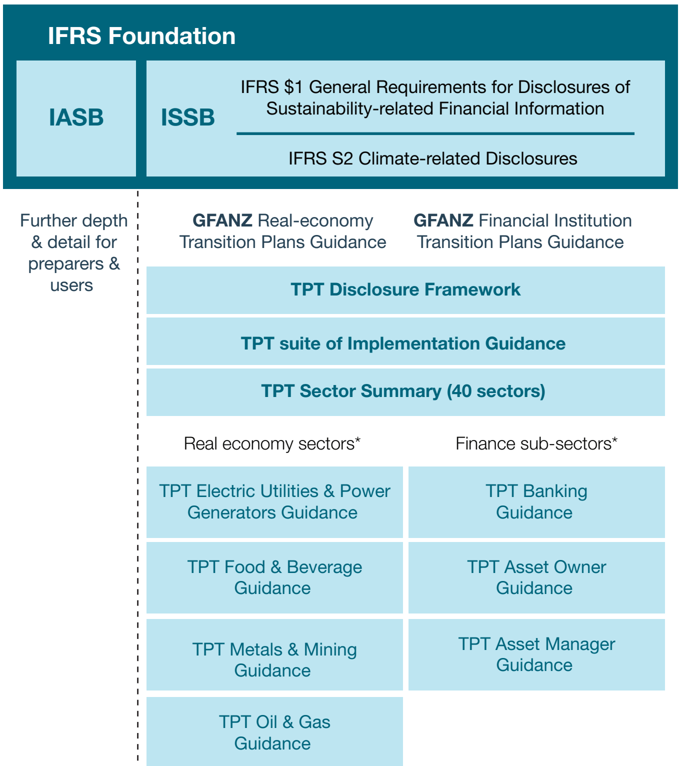
ETS / carbon tax schemes - Implemented, scheduled, and under consideration (2024)[2]



Sources: LSEG Carbon Market Year in Review 2023, S&P Global Commodity Insights, Bloomberg NEF, World Bank
1 Market value of compliance market; 2 The World Bank Dashboard

While Australia is not a significant emitter compared to global peers, our exported resources contribute to a large portion of emissions within some of our largest companies' value chains.

The UK Transition Planning Task-Force is recognised as the gold standard for companies to adopt decarbonisation planning and supported by IFRS/ISSB.



Consideration of data quality in decision making is obvious, which is why a lack of alignment on clear Scope 3 emissions reporting is frequently used as an excuse.

However, if and when Scope 3 begins posing an existential threat to customer bases this can create the impetus for change. These are the types of long-term challenges that boards should be contemplating and addressing in the near term, preserving value and seeking new opportunities.

Boards are challenged to weigh the costs of decarbonisation (and any ESG action) against potential long-term benefits, risk mitigation, enhanced reputation, and future profitability. ESG factors more broadly, can be critical components (not siloed pursuits) to financial health and should be actively integrated into management's strategy.

Principles	**Ambition**	**Action**		**Accountability**	
Disclosure Elements	**1. Foundations**	**2. Implementation Strategy**	**3. Engagement Strategy**	**4. Metrics & Targets**	**5. Governance**
Disclosure Sub-Elements	1.1 Strategic Ambition	2.1 Business operations	3.1 Engagement with value chain	4.1 Govemarce, engagement, business and operational matrics and targets	5.1 Board oversight and reporting
	1.2 Business model and value chain	2.2 Products and services	2.2 Engagement with industry	4.2 Financial metrics and targets	5.2 Management roles, responsibility and accountability
	1.3 Key assumptions and external factors	2:3 Policies and conditios	3.3 Engagement with government, public sector, communities, and ovil society	4.3 GHG metrics and targets	5.3 Culture
		2.4. Financial planning		4.4 Cartion credits	5.4 incentives and remuneration
					5.5 Skills, competencies and traimeng

Figure 3: The TPT Disclosure Framework

COMMERCIALITY AND COMPLIANCE CAN WORK TOGETHER TO ADD VALUE

New Directors are introduced to questions on the Australian Institute of Company Directors (AICD) company director's course that they need to ask themselves even if the company can do what it's been directed to do, should it be doing it? With decisions related to decarbonisation, the latter question is almost always positive, However answering the former is often more challenging in the context of climate change and ESG more widely.

