IIGCC

Energy investment policy: A building block for a robust transition plan

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In autumn 2023 we ran an Energy Investment Policy Webinar Series, guiding institutional investors through the rationale for an energy investment policy, key factors that require consideration when developing a policy, and steps to achieve the objectives of a policy.

This briefing summarises the key points made, aiming to inform and support investors in the development and implementation of an energy investment policy and drawing out investor case studies.

Acknowledgements

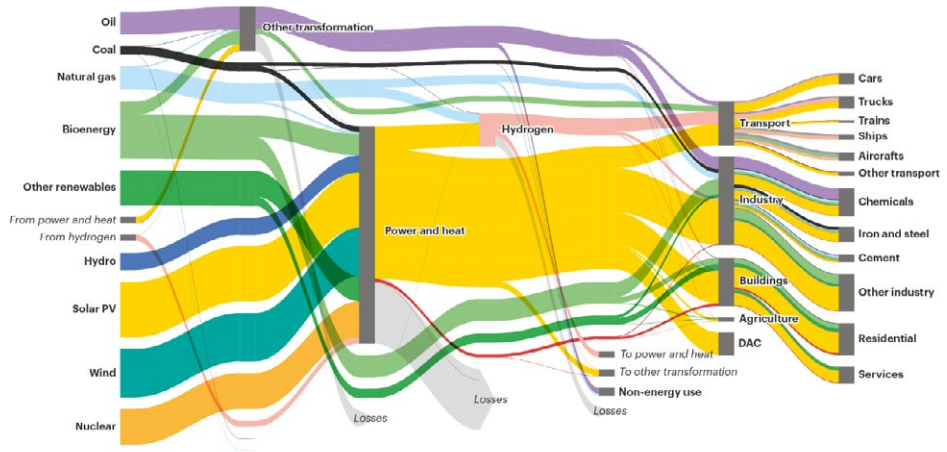
We would like to thank all those who participated in the series. A range of relevant stakeholders, from asset owners and asset managers to academics and intergovernmental organisations provided in-depth, industry-leading insights across a great breadth of subjects associated with energy-related investments. This made for a thoroughly engaging webinar series. We would also like to thank all members who joined the series, engaged with the presenters, and shared their own experiences.

The rationale for an energy investment policy (EIP)

The energy sector plays a critical role in the transition to net zero, making up almost 75% of emissions in 2020.[1] The industries that make up the sector therefore often contribute to a significant proportion of investors' financed emissions.

There are multiple decarbonisation pathways which target net zero by 2050 in a 1.5°C world, all of which detail a systemic shift required in the energy system. The International Energy Agency's updated net zero roadmap (IEA NZE)[2] shows how a clear, long-term shift away from a reliance on fossil fuels is achievable. Figure 1 provides a visual representation of what the energy system should look like in 2050 if global temperatures are to be limited to 1.5°C above pre-industrial levels.[3] To ensure the net zero roadmap remains achievable, the IEA has identified key ambitions for the next decade. This includes tripling renewable capacity and doubling energy intensity improvements, which the resolution from COP28 calls on countries to achieve.[4]

Figure 1. IEA Sankey Diagram showing the global energy flows in a 1.5°C world in 2050 according to the IEA NZE Scenario



The IEA has also identified positive trends in recent years, highlighting the shift away from high carbon energy. This includes substantial increases in investment in solar power and electric vehicles globally. Between 2015 and 2022, solar PV capacity additions increased by more than 400% and EV sales increased by nearly 2000%. The speed of additional capacity deployment has been particularly prominent since the start of this decade with approximately one-third of all solar PV deployment and 60% of all EV sales taking place in 2021 and 2022.[5] As technological innovations continue to occur and costs for low carbon energy declines, transition risks are likely to grow, with the potential for some assets becoming stranded.

Regulatory developments that support a systemic shift in the energy system may intensify transition risks, whilst creating further climate opportunities. Policy signals from governments aiming to incentivise the scaling up of clean energy investment and phasing down of fossil fuel investment are expanding. For example, the EU's Emissions Trading System incentivises emissions reductions, and the cost of EU Carbon Permits has risen from approximately €28 to €90 per tonne of CO_2 from August 2020 to August 2023.[6] Meanwhile, the Inflation Reduction Act is spurring investment in green technology in the United States through $369bn in subsidies, grants, loans and tax credits to public and private entities.[7]

There is also growing pressure from asset owners, who are communicating expectations of third party managers. Asset owners are increasingly expecting external mangers to align energy investments with a net zero scenario, as concerns rise over the potential misalignment of pension schemes' long term interests and managers' strategies. This includes increased scrutiny of managers' proxy voting at key annual general meetings of oil and gas majors.[8]

Transition risks are not limited to industries within the energy sector. Despite being called the 'lifeblood' of the global economy[9] due to other sectors' reliance on energy, the energy transition will have implications for assets across investors' whole portfolios, shown by Figure 1.

