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Principles for Paris-alignment

Position paper

ClientEarth

Top lines

- Climate change is a systemic threat to the social, economic and financial systems we depend on.
- A strategic response to systemic climate risk demands that business and investors set and pursue 'Paris-alignment' or 'net-zero' strategies – hundreds of firms are now doing so.
- As this new norm develops, business, investors, regulators and legislators must aim to maximise ambitions for reducing real-world greenhouse gas (GHG) emissions and to minimise the risks of 'greenwash'.
- To make these goals a reality, 'Paris-alignment' or 'net-zero' strategies must be underpinned by some basic principles – they must be (1) reasonable; (2) transparent; and (3) accountable.

Background

In order to best protect their shareholders, beneficiaries and other stakeholders from the systemic risks of climate change, leading companies and investors are increasingly setting and pursuing 'Paris-alignment' or 'net-zero' objectives and strategies.

We believe this is a major development, which has the potential to accelerate private sector action on climate change, in all of our best interests.

A principles-based approach can strike the required balance between flexibility and credibility.

Currently, a wide variety of methodologies are used to set and assess such strategies. This flexibility is useful in helping to drive ambition. Unfortunately, it also creates a significant risk that 'greenwash' will undermine real action. Over time, improvements and standardisation of methodologies will help to address this problem. In the interim, lack of a perfect approach should not be an excuse for delay.

To ensure that bold ambition is translated into real action, we believe that a principles-based approach, supported by clear, non-negotiable 'Red lines' can help strike the required balance between flexibility and credibility. Based on a review of existing methodologies, in this Position Paper, we propose three overarching 'Paris-alignment principles' and 10(+1) corresponding 'Red lines', that we believe should underpin all 'Paris-alignment' or 'net-zero' claims, initiatives and legislative interventions.

Principles for 'Paris-alignment'

All 'Paris-alignment' or 'net-zero' claims, initiatives and legislative interventions should be underpinned by the following 'Principles' and 'Red lines'.

Principle 1
Reasonable

Paris-aligned targets, assumptions and methodologies must be reasonable, precautionary, evidence-based and regularly updated in line with the best available science.

Red lines

(i) the entity must set an objective of achieving net-zero GHG emissions (Scopes 1–3) by 2050 at the latest, depending on sector, and consistent with a 1.5°C pathway

(ii) the entity must adopt a strategy which sets short, medium and long term targets to achieve its net-zero objective, including 2025 and 2030 targets (Scopes 1–3)

(iii) the strategy and underlying assumptions must prioritise reductions in direct value chain GHG emissions and not unreasonably rely on unproven or uncosted negative GHG emissions, offsets, and/or technology

(iv) the strategy must explicitly consider 'just transition' imperatives

Principle 2
Transparent

Targets, assumptions, uncertainties, method-ologies, performance and impacts must be transparently disclosed.

Red lines

(v) the entity must disclose its targets, assumptions, uncertainties, methodology, impacts, and strategy, and report annually against progress in its financial reporting

(vi) assumptions used in the entity's financial accounts, capital expenditure and/or investment decisions must be consistent with its targets and strategy

(vii) disclosures must be subject to third party assurance

Principle 3
Accountable

Decision-makers must be incentivised and accountable for meeting targets.

Red lines

(viii) the net-zero objective must be adopted in the entity's articles of association or other constitutive documents, subject to any restrictions in local law

(ix) responsibility for achieving targets must be allocated to specific individuals within the entity and linked to remuneration and performance incentives

(x) the entity's lobbying activity and trade association membership must be consistent with its targets and strategy

Red Line – Financial Institutions

(xi) Financial institutions must disclose a detailed policy which explains how they will influence reductions in their Scope 3 GHG emissions through investment, stewardship, financing and underwriting decisions, in order to achieve their targets.

Introduction

Climate change is a systemic threat to the social, economic and financial systems we all depend on.

We are already feeling the impacts. Increasingly severe extreme weather, droughts, floods and fires are now part of our daily reality.[1] At the same time, rapid technology advances, strengthening policy responses, and shifting consumer preferences are reshaping our economies and our lives.[2] Unless we rapidly reduce global GHG emissions through a just and orderly transition, mounting climate hazards will have disastrous and irreversible socio-economic impacts – affecting all of us.[3]

Business and investors are now waking up to the critical role they will need to play in this transition. Spurred on by industry-led initiatives, like the Taskforce on Climate-related Financial Disclosures (TCFD), it is now standard practice for firms to consider, manage and disclose commercial and financial risks associated with climate change.[4] Increasingly, it is an explicit legal requirement.[5] This mainstreaming of 'climate risk' has been an important step in catalysing private sector action. However, as analysis of the macroeconomic implications of climate change become more sophisticated, expectations on companies and financial institutions are also rapidly evolving.