While climate-related disclosures can force management to contemplate risks and opportunities, disclosures in and of themselves are simply a compliance outcome. What sits behind these disclosures can help directors and boards manage this evolving area, i.e. creating sound processes, policies and management systems. However, processes, policies and management systems alone will not deliver the required commercial outcomes, and whilst ESG reporting has been around for several years, the solutions required to act on that data cover a much larger spectrum of maturity.

Some transition-related solutions have been around at commercial scale for decades, such as solar, onshore and offshore wind and energy efficiency of industrial equipment. Others are still emerging, stuck in the laboratory or searching for funding to reach scale such as direct air capture (DAC), green high temperature process heat solutions and direct injection of hydrogen into diesel engines.

So often, boards and management teams are focusing on complying with 'an ask', including ESG disclosure, without thinking through the utility or value for an organisation.

An ESG disclosure might quench a boards thirst for 'action' but it does little to support management in executing strategy and ensuring all necessary commercial externalities are understood and capitalised to further enhance shareholder value – which perversely is one of the main fiduciary duties for a board.

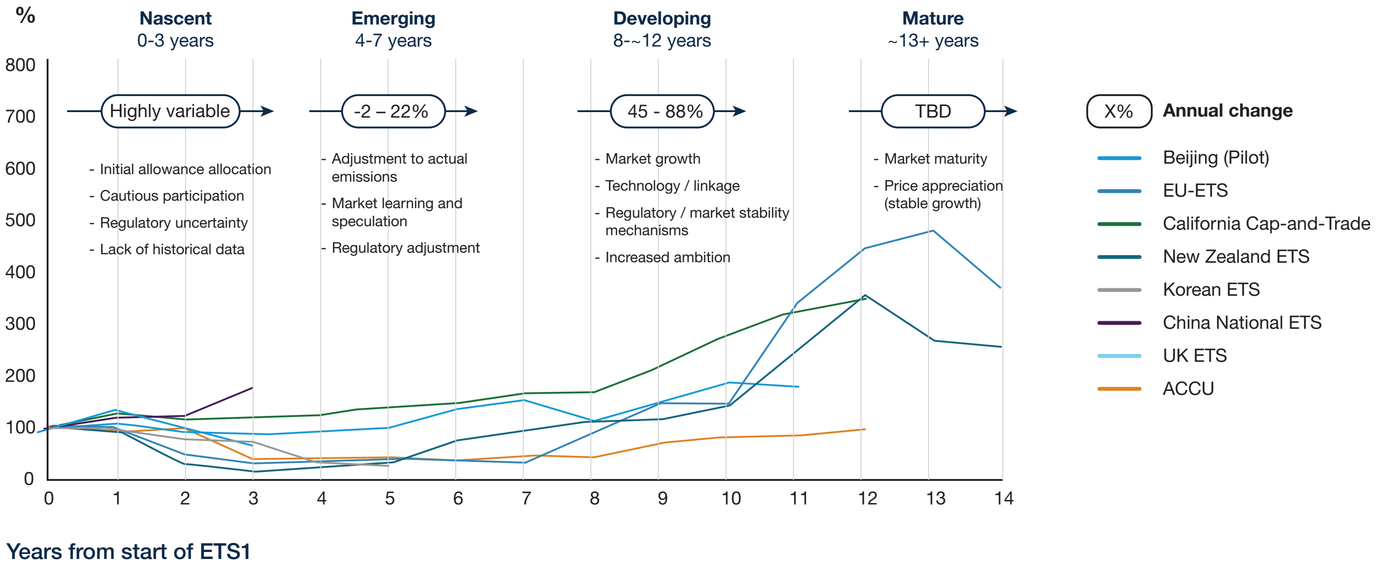
Decarbonisation and associated climate disclosures do not have to start and stop with risk mitigation or compliance-only approaches, so why is it that most boards stop at this point?

