INVESTING FOR THE LOW CARBON TRANSITION – TURNING PORTFOLIO TARGETS INTO ACTION

Investor Leadership Network

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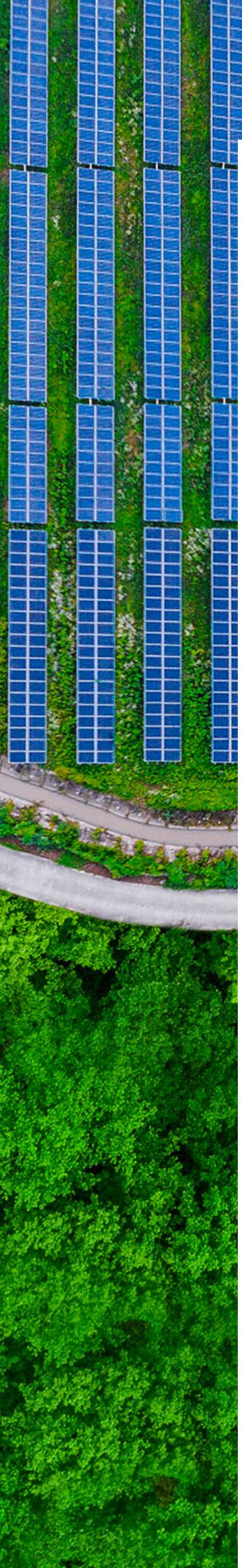

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INTRODUCTION

The transition to a low-carbon economy requires significant capital to enact, estimated at over US$3tn per year on average until 2050[1]. This financing demand presents a tremendous opportunity for the investor community to play a leadership role in the transition, alongside policy developments and consumer behaviour changes. Analysis shows that shifting to a green economy could yield a direct economic gain of US$26tn through 2030 alone[2], providing investors with opportunities to deliver lasting returns to their stakeholders.

This will not be a linear journey for investors and finance alone is not going to solve decarbonisation of the real economy. The transition is both nuanced and complex; portfolio strategies must reflect that it is unlikely that portfolio emissions will decrease incrementally year over year for the next thirty years. Investments in sectors such as energy, infrastructure and real estate require capital to support pivoting business models for the transition. In doing so, these investors can drive real-world decarbonization, although portfolio emissions may initially increase before operational and capital improvements are reflected in the portfolio footprint. In response institutional investors, including ILN members, have signalled their commitment to a low carbon future, and are hard at work turning these ambitions into concrete actions to support real-world decarbonization while maximizing risk-adjusted financial returns. These actions range from identifying the best strategies to progress towards a low carbon portfolio to collecting data on the underlying emissions of portfolio assets and establishing the credibility of portfolio companies' transition plans. ILN members are at the vanguard of this work, and this report provides practical examples of how decarbonization is being put into practice across diverse portfolios.

Investors operate against a backdrop of increasing scrutiny of decarbonization claims, with some constituencies arguing that plans are not doing enough to drive real-world emissions reductions, and other constituencies questioning the role of climate considerations in investment decisions[3]. In response, there is increasing recognition amongst financial sector participants of the need to support lasting change. Mark Carney (UN Special Envoy on Climate Action and Finance) cites that the goal of transition frameworks and supporting tools is "to guide the financial sector to support real-world decarbonization, not the false comfort of portfolio decarbonization."[4] To that end, this ILN Whitepaper provides:

1. A summary of investor challenges in aligning corporate decarbonization goals with portfolio strategies, including trade-offs between immediate action and longer-term approaches.
2. A study of approaches to credible short-term emissions reduction targets that account for the non-linear decarbonization pathways of high-emitting assets.
3. An analysis of strategies available to investors to achieve real-world decarbonization goals.
4. Acknowledgement of external enablers and barriers, and their impact in shaping systemic decarbonization efforts and improving financing flows.

This report builds on existing ILN Thought Leadership including the Net Zero Investor Playbook[5], which synthesized the landscape of relevant investor-specific frameworks and methodologies, along with related implementation challenges and anticipated enhancements in guidance. Extending that Playbook, we hope to drive awareness among the broader investor community of the successes and learning opportunities ILN members have shared as part of their decarbonization journey.

ABOUT THE ILN

Launched at the 2018 G7, the Investor Leadership Network (ILN) champions initiatives and facilitates collaboration across leading global investors who are committed to accelerating the transition to a more inclusive and sustainable economy. The ILN's membership is comprised of 12 global institutional investors across six countries, with over US$10tn in assets under management. This platform encourages members to share resources, expertise and networks to develop, promote and deliver scalable initiatives and solutions on climate change, diversity and inclusion, and sustainable infrastructure. The Investor Leadership Network (ILN) established its Climate Change Advisory Committee (CCAC) to facilitate collaboration among global investors, build on existing guidance and best practices, and promote and operationalize net zero commitments. The ILN's CCAC is dedicated to providing investors and other industry stakeholders with resources and guidance to assess, limit, manage and mitigate the impacts of climate change. The initiative's previously published reports have supported investors in integrating some of the most pertinent climate related initiatives and practices. Each publication has advanced the industry's understanding of climate change impacts and the urgency of investor's involvement in supporting mitigation and adaptation.

