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Dear Committee Secretary,

Submission to Senate Economic Reference Committee Inquiry on Carbon Risk Disclosure

ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. We are environmental lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

ClientEarth has established a respected project on company and financial law, with specialist expertise in relation to the risks and opportunities of climate change for companies, investors and their executives.

Together with the Stranded Assets Programme at the Smith School of Enterprise and the Environment (Oxford University) and HRH Prince of Wales Accounting for Sustainability Project, we are a founding member of the Commonwealth Climate and Law Initiative (**CCLI**), a research, education and outreach project studying the legal implications of climate change and carbon risk on companies, investors and the financial system.

The CCLI's primary mission is to investigate the legal basis for companies and their directors in common law countries to take account of climate change risks and societal responses to climate change, under prevailing statutory and common (judge-made) laws. Its main focus is on the laws of four Commonwealth countries: the United Kingdom (**UK**), Canada, South Africa and Australia.

In the context of this inquiry we define carbon risk broadly to refer to all potential risks to companies, markets and financial stability arising from climate change.[1] Carbon risk arises differently for all sectors, and includes those risks to company business models, strategies and operational procedures posed by climate change (all of which may ultimately impact on financial performance). Carbon risk may be both direct and indirect, and there is also mounting evidence that climate change represents a systemic or macro-economic risk to the global economy.

[1] The terms 'climate change risk' or 'climate risk' are also used to refer to this type of financial risk to companies, investors and markets.

This submission firstly discusses the systemic nature and materiality of carbon risk, a matter we consider relevant to each of the Committee's terms of reference.[2] It then responds to the specific matters in (a) and (b) of the Committee's terms of reference. We focus on the scope, adequacy and functioning of the regulatory frameworks in the UK and Europe, and trends in investor engagement with companies on disclosure. Although we make no direct comments on the adequacy or otherwise of the existing Australian framework, we note that parallels may be drawn between requirements in the UK and Australia for listed entities to disclose material exposures to risk.

1. What is carbon risk and why is it material?

Climate change is real and it is happening now.[3] The physical impacts of climate change on the global atmosphere and environment, together with the related legal, policy and technological responses of states and societies will have significant impacts on the global economy.[4]

In its seminal September 2015 report on the risks to the insurance industry arising from climate change, the Bank of England's Prudential Regulation Authority defined climate-related financial risks as falling into the three main categories, including physical risks,[5] transition risks[6] and liability risks.[7] Most definitions of climate related financial risk adopt the above taxonomy, as does the Financial Stability Board (**FSB**).[8]

Transition risks include the risk of stranded assets[9], which are of particular relevance to producers of fossil fuels and other carbon intensive commodities.

In addition to the above types of risk, the recently concluded Paris Agreement[10] demonstrates that carbon risk are now recognised as a current and universal **systemic** risk to the global economy, management of which requires enhanced transparency by organisations.

In November 2015, leaders of the G20 recognised climate change as 'one of the greatest challenges of our time.'[11] In response to a request by the G20 in April 2015, the FSB

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[2] Responding to question (e) of the Committee's Terms of Reference.
[3] See the Intergovernmental Panel on Climate Change's 5th Assessment Report at https://www.ipcc.ch/report/ar5/
[4] Prudential Regulation Authority, 'The impact of climate change on the UK insurance sector A Climate Change Adaptation Report by the Prudential Regulation Authority', Bank of England, September 2015, available at http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf
[5] Being first-order risks which arise from weather-related events, such as floods, droughts and storms which may have a physical impact on infrastructure and people. These risks comprise impacts directly resulting from such events, such indirectly through subsequent events, such as disruption of global supply chains or resource scarcity.
[6] Being financial risks which could arise for firms from the transition to a lower-carbon economy, including the costs to business arising from new and stricter government regulation of greenhouse gas emissions or high carbon products, or other state policy aimed at climate change mitigation and adaptation.
[7] Being risks that could arise for firms from parties who have suffered loss and damage from climate change, and then seek to recover losses from others who they believe may have been responsible. Liability may also arise from a failure to manage the impacts of physical or transition risks.
[8] FSB, Proposal for a disclosure task force on climate-related risks, 9 November 2015 available at https://www.fsb-tcfd.org/wp-content/uploads/2016/01/FSB_Disclosure-task-force-on-climate-related-risks.pdf
[9] For further details see the work of Carbon Tracker, http://www.carbontracker.org/report/unburnable-carbon-wasted-capital-and-stranded-assets/
[10] The Paris Agreement, negotiated in December 2015, and agreed to by 195 countries, committed those countries to the objective to hold the increase in the global average temperature to well below 2ºC above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5ºC above pre-industrial levels. The agreement is the latest encapsulation of over 20 years of international climate policy, with the UN Secretary General Ban-Ki Moon stating of the Agreement that "the unthinkable [global action on climate change] has now become the unstoppable". The agreement contains provision for a global stocktake - a periodic assessment of global progress towards the goals of the Paris Agreement, and a ratcheting mechanism for Nationally Determined Contributions that clearly set the global economy on a pathway to low carbon energy systems.
[11] G20 Leaders' Communique, Antalya Summit, 15-16 November 2015

