Destination 1.5°C

Engagement and stewardship on the road to net zero

Destination 1.5°C

With the 26th UN Climate Change Conference of the Parties (COP 26) now upon us, the world stands at a critical juncture in confronting the climate crisis. The threats facing the planet from rising temperatures are enormous: weather patterns are becoming extreme, polar ice caps and glaciers are melting, and sea levels are rising. The impacts are felt everywhere. Human health and livelihoods, wildlife, entire economies and societies, lie exposed to the consequences of climate inaction.

Global temperatures have already risen by approximately 1.2°C above pre-industrial levels. The margin for limiting temperature rises to 1.5°C, the limit agreed at COP 21 in Paris, is narrowing. The Intergovernmental Panel on Climate Change (IPCC) estimates that the world has emitted 2,400bn tonnes of CO2 since the mid-1800s, and that we have a carbon budget of just 400bn tonnes left to emit in order to have a 66% chance of keeping to 1.5°C. The IPCC believes that this target can remain within reach provided "there are immediate, rapid and large-scale reductions in greenhouse gas emissions".[1]

In quantitative terms, in order to ensure that the 1.5°C threshold is not passed, global greenhouse gas emissions need to be cut in half by 2030 with net zero emissions achieved by 2050. This is a tall order and requires a global economic restructuring many magnitudes of order greater than anything attempted before. Companies, and especially those from the highest emitting sectors, have a crucial role to play in this transition. As do we as investors, through our engagement and stewardship activities and through the clear expectations we set our investee companies. As Antonio Guterres, Secretary-General of the United Nations notes, although "the climate emergency is a race we are losing, but it is a race we can win".

> *The climate emergency is a race we are losing, but it is a race we can win*
>
> *A. Guterres*
> *– UN Secretary General*

Derek Traynor, CFA
Chief ESG Analyst
Danske Bank Asset Management

Carla Steuer
First Year Analyst
Danske Bank Asset Management

[1] *See: https://www.ipcc.ch/2021/08/09/ar6-wg1-20210809-pr/*

Our 1.5°C Commitment with the Net Zero Asset Managers Initiative

As part of our determination to play a part in supporting goals of limiting global warming to 1.5°C and achieving corresponding net zero emissions by 2050, Danske Bank Asset Management has joined the Net Zero Asset Managers Initiative. By joining this initiative, Danske Bank Asset Management aims to work in partnership with asset owner clients on decarbonisation goals, consistent with an ambition to reach net zero emissions by 2050 or sooner across all assets under management (AUM). Furthermore, we will set an interim (2030) target for the proportion of assets managed in line with the net zero goal and commit to review our interim target at least every two years, with a view to ratcheting up the proportion of AUM covered until 100% of assets are included.

This is a considerable commitment and requires – in addition to governments following through their own pledges to ensure the objectives of the Paris Agreement are met – that we both engage and partner with our investee companies to help them achieve real economy emissions reductions. As part of our commitment as one of the largest asset managers in the Nordics, we will implement a stewardship and engagement strategy, with a clear escalation and voting policy that is consistent with the scale of these ambitions.

The purpose of this white paper is to analyse the current 'state of play' of 35 large Nordic companies from some of the highest-emitting industry sectors. It focuses on management quality and governance of company carbon practices, in order to assess both their approach to greenhouse gas emissions reductions and their adaptability to the risks and opportunities stemming from the low-carbon transition. By understanding where companies currently stand on carbon policies and processes, and most importantly, where they are lacking, we can better formulate and target our stewardship and engagement strategy to align their ambitions with ours on the net zero targets.

By understanding where companies currently stand on carbon policies and processes, and most importantly, where they are lacking, we can better formulate and target our stewardship and engagement strategy

Addressing the commitment-action gaps for the largest Nordic companies

The importance of developing a coherent climate transition strategy

Of the 192 countries that are Parties to the Paris Agreement, more than 130 countries have set or are considering a target of reducing emissions to net zero by 2050. However, according to the United Nations, their planned combined emissions reductions, as stated by their National Defined Contributions (NDCs), still fall far below what is required in terms of ambition to achieve the 1.5 °C goal[2]. The UN Environment Programme's Emissions Gap Report 2021[3] finds that NDCs only take 7.5% off predicted 2030 emissions, while 55% is needed to meet the 1.5 °C goal. In other words, countries need to increase decarbonisation comittments to more than seven-fold from current levels.

Inconsistencies between long-term commitments and shorter-term actions and targets on decarbonisation are not a problem unique to countries or governments however. Companies are often just as inconsistent when it comes to aligning words with actions, and the association with greenwashing often looms over corporate climate policies. A lack of incentives can drive this gap. The transition to a greener and more sustainable future requires significant investment, and adequate incentives need to be in place to drive change.

Risks extend beyond greenwashing and reputational damage. By failing to fully integrate a coherent climate transition strategy into their businesses, these companies stand ill prepared to manage a broad range of financially material risks and opportunities related to the low carbon transition. Once such risk surrounds carbon pricing. Through implementing a carbon

[2] *https://www.un.org/en/climatechange/net-zero-coalition*
[3] *https://www.unep.org/resources/emissions-gap-report-2021*

price, the EU hopes to incentivise businesses to use less carbon while placing a premium on decarbonisation in order to stimulate innovation and adaption. This can serve as a key mechanism to translate company inaction into financial risk and therefore companies need to factor such developments into their climate strategy.

Lastly, and most crucially, companies have a critical role to play in helping the world avoid a climate catastrophe and all relevant stakeholders – investors, governments, society – expect them to act.

A framework for understanding company management of carbon transition risks and opportunities

While it is not feasible nor credible to assess a company's climate journey using a single number, the Transition Pathway Initiative's (TPI) Management Quality framework, which we leverage in this white paper, is amongst the stronger forward-looking methods of assessment[4]. This strength was recognised by Environmental Finance which awarded TPI 'ESG Assessment Tool of the Year 2020' at the Sustainable Investment Awards, crediting TPI with having been "instrumental in enabling asset owners to understand what the transition to a low carbon economy means for their major holdings in energy intensive sectors. It has simplified the message around climate change and has made it easier for asset owners to take action."

