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# Corporate net zero: we need a more sophisticated approach

Published on April 26, 2021

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9 articles

The private sector holds the key to decarbonising the economy over the next quarter century. As countries set "net zero" or equivalent targets backed by **carefully designed roadmaps for sectors** such as energy, transportation and food, there's a widespread assumption that "national net zero" should mean "net zero for all", including "corporate net zero" (CNZ) for today's businesses. Although there are some benefits to unpacking national net-zero targets in this way, there are also several important drawbacks. A more sophisticated approach is urgently required.

Ahead of the COP26 conference in Glasgow later this year, governments are likely to set or raise national targets for decarbonising their economies. In much of the world, the private sector will mobilise to serve rapidly expanding markets, for example for electric vehicles or plant-based food. Experience suggests that we're about to witness a huge amount of creative destruction as entirely new industries are born, nascent sectors flourish and demand for products and services we once considered permanent fades, threatening or even destroying what have been large companies – a fate similar to landline-based telephony or, potentially, to cash-based transactions.

As the opportunities and risks linked to climate change become mainstream for many companies and their stakeholders, corporate net-zero targets have several attractions. Faced with a simple message that they should develop, analyse and act on specific climate change opportunities and risks, management teams will not only identify ways to improve the company's risk-adjusted returns but may also produce or facilitate breakthroughs for their customers or suppliers, for example by placing bulk orders for low-carbon products.

Similarly, multiple CNZ commitments across a sector may enable discussions around possible collective action, for example the establishment of clusters to generate and consume "green" hydrogen. Early action by companies can encourage governments to develop further their policies to mitigate climate change, while corporate pledges may unlock capital to catalyse new climate-friendly activities, for example in nature-based solutions.

**The drawbacks of a blanket adoption of corporate net zero**

And yet there are several crucial drawbacks to the blanket adoption of corporate net-zero targets.

First, and most obvious, is the definition and interpretation of net zero. Apart from the ambiguity around each entity's pathway to net zero (i.e. "how much, by when?"), the role for offsets is contentious - for example, should a cement manufacturer be able to account for the carbon benefits of its investments in peatland restoration, or if we allow this, does that create a moral hazard (to pollute)? And how should low-carbon technologies be treated: for example, when a new wind farm is built, does it really make sense that the entity purchasing the electricity gets the carbon benefit while the investor (or wind farm owner) receives no such boost to their own carbon accounting?

Second is capital inefficiency. To ensure there's sufficient "creative destruction" as we reset our economy, we need to avoid hampering the essential sunsetting of certain activities in favour of new ones. The law of diminishing returns predicts that, as companies implement efficiency measures and cost-competitive technologies to reduce their emissions, they will need to consume more and more capital to save the next tonne of carbon, for example, steel manufacturers seeking to switch to direct hydrogen reduction. At the same time, companies producing alternative products, for example construction materials based on wood, may offer much higher financial returns on an equivalent amount of capital with much lower risk. Faced with a choice, investors are likely to prefer the latter.

Third, skills. To pivot successfully to entirely new activities, today's companies need to harness alternative expertise. For example, can today's oil majors with their competence in seismology and the handling of liquids, realistically develop a competitive advantage in the development of power projects and in electricity trading to outcompete today's power generators?

Fourth, value chain effects. Notwithstanding the challenges of measuring so-called "Scope 3" emissions, a company that pursues a net-zero position without concern for its customers or even its suppliers may unwittingly hold back climate change mitigation across the "system" (i.e., the wider economy). For example, if the renewable energy supply required to enable a manufacturer of insulation material to become net zero costs significantly more than the fossil fuel supply it used previously, the price of its product will rise, thereby reducing its potential to assist customers with their energy savings.

Fifth, the "someone else's problem" effect. It's too easy for today's management team to commit a company to long-term targets that they personally won't be around to deliver on.

And lastly, confusing signals. As decarbonisation progresses, management teams may be faced with a conflict between achieving financial objectives and delivering on the company's net-zero pledge. This may not matter at the outset, but once the "early wins" in emissions reduction have been secured, difficult conversations about the trade-off between financial and environmental outcomes are, in my view, inevitable.

