



Norfund

**Aligning to the Paris  
Agreement**  
Norfund's Approach



## EXECUTIVE SUMMARY

The Paris Agreement seeks to limit global warming below 2°C, aiming for 1.5°C. Achieving these targets is vital to mitigate severe impacts on economies, health, and food security, particularly in marginalized communities. Norfund commits to align all new investments with the goals of the Paris Agreement, thus supporting the transition to net zero, reducing transition risks and avoiding stranded assets.

To facilitate a structured approach to climate assessments, Norfund has introduced a climate tool. This tool is designed to evaluate Paris Agreement alignment, enforce the fossil fuel standard, and assess climate risk. For alignment with the Paris Agreement, Norfund adopts the EDFI harmonized methodology, classifying investments as either automatically aligned, misaligned, or conditionally aligned.

### Pre-CIP

In the Pre-CIP (Clearance in Principle) stage, the tool assesses if an investment is automatically aligned with the Paris Agreement, automatically misaligned (thus excluded from investment), or whether it requires further analysis during the Due Diligence stage to determine whether it is Paris aligned or not.

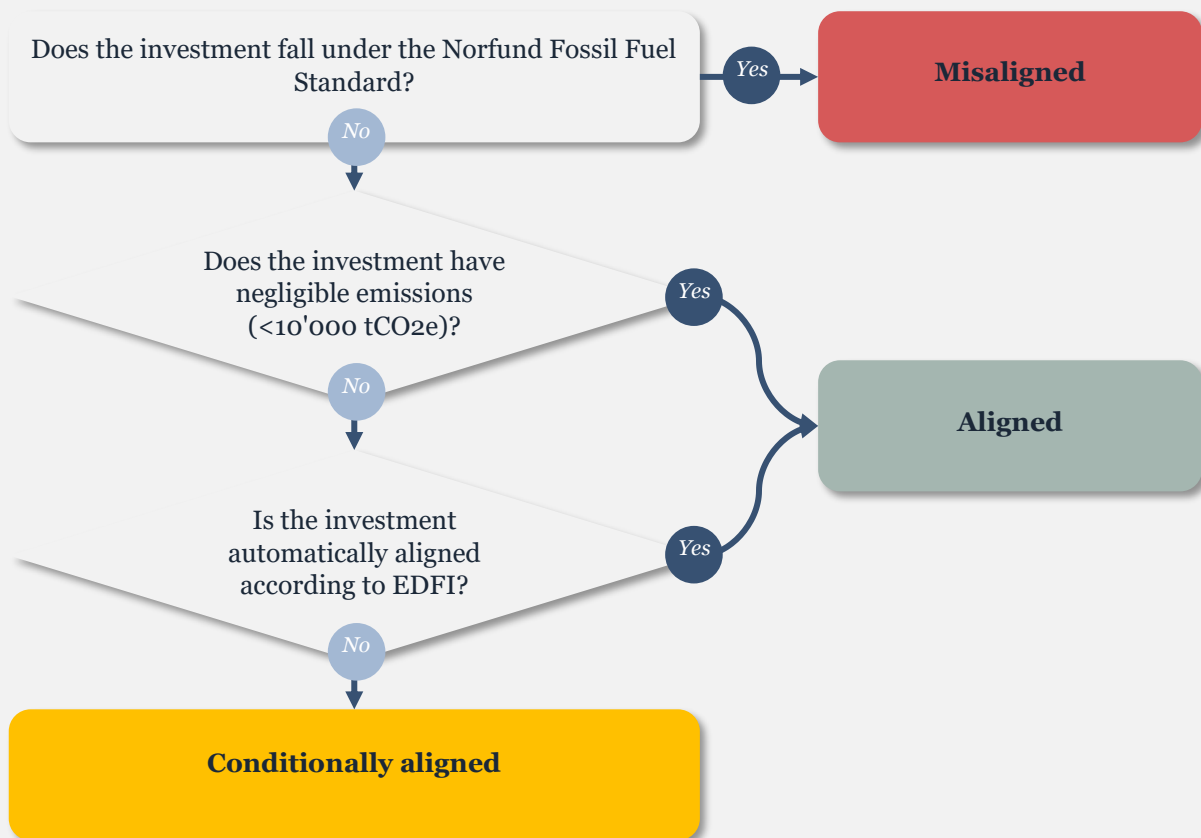


Figure 1: Pre-CIP Decision Tree for Paris Alignment

## *Due Diligence*

In the Due Diligence, the tool differentiates between automatically aligned and conditionally aligned projects. Projects that do not align with the Paris Agreement are excluded from further consideration. Automatically aligned projects undergo a climate risk assessment (based on TCFD framework) without the need for additional scrutiny regarding Paris alignment. Conditionally aligned projects, however, are subjected to a more comprehensive assessment. This includes nine questions that span across dimensions such as the system (country and sector level), asset level, and transition risk.

