Taking stock of the UN climate talks:
COP27 expectations, COP26 industry partnerships and investor takeaways

Issue Brief

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Dear Reader

Nykredit Asset Management is pleased to present our views on the latest climate science, the expectations for the UN COP27 in Sharm-El-Sheikh and the outcomes of the COP26 Glasgow Climate Summit.

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Key takeaways:

- A new UN Report concludes the word is still moving in the wrong direction; CO2 emissions are rising, and global temperatures are projected to reach 2.8°C by the end of the century. The world is not on track to reach the Paris Agreement target of a maximum 1.5°C temperature increase.
- This Issue Brief is a deep dive into the latest emission trends and climate targets by major economies ahead of the climate conference COP27 in Sharm-El-Sheikh in Egypt.
- At COP27, loss and damage as well as climate finance will be the key topics for discussion. Major breakthroughs on reduction targets are not anticipated.
- Last year's Glasgow Climate Summit at COP26 is analysed with an eye to industry partnerships.
- For private investors, the broad scope of sectoral partnerships at COP26 from shipping to buildings and hydrogen shows the magnitude of decarbonisation opportunities.
- While 91% of global GDP is now covered by countries with net zero targets in place, corporate reduction targets in 2025 and 2030 are increasingly called for by asset managers and institutional investors.

The October 2022 UN Gap Report: The World Will Warm 2.8°C by 2100

- The UN Emissions Gap Report 2022 published on 27 October, two weeks before COP27, analysed all climate targets tabled by the 191 countries subject to the Paris Agreement. The world would warm by 2.8°C by the end of the century.
- To get on track to meet the Paris Agreement goal, the world needs to reduce greenhouse gases by unprecedented levels over the next eight years. In fact, current emissions lead the UN to predict that carbon emissions will rise by 16% by 2030.
- Short-term reductions are therefore urgently important, but the Emissions Gap Report 2022 finds that the world must cut emissions by 45% to avoid severe climate risks.
- Such massive cuts require large-scale, urgent and systemic action across the globe.
- In fact, emissions rose since COP26 last year and as of 1 November 2022, the CO2 level in the atmosphere has risen to 416ppm, compared to 413ppm a year ago; and the current levels have not been observed in three million years.
- We will surpass the 1.5°C threshold in the Paris Agreement within a few years.

Expectations for November's COP27 in Sharm-El-Sheikh

- Climate finance, adaptation, loss and damage are areas where COP26 in Glasgow saw limited progress and weak decisions. But for the next two years, Middle Eastern and African countries will be hosting; COP27 will be held in Sharm-El-Sheikh in Egypt from 7 to 18 November 2022, followed by the United Arab Emirates in 2023.
- We should expect the African countries to set a strong agenda on adaptation and climate finance this year, whereas the energy transition and fossil fuel phase-down will be higher on the agenda next year.

Loss and damage will be the towering issue at COP27

- The Egyptian presidency and African countries have set the agenda that this COP should revolve around finance to vulnerable countries suffering loss and damage due to climate change. The rich countries have kept this question out of negotiations for some time, but now is the time to address this issue.

Long-term finance

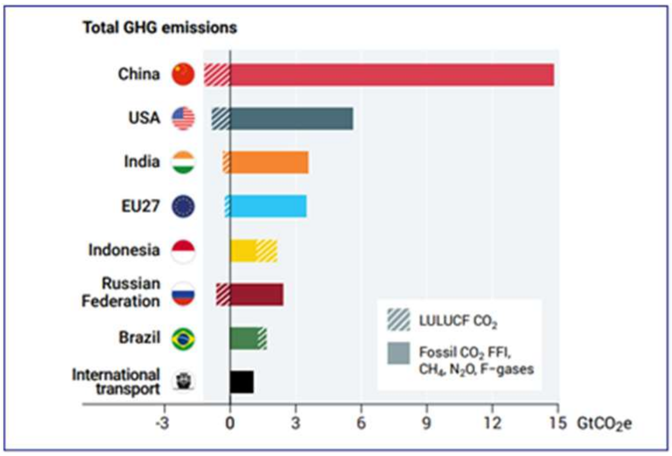
- At COP15 in 2009 a finance deal was brokered as part of the Copenhagen Accord. The USD 100 billion pledge from Copenhagen is still the focal point for negotiations and has been reiterated in the Glasgow Climate Pact.
- A delivery plan has been developed, aiming to get to USD 100 billion by 2020, and this has now been extended to 2023. Yet, the current crisis has made it more challenging for the OECD countries to find additional climate assistance funds in government budgets. It will be easier to decline this year.

