MSCI

TRANSCRIPT

The World Gets Into the Spirit of COP-eration and Energy Prices Be Crazy

Featuring:

Simone Ruiz-Vergote, *ESG Researcher, MSCI*

Elchin Mammadov, *ESG Researcher, MSCI*

Bentley Kaplan:

Hello, and welcome to the weekly edition of ESG Now, where we recover how the environment, our society, and corporate governance affect and are affected by our economy. I'm Bentley Kaplan, your host for this episode. And on this episode, we're going to start with a retrospective of COP26, as those inside and outside the world of responsible investment, digest the takeaways of a whirlwind conference that has evoked a lot of emotion. And after that, we'll take a look at one of the themes that was underpinning much of what was discussed at COP26, energy. We'll try to figure out what's behind the recent cost spikes in coal and oil and gas, and what that could mean for future greenhouse gas emissions. Thanks for sticking around. Let's get down to business.

COP26 meant a lot of things to a lot of people. There were iconic moments throughout and emotions that ran the gamut, and maybe neither the cynics nor the optimist were completely surprised by what unfolded over the two weeks in Glasgow. For many and especially the young, COP26 may have been the first conference of the parties that they really paid attention to, but for MSCI's own, Simone Ruiz-Vergote, this is COP number 7. She knows the beat. Simone oversees our work on ESG policy, and maybe not surprisingly, she has a formidable background in renewable energy, climate change, carbon trading and climate finance. Simone is technically based in MSCI's Frankfurt office, although like many of us, has been firmly anchored in a home office for the past few months and months and months. Let's just say that COP did wonders for Simone's step count. And I suppose that technically, there were other things happening there, too.

Simone Ruiz-Vergote:

Thousand side events or more, and over 10,000 attendees, and what was probably different from the previous COPs is said the private sector present was so overwhelming. This was maybe a bit overshadowed by the difficulty for activists to partake. If you look at the results, I think it's very easy to sort of dismiss it and say, "Well, again, nothing achieved, just empty words." But to be fair, this is probably the hardest job in the world. You negotiate with 196 country delegations over thousands of pages of texts. You have two weeks for that and synthesized this down to eight pages in a spirit of compromise, which was probably the most often heard sentence during the final closing plenary. There are three really big surprises for me in the text. The first timers, Non-CO2 greenhouse gas emissions mentioning particular methane, then the facing down of coal power and the facing out of fossil fuel subsidy.

So, this is really an announcement to the world that the energy infrastructure is up for a major overhaul. Secondly, the sense of urgency and then the peer pressure that was already in the Paris Accord in 2015, but now has really shown how it can come to play in the sense that everybody now needs to come forward with more ambitious targets in 2022, sort of the fast forward for the next scale of ambition. And also, the pledges that came in on a daily basis from the beginning on methane, on forests, on finance, then the China-US Corporation. We also had CleanTech. I think that really empowered the progressive voices on the negotiation tracks with this coalition of willing approach and the nudging of the more unwilling countries to engage in a very ambitious forward looking way. And thirdly, it's really impressive to close so many chapters that are more technical, the Paris Rulebook, which came also from the Paris agreement, but it essentially says, now you are really needing to show what targets you set yourself on a national level.

What's your baseline? What's the time period for achieving those? And there is highest scrutiny on the monitoring side, as well. Also, on carbon markets, the famous article six of the Paris Agreement, the whole carbon market infrastructure is up for an overhaul. There has been a clean development mechanism that was actually already in place in the Kyoto Agreement. The COP3 in 1997 will be now replaced with the new rules that govern how countries can achieve their climate pledges by purchasing carbon credits through emission reductions that are generated by their countries. And this is important as it will be the lifeline and potentially the financial glue that will hold these promises and commitments together.

Bentley Kaplan:

If like me, you haven't been to a conference of the parties or any other conference that pulls in 190 odd countries. It's probably hard to know what counts as a reasonable expectation. There are many who are probably disappointed with the major headlines coming out of COP, especially after some last gasp negotiations, but underneath those headlines is a lot of technical detail, the weeds, and in that detail, Simone saw a lot to be encouraged by, not only the sudden rise of the private sector and its barely of net zero pledges, but a growing body of countries making up a coalition of the willing, a bigger pressure point for those dragging their heels. More definitive ways of assessing and measuring countries' Nationally Determined Contributions or NDCs, their pledges to reduce emissions, better structures to carbon trading and offsets and specific inclusion of coal methane and fossil fuel subsidies in official text, and possibly most importantly, a clear recognition that the next major push after Glasgow will need to come much, much sooner than Glasgow did after Paris. But to roll all of this technical detail into one blunt force question, is it enough?