established a Task Force on climate-related Financial Disclosures (**TCFD**). The FSB's establishment of the TCFD indicates carbon risk is regarded as a macro economic trend affecting the financial sector.

The European Systemic Risk Board also published a report in February 2016 analysing the potential macro-economic impacts of the transition to a lower carbon energy system on the EU economy, based on differing policy scenarios.[12]

Standard and Poor's Ratings Services also recognise climate change as one of the most important trends of this decade - it considers the impact of climate change as one of two mega-trends (the other being population growth) which have emerged to dominate public discussion on global economic risks.[13] Although operating in the private sector, Standard and Poor's is one of the world's leading providers of independent credit research and benchmarks, issuing credit ratings for the debt of private companies and public borrowers including sovereign governments.

A recent submission to the TCFD from Howard Covington, Carolyn Hayman and Raj Thamotheram of economic think-tank Preventable Surprises, describes in detail the nature of the systemic risk climate change poses to the global economy. In summary, the submission finds that:

- there are systemic risks to the global economy building both from future climate damage and from the speed, extent and uncertainty of the changes that the global energy infrastructure must undergo if climate damage is to be avoided;
- these risks are hard to quantify, but such work as has been done points towards an investment portfolio value at risk from future climate damage of around 10% at probabilities of a few percent – in other words the kind of value at risk that would give financial institution managements concern if they arose in a stress test;
- with some notable exceptions, investment fiduciaries, and particularly pension fund trustees, are scarcely aware of these risks and, if they are aware, are doing little of substance to reduce them;
- the usual tools of portfolio management – diversification, hedging, asset allocation – cannot deal with these risks because they are systemic; and
- the risks could be reduced if investors guided the companies they invest in to do what they could to reduce their emissions (while preserving shareholder value), among other things by encouraging such companies to publish business plans consistent with a 2° warming emissions trajectory.

The above discussion of carbon risk demonstrates that climate change is not simply a matter of responsible corporate governance, but poses a **material financial risk** for many companies.

Accordingly, carbon risk may be a material financial issue for many shareholders, insurers, asset owners, investment managers, superannuation funds, regulators and all investors, in

[12] ESRB, ASC Report No 6, February 2016, Too late, too sudden: Transition to a low carbon economy and systemic risk, available at https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf
[13] Standard and Poor's Rating Services, 2014. Climate Change Is A Global Mega-Trend For Sovereign Risk [Online] Available at: https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1318252&SctArtId=236925&from=CM&nsl_code=LIME&sourceObjectId=8606813&sourceRevId=1&fee_ind=N&exp_date=20240514-20:34:43 [Accessed 17 February 2016].

short, the financial system as a whole. Adequate reporting and disclosure of this category of risk is therefore essential so that markets may efficiently allocate capital between companies.

2. Current and emerging international carbon risk disclosure frameworks

This discussion focuses on the current law in the UK and the European Union. We consider these matters relevant to the Australian context because:

- many large Australian companies are dual listed on stock exchanges in the UK and Australia (including BHP Billiton and Rio Tinto); and
- systemic carbon risk and stranded asset risk is likely to affect the Australian financial market more acutely, due to its dependence on the highly carbon intensive mining and minerals industry.

