Climate Change Compass: The road to Copenhagen

Introduction

Climate change is now widely recognised as one of the most significant challenges facing the global economy. The projected impacts on the environment and society are unprecedented. Climate change is undoubtedly a critical theme for today's (and tomorrow's) asset owners and asset managers. But what should investors be doing?

Building on last year's analysis, EIRIS reviewed the 300 largest global companies by market capitalisation listed on the FTSE All World Index to assess the current state of corporate responses to climate change. This report highlights the direction companies are taking with regard to the issue and examines its implications for investors.

Key findings

- **Some improvements, but further momentum needed**
  - 33% of companies have unmitigated climate change risk (down from 34% in 2008)
  - 55% have short-term targets on climate change (48% in 2008)
  - 91% of high and very high impact companies disclose absolute CO_2 or GHG emissions data (73% in 2008)
- **Opportunities at Copenhagen** - the UN Climate Change Conference may create significant opportunities for companies – linked to the development of green stimulus packages or a clearer regulatory framework.
- **Engagement is key -** many large cap companies face significant climate change risks and opportunities. Investors must understand the impact these issues will have on their portfolios and integrate climate change into their engagement strategies or when exercising voting rights.

Against a backdrop of the recent global financial crisis and growing evidence of the significant physical effects of climate change, the outcome of the United Nations Climate Change Conference in Copenhagen will set the direction for a financial and policy framework for future climate change investment for governments, corporations and investors.

In December 2009, Copenhagen will host the most important climate change-related meeting since 1997. The meeting of environment ministers and officials will include the negotiation of a post-Kyoto deal on climate change. If successful, this deal will lock the world into emissions reductions of around 80%. International agreement is sought for issues such as the willingness of industrialised countries to reduce their emissions and developing countries to limit the growth of their emissions and the degree of support given to developing countries to reduce their emissions and adapt to the impacts of climate change. The difficulties facing the negotiators include the requirement for high emissions cuts and the perception that industrialised nations are outsourcing carbon emissions to developing nations through their purchase of carbon-intensive manufactured goods. A key difference in the lead up to the negotiations at Copenhagen compared with Kyoto is the broad acceptance of the scientific evidence on climate change. Additionally, momentum has been gathering with a change of direction on burden-sharing for developing countries from binding emission cuts to other actions such as the adoption of energy efficiency standards and the take-up of renewable energies instead, which could make an agreement more likely.

A myriad of international meetings have preceded the conference in Copenhagen in recent months. From the Poznan climate change conference, via the G20 summit and the Bonn climate talks to the G8 summit in Italy. The latter witnessed the emergence of a consensus amongst industrialised countries for the need for action in the face of scientific evidence. This was reflected in a statement in which industrialised countries reiterated their willingness to share with all countries the goal of achieving a 50% reduction of global emissions by 2050 and for developed countries to reduce their emissions, in aggregate, by 80% by 2050 based on 1990 levels. A number of innovative initiatives have been discussed such as green funds paid for by countries according to a formula reflecting their economic size, greenhouse gas (GHG) emissions and population; a global cap-and-trade or ETS (Emission Trading Schemes), technologies such as CCS (Carbon Capture and Storage), investment funds focused on reducing the impact of forest degradation such as the United Nations Collaborative Programme on Reducing Emissions from Deforestation and Forest Degradation in Developing Countries (UN-REDD Programme), use of agricultural land for generation of renewable energy, and levies on developed economy international flights and shipping fuel to fund climate change adaptation in poorer countries.

The economic downturn brings a number of risks and opportunities. There are risks associated with near-frozen capital markets as well as uncertainty and opportunities linked to government stimulus packages focused on energy efficiency, cleaner technologies, renewable energies, taxation and forest protection. The 'green stimulus' packages support a low-carbon economy aimed at generating new jobs and businesses through 'green' growth. These were often launched against a backdrop of new regulations, such as the UK Climate Change Bill which introduced legally binding targets to cut greenhouse gas emissions by 80% by 2050.

The goal of achieving a low-carbon economy will favour low-carbon activities. At a time when global capital is in short supply, businesses who continue to pursue unmanaged high-carbon strategies will be risking their investments as well as the climate. Business leaders gearing up for a low-carbon economy understand the normative motives of reducing emissions as well as the long-term economic benefits of such action. It is important that 'green' industries have access to capital even in these times of tightened credit.

A key investment issue

Climate change has the potential to seriously impact shareholder value, especially in the medium to long term. Investors need to understand the risks to their investments and also the role they should play in the wider policy debate.

