Beyond transparency: the realities of shifting capital towards low-carbon assets

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International push on disclosure initiatives

- Chinese Guidelines for establishing the green financial system
- EU taxonomy
- EU green bond standard
- EU climate benchmarks and ESG
- BoE climate stress test and PRA
- ‘TCFD Pilot Projects’ launched by the UNEP
- New Zealand makes climate reporting compulsory
- EU taxonomy
- EU green bond standard
- EU climate benchmarks and ESG
- BoE climate stress test and PRA
- ‘TCFD Pilot Projects’ launched by the UNEP

2015
- Mark Carney on climate risks for the financial system
- French Energy Transition Act (Article 173)
- Portfolio Decarbonization Coalition

2016
- Task Force on Climate Related Disclosure (TCFD)
- Network of Central Banks and Supervisors for Greening the Financial System (NGFS)

2017/18

2019

2020
Expectations behind more transparency

Implicit assumptions behind disclosure initiative:

• to move away from carbon-intensive assets to reduce risks
• to re-direct capital to low-carbon opportunities

Are market participants responding ‘rationally’ to information – climate related-financial disclosure – and will change investment outlays?

1. Belief that disinvestment is driven by disclosure
2. Investment ‘switches’ from high to low carbon assets
3. Reorientation of policy focus
Fossil fuels declining financial returns over the last decade


Source: Bloomberg 2021
Fossil fuels declining financial returns over the last decade

MSCI Europe vs MSCI Europe Energy sector performance (2009-2020)

Source: Bloomberg 2021
Oil sector historical trends

Source: Statista 2021
Role of industry returns and future expectations

Oil is highly-volatile, high-return sector (until recently)

- Supply (OPEC influence, shale production) and demand (global crises, pandemic) factors affect the sector volatility
- Previous oil super-cycles enabled oil prices to vastly exceed production costs resulting in high returns

Today the sector has a very uncertain short and long-term outlook

- Declining returns over the last years (fossil fuel companies have underperformed the overall market trends)
- Climate change adds an extra layer of uncertainty that can further increase the sector’s volatility and reduce its returns
- Most investors monitors OPEC/Russia relations and OPEC decisions rather than disclosure
The transfer myth from high to low-carbon investment

Industry market structure: fossil fuel

**The Seven Sisters**
- Esso
- Royal Dutch Shell (Anglo-Dutch)
- BP
- Mobil
- Chevron
- Gulf Oil
- Texaco

**State-owned**
- OPEC
- Saudi Aramco
- Nigeria
- Angola
- Qatar
- Iran
- Ecuador
- Venezuela
- Algeria
- Kuwait
- Libya
- Iraq
- United Arab Emirates

**Consolidated structure**
- cost reduction along the value chain
- asset acquisition to support a fast growth
- strong negotiation power in contractual relationships

**High returns** on capital and value for stakeholders

**Financial ecosystem** used to dealing in huge scales thought major institutions
The transfer myth from high to low-carbon investment

Industry market structure: renewables

In the first decade of 2000s specialised companies started to emerge

Fragmented structure
- Young industry with a less integrated supply chain
- Many players specialised in just one technology and on a single geographic market
- Missing “its majors”

.. Other aspect: more sensitive to local conditions
- Not an internationally traded commodity (currency risks)
- Energy policy framework (regulatory risks)
Fossil fuel and renewables companies by market capitalization in USD Billions (2019)

- The lowest FF company equals the top RE
- The last ranked RE companies have a market cap 10 times smaller than the lowest FF

Market cap is positively associated with investments

Source: Bloomberg data (2021), authors’ analysis
Implications on investment

- **Fossil fuel assets** are the main target of mainstream investors. Financial sector is highly exposed to fossil fuels and climate policy-relevant sectors (~ 45%)

- **Renewables assets** still struggling in attracting key investors:
  - Low-liquidity (daily traded volumes and outstanding shares)
  - Limited number of companies meeting investors’ criteria (e.g. market cap > $200M)
  - Short trading history (around 2006-08), treated as developing asset class
Some reflections

Belief that disinvestment is driven by disclosure

- Equity returns in the fossil fuels are less attractive compared to the past
- Most investors hoping for “oil high returns” monitors OPEC-Russia relations and OPEC decisions, not the results of carbon transparency

Investment ‘switches’ from high to low carbon assets

- Different industries market structures’ affect the investment attracted
- These assets are quite different and there is not an "energy investment system" where capital moves easily from one technology towards the other
- Capital could simply exit the energy sector to other sectors like IT and pharmaceuticals, rather than flowing to low-carbon assets
A reorientation of the policy focus

**Boundaries of the financial system**
- Target specific investor groups, their heterogenous preferences and investment drivers
- Renewable players along the value chain (RE majors?)

**Interface between policy and financial elements**
- Broader integration of the finance dimension into policy design to capture synergies
- Taking sustainability transition perspective triggered by financial elements

**Capital flows in developing countries**
- Create financing channels to manage investment risks in developing countries
- Missing a strong narrative beyond public support – ”a climate investment trap”
Final remarks

Disclosure **seems an insufficient response** to the low-carbon transition:

- It protects the financial system from climate-risks, rather than redirecting financial flows towards low-carbon assets
- The disclosure narrative exempts the financial system from radical action and long-term, systemic changes

**More in-depth analyses:**
- low-carbon assets (as an asset class)
- interactions between financial market participants, their expectations, local contexts and policy

Some sectoral aspects (market structure and related capital) remain a challenge for renewables
- green bonds or exchange traded funds to scale up investment
- long-term policy signals
- redesign a financial system with preferential mechanisms supporting low-carbon assets
### Supplementary Info

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<tr>
<th>Company</th>
<th>Market Cap (USD) Billion (31/12/2009)</th>
<th>Revenues (USD) Million (12 months)</th>
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