Thermal coal – our approach for investments

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Understanding the global context for coal

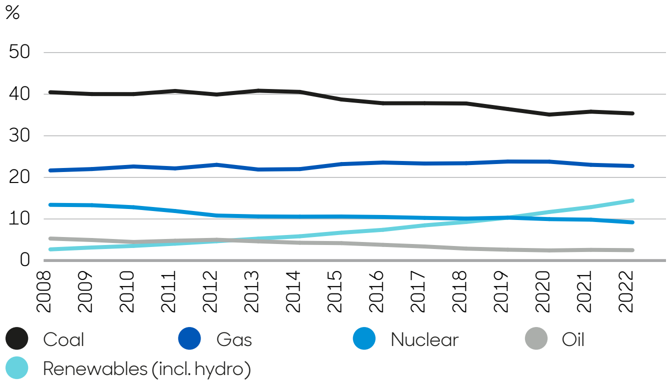
Coal is the most carbon-intensive fossil fuel and represents the largest single source of carbon dioxide (CO_2) emissions globally. The CO_2 emitted from coal combustion is responsible for over a third of the global temperature rise above pre-industrial levels[1]. Coal production and consumption also has a significant negative impact on the environment and human health, especially via water and air pollution. However, coal is still the most widespread fossil fuel source, representing over a third of total global power generation. Over 50% of global coal consumption is in China[2,3].

There is international recognition that the phase-out of coal use in power generation is crucial for combatting climate change.[4] At COP26, the Glasgow Climate Pact marked the agreement by nearly 200 nations to phase-down unabated[5] coal power, which was again confirmed at COP27. The G7 countries are committed to achieving a "fully or predominantly decarbonised power sector by 2035"[6],and "accelerating the phase-out of domestic unabated coal power generation in a manner consistent with keeping a limit of 1.5°C temperature rise." This is putting attention on the financing of coal. There is an expectation that governments and companies will be publishing clear policies, which can have a real-world impact on the thermal coal industry[7,8].

Why it matters to investors

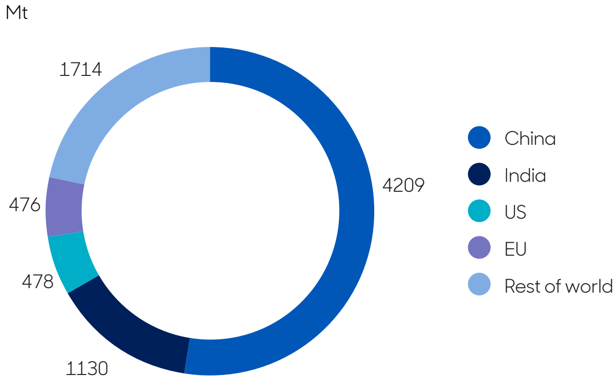
1. **Financial and reputational risk**: Coal operations face significant financial transition risks, as decarbonisation commitments increasingly come into force. New renewable energy is already cheaper than new coal in most regions,[9] and is rapidly becoming cheaper than operating much of the world's existing coal capacity (including India and China)[10,11]. Financial institutions that don't have effective, transparent strategies to phase-out coal investments could face increasing reputational risk.
2. **Stranded assets**: An increasing proportion of global coal operations are already unprofitable, but they are being propped-up by subsidies and policy support. With increasing climate policy stringency and technological developments, many plants will not run for their anticipated life-expectancy. This is likely to result in 'stranded assets'[12], making coal (and particularly new coal) an increasing financial risk for both equity and debt holders. Carbon Tracker's analysis indicates that if global action aligns to limit warming to below 2°C, $220 billion of operating coal assets would be stranded. For new coal plants, this would result in outstanding debt, interest, and undepreciated assets of around $315 billion, which would need to be written off[13].A planned approach to the early retirement of these assets should reduce the risk of them becoming stranded [14].It is estimated that recent 'no-new-coal' finance commitments have the potential to reduce stranding of international investments by over 50%[15].

Fuel shares in global power generation



Source: Statistical Review of World Energy 2023, Energy Institute.

Global coal consumption, 2022



Source: International Energy Agency (IEA), 2023.

abrdn's commitments

1. **Implement an investment approach that reflects the growing risks related to new coal investment, which is in line with the fiduciary duty we have towards our clients.**

   Investment in coal carries an increasing risk of financial impairment and exposure to stranded assets, as changes in regulation and policy alter the economics of coal-fired power generation. We have a responsibility to all our clients to consider how the global phase-out of coal will affect the value of their investments. We therefore consider coal-related risks and the ability to transition to alternatives in our investment decisions. We aim to avoid committing our clients' capital to coal-related activities where we see material financial risk.

   To identify these risks, we will undertake in-depth, bottom-up company analysis and complement this with relevant in-house analytical tools, such as our bespoke climate scenario analysis, which is used for certain investments. This provides us with the opportunity to consider how uncertain policy and technological pathways will influence the demand for, and cost of, thermal coal operations, beyond the near-term time horizon of current policies. Assessing the impact on coal-producing companies provides us with a forward-looking view that quantifies the risks associated with investment in thermal coal.