Simone Ruiz-Vergote:

I think the next year will be critical in terms of looking at how national commitments and all these pledges from methane to forest protection to fines are being implemented and followed up on. Clearly, the near term transition targets are the ones you need to look at more closely because here, you need to see real changes, real policies on the ground in the countries in the next months to come. There is this huge gap that is obvious. So, business as usual, actually means global emissions would rise by over 10% until 2030, while the Glasgow Climate Pact. So, these eight pages of text recognize that a 45% reduction is required if you want to limit global warming to below 1.5 degrees. Encouraging signs are there. India taking up a net zero target by 2070. The US-China Climate Pact allows for an exchange potentially on technology that would steer China to agree maybe on more ambitious targets, but a lot remains to be seen in the implementation over the next year or two to come.

Bentley Kaplan:

So, the answer to, "Is it enough?" is a no, but in fairness, a no with an asterisk. It's getting much harder to hide a lack of ambition in ambiguity and vague measurements. What happens next is as ever critical. But on the show, we largely avoid pontificating on the fate of our planet than high stakes geopolitical maneuvering. And instead, we try and focus in on the practical implications for investors and for them, Simone had some takeaways.

Simone Ruiz-Vergote:

On the one side, there is this message. There is a reference to energy in the text. That means that countries now have to put in place the face out plans for their fossil-based infrastructure. The idea being that in a couple of years from now, the fossil fuel infrastructure will have been replaced by low carbon energy. And the second is that as we are very close to missing our timeline on the 1.5 degrees target, it really is a matter of a few years until this window is closing. There will be a higher focus on adaptation and physical risks and the impact this could have on the financial sector.

And thirdly, there is a huge increase right now in the regulatory attention to transparency. So, we have seen tightening of this scrutiny on the carbon accounting side with the creation of the International Sustainability Standard Board and also publication of first disclosure prototypes for climate and sustainability. We have seen an enormous amount of private sector commitments around net zero, probably most prominently from the financial sector perspective is the Glasgow Financial Alliance on Net Zero, the GFANZ, and the UN Secretary General has already announced that he would implement a high level expert group next year to scrutinize the net zero commitments from non-state actors.

Bentley Kaplan:

Basically, if you thought the regulatory pressure for investors was intense before Glasgow, well, it's about to get a whole lot heavier. For companies, it's climate on all fronts, whether it's about disclosing a contribution to climate change or your capacity and strategy to cope with upcoming policies and physical climate risk or how you plan to slow climate change down. A lot more is going to be mandatory, but hopefully, a lot more is going to be standardized, and investors are going to have to grapple with their own set of challenges in measuring portfolio emissions, planning engagement efforts, and casting an optimistic eye over the growing pool of climate solutions. And as Simone further digests the outcomes of COP26, we're going to take our next story into a much more practical place. One that sits below the complex world of greenhouse gas reduction targets and NDCs, one that underpins a great deal of what was being discussed in Glasgow last week.

To work us through our next story, I'm going to bring in Elchin Mammadov. As lead analyst for the utility sector here at MSCI ESG Research, Elchin could talk about energy until the methane-emitting cows come home. And last week, he put out a paper called What do Surging Energy Prices Mean for Green Transition and Climate? It's not what you'd call a particularly abstract title. Elchin is a straight shooter. For now, it's only available for MSCI's clients, but I'm going to see what I can ring out of my good colleague for our lovely listeners, as well. And that's because there are a lot of good and timely reasons for writing a paper on energy. Take COP for one. But maybe, the main reason was that in September and through October, energy prices started going a little crazy, crazy expensive. And when I say energy, what I actually mean is coal, oil and gas, fossil fuel, greenhouse gas emitting energy.

Instead, against the backdrop of COP and NDCs and net zero commitments by companies, you would maybe expect that the value of fossil fuels would start to drop as interest in them waned and demand and policy support turned more consumers to renewable energy instead. Luckily, I'm not expected to understand the voodoo of energy markets and prices. For that, I have Elchin, who was able to put some context on why energy prices kicked up and why rising demand for energy is still being met by fossil fuels and not lean green renewable energy.

Elchin Mammadov:

We were expecting some recovery in gas, crude oil, and broader energy complex because the markets dive during the COVID pandemic, at the height of the COVID pandemic. However, the rise has been really, really high. I mean, we've seen prices rally as much at two and a half times since the start of the year. And now, they're at levels not seen in 10 years for certain commodities. A lot of companies have cut investments into oil and gas production and coal, as well. That's why we're seeing this surge in prices. It was partially upset by the fact that each year, we're seeing increase in renewable capacity, so that's a positive. However, because the demand rebounded very strongly and in some cases, there is estimations that emissions are already at pre-COVID levels.