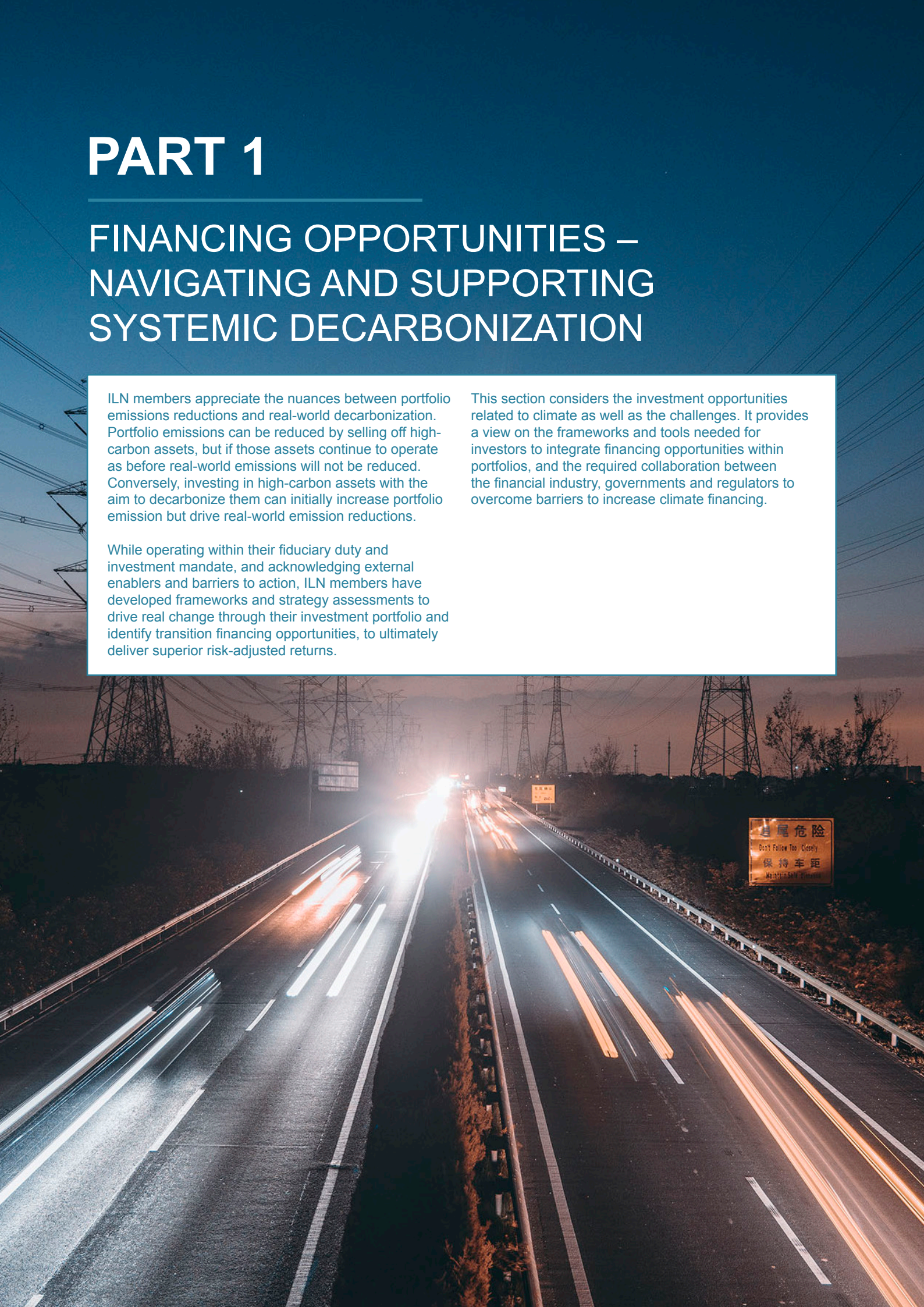
PART 1

FINANCING OPPORTUNITIES – NAVIGATING AND SUPPORTING SYSTEMIC DECARBONIZATION

ILN members appreciate the nuances between portfolio emissions reductions and real-world decarbonization. Portfolio emissions can be reduced by selling off high-carbon assets, but if those assets continue to operate as before real-world emissions will not be reduced. Conversely, investing in high-carbon assets with the aim to decarbonize them can initially increase portfolio emission but drive real-world emission reductions.

While operating within their fiduciary duty and investment mandate, and acknowledging external enablers and barriers to action, ILN members have developed frameworks and strategy assessments to drive real change through their investment portfolio and identify transition financing opportunities, to ultimately deliver superior risk-adjusted returns.

This section considers the investment opportunities related to climate as well as the challenges. It provides a view on the frameworks and tools needed for investors to integrate financing opportunities within portfolios, and the required collaboration between the financial industry, governments and regulators to overcome barriers to increase climate financing.



CLIMATE FINANCE – INVESTMENT OPPORTUNITIES IN A WARMING WORLD

There are tremendous opportunities for investors to accelerate climate financing and drive real-world decarbonization. The need for transition climate finance is estimated be over $3tn per year until 2050[6], while current global financing totals only $630bn per year[7], with less than half coming from private sector actors and financial intermediaries[8].

The need for increased climate finance also highlights the scale of the opportunities for investments with attractive risk-adjusted returns that support systemic decarbonization, while preserving and enhancing the long-term value of portfolios. A focus area for some ILN members is how to identify decarbonization alpha by investing in assets that will outperform the sector-national averages in their decarbonization pathways. It is crucial to develop methods to identify these assets and create conditions for their inclusion in investment portfolios.

Central to this is granular sector-level insight that allows investors to make strategic decisions about investable decarbonization opportunities. Such decisions need to be made in light of regional differentiation of sectors and businesses, and the significant variation in the transition-readiness of businesses within a given geography.

One way for investors to do this is through the development of a clear climate finance framework that has distinct timelines, priorities and financing goals. They also need diagnostic tools; these might include marginal abatement cost curves which show costs or savings expected from different capital expenditure alongside the potential volume of emissions reductions. Some ILN members are also exploring increased participation in blended finance, which seeks to mix public and private capital to leverage financing opportunities for developing countries.

Case Study: PSP Investments – Climate Strategy roadmap and Green Asset Taxonomy

The following case study from PSP Investments illustrates one example of an integrated climate finance strategy, which aims to increase investments in transition opportunities and integrate them into the organization's broader investment roadmap.

Member profile: The Public Sector Pension Investment Board (PSP Investments) manages the amounts that are transferred to it by the Government of Canada for the funding of benefits earned from April 1, 2000 by members of the public sector pension plans of the federal Public Service, the Canadian Forces, the Royal Canadian Mounted Police and, since March 1, 2007, the Reserve Force. The firm invests in a range of asset classes, including capital markets, private equity, credit investments, real estate, infrastructure, natural resources and complementary portfolio. It has CAD$243.7bn in assets under management as of March 31, 2023.

Decarbonization goals: PSP Investments is committed to using its capital and influence to support the transition to global net-zero emissions by 2050. PSP Investments understands the important role that the financial sector can play in addressing climate change, whether it be through investment choices, providing capital to support the transition to global net-zero or encouraging the reduction of GHG emissions among the companies in which it invests. PSP Investments has also announced short-term targets to be met by the end of fiscal year 2026. These include targets aimed at:

- Increasing investments in Green Assets to CAD$70bn from a CAD$40.3bn baseline in 2021.
- Increase investments in Transition Assets to CAD$7.5bn by 2026 from a CAD$5.1bn baseline in 2021.
- Ensuring that assets representing 50% of PSP Investments' carbon footprint will have commitments to implement mature, science-based transition plans.
- Reducing holdings in Carbon Intensive Assets that lack transition plans by 50% from a CAD$7.8bn baseline in 2021.
- Undertaking efforts to obtain GHG data for 80% of its in- scope portfolio of its carbon footprint.
- Steering at least 10% of PSP Investment's long-term debt financing toward sustainable bonds.

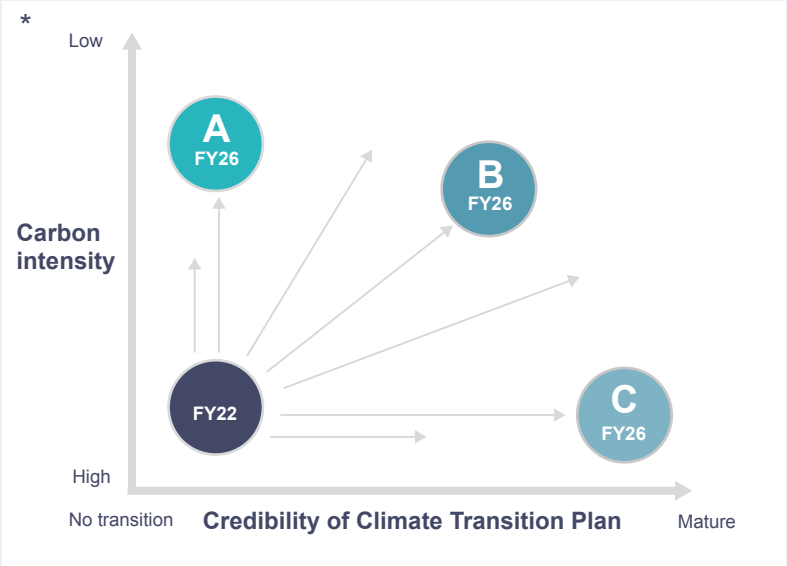
PSP Investments anticipates reducing portfolio GHG emissions intensity by 20-25% by 2026 (relative to a September 2021 baseline) by executing its climate strategy.

Process: The PSP Climate Strategy Roadmap lays out climate finance priorities including increasing investments in assets that support climate mitigation and adaptation, and reducing PSP Investments' exposure to carbon-intensive investments that don't have transition plans. PSP Investments also commits to engage with portfolio companies to encourage carbon footprint reductions, the adoption of science-based transition plans and the uptake of disclosure practices aligned with the Taskforce on Climate-related Financial Disclosures (TCFD).

To continue to evolve its climate measurement methodology and management approach, PSP Investments has developed an in-house classification system, called the PSP Investments Green Asset Taxonomy ("Taxonomy"), to establish its portfolio baseline and assess exposure to green, transition and carbon-intensive assets. Launched last year, the Taxonomy is a tailored, two-dimensional climate alignment framework. This Taxonomy considers two of the key variables of climate investing: carbon intensity and the credibility of a company's transition plan.

