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# Moody's Sets New Course to Rigorously Assess Carbon Transition Net-Zero Plans as a Business Imperative

- *Moody's has developed a resource to gauge company progress on carbon transition plans.*
- *The tool provides a description of a company's plan, as well as an analysis of its credibility, likelihood of success and governance commitments.*
- *Carbon transition plans are assessed on three areas: Ambition, Implementation and Governance.*
- *The paradigm shift by Moody's and other credit agencies raises questioning of corporate carbon transition plans to an institutional level.*

## Introduction

People who are interested in the progress that companies are making on the carbon transition have a new resource for objective information: The credit raters.

After being stung by the long-term impact of failing to warn about the mortgage meltdown, credit rating agencies (at least, Moody's Investors Service and Fitch Ratings) have responded by creating a lens for investors to review corporate carbon transition plans. This commentary examines the new Net-Zero Assessment (NZA) tool developed by Moody's as a prime and leading example of this initiative.

Many efforts have been launched to provide enhanced information to investors and the public related to the carbon transition. Most voluntary efforts have created resources that move the needle forward, but there is a steady drumbeat of concern that the models, data and paradigms that have been produced are quite limited. For example, the Teachers Insurance and Annuity Association (TIAA), which has $1.3 trillion in assets under management, discloses it cannot create a reasonable carbon footprint analysis for 70% of its portfolio due to limitations in the current state of carbon accounting.[1] Also, the political structure can hinder governmental regulatory oversight from setting even modest climate disclosure requirements—a particularly controversial issue in the United States.

The new Moody's diagnostic tool exceeds even the most stringent disclosure standards. The credit agency emphasizes performance, subjects company claims to independent assessment and publishes a report with a credibility ranking.

The tool arrives at a time when the public has seen most major companies make large emission reduction commitments. It is time to see if those commitments can become promises kept.

## What Is This New Tool?

The Moody's NZA tool provides a description of a company's carbon transition plan and an analysis of its credibility, likelihood of success and governance commitments. The tool is designed to apply to non-financial corporates and business-like public enterprises. It excludes specific projects, companies and entities that do not have greenhouse gas (GHG) emission reduction targets.

The tool is not designed to produce "gotcha" results, but rather to dispassionately lay out a company's transition plans and the likelihood of achieving them, given the company's commitment and resource allocations. It is intended to review company results over time, and to note progress or slippage. The goal of the Moody's NZA tool is to report both good news and bad news in a balanced context.

The analysis is focused on issuers and designed to gain insight into the energy transition on a company-by-company, sector-by-sector, country-by-country basis. The analytics emphasize the nuances of implementation and rely on the expertise of the rating agency staff.

The critical question is: Are issuer transition plans credible? The answers provided by the NZA tool aim to be fair, objective and complex. The work products can be used—beyond fixed income analysis—for internal strategic corporate reviews, independent public reviews, stock analysis and evaluations of private equity funds. Fiduciaries, staff and consultants can adapt some or all of the methodology to evaluate their own programs and/or assess portfolio companies. The Moody's endorsement, however, offers a more thoroughgoing, independent assessment.

Although the tool does not speak to the credit rating implications of the net zero transition, it provides an assessment of the credibility of companies' transition plans, information that can be used as part of the credit rating analysis. The NZA provides a concise score that can be valuable to investors and other stakeholders.

## What Advantages Does the Moody's Tool Have Over Existing Options for Sustainability Plan Review?

Issuers who engage in this process receive an assessment by a credit agency that rates $73 trillion in debt worldwide. The agency is involved with the credit standing of thousands of issuers, including companies and governments.

No other voluntary scheme or publicly mandated disclosure regime provides this type of assessment. Tools that have been developed to address the carbon transition have been poorly designed methodologically and are almost always considered biased.

The New York State Common Retirement Fund (CRF) recently conducted a review of the carbon transition plans of most major integrated oil company business plans. CRF's reviews appear to be similar in intention to the Moody's approach. ExxonMobil, the industry leader, failed the test, which led the CRF to divest some of its holdings in the company. Other holdings are being retained but with stepped-up diligence by the CRF. Support for the comptroller from climate activists was divided, however, due to weaknesses in the assessment and a failure to protect assets of the fund by excluding fossil fuel companies from the fund.