Bentley Kaplan:

Okay. So, as COVID starts waning, the world starts turning again. But we don't suddenly have brand new renewable energy infrastructure that can feed that demand. And even for infrastructure that was ready to turn out renewable energy, where the conditions didn't exactly cooperate. But what we did have was coal, piles of coal, and oil and gas, and that's what we fed into our energy demand. So, I instead of seeing our emissions tail off, we see the opposite, and in the short term, that's bad news. Rising emissions is exactly what 10,000 people in Glasgow are working to address. But somehow, Elchin was an all doom and bloom. For him, this is more of a short term anomaly than a long term trend.

Elchin Mammadov:

I mean, part of the reason why the prices have rallied is because despite the recovery in crude gas, coal prices, the companies are still very wary of investing in expanding or maintaining their production capacity to develop new oil and gas wells, expand the mines, et cetera. So, the companies are focusing on paying off their debt and paying generous dividends from all this extra windfall profits that they're now generating rather than investing, making big bets on further expanding their capacity. And I think that's where the investor push and the ESG theme is making itself fell. We are going to see in the long term, the shift towards greener energy mix and greener economy. Although in the short term, we're going to see an increase in emissions because not only are we seeing rebound in fossil fuel use, but also the governments are starting to increase the subsidies for those fossil fuels, because the jump has been so high that especially the vulnerable [holds 00:14:21] households, the vital industries that rely on energy, not just power gas, but also heat.

Bentley Kaplan:

Right. So obviously, it's complicated. The price of energy is the culmination of so many different factors and as this trend in rising energy prices rolled into COP26, I asked Elchin to give us his view of what happened in Glasgow and what that might mean for energy companies from the heaviest emitters to the leanest and greenest.

Elchin Mammadov:

There was some progress on the phase down of coal. Some countries like Canada, for example, plan to ban coal exports, and that has a knock on effect on US coal producers. Some of which were exporting abroad through Canada exports. There was some agreement on methane reductions. However, there's always these caveats with coal. The countries didn't commit to phasing out of coal, at least the biggest three, US, China, and India. We've got the same issue with methane emissions, where the likes of, again, Russia, for example, that our major gas producer didn't sign up to that initiative alongside with Australia and China for example. So, I am a bit disappointed, but it is the step in the right direction.

Because of this major energy transition, it creates not only threats, which we've discussed a lot especially for the fossil fuel sector, but also opportunities. Opportunities for growth for companies like Orsted, EDP, Meridian Energy, a Longyuan, which are traditional utilities, but also for oil and gas companies that are much more aggressive in investing in renewables. Notably, the likes of Equinor in total energies. And I think, they have some advantages because they are investing more money and they all also already have a bigger asset base to work on when it comes to renewables compared to their peers like Duke Energy, Chubu Electric and KEPCO, Inter RAO, and when it comes to oil companies, Exxon, I think hasn't been a very active in terms of energy transition, particularly in the power sector. So, I think these are some of the key takeaways from our report in terms of the company impact.

Bentley Kaplan:

It has been a sobering week for me, but an interesting one, in which to weigh through coverage of COP26 and what it's implications are and aren't. For Simone, this is another piece in the long running puzzle to address climate change. Now, the arc of progress is quite clear for her and she's encouraged by the earnest efforts of so many people that were in Glasgow and beyond. A big shift in COP26 from previous conferences has been the high level of press coverage, private sector involvement, and the great pressure from civil society and activists. Politicians probably have much less wiggle room than ever, but Simone also bluntly acknowledged that they remain many open questions and big numbers that need to move no matter how difficult it might seem. And Elchin's coming from a different angle. He's someone that's covered the energy sector for many years, as it's moved from very traditional fossil fuels into a much more uncertain future, one with an irresistible draw into renewable energy.

As Simone sits on the side of policy, nudging and urging change in consensus, Elchin sits on the other side, watching the effect of these policy changes and how companies respond. Maybe most interestingly of all was Elchin's emphasis that we focus so frequently on the risks and the downsides, which is a very normal tendency, but there are opportunities, too. Sometimes, not yet quantified, and it may be in these slightly hazy opportunities that we'll be able to answer the harder questions of climate change. And for now, it's all about finding the governments, the companies, and the investors willing to strike out and to pioneer those opportunities.

And that is it for this week. A massive thanks to Simone and Elchin for their take on the news with an ESG twist. Thank you very much for tuning in, for taking the time to listen to yet another breakdown of COP26. We hope you found this useful and not all doom and gloom. If you have the time, don't forget to rate the show and review us wherever you may be listening. The feedback, we love it all. Questions, ideas for future shows, hit us up. We are all ears. Next week is going to be a week off for our tiny team, as the US kicks back for the Thanksgiving break. But Mike will be back the week after on the 3rd of December to give you more of that sweet, sweet ESG news. Take care of yourselves, and thanks again for listening.

TRANSCRIPT

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.