This paper applies the framework to 35 large Nordic companies transcending some of the highest emitting sectors including oil and gas, shipping, autos, electricity utilities, aluminium, industrials, consumer goods, chemicals, construction, paper, mining and steel. We have grouped these sectors into broader categories of energy, industrials and materials, transport and buildings and consumer goods. The Management Quality assessment evaluates and tracks the quality of companies' governance and management of their greenhouse gas emissions as well as the risks and opportunities they face related to the low-carbon transition, in line with the Taskforce on Climate-related Financial Disclosures (see Box 1 and 2).

> *Long-term ambition from companies is worthless without credible short-term action plans and targets*

Enabling strong net zero stewardship and engagement

TPI's framework helps to align our obligations as members of the Net Zero Asset Managers Initiative by providing a tool that guides our stewardship of the companies that we invest in, focusing on real world change and accountability. Long-term ambition from companies is worthless without credible short-term action plans and targets. By assessing the management quality of a company's climate plan, using publicly disclosed data mapped to the TPI's Management Quality framework, we can better gauge the credibility of their action plans and the likelihood of meeting their long-term ambitions.

[4] *The Transition Pathway Initiative is a global initiative led by asset owners and supported by investors globally. It seeks to support efforts to get companies to align themselves with the transition to a low carbon economy. See https://www.transitionpathwayinitiative.org for more information.*

Box 1: TPI Management Quality Assessment

The TPI's Management Quality assessment framework utilises 19 indicators that seek to determine whether a company has implemented a particular carbon practice, each assessed through a binary yes / no question. Each of these questions are mapped to five levels – from Level 0 through to Level 4 – reflecting a company's level of progress with respect to implementation of carbon management systems and processes. The assessment covers areas such as emissions disclosures, setting targets and strategic policy commitments. The questions begin at a high level, such as 'does the company acknowledge climate change as an issue for the business?', becoming more targeted and strategy specific as they progress up the ladder. A company that achieves a perfect score across all 19 questions is provided a 4 Star categorisation.

In order to progress from one level to the next, companies need to answer 'yes' to all questions relevant to that level. Ultimately, the higher a company places on the ladder, the more anchored and more credible their climate transition plan is, meaning the likelihood of a company actually delivering on the required emissions reductions is higher.

Level 0
Unaware

Company does not recognise climate change as a significant issue for the business

Level 1
Awareness

Company recognises climate change as a relevant risk / opportunity for the business

Company has a policy (or equivalent) commitment to action on climate change

Level 2
Building capacity

Company has set GHG* emissions reductions targets

Company has published information on its operational GHG emissions

Level 3
Intergrated into oprational decision-making

Company has nominated a board member / committee with explicit responsibility for oversight of the climate change policy

Company has set quantitative targets for reducing its GHG emissions

Company reports on its Scope 3 GHG emissions

Company has had its operational GHG emissions data veried

Company supports domestic and international eforts to mitigate climate change

Company discloses membership and involvement in trade associations engaged on climate

Company has a process to manage climaterelated risks

Company discloses Scope 3 GHG emissions from use of sold products (selected sectors only)

Level 4
Strategic assessment

Company has set long-term quantitative targets (>5 years) for reducing its GHG emissions

Company has incorporated climate change performance into executive remuneration

Company has incorporated climate change risks and opportunities in its strategy

Company undertakes climate scenario planning

Company discloses an internal carbon price

Company ensures consistency between its climate change policy and position of trade associations of which it is a member

*Source: Transition Pathway Initiative . *GHG: Greenhouse Gas*

Box 2: TPI Management Quality Assessment

Level 0: Unaware of Climate Change as a Business Issue

1. Does the company acknowledge climate change as a significant issue for the business?

Level 1: Acknowledging Climate Change as a Business Issue

2. Does the company recognise climate change as a relevant risk and/or opportunity for the business?
3. Does the company have a policy (or equivalent) commitment to action on climate change?

Level 2: Building Capacity

4. Has the company set greenhouse gas emission reduction targets?
5. Has the company published information on its Scope 1 and 2 greenhouse gas emissions?

Level 3: Integrating into Operational Decision Making

6. Has the company nominated a board member or board committee with explicit responsibility for oversight of the climate change policy?
7. Has the company set quantitative targets for reducing its greenhouse gas emissions?
8. Does the company report on Scope 3 emissions?
9. Has the company had its operational (Scope 1 and/or 2) greenhouse gas emissions data verified?
10. Does the company support domestic and international efforts to mitigate climate change?
11. Does the company disclose its membership and involvement in trade associations engaged in climate issues?
12. Does the company have a process to manage climate-related risks?
13. Does the company disclose Scope 3 use of product emissions?

Level 4: Strategic Assessment

14. Has the company set long-term quantitative targets for reducing its greenhouse gas emissions?
15. Does the company's remuneration for senior executives incorporate climate change performance?
16. Does the company incorporate climate change risks and opportunities in their strategy?
17. Does the company undertake climate scenario planning?
18. Does the company disclose an internal price of carbon?
19. Does the company ensure consistency between its climate change policy and the positions taken by trade associations of which it is a member?

Source: Transition Pathway Initiative

Companies face unique sector-specific decarbonisation pathways

The importance of understanding sector dynamics

The International Energy Agency (IEA) has produced the "world's first comprehensive study of how to transition to a net zero energy system by 2050 while ensuring stable and affordable energy supplies, providing universal energy access, and enabling robust economic growth". As the report makes clear[5], to reach the goal of limiting warming to 1.5°C and achieving net zero emissions by 2050, each sector is expected to transition, while pathways to net zero emissions differ considerably depending on sector. Each company faces its own unique sector-specific decarbonisation challenges that vary across many dimensions such cost implications and the distribution of emissions concentrations across the value chain.