To protect against transition risks and account for opportunities stemming from a shift in the energy system, investors can consider defining a clear, net zero-aligned approach to investment in the energy sector.

A five-step process for developing and implementing an energy investment policy

Given the significance of the energy sector on portfolio emissions and the reliance of other sectors on energy, a coherent energy investment policy is central to a robust transition plan. Investors can break the development and implementation of an energy investment policy into a five-step process.

1. Identify objective(s) of the energy investment policy

There are various objectives that can underpin an energy investment policy and investors should clearly establish which are most suited to the organisation's investment strategy. Whilst protecting against transition risks and accounting for climate opportunities are common objectives, there are other objectives investors may wish to achieve. IIGCC presented on 8 potential objectives in the webinar series.

56 asset owners and over 300 asset managers have signed net zero commitments through the PAAO[10] and NZAM[11] initiatives respectively, and an energy investment policy could help signatories meet those commitments. Alternatively, achieving portfolio 1.5°C alignment or supporting real world decarbonisation may also be core objectives.

Integrating the just transition

Another potential objective is to support the energy trilemma: accessibility, affordability, sustainability.

Supporting the trilemma is central to a just transition, and considering the integration of regional decarbonisation pathways may help shape the policy, as, for instance, high- and low-income countries are unlikely to have parallel decarbonisation pathways and phase-out dates for high carbon energy.[12]

Considering the social impact of investments is also important, as the energy sector is arguably the most at-risk sector of detrimentally affecting local communities, workers, and other key stakeholders whilst "green" jobs can also be created.

2. Conduct research on key factors and assess portfolio exposure to certain characteristics

There are key, portfolio-specific characteristics and alternative factors to consider when developing an energy investment policy which will affect the ability to achieve the objectives set out. Identifying these factors and assessing the portfolio's characteristics is important to tailoring an energy investment policy to the individual investor and increasing its robustness. Hence, comprehensive research is needed to determine the best structure of the policy and how it should be implemented. Table 1 shows some of the key factors investors may want to consider when developing an energy investment policy.

Table 1. Key factors to consider when developing an energy investment policy

Key factors to consider when developing an energy investment policy (EIP)	
1.5°C pathways	**Scenario providers** – When using net zero scenarios to develop an EIP, investors may wish to consider that different scenario providers will offer differing methodologies and levels of granularity **Regional/ country** – To adhere to decarbonisation pathways on a granular level, investors could incorporate regional- or country-specific pathways into an EIP
Type of finance	**Existing** – Consider whether, and via which mechanisms, to phase down or out existing investments if they are hindering the achievement of the stated objective(s) of the EIP **New** – Evaluate new investment decisions against the objective(s) of the EIP, for instance new project finance for oil infrastructure
Asset class strategies	**Corporate vs project** – Investments directly financing projects may be simpler to assess against any EIP objectives as opposed to corporates undertaking multiple activities **Equities vs debt** – Different approaches could be considered when developing an EIP to maximise investor impact for different asset classes; e.g. engage equity, deny debt
Value chain focus	**Supply v demand** – Investors could consider reflecting the differing opportunity for impact between the supply and demand side of the energy sector; for instance, investors may see potential impact as higher on the demand side (i.e. through policy advocacy) **Up/ mid/ downstream** – An EIP may be tailored for activities across the energy value chain, for instance, defining separate approaches for extraction (upstream) and transportation (midstream)
Type of fossil fuel	**Unconventionals** – Investors may consider tailoring an EIP by different unconventional fossil fuels: arctic projects, fracking projects, tar sands, ultra deep water, etc Location of activity – Given the differing decarbonisation pathways across regions, considering the location that activities take place may be preferred for some investors
Type of GHG	**CO_2** – Decarbonising CO_2 which makes up the majority of emissions from the energy sector, likely plays a central role in an investor's EIP **Methane** – Compared with CO_2, methane has unique characteristics, such as a different length of life, different source of emissions and different IEA reduction targets. This may want to be considered when developing an EIP
Other ESG factors	**Social** – Investors may want to consider the social impact of investments in the energy sector, and wish to align strategies with a just transition **Nature** – Investors may want to consider any potential negative consequences of their investments on nature and biodiversity

