Hogan Lovells

Environmental, social and governance

COP26 5 Key Learnings

What you need to know

COP26 has been hailed as both a success and a failure. Whatever your view on the outcomes of the conference, the global engagement, discussions and agreements that took place in Glasgow will shape the global response to climate change and alter the landscape in which businesses operate.

"The world is watching" was the tagline for the summit, and all eyes have been on Glasgow as world leaders, CEOs, environmental activists and regulators met to try to advance the global climate agenda.

Although companies are not formally a part of the Conference of Parties meetings, COP26 represented a call to arms for businesses; Prince Charles was among many voices emphasising that the private sector offered the only real prospect of averting a climate disaster through a total economic overhaul. Key topics discussed at COP26, including government climate commitments, access to sustainable finance, corporate policies and development pledges, will affect all businesses and their stakeholders. Businesses must adapt to a world in which the environment is a key factor in corporate decision-marking and strategy.

Click here for our ESG Academy, a practical guide for businesses who are navigating ESG issues.

You can also explore our guide to key ESG trends for 2021-2022 to get a sense of the broader environmental, social and governance shifts which are fundamentally reshaping the way in which businesses operate.

5 To cut through the noise following the COP26 conference, we have set out the five key learnings for businesses and some thoughts on how businesses should prepare to respond to policy changes, social shifts and accelerating stakeholder scrutiny.

1. Government commitments translate to business reality

Governments have been criticised for failing to sufficiently step up their climate commitments during the COP26 negotiations. Despite this criticism, the outcomes from COP26 will change regulations on companies' energy use and environmental practices. Anticipating and adjusting to these regulatory shifts will be critical to business success as the net zero transition accelerates.

The Glasgow Climate Pact was the main output from the COP26 negotiations. The Pact requires the Parties (being the 197 states which are party to the United Nations Framework Convention on Climate Change) to:

- *"revisit and strengthen the 2030 targets in what is known as nationally determined contributions, as necessary to align with the Paris Agreement temperature goal by the end of 2022"*;
- accelerate *"efforts towards the phasedown of unabated coal power and phase-out of inefficient fossil fuel subsidies, while providing targeted support to the poorest and most vulnerable in line with national circumstances and recognizing the need for support towards a just transition"*; and
- maintain the 1.5°C target by *"reducing global carbon dioxide emissions by 45 per cent by 2030 relative to the 2010 level and to net zero around mid-century, as well as deep reductions in other greenhouse gases"*.

This pressure on governments to respond rapidly to the climate crisis and report on the manner in which they are achieving their climate ambitions will impact businesses as governments require and legislate for:

- the phasedown (or total phase out in many jurisdictions) of coal power, stopping fossil fuel subsidies, and an increase in investment in carbon capture and storage, hydrogen and other green energy sources – in short, an acceleration of the global energy transition;
- substantiated climate disclosures; and
- a more significant and rapid transformation of industries that are heavy emitters, such as cement, steel, plastics and chemicals producers, transport, agriculture and construction.

These new legal frameworks will be overlaid with investor expectations, market best-practices and "soft law" voluntary reporting standards, such as the UN Global Compact, the Extractive Industry Transparency Initiative and UNPRI.

However, it's important to note the continued reliance of the global economic system on fossil fuels. This is perhaps best exemplified by the energy crisis in Europe this autumn, caused by slow wind speeds, meaning reduced wind energy generation, as well as politico-economic pressures on Europe's gas supply. Hundreds of energy suppliers have folded, with people and industry being left without power, causing significant hardship.

Businesses then, must be ready to adapt to the increasing regulatory and economic burden placed on them by the climate crisis, whilst staying alive to the complexities of the global energy transition. Here, COP26 is really just an accelerator of the climate mood music telling businesses that their consumers, business counterparties and regulators want performance not just compliance. Importantly, buyers want to spend money on brands that shine in this space. COP26 soft law will continue to drive further hard law and regulation but compliance should be viewed as a framework for enhanced performance – not an end in itself.

For more detail on current ESG regulation around the world, use our free online ESG Global Vision tool. You can also read our guide to New and Emerging ESG Legislation and more at hoganlovells.com/esg.