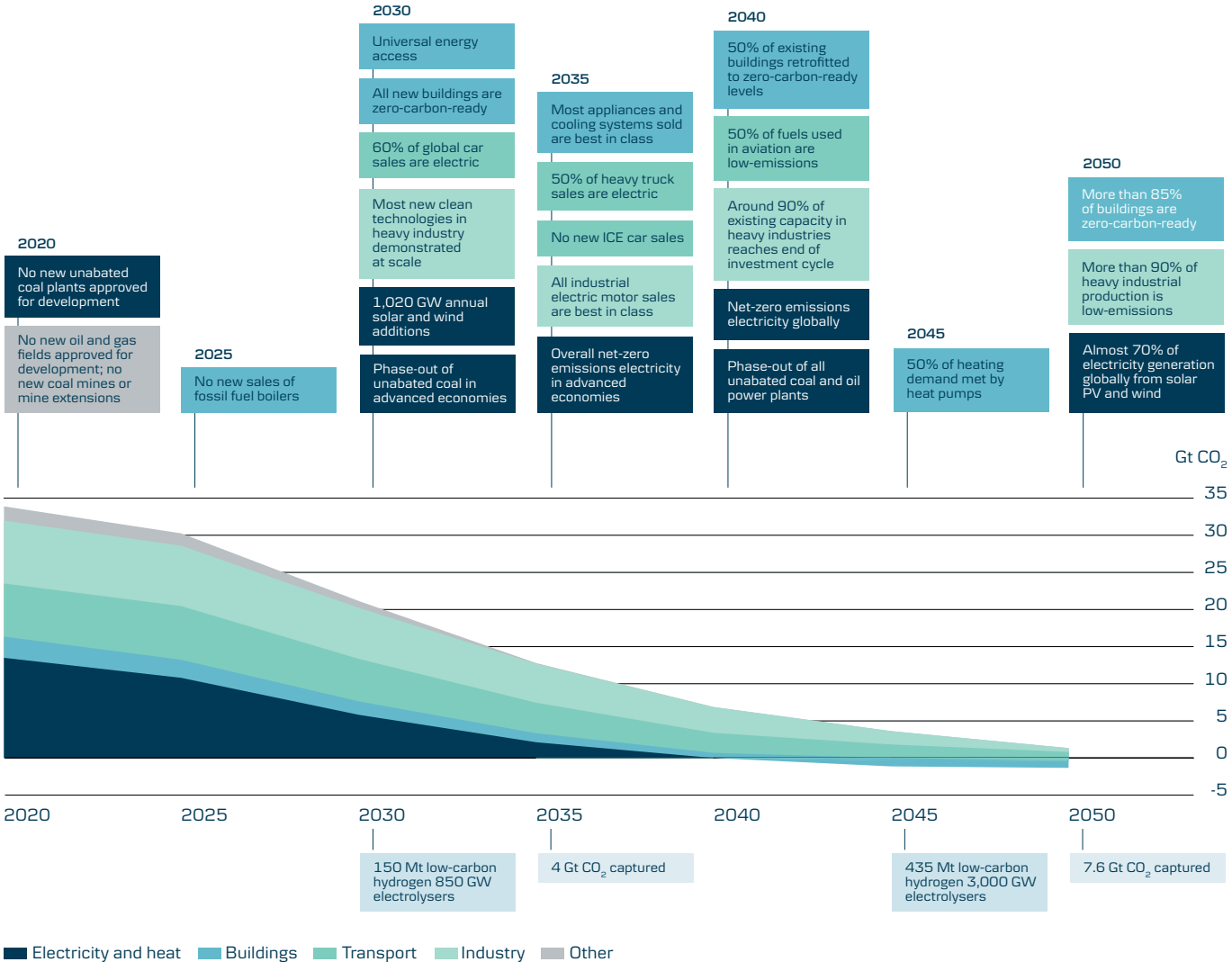
Figure 1 outlines the expected transition paths for different sectors according the IEA's Net Zero Emissions (NZE) scenario and serves as frame with which to understand the individual sector dynamics required to facilitate the transition. The heat and electricity utilities sector, for example, is expected to

[5] *The IEA published its Net Zero by 2050 – A Roadmap for the Global Energy Sector paper in May 2021. It is the world's first comprehensive study of how to transition to a net zero energy system by 2050. The report can be accessed here: https://www.iea.org/reports/net-zero-by-2050*

decarbonise rapidly, reaching net zero by 2040, driven by a switch to wind and solar PV renewables. With electricity generation being the single largest contributor to greenhouse gas emissions accounting for over a third of global CO2 emissions, this rapid transformation is critical to the achievement of net zero emissions by 2050.

In contrast, the likely decarbonisation path followed by heavy industry will be slower. Here CO2 emissions are expected to decline 20% by 2030 and 93% by 2050 under the IEA forecasts. While an improvement in the energy efficiency of equipment and materials and advanced technological solutions for new capacity add-ons will contribute to this reduction, they will not be sufficient alone. The IEA estimates that the bulk of heavy industry's emissions reductions will thus need to come from technologies currently under development but not yet commercially viable today.

Figure 1 – IEA Net Zero Roadmap – the sectoral path to decarbonisation



Source: International Energy Agency

Year	Total	Electricity & Heat	Industry	Transport	Buildings	Other
2025	-11%	-20%	-5%	0%	-17%	-11%
2030	-38%	-57%	-19%	-21%	-38%	-53%
2035	-63%	-84%	-39%	-43%	-59%	-95%
2040	-81%	-101%	-59%	-63%	-76%	-126%
2045	-93%	-102%	-79%	-79%	-90%	-142%
2050	-100%	-103%	-94%	-90%	-97%	-153%

Source: International Energy Agency, 2021

Identify those companies credibly in transition and those that are not

When setting our interim targets for companies and sectors, we will align our expectations based on what appears ambitious, yet feasible or achievable by 2030 utilising the IEA's Net Zero Roadmap and IPCC P2 as guiding references. The IPCC P2 scenario represents a very ambitious pathway allowing for only limited temperature overshoot while also considering very important social objectives in transition. This is a scenario with a broad focus on sustainability, including energy intensity, human development, economic convergence and international co-operation, as well as shifts towards sustainable and healthy consumption patterns, low-carbon technology innovation, and well-managed land systems with limited societal acceptability for BECCS (bioenergy with carbon capture and storage). Utilizing these pathways not only ensures that our targets are firmly rooted in science but also that we shape our net zero stewardship and engagement strategy for companies aware of the unique challenges they face.

