

Are electric utilities' governance and strategies fit for the energy transition?

- Report outlines the results of engagement with nine electric utilities
- All nine companies are focusing on decarbonization in the long run
- Mixed results on transparency of retiring coal-fired power stations

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Climate change poses serious risks to the stability of the global economy and is likely to impact many economic sectors. The increasing need to mitigate greenhouse gas emissions and to develop policies that support the transition to a low-carbon economy are challenging the business models of carbon-intensive industries. Increased climate policy action, the development of new technologies and market changes create both transition risks and opportunities for companies and their investors.

In addition, the physical effects of climate change, such as water scarcity and rising sea levels, also threaten business operations. A growing number of companies are recognizing these risks and are including them in their annual reports. A recent article by the Climate Disclosure Project (CDP) shows that 215 of the world's largest companies see climate change as a threat that is likely to affect their business within the next five years, at a cumulative cost of USD 1 trillion.

One of the sectors with the most significant exposure to climate-related risks is utilities, as this sector lies at the core of the energy transition. Climate policies and regulation can deeply affect the sector's development and perceived risks for investors. Plans for phasing out coal and the need to meet emission reduction targets set by some national governments are an example of potential transition risks. The energy transition implies a big shift in utility companies' business models. This brings a considerable degree of uncertainty, and also new opportunities, as renewables are increasingly becoming cost-competitive relative to energy generation from fossil fuels.

Climate-related financial disclosures help investors assess risks and opportunities

Climate-related financial disclosures have attracted significant attention since the task force established by the Financial Stability Board and chaired by Michael Bloomberg published its Climate-related Financial Disclosures (TCFD) recommendations in June 2017. They have four core elements: governance, strategy, risk management, and metrics and targets. This voluntary set of recommendations are intended to help companies measure and evaluate climate-related risks in their businesses. In turn, it is expected that these enhanced disclosures will help investors make better-informed investment decisions by making them better able to evaluate their risks and levels of exposure.

The recommendations have received broad recognition among regulators, corporates and investors. By June 2019, 785 organizations around the world had announced formal support for the TCFD recommendations, of which 42 are electric utilities. In the same month, the EU Commission published new guidelines on corporate climate-related disclosures that incorporate the TCFD recommendations.

As investors, we recognize that climate change risks are material, and that there is a need for information that helps pricing them in. At the same time, we acknowledge that climate change prevention can bring opportunities for our investments. Those companies that adapt their strategies towards a low-carbon economy will become more resilient in the long term. Climate-related financial disclosures can help investors identify which companies are at most risk, and differentiate them from those that are best prepared for the energy transition and are taking action.

'The findings of this analysis allow us to identify emerging best practices on climate-related disclosures in the utilities sector'

In this report, we outline our findings from the assessment of climate-related financial disclosures of the nine US and European electric utilities with the largest net-carbon footprint, according to CDP data. Our assessment is based on disclosures made under the annual, integrated and sustainability reports of 2018. Our goal is to gain a better understanding of the different reporting practices and to form our own opinion on the quality of information reported. The findings of this analysis allow us to identify emerging best practices on climate-related disclosures in the utilities sector, which can support our engagement activities with companies in the sector.

Decarbonization is a clear strategic priority in the sector

All nine companies are focusing on decarbonization in the long run, setting ambitions for 2030 and even 2050. Three have made the ambitious commitment of becoming carbon neutral by 2050. Of the six remaining companies, three have set long-term (2050) targets of 75%-80% emissions reductions, and three have only set mid-term (2030) targets.

Setting carbon emission reduction targets has been a key area of engagement for investors with electric utilities. It is encouraging to find that all companies have set reduction goals. However, most fail to disclose how they intend to achieve these goals, such as by explaining the expected changes in their energy generation mix, or the new technologies needed to achieve carbon neutrality. Also, none of the disclosures reviewed include the potential financial risk or impact on companies from pursuing these strategies.