Case Study: PSP Investments – Climate Strategy roadmap and Green Asset Taxonomy

Outcome: Since the calculation of the portfolio baseline emissions, PSP Investments has been using the Taxonomy to not only assess exposure to the different categories of the Taxonomy but also to monitor progress over time. The Taxonomy allows for a range of monitoring lenses, including changes in GHG intensity over time, and development or increasing credibility of transition plans. It also allows for monitoring progress at multiple levels including total fund, asset class, partners and underlying asset.



PSP Investments aims to use the Taxonomy to prioritize engagements (where appropriate),for example, by putting a greater focus towards supporting portfolio companies on transition planning and the implementation of science-based targets especially when assets are categorized as carbon intensive.

PSP Investments is also working to incorporate material climate change considerations into its portfolio construction process. In collaboration with the office of the Chief Investment Officer (CIO), PSP Investments has started to forecast the Taxonomy against the projected AUM of the fund, until 2050. This effort is aimed at establishing a top- down approach to achieving climate strategy objectives and ensuring continued focus on execution.

*PSP Investments Green Asset Taxonomy, p.11 : https://www.investpsp.com/media/filer_public/03-our-performance/03-ri-report/pdf/Green-Asset-Taxonomy-Whitepaper.pdf

ACKNOWLEDGING SYSTEMIC ENABLERS AND BARRIERS

Systemic enablers and barriers can have a significant impact on the ability to realize climate financing opportunities and influence the tools required by investors to achieve ambitious decarbonization goals. This section explores two critical areas to navigate that can act as both barriers and enablers: public sector initiatives and data limitations.

Government Initiatives and Guidelines

One example is the need for clear guidance from national and international bodies through policy roadmaps and incentivization. Policy commitments and sectoral pathways, such as a committed timelines for coal decommissioning, provide investors with the signals they need to support long-term investment in decarbonizing sectors and economies.

Governments and public actors in certain regions and sectors have shown a willingness to support and leverage private capital, which can serve to enable green finance on the private side. For example, some states in the Asia-Pacific region have designated significant public capital to improving climate infrastructure, specifically in the energy and transportation sectors[9]. These public initiatives to support private capital have helped East Asian governments avoid crowding out of private capital which can affect investments in climate technology and infrastructure[10]. Similarly, the Inflation Reduction Act (IRA) passed in the United States is designed to mobilize private capital towards sustainable investments rather than increase direct government spending toward climate initiatives.

DATA LIMITATIONS

Significant dependencies remain on the quality and coverage of reported data and methodologies that can affect the ability of investors to set and monitor decarbonization targets. Once high-quality data is collected from third party vendors or directly from companies (an extensive activity in itself) investors must then synthesize and use it effectively, considering that third party data is backwards-looking and there may be need for a blended approach, to overlay and validate more timely sources of insight. The growing market for ESG data, including climate change-related metrics such as GHG emissions - now estimated at over $1bn per year - provides broad coverage for public assets but still has gaps in data availability for private assets, where significant opportunities for real-world decarbonization can be found. ESG data also brings methodological differences, and a wide variety of possible use cases, which can create divergent outcomes that may not be fully understood by all parties within an organisation or its stakeholder landscape.

The promising news is that the continued growth of the data market and increased standardization are creating more high-quality data for investors than ever before. The International Sustainability Standards Board (ISSB) inaugural IFRS S1 and S2 disclosures standards aim to increase depth and comparability of company sustainability disclosures while creating a single access point for data, metrics and targets. These standards are also expected to form the basis for national-level regulation regarding climate-related financial disclosures. Taken together, these developments allow for increased comparability between sectors and investments, while the increasing scope of Partnership for Carbon Accounting Financials (PCAF) standards is creating a unified methodology for financial services firms to calculate their firm-wide financed and facilitated emissions, even in the absence of individual asset emissions data.

To build on this progress, investors are continuing to work directly with investee companies where their mandates and strategies allow, while developing their internal capabilities to critically assess third party datasets and external ESG ratings. As the largest buyer of ESG data, asset managers in particular can use their buying power to encourage the development of standards that align with investment and sustainability goals.

Investors also need to reflect the potential for a disorderly, hotter world in their portfolio strategy. Increased transition risk assessment planning at country level and a bottom-up asset and sector-level view will be necessary for investors to account for possible transition impacts including sharp increases in carbon prices and stranded assets. Accessing this granular information advantage requires capabilities such as assessing whether company transition plans are credible.

PART 2

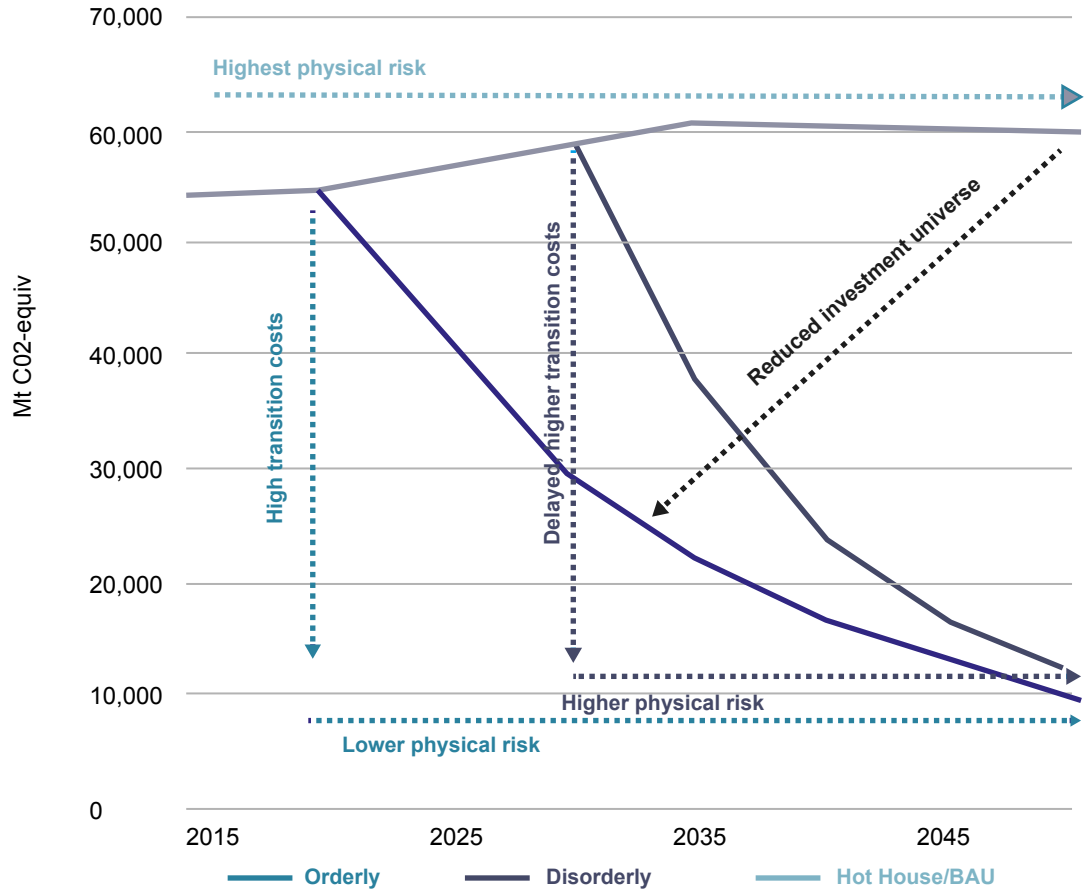
DELIVERING PORTFOLIO AND REAL-WORLD DECARBONIZATION - EXPLORING GOALS AND TRADE-OFFS

In navigating the current pathway of real-world decarbonization, investors and portfolio managers face a range of decisions when considering how to meet and contextualise portfolio goals. Investors need to evaluate their ability to meet specific risk, return and diversification metrics while aligning themselves with decarbonization goals.