We do not seek to exclude sectors outright, but rather seek to identify those companies that are credibly in transition and those that are not. For those companies deemed lagging, we can utilise the Management Quality framework as a tool to help frame a strong net zero stewardship and engagement strategy, whilst at the same time setting clear and reasonable expectations. We can monitor the progress of these companies through time and, if necessary, take corresponding action – including escalation, voting and as a last resort, eventual divestment.

> *We can utilise this framework to create a strong net zero stewardship and engagement strategy, while setting clear expectations, for those companies in which we invest*

By leveraging an open-source framework like TPI, we also support the Net Zero Asset Manager initiatives' spirit of "collaborative efforts for investors to have access to best practice, robust and science based approached and standardised methodologies, and improved data, through which to deliver these commitments".[6]

[6] *See the Net Zero Asset Managers Commitment at: https://www.netzeroassetmanagers.org/*

Destination 1.5°C: How are Nordic companies faring?

The 35 Nordic companies covered by this analysis are among the largest in the region and cover a number of high emitting sectors including oil and gas, shipping, autos, electricity utilities and industrials. These are high priority sectors accounting for a large proportion of emissions identified by the IEA under its NZE scenario. For each of these companies, the TPI's Management Quality framework was applied in order to assess the performance of company management and governance on greenhouse gas emissions as well as their degree of preparedness stemming from the risks and opportunities linked to the climate transition. Using disclosures from publicly available sources including company websites, annual reports, sustainability reports, and company climate disclosures to the Carbon Disclosure Project (CDP)[7] data was mapped to each question in the Management Quality framework. It should be noted that both the data gathered and company analysis undertaken in this study were neither produced nor reviewed by TPI.

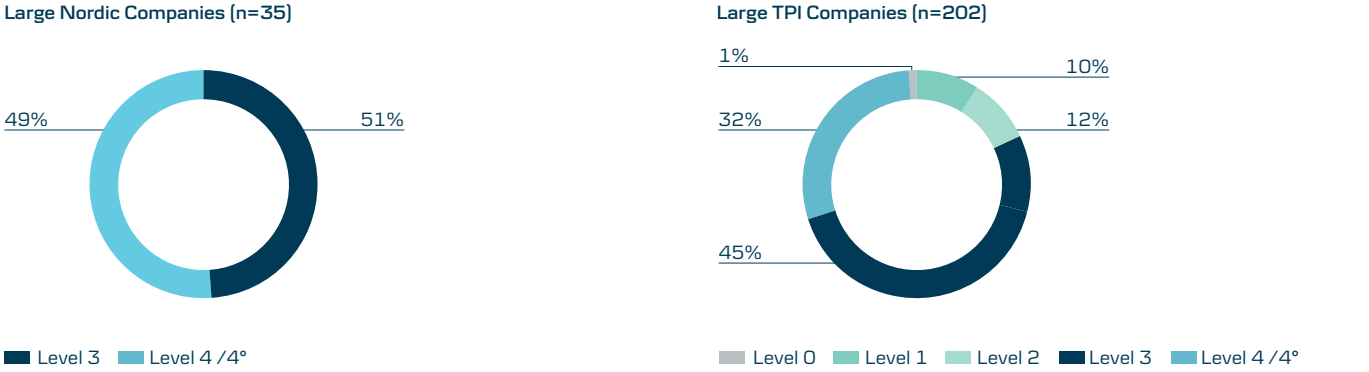
Overall, Nordic companies compare favourably to global peers. In aggregate, the companies in our sample have reached Management Quality Level 3 or 4. More specifically, 18 (51%) of the companies are at Level 3, implying that they are now in the process of integrating climate change into their operational decision-making. They do this by building capacity into their management systems and processes, by assigning senior management or board responsibility for climate issues and by providing comprehensive disclosures on carbon practices and performance. The remaining 17 (49%) of companies have reached Level 4, implying they have fully integrated the climate transition into their operational decision-making, and are now pursuing a strategic level of integration through business strategy and capital expenditure decisions.

By way of comparison, referencing similar sectors from the TPI's global dataset of large companies, which includes 202 companies across 33 countries, 155 companies (77%) achieve Level 3 and above. Of the remaining companies, 20 (10%) have only reached Level 1, implying that they have just acknowledged climate change as a business issue, while 3 (1%) companies are Level 0, and thus are either unaware of or are yet to acknowledge climate change as a business issue. Relative to the global dataset therefore, large Nordic companies compare favourably in aggregate. There are potential reasons why this might be the case. Notably, the TPI's global dataset also includes companies from several emerging markets such as Indonesia, South Africa, Mexico and Russia, countries that are at a lower level of economic development. Despite this, the framework does not include any 'just transition' questions resulting in a potential gap in the analysis. While