Oversight of climate issues is generally embedded in existing governance structures

Perhaps unsurprisingly, all nine companies have incorporated the management and oversight of climate-related issues into existing governance structures. Eight of them explicitly report that their board of directors is responsible for monitoring these issues. Three of the nine companies have a committee dedicated to overseeing sustainability issues. Only one explicitly tasks the risk management committee with the oversight of internal controls related to sustainability.



It is encouraging to find these issues are being addressed by the companies' top management and boards of directors. We particularly view positively its incorporation into the scope of oversight of the audit or risk management committee. This provides an indication that climate issues are being integrated into the organizations' internal controls and processes. However, only a minority of companies disclose the areas of attention and tasks being undertaken by the board and their committees, and explain how management and board interact with each other. Such disclosures would facilitate investors' assessment of the extent to which climate-related issues receive appropriate board and management attention.

Boards need to further develop climate knowledge

Our research finds that most companies are not taking sufficient steps to develop directors' knowledge of the implications of climate change, or the potential impacts they can have on their companies. This may prevent them from developing a well-informed view on how they should respond. At only two of the companies in the peer group were we able to identify board directors with the relevant expertise, for example on renewables development, sustainable finance and climate policy. One of them also reported providing training on sustainability and climate issues.

In our view, boards with the right skills-set are better prepared to identify and oversee the risks and opportunities. Boards can build up their access to such expertise by recruiting directors who have relevant skills, or by gaining regular access to external experts. This could be done, for example, using an advisory committee to the board composed of external, independent experts, through regular trainings, or via partnerships with reputable organizations.

Climate ambitions are yet to be backed by executive pay

Only three of the companies assessed link the remuneration of their CEO to their climate strategies. To assess performance, remuneration policies include quantitative metrics on emissions reduction targets and renewables availability, along with qualitative targets on the CEO's leadership in advancing the energy portfolio of the future. One of the companies has gone even further by also incorporating climate-related metrics into incentives for staff across the entire organization.

Remuneration is an important tool to align executives' and staff's interests with metrics and targets that promote business resilience, and thus create long-term value. As the energy transition is challenging the business model of electric utilities, remuneration policies are important to incentivize management into aligning the corporate strategy towards a low-carbon economy. To achieve this, boards may consider adding new climate-related criteria to their already long-term oriented compensation policies. Boards may also consider an entire reassessment of incentive schemes, to ensure that all criteria (even non-climate-related ones) are geared to protect future value and avoid risky, short-term oriented strategies.

Many roads can lead to carbon neutrality

Reliance on coal is one of the key transition risks for electric utilities. Most of the companies under analysis have significant exposure to coal, more so in the US than in European countries.

All nine companies have committed to not developing any new coal capacity, and have also taken steps to reduce their exposure to coal generation plants. However, significant uncertainty remains about when and at what pace coal-fired plants will be phased out. This transition depends significantly on the security of energy supply, for which the development of alternative energy sources is needed.

In order to gain a better understanding of the transition risks, investors would welcome further disclosures on the potential financial consequences stemming from coal generation assets. Disclosures could include asset-level information on the age, generation capacity and load factors of coal-fired plants, along with emissions data for CO₂, SO_x and NO_x. None of the companies reviewed currently provide this information.

Furthermore, more transparency is needed on the retirement schedule of coal-fired plants. The timing of this is important to understand the future financial impact on companies and the investments that will be needed to develop alternative generation sources. We understand that any power plant closures are subject to regulatory approval, where security of energy supply is an important consideration. Therefore, investors would also appreciate more transparency on the instances in which the closure of power plants is not being supported by regulators.

‘The speed of development of renewables and other low-emissions energy sources sets the pace of the shift away from fossil fuels’

Generation from coal should of course not be viewed in isolation. The speed of development of renewables and other low-emissions energy sources sets the pace of the shift away from fossil fuels. Moreover, carbon neutrality can only be achieved if new technologies and supporting infrastructure are developed. Some examples of this are storage, smart grids, and carbon capture and storage (CCS). We can also identify different trends between American and European companies. In the US, CCS for natural gas companies is being considered and companies are therefore investing significantly in this technology. In contrast, CCS is not a technology mentioned by European utilities, whose focus is on battery storage instead. The disclosure of a roadmap on how companies view their energy transition is desirable. Among the companies assessed, only one provided details on the steps it will take to achieve a new energy mix, including the projected share of each energy source. It is also notable that such disclosures were made following investor engagement and substantial support for a shareholder resolution requesting disclosures on the company’s strategy to align its business to a low-carbon scenario.

