

Stuck in second gear

Car manufacturers may appear to be complying with EU emissions standards, but a canny use of offsets and loopholes is masking sluggish progress towards Paris Agreement goals. How are we engaging with the sector to accelerate the transition from fossil fuels to electric vehicles? By Claire Milhench.

Setting the scene

The top 10 automotive groups account for 90% of EU-wide auto emissions and hold the keys to change. Yet a Federated Hermes analysis¹ identified erratic progress towards Paris Agreement-alignment, with car makers exploiting exemptions and loopholes within the EU's regulatory framework. As a result, overall emissions have risen not fallen. Meanwhile, due to air quality concerns, several EU countries are now introducing complete bans on internal combustion engine (ICE) vehicles by 2030. Faster adoption of battery electric vehicles must be a priority for auto companies, alongside a plan to retrain the millions of workers skilled in ICE technology, to deliver a just transition to a net-zero economy.

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In the US car market, gas-guzzling sports utility vehicles (SUVs) and oversized pickup trucks are popular models, reflecting the fact that gasoline is cheap. In parts of Europe, higher taxes on fossil fuels mean that smaller, more economical models have tended to have the edge. But things are changing – and not for the better.

An investigation by the Badvertising campaign² found that SUVs now make up 40% of new cars sold in the UK, while in 2019, over 150,000 new cars sold in the UK were too large to fit into a standard parking space. A bigger car means higher carbon emissions, because it requires more fuel to propel a heavier vehicle. Despite this, car manufacturers trumpet their green credentials with aspirational advertising of hybrid vehicles driving along empty roads through lush, green landscapes. So what's really going on?

Part of the problem is that manufacturers continue to produce and sell cars with high-emitting profiles and then push these heavier, more lucrative options, so that people are encouraged to buy vehicles bigger than they need.

In an attempt to bring the auto sector into alignment with the Paris Agreement and curb carbon emissions, in 2020 the EU implemented a target of 95 gCO₂/km across manufacturer fleets. This applies to all cars sold into the EU, so also impacts US and Asian manufacturers such as Ford and Toyota.

¹ <https://www.hermes-investment.com/ukw/wp-content/uploads/2021/02/fhi-backfire-on-emissions-responsibility-office-0221.pdf>

² <https://www.badverts.org/the-problem>

However, an analysis of the 2019 data by the international business of Federated Hermes in the report *Backfire on Emissions* showed that while most manufacturers looked likely to meet EU regulatory targets and thus avoid hefty fines, much of this was due to the extensive use of short-term enablers such as electric vehicle offset schemes, and the exclusion of the 5% most-polluting vehicles.

Aside from the pollution legacy, there are concerns that the EU's existing regulatory enablers are encouraging a sluggish transition strategy from car manufacturers.

Percentage of fleet whose emissions fall in the below groupings (0 g/km, 0-95, 95-110, 110-130, 130-150, and ≥150).

| OWNER | AVERAGE EMISSIONS | 0-95 | 95-110 | 110-130 | 130-150 | ≥ 150 |
|-------------------------|-------------------|-------|--------|---------|---------|-------|
| Volkswagen Group | 124.34 | 1.73 | 11.42 | 35.72 | 23.66 | 27.04 |
| PSA Group | 114.87 | 4.48 | 25.73 | 44.98 | 17.28 | 7.39 |
| Renault-Nissan Alliance | 117.44 | 2.39 | 13.64 | 40.51 | 24.41 | 17.76 |
| Hyundai | 123.55 | 2.6 | 11.59 | 40.15 | 22.57 | 21.55 |
| BMW Group | 126.91 | 3.61 | 3.94 | 37.46 | 29.37 | 25.28 |
| Daimler | 137.36 | 1.89 | 3.99 | 19.95 | 21.44 | 52.31 |
| Ford | 130.97 | 2.53 | 14.03 | 31.07 | 20.12 | 32.24 |
| FCA Group | 130.83 | 0.5 | 5.77 | 28.87 | 24.88 | 39.99 |
| Toyota | 99.76 | 26.34 | 19.82 | 17.07 | 23.79 | 12.9 |
| Geely | 132.51 | 9.63 | 0.31 | 18.71 | 29.28 | 42.07 |

Source: European Environment Agency, as of December 2020. Data until 2018 is final, 2019 is provisional. Analysis undertaken by Federated Hermes.