   We will also systematically engage with the companies we hold that have significant coal exposure to understand how they are managing coal-related risks and to assess the credibility of their transition plans.

2. **Support the collective global commitment to transition from coal to clean energy.**

   Science shows us that there is an urgent need to shift away from coal to limit global temperature rises and the health impacts associated with burning coal. We are committed to enabling power generation to move away from coal, to facilitate the early retirement of coal assets, to support a 'just' transition, and to mitigate marginalisation of coal companies with credible transition plans.

   Our commitment is aligned to the principles of the Powering Past Coal Alliance (PPCA), which aims to accelerate the 'just' transition from unabated coal power generation to clean energy. The PPCA Declaration was launched at COP23 in 2017 and its Finance Principles (last updated in 2023) translate a global phase-out of unabated coal power into tangible actions for the financial sector. These actions complement the recommendations from the Glasgow Financial Alliance for Net Zero (GFANZ), which abrdn is part of through our Net Zero Asset Managers (NZAM) membership.

   Importantly, our investment approach supports the managed phase-out recommended by GFANZ and PPCA[16].This enables us to effect real-world decarbonisation, rather than just passing these portfolio emissions on to someone else by divesting.

   We recognise the importance of clarity in terms of climate policy. This could lead to more stringent policy incentives and provide better clarity on the financial impact of coal assets. We have signed the annual Global Investor Statements on Climate Change since 2018 and the Just Transition statement to reflect this publicly. We have also been actively involved in the annual UN COP climate conferences in recent years, and we have been vocal about the need for appropriate climate policy. By engaging with industry groups and policymakers, we aim to help drive industry best practice.

The need for regional variation to support a just transition

There is an urgent need to rapidly shift away from coal use, to prevent new coal projects and to accelerate the retirement of existing coal plants. This is reflected in the key milestones of the International Energy Agency's (IEA) Roadmap to Net Zero by 2050[17]. The roadmap recommends a phase-out of coal by 2030 in advanced economies and by 2040 elsewhere. This is why our approach initially focuses on advanced economies, with a commitment to extend this out to developing economies in the future.

The roadmap recognises that many regions are still heavily reliant on coal and will need a longer timeframe for phase-out. Many of these regions are still developing economically, so continued access to affordable power is crucial. Global coal power likely peaked in 2022. But the rising demand for electricity driven by economic development, population growth, and short-term domestic energy policies is likely to increase dependency on coal in some regions. The cost competitiveness of coal also varies considerably by region, but this is expected to shift with the rapidly reducing costs of renewables.

While an accelerated coal phase-out may be socially and economically beneficial at a national level, regional differences in dependencies on the coal sector will have a localised impact on economies and communities. Therefore, when assessing investment risks and opportunities, we need to consider regional variations.

Examples

- Existing coal-fired power plants in emerging markets and developing economies are relatively young. For example, plants in Asia are on average 14-years old, compared with over 45 years for both Europe and the US.
- The resilience and connectivity of existing grids vary, and they will require upgrades to use clean power. This creates differing degrees of dependency on coal to maintain a stable power supply.
- In some countries, many operations are state-owned or benefit from subsidies. This requires policy and financial incentives to enable phase-out.
- Regional dependency on coal is also liable to fluctuate in response to changes in energy security. During global energy crises, some countries have increased their use of coal – despite climate and energy transition targets.

Regional variations in the phase-out of coal are critical to ensure a 'just' transition that carefully considers the impact on workers, communities and consumers[18].

Our strategy

To implement our commitments in practice, our strategy is based around three areas of focus: **investment process**, **corporate engagement**, and **annual review.**

1. **Investment process**

   Our first principle is to be good stewards of our clients' capital. We are committed to a managed phase-out approach for thermal coal investment, which acknowledges the need for regional variation, supports a just transition, and meets our fiduciary responsibilities.

   We believe there can be significant financial risks from holding coal assets in the future. We are therefore taking steps to reflect that in our active investment process. Starting in 2024, we will introduce an enhanced investment process for thermal coal as shown below.

* E.g valuation analysis, cash flow assumptions.

1.1 Identify coal-related companies that pose high financial risk

We will apply the following criteria to identify high-risk coal exposures.

Companies with thermal coal exposure (extraction and/or power generation) in the EU or OECD (with a view to expand to emerging markets in future), which are either:

a. developing new, or expanding existing, thermal coal assets (extraction and power generation); or
b. have high coal revenue (greater than or equal to 35% of revenue).

This analysis will be undertaken on a regular basis.

1.2 Reflect the financial risks in our investment process

Each asset class in scope will apply a formal enhancement to its investment process, to reflect the financial risks of high-risk coal companies. This will be applied to relevant actively managed strategies. Green bonds, which we recognise as being key enablers in the transition to a low-carbon economy, will be reviewed in line with our green-bond framework[19].

Certain strategies are out of scope. This includes strategies where we can't exercise full discretion in choosing an investment (through agreement with the client) or tracking an index, where the client's guidelines prohibit any such considerations, or where another manager has discretion over the underlying investments.

