The value of transition planning

Companies' climate transition plans are now regularly put to the vote during annual shareholder meetings, but the complexity of these plans can make them difficult to assess. Owen Tutt and Will Farrell explain what investors should be looking for.

Setting the scene

In 2015, when Mark Carney, then governor of the Bank of England, proposed a way to improve the data for assessing the consequences of climate change on investor portfolios, few could have imagined the impact that the Task Force on Climate-related Financial Disclosures (TCFD) would have. Since then, the breadth and depth of corporate reporting on climate change has exploded and reviewing company TCFD reporting has become an integral part of our engagement research. The official proposal that launched the TCFD also highlighted the importance of company climate transition plans to investors, but appraising transition plans is a complex and often resource-intensive challenge. In this article we discuss the role of transition plans, and how we assess their ambition and credibility.

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Shareholder votes on company climate transition plans are now a key feature of the AGM season in major markets, but the 'say-on-climate' is still in its infancy. As a consequence, it is complex for investors to analyse a company's climate risks and opportunities. To tackle this challenge, EOS has developed a framework to enable all investors to appraise transition plans as efficiently and effectively as possible. It's worth explaining how we got to this point, and why transition planning is seen as fundamental to good corporate governance.

The TCFD provided the framework for climate-related investment analysis by identifying the transition risks and opportunities that companies may face during the shift to a low-carbon economy. These could materialise in the form of policy, legal, technological, market or reputational factors. A transition plan is the company's strategy for mitigating these risks and becoming a low-carbon and climate-resilient company.

As climate risk reporting took off in the wake of the TCFD, companies started to offer investors increasingly sophisticated risk analyses and their fledgling strategies for mitigating climate risks. Companies set emissions reduction targets, and outlined plans for growing low-carbon business segments. In recent years, investors have been offered the chance to vote on a company's progress against its plan.

At the same time, standards and benchmarks proliferated for guiding and assessing this growing body of disclosure. These included CDP scores, the Science Based Targets initiative, the Transition Pathway Initiative, the Climate Action 100+ Net Zero Benchmark, the Net Zero Investment Framework, and the Institutional Investors Group on Climate Change Investor Expectations guides. We also saw moves towards standardisation by the International Sustainability Standards Board, the European Sustainability Reporting Standards, and US Securities and Exchange Commission climate-related disclosure rules. Although intended to be helpful, this created a complex maze of guidance and regulatory requirements for companies and investors to grapple with.

Companies should consider each carefully and comply with the reporting requirements of the relevant jurisdictions and investors' needs. But if climate-related risks are to be a C-suite priority and not just part of the compliance process, companies need a route through this reporting maze. A high-quality transition plan can offer this by adopting four key principles.

Principles of a high-quality transition plan

For companies in emission-intensive sectors, decarbonisation to net zero will require a fundamental business transformation on an accelerated timeline. Even less exposed sectors will see changes in customers, suppliers, regulation and other stakeholders as the economy transforms around them. Therefore, the first principle is that a transition plan – the blueprint for achieving and responding to this change – must be strategic and inseparable from the wider business strategy.

Governments assemble annually to reaffirm their commitment to the goal of the Paris Agreement to hold global warming to well below 2˚C and pursue efforts to limit the temperature rise to 1.5˚C. Investors are paying increasing attention to the actions being taken by governments to achieve their pledges, and to the accelerated development of decarbonisation technology. But if investors are to make use of a company's transition plan to evaluate, challenge, and ultimately price the risks and opportunities, it must be credible. So the second principle is that there must be sufficient detail and clarity on near-term objectives, timelines, and capital and resource allocation to inform the investment case.

However, clarity does not mean certainty. Unfortunately, there is a trade-off between setting the necessary ambitious targets to align with the 1.5˚C goal of the Paris Agreement and articulating a strategy for executing this that is rooted in established economics and adopted public policy. Achieving net zero will require the private and public sectors to go beyond the tried and tested. Therefore, principle three is the need for a transition plan to be bold in aligning with the Paris Agreement, while remaining commercial. This means being clear-sighted and transparent about the assumptions made and the plan's dependencies on supportive public policy or technological development.

