

Can you plan for the long term without knowing the implications of climate change?



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Last year closed with a startling fact: 2018 was the 4th hottest year on record. More and more data is showing that if today’s industrial and consumption patterns do not change, the world is on path to a 3-degree plus scenario (above pre-industrial levels) by 2030. A special report of the Intergovernmental Panel on Climate Change (IPCC)¹ concluded that global emissions need to fall by 45% from 1990 levels by 2030 to constrain the worst impacts. The transition to a 2- or a 1.5-degree world – the aim of the Paris agreement – has attracted a lot of debate on investors’ values.

Besides the discussion on the environment, we also need to consider the economic issues: consumer and regulatory trends are driving a largescale transition in the economy. And this transition is manifesting as financial risk in equity and fixed income portfolios. This could have a devastating impact on businesses. If society buys in to the Paris initiative and companies begin taking concrete action, many unprepared companies will be left with stranded assets on their balance sheets (i.e. in the fossil fuel, coal or oil sectors). As industrial and consumer demand as well as policy context change, some business models will thrive while others will die.

It is a worthwhile exercise to consider studies from the Fraunhofer Institut on German utilities². The institute’s research shows that in Germany, the quality of energy demand has critically pivoted since 2006. On the one hand, there has been a decline in conventional power source demand since 2006. On the other hand demand for renewable energy has consistently outperformed demand for conventional sources of energy in

Germany since 2012. Whilst renewables were still only 4% of total energy supply in Germany in 2017, they were 28% of incremental energy supply in 2017 (in return, incremental demand of fossil fuels as well as hydro and nuclear is contracting).

Consider another study by CDP (Carbon Disclosure Project)³ on the transition readiness of major global oil and gas companies as the world seeks to shift to a 2-degree scenario. Since 2010, the 24 companies in the study have invested US\$22 billion in alternative energies. However, spending on low-carbon assets for the sector as a whole remains low, and is expected to account for only 1.3% of total 2018 CAPEX. One reason for lower spending in this area may be accounting pressures to expense rather than capitalise these efforts, but the number still seems meagre, especially relative to the number of potentially stranded assets in energy sources such as coal.

Three things are clear: first, demand and policy pressures for conventional energy constitute value at risk. Second: companies need to better manage business models, operating models and likely their financial risk that will result from post-Paris agreement responses to climate change. Third: companies and investors are still in the early stages of identifying, quantifying, and valuing the impact of the possible “climatefriendlier” world. There is an urgent business need to accelerate these efforts.

There is also a need for companies to intensify their climate reporting so that investors who want to direct their resources toward sustainable businesses can do so effectively. Transparency is vital here as investment portfolio managers

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need solid metrics in order to measure success – you cannot manage what you cannot measure. One approach is to use scenario analyses of the impact business models have on the environment. Investors would be interested in testing their portfolios against hypothetical climate change scenarios.

As the climate inputs to scenario analysis are specifically difficult to identify, technical experts from academia have supported a UNEPFI (United Nations Environment Programme Finance Initiative) pilot financial task force (Task Force on Climate-related Financial Disclosures). It aims to implement and develop measures for policy, transition and physical risks (value at risk) for companies as the world seeks to transition to a 2-degree scenario. Nordea Asset Management is part of this multi-stakeholder initiative. The results were published this spring and will help sustainable investors to gain a more solid understanding of the risks and opportunities resulting from climate change.

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1. Source: Intergovernmental Panel on Climate Change 2018. “Special Report Global Warming of 1.5°”
2. Source: Fraunhofer Institut: Fraunhofer Technologies for the Herkulean Energy Transition Project “Energiewende”, 2018 (<https://www.fraunhofer.de/en/research/fields-of-research/energy-resources/renewable-energy.html>)
3. Source: Carbon Disclosure Project „Beyond the cycle”. November 2018.