It's important to note that while the tool provides a framework for assessment, each investment is unique and may present its own set of challenges. Therefore, some projects might require a more in-depth analysis beyond the tool. Moreover, these assessments involve a measure of uncertainty, stemming from various factors including limitations in data reliability. Consequently, investment evaluation is not precise climate science, but a starting point to continuously improve upon.

As of Q1 2024, the tool is compulsory for all new investments, except for investments through intermediaries (fund investments and investments in financial institutions). For these business areas, a methodology is currently being developed. Given the dynamic and challenging nature of climate assessments in finance, we recognize the importance of continuously adjusting and improving the approach.







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# 1 UNDERSTANDING PARIS ALIGNMENT

Paris Alignment refers to aligning activities, particularly in finance and development, with the objectives of the Paris Agreement. This legally binding international treaty on climate change was adopted by 196 countries at COP21 in Paris (UNFCCC, 2015). It aims to combat climate change and its most severe impacts while acknowledging different responsibilities of nations.

## ***Objectives of the Paris Agreement***

Article 2 of the Paris Agreement

Article 2.1 states that the aim of the Agreement is to “strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty, including by”:

(a) “Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change;”

(b) “Increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production;” and

(c) “Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.”

Article 2.2 states that the Agreement “will be implemented to reflect equity and the principle of common but differentiated responsibilities and respective capabilities, in the light of different national circumstances”.

Source: [UNFCCC, 2015, p. 2\[2\]](https://unfccc.int/sites/default/files/english_paris_agreement.pdf), *Paris Agreement*, [https://unfccc.int/sites/default/files/english\\_paris\\_agreement.pdf](https://unfccc.int/sites/default/files/english_paris_agreement.pdf)

The 1.5-degree Celsius target in climate science is crucial because it represents a threshold beyond which the risks and impacts of climate change, such as economic damage in key sectors and adverse effects on human health and food security, significantly increase. These impacts are more severe at 2°C of warming and disproportionately affect marginalized communities, hindering efforts to achieve Sustainable Development Goals (IPCC, 2023). Addressing these challenges requires substantial investment, estimated at US\$2.4 trillion annually by 2030 in emerging markets and developing countries, to facilitate a just energy transition, adaptation, and conservation efforts, without which the Paris Agreement goals remain unattainable (Bhattacharya et al., 2023).



## 2 NORFUND'S COMMITMENT

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In the EDFI Statement on Climate and Energy Finance (adopted in November 2020), the following commitment was made by individual institutions, including Norfund:

*EDFIs will align all new financing with the objectives of the Paris Agreement by 2022 and will transition our investment portfolios to net zero GHG emissions by 2050 at the latest. **EDFIs will, at the project level, adopt harmonized methodologies and approaches to ensure that each new financing is aligned with the objectives of the Paris Agreement (hereafter, “Paris-aligned”) and consistent with the decarbonization trajectory of the relevant sector or country no later than 2022, and will disclose the nature of such methodologies. EDFIs will, at the portfolio level, adopt approaches that will gradually decrease aggregated GHG emissions to net zero by 2050 at the latest.***

- EDFI, 2020 -

Ensuring Norfund's investments are in line with the Paris Agreement, will reduce Norfund's transition risk and the risk of Norfund sitting with stranded assets.



### 3 NORFUND'S APPROACH

The most reliable option is comparing the investment's current and projected emissions with sectoral decarbonization pathways (=industry-specific routes to reduce emissions and adapt to climate change). Sector pathways help assess whether an investment is on track of reaching the goals of the Paris Agreement and stays within its sector's carbon budgets.

To simplify the process of assessing Paris Alignment, EDFI has developed a framework for assessment categorizing investments into **"automatically aligned," "automatically misaligned," and "conditionally aligned"**.