This creates another external role for transition plans as a tool for policy advocacy and stakeholder engagement that facilitates the necessary changes outside the company's direct control. Similarly, by monitoring progress, investors can distinguish between management failure and macro headwinds. At Air Liquide, where we have engaged on aligning its lobbying activities with the Paris Agreement, the company's latest review of its industry associations provided a detailed list of its policy dependencies and advocacy principles, sending a clear signal to policymakers.

Finally, for a transition plan to fulfil the above requirements, delivering long-term value and reduced emissions, it must concisely articulate more about progress against the plan rather than just process implementation – principle four. As we approach an inflection point in the low-carbon transition, investors need to understand the actions being implemented and planned to transform the company. This is the core role of the transition plan. The routine processes, committees and CSR initiatives, while important, can be disclosed elsewhere.

Assessing transition plans

EOS believes these principles are largely embodied in the guidance recently published by the Transition Plan Taskforce, which was established by the UK government at COP26. In our view, it has developed the gold standard for private sector transition plans by building on the existing body of reporting guidance and the input of private sector experts. This included EOS through our contributions to sector-specific guidance and our co-chairing of the Oil & Gas Working Group.

Drawing on this and the Net Zero Investment Framework, from the Paris Aligned Investment Initiative, EOS has developed a proprietary approach to assessing transition plans and their alignment with the Paris Agreement (see box). This provides engagers with a sector-specific – and region-specific, where possible – assessment of transition plan ambition and credibility to inform engagement and voting.

Transition plans should be published as complete documents, not distributed through wider reporting, and should be updated at least every three years or whenever significant changes are made. Progress against them should be reported annually. Some companies may wish to offer an investor vote on the transition plan at the AGM – the 'say-on-climate' vote. While we support this principle of an advisory vote, we believe transition plans must ultimately remain the responsibility of the board and not replace ongoing engagement with shareholders on the substance of the transition plan.

How does EOS assess transition plans?

- **Ambition** – Companies should benchmark the goal of the transition plan against the ambition of international agreements. Therefore, EOS expects companies to set a clear goal to achieve net zero by 2050 across Scope 1, 2 and material Scope 3 emissions, and to set near-term and science-based targets that are aligned with feasible pathways to limit the global temperature rise to below 1.5°C.
- **Disclosure** – Scope 1, 2 and material Scope 3 emissions should be disclosed annually according to the Greenhouse Gas Protocol and efforts should be made to continually improve the quality of reported data. It should be clearly explained which Scope 3 emissions are considered material to the business, and which are not. Third-party assurance of emissions data should be provided.

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- **Performance** – A transition plan should transparently disclose the progress made against its targets and objectives, reflect on performance and evaluate the cause of changes over time. The contribution of offsets and emissions removal to performance data should be clear.
- **Strategy** – EOS expects companies to identify the key levers that they will employ to achieve their targets and the estimated quantified contribution of each, with greater detail expected for near-term targets. Transition plans should also articulate if and how the portfolio of products and services will change, and any policies that will be introduced to direct corporate behaviour. Where a transition plan uses unproven decarbonisation technologies or approaches, it should provide analysis showing the potential competitiveness of these choices and transparently disclose the assumptions and dependencies for this to be true. For example, if a company targets green hydrogen as the solution for a percentage of emissions reductions by 2035, then assumptions on cost, availability, and customer demand must be available for investors to inform their evaluation of credibility. The plan should also disclose other key assumptions and specific dependencies, including relating to policy and regulatory change, technology development, and relevant economic indicators.
- **Capital and resource allocation** – Companies must demonstrate that they have assessed the financial and human capital requirements for delivering the transition plan and set out a plan for mobilising these resources. The transition plan should also provide qualitative and quantitative information on how it, and the transition of the wider economy, are factored into financial planning and investment decision-making. Investors should be confident that the company will make adequate returns on projects under scenarios where the transition plan is implemented in full and the Paris Agreement's goals are achieved.
- **Public policy and stakeholder engagement** – A high-quality transition plan will target change that will inevitably require significant actions outside a company's direct control. As well as transparently and specifically identifying these dependencies, the transition plan should demonstrate how it is using public policy advocacy and engagement with stakeholders, including peers, customers and suppliers, to enable them. Specifically, a company should commit to aligning its direct and indirect external engagement activities with 1.5°C outcomes and its transition plan, and identify how it will prioritise engagement, assess alignment and escalate concerns where misalignment is identified.