2. Climate action is a competitive sport - “a bit better” isn’t good enough

A major theme of the COP26 conference was criticism of lukewarm action from private sector companies and governments that claim to champion climate action.

Companies need to take action now to avoid losing their competitive advantage. As the conference has shown, consumers, regulators, investors and employees view ESG issues as business critical, so failure to act may lead to a loss of demand, enterprise risk and massive opportunity cost. Loss of talent, reputational damage and regulatory non-compliance are all further risks if businesses fail to act in a timely manner. Conversely, companies who act quickly and have strong ESG positions are likely to attract and retain the best talent, have access to a larger pool of capital and build strong long-term partnerships with counterparties who share their values and commitments.

These risks have been playing out in AGMs, boardrooms and the courts. Activist ESG investors and shareholders are on the rise and effecting change in board membership and corporate policies. Activist investors consider it necessary to drive strong ESG performance to support their investment decisions. Failure by corporates to respond may result in direct intervention or a loss of access to capital.

The courts are also taking centre-stage as ESG litigation booms – class actions, tortious claims and criminal cases relating to ESG are all on the rise, as are fines, overhauls to ESG strategy and reputational damage attached to unsuccessful defendants.

The oil, gas and transport industries are already feeling the heat as the courts take action and place responsibility for climate change firmly on the shoulders of the fossil fuel industry. Examples of climate change activism and litigation in 2021 include:

- courts ordering large corporates to adhere to more ambitious emissions reduction targets;
- climate activists filing lawsuits against companies in relation to their emission reduction targets; and
- investors unseating board members in an attempt to drive stronger ESG policies and ramp-up emission reduction targets.

Although much of the focus is currently on the oil majors and automotive industry, this trend for activism is set to ramp up in the wake of COP26 and all businesses need to act now to ensure they meet the demands of regulators, their employees, shareholders and other stakeholders.

The Dutch, German, Australian and New Zealand courts have also tried to hold their respective governments to account by linking failures to meet emissions targets with human rights violations. This too will impact businesses as governments strive to meet their self-set targets, requiring greater commitments, disclosures and reporting from corporates.

Again, this is about performance not compliance; good performance is the best risk management strategy. The risks associated with poor ESG performance are growing and will become existential if not addressed.

You can read more about the rise in climate change activism here. If you are interested in exploring how your ESG commitments can drive strong commercial performance and mitigate risk, our ESG 360º Assessment tool assesses your ESG commitments and recommends ways in which your legal framework could be optimised to deliver positive impacts and sustainable returns whilst mitigating risks.

3. Show me the money!

Despite the significant pledges from wealthy governments to commit $100 billion to climate aid by 2020 (a target which has not been met...), there was general agreement at COP26 that public funds would not be sufficient to mitigate the climate crisis.

