Q4 2021 COP 26 REVIEW

In our Q3 2021 Research Spotlight, we reviewed key conclusions from the August 2021 IPCC report, and examined some of its implications for investors. This report, which was declared a "Code Red for Humanity" by the UN Secretary-General, underlined the urgency of addressing climate issues across the global economy and the critical importance of accelerating the global decarbonisation agenda. The IPCC report clarified that time for decisive action across the global economy is running out. Released less than three months prior to the COP26 in Glasgow, we believed that the report would provide crucial support for politicians and businesses to make the commitments necessary to avoid the most catastrophic effects of climate change. In this quarter's Spotlight, we review the key takeaways from COP26 and provide our assessment of whether it delivered on its promise, and what we see as the most important implications for investors.

The importance of the outcome from COP26 cannot be understated: at the outset, claims were made that the climate summit in Glasgow which took place in early November 2021 was the last COP to have a chance at preventing catastrophic global temperature rises and climate change effects.[1] Based on a general review of discussions in the media, we have not witnessed a strong consensus on the value of the outcomes, with some calling the conference a failure while others declaring a significant step forward for climate action. Regarding the outcome—the Glasgow Climate Pact—one news magazine put it bluntly: "It won't change the world, but it does move the needle".[2] What is clear to us is that the conference underlined a global commitment to addressing climate change, and while certain elements were disappointing (and will require future work and further commitments), in other areas real and tangible progress was made. Below we highlight several key developments from COP26 that in our view will impact both our planet and the long-term landscape for investors.

Global Carbon Market

One of the most important outcomes of COP26 was the establishment of rules for a new global carbon market. The agreement was six years in the making, and was a key contributor to what was broadly considered a failure at COP25 in Madrid in 2019 when no agreement on the framework was reached.[3] [4] The agreed-upon rules at COP26 establish a framework for the trading of credits representing carbon that has been reduced or removed from the atmosphere.

The new framework "will be comprised of two parts: a centralised system open to the public and private sectors, and a separate bilateral system that will allow countries to trade credits that they can use to help meet their decarbonisation targets".[5] Dirk Forrister, chief executive of the International Emissions Trading Association, declared it was a "solid and ambitious outcome, because it establishes an integrity framework to support the expansion of carbon markets to help governments and businesses deliver higher climate ambitions" and that it is now "up to the private sector to channel green investment using these new market structures and accelerate the race to net zero".[6]

In our Q2 2021 Research Spotlight, we discussed the emerging theme of a "levelling out of the playing field" in relation to carbon pricing, citing the EU Emissions Trading Scheme (ETS), the launch of the UK's own ETS in May, and China's later this year as evidence of the trend towards global convergence. The long-anticipated agreement of the rules and development of a global ETS supports the thesis that global convergence on carbon pricing means polluting (or being poorly

Global Carbon Market

Good News: The new global ETS framework confirms global commitment to carbon pricing. Germany's announcement for a carbon floor price may create a domino effect in other countries as has been the case with carbon tariffs.

Bad News: Old credits can be used in the global emissions trading scheme, weakening its impact.

Our Grade: A-

prepared for carbon regulations) will be increasingly costly going forward globally. Germany also announced post-COP26 that it would introduce a carbon floor price of €60 per tonne if the EU fails to agree on a minimum price in its emissions trading scheme.[7] While a very encouraging development, some concerns remain with the global carbon market agreement, focused primarily on the fact that old credits will be allowed into the new system. These old credits, created under the Kyoto protocol between 2013 and 2020, could represent as much as 300m tons, according to Carbon Market Watch estimates. Experts have expressed concerns they could potentially flood the market with cheap units that depress prices.[8] [9]

In our Q2 2021 Research Spotlight we also discussed the importance of the emergence of carbon tariffs and, in particular, the EU Carbon Border Adjustment Mechanism, designed to put EU firms on an equal footing with competitors in countries with weaker carbon policies. COP26 saw further developments in this area, with the UK confirming plans for its own carbon border tax that would affect imports from polluting countries, intended to "protect green businesses in the UK."[10]

We expect to see more regulatory action developing in this area in due course, broadening the financial importance and materiality of carbon emissions/carbon intensity for companies, and encouraging decarbonisation across a wider range of industries and goods. We believe companies better prepared for this transition will have a competitive advantage in the months and years ahead.