Uneven adoption of climate scenario analyses

Disclosures on scenario analysis remain very limited among the companies assessed, with only four of the nine doing it. However, none of the companies estimated the financial risks under each of the scenarios analyzed. Instead, they focus primarily on mapping only transition risks in their analyses. For example, some of the scenarios make assumptions about the timing of a coal phase-out under a fast-decarbonization scenario to limit global warming to 2 degrees Celsius. However, these scenarios do not specify the timing of the coal-fired power plant retirements. This information is important to understand the investments needed to develop capacity from cleaner energies, and their financial impacts.

The focus on scenario analyses on physical risks from climate change is noticeably lower among the companies assessed. Such assessments are also important, as climate change is likely to affect energy generation from sources like hydro and wind.



The development of new renewables capacity requires a thorough assessment of the physical risks to which these companies are exposed to in the markets in which they operate. Only one company is conducting further research to identify such physical risks, such as changing patterns of rainfall and wind strength.

Why do climate-related financial disclosures matter to investors?

We have long believed that integrating environmental, social and governance (ESG) factors into investment processes leads to better-informed investment decisions. Climate change is a material ESG issue especially for the electric utilities sector. The TCFD recommendations emphasize the need for transparency in pricing of climate-related risks to support investment decisions.

Governments are taking measures and adopting policies to reduce global emissions. These policies increasingly require rapid and far-reaching actions to transition to a low-carbon economy. This could lead to disruption across industries and regions, particularly in those industries that are reliant on fossil-fuels and may be less resilient to climate-related risks. Investors in carbon-intensive companies may experience negative impacts on the financial returns of their investments. Those companies that are preparing for a lower-carbon economy may have a competitive advantage over others, as their corporate strategies and operations may be more resilient in the mid- to long-term. Adopting the TCFD recommendations in corporate financial disclosures could help provide investors with decision-useful information.

In our view, the use of climate scenario analysis is the TCFD recommendation that is likely to provide the most insightful information. As the impacts of climate change on organizations are likely to materialize in the mid- to long-term, companies need to consider the potential risks and opportunities in their planning processes. As the potential effects and timing of climate change on their business is uncertain, companies should assess these implications under different conditions.

Engaging to help enhance climate-related financial disclosures

Historically, investor engagement has so far focused on asking utilities to commit to emission reduction targets, and disclose how they plan to align their strategies with a low-carbon scenario. The findings of this report reveals that there are several areas that would benefit from increased investor engagement. These include disclosures on board oversight on climate-related issues, access to climate expertise, the use of climate metrics in remuneration policies, transparency on asset-level coal-fired power plants and their retirement schedule, and climate scenario analyses of both transition and physical risks. We believe that constructive dialogue can, on the one hand, help investors understand how companies, their management and board of directors are addressing climate change-related issues. On the other hand, engagement can help companies understand what type of climate-related financial disclosures are useful for investors, and can contribute to making better-informed investment decisions.

As active investors, Robeco and Lyxor are engaging with companies in the utilities sector to gain a better understanding of how they are managing and addressing climate-related risks and opportunities. We are both members of the Climate Action 100+ Initiative, a global investor coalition with over 360 signatory asset owners and asset managers with USD 34 trillion in assets under management. The initiative aims to secure commitments from boards and senior management to (among others) implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risk and opportunities, and to enhance disclosures in line with the TCFD recommendations. The initiative engages with the 100 companies that contribute to up to two-thirds of annual global industrial emissions, alongside more than 60 others with significant opportunity to drive the clean energy transition.

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