QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

Taking the temperature

Assessing progress on climate transition plans

Across Quilter we have identified three thematic engagement priorities. This is part of our climate change theme.

Climate Change is the defining issue of our time and we are at a pivotal moment. From shifting weather patterns that threaten food production, to rising sea levels that increase the risk of catastrophic flooding, the impacts of climate change are global in scope and unprecedented in scale. Without drastic action today, adapting to these impacts in the future will be more difficult and costly[1].

SDG Alignment

> *We do not inherit the earth from our ancestors, we borrow it from our children."*
>
> Native American Proverb

Commitments made by governments and companies at COP28 in Dubai can be summarised as: some progress but probably not enough to put the global economy on a path to meeting net zero emissions by 2050. However, the summit did produce the first international commitment to transition global economies away from fossil fuels which is significant as it the first time the global community has formally agreed to end the fossil fuel era. A large part of the responsibility for executing these national commitments will fall on the shoulders of companies and by extension active owners of these entities.

In December 2023 we continued our ongoing engagement program on climate disclosure and transition planning with the largest emitters among our direct equity holdings. This systematic engagement process supports Quilter Cheviot's Climate Action Plan (to be released in 2024) and is conducted on a 24-month cycle. We initiated this program in 2021 and the first phase was very much engagement for information. This

1 United Nations

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second iteration aims to assess progress against previously stated plans, assessing the quality of transitions plans and whether investee companies are taking (or not taking) appropriate measures to align with a future lower carbon economy.

This is an ongoing process that will require systematic monitoring to ensure companies 'walk the talk' – but based on previous learnings we approach these engagements with a number of expectations on what a good climate transition plan looks like:

1. A focus on the next ten years with specific short- and medium-term targets (2050 goals are welcome but action over the next decade is critical).
2. We want to see a reduction in absolute emissions. This includes Scope 3 metrics and is largely absent of carbon offsets. Carbon intensity measures can be supplemental but should not be the main target.
3. Demonstrate alignment of capital expenditure with transition targets – and consideration of Paris Climate goals into significant capital expenditure projects.
4. Limited used of carbon offsets. Residual emissions may be abated with offsets and carbon capture and storage, but use should be specific with clear end dates. This should not be a structural element of reduction targets.
5. The linking of executive remuneration to internal carbon reduction targets to help integrate transition planning into company strategy.
6. Assessment of alignment of climate transition strategy with member industry associations lobbying activities.
7. Taking ownership of Scope 3 emissions and building these into carbon reduction targets.

Like many investors, our financed emissions are concentrated in a handful of companies. Although relatively stable, there has been some movement in the list of largest emitters by investment exposure (financed emissions) since 2021. We identified and engaged with the ten companies representing c.85% of Scope 1 and 2 financed emissions exposure within discretionary direct equity holdings. The companies making up most of Quilter Cheviot's financed emissions span various industry groups including industrial gases, cement manufacturers and utilities but unsurprisingly most conversations were held with oil & gas majors and diversified miners. Company responsiveness was high, and we were encouraged by the commitment to speak to shareholders. It should be noted that Chevron and Exxon are part Quilter Cheviot's list of largest emitters but were not part of the engagement group as both have been historically hesitant to engage.

nationalgrid

AngloAmerican

RioTinto

State of play in 2024:

Moving from planning to action

Diversified miners like Rio Tinto and Anglo American continue to see opportunities in minerals that will contribute to the electrification of the economy and are moving away from thermal coal. Material plans to electrify mining fleets are under way but despite ambitious targets these aims have met some technological challenges, moving slower than expected. For those miners involved in aluminium manufacture (an emissions-intense activity), like Rio Tinto,

capital is being committed to early-stage electrified or hydrogen-power smelting processes. Low-carbon hydrogen manufacture and use is an increasing focus for industrial gas producers like Linde, who is implementing significant capital expenditure over the next five years to retrofit existing facilities with carbon capture technology (supported by the US Inflation Reduction Act). UK-focused utilities National Grid and SSE appear to be broadly on track to meeting net zero commitments that have been in place for some time, motivated and facilitated by the UK Government's aim to decarbonise the energy grid. These two utilities companies are targeting two main levers for decarbonisation:

1. developing renewable energy generation and transmission infrastructure, and
2. diverting and transitioning customers from gas to renewable energy sources.

Climate transition plans are company and sector specific, but it is encouraging to see carbon reduction timelines built into strategic planning and there are signs that preparations for a lower carbon economy are underway.

Half of the companies we engaged with have now set carbon reduction targets that are externally verified by the Science Based Target Initiative (SBTi), with DS Smith, CRH and Linde all having achieved this since our previous climate engagement in 2021/22. This is excellent progress and outside of oil & gas companies and miners, demonstrates that other sectors are making significant decarbonisation commitments. Excluding oil & gas companies, most of our highest emitting holdings have outlined a path to significant carbon reductions. The next five years will be decisive in how successful they are in implementing these targets. Although targets and ambitions have been set, there is still a variation in the quality of plans, and we would welcome more granular information on the capital spending requirements and specific actions proposed to meet broader commitments.