Action on emissions reductions

- Ahead of COP27, progress on new and more ambitious climate targets has been limited. At least on paper, the Glasgow Climate Pact met the declared goal of keeping 1.5°C alive, and COP27 in Egypt will be aiming for the same.
- Investors had hoped that the Glasgow Pact's "ratcheting-up mechanism" would ensure stronger climate targets every year beginning in 2022.

- Overall, the G20's climate targets are highly important for setting a direction and raising ambitions. Below, figure 1 shows the developments in 2020 total GHG emissions, with China being by far the biggest emitter.

Figure 1: Total GHG emissions of major emitters in 2020



Source: UN Emissions Gap Report 2022

- Sadly, the G20 targets are still not in line with science. On a positive note, the change of government in Australia is encouraging with new climate targets being announced.
- Also the US Congress and President Biden approved the Inflation Reduction Act a few months ago, which pledges USD 369 billion in climate investments over the next decade.
- New US legislation will cut America's emissions by about 30-40% below 2005 levels by 2030. Scientists estimate that the country is closer to delivering on its pledge of a 50% reduction, which Biden put forward last year. Will this provide some positive momentum to the UN negotiations?

- Well, unlike at COP26 where China and the US surprised with a joint declaration, a powerful and more isolated China this year is not supportive for the UN climate talks. Unfortunately, Speaker of the US House of Representatives Nancy Pelosi's visit to Taiwan created a bifurcation between China and the US.
- Also India should ramp up on its short-term climate target with a net zero target in 2070, which is perhaps a bit too far into the future to ensure accountability, and the 2030 target is still emission intensity-based; to reduce emissions intensity of India's GDP by 45% by 2030.

Key sectoral agreements at COP26 brought in the private sector

- This year's climate conference is unlikely to bring a host of new industry partnerships, but keep in mind that COP26 did succeed where other COPs failed in bringing in commitments from the private sector. Last year, the UK COP Presidency presented a host of sectoral deals that investors should pay attention to, which we will review ahead of COP27.

Finance

- The Glasgow Financial Alliance for Net Zero led by former Bank of England Governor Mark Carney announced a commitment of taking USD 130 trillion in assets under management to net zero by 2050, representing 40% of the world's total financial assets managed by 450 firms across 45 nations.

- This was the largest financial commitment ever at a COP. To put that in perspective, a recent McKinsey analysis indicates that a net zero transition would require USD 150 trillion of capital spending, two-thirds of it in developing economies.

- After launching in April last year with 160 members, alliance membership had grown to 450 by COP26, and ahead of COP27, the Glasgow Financial Alliance for Net Zero stands at over 550 members from 50 jurisdictions, which is encouraging progress.

The Global Methane Pledge

- With methane levels soaring, and methane being 300 times more potent than CO_2 it was encouraging that the UK and the US put methane high up on the agenda at COP26.

- In Glasgow, more than 100 countries representing more than two-thirds of the global economy, pledged to cut methane emissions by 30% by 2030 compared with 2020 levels. Yet, China refused to join the US-led methane pledge.

The First Movers Coalition

- This initiative is encouraging as markets for new fuels and new materials need to be created, and this partnership supports demonstration projects and proof of concepts. Early adopters are working on ramping up direct air capture, which is largely unproven at scale.

- Technological solutions and cost reductions are needed in steel, cement, aluminium, chemicals, shipping, aviation and heavy duty trucking. These "hard-to-abate" industries account for more than a third of global carbon emissions, but do not have cost competitive alternatives to fossil fuels, which makes progress under this partnership urgent and important.

