Reclaim Finance response to consultation on
Net-Zero Asset Owner Alliance Target Setting Protocol Version 4

28 August, 2023

Reclaim Finance appreciates the opportunity to comment on this Asset Owner Alliance consultation. We do not however wish to comment on the technical aspects of the three new asset-class disclosure methodologies as we think it is of greater importance to discuss more general problems with the AOA's Target Setting Protocols (TSPs).

We have noted problems with the successive TSPs at various times (see e.g. here, here, here and here). Unfortunately it appears that with its process of producing the fourth version of their TSP the AOA is going to miss yet another opportunity to deal with these issues.

The need to align with HLEG

Many of the issues that we have raised were included in the recommendations of the UN High-Level Expert Group on net zero (HLEG) of which the AOA's chair, Günther Thallinger, was a member. These issues were also raised earlier by the UN's Race to Zero, of which the AOA remains a partner. Much of the work on the third version of the AOA's TSP, released in February 2023, had already been done before the release of the HLEG report in November 2022, so it was not surprising that TSPV3 did not seek to align with HLEG. **The Protocol did however note the work of HLEG and state that it would "consider the recommendations made in the HLEG report for the next version of the Target Setting Protocol."[1]**

Yet there is no sign in the consultation of any effort by the AOA to align with HLEG's recommendations, and so it appears that the AOA is not going to follow through with this commitment. The key recommendations of HLEG which the AOA needs to adapt clearly into its next TSP are listed below.

- *"Non-state actors must have short-, medium- and long-term absolute emission reduction targets and, where appropriate, relative emission reduction targets . . . " (HLEG Recommendation 2)*

AOA allows its members to set their 2030 portfolio targets based on either absolute or relative metrics. The minority of members that have set sectoral, as opposed to portfolio, targets are required to report their absolute emissions for priority sectors, but to only set targets using intensity metrics.[2] In its March 2023 Position on the Oil and Gas Sector the AOA insists that oil and gas companies should set both "absolute- and intensity-oriented emissions targets," yet fails to require its own members to set absolute targets for the oil and gas companies in their portfolios.[3]

[1] UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, p.xiv, January 2023
[2] UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, p.29, January 2023
[3] NZAOA, Position on the Oil and Gas Sector, p.7, March 2023

As the Race to Zero's expert group states, in most cases "absolute emission targets are necessary for ensuring real-world reductions."[4] GFANZ notes that "getting absolute emissions to zero is the end goal, and both absolute and intensity metrics should be considered together to measure progress of different pathways to net zero."[5] The new Principles for Net-Zero Financing from the US Treasury note that targets should "incorporate both intensity metrics, which allow for more effective comparisons among entities within a sector (particularly when based on physical production), and absolute emissions reduction metrics, which are necessary to assess progress towards economy-wide targets."[6]

Absolute targets require actual emission reductions, relative targets do not. For example, as portfolios increase in size due to positive fund performance and/or inflation, relative emissions (usually measured by AOA members in units of CO2e per unit of portfolio value) will decline at a much faster rate than actual emissions in a portfolio. Indeed declining relative emissions could disguise absolute emissions that remain constant, or even increase.

Out of 72 asset owners with 2030 targets listed on the AOA's website as of September 2023, only 10 have explicitly set absolute targets. A further nine have not published easily accessible disclosures that clarify if their targets are absolute or relative.

While intensity targets can be useful, e.g. for comparing decarbonization progress among asset owners of different sizes, TSPV4 must make it mandatory for AOA members to set absolute targets.

- *"Targets must include emission reductions from a non-state actor's full value chain and activities including: scope 1, 2 and 3 emissions for businesses [and] all emissions facilitated by financial entities" (HLEG Recommendation 2)*

The AOA continues to fail to require its members to set targets for the Scope 3 emissions of their investees. TSPV3 requires members to track investee Scope 3 emissions for their **portfolio targets**, but does not expect them to set targets on them until "data becomes more reliable."[7] Members that set **sectoral targets** are recommended to include Scope 3 emissions in their targets for high-emitting sectors "as soon as possible." But they are not required to include these emissions even for the oil and gas sector where the AOA notes that Scope 3 emissions are "especially material"[8] and even though it insists, in its Oil and Gas Sector position paper, that oil and gas companies should themselves set Scope 3 emission targets.[9]

It is not just HLEG that calls for financial institutions to include Scope 3 targets for sectors such as oil and gas where these are material and where sufficient data is available; other examples include the

