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Morningstar Sustainalytics Launches Low-Carbon Transition Assessment Tool for Investors

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In April 2023, as part of ongoing efforts to enhance transparency, Morningstar Sustainalytics launched a ratings system designed to provide investors with an assessment of a company's current net-zero alignment. The company's Low Carbon Transition Ratings provide a set of "forward looking" assessments of the degree to which a company's projected greenhouse gas (GHG) emissions diverge from its net-zero pathway between the time of the assessment and 2050. According to **Morningstar Sustainalytics**, the "two-dimensional framework" measures both a company's exposure from its expected GHG emissions and accounts for management actions, including its demonstrated short-term investment plans, policies and programs.

The new ratings framework builds on Morningstar's ESG risk ratings system and analyzes a company's low-carbon transition exposure and management preparedness across the company's value chain for each scope of emissions using the 1.5°C required policy scenario from the **Inevitable Policy Response (IPR)**. IPR is an initiative commissioned by the United Nations-backed global network of financial institutions **Principles for Responsible Investment (PRI)**, which seeks to prepare institutional investors for portfolio risks and opportunities related to climate change.

The company's overall degree of alignment is expressed as an "implied temperature rise"—the projected impact on the environment if all companies shared the assessed company's investment alignment and transition preparedness. Companies are placed in one of five categories: (i) aligned; (ii) moderately misaligned; (iii) significantly misaligned; (iv) highly misaligned; and (v) severely misaligned. The company-specific reporting also details the company's expected emissions across all three scopes from the present to 2050, its net-zero budget (i.e., the company's sector- and region-specific budget required to align to a net-zero emissions pathway by 2050), and the "expected emissions gap" (i.e., emissions that are not managed and the severity of misaligned emissions).

The value-chain analysis provides an individual assessment of the company's alignment to the net-zero budget for each scope of emissions (Scope 1, Scope 2, Scope 3 upstream and Scope 3 downstream), including how much each scope contributes to the company's overall rating. The analysis includes an assessment of GHG exposure, based on the expected emissions gap for each scope, and a score (out of 100) for management actions related to each emissions scope. Companies are also given an overall management score (out of 100) and individual scores across a set of indicators, including its GHG emissions reduction program, renewable energy program, scope of GHG reporting, GHG emissions targets, operating performance and solvency.

Taking the Temperature: As we have reported on extensively, the proliferation of ratings providers, using different criteria and ranking companies according to varied scoring systems, has prompted concern from regulators, investors and market participants. We thoroughly explored these issues in a longer article published in the Harvard Law School Forum on Corporate Governance, points echoed in a Review of Finance paper entitled Aggregate Confusion: The Divergence of ESG Ratings, which disclosed the findings of an investigation into the "divergence of sustainability ratings."

Regarding potential regulation, the UK government, for instance, recently launched a consultation set to close on June 30 on the scope of a future regulatory regime for ESG ratings providers. The Securities and Exchange Board of India launched a similar ESG ratings-focused consultation.

Moreover, ratings providers continue to adjust their approaches, with, for example, MSCI recently announcing significant changes to its ESG investment fund rating methodology that "aim to raise the requirements for a fund to be assessed as 'AA' or 'AAA' rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis." However, these changes will result in downgrades to 31,000 of the funds currently rated by MSCI. Likewise, Dow Jones recently announced changes to its Sustainability Index.