Helping boards bridge the decision gap between the current compliance disclosures and deciding to invest in meaningful solutions that deliver value to their business and decarbonise the economy is a critical next step in enabling boards to set direction and close the gap.

When it comes to capturing commercial opportunities with an ESG component, these rarely have a clear strategic value proposition, and those that do tend to have clear underlying penalties for non-compliance or rewards for taking on the risks associated with a leading position in the market. Understanding and meeting your decarbonisation obligations should not preclude strategic actions.

Carbon credit pricing is driven by maturity of the ETS, with growth typically seen from year 8 onwards…

Indexed price from start of ETS program,



Source: Carbon market exchanges, Exchange rates from IMF

1. Note chart normalizes all ETS start dates, except EU-ETS (started in 2005) and NZ ETS (started in 2008, which are both normalized to 2010

Most holistic board level ESG assessments tend to have a degree of survivability to them, i.e. can we continue as a going concern, can we pass these costs on to customers, can we make it to a more favourable political environment which would reduce the short-term risks? This may in part be driven by a level of expectation from the policy makers and supply side of the ESG equation (certainly in the case of decarbonisation) that aspirations need to be grounded in near virtual absolutes.

This position poses several challenges for boards across both compliance and commercial expectations

01 Long term targets that cannot be clearly linked to short term actions create a set of credibility and do-ability challenges and may be limiting outcomes.

02 The most likely strategic plan (and associated accounts / financial statements) generates concern that they are not shifting resources within businesses 'fast-enough' to meet these bold expectations.

03 Boards need to be comfortable that they are getting the full picture when setting strategic targets to capture value. Often businesses are breaking the age-old best practice of involving those who have to do the work in the setting of their targets – if the operational and technical teams who have to deliver the outcomes are not involved in setting the targets and then delivering them, it is unsurprising that large global companies have revised their targets to a level that can be achieved under current incentive structures.

04 Reducing the number of cost-effective solutions available to solve the challenges (such as those being debated by SBTi as part of their internal conflict) erodes the fundamental nature of the Paris Accords looking to the most economically efficient path to decarbonise the global economy to achieve a 1.5 degC trajectory. This also flies in the face of Bill McKibben's silver buckshot hypothesis.

When taking action to capture value, boards must ensure their companies have the necessary tools to collect, manage, and analyse ESG data, ranging from carbon emissions tracking to social impact metrics. This may attract untimely requests for capex or increased short term opex, however this should not be the sole focus or yardstick by which a board measures commercial or compliance outcomes. Analysing and understanding where systems and data can support management to pursue commercial outcomes should be the true focus. Commercial outcomes may be hiding in plain sight, but companies are failing to notice.

Directors continue to view climate as a significant priority for boards, with 60 percent of surveyed directors advocating Boards pay greater attention to climate governance.

#1 AUSTRALIAN DIRECTORS CONTINUE TO PRIORITISE CLIMATE GOVERNANCE

- Concern regarding climate change risk remains high among Australian directors, despite challenges like geopolitical conflicts, inflation and economic uncertainty.
- In this study, 80 per cent of directors express concern about the impact of climate change on their organisations, a three per cent increase from 2021, while extreme concern is down slightly to 19 per cent. Notably, 70 per cent of those most concerned about climate risk also see opportunities in addressing it
- There is a growing consensus among directors regarding climate governance as a critical issue, with 60 per cent of directors believing boards should pay more attention to it, up from 46 per cent in 2021.
- Attention to nature has emerged as priority, with half of directors considering nature and biodiversity a material risk to their organisations.

