RECLAIM Finance

Analysis of the updated version of the Net Zero Asset Owners Alliance (NZAOA) Target Setting Protocol

Background:

- **The UN-convened NZAOA is a group of 56 institutional investors across regions with a combined US$9.4 trillion assets under management (AUM).** By joining the Alliance, the members commit to transitioning their investment portfolios to net-zero emissions by 2050 consistent with the 1.5C pathway. The Target Setting Protocol ("Protocol") is a guideline on how individual members can establish science-based emission reduction targets in the next five years.
- The NZAOA recently published the **updates to the Target Setting Protocol** **for public review and comment until 29 October 2021.**

Reclaim Finance raises the following key points about the revised Target Setting Protocol:

- Key Issue #1: **NZAOA's recommendation on fossil fuel phase out dates fails to align with the IEA net zero scenario and climate science.**

Issue	**Details**
No change in the coal position loophole allows coal plants "under active construction" to continue. (p.21)	In 2020, NZAOA published a thermal coal position that said, "**other than coal plants currently under active construction**, no further thermal coal power plants should be financed, insured, built, developed or planned." In this updated Protocol, the Alliance confirms this position with the following statement, "The Alliance has produced a Position Paper on Coal and target setting on utilities with reference to coal should conform with the guidance as indicated in the paper."

	The updated protocol also still leaves out coal mining and coal related infrastructures.
Power assets & fossil fuel infrastructure project target setting guideline, encourages fossil fuel expansion (p.6-8)	**Regarding greenfield projects:** 1. For early development stage projects: - The Protocol urges Alliance members to "assess the total projected lifetime emissions for greenfield projects in the initial year of financing" and to "not invest in assets whose purpose is not aligned/cannot be quickly aligned with net zero ambitions." 2. For later stage projects: - The Alliance recommends assessing the projected lifetime emissions but **does not recommend members to no longer invest or provide debt if it does not align with net zero ambitions**. It is worth noting that "Existing greenfield investments of any kind invested via a fund structure do not currently require an estimate of lifetime emissions". **Regarding brownfield projects:** The AOA's guidance is even looser. However, the definition given by the AOA for greenfield means that some projects classified as brownfield because they require lesser levels of investments could contribute to an increase in fossil fuel production. These projects should also be submitted to scrutiny, even if an exception can be made for projects that directly aim at reducing methane emissions. **The Alliance explored the following net zero scenarios for sector pathways:** - IEA Net Zero by 2050 - One Earth Climate Model (OECM) - World Economic Forum Mission Possible Partnership (WEF MPP) However, for infrastructure target setting, the Protocol also references the following (see below) making it unclear whether investors can use the following as well for discerning whether a project is aligned with net zero ambitions.

	- EU Taxonomy for EU-based investors - Other taxonomies in various jurisdictions under development - Other 1.5℃ aligned scenarios/methodologies When it comes to defining energy-related sectoral targets, the Alliance relies on the One Earth Climate Model (OECM) and the IEA NZE scenario (the World Economic Forum Mission Impossible Partnership being used mainly for so-called hard to abate industries). Both the OECM and the NZE feature a swift and major drop in fossil fuel production and an immediate end to new fossil fuel production projects. However, **the Alliance does not make such key criteria requirements to define sectoral targets and to determine if a fossil fuel project should be supported or not.**

<u>Recommendation:</u>

Commit to a full exit from the coal sector by 2030 in European and OECD countries and globally by 2040. This means closing the following loopholes in its coal position paper:

a. No financing should be made to not only projects in early development or pre-construction phase, but all coal plants, mines and infrastructures in development including those under active construction.
b. Alliance commitment to "phase outs in 'most' thermal coal assets by 2030 for industrialized countries" allows coal plants to continue in these regions beyond 2030. We urge the Alliance to commit to ending 'all' coal financing in EU and other OECD countries by 2030.

Commit to immediately end support to oil and gas supply projects – either greenfield or brownfield - not already committed by the end of 2021.

<u>References:</u>

a. UN Secretary-General Antonio Guterres comment on coal finance
b. Reclaim Finance, Progress report and recommendations for financial institutions to adopt coal exit policies aligned with the 1.5°C objective.
c. The 2021 World Energy Outlook (WEO).

- **Key Issue #2: There are no significant changes in the engagement target section of the Protocol.**

<table>
<tr><th>Issue</th><th>Details</th></tr>
<tr><td>There is still no standard to what entails effective engagement.

