

# WHY FACILITY-LEVEL TRANSITION RISK SHOULD MATTER TO INVESTORS

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## HIGHLIGHTS

- Institutional investors have a fiduciary responsibility to understand the impact of transition risk on portfolio value.
- Economies are interconnected systems, with transition risk often concentrated in large high-emitting facilities such as industrial and power plants.
- Existing frameworks like TCFD and SBTi focus on company-level risks, which may overlook the risk embedded in these facilities.
- Investors cannot avoid these risks, particularly in concentrated markets, and must engage companies to address them.
- A forward-looking, facility-level approach can help inform effective engagement strategies to protect portfolio value.
- Guidance is needed to help investors identify, prioritise and address risks at the facility-level.

## INTRODUCTION

As global efforts to contain temperature rise to 1.5°C intensify, asset owners and managers face mounting pressure to decarbonise their portfolios and align with net zero initiatives. This pressure arises both from the growing set of disclosure requirements, and from the direct impact of transition risks tied to evolving policies, technologies and market dynamics that affect the underlying value of companies. Institutional

investors have a clear fiduciary responsibility to understand the transition challenges facing companies in their portfolios in order to maximise risk-adjusted returns for their clients.

Existing transition reporting and assessment frameworks largely focus on uncovering these risks from a company or sector level. However, transition risks are often concentrated in a relatively small number of large, high-emitting facilities such as those in industry and the power sector. Decarbonising these facilities often requires changes in production processes, feedstocks, and product lines which may or may not be technically or economically viable in a net zero future. Without interrogating these facility-level risks, aggregated sector- or company-level assessments risk obscuring vulnerabilities both for individual facilities as well as companies across the value chain.

This note provides the rationale for forward-looking, facility-level [Guidance](#) developed by Meridian Economics to help investors identify, prioritise, and address transition risks through engagement. This strategic approach is crucial, especially in concentrated markets where divestment may not be a feasible or comprehensive solution for managing risk. By considering a range of decarbonisation options, investors can maximise value protection by actively steering high-emitting facilities towards a low-carbon future.

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## LARGE FACILITIES CONCENTRATE TRANSITION RISK

Large systemically integrated facilities present unique transition risks to companies and portfolios for two main reasons. Firstly, large facilities are unable to respond quickly to changes in their external environment and pivot to new modes of operation because of the concentration of capital in one physical process or a set of integrated processes. Decarbonising these processes often entails discontinuous change, such as adopting new business models, products or inputs, alongside costly retrofitting or technology replacements that may not yet be commercially viable. Many large high-emitting facilities produce a diverse range of products. Decarbonising the production process, by changing to low-carbon feedstocks for example, can fundamentally alter the suite of products produced in that process with subsequent impacts on a company's business model and value chain. The difficulty to pivot to new low-carbon modes of operation means that these companies may struggle to adapt to external signals or shocks, such as movements in carbon or fuel markets, leading to stranded asset risk.

Secondly, the systemic integration of these facilities in combination with the novel nature of transition risks, presents a challenge of contagion as transition failures can have cascading impacts across economies. Since these facilities are large and form critical nodes in their respective value chains, their transition challenges and corresponding risk of closure not only affects the value of the parent company but also the value of upstream and downstream companies. These effects play out at the micro-level of sector and company supply chains and are inherently systemic in nature. The implication for asset owners and managers is that the transition risks associated with large facilities are unlikely to be contained to the companies operating these facilities alone; they may also impact the

valuations of other companies within their portfolios. Unless asset owners and management companies have processes to interrogate value chain transition risk issues, it may well be that these risks will not be picked up.

## WHY ARE THESE RISKS CURRENTLY HARD TO SEE?

Growing financialisation over the past four decades has led to an increasing disconnect between the financial and real worlds. Financial valuation metrics and economic models tend to abstract real-world complexity and context into flat metrics such as market and stock prices, losing sight of real-world interdependencies that may prove vital to outcomes as novel transition risks materialise. An aspect of this was evident in the 2008 Financial Crisis, where the high risk of subprime mortgages was obscured and amplified by complex financial instruments. Financialisation can mean that path dependencies in supply chains, contracting, logistics, infrastructure and markets are hidden from view. In the real world, actors are not able to change their behaviour as quickly and seamlessly as financial and economic models are primed to assume.

An additional factor is that the existing suite of climate transition disclosure, target-setting and assessment frameworks – such as those provided by the Task Force on Climate-Related Financial Disclosures (TCFD), the Science-Based Targets initiative (SBTi) and the Transition Plan Taskforce (TPT) – establish broad guidelines and metrics for disclosing and assessing transition risk at the sector and company levels, but don't foreground individual facilities and their contexts. For example, while the TPT requires that companies disclose information on current and anticipated changes to physical assets relating to their transition, what information to include and the detail of that information is largely left to company discretion. While other tools, such as Climate Value-at-Risk (CVaR), include facility-level assessments, their ability to account for highly



specific contextual factors and value chain interdependencies is questionable. Furthermore, CVaR tools again rely heavily on reducing risk to a few quantified metrics, obscuring the complex mechanisms through which risks manifest. Without a good understanding of these real-economy mechanisms, asset managers and owners may be unable to transparently identify and prioritise key transition risks to their portfolios, which are particularly pronounced for companies with large, high-emitting and systemically integrated facilities.

Finally, transition risk is a novel risk that may be realised over short timeframes, especially relative to the economic lifespans of most large facilities. As such it is not yet well-understood, and conventional investor valuation techniques may overlook its implications. Transition impacts may result in correlations between companies that were previously thought to be unrelated, leading to portfolio-level risks that will not be picked up from historical interactions. The timing of many climate transition risks are highly uncertain and discontinuous. Tipping points can dramatically amplify risks, such as a large emitter becoming uncompetitive following the imposition of a Carbon Border Adjustment Mechanism (CBAM) in a key export market. Given the economy-wide dependence on fossil fuel energy, transition risks are inherently systemic, and in highly fossil fuel dependent economies these problems are more acute.

## INTRODUCING GUIDANCE FOR FACILITY-LEVEL TRANSITION ENGAGEMENT

In meeting their fiduciary responsibility to maximise risk-adjusted returns, investors require a clear understanding of risk at both an asset and portfolio level. Particularly in concentrated,

emerging and smaller markets, large high-emitting facilities embody systemic risks that cannot be divested away. This underscores the importance of proactive stewardship of high-emitting facilities to ensure a managed, economy-wide transition.

From this perspective, existing transition risk assessment tools and frameworks fall short. They lack the granularity needed to identify and evaluate material risks to individual facilities, while traditional, backward-looking valuation techniques are inadequate for assessing the contagion of novel transition risks across portfolios.

Meridian has therefore developed [Guidance](#) for engaging on facility-level transitions as a forward-looking approach to complement the approaches that focus on companies and sectors. The Guidance:

1. assists investors develop a better understanding of facility-level transition risks and the spread of these risks across portfolios;
2. develops and tracks key indicators to guide facilities towards net zero; and
3. enables investors to focus their engagement strategy on companies operating high-emitting facilities that represent concentrations of transition risk within a particular market.

The Guidance is not intended for all facilities. Rather, by prioritising a few high-emitting facilities for this more granular analysis, investors can efficiently focus attention and resources on key concentrations of transition risk in their portfolios. This approach will keep investor engagement focused, specific and pragmatic, and therefore supportive of delivering outcomes aligned with fiduciary duty.