For companies and their investors climate change presents a number of risks and opportunities:

- **Regulatory challenges** - national and international policy frameworks for reducing GHG emissions are providing an imperative to reduce operational emissions. The outcomes of the meeting in Copenhagen may bring about a number of changes in national and international legislation. New directives and acts may come into effect subsequently. Investors should take account of regulation and government incentives when determining risks and opportunities regarding investing in companies with exposure to climate change. Environmental taxes and compliance costs now need to be factored into companies' operational costs.
- **Changing market dynamics** - higher and fluctuating energy costs present a significant impact, in particular for energy-intensive industries. However, changing consumer attitudes and demand patterns open up opportunities for new technology, products and markets.

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- **Changing weather patterns** – the physical risks of climate change include damage to assets as a result of flooding and extreme weather events.
- **Reputational** - customer, employee, investor and societal perceptions are having an increasing impact on brand value.

Tracking the global 300
EIRIS has analysed the impact and response of some of the world's largest 300 companies on the basis of 24 climate change indicators covering governance, strategy, disclosure and performance elements. This information was compared with the results of the report that EIRIS published in 2008. Key findings are highlighted below.

1) High level of unmitigated risk amongst global top 300
EIRIS classifies both the climate change impact of a company and its management response. In this way investors can understand whether the company has in place an appropriate management response to adequately address its climate change impact.

To profile the climate change impact of a company EIRIS has classified companies into over 50 sectors based on their business activities to identify their climate change impact. Each sector is defined as very high, high, medium or low impact based on their direct and indirect emissions alongside other factors such as a sector's projected growth, beneficial impact of the sector, allocation of emissions across the value chain and contribution to climate change solutions.

With input from investor groups, NGOs and companies (including WWF, Climate Group, Carbon Trust and Institutional Investors Group on Climate Change) EIRIS developed indicators to assess how companies should best address their climate change impacts and risks through their management response.

EIRIS indicators cover aspects such as:

- **Governance** – e.g. does the company have a corporate-wide climate change policy, or is board remuneration linked to climate change performance
- **Strategy** – e.g. has the company set targets
- **Disclosure** – covering the quality of carbon data, or quantified disclosure risks or opportunities
- **Performance** – e.g. year on year reduction in GHG emissions, or transformational initiatives such as large scale investment in carbon capture and storage

EIRIS combines the above indicators into five management response assessment levels which can be used to determine risk-relative assessments.

Fig 1. Climate change impact by percentage market cap of global 300 (2009)

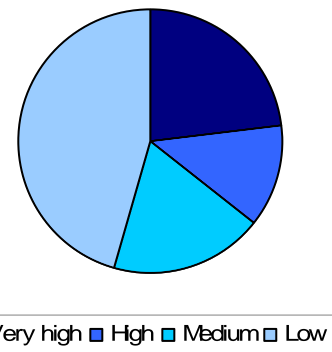

Figure 1 illustrates a similar profile of climate change impact to that of last year. Over a third (35.6%) of companies in the global 300 are classified as high or very high impact for climate change.

However, for a complete picture of a company's risk profile investors should look beyond emissions intensity and also consider how the company is responding to the challenges of climate change. While a larger number of companies are assessed as appropriately managing their climate change impact compared with last year there remains a high level of unmitigated risk amongst the global top 300. This is due to improvements in

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the practices of some of the companies included in last year's report as well as the good strategies of newcomers to the group of 300 largest cap companies. This is encouraging. However, some sectors, such as Industrial metals, Food producers and Oil & gas producers have a greater proportion of companies with unmitigated risk compared with last year.

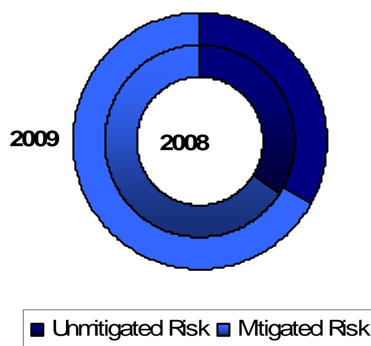


Figure 2 illustrates a slight decrease (33% against 34.2%) in the number of companies in the global 300 considered to have unmitigated risk.

Performance varies considerably – some sectors are making progress towards tackling the issue, whereas others have a high percentage of companies with unmitigated risk.