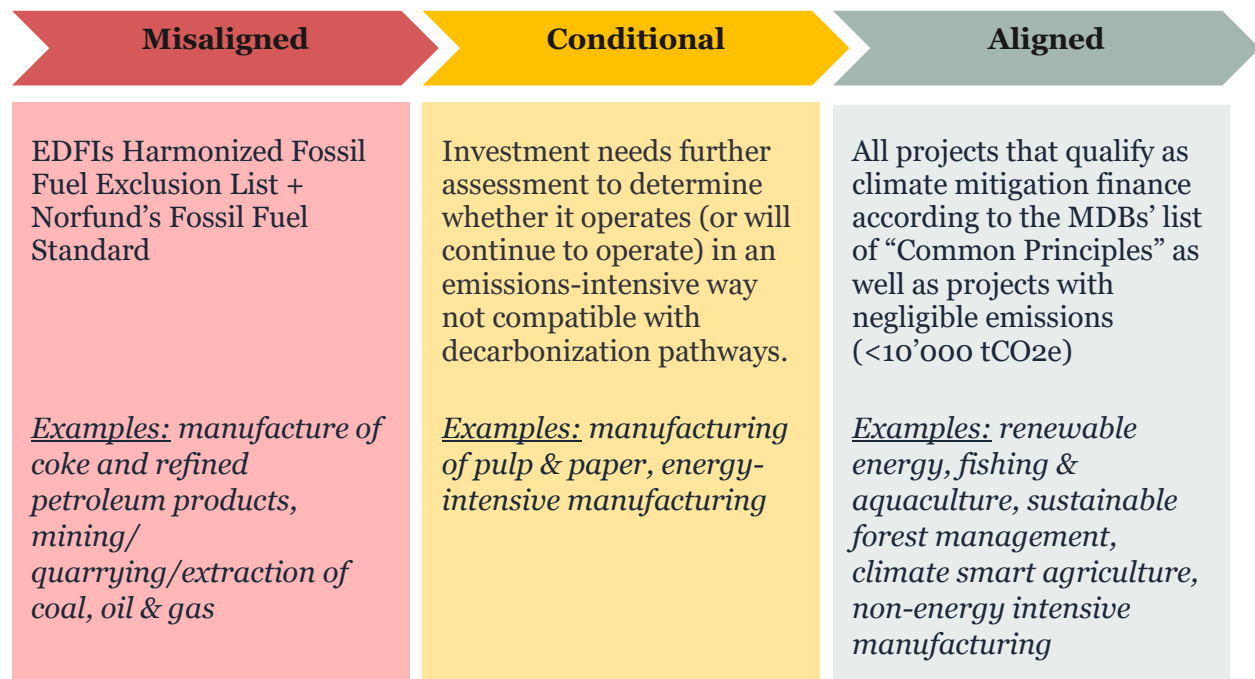


Figure 2: EDFI harmonized approach to Paris alignment at project level.

This framework accounts for the fact that many sectors lack pathways as of today and the lack of reliable emission data, which makes a thorough assessment of Paris Alignment particularly challenging. Thus, EDFI also considers other evaluation criteria. Further, this approach ensures materiality to focus resources on projects that are more susceptible to misalignment.

Norfund has adopted the EDFI methodology. Therefore, a tool has been developed that tries to simplify the assessment while not falling short of capturing relevant information necessary for Paris-aligned decision making. In this context, Norfund acknowledges uncertainties and lack of reliable data. As of now, it is challenging to make Paris-aligned investment decisions precise science and the assessment serves as a best-effort starting point. In essence, the tool differentiates between pre-Clearance-in-Principle (pre-CIP) and Due Diligence (DD) phase to categorize the investment first in the three categories and then, based on its outcome and depending on materiality, assess them more thoroughly in DD.

### 3.1 Automatically Misaligned

Automatically misaligned projects refer to Norfund's Fossil Fuel Standard (Norfund, 2023).

### 3.2 Automatically Aligned

Investment projects that can be considered climate finance or have low emissions, will be considered "automatically aligned" and will not require further assessment. This is to rather focus efforts on projects that have higher risk of misalignment.

Projects that meet criteria for climate mitigation finance developed by the Multilateral Development Banks (MDBs) (International Development Finance Club, 2021) are automatically deemed aligned, barring some exceptions. Additional considerations include:

- Treating certain non-material sectors for net zero as automatically aligned.
- Establishing an emission threshold to classify low emission investments as automatically aligned, especially in areas lacking specific sector pathways.
  - < 10'000 t CO<sub>2</sub>e: All investments that are not affected by Norfund Fossil Fuel Standard and emit less than 10'000 tCO<sub>2</sub>e p.a. are automatically aligned.