**Climate change resilience first**

So, what's to be done? A sound starting point is to use "corporate net zero" as an agenda item for a deeper discussion on climate change between companies and their investors. But rather than starting that conversation by simply insisting on the adoption of net-zero targets, investors should seek to assess whether the company is already or aiming to become "climate change resilient" using the framework recommended by the Taskforce on Climate-Related Financial Disclosure ("TCFD") which covers both emissions reductions and physical climate risks.

This should cover the four areas outlined by TCFD:

- First, governance: what changes has the company considered and made to ensure that climate change issues are managed comprehensively over a long timeframe?
- Second, strategy: how has the company's business strategy evolved in response, what alternatives has management considered and what will be the impact on the company's expected return on invested capital?
- Third, risk and opportunity: has the company mapped out the key changes in these areas arising from climate change and implemented programmes to monitor them over a long timeframe?
- And fourth, metrics, targets and reporting: is the company's planned reporting in this area likely to provide decision-useful information to shareholders and other stakeholders?

These conversations should lead to a comprehensive, rational plan for each company to manage climate change issues over time, tailored to its individual circumstances. For some, the optimal result will be to adopt a (simple to communicate) corporate net-zero target described in a way that avoids the drawbacks discussed earlier. For others (and in particular, in hard-to-abate sectors), a more appropriate response would be (a) a business plan focused on the efficient use of capital in the context of a wider set of risks, (b) imaginative and proactive collaboration with peers and government to shape new markets, and (c) clear communication with all stakeholders.

We need to be careful that "corporate net zero" does not turn into "one-size-fits-all". The failure to take a thoughtful and sophisticated approach to these issues is likely to result in management confusion, muddled or misleading external communication and perhaps most significantly, the misallocation of capital. Now is the time to get our proverbial ducks in a row!



Published by
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The current enthusiasm for "corporate net zero" is understandable, but there are significant drawbacks that are set to lead to confusion and unintended consequences. My take on why, in the face of climate change, companies should follow TCFD guidance and reporting, prioritising sound strategy and resilience.



**Harald Walkate** • 3rd+ 3mo
Sustainable Finance - Natixis Investment Managers & Advisor Impact Management Project
Excellent piece again Ian. And that's a large number of drawbacks, isn't it? Still, I would suggest adding one other, that you currently have listed in the 'benefits' section - which is the signal that CNZ commitments are sending to governments. Rather than an encouragement for governments to develop policies, I think it might be mistaken for the signal that the private sector is already sorting this out. However, as you suggest - and I think most climate scientists and economists would agree wi …see more
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**Ian Simm** • 3rd+ 3mo
Founder & Chief Executive at Impax Asset Management
Fully agree, Harald. There's a line of argument that if corporates move first then governments will have confidence that tough policies in GHG emissions reduction will be accepted (rather than lobbied against). However the risk that governments in some countries sit back and do too little is too great. The optimal path is of course for both "communities" to move together, which is something we should all be pushing for (and where investors have a powerful voice).
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**Harald Walkate** • 3rd+ 3mo
Sustainable Finance - Natixis Investment Managers & Advisor Impact Management Project
Thanks Ian, we're certainly in agreement on that! Some communities may be less excited about moving together once they realize this means 'sunsetting' for them but, as you say, investors should have a powerful voice in this and, I would argue, a more dispassionate one.
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**William "Billy" Gridley CFA FSA** • 3rd+ 3mo
Director, Investor Relationships, Paris Aligned Investment Research Lead, Public Policy Advocacy Lead | Cere…
Provocative. Thanks yet again to Ian Simm. Yes indeed. And if CNZ and Investor Net Zero (INZ), net zero and even "zero" are inadequate, reductionist, first derivative 1.0 versions, could not attendant and concerted progress (a big bite, a fat pie slice of the necessary near-term GHG reductions) be nonetheless potent? People are hard at best to organize. Then pursuit of those 5 dimensions in your version 2.0 of TCFD "emissions and resilience" … and more! I find I need more grist these mill …see more
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**Ian Simm** • 3rd+ 3mo
Founder & Chief Executive at Impax Asset Management
William "Billy" Gridley CFA FSA Those are critically important questions, Billy, and probably best discussed in another format. Great to see Ceres doing so much in this area! Would love to connect over Zoom/Teams at some stage.
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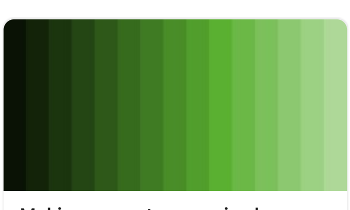

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