Oil majors are faltering

From our last review in 2021 it was clear that oil & gas companies were under intense pressure to reduce carbon emissions, particularly European majors. It is still the case that BP, Total Energies and Shell have committed to challenging Scope 1 (emissions from direct activities) and Scope 2 (emissions from electricity purchased and used) targets; with BP and Total committing higher levels of future capital expenditure to renewable revenue streams, as part of their transformation into lower carbon integrated energy companies in the long-term. Among some companies we are seeing indications of an increase in capital expenditure (CAPEX) on 'transition growth engines'. BP expects to increase the proportion of its CAPEX in transition growth businesses to more than 40% by 2025 and is aiming for around 50% by 2030. This is a significant transformation and, in terms of CAPEX committed, is ahead of most oil & gas majors.

Despite these areas of progress, it is fair to say that climate transition planning progress has stalled. Multiple factors are pushing oil & gas companies towards sustaining oil production, with energy price spikes arising from the Ukraine war and government pressure to deliver secure energy supplies combining with growing US shareholder pressure for companies to focus on traditional strengths and prioritise shorter term profits & dividends. This year Shell and BP pared back previous decarbonisation targets and slowed reduction in oil production levels. There is a growing focus on capital discipline (operating with tighter investment budgets) and fossil fuel extraction, notably the rapid increase in gas production. Gas can be a useful tool in displacing coal-based energy generation emissions – but without a detailed supplementary climate transition plan, it is increasingly unclear how some European oil & gas majors will decarbonise and what role they will play in a future net zero economy.

US oil majors have not matched the climate commitments made by European peers. Exxon and Chevron have both made high-level ambition statements on achieving net zero emissions by 2050 but have yet to provide credible plans to support this. Chevron has gone further in announcing a 2028 emissions intensity target, which is welcome, but is not comparable to the detail being provided by European peers and not aligned with the Paris Climate Agreement. One bright spot in greenhouse gas (GHG) reductions efforts across the energy industry (including Exxon and Chevron) has been the increased focus on cutting operational methane emissions through better leak monitoring tools and retrofitting of older transmission infrastructure, supported by substantial 2030 reduction targets. That said, since our last assessment the quality of climate transition planning has either remained low or deteriorated.

Scope 3 emissions are not adequately considered by the highest emitters

Many energy companies are facing a rising number of shareholder resolutions requiring the implementation of targets to reduce Scope 3 emissions (indirect emissions from supply chains and products sold). These emissions are often more complex to calculate and unlike Scope 1 and 2 emissions (those from power inputs and direct operations), measurement and management of Scope 3 emissions is not about assigning emissions ownership but assessing the organisation's carbon exposure. Scope 3 emissions can be seen as a good proxy for transition risk and often demonstrates that companies are exposed to these risks across the wider value chain, not just in operational activity[2].

Among miners and energy companies, Scope 3 emissions tend to make up over 90% of overall emissions but many of the climate transition plans in these industries exclude Scope 3. While there are some legitimate difficulties in allocating responsibility for how products sold by companies are used or external supply chains are managed, measurement and targeted reductions will be key to achieving the goals set out in the Paris Climate Agreement. In most instances these emissions can still be influenced by companies through indirect channels. Six of the companies engaged now have some form of Scope 3 emissions reduction aim, with these also incorporated into net zero targets. Linde has confirmed that it will look to publish Scope 3 reduction aims by 2025. Outside of high-level 2050 net zero aims, details on absolute Scope 3 emissions reductions are still missing from Shell, Rio Tinto and Total Energies' climate transition strategies. Exxon and Chevron's 2050 net zero aims only include Scope 1 and 2 emissions. Without companies fully recognising Scope 3 emissions, the transition plans they present will not address its full contribution to climate change. Investors may be exposed via the value chains of the assets they invest in. This is particularly relevant for the highest emitting sectors[3].

Analyst View: A challenging time for the transition – Jamie Maddock, Equity Research Analyst

Irrespective of strong intentions and while the destination is set, the course of the energy transition will at times be temporarily buffeted by unforeseen global events. Most recently, Europe found itself tragically ill-prepared for the devastating war in Ukraine. No more so than in its energy policies, which are reliant on cheap Russian fossil fuels. The rapid rise in fossil fuel prices following the invasion only worsened the challenges global governments faced in tackling post COVID-19 inflation. In response, interest rates were raised to tame strong inflation and there were hurried attempts to locate new fuel resources to reduce the flow of money to Russia.

Additionally, government responses to the invasion had sometimes paradoxical expectations placed upon the energy majors as different positions were taken. For some the focus moved to renewable energy investment at the expense of all else, others wanted more fossil fuel investment to satisfy domestic demand and tame inflation; a third group looked for more investment in both fossil and renewable energy.

Set against this complicated backdrop was the effect of the rise in interest rates, which dramatically changed investment rates of return hurdles that renewable energy projects couldn't meet. Irrespective of being a 'clean' or 'dirty' energy company, it was no longer feasible to justify these investments. Moreover, despite rapidly rising EV (electric vehicle) penetration, global fossil fuel demand continues to grow unperturbed.