80% of directors are concerned about climate change as a material risk

60% of directors want their boards to pay more attention to climate

70% of those directors most concerned about climate change also see opportunity

50% of directors see nature and biodiversity as a material risk to their organisations

Source: AICD climate-governance-study-2024

To achieve a compliance only outcome, boards are often looking to prudently manage the costs associated with shifting resources to address climate change.

A more proactive, and potentially less risky, approach, would be to position all investments as targeting a value accretive position for the business.

This approach would require boards to look at their business from a broader perspective than they potentially do today and go deeper into the wider economy for commercial solutions. This could include:

- Ensuring all measurement, reporting and verification (MRV) investments are not only used for reporting obligations, but also leveraging the data to better inform capital investment decisions
- Using this data to leverage AI and mega-data as it is becoming more commonly used to understand the true impact and benefits of decarbonisation on the business
- Ensure a carbon price is incorporated in all portfolio actions such that high carbon intensity acquisitions are discounted, and low carbon intensity sales are attributed fair value
- Build a portfolio of options across the spectrum of carbon solutions to reduce upfront risk, remain connected to innovative developments (both nature and technology based) and, provide a hedge against legislative and market movements
- Support economy-wide decarbonisation solutions to develop a higher confidence in what fair value looks like for the price that needs to be paid for a higher carbon intensity product versus a lower intensity one

In this fashion, compliance and commerciality work as a team. Companies and their various stakeholders and counterparties can continue building momentum in a risk managed fashion to transition the economy to a lower carbon future.

PRAGMATISM NEEDS TO TRIUMPH OVER PERFECTION

Decarbonisation involves reducing carbon emissions across all aspects of a business, from production processes to supply chains. Boards must first understand the full scope of their carbon footprint, leaning on the comprehensive data collection and analysis referred to earlier. In the end, data gathering and analysis is only the first step to deploying practical solutions, to avoid, abate, remove or offset emissions.

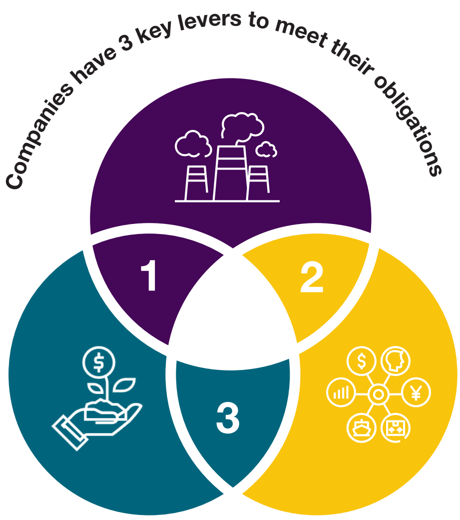
Following COP29, there appears to be a degree of relief that pragmatism appears to have won out and that the global carbon markets can continue to develop, scale and mature to provide more solutions with more informed pricing for available decarbonisation solutions.

The board level challenge…

How to meet or beat our decarbonisation obligations by 2031?*

Decarbonise own business
(Scopes 1 & 2)

- + Potential to create new revenue streams
- + High confidence in compliance
- − Higher upfront capital investment
- − Requires sufficient time to implement
- ⚠ Returns highly context dependent



Invest in third party decarbonisation projects

- + More opportunities available vs in-house projects
- + Opportunity to benefit from and leverage external expertise on decarbonisation
- − Investing in diverse industries potentially blurs strategic focus
- − Potential compliance risk in the event of legislation changes (e.g., methodology disallowed)
- − Returns may potentially be overestimated and subject to the volatility of the carbon markets

Buy credits
(e.g., ACCUs, SMCs)

- + Lowest up-front investment
- + Portfolio effect can spread compliance risk
- − Fragmented illiquid markets and ongoing concerns regarding credit integrity and value
- − Price of credits volatile and likely to increase
- − Ongoing purchasing and monitoring required

While many organisations will tend to focus on buying credits, the winning strategy will typically incorporate all these levers

*End of current safeguard phase

For boards, this should provide a degree of comfort that whilst the path is still evolving the direction has been clarified. Boards are used to working with uncertainty, however in the past, the degree of uncertainty has been significantly higher than most boards were able to act within.