3. Decide on the metric(s) to form the foundations of the policy

Energy investment policies can take many different forms, with a suite of metrics available to measure exposure to the energy sector. Determining which metric is best suited to achieving the objectives of the policy is a fundamental design stage. Table 2 provides examples of several metrics which investors may wish to use as the foundations of an energy investment policy, such as alignment[13] or climate solutions metrics.[14]

Table 2. Metrics available to use as the basis of an energy investment policy

Metrics	
Paris-alignment	Alignment-based metrics can be integrated into an EIP, including transition plans and NZIF's alignment criteria (e.g. net zero commitments and targets)
Emissions-based	An EIP can be developed to treat assets dependent on their absolute/ intensity emissions reductions, allowing investors to protect against assets that may be exposed to considerable transition risks
Revenue thresholds	Assets could be treated differently based on the percentage of their revenues derived from a certain economic activity that is misaligned with net zero scenarios (e.g. oil & gas exploration)
Climate solutions	To take advantage of transition opportunities, investors may consider integrating climate solutions metrics into an EIP (green revenues and capex, low carbon production capacity (MWh), etc)

Case study – PFZW

PFZW utilise a Paris-alignment approach, setting expectations of companies to commit to the Paris Agreement goals.[15] PFZW will only remain invested in fossil fuel companies that have a convincing and verifiable climate transition strategy by 2024. From 2024, PFZW will no longer invest in companies in the fossil fuel sector that do not meet these requirements.

4. Deploy relevant levers to implement the policy and achieve the objective(s)

Investors can deploy multiple levers of influence to achieve their objectives when implementing an energy investment policy. Certain levers may be more appropriate to deploy for certain objectives and metrics, and the potential impact of each lever may depend on the asset class. Table 3 outlines some of the levers available to investors. Developing an energy investment policy that combines a range of levers, tailoring for investor objectives and portfolio-specific factors, is likely the most effective way to support the energy transition.

Table 3. Levers available to support implementation of an energy investment policy and achieve the defined objectives

Levers	
Portfolio tilting	Investors can overweight portfolios, for instance towards energy sector assets with superior net zero alignment or those scaling up climate solutions quicker, encouraging corporates to improve climate performance
Stewardship and engagement	To improve a corporate's climate performance, investors can undertake stewardship and engagement actions. Stewardship and engagement strategies can be embedded into an EIP and vary across asset class
Climate solutions	Scaling up investment in climate solutions can support the energy system transition whilst taking advantage of climate opportunities
Policy advocacy	Engaging on a policymaker level can support the energy system transition and indirectly support an EIP in achieving the objectives
Screening and exclusions	An investor can set clear red lines in an EIP, screening investments to rule out assets that may be misaligned with their EIP objectives
Debt denial	New issuances can be screened out based on issuer misalignment with net zero scenarios or poor climate performance, potentially using this to open up a stewardship conversation to drive changes in corporate practice
Divestment	The possibility of divestment can encourage corporates to improve climate performance and can be an effective element of an EIP

Case study – Danske Bank

Danske Bank uses a range of levers to improve the Paris-alignment of its portfolio and to reduce carbon intensity of the portfolio by 50% by 2030, including active ownership, inclusions and exclusions.[16] Danske Bank aims to engage with over a hundred of the largest emitters in their portfolio by 2025, assessing the transition of energy companies by combining TPI's Management Quality and Carbon Performance scores.

5. Educate relevant internal and external stakeholders to ensure robust implementation

Organisation-wide understanding is critical to ensure the policy is integrated into investment strategies. Buy-in is required from a range of stakeholders, including senior management, fund managers, analysts, and risk teams. For asset managers, getting clients on board is also essential to ensure the mandate exists to implement the policy. Equally, for asset owners developing a policy, external managers will need to fully understand the energy investment policy and implications for the client's investment strategy. Clients and external managers will likely benefit from discussing the rationale and implications of the policy, and all investors may find publishing a high-level position statement a useful way to convey key messages.

Furthermore, NZIF 2.0, to be launched in Q2 2024, will include recommendations that an explicit mandate be sought from the asset owner's Board to develop an energy investment policy.

How IIGCC supports members to support the energy transition

IIGCC supports its members in deploying the levers listed above in multiple ways, through the development of asset assessment tools, engagement initiatives and policy advocacy guidance.