1.3 The outcome of the process will determine exposure and engagement

The outcome of this process will inform our portfolio construction decisions, including exposure and position sizing. It will also highlight engagement priorities (companies and topics), to obtain a deeper understanding of how financially material risks are being managed.

1.4 Regular review of coal exposures by our Chief Investment Officer (CIO)

The level of existing exposure, and any active investment decisions that result in exposure to high-risk assets, will be reviewed on a regular basis by the CIO and the leadership team. Exposure needs to be justified based on the financial risks and within the context of our commitments.

If clients favour an exclusion-based approach to coal, our sustainable funds offer a suitable range of thermal coal restrictions. In addition, we are able to apply exclusions to individual client mandates.

2. Corporate engagement

We believe engagement plays a central role in good stewardship, a view also taken by both the PPCA and GFANZ. Active ownership provides us with a forum to better understand the financial risks, outline our expectations, monitor corporate efforts, work with our holdings and challenge where appropriate. We will undertake regular engagement with the companies that we hold that have coal exposure to better understand the risks they are exposed to and the potential impact on our investment, paying particular attention to the credibility of a company's transition plans.

We acknowledge that asset managers' coal policies are often assessed based on the stringency of their coal exclusions. But as active investors, we believe in active management, engagement, and voting (where relevant) over exclusion. We don't believe that blanket exclusions are currently the best way to achieve a managed phase-out. While an exclusionary approach can theoretically increase the cost of capital for thermal coal companies, and therefore the amount of expansion the firm can undertake, there is evidence that this effect is currently too small to have a significant impact[20].Divestment also removes our voice and provides no incentive for the company to take corrective action[21].

We will prioritise companies that our investment process identifies as having high-risk coal exposure. In addition, we will consider the following criteria to ensure maximum impact through our engagement process: our investment exposure; company coal exposure and any plans for expansion; and existing company strategies relating to the phase-out of coal. We aim to initiate engagement with identified target companies by the end of 2024. We will revisit the prioritisation of target companies on an ongoing basis.

We will principally engage on existing transition strategies to assess their credibility, and therefore identify financially material risks that are related to coal exposure. Areas of focus will be based on areas that are relevant to our investment analysis and may include:

- timeline for exiting coal,
- metrics, targets, and governance,
- disclosure of plans for coal phase-out (shut-down or sell-off operations),
- assumptions regarding any abatement measures,
- principles of a 'just' transition.

We will use engagement to inform our portfolio construction, position sizing and overall risk appetite. We will assess companies based on their targets, milestones and timelines, and how action or inaction will affect overall portfolio risk and the outcomes we deliver for clients.

Where progress against milestones is insufficient, we will have an escalation process in place. This includes voting action where relevant. We use potential divestment as a last resort, where we think that a failure to do so could pose a material financial risk to our clients.

3. **Annual review**

We will review our engagement and investment process on (at least) an annual basis to assess the effectiveness of our approach, scope, alignment with the thermal coal phase-out timelines, and coherency with the wider strategy. This will include a review of our coal exposures and whether to extend our approach to emerging markets. By taking this active risk-based approach, we will enhance our portfolio construction decisions, and expect to reduce our exposure to high-risk coal assets over time. We will update and strengthen our approach as appropriate.

In line with PPCA principles, we are committed to disclosing our ability to meet our commitments on a 'comply or explain' basis when responding to TCFD or other reporting frameworks.

[1] Emissions – Global Energy & CO2 Status Report 2019 – Analysis - IEA
[2] Coal-Fired Electricity: Tracking Progress 2022, IEA, September 2022
[3] CO_2 Emissions in 2022, IEA, March 2023
[4] IPCC Sixth Assessment
[5] Coal power generation not equipped with operational carbon capture, use, and storage (CCUS) technologies or equivalent (PPCA definition)
[6] G7 Climate, Energy and Environment Ministers' Communiqué, April 2023
[7] GFANZ_Recommendations-and-Guidance-on-Net-zero-Transition-Plans-for-the-Financial-Sector_June2022.pdf
[8] Home | Global Coal Exit List
[9] On a Levelised Cost of Electricity (LCOE) basis
[10] Wood Mackenzie, January 2022
[11] How To Retire Early Making Accelerated Coal Phaseout Feasible and Just
[12] Do Not Revive Coal: Planned Asia coal plants a danger to Paris (carbontracker.org)
[13] Taking Stock of Coal Risks - Carbon Tracker Initiative
[14] The Managed Phaseout of High-emitting Assets
[15] Quantifying the regional stranded asset risks from new coal plants under 1.5°C
[16] The Managed Phaseout of High-emitting Assets
[17] Net Zero Roadmap: A Global Pathway to Keep the 1.5°C Goal in Reach – Analysis - IEA
[18] Financing the managed phaseout of coal fired power plants in Asia Pacific, GFANZ public consultation, June 2023
[19] abrdn Position Statement – Green, Social and Sustainable Bonds.pdf
[20] The Impact of Impact investing
[21] Socially Responsible Divestment, European Corporate Governance Institute, July 2023