

Are infrastructure investors ready for rising climate-related risks?

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On 7 June 2021, the G7 agreed to make climate reporting mandatory, in line with the recommendations of the global Taskforce on Climate-related Financial Disclosures (TCFD). Climate risk looks at the risks related to the transition to a lower-carbon economy, and the risks related to the physical impacts of climate change. While the physical risks can be more difficult to predict and measure, the transition risks and opportunities are becoming more clear and quantifiable.

EU carbon prices have doubled to EUR 50 (~USD 60) per tonne in the past 12 months. By 2030, global carbon prices need to increase to USD 160 per tonne to meet current climate change targets, according to Wood Mackenzie.¹ As the European Commission (EC) prepares to launch its "Fit for 55" legislative package to support the EU Green Deal, there will be more support for higher carbon prices. As more countries and corporates sign up to net zero, more regulation will follow. Carbon pricing has become an increasingly popular mechanism to deliver emissions reductions. Europe is leading the way in this respect, but momentum is also gaining in some parts of North America.

With regulators and investors demanding more disclosure on how climate risk is being managed, we reflect on the preparedness of the infrastructure sector for rising climate transition risk such as those presented through the Fit for 55 proposals.

Ambitious green agenda driving change in Europe and beyond

In May 2021, the European Council approved the EU Green Deal and the bloc's more ambitious 2030 emissions reduction target (55% below 1990 levels vs. previous target of 40%). The centerpiece of the EU's strategy to meet this target is to leverage the EU Emissions Trading Scheme (ETS), which currently covers 40% of the region's emissions.

The "Fit for 55" legislative package due to be published in July, includes 13 proposed changes to the scheme. The most significant proposals have potential to further increase the cost of carbon. This includes reducing the total number of free allowances for companies over time, and introducing an emissions trading scheme for buildings, road transport and the maritime sector. The package also includes the proposal to introduce a Carbon Border

Adjustment Mechanisms (CBAM) which aims to apply a tax to imports based on their carbon intensity. This is a critical proposal as it would allow carbon prices to rise, supporting the bloc's net zero ambitions, while protecting domestic industry from international competition with higher carbon intensity.

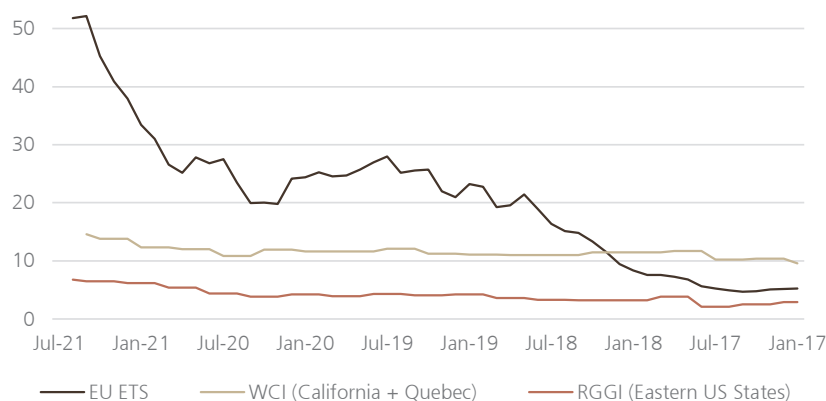
While these plans are ambitious, there are significant challenges around implementation, not least, how to measure, monitor and enforce compliance with a regional policy in a global marketplace. Nonetheless, the direction of travel is clear, and it seems inevitable that European corporates will be paying more for carbon through their direct operations and indirectly through their supply chain.

North America is still falling behind Europe in terms of carbon legislation. Although there is a carbon tax in Canada and a couple of regional cap-and-trade programs in the US, most US states currently do not have any CO₂ limits. The existing carbon markets, which consists of the Western Climate Initiative ("WCI", which includes California and several Canadian provinces) and the Regional Greenhouse Gas Initiative ("RGGI", which includes eleven northeastern states), are only 1/8th the size of the European carbon markets.² In the latest 2021 auctions, WCI price was ~USD19 per ton, while RGGI price was only ~USD8 per ton (vs. EUR50 per ton in Europe). These carbon prices are simply too low to incentivise significant emission reduction, especially in a continent that has benefitted from cheap shale gas.

Carbon regulations are especially difficult to implement in the US due to the economic importance of the oil and gas sector. A national carbon tax is not part of the Biden's climate change plan and his administration has also expressed skepticism around EU's CBAM proposal. Based on current politics, it is therefore difficult to foresee significant global coordination in carbon policies.

On a positive note, the recent trends are undeniably favorable. The American Petroleum Institute made a surprise announcement that they would endorse a tax on carbon emissions and more states have expressed an interest in carbon trading programs. In the past three years, North American carbon prices have risen by ~30% in WCI and ~100% in RGGI. The US may lack the more ambitious and coordi-

Carbon market pricing: Europe vs. North America (Eur/ton CO₂)



Source: Bloomberg, WCI, RGGI, June 2021

nated approach that European countries have taken on carbon regulations, but political sentiment is certainly headed towards the same direction.

What is the exposure for infrastructure investors?

The most exposed infrastructure assets are power generation, energy and transportation but other sectors such as social infrastructure (large buildings footprint) or data centers could also be impacted. Investors in power generation assets in Europe are already exposed to carbon taxes albeit at lower prices and benefitting from more free allowances than under the proposed plans. The impact on cashflows has been limited to date as higher carbon taxes have resulted in higher wholesale power prices. Moody's³ expects this relationship to weaken as the carbon intensity of power markets decreases, meaning that carbon intensive assets will feel a greater impact.

The EC's ambition is to reduce transport-related emission by 90% by 2050. The new proposals also plan to include the maritime and the road transport sector into an emission trading scheme, while the free allowances for aviation will also be cut. While the current proposals are unlikely to have a major impact on volumes for airports and ports, it gives some insights into the sectors that are likely to face increasing climate pressures in the future.

The exposure of each infrastructure asset will vary by asset type, location and competitive position. In the short term, af-

ected asset owners may be able to pass the increased cost through to end users. However, this may become less sustainable if the inflationary impact from higher carbon prices and/or climate-related legislation create an unbearable burden for consumers. This could lead to underutilisation or even stranded asset risk for carbon intensive assets.

While it is important to look at the risks of transitioning to a low-carbon economy, the opportunity set for infrastructure investors is sizeable with infrastructure managers already actively participating in the energy transition, circular economy, clean transportation and in the production of low carbon fuels. Whatever the financial impact for infrastructure investors, the requirement for more climate-related disclosures looks set to grow and frameworks such as the TCFD will be essential in helping infrastructure managers to assess, report and prepare for climate risk in their portfolios.

FOOTNOTE

- 1 Significant increase in carbon pricing is key in 1.5-degree world, Wood Mackenzie, March 2021
- 2 Refinitiv Carbon Markets Year in Review 2020, January 2021
- 3 Unregulated electric utilities – Europe Carbon prices rise sharply, but credit impact limited, March 2021

