XPS Investment

Investment briefing

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COP28 makes a historic first step in transitioning away from fossil fuels, but avoids commitment to phase-out

In brief

- Delegates met in Dubai for COP28 in November-December 2023.
- A first global agreement was reached to transition away from fossil fuels; however, this fell short of what many hoped would be a more robust agreement to 'phase-out' fossil fuels.
- Other pledges were made to treble renewable energy capacity, increase investment in carbon capture, and cut methane emissions.
- The first contributions totalling $700m were made to a Loss and Damage Fund, to support developing economies with their climate transition.
- The outcomes of COP will have implications for economies and financial markets – investors should ensure that their investment managers are taking these issues into account when making investment decisions and engaging with companies on their behalf.

The 28th Climate Change Conference of the Parties (COP28) summit drew to a close in the UAE on 13 December 2023. Despite the surrounding controversy of hosting the summit in an oil state, compounded by rumours that the COP President sought to use the talks to forge new deals on oil and gas, the final agreement brought new cross-country agreements around fossil fuels and sector pledges to address climate change.

In this note Matt Jarvis discusses key outcomes from COP28 and the implications for investors.

Background to the Conference

The UN Conference of the Parties meet every year to accelerate action towards the goals of the 2015 Paris Agreement, which created a binding commitment to limit global warming to 1.5°C above pre-industrial temperatures by 2100.

The latest estimates before COP from Climate Action tracker (an independent scientific project that tracks government climate action) suggested that the world is on track to miss these targets, with a projected global temperature increase of 2.8°C based on current policies.

The agenda for COP28 therefore focused on undertaking a global stocktake of carbon emissions, implementing the Loss and Damage Fund which was agreed at COP27, placing a renewed focus on reducing methane emissions around the globe, and deciding on the future use of fossil fuels.

> The final wording to 'transition away' from fossil fuels is a step in the right direction, but more is needed to achieve 1.5°C.
>
> **Matt Jarvis** – Consultant

Summary of key outcomes and commitments from COP28

Agreement to move away from fossil fuels – but not phase them out

In the final statement parties agreed to '**transition away from fossil fuels in energy systems in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050 in keeping with the science**'. There are two notable aspects to this statement:

1. Transitioning away from fossil fuels

✔ This is historic, as the first recognition by all parties that fossil fuels have no place in the future energy mix, and this should represent a turning point away from their extraction and use. Reducing emissions associated with fossil fuels is critical to limiting global warming. This is a welcome improvement on the draft only 24 hours before the end of the Conference which made no reference to reducing fossil fuels. There is also a call for the phasing out of inefficient fossil fuel subsidies.

✘ Many scientists and countries were still hoping for stronger language around 'phasing out' unabated fossil fuel emissions. Furthermore, there is no timeframe to the commitment, and the language is not instructive, using the phrase '*calls on* Parties', making it up to countries to decide how they move away from fossil fuels. This creates a risk that the action needed does not materialise in the short term.

2. The Just Transition

✔ It is positive to see explicit recognition of the need for a fair and equitable transition which considers the social implications of a global transition to a green economy.

✘ However, many small / island countries have voiced concerns that the agreement is not clear enough on the onus for developed countries to lead on the transition away from fossil fuels, when they have economically benefited from fossil fuels for longer, or for developed countries to provide sufficient finance to support developing nations with the transition.

Pathway to 1.5°C

The agreement recognises that to avoid a breach of 1.5°C, global emissions must peak before 2025, and decrease by 43% and 60% by 2030 and 2035, respectively, relative to 2019 levels. The text is clear that not all countries need to decarbonise at the same rate, the implication being that richer nations should lead the way – but this is not explicitly stated. Countries need to submit updated national targets by 2025.

Renewable energy and energy efficiency

The agreement notes the need to 'accelerate zero- and low-emission technologies' such as solar, wind and nuclear power, and pledges have been made to triple renewable energy capacity globally, as well as to double the global average annual rate of energy efficiency improvements by 2030. This is important as in order to transition away from fossil fuels there needs to be secure alternative sources of energy and reduced reliance on the production of energy generally (through greater energy efficiency).

Support for carbon capture

The agreement calls for acceleration in carbon capture, utilisation and storage (CCUS, i.e. stopping emissions at source and either using the carbon or burying it underground). Carbon capture will play an important role in reaching global net zero emissions for sectors which, for now, rely on the production of greenhouse gasses (such as cement, steel, and aluminium manufacture). However, many see this as a distraction and fear it will be used by big fossil fuel companies and countries as a route to continue to extract and burn fossil fuels. Carbon capture is relatively nascent and cannot currently be used at scale; today total global CCUS capacity captures around 0.1% of total emissions according to the World Resources Institute.

First contributions made to Loss and Damage Fund

Key decisions were finalised around the Loss and Damage Fund, which was established at COP27 to assist developing countries that are particularly vulnerable to the adverse effects of climate change.