Corporate engagement

Engagement and stewardship can complement a range of metrics. It may be particularly useful in supporting corporates to transition business models and align with net zero pathways.

IIGCC has a range of assessment tools to help investors assess the transition plans of companies across the energy value chain. Net Zero Standards are currently available for oil & gas[17], mining[18] and banks[19] as well as a sector-neutral transition plan framework.[20] Figure 2 illustrates IIGCC's assessment tools across the energy system, including forthcoming publications.

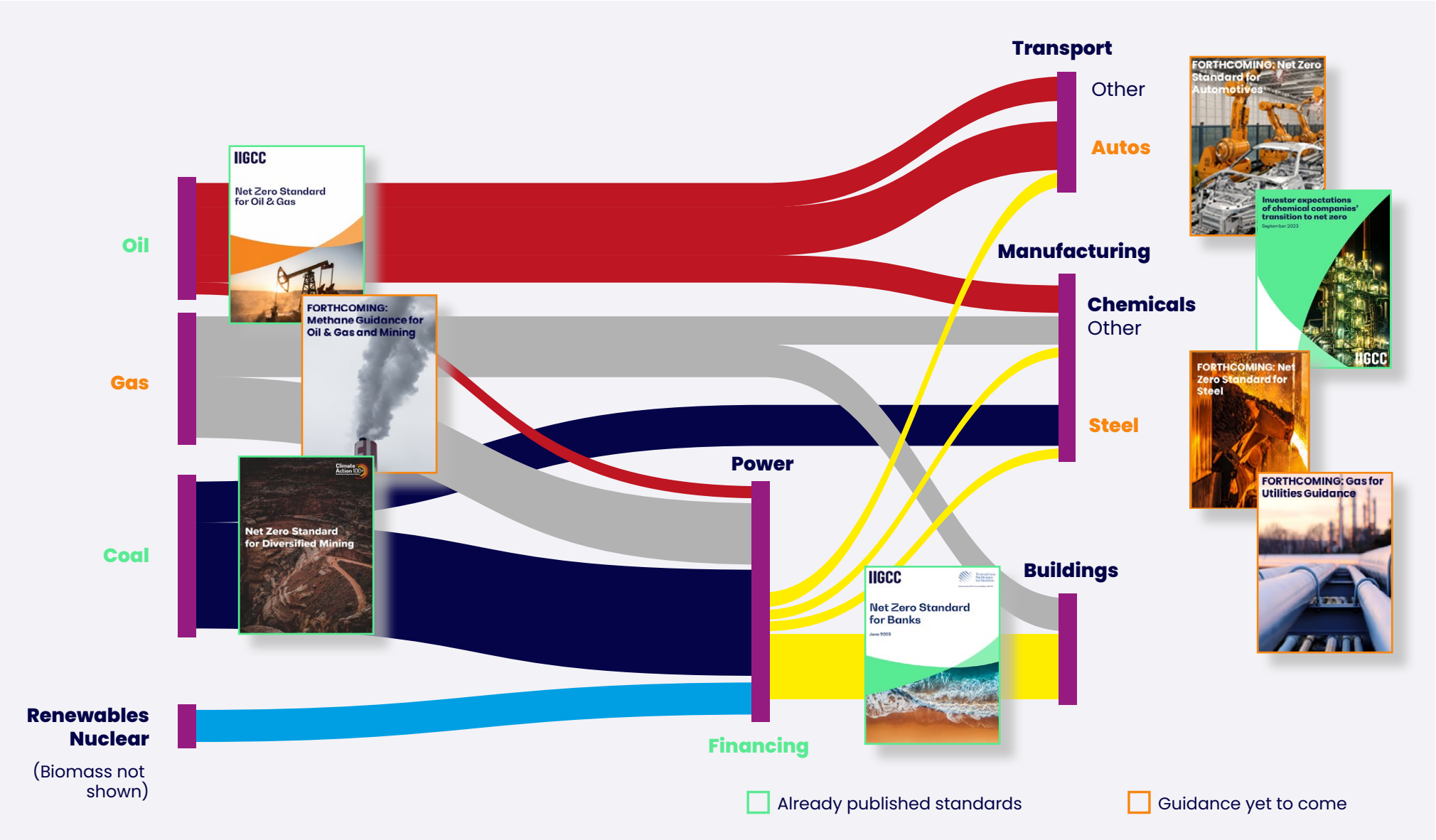
Climate Action 100+[21] and the Net Zero Engagement Initiative[22] are collaborative engagement platforms which allows IIGCC to support investors to effectively engage with key players in the energy transition.