[4] Race to Zero Expert Peer Review Group, Interpretation Guide, Version 2.0, Section 7, June 2022, accessed 23 March 2023
[5] GFANZ, Financial Institution Net-zero Transition Plans: Fundamentals, Recommendations and Guidance, p.79, November 2022
[6] US Department of the Treasury, Principles for Net-Zero Financing & Investment, p.8, September 2023
[7] UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, p.xi, January 2023
[8] UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, p.32, January 2023
[9] NZAOA, Position on the Oil and Gas Sector, p.7, March 2023

Net-Zero Banking Alliance (NZBA); [10] the Glasgow Financial Alliance for Net Zero (GFANZ); [11] the Race to Zero,[12] the Science-Based Targets initiative (SBTi),[13] and the US Treasury.[14]

A significant weakness of the AOA's target setting approach, is that it allows its members to set either portfolio or sectoral targets. And presumably because portfolio targets — and especially portfolio **intensity** targets — are seen as easier to meet, only 10 of its members have set sectoral targets according to the targets disclosed on the AOA's website.

TSPV4 should require AOA members to set both sectoral and portfolio targets and to require Scope 3 emission targets for all high-emission sectors.

- *"Non-state actors must publicly disclose comprehensive and actionable net zero transition plans which indicate actions that will be undertaken to meet all targets, as well as align governance and incentive structures . . . skills and human resource development, and public advocacy, while also supporting a just transition. Transition plans should be updated every five years and progress should be reported annually."* Specifically for financial institutions, net-zero transition plans should *"[d]emonstrate how all parts of the business (investment advisory, investment, facilitation, etc.) align with interim targets and long-term net zero targets, including a strategy to identify and progressively phase out stranded assets. (HLEG Recommendation 4)*

Previous versions of the TSP have stated that members who continue to invest in high-emitting companies are expected to ensure that these companies have robust transition plans aligned with relevant sector pathways.[15] They do not however explicitly require their own members to have robust transition plans.

TSPV4 should make clear that aligning with HLEG requires AOA members themselves to adopt comprehensive and robust net-zero transition plans which include the elements described by HLEG and so go beyond the specific targets and actions included in past TSPs.

- *"On coal for power generation, net zero targets and transition plans of all financial institutions must include an immediate end of: (i) lending, (ii) underwriting, and (iii) investments in any company planning new coal infrastructure, power plants, and mines. Coal phase out policies from financial institutions must include a commitment to end all financial and advisory services and phase out exposure, including passive funds, to the entire coal value chain no later than 2030 in OECD countries and by 2040 in non-OECD countries. Coal investments that remain in the portfolios of financial institutions must adopt phase out plans with facility-by-facility closure dates that include just transition plans for workers." (Recommendation 5)*

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[10] NZBA, Guidelines for Climate Target Setting for Banks, p.3, April 2021

[11] GFANZ, Expectations for Real-Economy Transition Plans, p.39, fn.87, September 2022

[12] Race to Zero Expert Peer Review Group, Interpretation Guide, Version 2.0, June 2022, Section 2.a, accessed 23 March 2023

[13] SBTi, SBTi Corporate Net Zero Standard, pp. 32-33, updated April 2023

[14] US Department of the Treasury, Principles for Net-Zero Financing & Investment, September 2023, p.8

[15] See e.g. UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, pp.9 and 22, January 2023

The AOA released a position paper on thermal coal in 2020 which stated that "no further thermal coal power plants should be financed, insured, built, developed or planned." This language is reflected in previous TSPs — but only applies to members setting sectoral or infrastructure targets. As explained above, only 10 members have set sectoral targets, and of these only five have set coal targets. Only three have set explicit infrastructure targets, one of which (Allianz) is included in those with sectoral targets.

The AOA's failure to clearly insist in its TSPs that all its members need to comply with the positions of its Thermal Coal Paper has meant that only a minority of its members seem to have adopted meaningful policies to end support for companies building new coal plants. Out of 53 AOA members currently included in the Coal Policy Tool, only eight have robust policies that exclude financing for new coal mines and power plants.

The second biggest consumer of coal after the power sector is the steel industry. None of the sectoral targets specifically mention the need to cut emissions from metallurgical coal, and only two asset owners have set steel targets.

The AOA should include clear language in TSPV4 noting that all its members should set HLEG-aligned policies on investments in coal mines, power plants and other infrastructure, regardless of the types of targets set by the members. Metallurgical coal should be covered in steel sector policies which end investments in companies building or expanding met coal mines or building or relining coal-fired blast furnaces. Investments in steel companies should be conditional on a commitment to stop developing coal-fired facilities, and to invest in new green steel technologies.