In 2022, TIAA customers filed a complaint with Principles for Responsible Investment (PRI), an independent but UN-supported network of investors.[2] The detailed complaint hit on basic flaws in TIAA's climate plan and process, identifying substantial carbon exposure left unaddressed by the plan. PRI rejected the complaint without explanation, but noted it would be conducting a review of its standards.[3]

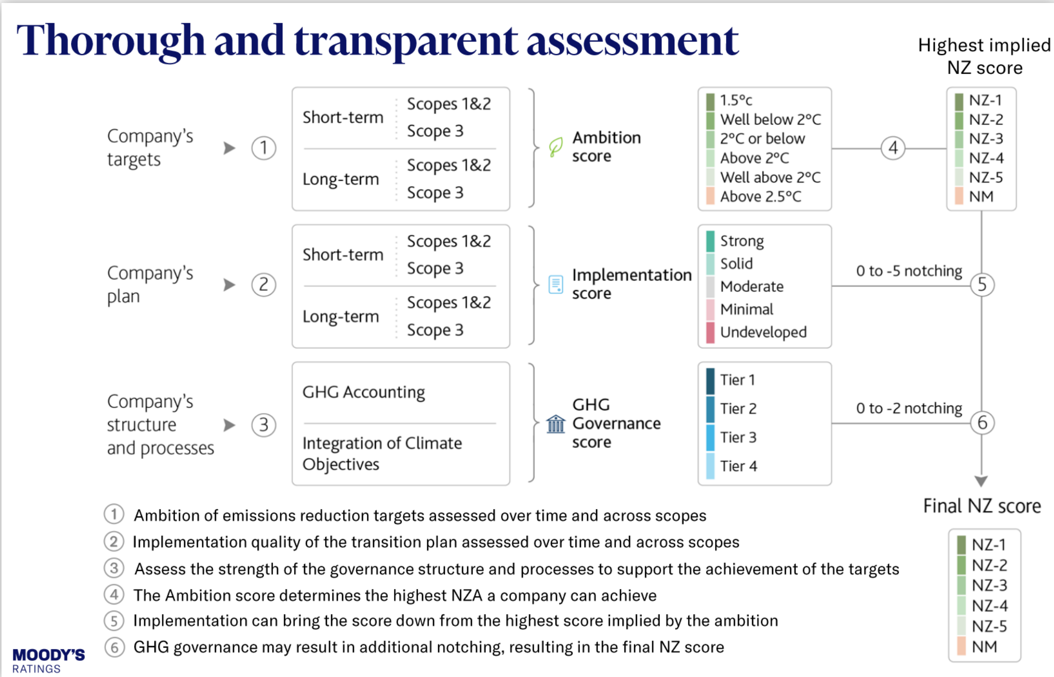
## The NZA Analytical Framework

Moody's work products that constitute the assessment draw from a series of standards that are generally consistent with the Paris Agreement.[4] Moody's derives an opinion on the strength of an issuer's carbon transition plan. It is Moody's independent assessment.

The analysis includes three parts: **Ambition, Implementation and Governance.**

The **Ambition** assessment provides an opinion on the magnitude of emissions cuts targeted by the entity. The assessment tool adds and subtracts the values attributed to actions that underlie emissions targets projected by issuers. The final adjusted statistical judgment by Moody's tells an investor whether the issuer has a plan that is likely to achieve a 1.5° C Implied Temperature Rating (ITR), which makes the issuer eligible for the highest score rating of NZ-1.[5] An issuer with a less ambitious plan could receive an NZ-5, a designation reserved for a plan that would reach 2.5° C. For plans that have very material gaps or significant weaknesses and do not qualify for an NZ-5, an issuer could earn the undesirable rating of Not Meaningful (NM).

**Figure 1: Moody's Framework**




The Ambition score drives the overall assessment, since it is the forward-looking metric that is associated with the entity's GHG emission target vs. the benchmark for the sector.

The assessment looks at short- and long-term targets through a weighting mechanism that incorporates Scope 1, 2 and 3 sub-factors.

The **Implementation** score is determined by examining the ambition of the plan and whether it is likely to succeed based on technical, financial and business assessments. The NZA score earned for Ambition is then reviewed against the quality of the issuer's Implementation plan and governance structure. The highest quality of implementation is "Strong." Other scores run a spectrum of "Solid," "Moderate," "Minimal" and "Undeveloped."

Each aspect of the NZA (including implementation) contains detailed discussions of the business and technical dimensions of the plan. Keys to credibility include disclosure, track record, recognition of obstacles and external hurdles, and corrective actions that maintain adherence to goals and establish effective pathways to achieve them.

