A watershed for climate change stewardship?

2021 may come to be viewed as a watershed year for climate change and investor stewardship, with a Dutch court decision against Royal Dutch Shell, Engine No. 1's proxy contest with Exxon, and majority support for a shareholder climate resolution at Chevron all occurring in May. With other recent developments, such as the International Energy Agency's Net Zero by 2050 report – and COP 26 on the horizon – have we reached a tipping point for climate stewardship?

If we needed more evidence that the pandemic has served as a wake-up call on climate for businesses, investors, policymakers and individuals, this year's voting season emphatically provided that. Mainstream sentiment has shifted, and the momentum is with investors calling for faster action on climate change.

We have seen this in the growing number of investment managers – including the international business of Federated Hermes – committing to net zero as part of the Net Zero Asset Managers Initiative.[1] Signatories pledge to work with their clients to reach a goal of net-zero greenhouse gas emissions by 2050 or sooner, in line with wider efforts to limit global warming to 1.5 degrees Celsius. With 128 signatories and around $43tn in assets, the initiative is close to representing almost half the global asset management sector in terms of total funds managed. Meanwhile, the UN-convened Net Zero Asset Owners Alliance has attracted over 40 institutional investors, representing over $6.6tn.

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[1] Net Zero Asset Managers Initiative – Home

With climate transition votes on the agenda for the first time at some 18 annual shareholder meetings, the stage was set for a busy season of scrutinising the fine detail of companies' transition strategies. Aside from the growing investor concern, there is regulatory and societal pressure on companies to align more quickly with the goals of the Paris Agreement, but as yet no established consensus or unified framework to guide an assessment of how aligned companies are. This presented investors with an analytical challenge and allowed some companies to win votes for transition plans that in our view had significant gaps or were misaligned.

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Central banks, policymakers and other financial standard-setters are now cognisant that climate change poses a systemic risk – one that could be far more severe than the economic hit from the pandemic. Addressing it will require a multi-faceted response – from cutting carbon emissions and improving the assessment and reporting of climate risks, to reducing the impact from issues such as deforestation, and rewiring the global financial system to support the transition to a low carbon economy.

Here we examine some of the defining moments from the past quarter:

The IEA gets to grips with net zero

The publication on May 18 of a landmark special report by the International Energy Agency (IEA) outlining a 1.5-degree scenario set the scene for the oil industry shareholder meetings that followed. *Net Zero by 2050: A Roadmap for the Global Energy Sector*[2] was a leap forward for an influential organisation that had previously taken a conservative approach to the growth outlook for low-carbon technologies. The report set out the priority actions needed to build a global energy sector with net-zero emissions. It argued that the technical challenges were surmountable, that oil sales had peaked, and that gas would not be far behind.

Why was this so significant? The IEA had released a Net-Zero Scenario – though with very little detail – at the end of 2020. The report provided this detail. Previously the IEA had lacked a 1.5-degree scenario, with its Sustainable Development Scenario (SDS) and B2DS the closest, although these were in the range of 1.6-1.8 degrees of heating above pre-industrial levels. To appreciate the significance of these scenarios it is worth noting how widely these are used by companies in their own scenario planning, including large oil and gas companies such as Chevron. Whilst the IEA's scenarios are intended for policymakers, the granularity of the information on certain technologies and the outlook for commodities is information that can be integrated into company and investor financial modelling.

We have engaged with the IEA over several years about the publication of a 1.5-degree report, understanding how significant this would be for companies undertaking scenario analysis to determine their climate strategies. As well as signing letters to the organisation through the Institutional Investors Group on Climate Change (IIGCC) and other bodies, in 2019 we went to Paris with a small group of investors to meet the IEA's executive director, Fatih Birol, to talk about the possibility of producing a 1.5-degree scenario.

In future IEA reports we will be looking for clear price assumptions on commodities to help us understand whether fossil fuel companies are using reasonable assumptions within their annual reports and accounts.

Dutch court ruling against Royal Dutch Shell

NGOs have tried to win legal cases against fossil fuel companies in the past – and failed. But in a case brought by the Dutch arm of Friends of the Earth, the judge ruled that the oil and gas major should materially update its strategy to align to the Paris Agreement goals.[3] This includes setting a target to reduce its emissions by 45% in absolute terms by 2030 across its entire energy portfolio and the aggregate volume of all emissions including those of its products. Shell is appealing the decision, but if it stands, it could set a legal precedent. In the meantime, Shell is complying with the judgement and is accelerating its strategy.

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The NGO's case was that Shell's strategy had not given due consideration to its duty of care to protect human rights under the Dutch Civil Code. Although Shell's goal is to become a net-zero business by 2050, the judge ruled that it must cut emissions deeper and earlier. Just a few weeks prior, investors had endorsed Shell's climate strategy through a 'say-on-climate' vote that delivered 88% support.

We had recommended a vote against the company's transition strategy because it appeared misaligned with the Paris Agreement goals, with a lack of climate action safeguards such as absolute reduction targets before 2050 or commitments to align the company's capex with meeting the Paris goals. We also recommended a vote against the financial reporting due to the lack of progress on aligning with Paris Agreement scenarios.