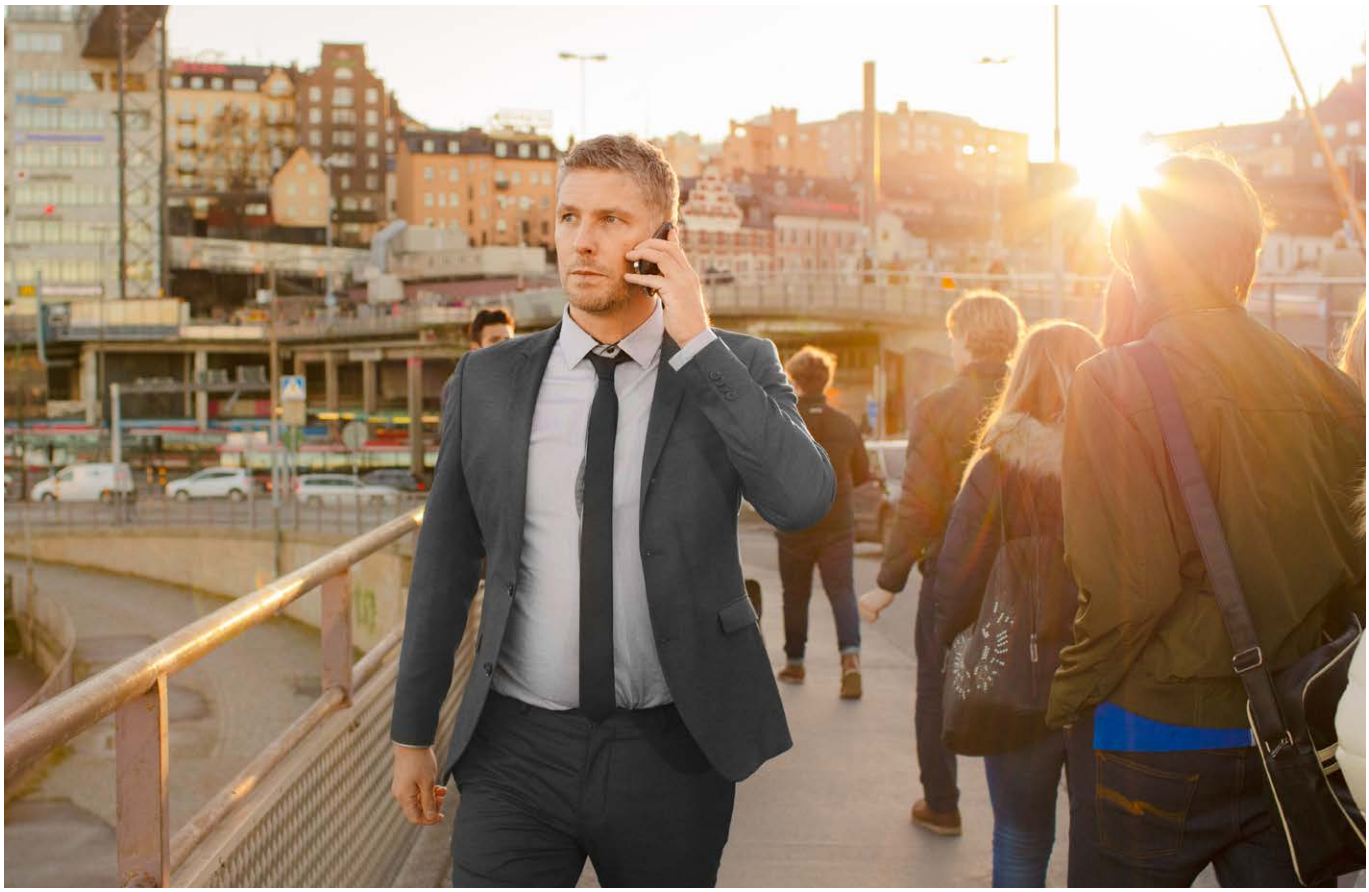
> *In aggregate, the 35 large Nordic companies from our sample have reached Management Quality Level 3 or Level 4*

[7] *The Carbon Disclosure Project is a not-for-profit charity that runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts. See https://www.cdp.net/en for more information.*

Figure 2 – Breakdown of Companies by Management Quality Level



Source: Danske Bank, TPI, November 2021



the application of the TPI's framework is global in nature, the process of transitioning away from fossil fuels to clean energy may be unique to each country, especially given differing levels of economic development.

The data highlights clear areas for engagement focus

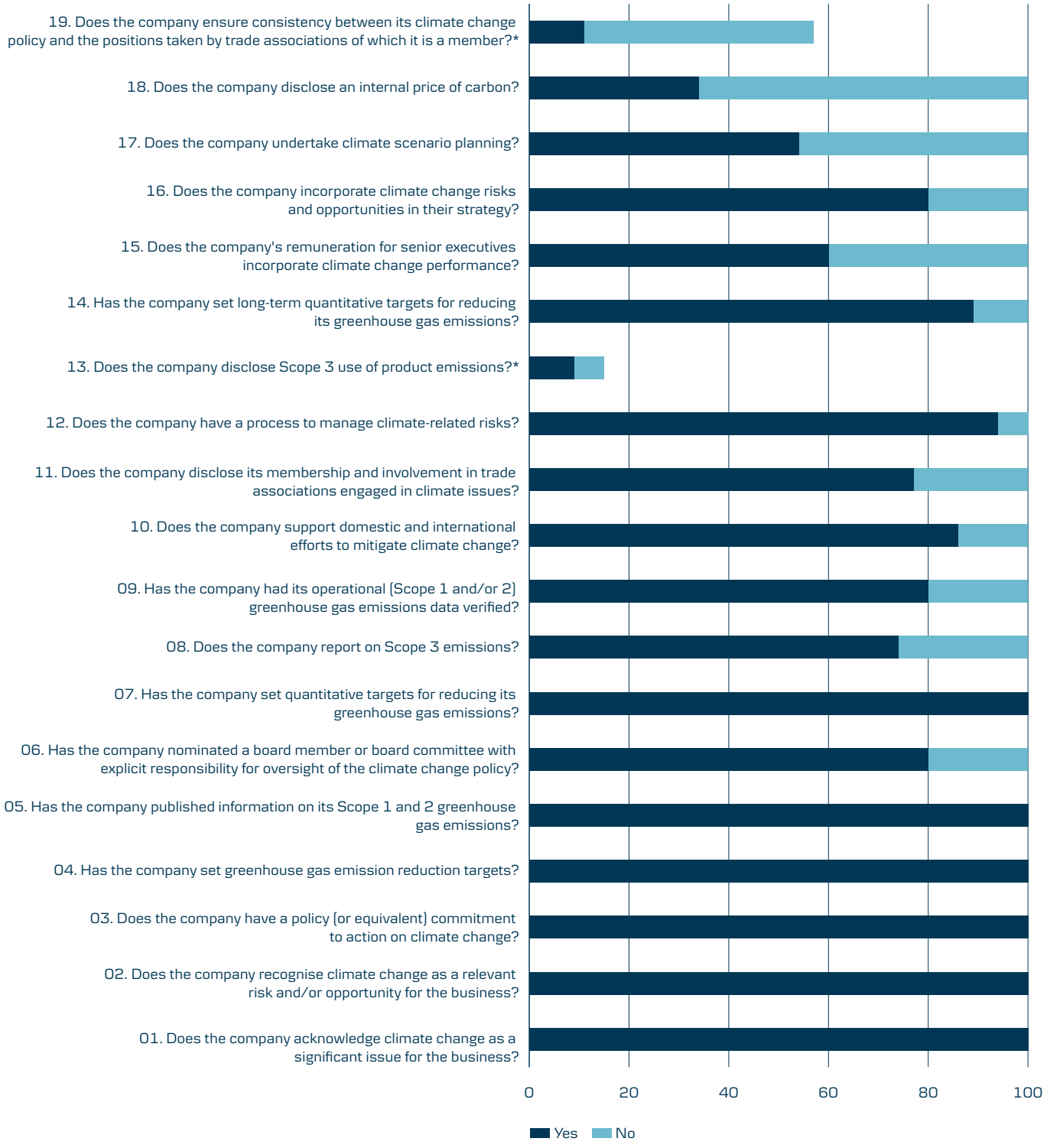
With few companies in the dataset achieving a perfect score across all questions, the Management Quality framework serves as a useful tool in which to target our net zero stewardship and engagement strategy. Where gaps exist, we can use this framework to articulate clear expectations with the companies that we invest in, monitoring their progress and standing ready to take corresponding action including escalation, voting and eventual divestment in the event of inaction. Unsurprisingly, companies underperform most on Level 4 questions related to the integration of climate transition risks and opportunities into business strategy and capital expenditures (Figure 3). It should be noted that Question 13 – "Does the company disclose Scope 3 use of product emissions?" only applies to a small subset of companies, while for Question 19 "Does the company ensure consistency between its climate policy and the positions taken by trade associations of which it is a member?" our dataset is incomplete, due to insufficient corporate disclosure. Transparency is something we expect from companies on climate issues, and timely disclosure is key point of our engagement focus.