According to our analysis, in 2019, petrol passenger cars accounted for 63% of sales and diesel cars 32%, while battery electric (BEV) and hybrids (including PHEV) were at 1% and 2% respectively. By December 2020, battery electric and plug-in hybrids had leapt to 23% of new sales³, but the average lifespan of vehicles is around 12 years, so the overall pollution legacy of new petrol and diesel cars is significant. There is a strong argument that car companies and consumers need to transition much faster.

Disorderly transition

Aside from the pollution legacy, there are concerns that the EU's existing regulatory enablers are encouraging a sluggish transition strategy from car manufacturers. There are 3.7 million car industry employees across the EU, and they will need to be reskilled, or they will bear the brunt of a disorderly transition. There is also a need to roll out charging points and other supportive infrastructure to enable rapid consumer take-up of electric vehicles. The removal of loopholes would force companies to make the necessary changes sooner rather than later.

Unfortunately, patent filings on EVs indicate that some companies are not spending enough on R&D. The EU is targeting much lower carbon emissions, suggesting that companies need to ramp up their EV production. For example, a 59g CO₂/km target would require EVs to make up 47% of the EU fleet.

Meanwhile, governments in Europe and Asia have announced dates for the total phase-out of sales of new ICE vehicles. The UK, Netherlands, Ireland, and Sweden have a 2030 phase-out date, while China and Japan have set a 2035 date. Norway, which has strongly incentivised EVs through tax breaks, smashed through 50% of new sales in 2020, a global record.⁴ It is hoping to end sales of ICE vehicles by 2025.

A quick guide to electric vehicles



Hybrid vehicle – The battery charges while the motorist drives, by using regenerative braking energy and the internal combustion engine (ICE), but when this charge is used up the car reverts to fossil fuel propulsion.

Plug-in hybrid electric vehicle (PHEV) – The motorist can charge the vehicle by plugging it into a special socket, but the batteries have a limited range, with petrol or diesel fuel acting as the fall back.

Battery electric vehicle (BEV) – Fully electric-driven, so the battery's range is critical.

Fuel cell electric vehicles – Electricity fuels an electric motor, but this is produced using a fuel cell powered by hydrogen.

³ MarketMonitor-EU-jan2021.pdf (theicct.org)

⁴ <https://www.theguardian.com/environment/2021/jan/05/electric-cars-record-market-share-norway>

Our engagement approach

These looming deadlines will require a shift in gears if car companies are to make it to the finish line in time. While light hybrids can be a reasonable bridging technology, 100% penetration of BEVs is needed by 2030 ideally, and 2035 at the latest. Unfortunately hybrids tend to be larger than non-hybrids on average and are less attractive in terms of lowering emissions than one might assume. There is a risk that companies waste time and money developing and investing in hybrid technologies that do not perform as well in the real world as is claimed or fall foul of tighter policy come 2030. It would make more sense to leapfrog hybrids and go fully electric with fast and furious adoption of BEVs. To get there, companies must not only invest in R&D, they must commit sizeable capex to reconfiguring production lines, and change their approach to marketing and sales.

Some companies – such as Daimler in 2019, and Nissan in January 2021 – have already announced a net-zero target for 2050, including Scope 3 carbon emissions. As part of this effort, by the early 2030s every new Nissan vehicle offering in its key markets will be electrified.⁵ It will also include end-of-life vehicle recycling or reuse.

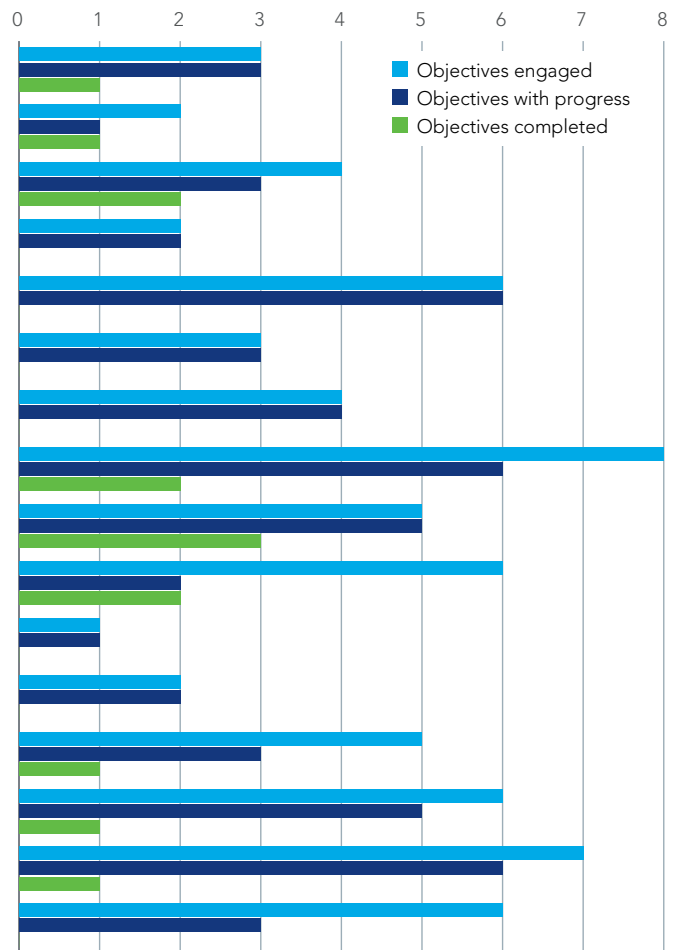
The picture elsewhere is less encouraging. Historical data show that incremental improvement to ICE technology – or even hybrid technology – is unlikely to deliver the scale and