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The judge said that there was a human rights obligation on the company to take further action. This suggests that it may not be sufficient just to consider climate-related financial risks based on the impacts from the energy transition and maintaining shareholder value. Investors and companies may also need to consider the impact of each business on the environment and the future harms that may be caused by historical emissions.

Over the past 12 months we have seen other legal challenges brought against big polluters based on climate damages – but this is the first where a company has lost. This should set alarm bells ringing at high-emitting companies. If a company's historical emissions are used to assess its overall environmental impact, there could be a higher level of litigation risk, even if a company's net-zero plans are robust. For example, over 90% of RWE's capex is now going into environmentally-sustainable investments[4], but in the past it was the largest emitter in the EU. One way to mitigate this risk might be for companies to set net-negative targets to reduce their past contribution.

[2] Pathway to critical and formidable goal of net-zero emissions by 2050 is narrow but brings huge benefits, according to IEA special report – News – IEA
[3] Dutch court orders Shell to accelerate emissions cuts | Financial Times (ft.com)
[4] As determined by the EU Taxonomy – https://www.group.rwe/en/press/rwe-ag/2021-05-12-rwe-confirms-forecast/

Votes on climate transition plans

This voting season saw a series of formal shareholder votes on companies' climate transition plans in the US, Canada, the UK, France and Spain, among others. This followed attempts in recent years to improve investor scrutiny of companies' actions on climate, and reflected the rapid expansion in company commitments to achieving net-zero emissions.

Whilst we were supportive of the idea in principle, we had some initial concerns about the concept. The high level of support for transition plans, including Shell's, suggests these concerns were justified. There is a tendency for investors to vote in line with management, which may suggest they do not have the technical skills or the time to evaluate plans properly. One of the biggest dilemmas is how to balance the absolute performance of the company in terms of its commitments and how Paris-aligned these are, against its general momentum on climate.

We decided to apply a more rigorous approach in our assessment of transition plans, setting a robust standard of alignment to the Paris Agreement goals for companies to pass. This meant that we recommended voting against some high profile names, including Total, Glencore, Shell and Aena (see our voting season article on page 21 for more details).

To an extent, high levels of investor support for such plans should have been expected as most of the companies targeted were considered "leading" on the climate transition in their sector. However, few companies came out of the process unscathed, given the public scrutiny. More investors are asking for such votes as an accountability mechanism, and we are seeing more large asset managers backing shareholder proposals calling for Scope 3 targets, as at Chevron, or supporting shareholder-proposed directors with a view to improving the company's stance on climate change, as at Exxon. However, there is still work to do to ensure that more investors understand what it takes to be Paris-aligned.

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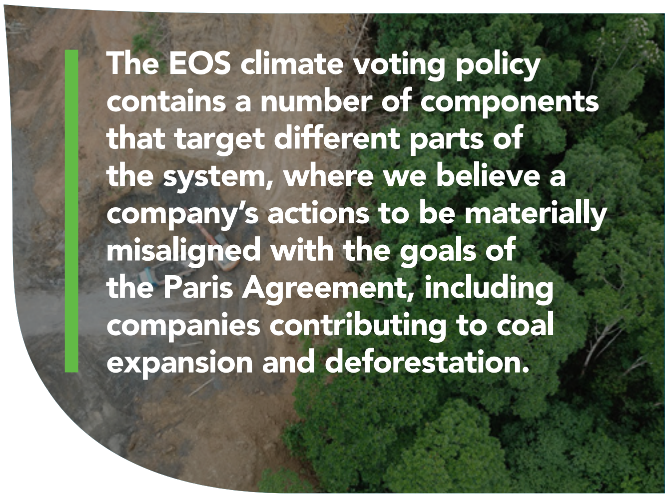

The EOS climate voting policy contains a number of components that target different parts of the system, where we believe a company's actions to be materially misaligned with the goals of the Paris Agreement, including companies contributing to coal expansion and deforestation.

Leaders and laggards

In March, Climate Action 100+ issued its net-zero benchmark for the world's largest carbon emitters.[5] This defined the key indicators of success for business alignment with a net-zero emissions future and the Paris Agreement goals. The benchmark, which we had helped to design, set clear engagement priorities to drive faster climate action. However, the benchmark assessments showed that no company had fully disclosed how it would achieve its goals to become a net-zero business by 2050 or sooner. The plan is to refine and expand the benchmark over time and it is likely to become a key test for companies.

EOS has continued its leadership on climate change engagement and voting by developing and testing its own assessments of companies and reflecting this in its voting recommendations. We have had a formal climate change voting policy in place since 2019, using the Transition Pathway Initiative (TPI) scoring system. While valuable, this assessment is reasonably limited in scope and in 2021 we expanded our policy to draw on a broader assessment of companies' actions.

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Given the growing momentum on this issue as COP 26 edges closer, companies stubbornly refusing to accept that climate change is something that they must address will be increasingly exposed – and vulnerable to accelerated policy changes and lawsuits. Investors are losing patience with the laggards, and a company's failure to pick up the pace could prove value destructive. This could happen sooner than some companies seem to think.

[5] https://www.climateaction100.org/news/climate-action-100-issues-its-first-ever-net-zero-company-benchmark-of-the-worlds-largest-corporate-emitters/

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Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

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