Mapping to TCFD

It is a useful exercise to map these questions to the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations (Box 3). TCFD climate disclosure recommendations are structured around four key thematic areas comprising the key areas of organisation operational focus: Governance, Strategy, Risk Management, and Metrics and Targets.[8]. TCFD, the most widely known and used climate risk reporting framework, is rapidly becoming the global standard for how companies disclose the risks they face from climate change. Increasingly governing bodies – including the European Union, United Kingdom, Switzerland and New Zealand – are incorporating the TCFD's requirements into formal disclosure requirements, while more than 2600 organisations and companies have now endorsed them.[9] As members of the Net Zero Asset Managers initiative, Danske Bank Asset Management is required to publish TCFD disclosures, and this paper illustrates just one way in which we can adhere to this commitment.

[8] See: https://www.fsb-tcfd.org/recommendations/
[9] 2021 TCFD Status Report, available at: https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Status_Report.pdf

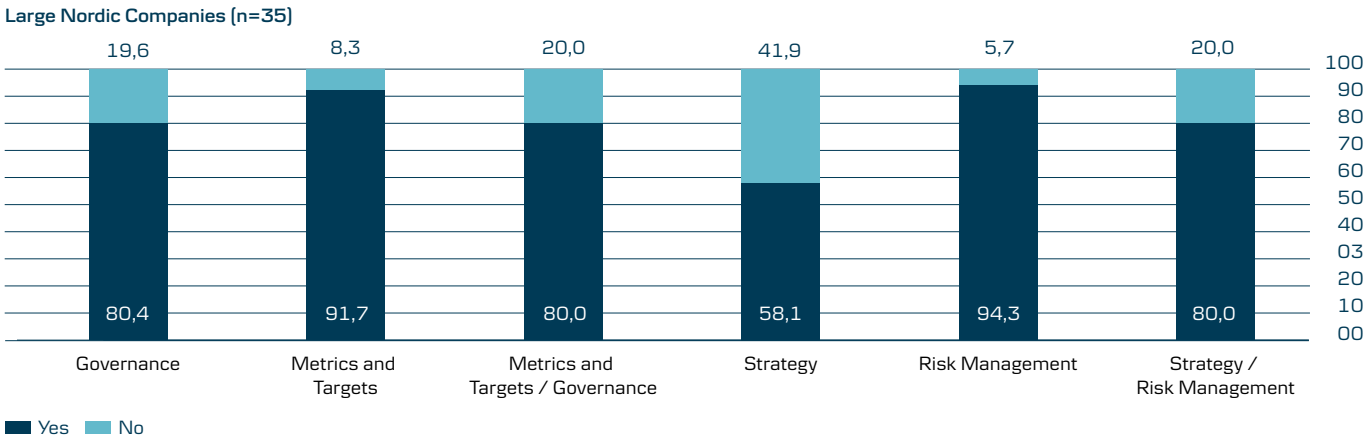
Figure 3 – Management Quality Questions and mapping to TCFD recommendations



*Source: Danske Bank, TPI, TCFD November 2021. *Scope 3 use of product emissions are only applicable to certain sectors, including autos and oil and gas companies. Data for question 19 is incomplete owing to lack of clear disclosure.*

Analysing the companies through the TCFD lens (Figure 4), most gaps in company Management Quality performance relate to Strategy considerations, while companies largely perform well on Risk Management and Metrics and Targets.

Figure 4 – Management Quality Questions mapped to TCFD recommendations



Source: Danske Bank, TPI, TCFD November 2021. Two Management Quality indicators map to more than one TCFD theme: 9. has the company had its operational (Scope 1 and /or 2) greenhouse gas emissions data verified? – Metrics and Targets / Governance; and 16. Does the company incorporate climate change risks and opportunities into their strategy – Strategy / Risk Management

Box 3: TCFD Framework

The TCFD's disclosure recommendations are centred on four interlinking core thematic areas related to how companies operate – Governance, Strategy, Risk Management and Metrics and Targets.

Governance: Disclose an organisation's governance around climate-related risks and opportunities.

Strategy: Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

Risk Management: Disclose how the organisation identifies, asseses, and manages climate-related risks.