In short, the last two years have proven exceptionally challenging to staying on course for delivering the energy transition and satisfying government and near-term societal demands. The interest rate increases, war in Ukraine and reframed European energy policies upended energy markets and the related investment opportunities. When considered within the context of the broader macro-economic and geo-political backdrop the energy majors' near-term goals and successes in reducing Scope 1 and 2 emissions should not be diminished or overlooked in importance to achieving the ultimate aim of achieving net zero in 2050.

2 IIGCC, "Investor approaches to Scope 3"

3 IIGCC, "Investor approaches to Scope 3"

Summary

In 2023, annual average global temperatures reached 1.5 degrees over pre-industrial levels for the first time[4], serving as a reminder that the pathway to 'Net Zero' emissions, and preventing this type of increase worsening, requires a rapid and radical transformation of the economy. We will continue to engage with the highest emitters within our centrally monitored universe on how they are preparing and contributing to this transition in order to assess their exposure to the risks and opportunities being presented. We have found that companies and industries are in many cases putting forward detailed plans on not only the GHG reduction targets they aim to meet but details on how these aims will be implemented. The next few years will be critical in assessing the performance of these companies moving from planning to execution.

The notable exceptions to this positive trend are oil & gas companies. In the US we have seen little progress in the development and sophistication of climate transition plans over the past two years. European oil majors are starting from a stronger base, with more comprehensive operational carbon reduction strategies and a continued pursuit of opportunities in low carbon business activities. Broadly speaking, interest in these new revenue streams has become more focused on convenience services and hydrogen production and away from renewable energy generation. Pressures to secure stable energy supplies and focus on traditional fossil fuel extraction strengths has led to a backslide in carbon reduction commitments and stalled progress in building out more comprehensive climate transition strategies. While, for now, European oil & gas companies continue to commit significant capital expenditure to diversifying revenue streams, it is still unclear how these low carbon activities will displace traditional activities in a net zero world.

We will continue to monitor the performance of our high emitting investee companies and engage to outline expectations for better management and disclosure of climate transition risk. We will leverage individual engagement activity as well as our participation in collaborative engagement groups such as Climate Action 100+ and the Net Zero Engagement Initiative. We will also continue to request a regular shareholder say on climate transition strategies and vote against management where we find progress lacking. In 2024 we voted against management resolutions and supported shareholder resolutions at the AGMs of Shell, Exxon, Chevron and Conoco Phillips.

Next steps

Heading into the second half of 2024 we have implemented a revised cross industry checklist to evaluate company alignment to net zero and progress against targets. This more advanced assessment will enable better benchmarking of investee company transition performance as we move into a critical period for preventing the most severe effects of climate change. The criteria include:

- **A clear vision**: Clear timeline of planned climate transition actions between now and medium-term targets, up through 2040. We would like to see companies clearly committing resources towards achieving decarbonisation targets now, rather than deferring. This can include internal case studies / research into climate solutions and cross-industry collaborations.
- **Shared emissions**: Systemic, integrated approach to addressing Scope 3 emissions. This should include a comprehensive inventory as much as possible, and effective targets to address efforts to decarbonise. Targets should include supplier outreach and collaboration across a company's sector, particularly for challenging, carbon-intensive end products (e.g., steel, aluminium).
- **Evidenced effort**: Demonstrable progress on decarbonisation targets – preferably with quantified progress (i.e., GHG emissions reduced) and attributed to specific actions in annual reporting.

4 World's first year-long breach of key 1.5C warming limit - BBC News

	Clear Vision			Collaborative Approach			Evidenced Effort	
	Emissions disclosed	Robust targets in place	A clear trajectory	Scope 3 target	Articulated supply chain strategy	Cross-industry collaborations	Reported progress towards goals	Quantified and demonstrable examples
Anglo American	Green	Green	Green	Amber	Green	Green	Green	Green
Rio Tinto	Green	Amber	Green	Red	Green	Green	Green	Green
CRH	Green	Green	Amber	Green	Amber	Green	Green	Amber
DS Smith	Green	Green	Red	Green	Green	Green	Green	Green
Linde	Green	Green	Red	Red	Red	Green	Green	Amber
BP	Green	Green	Amber	Amber	Red	Green	Green	Green
Chevron	Amber	Red	Red	Amber	Red	Amber	Amber	Red
Exxon	Amber	Red	Red	Red	Red	Amber	Red	Red
Shell	Amber	Amber	Red	Red	Red	Green	Amber	Green
Total	Green	Green	Green	Green	Amber	Green	Green	Green
SSE	Green	Green	Green	Green	Green	Green	Green	Green
National Grid	Green	Green	Green	Green	Amber	Green	Green	Amber

Key

- Green indicates a company satisfied the criteria clearly.
- Amber indicates the company satisfied the requirement but could improve relative to peers.
- Red indicates a company did not satisfy these criteria.

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