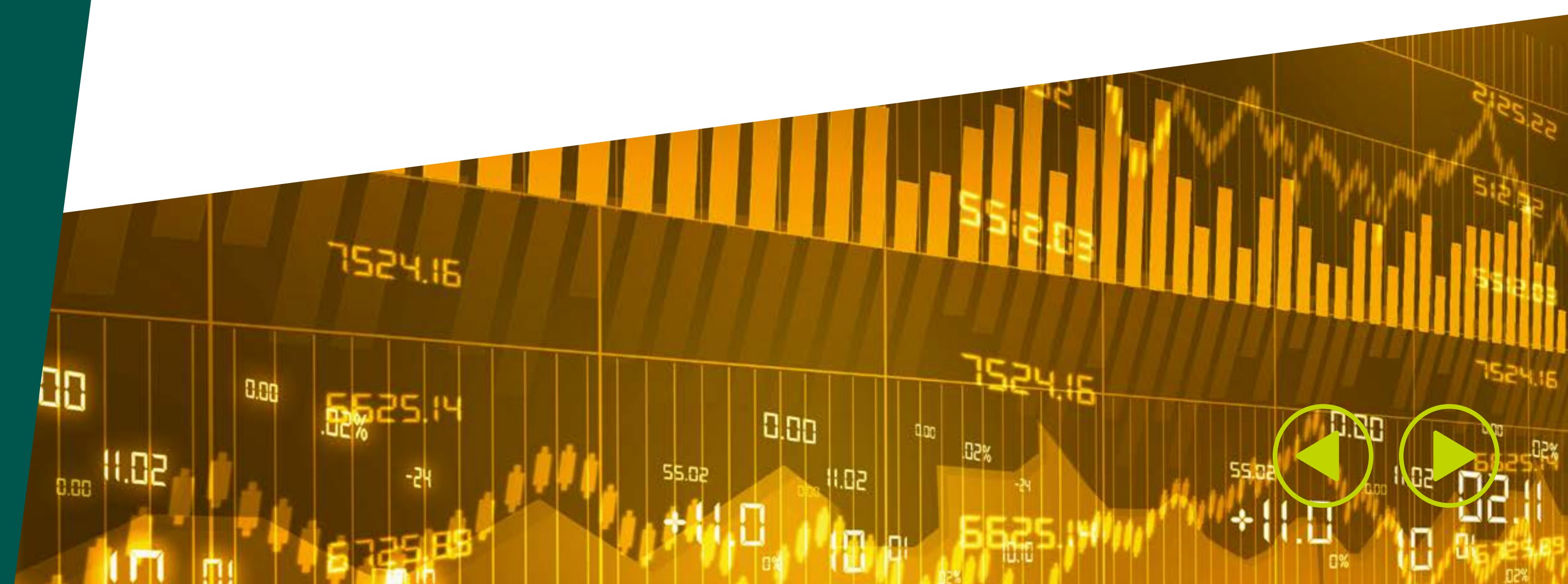
Under the Glasgow Climate Pact, rich countries are asked to "at least double" their provision of climate finance for adaption, which will help developing countries prepare for climate change, by 2025, compared to 2019 levels. This implies that adaptation funding should read $40 billion annually, from $20 billion in 2019. As the new Climate Finance Delivery Plan demonstrates, mobilising private capital to address climate targets is a key aim of policymakers in the wake of COP26.

Financial institutions will have to undergo a much more comprehensive shift to green finance. This will also impact both borrowers and issuers through their balance sheets. Governments link their debt to sustainability requirements amid ever-increasing interest from private markets, the already booming sustainable finance market is set for even greater growth.

There remain significant difficulties in financing a more sustainable future, which broadly fall into two challenges:

- ensuring there are sufficient funds available to support the costs of the climate transition; and
- ensuring that the funds are applied effectively, particularly where they are most needed – in the developing world.

The Glasgow Financial Alliance for Net Zero (GFANZ), an alliance of banks and asset managers committed to meeting the targets of the Paris Agreement and backed by former Bank of England Governor Mark Carney, goes some way to addressing the first point. The GFANZ is formed of over 450 firms representing ~$130 trillion, or 40% of the world's financial assets under management, and has now signed up to achieve and deliver net zero by 2050. While the money might be available, the big challenge for the private and public sector will be ensuring funds are accessible and deliverable where it is most needed.



For more information about sustainable financing and investment, please see our thought-leadership platform, Engage, for further information and resources.

GFANZ also plans to set standards for companies to follow when preparing a net zero transition plan. Understanding these standards will help business leaders respond to the demands of the investors that their companies need to sustain long-term growth.

The International Financial Reporting Standards Foundation recently announced the launch of a new International Sustainability Standards Board (ISSB) to establish a comprehensive baseline sustainability reporting and disclosure standard to assist with ESG reporting. It is hoped the ISSB will allow for a single global language for sustainability reporting which will drive greater confidence in providing finance to developing countries and providing more innovative financial products.

Companies seeking finance must evidence credible transition plans which include suitably ambitious targets and be innovative in their approach to tackling climate change and biodiversity loss. Companies who do not have a well-developed ESG programme or data to support their performance may find that their access to capital decreases, or that their cost of capital increases...

4. A global carbon market is coming

Rules to deliver Article 6 of the Paris Agreement were finally agreed at COP26. Article 6 establishes a framework for a global market in carbon offsets and emissions trading. This section of the Paris Agreement had been the subject of extensive (and unsuccessful) previous negotiations, and was a key reason that COP25 was largely viewed as a failure.