Decisions will be influenced not only by portfolio strategies and capabilities, but also by overlaying a view on the real-world trajectory. For example, many ILN members are using tools and data such as transition risk assessment planning at country level and a bottom-up asset and sector-level view, to account for the potential for delayed or failed climate action and impacts to the investment universe from a disorderly, hotter world. As shown in Figure 1 below, a disorderly transition may translate into higher transition and physical risks at the portfolio level, if steeper emissions cuts across regions and geographies are required to meet global climate goals[11].

One way to manage these risks is to form a 'house-view' on the global transition trajectory. This provides a view of when and where to invest and informs decision making on approach but requires the capabilities and data to analyze granular market and sectoral level insights.

Figure 1: Transition pathways and portfolio risks



This highlights that decarbonization may not be a linear journey for investors. The transition is nuanced, and portfolio strategies must reflect this; it is unlikely that portfolio emissions will decrease incrementally year over year for the next thirty years. Active investors, especially those that focus on private assets, may wish to seek out under-priced, carbon-intensive investments with an aim to decarbonize these assets given their ability to direct operational changes and implement strategies which focus on medium term value creation. Investments in sectors such as energy, infrastructure and real estate require capital to support pivoting business models for the transition. In doing so, these investors can drive real-world decarbonization, although portfolio emissions may initially increase before operational and capital improvements are reflected in the portfolio footprint.

Those investors with a passive or index-focused mandate can plot decarbonization paths through the addition and substitution of certain companies from market indices and are more reliant on economy-wide decarbonization progress and associated policy changes. As index managers cannot guarantee decarbonization in the tracked index, engagement is their primary approach. Their engagement strategy can be designed to enhance disclosure in the expectation that markets will price in climate risks.

SETTING AND MONITORING SHORT-TERM TARGETS AND REALISTIC PATHWAYS TO MANAGE DOWN EMISSIONS

A key task for investors is translating overall decarbonization goals into interim portfolio targets that reflect a realistic pathway, particularly for investors who target high carbon assets in the immediate term with the goal of financing their decarbonization and maintaining alignment with their investment mandates. Approaches to track and communicate interim targets can vary considerably as targets can be measured in multiple ways; various metrics can point to different aspects of the underlying decarbonization.

One approach used by ILN members is to combine multiple metrics into an integrated goal-setting framework with successive interim goals. This approach helps support informed decision making and identification of real-world decarbonization, while successive interim goals ensure the organization and underlying portfolio stay on track and meet their portfolio goals.

Case Study: OMERS – Approach to goal setting

Despite these challenges associated with this multi-tiered approach, setting impactful interim goals and tracking metrics that acknowledge fluctuations due to underlying asset changes provide an importance yardstick against which investors, managers and regulators can measure progress. ILN members are increasingly incorporating multiple metrics into their goal-setting strategy, including OMERS, who have developed a bespoke methodology that incorporates carbon footprint, Weighted Average Carbon Intensity (WACI), and future emissions projections to align portfolio planning with long-term decarbonization goals.

Member profile: OMERS (Ontario Municipal Employees Retirement System) is a Canadian investment firm that manages investments on behalf of the pension plan for Ontario's municipal employees. Its investment focus is global, and it invests in various asset classes including fixed income, public and private equity, infrastructure and real estate. OMERS has CAD$121bn in assets under management.

Decarbonization goals: OMERS has a target to reduce the carbon footprint of its infrastructure investments by 50% by 2025. Based on two years of carbon footprint and WACI data, and an understanding of the key drivers of its footprint, OMERS first set a preliminary 2025 reduction goal, followed by its net zero commitment by 2050.

Process: OMERS is taking a proactive and comprehensive approach to lowering its portfolio GHG emissions, aligned with the initiatives of globally recognized net zero frameworks for asset owners and managers. OMERS has developed a bespoke methodology that accounts for differences across Business units and incorporates granularity in emissions profiles at a sector and regional level across investments, including:

- **Projecting business-as-usual (BAU) emissions:** Carbon intensity projections were developed through 2030 under different capital allocation scenarios for each business unit.
- **Establishing emissions reduction trajectories:** For each sector and region in which OMERS is invested, possible 2020-30 trajectories were determined based on representative climate transition pathways. The pathways were developed using credible, publicly available climate scenarios and accounted for varying levels of emissions reduction across sectors and regions. As appropriate, OMERS leveraged credible emissions reduction commitments and initiatives from selected portfolio companies.
- **Forecasting emissions reduction potential:** Using the identified emission reduction trajectories, OMERS approximated the degree to which various sectors and regions may decarbonize by 2030. Combining this information with various capital allocation plan scenarios provided projections of possible future emissions reductions for the total plan.

OMERS portfolio emissions forecasting and target-setting tool supports the above steps. This tool added significant rigour to its target-setting exercise and enabled the testing of multiple investment scenarios for each business unit.

Outcomes: When determining OMERS' 2030 interim carbon reduction goal, the rigour of this approach allowed it to:

- Isolate the key drivers that impact future WACI
- Develop a range of possible assumptions for each of the key drivers
- Chose how aggressive or conservative to be with each assumption when determining the final interim goal
- Ensure actual emissions are being tracked against projections
- Provide blueprint for set future interim goals using consistent methodology

LEVERS AVAILABLE TO DELIVER PORTFOLIO ALIGNMENT

There are a range of decarbonization levers that investors can use to shape their assets' decarbonization journey. The task is to choose the appropriate mix of levers to align with their decarbonization goal, asset allocation, investment strategy and level of climate maturity of the individual assets themselves.

Not all levers are appropriate for all investors or investing strategies, with ILN members selecting a mix of strategies. For private assets and other direct investments, the focus may be on operational changes and capital allocation, while for passive strategies, it may be more on executive engagement, disclosure, and collective dialogue. While a number of frameworks are available, decarbonization levers tend to fall into three main approaches: capital allocation, engagement, and collective investor action and dialogue.

Figure 2. Indicative impact of decarbonization levers

Lever	Approach	Real World impact	Portfolio impact
Capital Allocation	Primary market investments in green tech/climate solutions	●●	●
	Invest in decarbonizing assets or those in sectors with high transition impact and demonstrated appetite to decarbonize	●●●	●●
	Portfolio tilit – integrating exclusions for high-emitting sectors or tiliting away from higher-emitting sectors/transition laggards	●	●●●
Engagement (portfolio dependent)	Incorporating decarbonization reporting into engagement strategies	●●●	●
	Engage with clients or portfolio companies to build awareness of need for transition planning and science-based targets	●●	●●●
Collective action and dialogue	Climate policy engagement with policy-makers, institutional organizations and regulators	●●●	●
	Collective industry action	●●	●●
	Measure and report on progress, disclosing material financed emissions and plans	●	●●

The approach chosen by investors is likely to incorporate these levers to varying degrees and at different time horizons depending on factors such as investment mandate, ambition, view of the trajectory and external enablers and barriers.

Case Study: Ontario Teachers' – Decarbonizing our portfolio and prioritizing levers

Regardless of the levers chosen, it is critical for investors to integrate them into the portfolio planning process early, especially given the long lead times between initiation and results for many levers. Starting the dialogue early with operational managers and integrating decarbonization and climate change consideration into ongoing review can ensure the smoothest decarbonization journey, with ILN members such as Ontario Teachers' Pension Plan (Ontario Teachers') integrating engagement, among other levers, into their planning and emissions reduction process.

Member profile: Ontario Teachers' is one of Canada's largest pension plans, with CAD$247.2bn in net assets as of December 31, 2022. The firm invests in a range of asset classes, including public and private equities, fixed income, real estate, infrastructure and natural resources. Ontario Teachers' aims to deliver retirement security to its members while seeking positive environmental and social outcomes.

