Sustainable Markets Initiative

Asset Manager and Asset Owner Task Force

Transition Categorisation Framework

January 2023

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In his former role as The Prince of Wales, His Majesty King Charles III launched the Sustainable Markets Initiative (SMI) at Davos in January 2020. The SMI is a network of global CEOs across industries working together to build prosperous and sustainable economies that generate long-term value through the balanced integration of natural, social, human, and financial capital. These global CEOs see themselves as the 'Coalition of the Willing' helping to lead their industries onto a more ambitious, accelerated, and sustainable trajectory. Read more here and here.

Terra Carta

In his former role as The Prince of Wales, His Majesty King Charles III, launched the Terra Carta at the One Planet Summit in January 2021. The Terra Carta serves as the mandate for the SMI and provides a practical roadmap for acceleration towards an ambitious and sustainable future; one that will harness the power of Nature combined with the transformative power, innovation, and resources of the private sector. Currently there are over 500 CEO-level supporters, including the Commonwealth and C40 cities. The Terra Carta has served as the inspiration for the Terra Carta Design Lab. The Terra Carta is a roadmap for public, private, and philanthropic collaboration and open to all countries, cities, companies, organizations, and schools who wish to support it. Read more here.

SMI Asset Manager and Asset Owner Task Force

Several of the world's largest Asset Managers and Asset Owners have come together as members of the Sustainable Markets Initiative's (SMI) Asset Manager and Asset Owner Task Force (AMAO) to work on meaningful and actionable plans to help accelerate the world's transition to a sustainable future. The Task Force was launched in at the invitation of His Majesty King Charles when in role as The Prince of Wales.

The Task Force is aimed at finding scalable ways for institutional investors to facilitate the reallocation of capital toward sustainable solutions, using the two most powerful levers at their disposal: 1) capital already invested in companies; and 2) fresh capital investments directed at climate mitigation and adaptation projects.

Article 6: Sustainable Investing at Scale

Article 9: Adopt Common Metrics and Standards

Overview

Limiting global warming to 1.5 degrees C requires a rapid reduction in global greenhouse-gas emissions. To achieve this, there is need to simultaneously scale investment in innovative solutions -- the low- or no-emissions technologies -- and in decarbonising high-emitting sectors. This spectrum of financing, now referred to as transition or blended finance, must be deployed at scale.

What we know now: The Business Case

To date, the investment industry has rapidly scaled flows to climate solutions. Investment in the energy transition in 2021 totalled $755 billion, up 27% from 2020, according to BloombergNEF's annual investment report. The report forecasts that clean energy investment alone will need to triple between 2022 and 2025 to average $2.1 trillion per annum to get on track to reach global targets. Unfortunately, the pace of investment aimed at decarbonising high-emitting sectors is lagging – particularly in emerging markets and economies.

The challenges are multiplied by the pressure on investors to adopt decarbonisation targets, carbon budgets and exclusions policies. Instead of working with the highest-emitting companies to drive down emissions, there is pressure to focus on divestment only strategies, which is problematic because reducing portfolio exposure to high emitters does not necessarily cut emissions in these sectors. It simply improves the optics of a portfolio. Another issue is a dearth of guidance on what constitutes genuine transition and what is brown, grey or dressed up as green.

A transition framework to scale sustainable solutions

The Sustainable Markets Initiative (SMI) Asset Manager and Asset Owner (AMAO) Task Force has designed a Transition Categorisation Framework that is consistent with industry ambitions to achieve net zero. The intention of the framework is to categorise assets that fulfil the objectives for a pathway to a net zero transition, at both a company and a project level and ensure that investors are not simply disinvesting from the more difficult sectors especially in emerging economies.

Transition finance involves financing the investment required for the decarbonisation of the five sectors responsible for 95% of global emissions[1]: power, buildings, mobility, industry, and agriculture. The IEA estimates that by 2030 the world will need to invest more than $30 trillion in these industries to facilitate their transition – across emerging and developed countries.