- *"oil and gas phase-out policies from financial institutions must include a commitment to end financing and investing in support of: (i) exploration for new oil and gas fields, (ii) expansion of oil and gas reserves, and (iii) oil and gas production.*

TSPV2 in 2022 took a first step toward requiring AOA members to stop financing fossil fuel expansion. The 2022 protocol stated that targets for the energy and utility sectors "should reflect" the findings of the IEA's Net Zero Emission scenario and the One Earth Climate Model and "withdraw financing from new coal-related assets and new oil and gas fields and respectively refrain from investing in, or providing assets to, assets that support the expansion of coal, oil, or gas production and to scale down production."[16] It also said that for members setting infrastructure targets, they must exclude financing for new "upstream greenfield" oil projects "beyond those already committed by the end of 2021." This language was repeated in TSPV3.

However only two out of the 72 AOA members with targets published on the AOA site have set oil and gas specific targets and, as noted above, only three have set infrastructure targets. The recommendations on stopping financing oil and gas expansion in TSPV3 are therefore largely meaningless.

[16] UNEP/NZAOA, Target Setting Protocol – Second Edition, January 2022, p.60

The AOA noted in TSPV3 that it would offer further guidance on oil and gas investments in a forthcoming Position on the Oil and Gas Sector which was published in March 2023. Yet despite the AOA's recognition of the scientific reality that the carbon budget has no room for new oil and gas projects, its oil and gas paper failed to require its members to stop investing in companies expanding oil and gas production.

The paper calls on investors to halt "new investments in infrastructure projects in new upstream oil and gas fields." This expands the language in TSPV3 to also cover gas fields, but there is nothing to indicate that this policy recommendation goes further than the TSP and applies beyond those few members with sectoral or infrastructural targets (indeed the position paper only explicitly mentions this exclusion applying to direct private asset investments in infrastructure).

The AOA recognizes that science-based no- or low-overshoot 1.5° pathways with limited dependence on negative emissions show there is no room in the carbon budget for new oil and gas projects. TSPV4 must take the logical next step, and align with HLEG, by requiring AOA members to stop investing in the companies that are developing these projects.

Engagement Targets

While AOA members can currently choose being setting portfolio or sectoral targets, all are required by previous TSPs to set targets for engaging with asset managers (AMs) and investee companies. According to TSPV3, members' engagement must

a) increase their AM's understanding of the asset owners' positions on climate, and
b) increase the alignment between AM actions and asset owner interests.

Members' engagement targets and practices are recommended (but not required) to

a) "clearly define escalation procedures for their own climate engagements, or set escalation expectations for the AMs" conducting engagement on their behalf
b) "transparently explain how proxy voting is systematically employed to align with their net-zero commitment," and
c) integrate AOA principles on proxy voting in the selection, appointment and monitoring of AMs.[17]

These are all important actions, but the AOA needs to clarify in TSPV4 the concrete steps that its members must take to implement these demands and recommendations.

Some of these measures are noted in an April 2022 AOA position paper on the future of investor engagement, and should be incorporated into TSPV4.[18] Examples are:

[17] UNEP-FI/NZAOA, Target Setting Protocol – Third Edition, p.19, January 2023
[18] UNEP-FI/NZAOA, The Future of Investor Engagement: A call for systemic stewardship to address systemic climate risk, April 2022

"investors utilising the [Climate Action 100+] Net-Zero Company Benchmark can systematically integrate company scores into stewardship approaches; low scores inform escalation strategies— such as votes for or against directors, climate resolutions, and/or transition plans." (p.8)

And

"Investors can strengthen these engagements by holding companies accountable through stewardship activities that follow these expectations in the normal course of investor actions. This includes incorporating expectations into merit-based proxy voting policies that set clear criteria for evaluating resolutions and election of directors. (p.15)

TSPV4 should also go further in setting out a clear escalation process that its members must follow, with systematic sanctions to be implemented every year where expectations have not been met by companies. Reclaim Finance has described such an escalation strategy in our August 2023 paper Climate Stewardship: A guide for effective engagement and voting practices. As described in this paper, expectations to companies must focus on 1.5°C alignment rather than on disclosures.

TSPV4 should also require members to ensure that their AMs follow the four "key principles" for AMs listed in the AOA's March 2023 position paper on climate policy engagement.[19] Members should be required to publish their expectations for AMs and the number and proportion of the AMs that follow these key principles.

Finally, TSPV4 should insist that its members that are using the IEA's 2021 Net Zero Emissions pathway should now use the updated September 2023 version of this road map to net zero.[20]

[19] UNEP-FI/NZAO, Aligning Climate Policy Engagement with Net-Zero Commitments: A foundation for asset owner engagement with asset managers, April 2023
[20] IEA, Net Zero Roadmap: A global pathway to keep the 1.5°C goal in reach. 2023 Update, September 2023