Decarbonization goals: Ontario Teachers' has set a target to reduce the carbon footprint of its investments 45% by 2025 and 67% by 2030. In 2021, Ontario Teachers' set a target to align the portfolio companies in which it has significant stakes (minority or control) to a credible net zero by 2050 plan, or what it is calling a "Paris Aligned Reduction Target" (PART).

Process: Through collaborating with and providing resources to portfolio companies, Ontario Teachers' has made progress since PART's inception in 2021, including creating a decarbonization playbook, with detailed guidance on:

- The case for change, including board and management education
- Carbon footprint baseline development
- Decarbonization lever identification and assessment
- Target setting, validation and communication
- Guidance on what a credible net-zero plan entails based on internationally recognized standards and initiatives.

Outcomes: Ontario Teachers' bolstered carbon emissions reporting to cover 88% of emissions in its direct private portfolio, up from 37% in 2019. Ontario Teachers' are now engaging a first wave of select portfolio companies to implement the decarbonization playbook and have prioritized those companies based on their share of emissions and ownership stake. This helps Ontario Teachers' focus efforts on the highest-emitting companies to maximize impact where it has actionable influence over emissions.

Case Study: State Street Global Advisors – Providing optionality to index clients

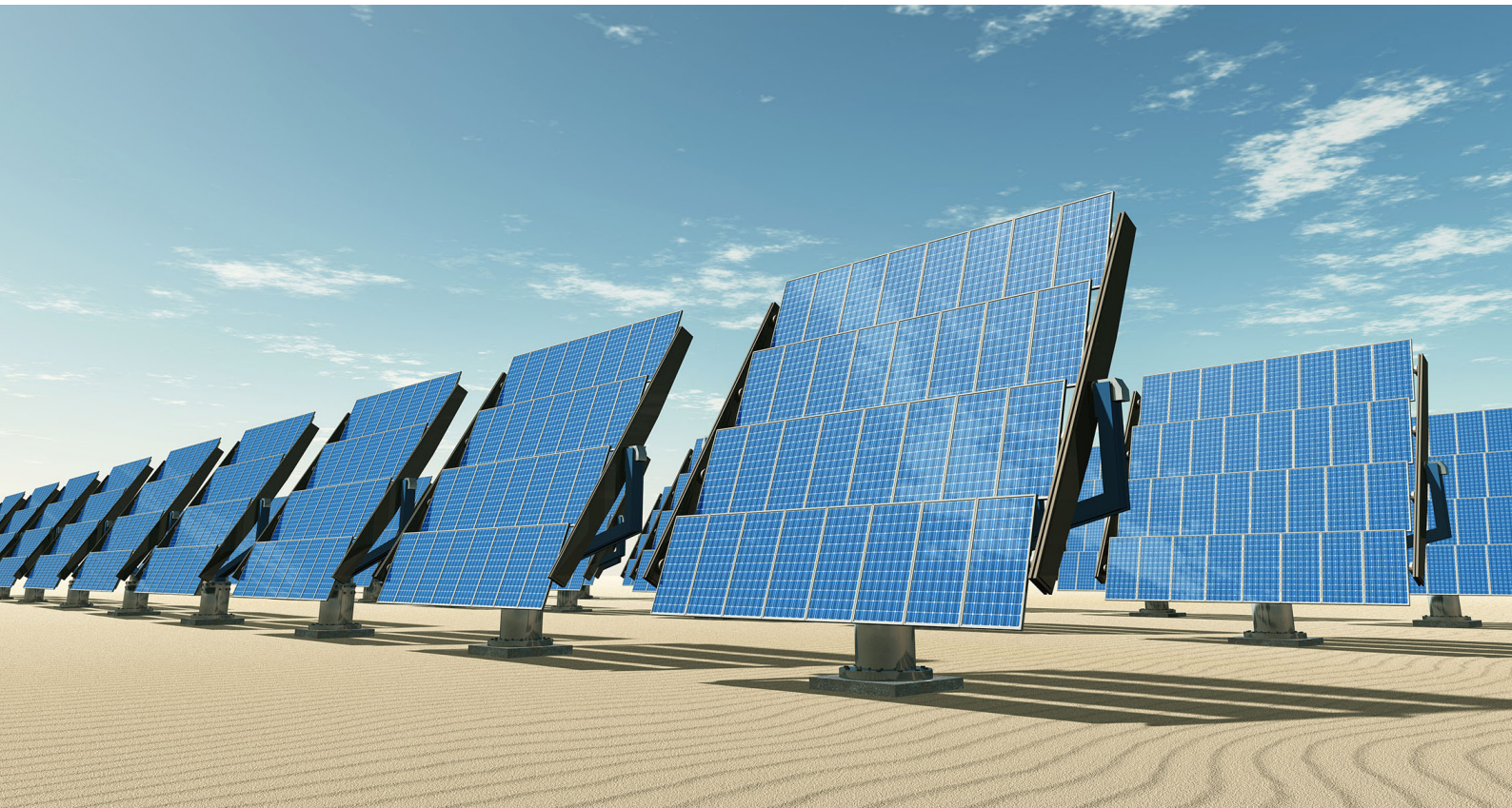
As one of the largest passive managers in the world, State Street Global Advisors (SSGA) occupies a key position between public and private spheres. SSGA aims to provide investors with a range of investment options so that clients can select the strategies that reflect their investment need.

Member profile: SSGA is the asset management arm of State Street Corporation. It is one of the world's largest asset managers, responsible for over $3.48tn in assets under management (as of December 31, 2022). The firm partners with many of the world's largest, most sophisticated investors and financial intermediaries to help them preserve and create value through a rigorous, research-driven investment process that spans both indexing and active investment disciplines. SSGA invests in a range of asset classes, including equities, fixed income & cash, multi-asset and alternative investments such as private equity, hedge funds and currency. SSGA is known for creating the first US ETF and are pioneers in index, active and ESG investing. SSGA is a signatory to the Net Zero Asset Managers Initiative.

Decarbonization goals: As an asset manager whose book of business significantly involves index tracking portfolios, SSGA faces particular challenges in decarbonizing its portfolios. Clients choose the index they wish to gain tracking exposure to and SSGA generally has limited influence on that decision. In that context, SSGA has a fiduciary duty to clients to track the index they are mandated to as accurately as possible. If this index includes high emitters or companies that do not align with the Paris Agreement, then SSGA is still required to invest in those companies on behalf of the fund or client for which it is acting as those companies are part of the index.

Process: Where clients choose to adopt decarbonization targets into their portfolios, SSGA offers capabilities to track third party climate indexes. SSGA also offers low carbon or climate-aligned strategies to clients (both index and active), alongside a range of ESG options to meet clients' requirements. Nevertheless, it is expected that a large part of SSGA's business will remain in non-aligned indices and therefore stewardship and engagement are important tools. Given SSGA's business model, the aggregate portfolio broadly reflects the market, and their perspective is that of a "universal owner" of assets. This means that real economy carbon emissions reductions, across all sectors and all regions, are critical for SSGA's ability to meet Net Zero goals by 2050.

Outcomes: SSGA conducts engagement and advocacy across the investment ecosystem (including with investee companies, clients, index providers, regulators and policymakers). SSGA prioritizes issuer (real economy) emissions reduction over portfolio emissions reductions and chooses engagement over divestment. SSGA believes that constructive engagement and stewardship with the companies it is invested in will drive greater transparency and disclosure of effective energy transition plans.



CREDIBILITY CHECK – EVALUATING THE FEASIBILITY OF TRANSITION PLANS AND TARGETS

A key tool for delivering portfolio goals and real-world decarbonization is assessing the ambition and credibility of company transition plans. Long term commitments, such as net zero by 2050 can be difficult to assess given the decades-long lead time, while near-term plans can involve ambiguities in scope, methodology and treatment of offsets.

