COP26 Implications

Regulatory Risks Rise, Methane and Deforestation Pledges Sharpen Focus on New Areas

Progress in key benchmarks for success for COP26 that Sustainable Fitch set out ahead of the conference was mixed, but there were agreements in areas that will have an impact. Specifically, this covers pledges for methane, limiting coal financing abroad, and a bigger success than expected on voluntary carbon credits market with the finalisation of Article 6. These agreements can catalyse change, both on a policy and regulatory level and corporate behaviour level. In addition, the pledge to limit unsustainable deforestation provide much new momentum for biodiversity and natural capital risk assessments that have been a rising area of importance for investors. This will bring new levels of scrutiny from investors and regulators on supply chains, commodities sourcing and agriculture.

Regulatory Risk Increases in the Aftermath of COP26

Regulatory risk will increase in the aftermath for COP26 particularly for segments that have largely gone under the radar, but that may be affected by the pledges and the likely action in different countries and jurisdictions on methane and deforestation.

At the same time, we reiterate the risk of a regulatory policy gap has also been accentuated by the inadequacy of Nationally Determined Contributions (NDCs) submitted ahead and COP26 to meet the target of limiting long-term global temperature increase to 1.5degrees Celcius. If efforts to meet this target are to be made by governments and policymakers then the interventions will need to be more robust, more immediate and more abrupt. Updated NDCs submitted in 2022 with a clear pathway for emissions reductions this decade may alleviate some of this risk.

Coal Phase Down Will Require Financing for Stranded Assets

An agreement to phase out unabated coal by a specific date was not ultimately feasible on a universal level, or a level that would make major users agree to it, though several countries made commitments to phase out coal. However, language on limiting unabated coal appears for the first time in a UN COP text.

An ultimately faster than expected phase out may also take place given the vast network of financial institutions that have signed up to report annual financed emissions under the Glasgow Financial Alliance for Net Zero (GFANZ) and who can rapidly move capital away from coal financing.

Notably, the agreement to phase out financing of foreign coal power plants seems to be on firm footing post COP26. This may have implications for countries that have relied on foreign financing, primarily, though not exclusively, along China's Belt & Road corridor for new coal-fired power generation capacity. It may also reduce demand for coal and lead to projects staying on the drawing board due to lack of financing.

The issue of a just transition is relevant when it comes to coal-fired power and the reliance many emerging economies have on it. In addition, coal assets in emerging markets are much newer than those in developed markets and could become expensive stranded assets if shut down. Novel ways of financing a transition away from coal will therefore be needed for several emerging markets. A total of USD8.5 billion has been pledged to South Africa's Eskom Holdings SOC Ltd. (B/Negative) from the US, UK and EU for phasing out coal-fired power plants over three to five years through grants and concessional finance. Securitisation for stranded assets is one proposal that has gained traction to help manage the costs and risks of coal retirement.

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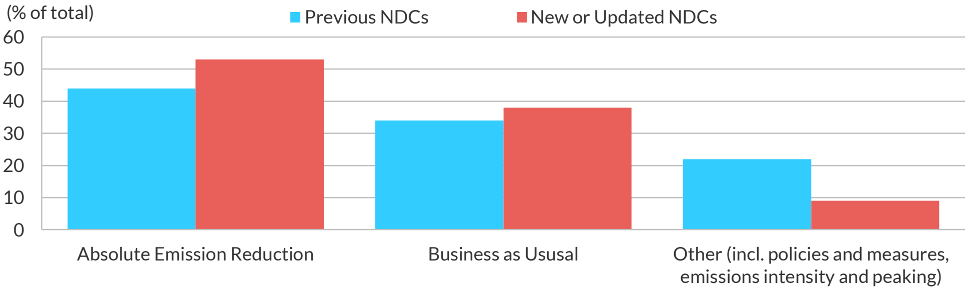
Methane Reductions Broaden Scope of Industries Under the Spotlight

An early success in emissions reductions was the strengthening of the global methane pledge, with signatories agreeing to reduce methane emissions by 30% by 2030. This is important as it means much more direct focus by policy makers on areas of heavy anthropogenic methane emissions from energy (upstream and midstream) as well as agriculture and waste.

Parties also committed in the final text to strengthen their currently inadequate emissions reduction efforts in their NDCs to limit emissions this decade and help limit temperature rises to 1.5^0C. These will be expected ahead of COP27 in Egypt in 2022, which means there may be more policy action pledges announced over 2022 for countries that revise their plans.