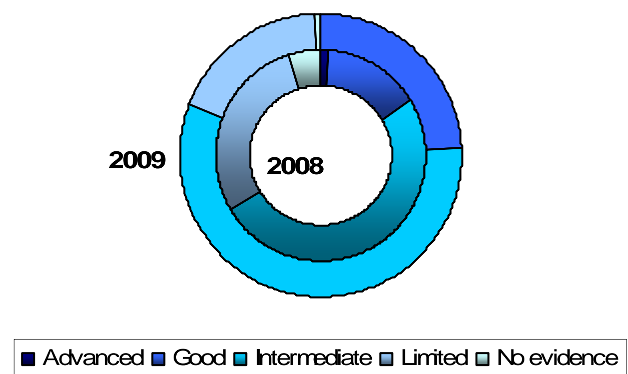
Table 1. Percentage mitigated risk for a selection of high impact sectors (by number)

Sector	% global 300	% mitigated risk (% variation)
Chemicals	3%	77.8% (+23.4%)
Construction & materials	1%	25% (+25%)
Electricity	3%	30.0% (+21.7%)
Food Producers	3%	50.0% **(-20.4%)**
Industrial Metals	2%	0% **(-24.3%)**
Mining	4%	18.2% (2.4%)
Oil & gas producers	9%	3.6% **(-6.2%)**

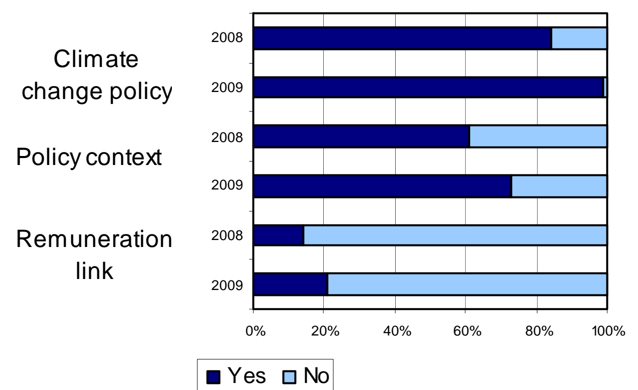
Many large cap companies are impacted by climate change. Investors should understand the effect these impacts will have on their portfolios.

2) High risk companies are improving but there is still a long way to go

Some of the highest risk companies for climate change are not adequately responding to risks and opportunities.



In general, the quality of companies' management response to climate change issues has improved since the last report. Less than a fifth (19%) of very high and high risk companies (by number of companies) have no or a limited response to climate change. This is an improvement from over a third (34%) in 2008.



All but one of the companies (99%) with a high or very high climate change

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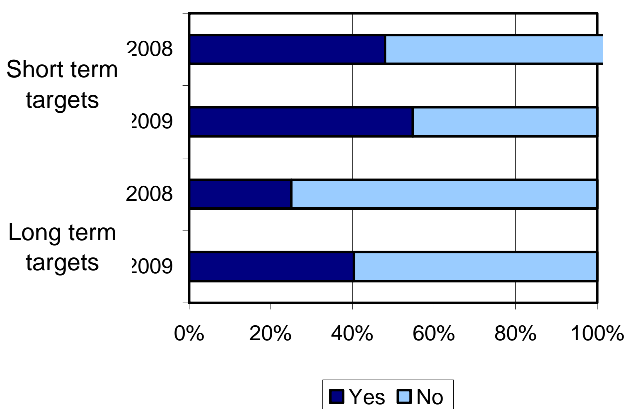
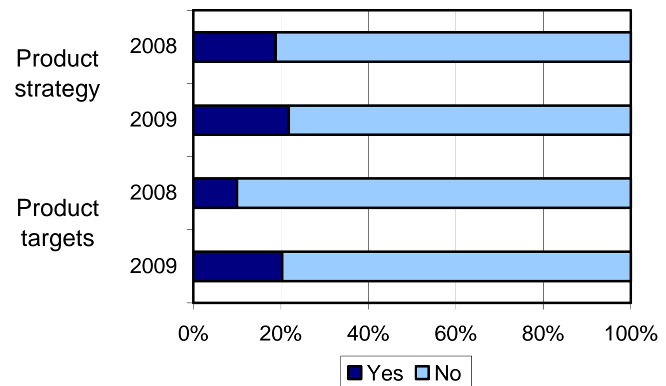
impact has a corporate-wide climate change commitment (in comparison with 84% in 2008). This can be explained by a number of drivers coming into play including the increasing activity of investors. Almost three quarters (73% compared with 61% last year) have referenced the wider policy context by referring to international targets, regulations or the scientific imperative. This is good news. However, only 21% (14% in 2008) of companies have integrated this commitment by linking board or senior management remuneration to GHG emission reductions or equivalent climate change strategies. Investors may want to focus on this area when developing their engagement strategies or when exercising voting rights.