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1 https://www.mckinsey.com/~/media/mckinsey/business%20functions/sustainability/our%20insights/the%20net%20zero%20transition%20what%20it%20would%20cost%20what%20it%20could%20bring/the-net-zero-transition-what-it-would-cost-and-what-it-could-bring-final.pdf

The Transition Categorisation Framework, outlined with methodology below, identifies five categories of transition assets, four of which qualify as Paris-climate agreement aligned. Concrete guardrails that define a transition asset are critical to ensure the integrity of this categorisation so that transition investing does not lead to greenwashing. Critically, the categorisation enables investment into sectors and regions vital to the net zero transition. The SMI AMAO Task Force is working with climate specialist organisations to support the appropriate metrics, thresholds and timelines required by a company or project to qualify for each category below. In addition, the SMI's Energy Transition Task Force has also developed a transition rating methodology, which complements this categorisation and could help determine the assets that would qualify for one or more of the categories.

Desired outcome

The SMI AMAO Task Force's aim is for investors to utilise and adopt the categorisation as an enhancement to existing net zero strategies. Doing so would help guide effective and meaningful transition investment through general portfolios or specific vehicles that fund pathways to net zero in critical sectors.

Summary

The SMI AMAO Task Force's initial framework is a first step at identifying ways in which the industry of asset managers and asset owners can drive meaningful action to address one of global society's biggest challenges, climate change. Through this framework a dialogue and guidance can occur to bring forth standardisation and methodology that can be productive and directional.

Categorising transition: Defining the green-to-olive continuum

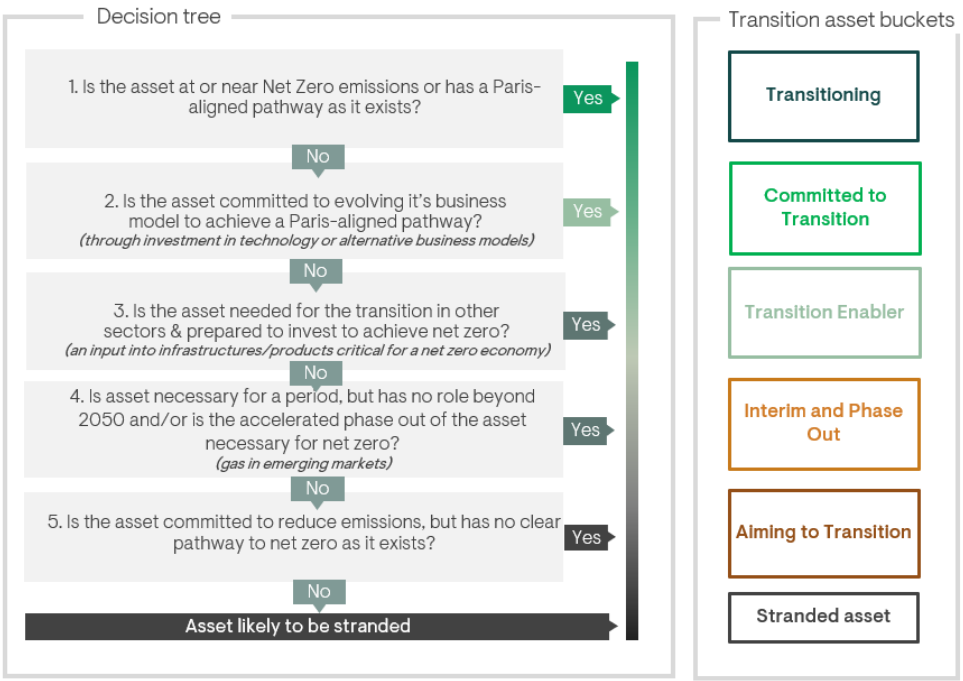
The decision tree in Figure 1 outlines the logic behind the categorisation. There are five transition categories. They capture the characteristics of companies associated with the five high-emitting sectors that need to transition.