The global changes continue, and it is not to say that there will not be significant shifts still to come, however, these are starting to fall into the categories of pace of change and the tactical solutions, as opposed to the more strategic directional questions of the last few years.

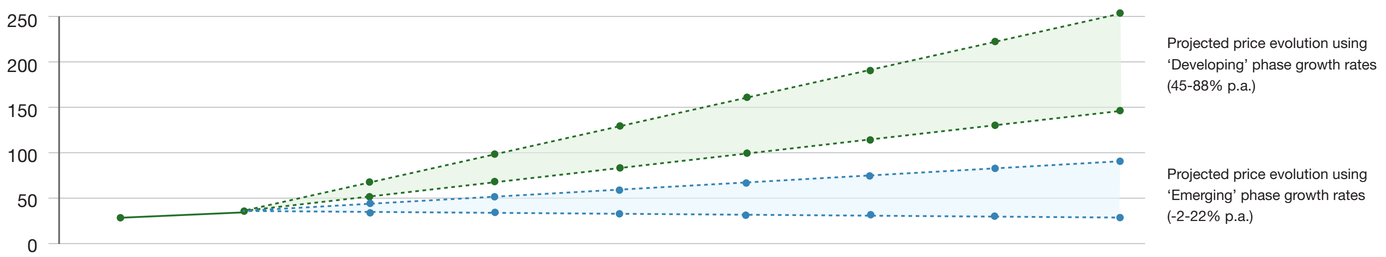
Any global event appears to bring both headwinds and tailwinds to bear on how the Paris Accords and our global agreement to decarbonise is viewed. Traditional global economic leaders, such as the US, in this instance, appear to be more comfortable following the rest of the world, and then rapidly capitalising on new market opportunities as has been their forte in the past.

For companies operating internationally, remaining pragmatic can be hindered by varying ESG regulations and standards across countries, adding unnecessary complexity to ESG management. Boards and management teams are significantly challenged to adopt ESG strategies that are flexible enough to meet diverse regulatory requirements, while maintaining consistency in reporting and action across global operations.

Focusing on what matters to company operations can help. This includes overseeing due diligence processes to ensure appropriate supply chain resilience and ethical practices are in place. Data collection and analysis is part of this, as are aligned oversight mechanisms. All with a view of resourcing what matters and less focus on what does not.

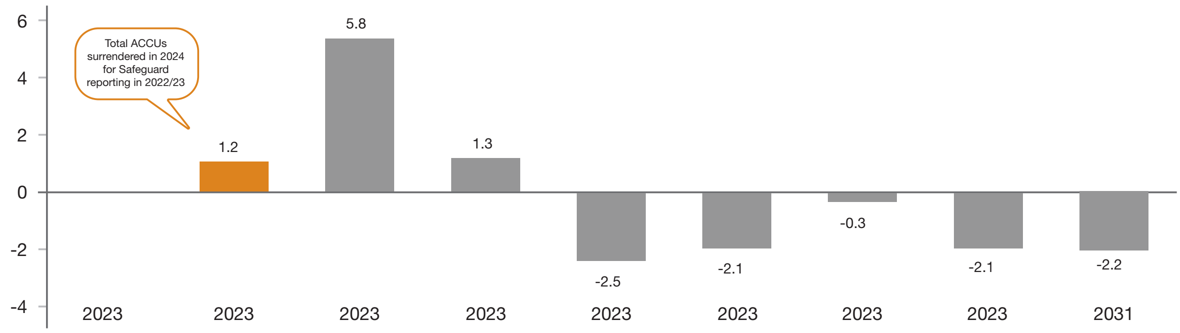
Projected ACCU annual average price

AUD



Projected ACCU supply deltas, net of assumed SMC allocation

Million Units



Source: CER Quarterly Carbon Market Report 2024, CER Safeguard facility reported emissions data, ICE EUA Futures Pricing