Fig 5. Strategy performance (% very high & high impact companies)



Targets are an important indicator of corporate climate change strategy and are also an important indicator of a company's commitment to achieving GHG emissions reductions. Over half (55% increased from 48% in 2008) of high and very high impact companies analysed have a short-term (less than five years) management target either publicly stated or as an internal target. The proportion of companies disclosing a public long-term (at least five years) strategic target has increased to 40%, from a quarter in 2008. Although the increased presence of short-term targets is good news for investors seeking companies that are actively managing their GHG emissions, the lack of long-term targets is a concern and may reflect the uncertainty regarding the future policy framework and longer term caps on GHG emissions. While a number of countries are publicising national GHG emissions targets many companies are looking to the outcome of Copenhagen as a signal for long-term reduction targets.

Fig 6. Product performance (product-relevant companies)



For many companies their greatest climate change impact is through their products. Focusing on the subset of companies with a significant product impact, over a fifth (22% compared to last year's 18.8%) publicly recognise the company's responsibility to address the climate change impact of their products. However, while only 20% have made a public commitment or disclosed a quantitative target to reduce the climate change impact of their products, this is a 50% improvement from last year's level. Whilst some high impact companies have made initial steps in terms of high level commitments to addressing the risks of climate change through their products, evidence of how these commitments are translated into a coherent strategy is less apparent.

3) The quality of quantitative disclosure remains a challenge

The proportion of companies in the global 300 assessed as having no or limited disclosure on climate change has reduced to less than 12% (from 29.4% in 2008). Over four fifths (85%) of very high or high impact companies disclose

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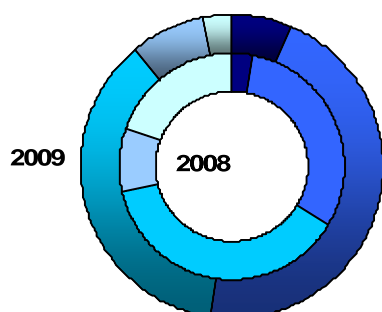
either absolute or normalised data (up from 81% in 2008). Impressively, 91% of very high or high impact companies (up from 73% in 2008) disclose absolute carbon dioxide (CO_2) or GHG emissions data and 79% of companies (up from 70% in 2008) disclose normalised data. Over three quarters of these companies (83% from 38% in 2008) disclose an indication of scope of data or methodology used and almost half of this information (48% up from 36% in 2008) was verified by an external party.

Fig 7. Disclosure performance (% very high & high impact companies)



This is an impressive improvement in proportion of companies disclosing data and an encouraging trend in terms of disclosure of scope or verification of data. However, more does not necessarily equal better. A lack of clarity and comparability of quantitative data persists and can compromise investment decisions based solely on the disclosure of quantitative data. Initiatives such as the Carbon Disclosure Project (CDP) have made a significant contribution to the amount of data disclosed. Figure 7 shows that over a quarter (26% up from 18% in 2008) of very high and high impact companies are providing a quantified assessment of the financial, regulatory or physical risks or opportunities posed by climate change. This is in large part driven by the inclusion of this question in the CDP questionnaire. Disclosure in the area of climate change will increase as a result of investor, regulatory and wider stakeholder pressure. The launch of the CDSB (Climate Disclosure Standards Board) framework for the inclusion of climate change data in mainstream reports will support the efforts of companies to disclose further information on their performance regarding climate change. The framework clarifies which climate change data should be reported and provides guidelines designed to streamline disclosure procedures. Investors should consider addressing reporting and disclosure on climate change through their engagement strategies and when exercising their voting rights.

Hopes for Copenhagen

In the run up to Copenhagen we are hearing clear messages from investors and companies for firm targets and a greater degree of certainty around climate change.

Asset owners and asset managers have an interest in ensuring a robust policy framework to provide a clear and consistent market signal. To this end, in April 2009, six networks of global sustainable and responsible organizations (ASrIA, Eurosif, RIAA, Social Investment Forum, SIO and UKSIF) approached the world leaders meeting in London at the G20 to request financial instruments and incentives to build the green economy using private investment alongside direct government support and financial reform measures to require greater transparency and responsible ownership.

Likewise, the 'Copenhagen Call' (a wish list of a large number of corporations and issued by the World Business Summit on Climate Change) asks for:

- governments to set out a timeline of emissions reductions targets;
- standards and regulations for energy efficiency;
- a standardised method for companies to report on their low-carbon progress;
- economic incentives to drive the development, financing and employment of low-carbon technology;

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- a rapid scale-up of carbon markets; immediate action to protect forests and a fund for adaptation.