The decision tree applies at the level financing is provided and works as follows:

1. **Transitioning.** Is the asset at or near net zero emissions or does the asset have a deliverable Paris-aligned pathway as it exists? If so, it is classified as Transitioning.
2. **Committed to Transition.** Is the asset committed to net zero and does it have a plan for evolving its business model to achieve a Paris-aligned pathway via investment in technology or alternative business models? If so, it is classified as Committed to Transition.
3. **Transition Enabler.** Is the asset needed for the transition in other sectors and is it prepared to invest to achieve net zero itself? Is the asset an input into infrastructure or products critical for a net zero economy? If so, it is classified as Transition Enabler.
4. **Interim or Phase Out.** Is the asset necessary for a period but with no role beyond 2050 or is the accelerated phase-out of the asset necessary for net zero? If so, it is classified as Interim or Phase Out.
5. **Aiming to Transition.** Is the asset committed to reducing emissions but with no clear pathway to net zero as the asset exists? If so, it is classified as Aiming to Transition. Assets in this category do not qualify for aligned transition.

Stranded. If the asset does not qualify for one of the five categories, it is likely to be stranded in future.

Figure 1. SMI AMAO Task Force Transition Categorisation "Decision Tree"



Setting the metrics: Ensuring credibility of a transition categorisation

The minimum standards of an asset in one of the four categories qualifying for transition allocation are:

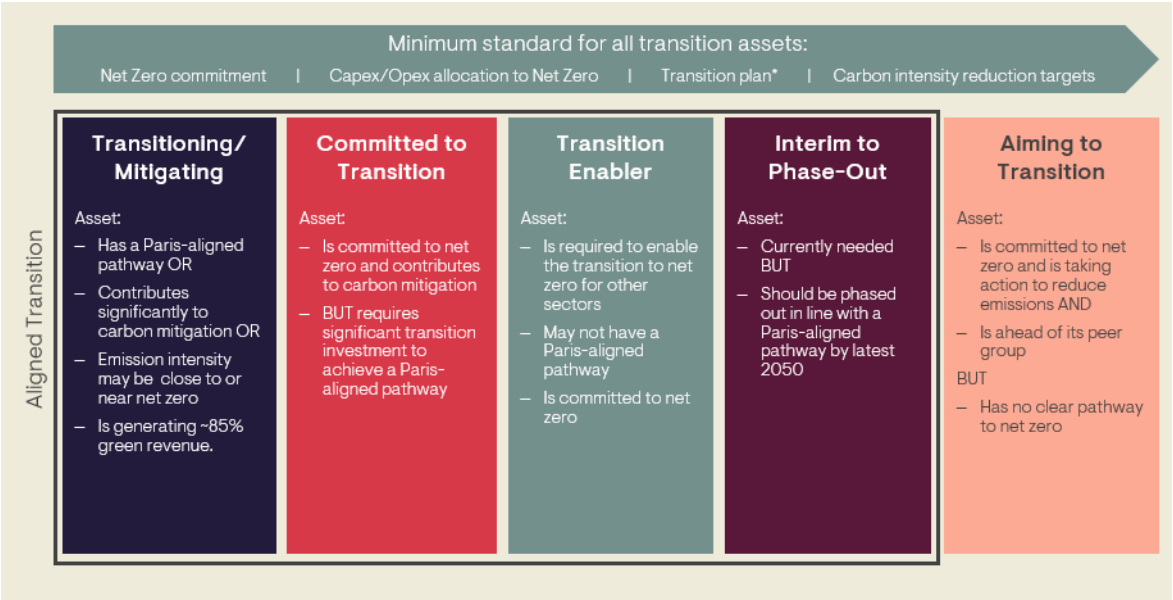
1. A commitment to decarbonisation, expressed through a public undertaking to achieve net zero or otherwise unambiguously stated; and
2. A credible transition plan, which, like a financial plan, shows the investor how the company aims to achieve its targets and at what cost.