Carbon offsets represent units of carbon that have been permanently avoided or removed from the atmosphere, and can compensate for emissions elsewhere. The new framework establishes:

— a centralised system open to the public and private sectors;

— a separate bilateral system that will allow countries to trade credits that they can use to help meet their decarbonisation targets; and

— a framework for common robust accounting rules.

Investors, activists and governments alike believe a functioning carbon market to be a key weapon in the fight against climate change. It is not only government pressure that will lead to corporates adopting carbon market policies – as companies are required by law to go net zero, voluntary entry into carbon markets will likely be an increasingly attractive option, allowing companies dependent on emissive outputs, such as transport and fossil fuels, to go net zero whilst seeking to decarbonise.

The new rules for carbon markets are likely to unlock significant capital investment in biodiversity protection, reforestation efforts, renewable energy projects and other initiatives to meet net zero. Project developers will be required to submit five per cent of the credits generated by a project into a fund to help developing countries adapt to climate change, and also make a monetary contribution.

These structures may allow rich countries to pay developing countries for offsets, with a corresponding accounting mechanism to avoid double-counting which may be a positive contributor to a just transition. The private sector will be able to channel green investment through the global carbon markets in order to meet climate change targets. More generally, companies should consider the investment opportunity and the potentially significant impact of emerging global carbon trading on their risk profile and business model.

There remains concern about the pricing of carbon credits (for example, as credits created between 2013 and 2020 will be traded depressing the overall price of credits) and whether current pricing reflects the true cost of carbon. As government and regulatory action to establish a true carbon prices advances, this will impact all parts of the value chain; the risk of carbon leakage between countries (in particular, between developed and developing countries) will need to be addressed.

There are also concerns that corporates will rely solely on carbon offsetting to meet their own climate targets; carbon offsets might form part of a strong ESG policy, but cannot be relied upon to meet the demands of customers, investors and regulators – companies will need to demonstrate a more holistic ESG strategy that goes beyond "on paper" compliance and drives performance.

5. Pivot to the rainforests – don't forget biodiversity when you talk about climate change

Further key themes of COP26 were adaptation, climate resilience, nature and biodiversity. These topics are often overlooked, as businesses and governments focus on carbon reduction targets, but the World Economic Forum estimates that $44 trillion of economic value generation, which represents more than half of world GDP is moderately or highly dependent on nature.

As part of government negotiations at COP, representatives from around the world discussed how to further boost flows of climate adaptation funding, and framed it as being as critical as funding for clean energy generation or carbon reduction. From the start of the conference, there was much focus on reforestation with commitments to end and reverse deforestation by 2030 and an associated pledge of $19.2 billion of public and private funds. In addition, a technical assistance program, called the Santiago Network, will be operationalised to address the loss and damage associated with climate change.

The Taskforce on Nature-related Financial Disclosures (TNFD) calls nature loss "a planetary emergency" and aims to create a framework for corporates and financial institutions to assess, manage and report on their dependencies and impacts on nature. The fifteenth meeting of the Conference of the Parties (COP 15) to the Convention on Biological Diversity (CBD) was held on 11 October 2021, where over 100 nations signed the 'Kunming declaration on biodiversity', pledging to protect the wider biosphere, with targets to be finalised at a further meeting in April 2022.

Unlike climate, where government has powerful centrally managed levers it can pull, nature is generally less centrally planned. This makes implementing top down solutions harder, and requires more local solutions. It is here that business can and should play a big role by showing leadership, implementing nature-positive solutions as part of operating practices, setting biodiversity targets, developing mitigation and climate adaptation strategies, and making disclosures under TNFD.

COP26 and other recent governmental commitments have set the scene for even greater regulatory reform across the globe. The global community's response to the climate crisis will continue to shape the way in which businesses operate. There are many risks and challenges, but this changing landscape also offers significant opportunities for those companies that adapt and drive performance through their environmental and social commitments, with a real focus on biodiversity, climate resilience and supporting developing nations.

With so many powerful forces in play, it is clear that ESG issues will continue to grow as a priority for corporate boards, investors and governments throughout 2021 and into 2022. Alongside that growth will come opportunities and challenges that will need to be addressed through the law, so it is critical that in-house teams prepare accordingly.

Contact us for more information and to help you navigate.

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