Sustainability

US to Take the Path Less Traveled, Exiting COP21

Trump has officially announced his intention to exit the COP21 climate agreement. Our view remains that the climate trajectory is largely unchanged given already inadequate country NDCs to meet the 2°C goal, and that economics are still driving US sectors, not regulation.

President Trump has announced that "the United States will withdraw from the Paris climate accord." He added that he will "begin negotiations to re-enter either the Paris accord, or an entirely new transaction on terms that are fair to the United States, its businesses, its workers, its people, its tax-payers." We would expect this to be a long process, though, with other countries unlikely to agree to more attractive terms for the world's second largest emitter of greenhouse gases.

Our view remains that, despite this announcement, the climate trajectory is largely unchanged, given that current country commitments are insufficient to meet the stated 2°C goal. We acknowledge the possible risk that other countries could follow suit in withdrawing from the agreement, but none have voiced this yet, while Europe and China are doubling down. In fact, Trump's decision appears as a divergence from what many companies and investors have been signaling lately. Further, we reiterate our view that most sectors are currently driven by economics and technology rather than policy.

An exit from the agreement will take several years. Because the US has already ratified the Paris agreement, officially retreating from its commitment would take four years — unless the US were to exit altogether the 1992 parent treaty establishing the UNFCCC, which presumably would void US obligations to both agreements in one year. It's unclear which option Trump is weighing. Upon exiting the COP21 agreement, the US will be joining only Nicaragua and Syria and leaving ~190 signatory parties in the lurch. (Note that these are the only two UN Climate Convention member states not to sign — Nicaragua because it believed the agreement did not go far enough by remaining voluntary, and Syria for the obvious reason of its ongoing civil war.)

No penalty to remain in agreement. COP21 was intentionally designed not to have legal enforcement of countries' commitments in order to allow the US to accept the agreement without a vote of the US Senate. This means that Trump could in theory have done nothing on Paris and still rolled back environmental policies. This would suggest other motives by the administration in making a statement unequivocally against the Paris agreement (likely to appease a support base), as opposed to remaining neutral by taking no action.

Republicans warned that not exiting would put US at risk. Two letters to Trump from elected officials last week were in support of the withdrawal — one from 10

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attorneys general and another from 22 senators. Among their arguments against staying in the pact was that it would open up the country to litigation risk if commitments were not kept.

**Withdrawal could damage negotiations with other countries.** Most countries favor the Paris accord, and they have made it known they will not view a US exit favorably. A potentially thorny issue to consider is the bilateral agreements on action against climate change that the US made in the last couple years with China and Canada. It is unclear whether the administration intends to walk away from those as well.

**Payments to the UN Green Climate Fund to stop.** The Obama administration pushed through $1bn of the $3bn in contributions committed to the UN Green Climate Fund, which have been locked in. However, the other $2bn will not be forthcoming. This isn't a surprise, though, given no funding was earmarked in the recent budget proposal.

**Climate trajectory largely unchanged, either way, in our view.** Regardless of Trump policies, carbon reduction commitments by the US and the other nearly 200 countries party to the Paris climate agreement are known to be insufficient to meet the agreement's 'well below 2 degree Celsius' goal. Thus, the climate trajectory is likely to experience only a slight shift as a result of Trump policies or policy reversals. The US would be challenged to meet its NDC target (26-28% reduction below 2005 levels by 2025) with the reduction of Corporate Average Fuel Economy (CAFE) standards; on the positive side, however, renewables and natural gas generation have been growing rapidly, displacing coal.

**As we've noted, economics are still driving, not regulation.** Our energy commodities team's fundamental analysis of power generation economics shows that longer term coal cannot compete with natural gas or renewables (even on an unsubsidized basis). In a recent report (here), they cut the 2017 coal burn forecast by ~4%, and now see only a modest year-over-year improvement, with a majority of gains lost by 2018 due to ongoing competition from gas and growing renewables.

**The rate of change in solar and wind economics is picking up,** we think more rapidly than investors appreciate, with a nearly 50% price reduction in solar panels over just 2 years (2016-17e) and wind power with an all-in cost in windier portions of the US that is ½ - ⅓ that of the all-in revenue needed for a new gas-fired plant at $0.055-0.065/kWh. Just this month, Tucson Electric Power (TEP), an Arizonan utility, signed a 20-year contract with NextEra to buy energy at what is reportedly the lowest price for solar PV achieved in the US to date — below US$0.03/kWh. Wind has already achieved all-in costs of US$0.015-0.025/kWh with tax credits, and NextEra expects wind to be a $0.02-0.03/kWh product, even without tax credits, by early next decade. This progress is largely driven by improvements in wind turbine technology — taller tower design and wider rotor diameters — which could drive net capacity factors to nearly 60%.

**Reactions — and potential reactions — from countries, companies, and investors:**

**Some countries may want to follow a US exit...** There may be developing countries that are glad for an excuse to exit the agreement due to the burden they perceive it will cause them. However, we note that during COP21 negotiations, countries agreed not only to hold the temperature increase to 'well
below 2°C" but also "to pursue efforts to limit" it to 1.5°C above pre-industrial levels. The mention of the more ambitious 1.5°C target was actually a bargaining chip to bring more countries into the agreement, rather than fewer.

**...while other countries take this opportunity to step up.** In response to rising global climate concerns since the US election, many countries have doubled down on their climate change rhetoric and are not echoing the shifting stance of the US on carbon. European foreign ministers have committed to raising awareness among partners and to reinvigorating global alliances on climate policies, including bilateral meetings with Canada, China, India, and Iran. Some argue that China could take the renewable energy lead from the US and play a critical role in the Paris climate agreement if it continues along its current path of three years of coal consumption declines and shutting of small, inefficient coal mines.

**Even individual US states have been spurred into action.** In recent days, the California Senate has proposed a series of bills ranging from accelerating renewable energy targets to keeping landmark federal environmental laws such as the Clean Air Act and the Clean Water Act enforceable under state law even were they to be eliminated. These bills are in part viewed as "insurance" against federal action. This follows on the US Senate recently rejecting the repeal of limits to methane emissions from oil and gas drilling. Amid what was a growing string of recent US environmental policy reversals, this was the first to fail.

**Companies have been stepping up too, arguing for competitiveness.** A group of large public companies and CEOs signed two recent letters urging President Trump to remain in the Paris climate agreement for reasons of competitiveness, job creation, and business risk management. These follow on hundreds of others — including from energy and coal companies — which had started as early as last fall after the election.

**Last, but not least, investors are speaking up.** In recent AGMs, shareholders have been particularly outspoken on climate related proposals. Just yesterday, ExxonMobil shareholders making up 62.3% of votes voted against management's recommendation and in favor of the company reporting on its climate progress. This follows on a similar vote at Occidental Petroleum (67%) in recent weeks. Similar proposals at Duke Energy, Southern Company, and Dominion narrowly failed with 46-48% of votes.

**Related Reports:**

- Sustainability: Trump's EPA: Closer to Reality (08 Mar 2017)
- Sustainable Economics: No Time To Chill (18 Apr 2016)
- Sustainable and Responsible: COP21 Recap: The Proof is in the Pudding (14 Dec 2015)
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