Business Model

1. Introduction

Universal Owner is committed to developing a framework to measure engagement impact on climate change and to using this framework to develop an evidence-base to inform the market about which kinds of engagement tend to have the most impact. This is a deliberate systemic intervention with the ability to upscale the quality of investor engagement profoundly. It encompasses three interlinked issues: measuring impact, establishing best practice, and motivating adoption.

2. The Problem

If the world is to avert catastrophic climate change, greenhouse gas emissions must almost halve by 2030 before falling to net-zero by 2050. Publicly listed companies are responsible for around a quarter of global emissions and stand at the frontier of climate innovation. It is predominantly the financial system that holds ownership rights and powers over these companies.

Institutional investors increasingly rely upon engagement to influence their portfolio on climate change. The rise of passive investing and institutions' increasingly diversified portfolios makes 'exit' impossible. There is also a growing academic consensus that the principal alternative to engagement, capital allocation, can only influence companies under limited conditions.

Yet, there is currently no way of measuring engagement impact. The consequences are parlous. We have no way to reliably distinguish between successful and unsuccessful engagements and no evidence base from which to derive conclusions about best practice. Investors cannot be held to account for their engagement by stakeholders and civil society, or answer the emerging legal expectation that they justify the impact they claim for themselves.

Our early research suggests that there is a wide variation in the impact of different engagement asks. Studying the utility sector, we found that demands for business model change, political lobbying audits, and the adoption of net-zero targets proved most impactful. But these are not what most of the world's leading institutional investors tend to engage on. Instead, they focus overwhelmingly on the disclosure of climate risk. We call this the 'engagement gap', and we have written a follow-up report analysing Vanguard as an exemplar of this dissonance. We strategically also needed to make our case for universal ownership theory, as we believe it can widely underpin the financial system's justification for demanding climate impact.

3. The Solution

We have developed a novel methodology to measure engagement impact. At its most general, an engagement's climate impact is the change it effects on a company's emissions. Impact is often incorrectly equated to exposure, the emissions of the companies in an investors' portfolio. But an investor can claim no benefit for holding green companies if they have done nothing to green them. More precisely, an investors' impact is a function of two quantities: how far the company moves towards Paris-alignment, and what share of responsibility the engagement has for that movement.

Change

If an engagement's impact is the degree of change it affects in a company, any measurement of impact must begin by specifying its end. We take the Paris Agreement's goal of limiting global warming to 'well below 2, preferably to 1.5 degrees Celsius' as the ultimate end of all climate engagement. But there are different kinds of change towards that common end.

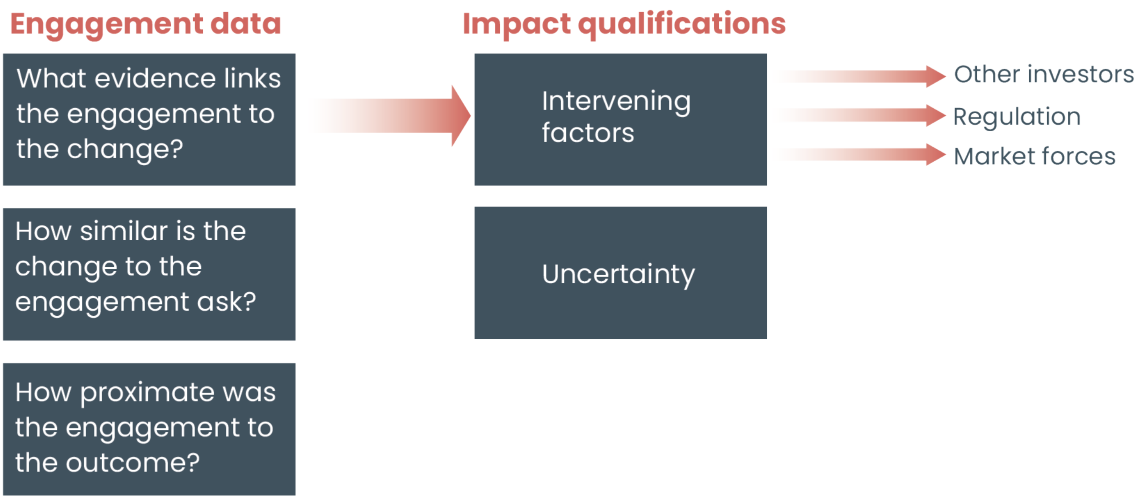
First, we measure two forms of direct engagement impact. An investor can incentivise or force a company to change the real-world activities that bear the most on the problem of climate change: its business model and its political lobbying. These 'real-world' changes are distinct from modifications to process, disclosure, or policies internal to a company. We measure an engagement's impact on a company's political lobbying according to how far it moves the company along a scale of progressively Paris-aligned lobbying positions. This scale is not too great of a departure from the existing methods of InfluenceMap.