Mixed Progress on NDCs

Plans for Nationally Determined Contributions



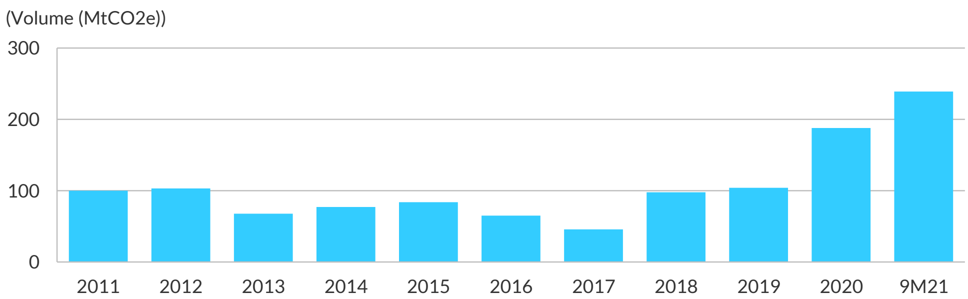
Source: UN FCCC, Nationally Determined Constribtions Synthesis Report, Septmber 2021

Article 6: A Highly Effective Outcome for the Growing Voluntary Carbon Markets

One of the least expected, but potentially most effective, outcomes from COP26 was the finalisation of the Paris Rulebook with agreement on Article 6 on voluntary carbon markets. Based on the agreement, a centralised market infrastructure (with a supervisory body and registry to be established in 2022) should strengthen efficiency, scale and integrity of the rapidly growing voluntary carbon markets. According to Ecosystem Marketplace, the scale of the market will exceed USD1 billion in 2021. CORSIA-eligible carbon credits have risen in price by over 900% this year, and REDD+ credits have grown in volume by nearly 300% this year, according to Forest Trends.

We reiterate our view expressed in our recent analysis of the topic that the market may split between high-quality credits that gain in price and lower-quality ones as buyers of voluntary offsets will not be compelled to purchase these from the central registry.

Market Size by Traded Volumes of Voluntary Carbon Offsets



Source: Fitch Ratings, Ecosystem Marketplace, Forest Trends

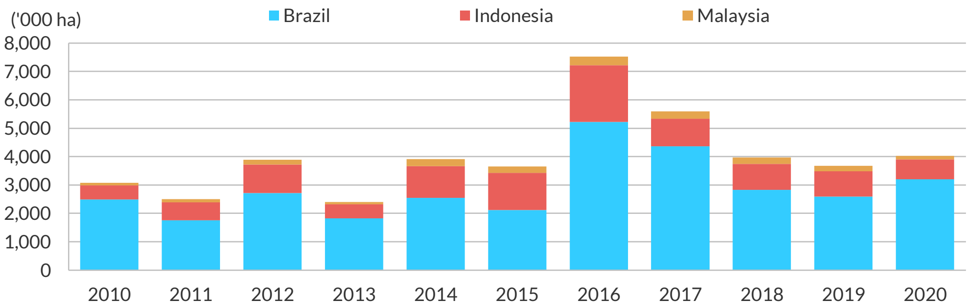
Key parts of the agreement include a centralised pool of voluntary carbon offsets will allocate 5% of its proceeds for adaptation in developing countries. However, this levy will not apply to bilateral country emissions trading but credits sold will not be counted towards a country's NDCs. Any carbon offsets registered since 2013, about 320 million tonnes of CO_2, will be carried forward into a new trading system.

Directly related to the agreement on carbon credits is the deforestation pledge, given the direct links between re-forestation and voluntary carbon offsets.

Biodiversity and Deforestation Pledges Signal More Regulatory Interventions

With rising demand for forest carbon offsets in particular, investor interest in forestry as an asset is rising. The early global pledge on limiting unsustainable deforestation was one of the most crucial outcomes of the conference. It can galvanize action both on a country and also company level on mitigating and costing natural capital risk. It makes the work of the TNFD rise in prominence with higher expectations that new disclosures and higher accountability by corporates, asset owners, managers and financial institutions on the issue.

Tree Cover Loss in Natural Forests



Source: Fitch Ratings, Global Forest Watch

It is notable that in the week following COP26 the EU Commission presented a legislative proposal for new mandatory due-diligence rules, including strict traceability, for importers of forest-risk commodities in the EU, including soy, beef, palm oil, wood, cocoa and coffee as well as derived products such as leather, chocolate and furniture. This provides an early indication on how the pledge on deforestation and biodiversity can have tangible impacts on supply chains and operations of corporates that rely on them.

Related Research

Sustainable Fitch: COP26 Crucial for Global Climate Policy Momentum (October 2021)

Tightening Voluntary Carbon Markets to Drive Up Costs (October 2021)

Investors Grapple with Stemming Biodiversity Loss (September 2021)

Financial Sector Confronts Deforestation as a Key ESG Risk (September 2020)