Businesses and investors are waking up to the critical role they will need to play in this transition.

In recent years, studies by central banks and others have become increasingly clear that, over the medium term, the biggest financial threats from climate change are not from short-term shocks or stranded assets, but from broader systemic macroeconomic impacts. Because such systemic threats are largely unhedgeable through a narrow risk management paradigm, leading firms have realised that the only way to meaningfully protect the interests of shareholders, beneficiaries and stakeholders is to contribute to rapid reductions in global GHG emissions, in line with the goals of the Paris Agreement.[7]

1 https://www.wsj.com/articles/pg-e-wildfires-and-the-first-climate-change-bankruptcy-11547820006
2 https://carbontracker.org/clean-tech-and-climate-policy-could-cut-fossil-fuel-profits-by-two-thirds/
3 https://www.mckinsey.com/business-functions/sustainability/our-insights/climate-risk-and-response-physical-hazards-and-socioeconomic-impacts
4 See https://www.fsb-tcfd.org/publications/tcfd-2019-status-report/
5 See, eg, https://www.fca.org.uk/publication/consultation/cp20-3.pdf
6 https://www.ngfs.net/en/technical-supplement-first-ngfs-comprehensive-report;
7 https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

As a result, many firms are now seeking to do exactly that. For example:

- Over **900 companies globally** have publicly committed to pursuing scientifically informed emission reduction targets under the Science Based Targets Initiative (SBTI);[8]
- Investors with over **$US 4.6 trillion assets under management (AUM)** have signed up to the Net Zero Asset Owner Alliance and committed to transition their portfolios to net-zero GHG emissions by 2050;[9]
- Over **130 of the world's biggest banks** ($US 47 trillion) have committed to the Principles for Responsible Banking, to align their financing with the Paris Agreement goals;[10] and
- **Institutional investors** are increasingly bringing AGM resolutions, requiring companies to set and report against Paris-alignment targets.[11]

900+

companies globally have publicly committed to pursuing scientifically informed emission reduction targets.

The UN has also recently launched a major new 'Race to Zero' umbrella campaign that aggregates net zero commitments from other initiatives across the private and public sectors, including from cities, universities and sub-national regions.[12]

We believe that this transition from a paradigm of narrow and reactive 'climate risk' management to one of strategic alignment with the Paris Agreement is a significant step forward. Because of the strong potential to influence company capital expenditure and operations, widespread uptake of 'Paris-alignment' or 'net zero' objectives by investors and business could rapidly accelerate reductions of GHG emissions in the real economy. This in turn will help minimise risks of capital misallocation and stranded assets as governments scale-up their policy response and technology and consumer trends further develop. Mitigating these systemic climate-related risks is in all of our best interests.

Currently, a wide variety of methodologies and frameworks for assessing 'Paris-alignment' or 'net-zero' objectives are being used and developed.[13] These differ significantly based on approach, scope, and assumptions used. Various attempts are now underway to achieve consensus methodologies. However, because of the 'constructive ambiguity' inherent in the Paris Agreement itself, and the lack of current consensus on emission reduction trajectories and alignment methodologies, there is a significant risk that Paris-alignment and 'net-zero' commitments will act as greenwash (or 'greenwish') for inadequate and incremental change.[14]

8 https://sciencebasedtargets.org
9 https://www.unepfi.org/net-zero-alliance/
10 https://www.unepfi.org/banking/bankingprinciples/
11 https://2degrees-investing.org/wp-content/uploads/2019/12/2DII_Shareholder_Resolutions_Report_Passing_the_Baton.pdf
12 https://unfccc.int/climate-action/race-to-zero-campaign
13 See, eg: https://sciencebasedtargets.org/net-zero/; https://2degrees-investing.org/resource/pacta/; https://www.transitionpathwayinitiative.org/; https://www.unepfi.org/banking/bankingprinciples/; https://carbonaccountingfinancials.com/; https://www.climatepolicyinitiative.org/publication/implementing-alignment-recommendations-for-the-international-development-finance-club/; 'Principles to Guide Investment Towards a Stable Climate' (Hepburn et al.): https://www.nature.com/articles/s41558-017-0042-4; https://www.theclimatepledge.com/; https://www.unepfi.org/net-zero-alliance/; https://www.iigcc.org/download/iigcc-paris-aligned-investment-initiative/?wpdmdl=2292&refresh=5e3d2abb2e1581066939 ; https://www.i4ce.org/wp-core/wp-content/uploads/2019/09/I4CE%E2%80%A2Framework_Alignment_Financial_Paris_Agreement_52p.pdf; https:/theinvestoragenda.org/
14 https://preventablesurprises.com/wp-content/uploads/2019/07/2019-07-19-Greenwish-Essay.pdf