External hurdles are defined as "unproven-at-scale technologies or material dependencies." For example, many companies have goals that are back-loaded, based on nascent technologies. This poses significant challenges for the NZA implementation scoring by Moody's. Here is how the tool addresses the issue in part:

> For entities whose transition plan largely relies on the adoption of non-existent or nascent technologies or a complete redesign or phaseout of their products, the reasonableness of the solutions is an important consideration in our assessment of technical soundness including their readiness or expected availability over time and the potential emissions reduction gains associated with these solutions.

> However, plans overly dependent on a long-term unproven technology deployment that lacks feasible short-term reduction actions are likely to receive lower scores. Sound short-term actions also increase the likelihood that longer-term emissions reductions will materialize. For example, an entity's investments in nascent technologies, in the form of R&D expenditures, joint ventures or partnerships, and pilot projects is likely to support the future deployment and scaling up of those technologies. Although an entity's individual efforts to deploy an innovative technology are rarely sufficient for its widespread adoption, individual entities' efforts are needed to attain ambitious emissions reduction goals. Such efforts signal these entities' commitment to their plans and enhance their knowledge of the long-term technical decarbonization options. We would assign a score of Solid at best to an entity whose transition plan, all else being equal, relies extensively on the deployment of unproven technologies in the long-term.

These are not perfect standards. The track record of the technologies and the issuers' involvement with the technologies matter.

The cumulative significance of these assessment factors is that the questions are being asked by a credit rating agency that supports $73 trillion in debt issuances—not by an advocacy, industry, trade or shareholder group who possesses limited or no recourse if the responses by the issuer are evasive.

**Governance** issues cover two areas: Integration of Climate Change (into the issuers' operations) and Greenhouse Gas (GHG) Accounting. Those considerations are specified around the following benchmarks:

- Strength of GHG Disclosures: These include the comprehensiveness of reporting on all scopes, as well as separate reporting on carbon offsets and avoided emission.
- Third-Party Assurances: Verification of GHG disclosures for Scopes 1, 2 and 3.
- Targets Frequency and Reporting: Targets formulated on absolute emissions and reporting on all scopes.
- Corporate Climate Conduct: Coherence of issuer's behavior vs. its stated environmental commitments.
- Quality of Board Oversight: Disclosure of board oversight and board experience with respect to climate risk.
- Management incentives: Compensation for senior executives linked to climate-related performance.
- Binding Mechanisms: Target approval and oversight level by owners or public authorities (i.e., a binding shareholder vote on GHG reduction targets).

The Governance analysis takes an initial step in addressing greenwashing. An issuer will receive a zero Governance grade if its actions "are directly opposed to stated objectives, such as significant investments in fossil fuel production contrary to stated plan objectives or lobbying that is inconsistent with the entity's transition plan, which could include membership in trade associations lobbying against climate polices or a failure to disclose trade association memberships or public engagement." Analyzing whether a company's implementation plans stack up to their published ambition and targets also helps address questions around greenwashing.

Moody's defines a just transition as "a carbon transition that is inclusive and fair, creates social and economic opportunities for all affected populations and mitigates any challenges." The credit agency notes that "[social] dialogue and respect for fundamental labor principles and rights are key elements of a Just Transition." Moody's emphasizes that "buy-in" at the highest levels of the issuer is key if it is to integrate the carbon transition plan into day-to-day operations. The issuer must also be cognizant of how it "is incorporating the fight against climate change into the entity's core values and business goals."

The explicit recognition by Moody's of the connection between an issuer's statements, its behavior and its creditworthiness is bound to create a stir, but it is appropriate.[6] Every fiduciary has a responsibility to look beyond short-term profits when the question of long-term value is at stake. A sound long-term, successful enterprise can only be built by giving due consideration to all stakeholders (customers, communities, and employees), as well as all relevant information. Stakeholders, broadly understood, are critical to (and sometimes critical of) the inextricably linked network that places the issuer at the center of a web. Tending to the web requires that sufficient time and resources be devoted to the task, and even sometimes requires seeking external help.

These issues—investments and political action that are consistent with stated plans—go to the heart of credibility. Social engagement that requires good faith is fundamental to the creation of credible and creditworthy sustainable profit scenarios. It requires building an enterprise to respond to changing times, and part of that requires the realization that failure to do so can result in social mobilization that can become its own form of financial risk.