China US Joint Declaration

Continuing on the theme of global regulatory convergence, a landmark announcement by two rival superpowers surprised conference attendants. China and the U.S., the world's two biggest emitters, unveiled a joint declaration to work closely to achieve the 1.5°C temperature goal set out in the 2015 Paris Agreement.[11] Steps were agreed on a range of issues including methane emissions, the transition to clean energy, and de-carbonisation.[12] The timeline is important, with the joint declaration focused on "enhancing climate action in the 2020s".[13] The agreement calls on both countries to strengthen their plans to cut emissions. China also agreed to "phase down" coal consumption during their 15th Five-Year Plan, which starts in 2026, and committed for the first time to address emissions from methane.[14] The declaration follows an EU-China Joint Statement on Climate Change adopted at the EU-China summit in 2015, where the two entities agreed to further enhance their bilateral cooperation on carbon markets.[15] This was a very constructive piece of news, and shows that even political rivals can find room to agree on climate action. Still, the Glasgow declaration was short on firm deadlines and perhaps light on specific commitments.

China US Joint Declaration

Good News: The US and China have both agreed they will work closely to meet Paris targets.

Bad News: It is still too early to fully assess the announcement and level of cooperation between the nations. Deadlines and specific commitments remain to be seen.

Our Grade: B+

Global Methane Pledge

Another landmark event confirming the trend of global regulatory convergence was the announcement of the Global Methane Pledge, which gathered backing from 105 of the UN's 193 member states.[16] Highlighted as an emerging climate theme in our Q3 2021 Research Spotlight, methane comprises about 95% of natural gas, and, after CO2, is the second most significant greenhouse gas. Methane is 80x as effective at trapping heat than CO2 in a 20-year period, and, as such, is a much more powerful short term heat trapper than CO2.[17] The Global Methane Pledge announced at COP26 commits signatories to reducing their overall emissions by 30% by 2030, compared with 2020 levels.[18] The U.S. government also published a detailed blueprint of how it intends to meet the goal.[19]

Global Methane Pledge

Good News: The Pledge represents a significant step forward to address the climate impact of methane emissions, with a majority of UN member states participating.

Bad News: Important major emitters have not signed the pledge, but may develop national policies. Not all sources of methane are currently addressed.

Our Grade: B

While very encouraging, some needed elements were clearly missing from the current pledge; for example, some sources of methane leaks, including abandoned wells and malfunctions in gas flaring, are not yet covered. However, the U.S. Environmental Protection Agency said it will release a supplemental proposal next year to "flesh out the rules" and possibly expand them to cover methane sources not currently covered.[20] The new global initiative emphasises making cuts by tackling methane leaking from oil and gas wells, pipelines and other fossil fuel infrastructure.

Importantly, the voluntary pledge is backed by 15 of the world's biggest methane emitters including the EU, Indonesia and Iraq, and the pledge covers countries which emit nearly half of all methane.[21] Disappointingly,

several major emitters including India, Russia, China, and Iran did not sign the pledge, despite being included as targets to join the pledge.[22] However, some of these emitters are rolling out their own national methane control plans, regardless. For example, China announced that the country will accelerate the introduction of methane emission control action plan and establish a system of policies, technologies and standards on methane emission reduction in the fields of coal, oil, gas and solid waste in urban areas during the 14th Five-Year Plan (2021-25) period.[23]

Coal

The most highly anticipated and fiercely debated outcome of COP26 was the global agreement on coal use. The intention of the UK hosts and most other nations was for the conference to "consign coal to history".[24] In the final hours of the conference, India and China won a last-minute concession from the EU and the U.S. Changes were made to the Glasgow Climate Pact over the wording of an intention to abandon coal, which was watered down from "phase-out" to "phase-down".[25] The final language of the Pact called for "phasing down" unabated coal power and phasing out "inefficient" fossil fuel subsidies.[26]

Sagarika Chatterjee, Director of Climate Change at the PRI, also noted that there was a high presence of fossil fuel lobbyists at the conference.[27] Many of the member states expressed deep disappointment at this last-minute concession, and the world's most vulnerable countries emphasised that this distinction would be detrimental to their nations, including the environment minister of the Maldives, who stated that "It will be too late for the Maldives. What is balanced and pragmatic to other parties will not help the Maldives adapt in time".[28] Following the announcement of the agreement COP26 President Alok Sharma stated that he was "deeply sorry" the deal had been amended in that way.[29] Despite global disappointments around the watered-down agreement, it is important to note that the Glasgow Climate Pact is more specific than previous UN climate agreements on how to achieve the 1.5°C goal, and that the words "coal" and "fossil fuels" have never been mentioned in any prior UN climate agreement. Frustratingly, the deal did not specify a timeline for either commitment.[30]

Coal

Good News: COP26 delivered the first UN climate agreement to address coal, and a firm universal commitment to phase down unabated coal power. This will have an overall positive impact in reducing coal use.

Bad News: The final agreement is less stringent than expected, and lack of timeline and firm commitments on phase-out will likely have detrimental consequences for vulnerable populations.