Over time, improvements and standardisation of methodologies will help to address this problem. In the interim, some level of flexibility may also be helpful in driving uptake and ambition and prevent the lack of a perfect approach becoming an excuse for delay. To ensure that bold ambition is translated into real action, we believe that initially a principles-based approach, supported by clear, non-negotiable 'Red lines' can help strike the required balance between flexibility and credibility. Based on a review of existing methodologies, we propose three overarching 'Paris-alignment principles' and 10(+1) corresponding 'Red lines', that we believe should underpin all 'Paris-alignment' or 'net-zero' claims and initiatives made by businesses and investors, as well as legislative and regulatory interventions intended to support them.

Our Principles are intended to be broadly applicable to all private sector firms.

These Principles and the associated 10 Red lines are intended to be broadly applicable to all private sector firms. Because of the particular considerations for financial institutions and investors, we have included an additional Red Line specific to these actors. We recognise that this is a dynamic and quickly developing area and that many organisations are working on these issues. Our intention is that these proposed Principles can provide a useful framework that helps complement other related initiatives and that the Red lines will evolve over time as science, methodologies and commercial practices develop. We welcome discussion and feedback on these matters.

Paris Agreement Goals

The overarching temperature and emission reduction goals and timelines established by the Paris Agreement are set out in articles 2.1(a) and 4.1.

To keep global warming to 1.5°C, GHG emissions need to be at 'net zero' around 2050.

These state as follows:

- **Article 2.1**: This Agreement … aims to strengthen the global response to the threat of climate change … including by:

  (a) Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change…;

- **Article 4**: In order to achieve the long-term temperature goal set out in Article 2, Parties aim to reach global peaking of GHG emissions as soon as possible, recognizing that peaking will take longer for developing country Parties, and to undertake rapid reductions thereafter in accordance with best available science, so as to achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases in the second half of this century, on the basis of equity, and in the context of sustainable development and efforts to eradicate poverty.[15]

In effect, these articles of the Paris Agreement establish goals of keeping global average temperatures to well below 2°C and aiming for 1.5°C, and undertaking rapid reductions in line with best available science to achieve 'net-zero' GHG emissions in the second half of the century.

Subsequently, the IPCC Special Report on the Impacts of Global Warming at 1.5°C (IPCC 1.5°C Report) has found that to keep global warming to 1.5°C, GHG emissions need to be at 'net zero' around 2050, or around 2070 for 2°C.[16] This now serves as the most reliable guide as to what is required to meet the temperature objectives in art 2.1(c), and the 'best available science' informed emission reduction targets of art 4.1. Accordingly the concept of reaching 'net-zero' by 2050 or earlier has also become a useful shorthand for describing Paris-alignment. These dual temperature and emission reduction goals must therefore form the basic reference point for any Paris-alignment strategy or objective, but may develop over time, in line with the best available science.

15 https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
16 https://www.ipcc.ch/sr15/chapter/spm/

Proposed Paris-alignment principles

Principle 1 – Reasonable

Paris-aligned targets, assumptions and methodologies must be reasonable, precautionary, evidence-based and regularly updated in line with the best available science.

Red lines

(i) the entity must set an objective of achieving net-zero GHG emissions (Scopes 1–3) by 2050 at the latest, depending on sector, and consistent with a 1.5°C pathway

(ii) the entity must adopt a strategy which sets short, medium and long term targets to achieve its net-zero objective, including 2025 and 2030 targets (Scopes 1–3)

(iii) the strategy and underlying assumptions must prioritise reductions in direct value chain GHG emissions and not unreasonably rely on unproven or uncosted negative GHG emissions, offsets, and/or technology