To account for emission thresholds, a high-level emission estimation is conducted based on data on sector, revenue & country by using the Joint Impact Model (JIM Foundation, 2024). This gives an indication whether the investment is high, medium or low emitting. It must be noted that the JIM is not designed for such project level ex-ante emission estimates, but rather portfolio reporting. While the emission estimation currently used is rather imprecise and not interchangeable with actual data, it is a practical implementation to categorize investments as it gives an indication to decide whether it is material to conduct detailed assessment or not. Norfund is continuously working on improving its emission estimation approach.

Automatically aligned investments are only subject to climate risk questions during Due Diligence, but not subject to further assessment regarding Paris-alignment.

### 3.3 Conditionally Aligned

Investments not included on either of the lists remain ambiguous or "conditional", necessitating further examination. Such conditional investments will undergo more detailed assessment criteria. This analysis will be guided by the EDFI's proposed indicator framework in three distinct areas: (i) system level, (ii) asset level, and (iii) transition risks. Special attention will be paid to sectors with significant risk of misalignment. This determination is based on factors like:

- (a) substantial greenhouse gas (GHG) emissions, including Scope 3 emissions,
- (b) pronounced structural or induced climate impacts, or
- (c) high susceptibility to climate change.

For simplicity these 15 questions have been reduced to 9 questions which will be explained in the following. An indicative score resulting from these questions guides the project manager and the investment committee in assessing the project.



### 3.3.1 System Level

#### 3.3.1.1 Question 1: Is the country clearly committed to low-carbon pathways?

This assessment question assesses the national context of the investment and is based on the Nationally Determined Contributions (NDCs). NDCs are climate action plans every country submits under the Paris Agreement, outlining their efforts to reduce greenhouse gas emissions and adapt to climate impacts (UNFCCC, 2023). Countries committed to low-carbon pathways are more likely to support and benefit from Paris Aligned investments.

#### 3.3.1.2 Question 2: Is the investment aligning with the country's mitigation efforts and existing development pathways?

While the first question does only focus on the country itself and not the investment itself, this question assesses how well the investment aligns with the country's efforts to reduce greenhouse gas emissions (mitigation efforts) and its broader development plans. This alignment is key to ensuring that the investment supports the country's climate goals.

It is important to note that the NDCs are by far not sufficient to reach the 1.5 degree target with currently implemented policies result in projected emissions that lead to warming of 3.2°C, with a range of 2.2°C to 3.5°C. Thus, aligning with a country's mitigation efforts can oftentimes be somewhat seen as bare minimum and various other factors have to be examined as well.

#### 3.3.1.3 Question 3: Does the investment meet relevant sector criteria and/or follow sector-relevant decarbonization pathways?

This question evaluates whether the investment aligns with sector-specific decarbonization standards and practices, essential for reducing greenhouse gas emissions within that sector. Projecting an investment's emission and comparing it to various sectoral decarbonization pathway can be considered the most reliable method of assessing Paris alignment. However, it often is difficult to obtain reliable emission data and suitable decarbonization pathways as benchmarks.

### **Deep Dive: Sector Pathways**

Sector pathways primarily serve as an emission reference to assess Paris Alignment or consistency with other emission reduction targets of an economic activity. They are not predictions, but rather benchmark scenarios to figure out if an activity is in line with the stated climate objectives. Usually, these pathways are based on the findings of the latest IPCC report and reflect different emission scenarios.

Most emission pathways were initially designed for use in industrialized countries. Consequently, there is rarely an ideal reference pathway to use for investments in Norfund's core countries. Therefore, Norfund applies sector pathway alignment on a best-effort basis. The Transition Pathway Initiative (TPI, 2023) provides global pathways for the highest emitting sectors with emission scenario benchmarks ranging from 1.5°C degree world, 2°C world, scenario with implemented policies/NDCs and others. The tool has incorporated these pathways for certain sectors. If the project has a high risk of misalignment, the user shall compare the investee's emission scenario with the benchmarks provided. Thereby, the investment teams can derive an opinion whether the scenario is in line with 1.5°C degree or below 2°C degree (Paris aligned). If the investee's emission scenario is above either of those lines, it might indicate that it is not Paris aligned. However, as these scenarios might not accurately reflect regional differences (TPI are global scenarios), the user can also employ other benchmarks (e.g. EU Taxonomy, etc.) to form an educated opinion on alignment based on different pathway sources.