While individual assessment frameworks differ, Credible Transition Plan (CTP) assessments combine publicly available data with sector-specific insights and additional detail (both qualitative and quantitative) collected through bilateral company engagement to determine the feasibility of a company's transition plan[12].

Using a mature credibility framework showcases the routes to decarbonization, highlighting the most efficient actions and sequence, as well as trade-offs between speed and costs. It also lets other stakeholders, such as investors, track progress. ILN members are creating their own CTP frameworks, many of which incorporate guidance from external organizations such as the Net Zero Investment Framework Supplementary Target Setting Guidance[13] from the Institutional Investor Group on Climate Change (IIGCC) and the GFANZ Recommendations and Guidance for Net Zero Transition Plans[14]. National regulators are also developing their own transition plan requirements based on this guidance, including the UK's Transition Plan Taskforce[15](TPT)

These frameworks supplement target verification approaches, such the Science Based Targets Initiative's (SBTi) Target Validation Protocol, which focuses on the decarbonization outcome and timeline rather than actually charting the specific route and associated cost for getting there. While both approaches are important, the purpose of a well-designed credibility framework is to provide guidance at a company level on which actions to take, and in which order. For investors, evidence of robust transition planning is a helpful indicator of genuine decarbonization potential.

Some investors may look for companies with the potential to decarbonize but whose plans lack ambition or specificity and work to unlock hidden value through credibility checks. Other strategies involve looking at the financing pathways for decarbonization to predict the predicted future value of a company and using the insights to drive excess returns. In both cases credibility checks can generate insights and value for investors.

In addition, many investors have begun examining capital expenditure (Capex) and operating expenditure (opex) spending by companies in order to evaluate the credibility of their transition plans. Some ILN members are also using Marginal Abatement Cost Curves (MACC) to assess and rank the long-term economic viability of decarbonization investments and operational changes.

Case Study: CPP Investments – Abatement Capacity Framework

CPP Investments' Abatement Capacity Framework was developed with the goal of addressing information gaps for investors and boards, who require concrete disclosure from companies and their management about a company's ability to abate GHG emissions.

Member profile: CPP Investments is a global investment management organization that manages investments on behalf of the Canada Pension Plan. CPP Investments invests in a range of asset classes, including public and private equities, real estate, infrastructure and fixed income. The firm's key stakeholders are Canadian contributors and beneficiaries of the CPP, and it has over CAD500bn in assets under management.

Decarbonization goals: In February 2022 CPP Investments committed its portfolio and operations to net zero GHG emissions across all scopes by 2050. This commitment was made on the basis and with the expectation that the global community will continue to advance towards the goal of achieving net-zero GHG emissions by 2050. These advancements include the acceleration and fulfillment of commitments made by governments, technological progress, fulfillment of corporate targets, changes in consumer behaviours, and development of global reporting standards and carbon markets. To assess the ability of companies to meet their decarbonization goals, CPP Investments developed an Abatement Capacity Framework and standardized template for assessing a company's potential and ability to decarbonize. By providing standardized disclosure about a company's current and projected ability to abate its GHG emissions based on current pricing, technology and regulations, the framework provides investors with a greater degree of confidence in a company's commitment and ability to transition. It is also a mechanism for helping companies take the first steps in assessing their capacity for reducing emissions.

An Abatement Capacity Assessment Framework provides a standardized template for companies to identify and report all sources of GHG emissions and calculate the economic viability of abating those emissions under different carbon price scenarios.

For corporate boards and management

- Enables development of transparent and credible plans to achieve net-zero goals.
- Allows identification of emissions-reduction and cost-saving opportunities that might otherwise have been missed.

For investors

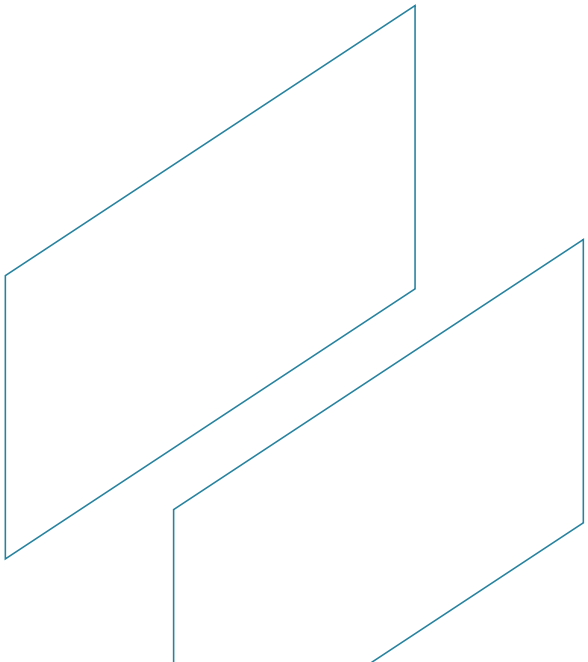
- Enables greater confidence in the credibility of corporate net-zero plans and long term viability of companies.
- Facilitates better capital allocation decisions.
- Provides a standardized procedure that allows comparisons across companies, and geographies.

For regulators

- Helps prioritize new rules.
- Provides a complement, rather than a standalone exercise, to the recommendations of standard-setting bodies like the International Sustainability Standards Board (ISSB).

For innovators

- Helps guide their research priorities.



Case Study: CPP Investments – Abatement Capacity Framework

Process: The Abatement Capacity Framework has three basic steps:

- **Determine current (proven) Projected Abatement Capacity:** The first step for a company is to add up its current emissions and estimate how much of those emissions are economic to abate with currently available, proven economic technologies. For example, a cement plant may be able to eliminate 100% of emissions associated with its electricity consumption by switching to renewable electricity, but most of the emissions from its kilns cannot be reduced cost-effectively with the technologies currently available. Scope 3 emissions are the most challenging for companies to assess since their inclusion would require suppliers and customers to provide abatement capacity assessments for their own Scope 1 and 2 emissions. Methods for assessing Scope 3 emissions, while avoiding double counting and ensuring the integrity of the data, are being finalized. Until this is resolved, CPP Investments believes companies should prioritize assessing their Scope 1 and 2 emissions.

- **Assess the long-term (probable) Projected Abatement Capacity:** The uncertainties associated with technology costs, the pace of innovation, regulatory regimes, and carbon prices make it difficult to standardize methods of assessing future abatement capacity. To cope with this complexity, CPP Investments assumes no change to today's technology costs and regulations but uses standardized carbon prices that are higher than current levels. The original Framework used US$75 and US$150 per metric ton of carbon dioxide equivalent (tCO2e) to create two scenarios for determining future abatement capacity. After recent price increases in the European Union, the framework is being updated to US$100 and US$150 per tCO2e. The use of a carbon price of US$150/tCO2e, which currently may seem high, could provide additional visibility on the ability of companies to further abate their emissions. However, in addition to these carbon prices, companies could also consider using internal shadow prices that they would select based on their own unique situations.

- **Determine uneconomic Projected Abatement Capacity:** CPP Investments believes that the Framework will enable companies to identify opportunities to cut emissions. Some may even find that emissions can be cost-effectively brought down to net zero at various prices of carbon. However, others will find that some emissions are uneconomic, or even technologically impossible, to eliminate. Those residual emissions could then be reported along with management's assumptions on how they will eventually address the issues. Possible strategies could include the managed decline or shuttering of business activities, relying on further technology development, or purchasing high quality carbon removal credits.

Outcomes: Since introducing the Framework, CPP Investments has conducted successful pilots with more than ten of its portfolio companies, with encouraging and informative results. The framework is helping identify and quantify the emissions-reduction opportunities for select companies in CPP Investments' portfolio.

