

COP26 – Keeping 1.5°C alive

The 26th Conference of the Parties (COP26) in Glasgow ended with what is best described as incremental progress on new net-zero targets, and a request for countries to strengthen their 2030 targets by the end of 2022.

The purpose of the conference was to turn broad commitments on climate change into specific, tangible and meaningful action. This has long been a challenge for multi-lateral organisations, where such gatherings are typically big on talk but are then followed by a disappointing lack of concrete action as politicians return home to realities of domestic politics.

Climate change is different. Firstly, there is at least the robustness of a framework grounded in the Paris Agreement with its 196 signatories. Secondly, there is increasing evidence of the reality of the damage already being done to the planet. Thirdly, and by no means least, there is a groundswell of concern and calls for action from the global population at large that politicians ignore at their peril.

That said, the lead-up to COP26 was less than auspicious. At its meeting, prior to the Glasgow gathering, the G20 agreed to pursue efforts to limit global warming with “meaningful and effective actions”. However, there was little in the way of concrete commitments.

COP26 thus began somewhat on the political back foot but with ambitious goals:

1. Secure global net-zero by mid-century and keep 1.5 degrees within reach
2. Adapt to protect communities and natural habitats
3. Mobilise finance
4. Work together to deliver

Increased ambition

- Including New Zealand, 151 countries (representing 81.2% of global emissions) have submitted a new or updated Nationally Determined Contribution (NDC). New Zealand increased its 2030 ambition to a 50% reduction in net greenhouse gas emissions by 2030.
- During the conference, India surprised everyone when Prime Minister Narendra Modi pledged to reach net-zero emissions by 2070, reduce carbon emissions by one billion tonnes by 2030, and raise the share of renewables in the energy mix to 50%. This was the first time the country had put an end date on its contribution to climate change, and as the planet’s third-largest emitter of carbon dioxide, it was something to celebrate.
- According to Global Action Tracker, if all pledges are met, global temperatures will likely rise by 2.1°C by the end of this century. So much is riding on the current ‘best case’ of delivering on these promises, so more frequent reporting against country targets will be critical in the realistic assessment of global warming mitigation before 2030.

Sectoral Cooperation

During the two-week meeting, there were some expected and unexpected declarations.

Global Methane Pledge – Over 100 countries pledged to reduce methane emissions by at least 30% from 2020 levels by 2030, which New Zealand signed, and Australia did not.

Glasgow Leaders Declaration on forests and land use – over 140 countries committed to halting deforestation by 2030, including New Zealand and Australia.

US-China Joint Glasgow Declaration on Enhancing Climate Action in the 2020s – pledging the two countries would work together to slow global warming during this decade and ensure that the Glasgow talks result in meaningful progress. The agreement looks to reduce methane emissions, tackle deforestation, and regulate decarbonisation.

First Movers Coalition – a partnership between the World Economic Forum and the US Office of the Special Presidential Envoy for Climate. It initially targets four sectors — shipping, aviation, steel, and trucking — and asks participating companies to commit to buying low-carbon products by 2030 to help develop green supply chains and meet the world's climate goals.

Glasgow Financial Alliance for Net Zero – a commitment of over \$130 trillion of private capital to transforming the economy for net-zero from over 450 firms across 45 countries. Signatories must commit to using science-based guidelines to reach net-zero carbon emissions by mid-century with 2030 interim goals.

Phasing Down of Coal – More than 40 countries agreed to phase out their use of coal power while 23 countries signed the COP26 Coal to Clean Power Transition Agreement, committing for the first time to stop constructing and issuing permits for new coal plants. Major international banks also committed to ending international public financing of new coal by the end of 2021. New Zealand pledged to shift away from coal, Australia did not, along with other large coal consumers (India, China and US).

Challenges, solutions, and opportunities

In our July Insights paper *Climate Change – The Time is Now*, we identified roles for everyone in meeting the challenge of net zero by 2050: politicians, consumers, businesses, and investors. COP26 was mostly about the politicians, but also how they could use public policy to influence and incentive the rest of us to rise to the challenge with both sticks and carrots.

Only politicians can create the necessary global collaboration, consistency of approach and the necessary transfer of resources from the richer developed countries to the poorer developing countries to achieve net-zero by 2050.

