

# Net Zero

## Climate Metrics



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“The first stage to understanding climate risk”

### Introduction

The race to Net Zero has begun!

At a global level many nations are implementing policies and legislation to facilitate the transition to “Net Zero” by 2050 or earlier - the goal of balancing carbon emissions produced with those absorbed from the atmosphere. However, it is not just at a government level that action is required; all asset owners need to consider what steps to take to mitigate climate change risk in their portfolios.

### Impact on Pension Schemes

There are various aspects to climate change risk that pension scheme trustees need to consider, from the potential impact on the sponsoring employer’s business to the scheme’s portfolio of investments. With many defined benefit schemes already being closed and becoming increasingly mature, looking ahead, defined contribution (“DC”) schemes will have an increasingly important role to play in supporting the decarbonisation transition. Many pension scheme trustees are recognising that a rapid move to Net Zero is likely to be the most cost effective action to take to mitigate the financial effects of climate change risk.

### Drivers for change

New pensions regulations in the UK, the desire to align pension schemes with corporate Net Zero policies and increased public concern and awareness of the impact of climate change are all accelerating the adoption of Net Zero policy objectives. There are also a number of industry-led initiatives, including the Paris Aligned Investment Initiative and the Net-Zero Asset Owner Alliance, to assist asset owners with the transition.

Pressure for change is also coming from the pension scheme membership, who are being asked to “Make My Money Matter” and challenge pension scheme trustees to adopt more sustainable investment options and become “Net Zero Heroes”.

Recognising that failing to incorporate climate change into DC investment options and, in particular, the default investment option, risks poorer outcomes for members. In the future there could even be the potential for legal action against those governing pension schemes who fail to take appropriate and timely action. Consequently DC scheme trustees are increasingly reviewing their investment options, with a view to aligning them with Net Zero by 2050 or sooner.

### Where do you start?

The first stage to understanding climate risk in an investment portfolio is to determine the level of Green House Gas (GHG) emissions within the portfolio. This then provides a baseline for future actions and monitoring against a Net Zero objective.

With some investment managers being accused of over promoting their ESG<sup>1</sup> credentials and the number of different climate metrics being used, this is not always straightforward. We thought it would be useful to take a closer look at the rapidly developing area of climate metrics and how they can assist in tracking progress towards reaching the Net Zero objective.

### Carbon Metrics

There are several different measures available. However, each one is looking at things from a different perspective.

### Total Carbon Emissions

Carbon dioxide equivalent (CO<sub>2</sub>e) is a standard unit to compare the emissions of different greenhouse gases (GHG). Total carbon emissions is a measure of the absolute tons of CO<sub>2</sub>e for which an investor is responsible. Under this approach, for each equity held, a company’s total emissions are apportioned to the investor based on the proportion of the company’s shares they hold. These emissions are classified depending on whether they arise directly or indirectly from an organisation’s operations.

Scope of Green House Gas (GHG) Emissions	
Classification	Description
Scope 1	All direct GHG emissions from sources owned or controlled by a company. For example, emissions from company-owned cars, or heating.
Scope 2	Indirect GHG emissions from consumption of purchased or acquired energy, such as electricity.
Scope 3	Indirect emissions from sources not owned or controlled by the company. For example, emissions as a result of transportation and the use of sold products.

As corporate supply chains can be complex, Scope 3 emissions are harder to quantify and less data may be reported.

### Carbon Emissions

Total carbon emissions are directly linked to the size of the portfolio. To make it easier to compare portfolios of different sizes, carbon emissions can be normalised by expressing them as carbon emissions per \$1m invested. While enabling easier comparison between portfolios, this does make this metric sensitive to changes in the market value of the portfolio.



### Carbon Intensity

Rather than express carbon emissions per \$1m invested, carbon intensity measures the carbon emissions per £1m of sales generated by the portfolio measured over the same period (tCO<sub>2</sub>e/\$m). This is a more accurate measurement of the efficiency of output, rather than a portfolio’s absolute footprint.

### Weighted Average Carbon Intensity (WACI)

WACI measures a portfolio’s exposure to carbon intensive companies. Instead of carbon intensity being calculated at a portfolio level, it is assessed at a company level. The carbon intensity of each company within the portfolio is then multiplied by its portfolio weight, to arrive at the weighted average carbon intensity for the portfolio. Unlike the previous metrics, carbon intensity is apportioned based on portfolio weights rather than the portfolio’s share of market capitalisation. It is simple to calculate and can be used across all asset classes - not just equities. In addition, WACI is the metric preferred by the Task Force on Climate-related Financial Disclosures (TCFD).

### Data Limitations

The level of reporting and quality of carbon data available for different entities varies, but it is continually improving. Where data is not yet available directly, ESG research and rating companies can be used to provide estimates of the emissions.