It is comparatively more difficult to measure business model changes. Publicly available information is barely sufficient for our purposes. Ideally, this work requires an understanding of individual asset-level changes (e.g., the retirement of a coal power plant), how CAPEX decisions feed into asset-level changes and a model of how these changes move a company consistent with a Paris-aligned scenario. Granular asset-level data for climate-critical sectors has been aggregated by both the 2Dii subsidiary Asset Resolution and the Oxford Sustainable Finance Programme. This data can be combined with Carbon Lock-In Curves or some comparable sector-by-sector model of scenario alignment to establish how far a given change in assets moves a company towards Paris-alignment.

Second, as our research into the utlity sector demonstrated, company-wide targets represent significant commitments and often serve as pivot points in business strategy. Yet clearly, targets do not define a change to a company's business model or political lobbying in themselves. Their impact is indirect. Therefore, we can measure an investor's impact when they move a company to adopt company-wide targets by looking at the quality of those targets: their scope, intermediate goals, and implied rate of decarbonisation.

Responsibility

It is not enough to know that a company has changed on the subject on which an investor engaged it. It is necessary to establish what responsibility the investor has for that change. An investor can only claim a share of the impact of a change proportional to its contribution to bringing it about. We use three heuristics to analyse the relationship between an engagement and a given company change: the direct evidence linking the two, the proximity of the engagement to the change, and the similarity of the change to the engagement ask. We then identify intervening factors – from other investors to market forces, to state action – and apply the same heuristics, allowing us to make a holistic assessment of the relative contribution of the engagement.



Not all investor-company engagements are equally clear. Sometimes available information is limited. We err on the side of conservatism, giving less responsibility to investors in those cases for which we have less information. In this sense, what we are interested in is not responsibility as such, but credible responsibility. We represent our completeness of information for each case with a 'credence score'.

4. Achieving Scale

Our organisation was set up with the help of two philanthropic grants of over £50,000. We will be migrating to include private sector income by the end of 2021 by providing an impact verification service to asset managers. Working with influential asset managers is one way of changing the market. But this could be a slow route to the kind of scale that we would need to transform the market. Many asset managers are wedded to a paradigm of climate risk mitigation and may be wary of third parties auditing/verifying their engagement impact. This is also pushing us towards working with asset managers who are already closest to best practice rather than lifting up the market as a whole.

We are also working with a mainstream RI standard-setter that is developing a certification that includes engagement impact. However, whereas its processes limit its analysis to investors' public claims of impact, they need us to provide critical insights into whether their claims are justified.

Our core product is our novel methodology, but it has several possible use-cases. We can harness it to establish general conclusions about which kinds of engagement are the most impactful. We can also use it to institutionalise a framework for measuring and demanding engagement impact. Working as consultants for individual asset managers would allow us to do the first of these effectively. But the second and the third are better suited to a philanthropic venture. This is because they attempt to introduce a framework and evidence-base to improve the market as a whole, i.e., they are public benefits, not private benefits that commercial fees can cleanly capture.

We believe the most effective way to systematically change the market is to set up a working group with leading asset owners. Major asset owners tend to have more ambitious policies on climate change than their asset managers. Asset managers face the risk of an impact verification process returning a negative result. For asset owners, it is all upside: they want to know if their managers are doing a good or a bad job. Asset owners can also drive change along the investment chain. If they begin to demand engagement impact as part of their mandates, asset managers will feel competitive pressures to prove engagement impact as part of their standard offering.

We are already in talks with some of the world's largest and most influential pension funds and sovereign wealth funds (from Australia, Norway, Sweden, the UK, and the US). They are interested in whether we can help them understand their asset managers' engagement impact and what they should be demanding of their managers. Our ambition in collaborating with these institutions is threefold:

- To draw on their collective expertise to refine the concept of engagement impact.
- To use asset owners' influence to help us access the private engagement data of asset managers. From this, we can derive general conclusions about best practice. We can also give the asset owners a unique insight and overview of their contribution to real-world impact through their asset managers.
- We believe that working with asset owners will be the fastest route to market buy-in and legitimacy. It would give us a platform to institutionalise our framework for measuring engagement impact and to disseminate our results on engagement best practice.

Our planned output of this collaboration is to release a report before the end of 2021. The research and modus operandi would be similar to how 2Dii worked with Swiss insurance companies to road-test and socialise its PACTA methodology in 2017. We would deliver a standardised definition of engagement impact, a framework to measure engagement impact, and conclusions about the state of the market and best practice. We would also draw up actionable recommendations for asset owners and asset managers.