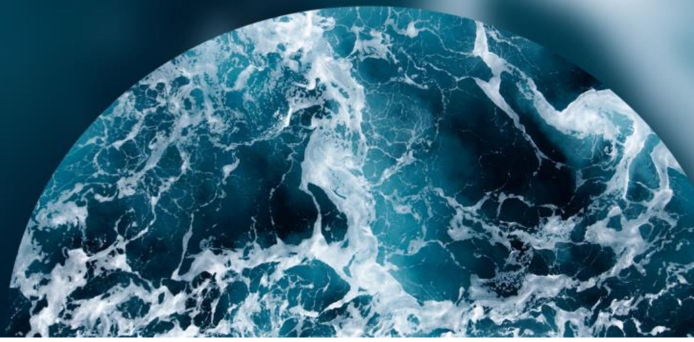
Case study | Capability story

November 2020

Addressing climate change through ESG integration

Transition Pathway Initiative



Challenge

Investors needed a practical, easy-to-use tool for them to assess companies' preparedness for the transition to a low-carbon economy and engage with the companies in which they are invested.

Criteria

Evaluate companies' low-carbon transition strategies against the goals of the Paris Agreement, against the requirements of the Task Force on Climate-related Financial Disclosures and in terms of their overall positioning for a low-carbon economy.

Solution

The Transition Pathway Initiative was developed as an asset owner-led initiative, with partnership support from FTSE Russell and the Grantham Research Institute at the London School of Economics to assess the quality of companies' management of climate change-related risks and opportunities, and their carbon performance.

The need

Under the 2015 Paris Agreement, countries have committed to limit increases in global average temperature to less than 2°C above pre-industrial levels, with further objectives to keep increases within 1.5°C of pre-industrial levels. National and international policy action presents both an investment risk and opportunity. Transitioning to a low-carbon economy may affect company cash flows and profits as well as result in "stranded assets", reducing the value of carbon-intensive assets. The GHG emission reductions set by the Paris Agreement will require considerable effort and capital inputs from both the public and private sectors, and will have major implications for individual companies and sectors.

What is the Transition Pathway Initiative?

The Transition Pathway Initiative (TPI) is an asset owner-led initiative (currently supported by asset owners and funds with over $22.5 trillion assets under management and advice, as of 29 October 2020), in partnership with FTSE Russell and the Grantham Research Institute at the London School of Economics that assesses companies' preparedness for the transition to a low-carbon economy. TPI assesses the quality of companies' management of climate change-related risks and opportunities, and their carbon performance. FTSE Russell provides the data that underpins the management quality assessment, and is a member of the TPI's Technical Advisory Group.

"The results show the value of using high-quality and objective indicators to assess company management quality and performance. They allow us to differentiate between companies, and to assess performance and impact in a robust manner."

– Adam Matthews,
Co-Chair of the Transition Pathway Initiative and Head of Engagement for the Church Commissioners and Church of England Pensions Board

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Objectives

To enable asset owners to take action on climate change through the public distribution of data and information on:

– The quality of companies' processes for managing greenhouse gas (GHG) emissions and the risks and opportunities related to the low-carbon transition
– The extent to which companies align their disclosures with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)
– Companies' future carbon performances compared to two benchmarks i) the Paris Agreement's international targets and national pledges and ii) 2°C degrees

TPI methodology and application

The TPI was developed to complement existing initiatives and frameworks, by aligning with prevailing disclosure initiatives and with investors' climate change and sustainability expectations. TPI assesses companies on two dimensions, namely Management Quality and Carbon Performance. Management Quality evaluates how companies manage their GHG emissions management and the risks and opportunities related to a low-carbon transition and is being aligned with the requirements of the TCFD. Carbon Performance measures companies' current and future carbon performance in comparison to the Paris Agreement's targets including 2 degrees.

Investors can use the TPI assessments to evaluate companies' low-carbon transition strategies against the goals of the Paris Agreement, against the requirements of the TCFD and in terms of their overall positioning for a low-carbon economy. The TPI can be applied in a variety of ways including developing organisational climate change policy and internal processes, investment analysis and decision-making, reporting and accountability, and engagement with asset managers, companies and public policy.

FTSE Russell's partnership with TPI

FTSE Russell is a data provider for TPI. FTSE Russell's data on climate change and corporate governance form the basis of TPI's Management Quality framework.

