

Net-zero is only meaningful emissions target for ESG funds

Fund managers must push companies much harder, but the targets are realistic and achievable

Despite the 2015 United Nations Framework Convention on Climate Change Paris Agreement, current global warming is heading for at least 3°C by 2100. This is well above the 1.5°C to 2.0°C goal set out by the international accord. Emissions reductions of at least 40% by 2030 are needed, scientists say, with net-zero emissions necessary for global warming to stabilise.

Many investors are aware of the likelihood of extreme weather events associated with global warming. While we can invest in adaptation measures, the primary focus must be on reducing greenhouse gas emissions, particularly carbon dioxide (CO₂). That is where the net-zero carbon 10 (NZC10) target comes in.

The target is for 10% or more of portfolio assets to be invested in firms with net-zero carbon emissions; or achieving net-zero emissions by 2030 with current technologies; or actively engaging with firms to achieve this.

If the emphasis is only on carbon reduction without a net-zero goal in mind, there is a risk of falling into a Malthusian trap. This occurs when incremental emissions reductions are taken up by population growth or increases in the carbon-based economy. To quote 19th century priest Thomas Malthus himself (pictured right), 'The power of population is indefinitely greater than the power in the earth to produce subsistence for man'.

For example, a 10% reduction in emissions per capita could be countered by a 10% increase in population, resulting in no overall decrease. Net-zero emissions are required to avoid this. Companies will have to develop strategies for contributing to a carbon-neutral economy as well as reduce CO₂ emissions and



identify solutions to remove CO₂ already in the atmosphere.

TARGET DEVELOPMENT

The NZC10 target was developed to meet scientific climate requirements. Net-zero emissions by 2050 should be consistent with 1.5°C of warming, and many

initiatives adopted by sustainable investors reflect this aspiration. Sustainable fund managers can use NZC10 to demonstrate leadership on global warming. The target launched in July 2018 and provides a clear, systematic framework for investors to have conversations with firms they hold. The adoption of this target by funds with assets under management from £160 million to £900 million (£2.3bn in total) demonstrates that it can be practically implemented.

However, for genuine leadership, greater ambition is required, which is why NZC10 uses a 2030 net-zero target.

In the low carbon transition, many firms will be late adopters and become net-zero carbon after 2050, if at all. Sustainable investors need to encourage companies to

become net-zero well before 2050, both to reduce emissions and provide social leadership. The 2030 target of NZC10 expresses a climate ambition consistent with keeping warming below the lower 1.5°C of the Paris Agreement.

For the design of NZC10, balance was required: if the climate ambition was too high, few investors would adopt it, reducing its impact. Conversely, a target with low ambition but adopted by many investors would only have modest impact. NZC10 seeks a balance between climate ambition and ease of adoption to maximise impact.

BOARDROOM BATTLE

Few sustainable fund managers challenge boards on their strategy to achieve net-zero, mainly because they lack a framework for the conversation.

NZC10 allows fund managers to align their policies with the carbon neutrality requirement, rather than just emission reduction. The focus on net-zero emissions means firms can have some CO₂ emissions, providing they are reliably offset. The firms are carbon neutral if they meet the requirements of the British Standards Institution's PAS 2060 carbon neutrality standard or an equivalent.



Net-zero emissions strategies are also expected to use current technologies, since transition to a low carbon future is as much a social, as a technological, challenge. This avoids the risks of depending on future technologies for CO₂ removal, which may not materialise at the necessary rate or prove incapable of reaching the required scale.

The intention is to tighten company standards following climate science under the guidance of our ethical oversight committee. Apart from increasing the required asset percentage of 10%, this will likely include minimum engagement requirements and improved definitions for carbon offsetting standards.

EMISSIONS IN SCOPE

Ideally, progress to net-zero should be by emissions reduction. However, residual emissions must be offset. Carbon offsets must be high-quality, realistic and verifiable and based on currently available technologies. Following PAS 2060 and the Greenhouse Gas Protocol, emissions should include all Scope 1 and 2 emissions and all Scope 3 emissions that contribute more than 1% of the total footprint.

These different scopes classify how emissions originate from an organisation's activities. Scope 1 emissions originate from sources that are directly owned and controlled, including, for example, fuel used by company vehicles.

Scope 2 and Scope 3 cover indirect emissions: Scope 2 emissions result from using energy, including electricity, heating and cooling, while Scope 3 emissions cover all other indirect emissions, such as upstream and downstream value-chain emissions and emissions from suppliers and customers. Scope 3 emissions cover financial investments (including equity, debt and project finance) under category 15 of the GHG protocol.

Carbon neutrality includes all greenhouse emissions. It applies to CO₂ but also other gases such as methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, sulphur hexafluoride and nitrogen trifluoride.

PAS 2060 states that a carbon neutrality declaration cannot be achieved only through offsetting, except at the start of the process. At later stages, emissions reductions are required. A declaration of achieving carbon neutrality requires an

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entity to have achieved reductions in its carbon footprint and to have offset remaining greenhouse gas emissions.

While using NZC10 incurs no charge, managers and investors wishing to adopt it must register with P1 Investment Management. P1 monitors the target to ensure standards are maintained, and that the NZC10 designation is not misused.

NEXT STEPS

The NZC10 target offers clarity to fund managers. While quantifying historical portfolio or company impacts is a valuable activity, NZC10 proposes actions that investors can take to support the movement towards a net-zero emission economy and provides a standard framework for corporate engagement.

The participating managers show how investing can address climate change. Recent UK Climate Change Committee recommendations for carbon neutrality by 2050 seem ambitious, but many climate scientists advise stronger action.

Working with climate scientists, we are undertaking a 'gap analysis' on how future NZC targets can more closely align with our changing climate. Although the emphasis on carbon neutrality by 2030 is ambitious, there are still other aspects to consider for protecting the climate.

Potential areas for development include the proportion of portfolio assets covered, methods of engagement, collaborations between investors, improved offsetting requirements and verification. Climate scientists prefer offsetting schemes that remove CO₂ from the atmosphere into a repository, rather than compensation to a third-party for emission reduction.

All the participating managers engage

with company boards to obtain information on their plans to achieve net-zero emissions and plan to follow up with multi-year programmes.

Apart from registering with P1, managers adopting NZC10 are demonstrating their commitment by participating in a net-zero carbon target seminar, which we are currently rescheduling. The threat of coronavirus weighs heavy, but we hope the event will still go ahead (read about the coronavirus impact on pages 11 and 34).

A survey of participating managers is guiding enhancements. For example, they are keen to move beyond the initial 10%, to 20%. Developments will follow climate science under the guidance of P1's external ethical oversight committee.

Recent work on sensitive intervention for post-carbon transitions shows the importance of feedback amplifiers for climate investment initiatives. Investor leadership amplifies their effects, as fund managers engage with multiple company boards. Adoption of targets such as NZC10 allows a 'silent pro-climate majority' of investors to express their views.

Apart from individuals with savings, this can include pension funds, trusts and charity funds. The Pensions and Lifetime Savings Association recommends that trustees explain how climate change relates to their investment strategy, as well as how they are mitigating climate risk and seeking low-carbon investment options. This echoes the approach taken by the pensions minister Guy Opperman last year, who demanded pension schemes be more transparent about their climate change and ESG investing policies.

Enhanced NZC targets will be challenging yet achievable, leaving no one behind. The existing NZC10 target will remain for existing users and as a stepping stone for investors who wish to adopt it later on. ■



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