Case Study: Ninety One – Transition Plan Assessment

While it can be difficult to measure the sufficiency of capital expenditures in relation to scenario alignment, the comparison between targets and actual spending can paint a detailed picture of a company's priorities. Ninety One's Transition Plan Assessment (TPA) is an example of an integrated credibility check that applies a financial lens to assess transition plans.

Member profile: Ninety One is a global asset manager with South African roots that offers a range of investment solutions, including equities, fixed income, multi-asset and alternative investments. It has a presence in over 20 countries and serves a diverse range of clients including pension funds, insurance companies and sovereign wealth funds. Ninety One is a proud investor in emerging markets and often publishes thought leadership on investing for a just transition. Ninety One has GBP143.9bn in assets under management.

Decarbonization goals: Ninety One has set a target to reduce the carbon footprint of its investments by 50% by 2030 and has several climate change-focused funds including a Climate Transition fund. As shareholders, Ninety One has a critical role to play in motivating portfolio companies to set ambitious, credible and feasible transition plans. There is also a need to assess and engage companies on the key indicators of a plan to better understand the transition risks and opportunities Ninety One's investments. As part of its approach to delivering "sustainability with substance", Ninety One focuses on assessing and engaging the highest contributors to financed emissions to drive change and manage risks.

Process: Ninety One's proprietary TPA tool has been adopted by the investment teams to assess the transition risk and potential of companies. The tool is built upon three key pillars: level of ambition, credibility of plan and implementation of plan:

A TPA is carried out for the highest contributors to financed emissions, with sectoral and regional modifications made to tailor assessments to each company. The TPA tool uses indicators derived from mature disclosure and measurement frameworks, including the Climate Action 100+ benchmark, Transition Pathway Initiative, CDP climate data, Influence Map and IIGCC guidance. The tool builds on these frameworks to incorporate, or emphasize, factors that Ninety One considers imperative for a successful transition, such as the financial viability of the plan or the approach to just transition, and explicitly seeks to avoid rewarding companies using divestment to achieve their emissions targets. Ninety One has also developed a light-touch version of the TPA using a subset of the indicators from the full TPA. This is used by investment teams, which are integrating it into their investment analysis to assess the transition risk and potential of other material emitters within their portfolios.

Case Study: Ninety One – Transition Plan Assessment

Outcomes: The output of the assessment identifies key risks that Ninety One as shareholders should be aware of and sets the stage for engagement with the underlying company to encourage it to set decarbonization targets. The TPA has assisted Ninety One in making progress towards 2030 targets, with 8.5% of financed emissions and 26.4% of corporate AUM having set science-based transition targets. It is anticipated that higher-emitting companies will make slower progress towards a transition than those in asset-light industries — particularly as SBTi methodologies have not yet been developed for some high-emitting sectors such as oil and gas. Ninety One continues to focus on real-world decarbonization challenges and looks to engage with its top emitting companies to encourage them to deliver on transition plans. Since the launch of this tool, 31 companies have since been assessed of which 15 are located in emerging market companies.

EFFECTIVE ENGAGEMENT – MAKING AND MONITORING PROGRESS

Effective engagement is a critical focus for many investors given the importance of management support for successful decarbonization plans. Engagement is a broad umbrella that covers a variety of specific strategies across public and private assets, with specific tactics including the inclusion of emissions metrics in strategy and planning and linking remuneration to selected climate goals.

Shareholder resolutions and routine annual voting can be an engagement lever for investors by drawing attention to climate concerns. Voting to put climate change on management's agenda, and to follow basic disclosure requirements can have powerful effects by allowing the market to price a company's exposure and planning for future climate change. For companies that are lagging in the transition, influencing strategies and transition plans can encourage them to increase the scope of their ambition and move ahead of market peers. There have been some notably successful engagements in the past few years, with large shareholders backing more ambitious climate change plans at National Grid, TotalEnergies and Shell in the second quarter of 2023, and demonstrating large institutional support for serious engagement and effective transition plan monitoring. The appropriate engagement path depends on the investor's strategy, level of control and influence, and maturity of the asset along the decarbonization journey. Public engagement strategies also need to take into account the relevant cultural context when working with management. Especially in developing countries, ILN Member Ninety One has found it critical to understand cultural context to achieve the most effective engagement. Some business cultures require introduction to the board as a precondition for successful engagement, while in other cultures direct engagement with sustainability teams can prove a more effective route. Building this support is critical, as management can cite any number of cost reasons for not pursuing decarbonization if they are not aligned with the broader strategy. By working with management to develop buy-in, investors can help create value for the individual assets, and create big "wins" for companies themselves.

For investors with some level of operational control, whether through size of the stake or private ownership, being able to directly shape transition plans can be a significant value-add for both parties. Many companies are supportive of the insight that can be provided by experienced institutional investors. Given the difficulty of creating a compelling decarbonization plan for some companies and industries, investors can use their expertise and higher-level view to create a two-way engagement conversation, sharing insights and best practices while integrating feedback from their investee companies, especially recognizing the challenges faces by some sectors and regions, including investments based in emerging market economies that still require transitional finance to move away from coal-based energy.

As an example of this, Nintety One's portfolio includes large stakes in companies in emerging market economies such as South Africa, and they have worked directly with management and executive boards to advance the ambition of their decarbonization journeys, while understanding the underlying context of emerging market economies that require different decarbonization pathways than European or North American markets. These pathways see adoption of decarbonization strategies that add capacity while including a slower phase-out of fossil fuel use, and the use of transition fuels to move away from coal use ahead of a slower renewable buildout, while meeting the demands of a growing economy and consumer base.

On the investor side a key question is the priority of engagement, and whether the most difficult to transition investments should be dealt with first. Alternatively, investors can focus on "low hanging" fruit. Despite widely different investment strategies and asset bases both State Street and Ninety One have chosen to focus on engaging the highest emitters first. Other ILN members have adopted a combination of strategies depending on their portfolio and investment remit.

Case Study: Nordea – Investing with a view to enabling the transition

Additionally, Nordea's Global Climate Engagement strategy is an example of ILN members using a broader decarbonization framework and multi-sector approach to drive climate finance opportunities.

Member profile: Nordea Asset Management (NAM) is a European asset manager with global presence and a long history in responsible investing. NAM services a broad range of pension, insurance and other institutional and wholesale clients, offering them equities, fixed income, multi-asset and alternative investment solutions. NAM is a founding signatory of NZAM and has offered climate investment solutions since 2008.NAM has EUR239bn in assets under management.

Decarbonization goals: As a signatory to Net Zero Asset Managers Initiative, NAM is committed to supporting the goal of net zero greenhouse gas emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5°C. NAM's short-and mid-term targets work towards this overall ambition, through complimentary top-down and bottom-up approaches:

- An organizational-wide 2030 target to achieve a 50% reduction in the weighted average carbon intensity (WACI) of investments.
- Portfolio-specific carbon footprint reduction targets in line with sector-specific 1.5°C pathways.
- A target to ensure NAM's top 200 biggest carbon footprint contributors are engaged to become 1.5°C aligned.

Process: NAM focuses its efforts on increasing Paris alignment amongst investees. One example is its Global Climate Engagement strategy. The strategy invests in companies in high-emitting sectors which are essential to the economy yet typically lagging the green transition such as energy, utilities, chemicals for instance. However, NAM believes that these companies is in a good position to decarbonize faster than their peers and that the market has not yet recognized this. There are two key steps that may unlock their real value: making and implementing commitments to change – backed by science, and ensuring the market understand these actions – which requires full transparency. NAM's engagements focus on achieving these steps in a structured way, with specific KPIs thus giving companies the necessary nudge to move faster along their transition journey.