Net zero buildings

- More than 40 companies signed up to the Net Zero Carbon Buildings Commitment. This coalition represents annual revenue of USD 85 billion, and by the end of the decade these companies have to cut all emissions of new and existing buildings etc.

- Progress under this partnership is urgent, as 40% of global energy is used in constructing or heating of buildings.

Green hydrogen

- A group of 28 companies from the mining, manufacturing and financial sectors pledged in Glasgow to grow both the demand and supply of green hydrogen; hydrogen created through the use of excess renewable energy.

- The initiative will create a demand of 1.6 million tonnes per year. Hydrogen is used directly in fuel cells, but can also be turned into methanol, ethanol or ammonia, which is more desirable due to the corrosive nature of the hydrogen molecule.

Shipping

- The maritime sector launched a major partnership, the Clydebank Declaration for Green Shipping Corridors in which more than 20 national governments including Denmark pledged to develop zero-emission shipping routes between ports and test new technologies and fuels.

- Investors are rallying around energy islands, and hydrogen production is set to improve, also backed by the EU Commission's RePowerEU plan launched this year.

Investor takeaways

- In the end, the UN climate negotiations provide the overarching framework for investors, and countries pledge help to set the direction of the global economy. The UN talks are slow-moving because consensus is required.

- The ambition level from governments is disappointing and worrying from an investor and risk management perspective. As asset managers and investors, we see several important takeaways:

First, the partnerships at COP26 show the enormous width and scope of decarbonization opportunities.

- Coordinated action across industries implies convergence around key initiatives. Investors would be wise to keep a vigilant eye on the large scale partnerships and invest their capital to support these endeavours.

- Corporations can exert downward pressure on value chains. This is seen when shipping companies invest in new methanol fuelled vessels, consortiums are forged to produce new sustainable fuels and renewable energy islands are funded by pension funds.

Second, aligning your business with a net zero pathway is now a central part of corporate strategy.

- Net zero is now an organising principle for business, as McKinsey puts it. Following through on a net zero strategy may require raising funds in the green bond market, acquiring new business units, divesting assets, as well as capex investments in decarbonization technologies.

- Credible commitments are needed to get on to a net zero pathway. Preparing detailed plans for how they will achieve net zero is like taking a "corporate X-ray", every business unit must participate.

Third, expect short-term corporate reduction targets to become objects of serious investor focus.

- Elaborating reduction targets means setting goals for 2025 and 2030 that are clearly aligned with science-based trajectories or sector-specific trajectories.

- The chart below shows how much of the global economy is now covered by net zero targets, which is encouraging.

Figure 2: Global Net Zero Coverage

Source: Stocktaking Report by Oxford University, June 2022

- Already, we see corporations converge around the Science Based Targets Initiative (SBTI), which validifies corporate transition plans, making it easier for investors and shareholders to assess the seriousness of management and board commitment to deep decarbonization.

- Nykredit Asset Management has already set climate targets for our investment funds as a member of the Net Zero Asset Managers Alliance.

- On 4 November 2022, Nykredit also signed up to the Science Based Targets initiative in order to have our climate efforts and targets validated and measured against the highest international standards.

- We have committed to reaching net zero by 2050 at the latest across our mortgage loan portfolio, our investments and our own operations. By 2030 Nykredit aims to achieve a 75% reduction in emissions compared to 2021 levels across Nykredit's suite of mortgage loans.

- As investors we look for clear transition plans. Corporations must assess the spending of transition capital in the short term that will be required to reduce emissions, especially from existing emissions-intensive assets.

- Achieving net zero will challenge the energy-intensive, hard-to-abate industries the most, where shifts are already happening from coal use to natural gas to green hydrogen.

- This does not mean investors should shy away from the hard-to-abate industries; winning investments could well be those corporations that exert real industry leadership and embrace deep decarbonization at the corporate strategy level at the business unit level and along their value chain.

- This means corporations should not wait to act, but should make no-regrets moves immediately, even while detailing their long-term transition plans.

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