By Raad Alkadiri and Shari Friedman

A lack of clear policy signals complicates energy and commodities transition strategies

Takeaways

- COP26 failed to deliver a clear policy pathway to net-zero by 2050.
- Investment signals for energy and commodity companies remain uncertain, even though financial institutions are increasingly setting ESG standards of their own.
- In the absence of a global governance framework and clear policy steps, energy and commodity companies will face continued uncertainty.
- Capital will be invested more inefficiently, and the energy transition will proceed more slowly.

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COP26 delivers no clear pathway to net-zero

COP26 in Glasgow may not have delivered as much as was hoped, but the meeting did underscore an important point: that the trajectory of energy transitions, if not their pace, is set. The climate debate has shifted fundamentally over the past few years. The science of climate change is no longer in dispute, nor is the imperative to reach net-zero by 2050 if the temperature rise is to be kept to 1.5 degrees centigrade above pre-industrial levels, and the worst ravages of climate change are to be avoided.

What remains, however, is the key question of how to accelerate change and how to put in place the framework to make the emissions target achievable. In that sense, COP26 missed the mark. No global governance structure was agreed upon, and no clear pathway to net-zero was presented. These omissions will make energy transitions a more difficult process in the long run.

Some progress, but a lack of policy detail

COP26 did deliver some notable achievements. The commitment to phase down coal use signaled a breakthrough, and rules for a global carbon trading system were agreed upon. In a first-of-its-kind agreement, specific financing commitments for South Africa's energy transition were made, and a broad pledge to end deforestation by 2030, which included Brazil, the Democratic Republic of Congo, and Indonesia (where most of the world's remaining virgin rainforests are), was also inked.

But the devil remained in the detail. While more countries have now formally announced long-term net-zero targets, many – such as China, India, Indonesia, and Russia – are aiming beyond 2050. Moreover, the commitments made offer little in the way of a detailed policy blueprint for how these emissions targets will be achieved, especially over the next nine years, when a lot of the heavy lifting needs to be done. The best COP26 could do was agree that countries would come back with more ambitious and detailed plans by COP27 next year.

Similarly, while the financial sector is stepping up its commitment to promoting common emission reporting standards and to directing capital to clean energy investment, the standards are still being developed, and access to capital for climate adaptation and mitigation is far from universal, especially for poorer countries that urgently need to fund these types of projects.

Companies need long-term investment signals

All of this still leaves an uncertain environment for the energy and commodities sectors as energy transitions unfold. The rewards for those companies that get their strategies right will be immense. The International Renewable Energy Agency (IRENA) estimates that US$131 trillion will be invested in energy transitions between now and 2050. Governments from major industrial economies, including China, Japan, and Germany, see the green transition as much as an industrial growth opportunity as a climate one.

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But the absence of a commitment by governments worldwide to meeting net-zero targets by a common date, combined with the lack of clarity about the precise policies they will introduce to get the world to those targets, creates confusing investment signals for the energy and commodities sectors, both of which are generally characterized by long life cycle projects.

Put another way, the current regulatory and policy ambiguity and confusion complicates the ability of corporate leaders in these two sectors to make the right capital allocation choices at the right time to ensure that they can secure long-term capital access and maximize returns on investment through the transition period.

European energy crunch illustrates the investment challenge

The recent energy crunch in Europe illustrates the challenges energy companies face in the absence of clear policy guidance. In the past, a gas supply crunch and cyclical upswing in prices would encourage increased investment in the commodity, which, along with price effects on demand, would restore market balance.

But with rising uncertainty over whether gas will be considered a transition fuel in the medium to long term given the emissions associated with its production and transport, many companies will be reticent to invest in new capacity. At the same time, the gradual shift away from fossil fuel investment among banks and funds limits the availability of capital and undermines the long-term economics of these projects.

The world may need gas now, and in the future, and these projects may turn out to be profitable. But energy companies’ aversion to investing in what may become stranded assets before their life cycle is complete, and the higher cost of capital because of environmental, social, and governance (ESG) concerns, create an obstacle to capital allocation.

Indeed, some companies may instead direct capital toward renewables to mitigate this risk. But this approach carries dangers of its own, especially if these projects turn out to deliver significantly lower returns, as shareholders have yet to show that global welfare matters more than profit.

Availability of rare minerals a cause for concern

A similar challenge exists in other commodities sectors. The dependence of renewables on rare-earth minerals is already creating supply shortages that are driving up prices.

But in the absence of a clear demand picture in the medium term, and with increasing ESG standards being demanded for operations and financing, mining companies face challenging investment uncertainties of their own that could create additional bottlenecks that slow the pace of energy transitions overall.

Governments need to act collectively … and quickly

Establishing universal standards and collective policy steps to address climate change is not a panacea. Net-zero targets may still not be met by 2050. But in their absence, companies will continue to face uncertainty as multiple rules and jurisdictions apply, capital will be invested more inefficiently, and the transition is likely to be more sluggish at a time when the urgency of climate change demands rapid action.

The private sector can only do so much on its own to guide the transitions process. Companies have a duty to serve the interests of their shareholders, and in the absence of clearer investment signals, they will likely be more conservative with their capital allocation choices. Ultimately, they need governments to step up and provide greater policy certainty over the road map to net-zero, and, in that sense, COP26 was a missed opportunity.

About the authors

Raad Alkadiri is Managing Director for Energy, Climate and Resources at Eurasia Group. He focuses on the nexus between politics, economics, climate, and the energy sector, as well as their effects on market behavior and investment risk. He works closely with clients, advising them on capital-allocation options, risk-mitigation strategies, and policymaking. He also closely follows medium- and long-term geopolitical, energy, and climate trends, and their impact on the risk environment.

Shari Friedman is Managing Director for Climate and Sustainability at Eurasia Group, where she focuses on environmental and social policies, and on trends affecting energy companies, industrial production, retail, supply chains, technology companies, agribusiness, and financial institutions. Shari works across regions and sectors to help clients understand evolving policies and how they will affect clients' businesses today and in the future. Shari has been involved with climate and sustainability issues for over 25 years, working for the U.S. government during the Kyoto negotiations, and in venture capital, consulting, and banking. Immediately prior to joining Eurasia Group, Shari led climate strategy at the International Finance Corporation.