Outcomes: Once NAM recognises that an investee company achieves its engagement / decarbonisation targets and this is recognised by the market, capital will be reallocated to invest into other high emitters in the universe. Because of this active approach, the fund's emissions are expected to fluctuate around a downward-sloping trend line. The long-term goal for the strategy, and for NAM, is to reach the net zero target while taking a more active approach than the more traditional top-down portfolio tilting towards lower emitting sectors and companies.

ENCOURAGING A RESPONSIBLE AND MANAGED DECLINE OF ASSETS

All portfolio and investor decarbonization targets envisage a decrease in the amount of emissions attributable to an owner's investment decisions. However, portfolio emissions are unlikely to decrease incrementally year over year given changes in asset allocation and the need to invest in decarbonization solutions.

Active investors, especially those that focus on private assets, may wish to seek out underpriced, carbon-intensive investments with an aim to decarbonize them given their ability to direct operational changes and implement strategies which focus on medium term value creation. Investments in sectors such as energy, infrastructure and real estate require capital to support transitioning business models. These investors can drive real-world decarbonization, but with the consequence of an initial increase in portfolio emissions before improvements in emissions performance are reflected in the reported footprint.

Without a rigorous framework that recognizes non-linear decarbonization pathways and incentivises real-world reductions, an investor may be disincentivized to invest in assets which present greatest potential for real economy decarbonization given conflicts with portfolio emissions reduction goals.

Case Study: CDPQ – A $10bn envelope to accelerate the transition

An example of another nuanced approach is CDPQ's transition envelope. This financing tool is used only for companies that have a Paris-aligned decarbonation strategy, and that are part of the four highest-emitting industries – raw materials production, transportation, power and agriculture. The transition envelope allows capital to be provided to companies within these sectors that are actively decarbonizing their operations, and thus contribute to the decarbonation of the real economy.

Member profile: CDPQ is a Canadian global investment group that manages assets on behalf of Québec pension plans and insurance funds. It invests in a large range of asset classes, including fixed income, public and private equity, infrastructure, real estate and private debt. As of December 31, 2022, CDPQ has CAD$402bn in assets under management.

Decarbonization goal: CDPQ has set a target to reduce the carbon intensity of its portfolio by 60% by 2030 compared to 2017 and has committed to investing CAD$54bn in low carbon assets by 2025.

Process: CDPQ considers that the transition of the highest-emitting industries is a key component of its decarbonization strategy and offers companies constructive and innovation-based support to assist them on their journey. CDPQ works with independent experts to analyze the decarbonation pathway and to ensure alignment with the Paris Agreement, including elements showing the level of integration of climate change within the company's strategy. This indicates the overall decarbonization strategy and which phase of the journey the company is in. Moreover, companies must meet specific standards set by the Climate Bonds Initiative (CBI) or the Science Based Target Initiative (SBTi) and have a proven decarbonization strategy. They must also have an implementation strategy and disclose their progress internally and externally.

Outcomes: In 2022, CDPQ completed three transactions that meet the criteria of the transition envelope. These investments were evaluated by internal teams and reviewed by independent external experts to validate the rigour of their respective decarbonization plans and to ensure alignment with the Paris Agreement. The specific transition envelope case studies are provided below:

- **KKR - Albioma SA:** CDPQ supported KKR's acquisition of Albioma SA, a French energy producer that operates more than 1 GW of thermal, solar and geothermal energy facilities worldwide. This transaction will accelerate the energy transition strategy already begun with the conversion of its coal-fired power plants to primarily residual biomass power plants. Albioma SA has set itself a goal of abandoning coal by 2025 and plans to generate 100% of its electricity from renewable energy by 2030.
- **AES Indiana:** CDPQ reinvested in this U.S. electricity provider that generates, transmits and distributes electricity to more than 500,000 residential, commercial and industrial customers in Indiana, USA. This transaction will allow the company to finance two investment plans: one to optimize its transmission and distribution operations, and the other to replace coal-fired generation units with renewable energy by the end of 2023. This is a doubly effective strategy that will allow the company to decarbonize both its operations and the energy it supplies to customers.
- **Apraava Energy:** CDPQ reinvested in this Indian electricity provider. The transaction will ensure the implementation of a plan to increase the company's renewable energy generation capacity to reduce its reliance on coal combustion. Apraava Energy has also adopted an ambitious decarbonization objective inspired by the SBTi methodology.

Case Study: CDPQ – A $10bn envelope to accelerate the transition

As a result of these first three transactions, the carbon footprint of the transition envelope is 0.6 $MtCO^2e$, for a carbon intensity of 1,489 $tCO^2e/M$$. This validates the importance of this capital for companies' decarbonization processes and explains why the footprint of this envelope is accounted for separately from the rest of CDPQ's portfolio.

Moreover, this footprint is subject to the same external review as that of the portfolio, and it evolves according to the trajectories of its constituent companies and their implementation of decarbonization plans aligned with the Paris Agreement.

Based on the decarbonization plans of these three companies, the footprint of these investments could decrease by almost 60% by 2030 and close to 70% by 2035.

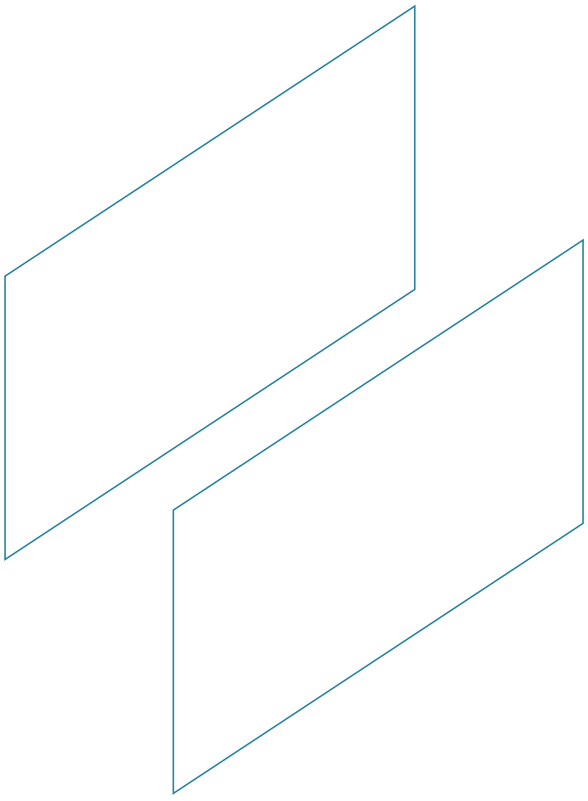
CONCLUSION

There remains a significant gap between the funding needed for achieving the Paris Agreement's goals and the current level of global climate financing. Overcoming this requires private sector support alongside the necessary policy implementation, progress made by other industry actors and demand from consumers. Investors are successfully integrating transition finance strategies and diagnostic tools into their investment roadmap, to identify high-value investments in climate-supportive assets, engage with portfolio companies for carbon reduction and adopt science-based transition plans.

As ILN and peer collaborative initiatives have demonstrated, portfolio strategy can be supported by understanding the decarbonization pathway of the global economy. While investors face challenges and tradeoffs in their approach, there is significant opportunity in translating portfolio decarbonization goals into real-world emissions reductions, and ILN members are incorporating a blend of decarbonization approaches that combine a variety of levers, metrics and approaches for effective fund growth and positive real-world impact.

The community of investors can promote future developments in decarbonization by sharing best practices and lessons learned from their experiences in aligning decarbonization goals with portfolio strategies. Through knowledge sharing and collaboration, investors can collectively drive improvements in data availability, standardization and metrics for setting emissions reduction targets. Continuing to prioritize engagement with portfolio companies and advocating for ambitious transition plans, and their disclosure, investors can influence the adoption of sustainable practices and accelerate the transition to a low-carbon economy.

We hope that ILN's contribution to this shared knowledge will have a similar impact as our member decarbonization efforts and engage the broader investment community to increase climate financing flows and accelerate the transition to a more inclusive and sustainable economy.



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