Metrics and Targets: Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material

The 19 indicators comprising the TPI's Management Quality framework aligns with and complements the TCFD's disclosure recommendations. TPI has mapped each indicator to the four thematic areas specified by the TCFD:

TPI Management Quality Indicators	TCFD Themes
1. Does the company acknowledge climate change as a significant issue for the business?	Governance
2. Does the company recognise climate change as a relevant risk and/or opportunity for the business?	Governance
3. Does the company have a policy (or equivalent) commitment to action on climate change?	Governance
4. Has the company set greenhouse gas emission reduction targets?	Metrics and Targets
5. Has the company published information on its Scope 1 and 2 greenhouse gas emissions?	Metrics and Targets
6. Has the company nominated a board member or board committee with explicit responsibility for oversight of the climate change policy?	Governance
7. Has the company set quantitative targets for reducing its greenhouse gas emissions?	Metrics and Targets
8. Does the company report on Scope 3 emissions?	Metrics and Targets
9. Has the company had its operational (Scope 1 and/or 2) greenhouse gas emissions data verified?	Metrics and Targets / Governance
10. Does the company support domestic and international efforts to mitigate climate change?	Strategy
11. Does the company disclose its membership and involvement in trade associations engaged in climate issues?	Governance
12. Does the company have a process to manage climate-related risks?	Risk Management
13. Does the company disclose Scope 3 use of product emissions?	Metrics and Targets
14. Has the company set long-term quantitative targets for reducing its greenhouse gas emissions?	Metrics and Targets
15. Does the company's remuneration for senior executives incorporate climate change performance?	Governance
16. Does the company incorporate climate change risks and opportunities in their strategy?	Strategy / Risk Management
17. Does the company undertake climate scenario planning?	Strategy
18. Does the company disclose an internal price of carbon?	Strategy
19. Does the company ensure consistency between its climate change policy and the positions taken by trade associations of which it is a member?	Governance

Source: TCFD, TPI, Danske Bank

As concluded earlier, the Nordic companies included in this analysis perform well in a global context when it comes to their Management Quality. However, there are three areas in particular where companies should focus going forward, the internal price on carbon, climate scenario planning as well ensure that climate KPIs are integrated into Senior Executive Remuneration. This would position Nordic companies as global best practice.

Internal price on carbon

Two thirds of companies in the analysis do not appear to disclose an internal price on carbon. As discussed earlier, since the external pricing of carbon will become an important tool for bringing down emissions globally while incentivising investment into cleaner alternatives, companies need now to position for higher carbon prices in order to reduce climate transition risks. They can do this by setting an effective internal carbon price that may help to direct company investments towards lower emissions, while making carbon considerations more central to business operations and de-risking against future regulatory developments in this area. In short, by setting an internal price, companies can better position to achieve net zero targets.

Climate Scenario Planning

Nearly half of companies do not appear to undertake any form climate scenario planning despite being a key recommendation from the TCFD. Climate scenario planning, using established climate change science as a guiding framework, incorporates potential adverse and positive impacts to a business stemming from both physical climate risks as well as those risks and opportunities linked to the climate transition. Climate scenario plans enable companies to get a better handle on the potential impacts of climate change across their value chain, while allowing investors to assess these consequences and their effect on the long-term viability and value creating potential of the business.

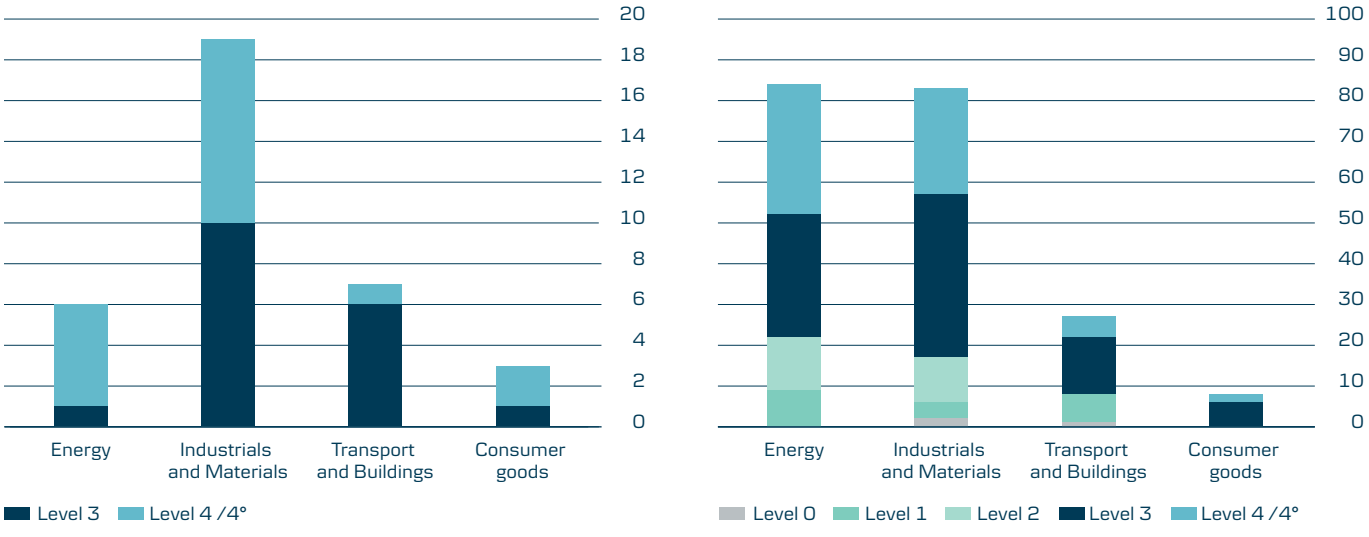
Climate KPIs in Senior Executive Remuneration

Incentive payment plans linked to emissions reductions serve to hold executives to account for the delivery of these objectives. By setting long-term quantifiable CO2 reduction targets and utilising shorter-term rolling targets linked to executive compensation plans, companies can keep management aligned with these goals and increase the probability that these goals will be realised. Despite this, we find that 40% of companies in our analysis do not incorporate climate change performance into executive remuneration. In our view, compensation and incentive programmes linked to climate-metrics are important tools to encourage senior management to integrate climate change into the company's business strategy. This helps us ensure that company carbon reduction performance is consistent with the overall aim of achieving net zero emissions by 2050 or sooner.

Sector analysis and considerations

Figure 5 details the distribution of Levels assigned to the 35 large Nordic companies from high emitting sectors in our analysis, as well as those Levels assigned to large global companies by the TPI across similar sectors.

Figure 5 – Management Quality Level Distribution: Large Nordic Companies (n=35, LHS), TPI's Global Large Company database (n=202, RHS)



Source: Danske Bank, TPI, November 2021

Energy

Under the IEA's Net Zero scenario, the energy sector is expected to be the first to decarbonise, reaching that milestone by 2040. That is a considerable achievement, given that electricity generation was the largest source of global emissions in 2020. The IEA expects emissions to fall 60% in the period to 2030 as coal usage winds down, before reaching net zero in 2040.