The credibility of transition plans for high-emitting sectors is the keystone in the transition finance agenda. While consensus is developing around "what good looks like" from a sectoral perspective, there is lack of consistency on criteria. Differences across sectors and regions need to reflect the complexity of transition and a range of starting points. Criteria could include decarbonisation targets, capex allocation, and governance mechanisms. For example, what an oil and gas company must do to achieve a 1.5 degree C pathway versus what a diversified mining company must do will differ. An emerging market company and a developed market competitor will not be expected to share a pace to decarbonisation.

Clear criteria for each transition category within the framework are needed to engender confidence and consistency. The SMI AMAO Task Force is working with climate-specialist organisations to agree on the appropriate metrics, thresholds and timelines required for a company or project to qualify per category.

Figure 2, below, contains descriptions of the high-level criteria anticipated for each category. The categorisation differentiates between Aligned Transition including categories one through four, which are considered Paris-aligned transition pathways, and category five, which recognises those companies in sectors without a Paris-aligned pathway but endeavour to transition indicated through robust transition plans and high levels of ambition. *Transition Enablers* have been included as Aligned Transition given the dependence on their inputs for the glow carbon economy albeit not necessarily having Paris aligned pathways.

Figure 2. SMI AMAO transition categories with high-level qualification requirements



1. The **Transitioning** category, which covers assets classified as green or expected to deliver on existing Paris-aligned pathways, is included because, within it, are emerging market assets which require increased investment. An example would include a use of proceeds bond for a company producing large scale batteries or building renewable power.

2. The **Committed to Transition** category covers assets which have a clear pathway to net zero but are high emitters that need significant investment. Under most current net zero frameworks, adding such assets to portfolios would be difficult because doing so would increase the portfolio's carbon footprint. An example would be an electricity utility with a large installed fleet of ageing thermal power plants that is rapidly building renewables and has plans to decommission its thermal power in line with a Paris-aligned pathway.

3. The **Transition Enabler** category encompasses companies potentially in high-growth sectors due to the product or material being a core component of "solutions." An example would be a mining company producing lithium or copper as an input into solar-PV or battery technology and broad electrification. For illustrative purposes, criteria that could be used for a company to qualify could include:
   - committed to net zero;
   - has a product needed for a transition to net zero with no commercially viable alternatives or with higher carbon alternatives;
   - committed to reducing carbon intensity of production in line with Paris-aligned pathway for the sector (as assessed by TPI or SBTi) by [x]% per annum to [2030];
   - increased capex allocation to low-carbon transition to [y]% by [2030];
   - generated >[z]% revenue by low carbon/"transition" product by [2030].

4. The **Interim or Phase Out** category is the most contentious. The SMI AMAO Task Force is working to establish frameworks for phasing out coal mines and coal-fired power stations as well as ways to determine conditions to qualify gas investment in a low-income country as aligned.

5. The **Aiming to Transition** category seeks to recognise those fossil-fuel producing or reliant companies which will not be needed in the future but are doing the most to transform their business models. An example would be an oil producer that is already investing to transition its revenue to green sources. The SMI's Energy Transition Task Force has developed a transition-rating methodology which is being processed with an external ratings agency. The outcome would be a rating score to indicate an asset's transition credentials. A minimum threshold for this rating could prove to be the appropriate threshold for an asset to qualify for the Aiming to Transition category. The rating could also be a metric to determine if an asset qualifies for the **Enabler** category.

Next Steps: Validating metrics and implementing goal

The SMI AMAO Task Force are taking a phased approach to the development of the Transition Categorisation Framework. This white paper completes the first phase.

During the first half of 2023, the SMI AMAO Task Force will progress the second phase, which will consider the qualifying criteria for each of the transition categories. During the second phase, the SMI AMAO Task Force aims to finalise and publish an analysis of metrics, thresholds and timelines required by companies or projects to qualify for the transition categories outlined in this Transition Categorisation Framework.

The wide adoption and application of this categorisation will guide funding for a genuine transition to net zero.

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