Examples of the data points being used by TPI include:

– Climate change policy
– Financial costs of climate change risks
– Energy reduction targets
– Short and long term emissions reduction targets
– Remunerations for senior executives including ESG performance

FTSE Russell's data on climate change and corporate governance are a part of FTSE Russell's ESG data model. FTSE Russell draws from international standards to analyse the ESG Scores of over 8,000 securities and to identify companies with strong or weak ESG practices.

In addition to providing data, FTSE Russell is also a member of TPI's Technical Advisory Working Group. In this capacity, FTSE Russell contributes to the evolution of TPI's methodology.

The TPI provides:

– A clear framework outlining expectations of managers and companies from asset owners and managers
– Identification of companies with robust carbon management systems and processes, and companies where further work is required
– Identification of companies whose business models align with the transition to a low carbon economy
– A practical, easy to use tool for asset owners to engage with the companies in which they are invested

Aligning with the Task Force on Climate-related Financial Disclosures

The Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) has published recommendations for voluntary climate-related financial disclosures, with a mission to enhance access to company-specific climate-risk data. As of February 2020, financial firms responsible for assets of US$138.8 trillion have backed these recommendations.

The TCFD recommendations enable companies to effectively measure and assess risks while investors can make more informed investment decisions. The recommendations focus on four core themes: governance, strategy, risk management, and metrics and targets.

- **Governance:** disclose the 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, strategies and financial planning
- **Risk management:** disclose how the organisations identifies, assesses and manages climate-related risks
- **Metrics and targets:** disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities

Following the release of the TCFD recommendations in June 2017, FTSE Russell worked with TPI to conduct a full review of its climate-related indicators in order to ensure its methodologies and criteria are aligned. FTSE Russell now collects data on these indicators for its universe of 8,000 securities. One of the key revisions to FTSE Russell's Climate Change research model was the addition of seven new indicators, as shown in figure 1.

Figure 1. Integration of TCFD recommendations in FTSE Russell's climate change research model

Governance	Strategy	Risk management	Metrics and targets
FTSE Russell's main indicators: – Board oversight of climate change issues	**FTSE Russell's main indicators:** – Describe climate change as a relevant risk to the business and discloses time horizon – Impact of climate-related risks on strategy and financial planning – Financial quantification of cost associated with climate-change – Climate scenario planning (2 degree and other) and the business impacts	**FTSE Russell's main indicators:** – Climate-related risk management procedures – Adaption and mitigation of climate-related risks	**FTSE Russell's main indicators**: – Internal carbon price – Scope 1, 2, 3 – Energy consumption – Emissions reduction targets – More than 20 sector specific metrics

Source: FTSE ESG Scores Methodology, Final Report Recommendations of the Task Force

These revisions enable the TPI to align its Management Quality indicators with the TCFD recommendations. Furthermore, TPI in conjunction with FTSE Russell is developing indicators to assess the quality of companies' scenario analysis (e.g., does the company publish a scenario analysis? Does it document its assumptions? Does it identify its central scenario?), and a more detailed framework that may be used to analyse individual company scenario analyses.

Example application of TPI methodology: automobile manufacturers

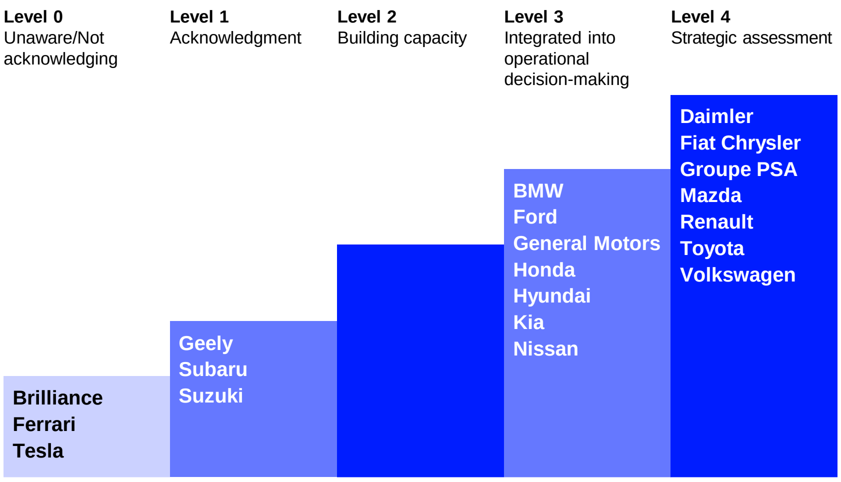
In February 2018, TPI released the carbon assessment of the global top 20 automobile manufacturers. TPI examines how those companies manage climate change risks and opportunities and how their current emissions and emissions reduction targets compare with the international benchmarks for the sector.