### 3.3.2 Asset Level

#### 3.3.2.1 Question 4: Are there feasible lower-carbon alternatives to this investment?

This question is aimed at identifying options that achieve the same or similar investment goals but with a lower carbon footprint. Therefore, the investment teams assess whether there are feasible alternative technologies that serve the same function as the proposed investment but are more carbon efficient.

#### 3.3.2.2 Question 5: Is there a risk of the asset remaining emission-intensive throughout its life?

The objective of this question is to assess the likelihood of the investment contributing to sustained high carbon emissions over its entire operational life. This assessment is distinct from a later transition risk assessment, as it focuses specifically on the inherent emission characteristics of the asset itself, rather than on the broader risks associated with transitioning to a low-carbon economy.

#### Underlying Concepts



**Carbon Lock-In:** The concept refers to the tendency of certain carbon-intensive technological systems to persist over time, making it difficult to transition to lower-carbon alternatives. This can be influenced by technical, economic, and institutional factors. Understanding carbon lock-in is crucial to assess the long-term emission potential of an asset (World Resource Institute et al., 2021).

**Stranded Assets and Carbon Lock-In:** The risks associated with stranded assets and carbon lock-in are critical to understand, particularly in the context of investments in carbon-intensive infrastructure. Stranded assets are those that can no longer earn a return on investment due to changing market dynamics or regulatory factors, while carbon lock-in refers to investments that delay or prevent a transition to low-emission alternatives. The interplay between these risks is essential to consider when assessing the long-term emission potential of an asset (Erickson et al., 2015).

Considering these aspects helps in evaluating whether an investment is likely to contribute to prolonged high emissions, thereby impacting its alignment with Paris Agreement goals.

#### 3.3.2.3 Question 6: Does the investment replace a higher carbon asset?

The goal of this question is to determine if the proposed investment will replace an existing asset that has a higher carbon footprint, thereby contributing to avoiding emissions. This is important in assessing the investment's positive impact on climate change mitigation. In some cases, a Life-Cycle Assessment is necessary to answer this question.



### 3.3.3 Transition Risk

#### **3.3.3.1 Question 7: Are there policies and regulations in place that could significantly affect the business' profitability and growth prospects due to carbon constraints?**

The aim of this question is to assess the potential impact of current and forthcoming carbon emission policies and regulations on the profitability of the business. Understanding the regulatory landscape is critical as it can significantly influence the financial viability of investments in the context of carbon constraints.

As for this question and the following transition risk question, Norfund has oriented itself on the TCFD (TCFD, 2022).

#### **3.3.3.2 Question 8: Is there a significant risk of the investment's products or services being substituted by lower emissions options?**

This question aims to determine the risk of the investment's products or services being substituted by lower emission alternatives, considering changing market dynamics, technological advancements, and evolving consumer preferences.

#### **3.3.3.3 Question 9: Is it likely that the valuation/exit/refinancing of the investment will be negatively impacted by investors reducing their exposure to high carbon assets?**

This assessment helps to understand the potential financial risks associated with high-carbon investments in the context of changing investor preferences.



### 3.3.4 Scoring System

The scoring system in the Paris alignment assessment of the tool gives an indicative view of an investment's alignment with the Paris Agreement. It serves to summarize the preceding complex assessment. The score is derived from a simplified "yes/no/uncertain" answering of the questions, which will not capture the nuances and specifics of each investment. Therefore, while the scoring provides a quick reference point, it is meticulous research that enables informed decision-making.

#### How the scoring works?



Each of the questions presented above is assigned a weight that signifies its importance in the overall assessment of an investment's alignment. All questions together yield a maximum score of 100. The indicative results of the score can usually be interpreted as follows:

Score > 80	Investment is fully aligned!	You can proceed with the investment. It aligns well with the Paris Agreement standards. Insert the score in the Investment Paper.
80 > Score > 50	Investment is likely aligned!	Please proceed with caution and consider using external verification. Insert the score in the Investment Paper and attach a reasonable explanation in the executive summary of the Investment Paper.
Score < 50	Investment is likely not aligned!	The tool recommends not proceeding with the investment unless there are concrete measures that can be taken for the investment to be Paris aligned (i.e. apply new technology) not already captured by the tool. Investment teams shall consider doing further analyses and external verification (such as LCA analysis) and explain thoroughly how this investment can be Paris aligned.