From our analysis of the energy industry, incorporating both electricity utilities and oil and gas companies, we can draw a number of conclusions. First is the strong performance of the electricity utilities companies, each of which have reached Level 4, reflecting the fact that these companies have fully integrated climate issues into operational decision-making. They have now reached the stage where they have a strategic understanding of the risks and opportunities related to the low-carbon transition, integrating these considerations into both business strategy and capital expenditure decisions. This performance is consistent with the TPI's findings at a global level. They find that electricity utility companies routinely feature as the top, or joint-top, performing sector, which can be somewhat explained by the extent of emissions regulation that sector faces, particularly in Europe.

Under the IEA's Net Zero scenario, the energy sector is expected to be the first to decarbonise, reaching that milestone by 2040.

There are however a number of areas where Nordic electricity utilities can improve performance further, and where we can thus target our engagement and stewardship activities as investors. This includes Strategy-focused areas including disclosing an internal carbon price and undertaking climate scenario planning, as well in Governance-focused areas such as ensuring consistency between company climate change policy and that of the positions taken by trade associations of which it is a member. Through constructive dialogue with electricity utilities companies in these areas, we can better ensure that they are prepared for the significant climate transition changes facing that industry.

Nordic oil and gas companies perform strongly across most indicators, seemingly reflecting a keen awareness from the sector that it stands significantly exposed to the risks and opportunities of the climate transition. Governance-focused areas are among those that weigh on performance, including disclosure of membership and involvement in trade associations engaged in climate issues, as well as in ensuring company and trade association climate policy alignment. Trade associations have a tremendous amount to bring to the table on climate matters, and can often be instrumental in moving policies forward. Through our engagement activities we encourage our investee companies to better disclose their memberships and to actively seek alignment of their climate policies with industry groups.

Industrials and Materials

Companies from the diversified mining, other industrials, steel, aluminium, chemicals and paper sectors typically produce materials and products that are critical components of modern economies. Yet these industries also tend to be highly reliant on carbon emissions in their production processes. According to the IEA, three heavy industries – steel, chemicals and cement – together account for 70% of emissions from the industry sector[10]. As the second largest emitter of energy emissions globally, these companies have a crucial role to play in ensuring we arrive at net zero by 2050. Similar to the energy industry, these companies falter when it comes to disclosing an internal carbon price and in undertaking climate scenario planning, two areas of Strategy focus under the TCFD framework. These companies also fall short within the Governance theme, with many companies failing to link climate performance to executive compensation incentives.

For those industrials and materials companies failing to progress beyond Level 3, among the key areas impacting Management Quality performance include Scope 3 emissions reporting and verification of Scope 1 and 2 emissions[11]. Typically, most companies will focus on Scope 1 and 2 emissions given their ability to influence these directly. Companies that are more progressive may also extend their focus to encompass Scope 3 emissions, and use their influence to encourage supply chain counterparts to reduce emissions.

Transport and Buildings

Three sectors in our study fall under the Transport and Buildings category – autos, shipping and construction. The transport industry has historically been heavily reliant on oil products, which accounted for more than 90% of the sector's energy needs in 2020 according to IEA. In the coming decades, transportation will decarbonise with electricity, followed by hydrogen, set to become the dominant fuel input for road vehicles. Heavier transport modes such as shipping and aviation will likely rely increasingly on biofuels.

[10] *IEA – Net Zero by 2050: A Roadmap for the Global Energy Sector. Available here: https://www.iea.org/reports/net-zero-by-2050*

[11] *According to the Greenhouse Gas Protocol: Scope 1 emissions – Direct GHG emissions: occur from sources that are owned or controlled by the company – for example emissions from combustion in owned or controlled boilers, furnaces, vehicles etc. emissions from chemical production in owned or controlled process equipment. Scope 2 – Electricity indirect GHG emissions: accounts for GHG emissions from purchased electricity consumed by the company. Scope 2 emissions physically occur at the facility where the electricity is generated. Scope 3 – Other indirect GHG emissions: an optional reporting category that allows for all other indirect emissions. Scope 3 emissions are a consequence of the activities of the company, but occur from sources not owned or controlled by the company. Examples of Scope 3 include the extraction and production of purchased materials, transportation of purchased fuels and use of sold products and services.*

The auto and shipping companies in our analysis have been assessed at Level 3 in terms of Management Quality, with several indicators weighing on company performance and preventing progression to Level 4. Most companies analysed do not have either a board member or board committee responsible for the explicit oversight of climate change policy, while several companies do not report Scope 3 emissions. Further Governance issues also appear in terms of the lack of alignment between executive remuneration and climate change performance, as well as disclosure of memberships and involvement in trade associations engaged in climate issues. The construction companies in our analysis generally perform better – one company reaching Level 4, the other Level 3 but failing on fewer indicators. However, these companies are marked down due to lack of internal carbon price disclosures, climate scenario analysis planning and reporting of Scope 3 emissions amongst others – again key engagement areas of focus.

Conclusions

The United States' climate envoy, John Kerry, describes COP 26 as being the "last best hope for the world to get its act together". The stakes have never been higher. The world cannot reach net zero without companies – the lifeblood of economies – acting in concert to decarbonise. Every company has an important role to play. As asset managers, asset owners and investors, we also have a crucial role to play. We must actively engage with the companies we invest in, encouraging them when they implement important policy improvements, yet questioning them where they need to perform better.
For those companies deemed lagging, the TPI's Management Quality framework serves as a powerful tool to frame a strong net zero stewardship and engagement strategy. We can assess companies' current state of play today, and where necessary, set clear and reasonable expectations of where we expect companies to go on their climate transition path. We can monitor the progress of these companies through time and, if necessary, take corresponding action – including escalation, voting and as a last resort, eventual divestment. Where the framework identifies gaps, we can utilise the framework to target these with our engagement activities. The road to 1.5°C is not an easy one, but it is a hugely necessary one. COP 26 presents an opportunity to get the world together on this journey, but we must all do our part to make it happen.