Transition plans in context

While the concept of a transition plan may seem focused on greenhouse gas emissions, the successful implementation of a transition plan strongly depends on a number of connected sustainability issues. The most important of these are climate adaptation, nature, and realising a just transition.

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Even limiting the global temperature rise to below 1.5˚C will result in significant risk of damage and disruption from climate change. Companies must therefore assess their exposure to these physical risks using scenario analysis and develop an adaptation plan to build resilience to acute and chronic climate events. This priority will increasingly compete for resources with, and complicate the implementation of the transition plan as climate change worsens, so transition plan development must also consider adaptation requirements. In our engagement with Equinor, we are requesting greater detail on how scenario analysis is conducted, while also asking the company to develop an adaptation and resilience plan to be integrated with its transition plan.

Alongside the risks associated with climate change, those posed by nature and biodiversity loss are similarly threatening to businesses and their investors, yet less well understood and deeply interrelated with climate change. A successful transition plan will therefore need to consider these interrelations and drive the business to respond to both risks simultaneously. Equally, investing in a decarbonisation approach that exacerbates biodiversity risks could face significant headwinds as public policy increasingly attempts to limit the negative impacts of the economy on nature.

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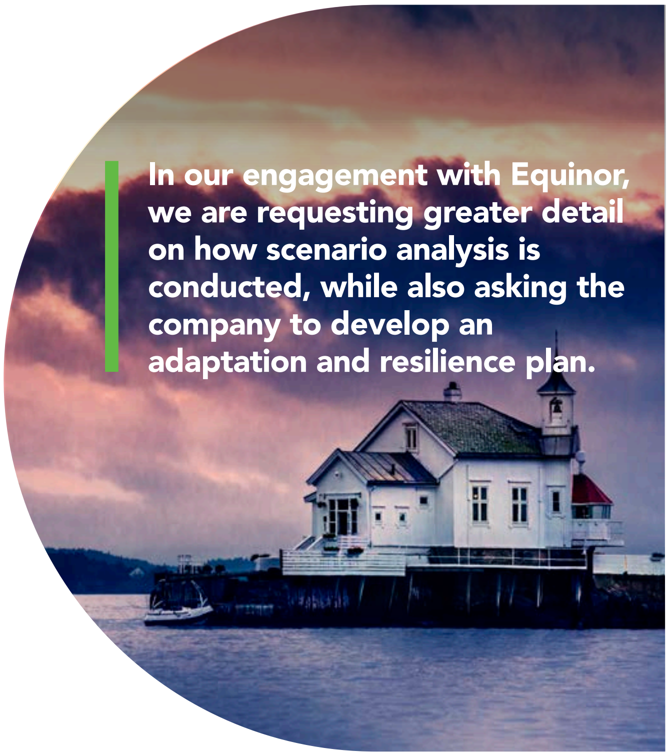

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Finally, just as climate change is caused by humans, its solutions will be implemented and experienced by humans as well as the wider natural world. It is therefore essential that businesses carefully consider the social impacts of their transition plan and work to address them. This contributes to a fair and just transition, and increases the chance of achieving the transition by supporting the alignment and buy-in of stakeholders.

Outlook

For investors seeking to identify and respond to the risks and opportunities from climate change, high-quality transition plans must become a priority for stewardship and investment teams. And if the Transition Plan Taskforce sparks another watershed in company action on climate change like the TCFD that preceded it, then achieving the goals of the Paris Agreement may become within reach. We will continue our engagement with companies to promote their success and create value as the energy transition enters a new phase.

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Why EOS?

EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of their assets. EOS is based on the premise that companies with informed and involved investors are more likely to achieve superior long-term performance than those without.

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