### 3.3.5 Results

Automatically aligned and automatically misaligned investments give clear indications on how to proceed. Conditionally aligned investments are more difficult to decide upon. An investment with a low score, but with a credible path to become Paris aligned, can still be something Norfund invests in. Whether Norfund chooses to move forward with the investment or not, will depend on how confident we feel that the investment can transition and that we have the tools and resources to support the company transition (i.e. the use of business support, close follow-up, climate action plan). The final decision rests with the Investment Committee.



## 4 CLIMATE RISK ASSESSMENT IN THE CLIMATE TOOL

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In addition to supporting Paris Alignment, the tool also enables investment teams to conduct a climate risk assessment that is guided by the principles of the Task Force on Climate-related Financial Disclosures (TCFD) as well as Norfund’s internal climate risk standards. It applies to both conditional and automatically aligned investment (misaligned investments are excluded from further investment considerations).

### 4.1 Lens 1: The actual climate risk and opportunity the investee is exposed to - physical risk assessment

#### 4.1.1 *Physical Risk Assessment at Pre-CIP:*

In the tool, investment teams will evaluate both acute physical risks, such as increased severity of extreme weather events like cyclones or floods, and chronic physical risks, which involve longer-term shifts in climate patterns, for example, sustained higher temperatures leading to sea level rise or chronic heat waves. Websites like *Think Hazard!* provide free location based physical risk information. Users should indicate the level of risk that these events pose for the investments.

#### 4.1.2 *Transition Risk Assessment at DD:*

During Due Diligence, the tool covers transition risk assessment, which are addressed comprehensively in the Paris alignment assessment under *Transition Risk*. If the investment is automatically aligned, the tool still demands that investment teams assess transition risk. The tool then assists in summarizing these risks to categorize the overall level of climate risk. It is highly recommended to consider transition risk also at Pre-CIP as defined in Norfund’s Climate Risk Guidance Note.

### 4.2 Lens 2: The investee's capabilities in managing climate risk and opportunity

Moreover, the tool evaluates the investee's capabilities in managing climate risks and opportunities during the DD phase. This includes assessing whether the organization has identified climate-related risks and opportunities in the short, medium, and long term, whether processes are in place to manage these risks, and if specific metrics are tracked to assess climate-related risks and opportunities. Users are prompted to summarize their findings on the investee’s capabilities in managing these risks.

To conclude, the tool serves as a guide for investment teams to assess minimum requirements for climate risk, covering both physical and transition risk. For projects that face significant climate risks, Norfund conducts more in-depth assessments, e.g. by engaging with external consultants.

## 5 LIMITATIONS

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The climate tool designed for assessing climate criteria in investments exhibits limitations that must be acknowledged for effective use.

It's a one-size-fits-all model, which may not align with the specific context or unique variables of every investment case. The tool's scoring system, while indicative, can oversimplify complex assessments, potentially skewing its reliability. Simplification can also be attributed to the climate risk assessment. While it offers guiding questions, it does not guarantee a comprehensive climate risk assessment of every investment. This strongly depends on the investment team's research, thorough Due Diligence, and several aspects beyond Norfund's control. Additionally, the tool has room for enhancements on quantitative data-driven evaluation as well as on assessing adaptation. Norfund considers adaptation a crucial aspect of the Paris Agreement. Further, the tool currently does not serve intermediary investments (Funds & FI). For these investment areas, an approach is currently being developed. Finally, the tool is in its first version and will be regularly reviewed. To conclude, while it is important to use this tool thoroughly and extensively, its results must be taken with caution, and it is imperative to continuously improve on a best-effort basis.

## 6 CONCLUSION AND FUTURE DIRECTIONS

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The climate tool represents a significant step for Norfund, introducing a structured approach to climate assessment and guiding investments towards alignment with the Paris Agreement. It serves as a foundational tool to evaluate direct investments against various climate criteria, including Paris Alignment, fossil fuel exclusion, and climate risk.

While the tool offers a systematic starting point, it's important to acknowledge that climate assessment is an evolving field. The investment teams are encouraged to report any discrepancies or unusual findings as well as ideas for improvement.

Looking ahead, the tool is set to undergo several advancements. This includes refining the existing features based on feedback from the investment teams, extending its scope to include indirect investments, and improving emission estimations for more precise assessments. Further, training sessions for the investment teams will ensure adept usage of the tool. Additionally, increasing emphasis on adaptation strategies will ensure a more comprehensive approach to climate resilience. This evolution will be guided by ongoing exchanges with other Development Finance Institutions, fostering continuous improvement in climate assessments.

The climate tool, as it evolves, will play a crucial role in shaping a sustainable and climate-resilient future at Norfund and the companies we invest in.



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