Our Grade: B-

Glasgow Financial Alliance for Net Zero

It was also evident that the private sector was more involved and engaged at COP26 than at past COPs, and the finance sector pushed forward with commitments to accelerate the climate transition. The Glasgow Financial Alliance for Net Zero (GFANZ), co-chaired by Mark Carney, announced that over 450 banks, asset managers and insurers from over 45 countries would deliver more than $100tn in climate transition financing by 2050. GFANZ was presented as the finance industry's most ambitious climate coalition yet, with asset management participants "committed to supporting the goal of net zero greenhouse gas emissions by 2050".[31] At face value it seems that the pledge could have a tremendous impact. However, metrics to measure GFANZ portfolio alignment with the Paris Agreement have not yet been agreed, nor are there clear deadlines for defined outcomes or a requirement that any members reduce the carbon emissions of their portfolios of loans and investments before 2050.[32] [33] Finally, some of the biggest players, including Blackstone Inc., Apollo Global Management, and KKR & Co. Inc. are missing from the pledge.[34]

Glasgow Financial Alliance for Net Zero

Good News: The GFANZ initiative demonstrates a clear intent across the global financial sector to facilitate the climate transition and help to achieve Net Zero goals.

Bad News: It is difficult to assess GFANZ in its current stage, as many key elements have not yet been agreed, nor have metrics and deadlines been defined. Several major players have not signed on.

Our Grade: B-

Given the lack of firm short term commitments, it is easy to be critical of the GFANZ initiative. However, it is important to acknowledge the GFANZ and its subsector Net Zero initiatives in terms of "direction of travel" for the industry, and that the announcement at COP26 is just a first step. In the accompanying report, it is stated that the road ahead includes consultation with advisors, industry organisations, corporates, and financial institutions on the components of best practice guidance to achieve Net Zero aims. Plans for 2022 include releasing examples of "what good looks like" for individual elements of transition plans and providing recommendations for how financial institutions across different subsectors can coordinate their work in

assessing corporate transition plans.[35] It remains to be seen whether the initiative has what it takes to fulfil its ambitions as announced at COP26.

Did COP26 address the “Code Red”, and are COP26 declarations aligned with the IPCC report?

COP26 closed with countries agreeing in the Glasgow Climate Pact to reinforce action and finalise the Paris Agreement rulebook to “keep 1.5°C alive”.[36] Unfortunately, analysis by Climate Action Tracker suggests that current policies put us on course for a 2.7C world.[37] The pledges on emissions cuts made at COP26 appear to fall short of those required to limit temperatures to 1.5°C.[38] If, and that’s a big if, all commitments made before and during COP26 are fulfilled, we will be on track for 1.8°C, according to the International Energy Agency.[39] In our Q3 2021 Research Spotlight we discussed in depth the IPCC’s latest report and the expected effects of a 1.5°C increase in global temperatures. These included up to several hundred million more people than already are becoming exposed to climate-related risks, and water and food scarcity by 2040 at the latest.[40] It is clear that material, tangible and important progress was made at COP26 on a number of fronts that will affect both the environment but also future economic prospects for companies across the globe.

COP26 REVIEW:

Our Overall Grade: B

Unsurprisingly, politics and domestic political priorities also affected the outcome. While constructive overall, in our view the key will be ensuring action and alignment with the commitments made at COP26 going forward, which we will be monitoring closely in the months and years ahead. We expect to see stricter targets, clearer timelines, and firmer commitments coming from COP27, scheduled to take place in Egypt in November 2022.

Implications for Investors

As highlighted in prior Research Spotlight, 2021 has proven to be challenging for investors focused on environmental (“E pillar”) considerations in their investment process; recent underperformance of thematic factors like carbon intensity, and sector specific issues such as significant underperformance of the renewables sector have challenged the investment thesis around the “E” in ESG. Has COP26 improved the outlook going forward? We feel that the longer term structural trends remain very much in force, and, in part due to the progress at COP26, are likely to accelerate in terms of financial markets impact. **Here’s why:**

An Accelerating Timeline for Progress

Under the Paris Agreement, countries agreed to review their climate plans every five years, with a view to raising ambitions. At COP26, however, it appeared universally understood that this five year timeline was no longer feasible. Under the new Glasgow Climate Pact, countries are asked to “revisit and strengthen” their 2030 climate plans by the end of 2022 to align with the Paris temperature goals[41] [42] and to report their progress towards more climate ambition next year at COP27.[43] This accelerated timeline for future COPs highlights the consensus that environmental concerns have become a top priority for policy makers, accelerating regulatory trends we have discussed in prior Research Spotlight and the impact on the corporate sector. Increasingly stringent reporting standards requiring more consistent and comprehensive disclosures will also help with transparency, influencing market prices, and assisting investors in making more informed decisions.

While cyclical considerations and political setbacks can prove challenging in the short run, we believe that the commitment to addressing climate change challenges seen at COP26, as well as the political and regulatory backdrop, firmly supports the investment rationale for a focus on best-in-class companies when viewed through the lens of climate change mitigation and adaptation.

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