These are aimed at generating more regulatory certainty. Business will need to work closely with governments to create effective and practical rules to bring forward the low-carbon investments and guarantee sustainability.

Conclusion

Climate change will continue to have significant physical and economic impacts. As these increase, investors need to develop mechanisms to factor in the effect of climate change and to secure financial returns in a carbon-constrained economy.

The Copenhagen meeting could result in beneficial outcomes for various industries linked to the development of stimulus packages and clearer regulatory framework. A number of improvements have been observed in the strategies that companies have put in place with regard to their climate change impact. A higher proportion of companies have policies and systems in place while the number of companies that report on their performance has also increased. However, there are areas where further progress can be achieved such as the involvement of the board in the company's climate change initiatives through linking remuneration to performance in this area. Likewise, the increased use of external verification for GHG emissions data will provide investors with further reassurance on the reliability of the information published. These are key areas where investors should focus both on minimising their risk but also on further exerting their influence.

Given the importance of Climate Change and the likely impact of it on future long-term corporate financial performance it is increasinly seen as an investor's fiduciary responsibility to integrate consideration of climate change into their investment strategy as outlined in the UNEP-FI Fiduciary II report.

Challenges for investors

The findings above highlight the following key challenges for investors:

- **High level of unmitigated risk amongst global top 300** – asset owners should demand that their asset managers integrate climate change in their investment process and should monitor their performance in this regard
- **High risk companies are improving but there is still a long way to go** – there is an opportunity for investors to exercise their voting rights and to engage companies to minimize risk
- **The quality of quantitative disclosure remains a challenge** investors should demand greater transparency to evaluate the exposure and performance to climate change of their portfolios

Protecting & enhancing investments

EIRIS has identified the following steps investors can take to protect or enhance their investments:

1. **Identify portfolio risks**
   Understanding the carbon profile or footprint of your portfolio is an important first step. But for a complete picture of a company's risk profile investors should also look beyond emissions intensity to how the company is responding to the challenges of climate change.

2. **Factor in carbon**
   This involves fully understanding carbon risks and opportunities - within both the portfolio and the wider economic picture. This isn't just about divesting from high impact companies. Investors should factor in carbon when pricing very high and high impact companies. Investors should also identify those companies actively managing their risks or seeking out

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opportunities (e.g. in terms of establishing a competitive advantage, preparing for future challenges such as regulation, or adapting their business model). A focus on investing in climate change solutions companies, such as renewable energy or energy efficiency, is another way to factor in carbon.

3. **Engage**
   This includes using investor influence to engage with companies and the wider policy debate. Company engagement includes focusing on specific issues and sectors (e.g. challenging electricity companies to look at more efficient generation and distribution), or encouraging improved disclosure from all companies on how they are responding to climate change.

References of interest:

- Institutional Investors Group on Climate Change – Report 2008: www.iigcc.org/docs/PDF/Public/2ndAnnualReportInvestorStatementonClimateChange.pdf
- UNEP-FI – Fiduciary responsibility report: www.unepfi.org/fileadmin/documents/fiduciaryII.pdf
- Carbon Disclosure Project: www.cdproject.net
- UN Climate Change Conference Copenhagen: http://en.cop15.dk

How we can help – EIRIS Climate Change Products for Investors

EIRIS has developed a comprehensive suite of products to help investors assess their portfolios and design investment strategies in response to the challenge of a carbon-constrained economy.

- EIRIS **Carbon Profile** - assesses the climate change performance of a portfolio against major market indices. It is designed to help investors understand the quantitative climate change impact of their portfolios. It provides a qualitative assessment of company responses to climate change.
- EIRIS **Carbon Engager** – helps investors to target their engagement on climate change and identify key priorities. It provides detailed reports on individual company performance and best practice examples to support a variety of engagement approaches.
- EIRIS **Carbon Risk Factor** - quantifies individual company performance on climate change. It provides a risk-weighted score based on each company's carbon impact and management response to climate change. It is designed to be easily integrated into analysts' models.

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About EIRIS
EIRIS is a leading global provider of independent research into the social, environmental governance and ethical performance of companies. EIRIS, a UK-based organisation with an office in the US together with its international research partners has a wealth of experience in the field of responsible investment research. EIRIS provides comprehensive research on around 3,000 companies in Europe, North America and the Asia Pacific region. EIRIS is already retained by 100 institutional clients including pension and retail fund managers, banks, private client brokers, charities and religious institutions across Europe, North America, Australia and Asia. For more information on EIRIS' products and services visit www.eiris.org or email: clients@eiris.org

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