Although Moody's has provided an illustration of the impact that organized opposition to fossil fuels can have on project plans and credit outlooks,[7] Standard and Poor's (S&P) has put it most bluntly when it comes to petrochemical hubs.

In a 2021 review of a Formosa Plastics proposed plant in Louisiana, S&P made clear that the mega project was unlikely to move forward due to political and market forces. The analysis added political opposition to the scope of investment risk to all mega petrochemical facilities worldwide. The political opposition referred to by Standard and Poor's is driven by rising carbon emissions and pollution concerns. The credit opinion strongly implied that project cancellation would improve the credit position of the company, and investments in energy transition-related projects would improve the company's operational portfolio.

## Observations

The paradigm shift by Moody's and other credit agencies raises questioning of corporate carbon transition plans to an institutional level. It surpasses existing climate monitoring schemes due to its independence and role in the capital formation process.

First, the scope of the NZA tool goes beyond the standard fixed income community that is Moody's traditional home. This new analytical tool is relevant to corporate leadership beyond the "finance team"—it belongs in senior executive meetings and board rooms. And this includes the leadership of pension funds, universities, religious organizations and foundations. It is critically important to anyone with a fiduciary duty.

The problem of climate change, like the carbon transition plans under review, cuts across boundaries—geographic and political boundaries, intellectual and professional disciplines, and varying economic sectors, to name a few. The NZA tool does the same, which makes it highly relevant to stock analysts, private equity stakeholders, financial consultants, financial product designers, private equity managers, consultants and advisors.

The assessment tool is also broadly useful for public finance officials engaged with budget planning, bond underwriting and economic planning. Public officials with responsibility in the environmental, public health and safety areas should also familiarize themselves with the basic concepts of financial viability going forward.

Second, Moody's is proposing an institutional tool to measure progress on carbon transition plans and their actual implementation. There is a big difference between self-reported data from companies and industry groups—or information produced by various stakeholder groups—and an **institutional** assessment. Even when stakeholders produce perfectly objective information and analysis, bias is still implied. If there is a bias in Moody's as an institution, it is the perspective of the market.[8]

Could credit rating agencies become captives of individual interests? That is a risk. And if the NZA tool is broadly adopted, questions about Moody's objectivity will become a topic for more public discussion.

Third, this is a roadmap for corporate officials and climate campaigners. Although they are usually at odds, they are working toward a common solution. The tool could create new and better venues to confront very difficult questions, in which constructive climate solutions can be validated, experimentation rewarded and short-term expediency rejected.

Fourth, Moody's and the other credit agencies have embarked on a risky endeavor with significant potential benefits. If they are willing to take a dose of their own medicine and listen to critiques from all sides, they can construct an even more meaningful tool. Substantive and procedural considerations remain unaddressed by the NZA, and the application of the paradigm is bound to bring requests for clarifications and reconsiderations. How the credit agency deals with stakeholder communications is very important to its own credibility and the growth of the tool as an industry leader. The work products are analytic. They are not the last word. They are, in this sense, catalytic.

Fifth, given Moody's plan for greater transparency, professionals with scientific and technical information related to carbon transition and climate campaigners have relevant information to provide. Both individual companies and trade groups will also have views on the NZA. Moody's has an opportunity to create and sustain a global dialogue on carbon transition that only a few other institutions could manage.

## What Are Potential Impediments to the Use of the NZA Tool?

The Moody's NZA tool is not a credit rating, which will disappoint many. According to the NZA, however, the assessment "potentially combines with credit rating scenario analysis."[9] How the assessment is embraced by the market will obviously create the potential for combining the climate assessment with traditional credit rating standards.

Another potential impediment to broad use of the NZA tool is that issuers must request a Moody's assessment. Why would companies—particularly those with high carbon exposure—subject themselves to an assessment that could produce negative results for the company? The NZA is a diagnostic tool and should be appreciated by any board of directors interested in receiving a well-informed, third-party review of information provided to it by corporate managers. Further to the point, the coal, oil and gas sector do not have much credibility when it comes to the carbon transition.[10] According to a 2023 survey by Ipsos, a global polling organization, only 23% of the world's population trusted the oil and gas industry, while 37% found them untrustworthy. (The plurality was somewhere in between.) Only the government and social media companies are considered less trustworthy. Further, most of the companies are so discredited that few will believe almost anything they say.[11] A Moody's assessment is likely to combine both good and bad news—the bad news is already mostly known to those who watch climate matters closely.