(p.27)</td><td>NZAOA claims engagement is essential for achieving real world decarbonization (rather than exiting companies via divestment).

For engagement with companies (a mandatory activity for Alliance members):
- There is still no clarity on what effective engagement process and result looks like and what it would take for members to implement escalation tactics (voting against boards, co-filing or voting on climate resolutions, divestment).

For engagement with asset managers:
- There is no update on how asset owners will hold asset managers accountable and ensure asset managers are meeting their climate commitment expectations.
- The framework downplays asset owners ability to select 1.5°C aligned asset managers.

The frameworks fails to underline the possibility for asset owners to have direct influence through the submission and championing of climate resolutions.</td></tr>
<tr><td>No action on how the Alliance will defuse negative lobbying of investee companies.

(p.28)</td><td>The Alliance commits to aligning its own lobbying activities with the goal of the Paris Agreement but does not send a strong message on defusing negative climate lobbying of investee companies stating, “Alliance members are encouraged to review the lobbying activities of their investee companies to gauge level of Paris-alignment.” (p.28)

The Alliance does not cover the lobbying done by the various organizations assets owners are part of.</td></tr>
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Recommendation:

Outline the process and goals that support assertive engagement that will lead to real world impact.

a. Company engagement: **Commit to a transparent engagement track that is time-bound with clear, pre-announced escalation steps, and that ultimately result in divestment if the company boards don't respond sufficiently to investors within 12 months.** "Engagement escalation policies should be developed and disclosed, which include details on how and when engagements will be escalated. This should include escalation to public statements, voting against management-proposed resolutions such as director re-elections, co-filing shareholder resolutions, and ultimately divestment or refusal to purchase new bonds in active strategies. Sector-specific expectations on climate change, including time-bound milestones and clear targets, should also be developed and disclosed. The credibility of engagement depends upon such policies and a willingness to publicly oppose management when necessary." (Source: COP26 declaration: asset owner climate expectations of asset management.)

b. Asset manager engagement: NZAOA published a guideline that outlines the expectations of asset managers on proxy voting practices - all members should commit to using their influence with their existing asset managers, and to finding alternative managers if needed. Members should also, via the Net Zero Asset Manager Initiative, pressure AMs to adopt robust coal policies (especially with an immediate exclusion of all coal expansion) that also apply to 'passively' managed products (including making sure they plan on switching entirely to coal-free underlying indexes).

c. Policy and voting transparency: each Alliance member should commit to publishing a clear stewardship policy, with escalation pathways. This should include a presumption to vote in favour of shareholder resolutions aiming at Paris alignment, to publish a record of votes, and to explain the rationale for them.

References:

- With clear evidence by MSCI Net Zero Tracker that majority of listed companies on the on track to cause average temperatures to rise by nearly 3°C above pre-industrial levels with less than 10% of listed companies align with a 1.5°C temperature rise, there is no time to lose with engagement targets without consequences.
- Majority Action, Climate in the Boardroom 2021 report concluded that "proxy voting by asset managers with over $1 trillion in AUM remained insufficient to the scale and urgency of the climate crisis."
- ACCR, Super Votes: How Australia's largest superannuation funds voted on ESG resolutions in 2020. As one of the recommendations, ACCR calls for "funds delegating voting to asset managers to disclose the proxy voting record of those managers."

- **<u>Key issue #3:</u> Uncertainties around the scope and relevance of targets**

Issue	Details
Scope 3 are not always included	The Alliance often states that “scope 3 emissions should be included wherever possible”. While the Alliance “assumes” that Scope 1 and 2 emissions would be fully covered by target by 2025, it sets no such expectations for scope 3. For oil and gas companies, the Alliance pledges to “work to clarify the definition of Scope 3 emissions and provide open-source data for the largest oil and gas companies within 3 years”.
Sector pathways - The Alliance still allows the setting of targets based on carbon intensity rather than absolute emissions	The Alliance allows asset owners to choose the metric used. While intensity targets could be valuable, they should always be paired with absolute targets. For the fossil fuel sector, production targets are also highly relevant and should be required.

<u>Recommendation:</u>

a. Clearly establish deadline for the inclusion of scope 3 emissions to all the targets, prioritizing inclusion in sector where scope 3 emissions represent most total emissions. Specifically for the fossil fuel sector, recognize that no more information is needed to act and phase out investments in companies involved in fossil fuel expansion.
b. Require that target should always be set in absolute emissions. For the fossil fuel sector, require additional targets to be set regarding fossil fuel production.