The Fund will be administered by the World Bank and will include a Board of 14 developing countries and 12 developed countries. Finance will be provided by the Fund for climate-related emergencies such as sea-level rise, migration and climate-resilient reconstruction and recovery. A total of $700m was pledged by a series of supporting parties – critics responded that this falls far short of the finance required in this area.

Reduction of methane emissions

An agreement was made to 'accelerate and substantially reduce' other greenhouse gas emissions beyond just carbon dioxide by 2030, with specific reference made to methane. Methane has c.80x the warming potential of carbon dioxide over a 20-year period according to the IPCC.

Linked to this, the **Oil and Gas Decarbonisation Charter** was signed by 50 oil and gas companies representing c.40% of global production, committing them to achieve near-zero methane emissions by 2030. The Charter also pledges net zero oil and gas operations by 2050 and the elimination of routine flaring – the burning of natural gas when extracting oil which contributes significantly and unnecessarily to global warming. According to the World Bank the amount of gas currently flared each year – about 140 billion cubic meters – could power the whole of sub-Saharan Africa.

Global Goal on Adaptation

The final agreement includes calls for a doubling in adaptation finance and plans for assessments and monitoring of adaptation needs. There are 2030 targets on water security, ecosystem restoration, and health. However, there are still questions around the adaptation finance gap so additional details on financing expectations and targets are needed at COP29.

Other notable points

- The statement on coal has weakened from 'rapidly phasing-down unabated coal' to 'accelerating efforts towards the phase-down of unabated coal'.
- More than 20 parties committed to tripling nuclear energy capacity by 2050 along with a series of other commitments around mobilising global investment in nuclear energy.
- An Industrial Transition Accelerator was created, representing a $30m commitment to provide funding for research and development to help the industrial sector (steel, aluminium, cement) transition to net zero.
- Ghana, the Democratic Republic of Congo, and Papua New Guinea made new pledges on nature, forests, and peatlands, supporting their commitment to achieving 2030 national and international forest targets.
- For the first time wording explicitly linking the climate and nature crises, and how the international goals of the Global Biodiversity Framework agreed last year (containing objectives to conserve, protect and restore nature), can play a key role in sequestering carbon and delivering the Paris Agreement.

Reaction and what this means for investors

The commitments made at COP28 by countries to move away from fossil fuels and to increase cleaner energy capacity should lead to significant finance towards mitigating climate change. Progress to date on these issues indicate there have been signs of development and reason for optimism; the latest estimates by Climate Action Tracker before COP28 suggested the expected temperature rise above pre-industrial levels for 2100 is expected to be 2.8°C, compared to c.4.0°C as recently as 2021.

Nevertheless, there's no denying that 2023 is set to be the hottest year on record, with the temperature rise expected to be already around 1.4°C. Many warn that the agreement and pledges do not go far enough to meet the ambitions of the Paris Agreement. The International Energy Agency reported that key pledges made at the conference will not be enough to limit global warming to 1.5°C, only cutting emissions by a third of what's required by 2030.

It's therefore clear in our view that in order to hit 1.5°C, or even stay below 2.0°C, more significant regulation and policy intervention will be required. This may lead to an increasingly disorderly and abrupt climate transition, detrimentally impacting sectors and companies which are not aligned to a low carbon future. Also, whilst more meaningful action is delayed, it's likely that physical risks of climate change, which are already having material financial impacts, may get worse.

Pension scheme trustees have a fiduciary duty to act in the interests of members and it's clear that considering the impact of and solutions to climate change is aligned to members' long-term financial interests. It's critical that all investors are aware which of their holdings are at risk of the climate transition and look to steer investment into companies which are adapting and thriving in a green economy. There will be much discussion on fossil fuels in particular, and the case for investment given there is now a global directive to reduce reliance on the sector.

Next steps for investors

Climate change represents the greatest systematic investment risk issue of our lifetime and it can be complex to understand the implications of global policy developments and real-world outcomes on an investment portfolio. We note that even if for those schemes approaching buy-in within the next few years, climate change risks remain highly relevant as it's highly possible there will be market shocks resulting from climate policy action or physical events in the short to medium term.

Actions for investors:

1. **Training** to understand the science behind climate change, what government and company net zero goals are, and what they mean for expected financial outcomes.
2. **Review** your beliefs and priorities around climate change, in particular your views on investing in fossil fuels and whether you want to directly finance solutions. Set a **Responsible Investment Policy** to ensure climate change factors into strategic decisions.
3. **Assess** your exposure to climate-related activities, risks and opportunities in developed and emerging markets. Focus on forward-looking transition alignment (i.e. where companies can get to and over what timeframe) in addition to their current emissions.
4. **Consider switching** into Sustainable funds which have a Paris alignment objective, or which contribute to UN Sustainable Development Goals (supporting the Just Transition). The **XPS Sustainable Designation** can help you identify funds which deliver these outcomes whilst supporting your financial objectives.

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