## Conclusion

The Moody's NZA diagnostic tool presents an opportunity to strengthen the analysis of corporate carbon transition plans, an advance that is sorely needed. The impetus for the carbon transition is affecting major societal institutions—creating new, contentious issues with few mechanisms to offer signposts to guide us through the next 10 to 20 years. Climate-related change is touching the fundamental assumptions of science, technology, politics, governance, law, economics and finance. As ideological camps assert hard-and-fast interpretations of change and its outcomes, the reality of climate change continues to tear at every attempt to ignore or corral its definition and solutions. The Moody's diagnostic tool surpasses standard disclosure measures. The credit agency's analytical approach could help smooth markets during a bumpy period of transition and provide an element of public confidence at a time when it is in short supply.

## Endnotes

1 TIAA's recent report reflects its association and awareness of numerous industry initiatives including: Principles for Responsible Investment (PRI), Task Force on Climate Related Financial Disclosure (TCFD), Intergovernmental Panel On Climate Change (IPCC), International Sustainability Standards Board (ISSB), Morgan Stanley Capital International—Environmental, Social and Governance (MSCI-ESG) and private research tools, e.g. FactSets. Despite reference to these resources and its own staff TIAA cannot produce even the most basic information with a reasonable degree of reliability.

2 Also see: Principles for Responsible Investment. About the PRI. Accessed March 27, 2024.

3 Also see: IEEFA. IEEFA responds to PRI's dismissal of complaint against TIAAs climate action plan. December 2022.

4 The weaknesses in the Paris Agreement are well publicized and documented. Some of those problems relate to a weak focus on fossil fuels, poorly defined terms used in national plans, adherence to national plans by participating countries, policy and financing biases against the global south, etc. For example, see Alliance for Citizen Engagement. Failures and Successes of the Paris Agreement. August 8, 2023 Carnegie Europe. How deep is North-South divide on climate negotiations. October 6, 2021. Fossil Fuel Non Proliferation Treaty. Why do we need a global fossil fuel non-proliferation treaty? Last visited March 27, 2024.

5 For a concise discussion of the evolution and relevance of Implied Temperature Rating and climate goals see: Climate Action Tracker. Paris Temperature Goal. Last visited March 29, 2024.

6 At the recent CERAWeek event, leaders of the conference barred climate activists this year. In prior years they were welcomed so long as they paid the conference admission price which was several thousand dollars. Houston Chronicle. Fossil fuel protesters rally outside Houston's CERAWeek energy conference. March 19, 2024.

7 Moody's Ratings. Shifting environmental agendas raise long term credit risk for natural gas investments, Sector In Depth. September 30, 2020. (Proprietary)

8 The failure of the credit agencies to adequately address the mortgage meltdown created renewed interest in the institutional structure of the credit agencies. Those structures are likely to come under increased scrutiny with wider adoption of the NZA. This debate should continue to ensure ongoing scrutiny regarding the ethical climate that exists within the community of credit rating agencies. See: Chunping Bush. Dealing with conflicts of interest in credit rating agencies. *Capital Markets Law Journal* 17(1):334-364. June 2022.

9 Moody's Investor Services. Net Zero Assessments. March 2024, p. 5. (Available upon request)

10 Recent academic research demonstrates that oil and gas company strategies on climate are designed to protect oil and gas drilling. Science Direct. Fossil fuel companies' climate communication strategies: Industry messaging on renewables and natural gas. April 2023.

11 New York Times. Oil Executives to Face Congress on Climate Disinformation. October 27, 2021. See also: World Benchmarking Alliance. Research reveals no oil and gas companies have plans to phase out fossil fuels. June 29, 2023.

## About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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Tom Sanzillo, director of financial analysis for IEEFA, is the author of numerous studies on the oil, gas, petrochemical and coal sectors in the U.S. and internationally, including company and credit analyses, facility development, oil and gas reserves, stock and commodity market analysis and public and private financial structures. Sanzillo has experience in public policy and has testified as an expert witness, taught energy industry finance and is quoted frequently in the media. He has 17 years of experience with the City and the State of New York in senior financial and policy management positions. As the first deputy comptroller for the State of New York Sanzillo oversaw the finances of 1,300 units of local government, the annual management of 44,000 government contracts, and over $200 billion in state and local municipal bond programs as well as a $156 billion global pension fund.