	Adapt to headwinds	Sail the tailwinds
US Elections	With the US exit from the Paris Accords once again, Trump's increased support for fossil fuel expansion projects, and the pause in IRA funding, **new clean energy investments may slow down, leading to a reduced demand for critical minerals in the US.**	This shift could also present opportunities, as the **global energy transition will persist, and other countries are expected to step in to fill the gap left by the US.**
COP29 Outcomes	A limited commitment to the NCQG could pose **challenges to achieving global consistency in the adoption of regulatory frameworks.**	The ratification of Article 6 at COP29 is anticipated to **support further growth and alignment in international carbon credit markets and underlying transactions** as more countries enter into bilateral agreements and start making use of the Article 6.4 marketplace.
ETS Markets	More countries **implementing ETS could hinder business growth,** as rising Scope 1 emissions may increase compliance costs, create competitive disadvantages, and make high-emission activities economically unviable in some regions.	As ETS markets expand globally and countries face challenges in meeting their NDC targets, **more nations, (including China, Indonesia, South Korea, Singapore, and Brazil) are anticipated to make use of carbon credits to incentivize decarbonisation.**
CBAM	The **CBAM will introduce additional costs for steel imports,** and Europe has yet to determine whether international carbon credits will be permitted.	The **CBAM can offer a competitive advantage to early movers who look to decarbonize their products,** as addressing these emissions in line with the EU regulations can help maintain leadership in any sector where lower carbon intensity products are valued.

Note: NCQG (New collective quantified goal), ETS (Emissions trading system), CBAM (carbon border adjustment mechanism)

Investing in ESG initiatives often requires significant upfront costs, such as adopting new technologies or overhauling supply chains. Boards must weigh these costs against potential long-term benefits, such as risk mitigation, enhanced reputation, and future profitability. Recognising ESG factors as critical to financial health, boards must integrate these risks into their overall risk management strategy.

INNOVATION IN ASSET CLASSES

If you can make carbon commercial and generate a revenue stream via a value accretive carbon price (or as a minimum pass the full costs through to an end customer) why would your business not want to own more of this 'asset'?

Holding this type of asset on a companies' balance sheet will trigger several fundamental questions that should be within the board's purview, certainly until they are well established:

- Will these carbon assets be perceived as non-core? How do we communicate to shareholders / other key stakeholders as to why we have made this change?
- How do we integrate this asset class with our existing corporate strategy and broader asset portfolio? Who will make portfolio decisions regarding how risk and value is managed and traded-off?
- Do we have the skills and capabilities within the business to manage these types of assets? Should this be in-house or are we better positioned to use a partnership or outsourcing model?
- If we bring it in-house, where should it sit? Does it compromise the CFO function's independence if it sits in the finance function? How do we balance the trading and investing skills required to optimise the value delivered by these assets?