TPI ran a qualitative analysis of carbon risks management and a quantitative analysis of the current and anticipated carbon performance.

On management quality, the analysis found that automobile manufacturers divided into two clusters (see Figure 2). Six companies were relatively poor performers. Of these, three companies were on Level 0 (Unaware of, or not Acknowledging, Climate Change as a Business Issue): Brilliance, Ferrari and Tesla. The other three companies were on Level 1 (Acknowledging Climate Change as a Business Issue): Geely, Subaru and Suzuki.

The other cluster of 14 companies rated highly on management quality; companies were on either Level 3 (Integrated into Operational Decision-Making) or Level 4 (Strategic Assessment). Seven companies were on Level 4: Daimler; Fiat Chrysler; Groupe PSA; Mazda; Renault; Toyota; and Volkswagen. Only Daimler satisfied all 14 criteria.

Figure 2. Management quality of the world's top automobile manufacturers



Source: Management quality and performance of automobile manufacturers as of February 2018

On carbon performance, the assessment profiled companies on the basis of the CO_2 emissions performance of their fleets of new vehicles.

Companies' fleet emissions were benchmarked against three scenarios, using modelling from the International Council for Clean Transportation.

Three benchmark scenarios:

1. ***2 Degrees (High Efficiency)*** – this benchmark achieves the overall aim of the Paris Agreement to limit global warming to below 2°C primarily through vehicle efficiency improvements and alternative fuel technologies
2. ***2 Degrees (Avoid-Shift-Improve)*** – this benchmark achieves the Paris Agreement's 2°C target by placing more emphasis on avoiding the need for travel and shifting modes of transportation, which allows for higher average new vehicle emissions
3. ***Emissions reductions actually pledged by countries as part of the Paris Agreement in the form of Nationally Determined Contributions or NDCs***

Using data on companies' future carbon intensity (based on the quantitative targets they have set themselves to reduce new vehicle emissions), the research found that 12 out of the 20 companies had set such targets, five of which extend beyond 2020. Eight out of 11 companies are aligned with the 2°C benchmarks in 2020 (Figure 3). The companies with the lowest-carbon fleets of all in 2020 are Tesla, which only makes electric vehicles, and Suzuki, which specialise in small, efficient vehicles for the Indian and Japanese markets.

Figure 3. Carbon performance of the world's top 20 automobile manufacturers

Company	New vehicle average carbon emissions (gCO2/km, NEDC)							
	2013	2014	2015	2019	2020	2022	2025	2030
BMW	159	152	147	138	137			
Brilliance	174	171	157					
Daimler	169	161	155	141				
Ferrari	No data							
Fiat Chrysler	176	182	170					
Ford	156	155	156					
Geely	153	156	139	121	117			
General Motors	168	166	165					
Groupe PSA			129	120	117	113	106	
Honda	153	149	144	130	127			
Hyundai	154	156	153	129	122			
Kia	154	160	157					
Mazda	141	135	134	120	117	110	100	83
Nissan	145	148	140	117	112	102	89	71
Renault	137	132	127	117	114	109		
Subaru	160	160	157					
Suzuki	114	111	109	106	105			
Tesla	0	0	0	0	0	0	0	0
Toyota	142	136	134	118	114			
Volkswagen	152	148	144					
2 Degrees (Avoid-Shift-Improve)	147	145	143	124	119	111	99	80
2 Degrees (High Efficiency)	147	145	143	124	119	100	71	41
Paris Pledges	147	145	143	128	123	120	115	109

Aligned with 2°C (High Efficiency)

Aligned with 2°C (Avoid-Shift-Improve)

Aligned with Paris Pledges

Not aligned

Source: Management quality and performance of automobile manufacturers as of February 2018

Additional information

Learn more about the FTSE TPI Climate Transition Index.

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