pace of emissions reductions needed from the auto industry. To highlight this, we wrote to several leading car manufacturers, including BMW, Stellantis, Daimler, Renault, Toyota, Geely, Hyundai, and Ford.

In our letters, we challenged companies on the fact that vehicle weights have been increasing, pointing out what this means for legacy emissions. We asked about their decarbonisation and capital allocation strategies, and queried any tilts towards PHEVs, when BEVs must take the lion's share of the market to ensure that emissions targets are hit. We said we were sceptical that investment in a hybrid-to-BEV technology transition pathway over five to 10 years would deliver the most attractive return on shareholder capital, given the relatively short time period before all such vehicles would need to be fully electric.

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| Company Name |
|---------------------------|
| Bayerische Motoren Werke |
| Continental |
| Daimler |
| Ford Motor |
| Geely Automobile Holdings |
| General Motors |
| Honda Motor |
| Hyundai Motor |
| Nissan Motor |
| Renault |
| Stellantis |
| Subaru |
| Suzuki Motor |
| Tesla |
| Toyota Motor |
| Volkswagen |



Source: EOS data, January 2019 – March 2021

⁵ <https://global.nissannews.com/en/releases/release-18e8181d3a7c563be5e62225a70c61b2-nissan-sets-carbon-neutral-goal-for-2050>

We are also participating in the Climate Action 100+ (CA100+) Net Zero Benchmark Initiative, where we are the Daimler lead and BMW co-lead. Investors working through CA100+ are seeking more robust and comparable information on how companies are realigning their business strategies and operations with the goals of the Paris Agreement, and a net zero emissions future.

Accordingly, the net zero benchmark builds on the TCFD recommendations, with more guidance on the specific company actions and disclosures that are most relevant to investors' decisions. These include analysis of elements such as a just transition for affected auto workers so that no one is left behind, climate policy support and capital alignment, targets and goals, the company's decarbonisation strategy, plus assessments of its reporting and governance.

As part of this engagement, in September 2020 we sent letters to Daimler and BMW explaining the benchmarking initiative. We asked them to make or reconfirm a commitment to achieving net zero emissions by 2050 or sooner, with medium-term targets or goals consistent with a global reduction in emissions of 45% by 2030, relative to 2010 levels.

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An analysis of company alignment with these indicators was conducted by CA100+ in collaboration with the Transition Pathway Initiative. The company scorecards, published on March 22, reveal that Volkswagen and Daimler were the highest-ranked auto companies, while Fiat Chrysler Automobiles (now Stellantis) was a laggard. However, the scores do not tell the whole story, as they are mostly an indicator of how much information a company has disclosed. It is possible to earn a high score, but not be closely aligned to the Paris Agreement goals.⁶

We are now using the detailed analysis and benchmark scorecards to inform our engagements with car manufacturers, and in the months ahead we will urge the laggards to put their foot to the floor and pick up the pace.



CASE STUDY

Daimler



Daimler is one of the world's largest manufacturers of premium passenger cars and commercial vehicles. We have a long history of engaging with Daimler, extending back to 2007 and covering a wide range of ESG issues.

Since 2010, we have been engaging on climate change, aiming to achieve a roadmap for alternative technologies and sustainable vehicle models aligned to international climate goals.