Policy advocacy

Establishing credible policy pathways towards decarbonisation within the energy sector is key to accelerating the climate transition. To ensure finance flows support the energy transition, regulation must prioritise transition finance and facilitate the role of investors as capital allocators and stewards of assets.

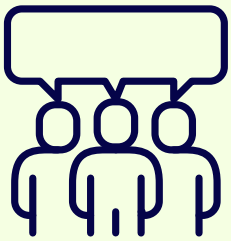
Investors can directly engage with the development of such regulation by directly engaging with policymakers, signing IIGCC member letters and getting involved with sectoral initiative work and IIGCC's COP work.

Figure 2. Sankey diagram illustrating IIGCC's net zero standards across the energy system



Appendix

IIGCC members can access the four webinars which provide more detail on the stages outlined above here.

Webinar	Description	
# 1 **The rationale for developing an energy investment policy**	IIGCC presented on the transition risks stemming from the energy sector and why there is a growing need to develop an energy investment policy. The International Energy Agency presented the latest update to the IEA's Net Zero Emissions scenario.	
# 2 **Approaches to energy investment policies**	IIGCC presented how the three leading net zero methodologies for investors, the Net Zero Investment Framework, the AOA's Target Setting Protocol and the SBTi Finance Framework, differ in their recommendations for investment in the energy sector. Danske Bank and PFZW presented their recently developed energy investment policies.	
#3 **The anatomy of an energy investment policy**	IIGCC broke down key factors to consider when developing and implementing an energy investment policy, including the potential objectives, portfolio-specific characteristics, metrics and levers. IIGCC then presented the support available to investors in implementing their policies, including engagement actions for corporates and policymakers, and alignment assessment tools.	
#4 **Integrating the just transition**	IIGCC presented some initial work uncovering the differing regional and sectoral decarbonisation pathways. LSE's Grantham Research Institute presented on a host of materials they have developed to support investors in assessing the social impact of their investments. Schroders and Royal London shared their approaches to and experiences in engaging with companies on the just transition.	

Endnotes

1 Our World in Data (2023), Emissions by sector: where do greenhouse gases come from?

2 International Energy Agency (2023), A renewed pathway to net zero emissions – Net Zero Roadmap: A Global Pathway to Keep the 1.5 °C Goal in Reach

3 International Energy Agency (2023), Energy Technology Perspectives 2023

4 The Guardian (2023), Good Cop, bad Cop: what the Cop28 agreement says and what it means

5 International Energy Agency (2023), Progress in the clean energy transition – Net Zero Roadmap: A Global Pathway to Keep the 1.5 °C Goal in Reach

6 Trading Economics (2024), EU Carbon Permits

7 UK in a changing Europe (2023), What is the Inflation Reduction Act?

8 IPE (2023), Brunel Pension Partnership calls for constructive dialogue on long-term interests

9 The Global View (2012), Challenge of the century: How to keep energy 'lifeblood' flowing

10 Paris Aligned Asset Owners (2024), Paris Aligned Asset Owners – Investing for a net zero future

11 Net Zero Asset Managers (2024), The Net Zero Asset Managers initiative – An international group of asset managers committed to supporting the goal of net zero greenhouse gas emissions

12 SBTi (2023), The SBTi Fossil Fuel Finance Position Paper Consultation Draft

13 Paris Aligned Investment Initiative (2021), Net Zero Investment Framework Implementation Guide

14 Institutional Investors Group on Climate Change (2023), IIGCC Climate Solutions Guidance

15 Paris Aligned Asset Owners (2022), PAAO Progress Report November 2022

16 Danske Bank (2023), Danske Bank Position Statement on Fossil Fuels

17 Institutional Investors Group on Climate Change (2023), Net Zero Standard for Oil & Gas

18 Climate Action 100+ (2023), New guidance helps investors assess mining companies' net zero transition

19 Institutional Investors Group on Climate Change, Transition Pathway Initiative (2023), Net Zero Standard for Banks

20 Climate Action 100+ (2024), Climate Action 100+

21 Institutional Investors Group on Climate Change (2023), Investor Expectations of Corporate Transition Plans: From A to Zero

22 Institutional Investors Group on Climate Change (2023), Introducing the Net Zero Engagement Initiative: The next step in investor corporate engagement

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