The challenge for politicians, and therefore the planet, is that climate change adaptation and mitigation is a long game and politicians tend to generally think in blocks of time commensurate with their respective election cycles. Their concern is decisions made and implemented now will have initially negative implications for jobs, economic growth, living standards and votes.

That is why a long-term comprehensive and well-articulated plan is so important. If the pathway is clear, businesses will be able to plan and invest, consumers will be able to make better choices, and investors can invest with greater certainty.

In the meantime, regulation will play an increasingly important role in reducing emissions, especially given evidence, particularly in Europe, that stricter environmental standards can assist in reducing emissions. The risk with regulation, as always, is the risk of perverse outcomes and unintended consequences.

Governments can also set targets for such things as the phase out of coal and internal combustion engines, and the take-up of electric vehicles as a proportion of their respective motor vehicle fleets.

Carbon taxes and emission trading schemes will need to do a lot of the heavy lifting. Price signals from rising carbon prices is already seeing producers and consumers needing to adapt. The incentives for changed behaviours and innovation will only increase as the price of carbon also rises.

Innovation has led to a meaningful decline in the cost of renewables. However, this will only ever lead to a very slow reduction in the carbon intensity of the global economy given the already heavy reliance on fossil fuels. At the same time the global economy is growing and so too is energy demand which makes emission reduction targets harder to achieve.

Understanding and supporting the transition to a low emission economy will be important. While there will be many successful new companies providing new solutions, the economy can't transition immediately. Some currently high emitters that are investing in transformational technology to reduce their resource intensity may prove to be long-term success stories.

The capital requirements to meet net-zero by 2050 are substantial. Former Governor of the Bank of England who assembled the Glasgow Financial Alliance for Net Zero (GFANZ) puts the required investment at US\$100 trillion over the next three decades.

That will require public and private finance commitments. That again highlights the need for a well-articulated long-term plan to reduce the risk to, and increase the commitment from, private finance.

Mechanisms will also be required to shift financial resources from developed to developing countries. Developing countries are already some of the world's largest emitters. But such is the stage of their economic development that intervention with financing now can prevent a bad situation from becoming worse.

Implications for firms, the economy, and portfolios

The fundamental structure of the economy will change. Reducing GHGs will require a fundamental change in the energy value chain. The operational dynamics of nearly every business will change to some degree. This will lead to shifts in firm competitive advantage with the key metric of success being a firm's ability to minimise its carbon footprint. There will be losers, but there will also be winners.

Deep knowledge of industries and engagement with companies will be critical. Effective stock selection through active management will be key to managing environmental risks and identifying opportunities. This includes those companies that are finding new solutions but also those that are an important part of the transition to a lower carbon future.

Climate change is creating a proliferation of new risks that need to be managed in society, in firms and within portfolios. This includes the actual physical risks of climate change including extreme weather events and rising sea levels, growing regulatory and policy risks around emission standards for cars and buildings etc., and the reputational risk for companies not meeting the new standards of stakeholders and suffering customer or investor revolt.

Our selection of Morgan Stanley Investment Management (MSIM) to manage the Salt Sustainable Global Shares Fund and Cohen & Steers (C&S) to Manage both the Salt Sustainable Global Listed Infrastructure and Global

Listed Property portfolios was with these structural trends, challenges, and opportunities at the forefront of our decision making.

MSIM's focus on ESG engagement of their companies (sustainable compounders) is one of the ways to reduce carbon emissions in our portfolios. These company engagements focus in on company carbon footprints, their measures to further reduce emissions and encourage companies to plan out and demonstrate what they are doing to achieve their targets. Over the first half of 2021, the team had 47 engagements specifically related to decarbonisation.

C&S believe renewable energy has strong political and regulatory backing, while declining production costs for solar and wind have allowed these technologies to become cost-competitive with coal, gas and nuclear generation. Though experts disagree on the timing and scale of the transition away from carbon-based fuel sources, C&S believe increased reliance on green power is a potentially game-changing growth opportunity for utilities, pure-play owners of solar and wind assets, and owners of transmission businesses.

Wind, solar and biomass's current share of global power generation is only slightly more than 10% today, but it is expected to rise to 29% by 2040 under current policies. The International Energy Agency estimates that figure could reach 49% by 2040 if additional sustainable policies are adopted. Increased government support could improve potential returns for developers and investors while likely accelerating the pace of the transition.

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