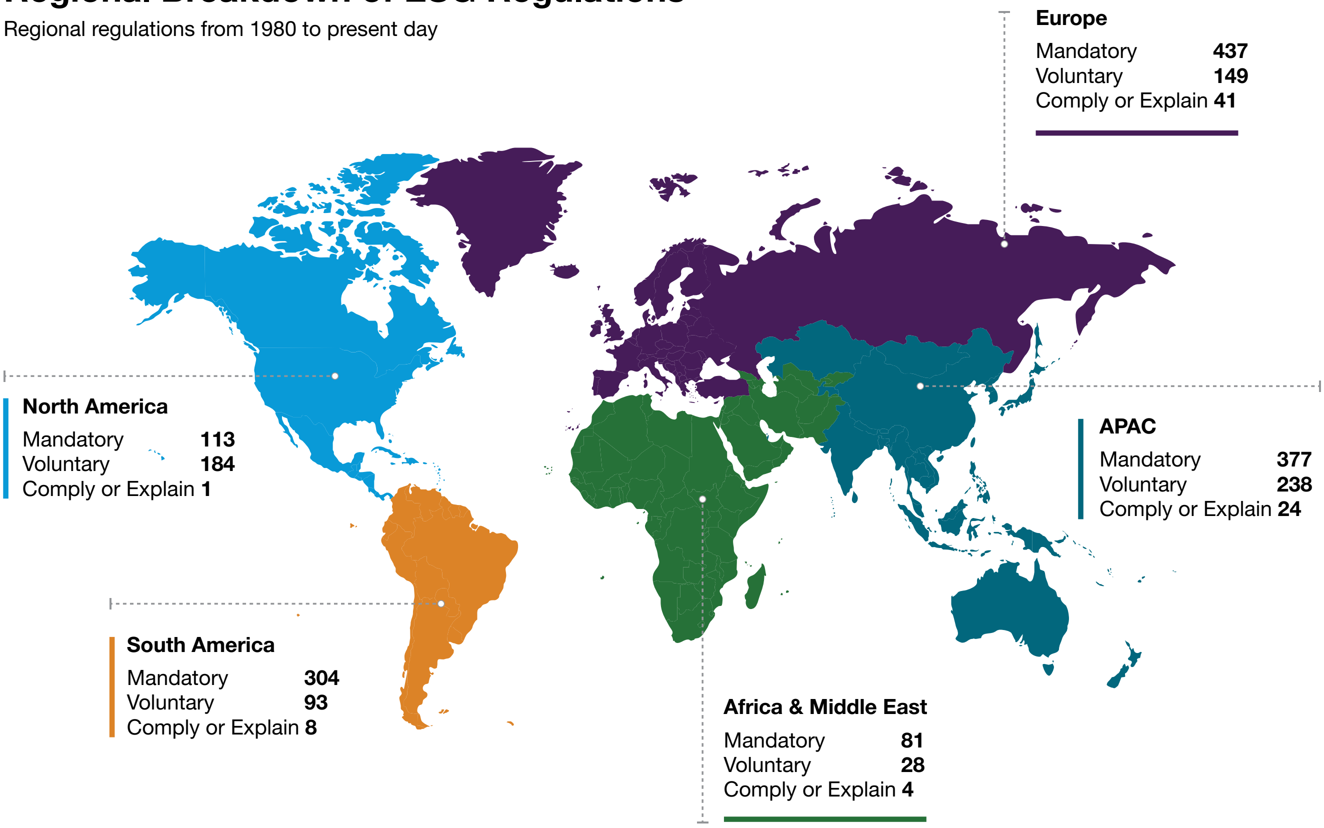
Whilst these types of questions are not new for boards, the unique features of carbon as an asset class present new challenges. And perhaps most importantly, what happens if you get it wrong? There are some scenarios which can be extremely dire from a board perspective, and today's boards appear to over index on managing the downside risk.

Breadth and number of global investor, and national jurisdictions' ESG related policies increasing.

Research shows that global ESG regulation has increased by 155% over the past decade, with 1,255 ESG policy interventions introduced worldwide since 2011, compared to 493 regulations published between 2001 and 2010

Regional Breakdown of ESG Regulations

Regional regulations from 1980 to present day



Source: [ESG Book | Global ESG regulation increases by 155% over past decade]; [Regulation database | The PRI's global policy work]

This leads back to a pragmatic approach which builds confidence, scale and resilience in the new asset class whilst reducing the perceived (and actual) risks associated with decarbonising a global economy.

The financial implications of decarbonisation are profound. Boards must balance the costs of implementing sustainable practices with the potential for long-term savings and revenue growth.

This includes assessing the return on investment for green technologies and considering the financial risks associated with climate change, such as asset devaluation and increased insurance costs.