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<sup>1</sup> Environmental, Social and Governance



Other Analysis

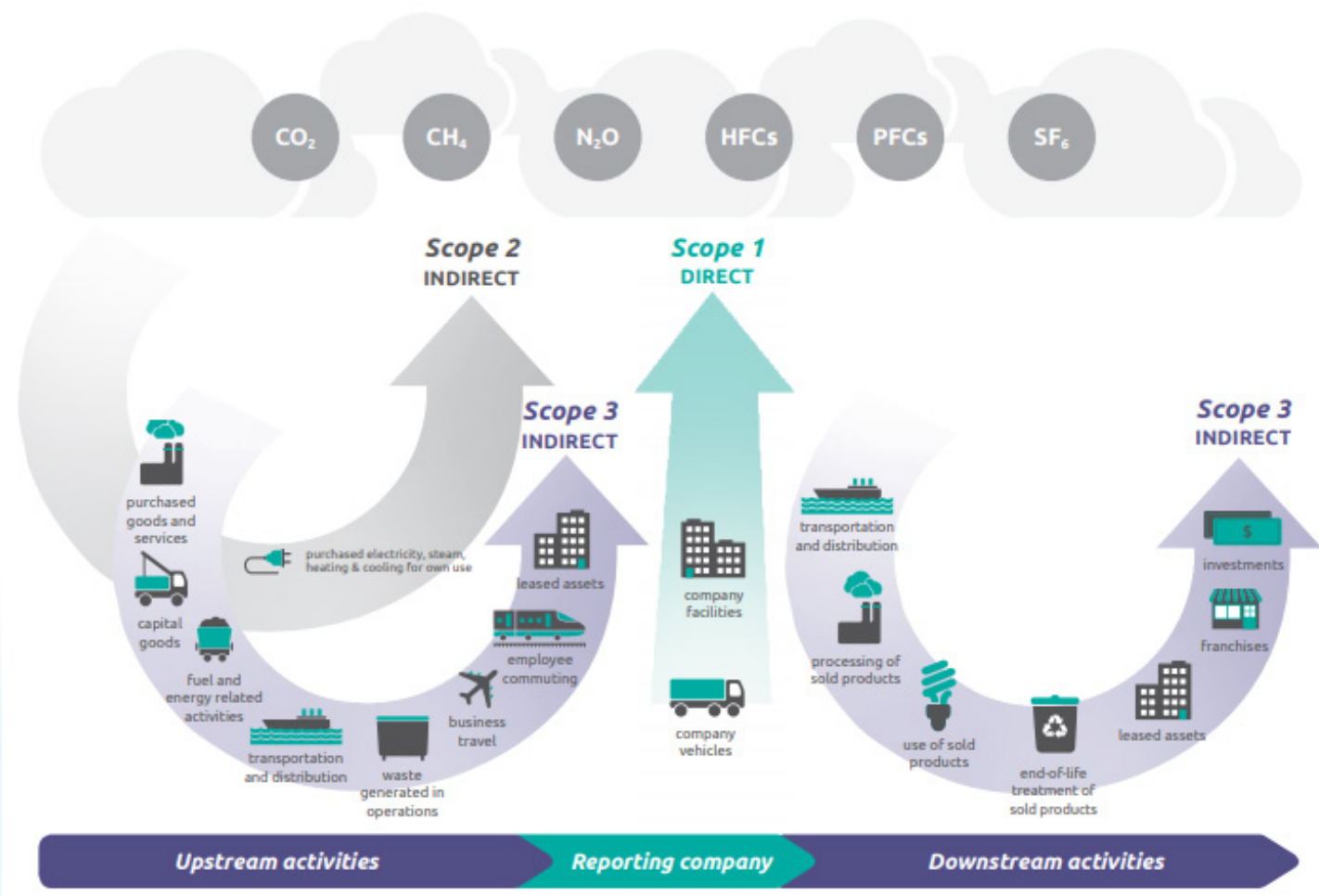
While all of these carbon metrics provide a useful snapshot of the overall carbon exposure of a portfolio, further analysis and metrics are needed to manage climate risk and alignment with Net Zero. A key step would be to set targets for the carbon metrics and then monitor progress towards them over time.

Care needs to be taken when considering how to use the data. This is because two companies with the same level of carbon emissions could still have very different policies for carbon reduction in the future and so may be exposed to very different levels of climate-related risk. Considering metrics on Fossil Fuel Reserves and the alignment of company policies with Net Zero for example, could further assist in reducing a portfolio's climate risk.

Future Developments

New regulations will require UK pension schemes to produce climate reporting in line with the TCFD recommendations. This includes obtaining GHG data (Scope 1, 2 and 3) as far as trustees are able and calculating at least three climate change metrics, including a carbon intensity one. Trustees must then select and monitor a metric against their chosen target. Initially this has been introduced for the largest schemes, with reporting starting for scheme years ending after 1 October 2021 for schemes with assets greater than £5bn; from 1 October 2022 schemes in the £1bn-5bn bracket will also be included. A further review of these requirements is scheduled in 2023, with the expectation that climate change reporting will be further extended to smaller schemes.

Overview of GHG Protocol scopes and emissions across the value chain



Source: Figure 1.1 from the 'Corporate Value Chain (Scope 3) Accounting and Reporting Standard' report - Greenhouse Gas Protocol

How can we help?

BWCI is already assisting clients with the reporting of climate metrics and monitoring these against targets. In addition, a number of our clients have carried out a review of their own DC scheme investment options. As a first step, some have decided to ensure that sustainable investment options, including lifestyle options, are available to members and future reviews are also planned. Other schemes' trustees have already gone further and are incorporating sustainable funds into the default investment option.

We have recently subscribed to Morningstar Direct which is an investment analysis platform. This has enabled us to expand our regular unit fund performance monitoring reporting to include climate metrics for unit funds.

The peer comparison graph below illustrates an example of the type of climate change metrics analysis we are now able to provide.