In 2018, we took on the lead role of engaging with Daimler as part of the collaborative initiative Climate Action 100+, intensifying engagement through a series of meetings with the supervisory board chair and company executives.

We challenged the company to articulate its mobility strategy more clearly and requested more ambitious emissions reduction targets aligned with the Paris Agreement goals.

We also raised concerns with the chair about the apparent misalignment between the company's position supporting the Paris Agreement and the positions of its third-party member industry associations, which openly lobbied against more ambitious 2030 vehicle emissions reduction targets in Europe.

Carbon neutral production

In May 2019, a week before its annual shareholder meeting, the company announced its "Ambition2039" strategy, outlining its plans for a transition to a low carbon business model. The strategy set targets for carbon neutral production, and specified that all Mercedes-Benz passenger vehicles sold must be carbon neutral in both manufacturing and use by 2039, aligned with our request.

In our speech at the 2019 shareholder meeting, we welcomed the progress Daimler had made. We also stressed the need for Daimler to ensure alignment between its own support for ambitious climate policies and the positions of its membership industry associations. In statements from both the supervisory board chair and CEO, the company acknowledged the importance of aligning corporate lobbying with the Paris Agreement.



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⁶ <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

 CASE STUDY

Hyundai Motor



South Korea's Hyundai Motor is one of the world's largest vehicle manufacturers, with over 50% of its sales overseas.

In 2017 we raised our concerns about the apparent weakness in the company's sustainability performance, particularly the carbon intensity of its vehicles, as revealed in a report published by the non-profit organisation CDP. We introduced it to CDP and following this, the company acknowledged that its performance could be improved.

It then shared its improvement plans, including around catching up with Japanese peers who had invested earlier and more decisively in green technologies, and enhancing its communications around this. With little initial improvement, we continued to question vehicle sustainability performance over the next three years, including meeting with the independent chair in 2018.

Hyundai Motor has now made good progress in improving the sustainability of its vehicles, launching a number of lower emissions models including IONIQ, offered as a hybrid, a plug-in hybrid and a fully electric vehicle, and KONA Electric, the first fully electric compact SUV.

The company is also accelerating the development and promotion of hydrogen fuel cell vehicles and plans to increase its sustainable vehicle models from approximately 3.8% to 20% of total sales by 2025.



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Sector lead: Transportation

Electric dreams



Range anxiety is often cited as one of the main factors preventing greater consumer take-up of all-electric vehicles. No one wants to be stranded far from home. So why aren't we seeing a rapid roll-out of charging infrastructure?

Even if companies scale up their production of EVs to meet countries' 2030 ICE sales ban deadlines, another question remains – will motorists be able to find a place to charge them? Although charging points have popped up at kerbside in some major cities, they are still few and far between.

Electric-charging infrastructure must be rolled out faster at work, home and across business premises if mass adoption by 2030 is the goal. Electricity grid capacity will need to be expanded to accommodate this. We are seeing some announcements, such as that made by the UK government to invest over £500m in growing the EV infrastructure, but much more needs to be done.

According to the EU Green Deal, to achieve climate neutrality, a 90% reduction in transport emissions is needed by 2050. This strategy should be implemented with a socially responsible approach to preserve jobs and reskill workers, in line with the principles of a just transition to a low-carbon economy.

With utility companies, we advocate for a faster roll out of charging points, but the policy framework is critical. To this end, we have informed policymakers, regulators, and industry associations of the Net Zero Company Benchmark expectations to galvanise the support needed.

In February 2021 we responded to the EU's public consultation on the revision of CO₂ emissions standards for cars and vans. We recommended the removal of the regulatory enablers for auto companies that give them the leeway to continue selling high emission vehicles.

We also want to see vehicle tax reform to penalise consumers that buy highly polluting vehicles. Aside from motorists' fears about running out of charge – which experts say are overdone – cost is the other major barrier preventing mass switching to EVs. Norway has turbo-powered EV sales by offering tax breaks to make electric cars cheaper.⁷ Germany has also joined forces with car companies to fund grants for BEVs to drive up demand. By contrast, the UK government has frozen fuel duty on petrol and diesel since 2010.⁸

⁷ <https://www.theguardian.com/environment/2021/jan/22/electric-vehicles-close-to-tipping-point-of-mass-adoption>

⁸ [Why are the Tories putting up the wrong taxes? | Financial Times \(ft.com\)](https://www.ft.com/content/2020/01/27/why-are-the-tories-putting-up-the-wrong-taxes)

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