(iv) the strategy must explicitly consider 'just transition' imperatives

Explanation

To achieve economy-wide alignment with the Paris Agreement objectives, some geographies, sectors and entities will need to transition to a net-zero carbon economy more quickly than others.[17] Each entity should seek to set the soonest possible date by which they can achieve net zero GHG emissions or align with the Paris Agreement's temperature goals. These commitments must include short, medium and long term targets (including 2025 and 2030 targets), and cover emissions from both upstream (supply chain) and downstream (ultimate use of products) activities (i.e., scope 1, scope 2 and scope 3 emissions).[18] Entities must take a prudent and precautionary approach to the best available science, and assumptions and methodological choices must be reasonable and supported by evidence. In particular, the underlying scenario or pathway adopted as the basis for alignment should itself be aligned with the 1.5°C temperature goal.[19]

Each entity must adopt a strategy which sets short, medium and long term targets to achieve its net-zero objective.

17 See https://preventablesurprises.com/publications/blog/making-net-zero-count-by-facing-up-to-its-shortcomings/
18 https://ghgprotocol.org/
19 See, eg., https://mission2020.global/letter-to-iea/

The entity's strategy and targets should be regularly reviewed and updated in line with the best available science.

Entities must adopt a strategy that ensures the entity will meet its Paris-alignment or net zero objective. The strategy should detail how the entity plans to meet its target, including a strategy for how it plans to influence reductions in its Scope 3 emissions. The strategy must set out how the company will address both physical and transition risks posed by climate change and take into account the interests of workers and other stakeholders in a 'just transition'.[20] The strategy and underlying assumptions should prioritise reductions in direct value chain GHG emissions and not unreasonably rely on unproven or uncosted negative GHG emissions technology or offsets.[21] Decisions relating to capital expenditure, operational expenditure, and asset allocation should be consistent with the strategy. The entity's strategy and targets should be regularly reviewed and updated in line with the best available science.

In many cases, entities may also need to consider sector and activity-specific exclusions and benchmarks in relation to certain sectors and activities responsible for the bulk of GHG emissions, including, for example the extraction and combustion of fossil fuels and deforestation.[22]

20 https://www.tuc.org.uk/research-analysis/reports/just-transition-greener-fairer-economy; http://www.lse.ac.uk/GranthamInstitute/investing-in-a-just-transition-global-project/
21 See, eg, https://www.ox.ac.uk/news/2020-09-29-oxford-launches-new-principles-credible-carbon-offsetting
22 See, eg, https://www.ran.org/wp-content/uploads/2020/09/RAN_Principles_for_Paris-Aligned_Financial_Institutions.pdf

Principle 2 – Transparent

Assumptions, uncertainties, methodologies, performance and impacts must be transparently disclosed.

Red lines

(v) the entity must disclose its targets, assumptions, uncertainties, methodology, impacts, and strategy, and report annually against progress in its financial reporting

(vi) assumptions used in the entity's financial accounts, capital expenditure and/or investment decisions must be consistent with its targets and strategy

(vii) disclosures must be subject to third party assurance

Explanation

Because of the wide variety of possible methodologies and assumptions which can underpin a Paris-aligned pathway, it is imperative that companies are transparent about their assumptions and targets, their performance against those targets, and how their behaviour is impacting GHG reductions in the real economy. This information therefore needs to be disclosed publicly on a regular and ongoing basis. If the company does not use a methodology published by an independent third party,[23] it must publish the methodology it has used to calculate its target. Targets should be regularly updated over time to reflect the entity's highest possible ambition, which should be informed by the best available technologies at the time of the review.

Where possible, this information must be integrated in existing formal reporting and aligned with broader climate-related reporting consistent with the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD).[24] To ensure that the Paris-aligned strategy is being implemented, assumptions used in the entity's financial accounts (IFRS/GAAP), management accounts, capital expenditure, operational expenditure, and other investment decisions must be consistent with those used to set its targets and strategy.[25] The entity should also disclose any assumed internal price of GHG emissions (commonly known as the "carbon price") used to inform investment or capital expenditure decisions.[26]
All disclosures relating to targets, assumptions, methodology, impacts, and strategy must be subject to third party assurance.

Targets should be regularly updated over time to reflect the entity's highest possible ambition.

23 For instance, the methods set out by the Science Based Target Initiative, available at: https://sciencebasedtargets.org/methods/
24 https://www.fsb-tcfd.org/
25 https://www.unpri.org/accounting-for-climate-change/public-letter-investment-groupings/6432.article
26 See, eg, https://carbontracker.org/when-capex-met-climate/

Principle 3 – Accountable

Decision-makers must be incentivised and accountable for meeting targets.

