

Vantage Infrastructure

TCFD: The Case For Decision-making

A Q&A with Anne-Noëlle Le Gal, an investment director at Vantage Infrastructure, about the benefits and challenges of performing quantitative climate-scenario analysis across a diverse equity portfolio of infrastructure businesses

Many infrastructure managers have recently become TCFD (Task Force on Climate-Related Financial Disclosures) supporters. What has driven their decision?

There are definitely more infrastructure managers supporting TCFD now than two years ago, when we did. In fact, starting to embrace TCFD now is hardly a differentiator; it is simply catching up. Regulation has certainly been a driver. In some countries, TCFD is or will become a requirement for larger managers, their clients or portfolio companies. In the United Kingdom, for instance, mandatory TCFD-aligned climate disclosures have applied to large companies, pension funds and managers since April. But there are other compelling reasons besides legal obligations. We view TCFD as an effective tool to assess and present the impact of climate change on businesses. Importantly, it also helps compare assets within a portfolio on similar terms. The framework has three components: (1) Risk and opportunities assessment, including through scenario analysis; (2) Integration of climate-related considerations in governance, strategic planning, risk management and reporting; and (3) Disclosures guidance. Quantitative scenario analysis is the most insightful step. Unfortunately, it is also the most challenging to perform.

So, what can you gain going through such a challenging exercise, apart from a tick in the disclosure box?

Ultimately, it helps evaluate how material the impact of plausible climate pathways can be on investments' financial performance and value. In turn, this drives strategic choices and supports making asset allocation, investments or divestments and business decisions. For an asset owner, it can influence how you construct your portfolio. Is that risk within the portfolio's tolerance? Should you diversify by investing in sustainable assets? For an active manager, like Vantage, it drives asset-management initiatives to improve the resilience of investments' values and performance. For a portfolio company, it informs strategic planning, stakeholder engagement and actions to mitigate critical risks or capture opportunities.

How should infrastructure managers run this analysis across their portfolio?

I see five steps.

1. Climate-change risk assessment. The first step involves identifying climate-related risks and opportunities for each company and ranking them within a portfolio in terms of potential value impact. At Vantage, we designed a climate-related risk assessment tool to analyze materiality, risk-to-value and time horizon of physical and transition risks, and opportunities. Uncertainty around government policies, regulatory frameworks for 2050 net-zero targets, alternative technologies, shifting consumer preferences and increased cost of financing were found to be key risks for certain portfolio companies. Those equity investments identified as more exposed were then prioritized to run targeted TCFD-scenario pilots. Our gas-distribution network

was one of them, given both the policy uncertainty faced by all distributors of fossil fuels and the opportunities to provide a cost-effective solution for the decarbonization of heat.

2. Scenario selection. First, it is advisable to consult with your investors, co-shareholders and portfolio companies on a specific set of scenarios already in use. Mapping scenario requirements across stakeholders can sometimes (not always) facilitate their initial selection and, down the line, their practical implementation across a portfolio. If you start from scratch instead, best to use established scenarios recognized by scientists and policymakers, such as NGFS, IPCC or IEA. We prefer to choose a minimum of three relevant pathways, such as the commonly referred NGFS "orderly," "disorderly" and "hot house" scenarios. Although standard scenarios provide macro-trends around future economic activity, population growth or technological progress, they do not necessarily cover sector- or company-specific circumstances.

3. Qualitative scenario analysis. For each company, this involves thinking with management about the impacts of climate change and effectively translating the three macro climate scenarios into more micro-operating environments. As I said earlier, for our gas-distribution network, we identified a number of transition risks (e.g., What happens if government restricts the company's activity?), physical risks (e.g., If the country becomes warmer, do people use less gas?) and opportunities (e.g., If hydrogen prevails, how will the company leverage this burgeoning industry?). But the materiality and likelihood of each can vary massively under each scenario.

4. Quantitative assumptions. The macro and micro considerations mentioned earlier need to be converted into figures. Pick only those assumptions that matter most – sensitizing every single assumption in a model would be an endless and futile task. Those might include macroeconomic variables for GDP-correlated or inflation-linked assets, power prices and output for renewable generators, volumes and commercial obsolescence for fossil-fuel companies, maintenance spend linked to frequent extreme weather events, decarbonization actions, and resilience programs for regulated utilities.

5. Scenario running in model. Depending on the purpose, the approach may vary. Many large investors appoint consultants to perform a top-down exercise with complex macro models for asset allocation purposes. This does not exonerate their managers and portfolio companies from conducting their own bottom-up analysis and driving specific business actions. These two approaches may be complementary, albeit with potentially disconnected outcomes.