DEGREES OF CONTROL

While we would like to believe we are all in control of our destiny, certain businesses will have a higher degree of urgency to address some of the questions and challenges posed above. Those businesses with an existential threat due to carbon emissions (e.g. small-scale industrials), or the need for a new market to emerge and support development over time (e.g. critical minerals markets, including lithium) will be incentivised by returns or survival to move at a faster pace than others. They need to be supported by the broader market, otherwise the gains they make in forging a path will be quickly lost as the scale, and network effects run the risk of being lost. This makes the challenge about not who is going to lead, but who is going to follow fast and at scale.

This level of interaction is easily seen when you consider that a significant portion of a company's carbon footprint often lies within its supply chain. Boards must work with suppliers to reduce emissions, which can be challenging due to varying levels of commitment and capability among suppliers. This requires collaboration, setting clear expectations, and possibly restructuring supply chain relationships.

Businesses love certainty in their economic environment and Australia has suffered in recent years from several interventions and changes that have been imposed on some large operators and investors. As that storm has been weathered, there appears to be a desire for stability to enable a return to the pragmatic approach that has served Australia well over generations – working the problem and getting the job done, whilst making money at the same time.

Boards can adopt one of four main carbon philosophies based on industry setting, asset portfolio and broader strategic focus

Compliance and cost containment	Compliance and value optimisation	Exceeding compliance and value creation	Full value extraction and economic moat
• Strategy focused on **avoiding penalties** rather than seeking competitive advantage • Carbon accounting vs carbon management, treated as **cost center** within ESG team • Focus on purchasing allowances at lowest cost, and **limited participation in markets** beyond compliance • **Limited investment** in low-carbon technologies	• Compliance remains the priority, but with some focus on realizing **financial or operational benefits** • Established **carbon management function,** interfacing with finance and operations to optimize costs • **Active participation in carbon markets** to trade allowances and reduce compliance costs • **Selective investment** in low-carbon tech where ROI is clear	• Carbon seen as an **opportunity for differentiation** • Dedicated **carbon strategy team** reporting to senior leadership • **Investments** in emissions reduction projects and low-carbon technologies **to create new revenue streams** • **Proactively shaping policy** and regulations to favor company strategy	• Sustainability and low-carbon innovation used as a **moat to protect market position** • Carbon fully **embedded in corporate strategy**, led at the C-suite or board level • Surplus allowances, offsets, and sustainability-linked assets **leveraged for revenue** • **Strong engagement** with regulators, industry groups, and policymakers

	Compliance and cost containment	Compliance and value optimisation	Exceeding compliance and value creation	Full value extraction and economic moat
Financial Services	Multiple cases observed	Individual / select cases observed	Individual / select cases observed	No cases observed
Transport & Logistics	Multiple cases observed	Multiple cases observed	Individual / select cases observed	No cases observed
Oil & Gas, Mining	Multiple cases observed	Multiple cases observed	Multiple cases observed	No cases observed
Utilities, Agriculture	Multiple cases observed	Multiple cases observed	Multiple cases observed	No cases observed
Manufacturing	Multiple cases observed	Multiple cases observed	Multiple cases observed	Individual / select cases observed
Consumer Goods & Retail	Multiple cases observed	Multiple cases observed	Multiple cases observed	Multiple cases observed

Board-communicated targets | Multiple cases observed | Individual / select cases observed | No cases observed

Australia's connection to the developed and developing worlds across several fronts, be it China, the US, pacific islands, Latin America or Southeast Asia, creates a unique position where Australian businesses can be the virtual glue that leads the way through to economically attractive solutions that decarbonise the global economy.

At Alvarez & Marsal this aligns to our core belief around rolling our sleeves up and working closely with our clients to make whatever needs to be done happen. Never has this been truer than in the global climate space when it comes to decarbonising our economy.

Decarbonising a business is a complex and multifaceted challenge that requires strategic leadership and commitment from company boards. By understanding the challenges and barriers to effective decarbonisation, boards can develop comprehensive strategies that align with their ESG goals and drive long-term value creation. Through proactive engagement, investment in innovation, and effective carbon pricing, businesses can navigate the path to a sustainable and low-carbon future.

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