Red lines

(viii) the Paris-alignment/net-zero objective must be adopted in the entity's articles of association or other constitutive documents, subject to any restrictions in local law.

(ix) responsibility for achieving targets must be allocated to specific individuals within the entity and linked to remuneration and performance incentives.

(x) the entity's lobbying activity and trade association membership must be consistent with its targets and strategy.

Explanation

Because of the potential for the achievement of Paris-alignment or net-zero objectives to be misaligned with other internal and external incentives for actors within firms, it is imperative that they are supported by robust incentives and accountability measures.

As many companies, banks and investors are now doing, the Paris-alignment/net-zero objective must be formally adopted in the entity's articles of association or other constitutive documents, subject to any restrictions in local law.[27] The entity's senior decision makers must be ultimately responsible for meeting the entity's commitments and targets. They should be appropriately incentivised to achieve targets and effectively accountable, where they fail to do so. To ensure that targets are met, entities must adopt policies to link senior decision-maker remuneration and other incentives to both the overall target and the quantitative interim targets. Such incentives should include both financial and non-financial measures, and take into account legal, market-based and behavioural factors.

Entities must also ensure that their membership of trade associations and industry groups are consistent with their strategy and targets, and promote legislative and regulatory changes that would support their stated objectives.[28]

The entity's senior decision makers must be ultimately responsible for meeting the entity's commitments and targets.

27 See, eg, https://www.clientearth.org/responding-to-investor-pressure-barclays-presents-new-climate-policy/
28 https://hbr.org/2019/10/corporate-action-on-climate-change-has-to-include-lobbying

Financial institutions

Red line

(xi) Financial institutions must disclose a policy which explains how they will influence reductions in their Scope 3 GHG emissions through investment, stewardship, financing and underwriting decisions, in order to achieve their targets.

Explanation

The alignment of financial institutions' strategies with the Paris Agreement is heavily dependent on the alignment of their real economy clients and investees.[29]

For this reason, it is particularly important for financial institutions that claim a Paris-alignment objective to articulate how they will strategically use their investment, stewardship, financing and underwriting decisions to influence their Scope 3 emissions by changing the behaviour of real economy actors (companies and households).[30] Financial institutions' investment decisions and level of engagement will play a significant role in determining whether or not the goals of the Paris Agreement are met. Different types of financial institutions should also consider specific issues relevant to their activities, such as:

Banks

Before providing financing, banks should require that counter-parties have a Paris-aligned business strategy, or agree to adopt one by a prescribed deadline.

As banks develop insights on best practices for decarbonisation by sector, they should start to engage with counterparties on their Paris-aligned business strategies before new financing or re-financing is provided, which may include setting targets or deadlines to achieve their net zero objective. Where appropriate, financing should be subject to conditions and borrower covenants reflecting the above that link to events of default. Counterparty compliance should be monitored, enforced and reported against on an ongoing basis.

Financial institutions' investment decisions and level of engagement will play a significant role in determining whether or not the goals of the Paris Agreement are met.

29 https://www.climate-kic.org/insights/how-can-financial-institutions-move-beyond-climate-risk-management-towards-much-closer-alignment-with-climate-outcomes/ https://rmi.org/insight/navigating-five-barriers-to-climate-aligned-finance/
30 See, eg, https://www.brunelpensionpartnership.org/climate-change/

Insurers

Before providing insurance coverage or renewals, insurers should require that the insureds have a Paris-strategy, or agree to adopt one by a prescribed deadline.

As insurers develop insights on best practices for decarbonisation by sector, they should start to engage with the insureds on their Paris-aligned strategy before insurance coverage is provided, which may include setting targets or deadlines to achieve their net zero objective. Insurance coverage should be subject to conditions reflecting the above that link to events of default. Compliance should be monitored, enforced and reported against on an ongoing basis.

Investors

Investor's stewardship policies should establish an expectation that all portfolio companies adopt a Paris-aligned strategy.

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The investor should then explain the actions it will take (forceful stewardship, proxy voting and public affairs influence) to influence portfolio company adoption and compliance with such strategies.[31]

In order to help overcome any practical and technical collective action challenges, investors should join and actively participate in industry-wide initiatives to demand that portfolio companies pursue Paris-alignment/net zero strategies, and hold them accountable for their progress.[32]

31 See further https://preventablesurprises.com/publications/blog/forceful-stewardship-says-show-us-your-2c-transition-plans/
32 See, eg, http://www.climateaction100.org/

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