This roadmap makes it seem quite manageable. Are there specific difficulties for equity managers?

There are many, especially for a fund managing a portfolio comprising different equity infrastructure investments in terms of size, sector and exposure to climate risks. And this is why,

while many more managers are now embracing TCFD, only a few are enthusiastic about its implementation. The main practical challenges include:

- **Resources** (time, skills and costs), especially for small companies. This is a technically complex exercise, which requires the involvement of mid- and senior management, in addition to the fund managers themselves. They may not all have skills or financial resources to hire consultants.
- **Scenario alignment.** Once you have gone through the effort of understanding the plethora of scenarios available and eliminating some, it can still be difficult to apply a single set to all companies in a portfolio. Some reference scenarios may be best suited for one sector, while another sector may use a different set following guidance from its regulator, making portfolio consolidation difficult.
- **Consistency.** Different scenarios may mean different things to different management teams. The same macro climate scenarios might be adopted by each portfolio company inconsistently. For instance, some companies may focus on GDP and inflation drivers, while others may sensitize only capex or energy prices.
- **Assumption calibration** raises many questions. Should a net-zero scenario involve gas networks repurposed to distribute hydrogen or a world of stranded existing networks? Will the investments required by a water company to increase resilience to extreme weather events be funded in the future by the regulator? The value of these insights makes the exercise worth doing, though, and there are always ways to get over those difficulties.

Your best tips to overcome those challenges?

It was easy to make mistakes at the beginning of this journey, when companies had hardly heard of TCFD, consultants were just venturing into scenario analysis, and no peers had any experience to share. Four years on, here is what we have learned:

- **Prioritize**, especially if resource constrained. Focus on material risks and drivers. Walk before running to build the right process and experience over time. Use pilots if appropriate. Set TCFD adoption as a firm objective and allocate responsibilities among your investment team members, including one portfolio coordinator.
- **Engage** with all your stakeholders. As an active manager, Vantage has deliberately decided to roll out workshops to educate clients and portfolio companies on climate change and TCFD recommendations, and we regularly coordinate with co-shareholders. We have also embedded gradual TCFD

adoption as a management KPI. This can help secure buy-in from asset teams, who will execute action plans and drive them in the day-to-day operations.

- **Share.** Regularly exchange knowledge with your portfolio companies, clients, colleagues and peers through collaboration platforms, such as Initiative Climat International (ICi).
- **Simplify.** Simplify assumptions from the start and increase sophistication gradually. Refrain from seeking false precision estimates or perfect scenario alignment. Our water-distribution company, for instance, is using IPCC scenarios, and simplifying assumptions can be robustly used to translate those into our selected NGFS scenarios. In the earlier net-zero dilemma, our gas-distribution network decided to run two alternative policy subscenarios for net zero.
- **Focus.** TCFD is not a predictive tool. Focus on scale and direction of risks. The journey of determining possible business impacts and available actions to mitigate risks and realize opportunities is more important than being right about forecasting the future.

Ultimately, it helps evaluate how material the impact of plausible climate pathways can be on investments' financial performance and value. In turn, this drives strategic choices and supports making asset allocation, investments or divestments, and business decisions.

Once done, what do you do with the results?

I do not think any managers today can say they are "done" with their TCFD analysis. It is a never-ending journey, with constant reviews, updates and improvements, as the quantitative analysis gets more sophisticated.

What do we do? We define actions to incorporate findings in companies' strategic planning, investment decisions and disclosures. To use our pilot example, we have been working with our gas-distribution company to develop a comprehensive stakeholder management plan on energy policy and the economics of greener heating alternatives, and we have been seeking opportunities for biomethane and hydrogen injection into existing networks. We have been rolling out the same process with all our portfolio companies. While there are still some residual gaps to close against the TCFD recommendations, we have achieved significant progress.

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Vantage Infrastructure is an independent infrastructure debt and equity specialist committed to delivering sustainable investment solutions as a long-term partner to its clients. With \$3.9 billion assets under management (as of June 2022), the firm has a heritage as one of the world's first infrastructure investment firms, with a long track record of partnering with global clients to implement leading investment solutions within the infrastructure sector, while aiming to protect its clients against downside risks. Fundamental to its approach is responsible investing and embedded ESG (environmental, social and governance) considerations in its process as a driver of value and risk. Reflective of this, Vantage Infrastructure is a signatory to the Principles for Responsible Investment (PRI), a supporter of the Task Force on Climate-Related Financial Disclosures (TCFD), a GRESB Infrastructure Member, and an investor member of the Institutional Investors Group on Climate Change (IIGCC). Through its managed investments, the firm contributes to 10 out of 17 U.N. Sustainable Development Goals. www.vantageinfrastructure.com