Section 414A of the Companies Act 2006 (**Companies Act**) requires companies incorporated in the UK to prepare a strategic report for each financial year. The strategic report must include the following information:

- to the extent necessary for an understanding of the development, performance and position of the company's business…the main trends and factors likely to affect the future development, performance and position of the company's business (section 414C(7)(a) Companies Act, applying to quoted companies);
- a description of principal risks and uncertainties facing the company (section S414C(2)(b), applicable to all companies); and
- information about environmental matters, social, community and human rights issues (section 414C(7)(b), applicable to quoted companies).[14]

The UK's Financial Reporting Council (**FRC**) has provided guidance on how to satisfy the content requirements for the strategic report in its June 2014 "Guidance on the Strategic Report" which provides further explanation in relation to each of these components.[15]

In the EU, the Transparency Directive and Accounting Directive[16] (implemented partially in the UK by the Financial Conduct Authority's Disclosure and Transparency Rules) also require companies across the EU to prepare a management report including similar information to that required by the strategic report.

As the discussion in section 1 demonstrates, carbon risk is a main trend or factor likely to affect the future development, performance and position of many sectors of the economy particularly the fossil fuel industry. Therefore, in order to comply with section 414C(7)(a) of the Companies Act, quoted companies are required to discuss carbon risk in their strategic reports.

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[14] Non-financial information in relation to these matters is also now required by the EU Non Financial Reporting Directive.
[15] https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf
[16] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (Directive 2004/104/EC) and Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC (Directive 2013/34/EU).

Similarly, we consider that companies in carbon intensive sectors must now disclose carbon risk as a principal risk and uncertainty facing their businesses.

We have written to the FRC expressing our view on these issues, a copy of that correspondence is included as **Attachment A.**

Our letter explains that many carbon-exposed companies are not satisfying these existing mandatory reporting requirements by failing to adequately disclose carbon risk. We urged the FRC to enforce the existing framework by developing a strategy to ensure that annual reports from carbon-exposed fossil fuel companies satisfy the mandatory requirements of the Companies Act.

On 15 December 2015 the Chief Executive of the FRC wrote to the Audit Committee Chairmen of larger listed UK companies summarising key developments for 2015 annual reports. The letter states that investors are "expressing surprise" that risks from climate change are not reported more often as principal risks (letter included as **Attachment B**). This demonstrates that the FRC is beginning to recognise the deficit in company reporting on carbon risk in the UK.

3. Current carbon risk disclosure practices within corporate Australia

We understand that recent Australian case law (namely *ACCR v CBA* [2015] FCA 785) has confirmed the position that Australian shareholders do not have the right to propose resolutions at the company's AGM containing an opinion that the company should provide additional disclosures of carbon risk.

Given this legal position, we suggest it is of greater importance that regulatory frameworks ensure that investors have access to accurate, timely and fulsome information in relation to carbon risk, to improve the efficiency of the Australian market. We support the submission of the Australasian Centre for Corporate Responsibility (**ACCR**) to this inquiry suggesting legal reform in relation to this issue.

Adequate disclosure of carbon risks is a critical aspect of providing information to investors, so that they can make informed investment decisions about the companies they invest in and engage in effective stewardship with those companies where appropriate. We stress that good disclosure allows investors to compare data across companies in similar sectors, and that accordingly data disclosure must be:

- consistent;
- comparable;
- verifiable; and
- delivered to investors in a timely fashion.

Speaking at the COP21 Paris Climate Change Conference, FSB Chair Mark Carney observed that 'access to high quality financial information will allow market participants and policymakers to understand and better manage those risks which are likely to grow with time.'[17] Founder of the TCFD, Michael Bloomberg has also underscored that 'it is critical that

[17] FSB, 2015. FSB to establish Task Force on Climate-related Financial Disclosures. [Online] Available at: http://www.fsb.org/2015/12/fsb-to-establish-task-force-on-climate-related-financial-disclosures/ [Accessed 17 March 2016].

industries and investors understand the risks posed by climate change, but currently there is too little transparency about those risks.'[18]

The flow of actionable information to shareholders is crucial to promote efficient capital allocation. If investors do not have all relevant information to hand then they will not be able to factor this information into their investment decisions. As the 2012 Kay Review in the UK noted:

"The principal role of equity markets in the allocation of capital relates to the oversight of capital allocation within companies rather than the allocation of capital between them. Promoting good governance and stewardship is therefore central, rather than incidental, function of UK equity markets."[19]

Investors, particularly institutional investors, are now well aware of carbon risk and are seeking disclosure from companies already through shareholder resolutions. In 2014, ClientEarth worked with the "Aiming for A" investor coalition to file historic shareholder resolutions with Shell and BP, calling on the companies to demonstrate "strategic resilience for 2035 and beyond." The resolutions called for routine annual reporting from 2016 to include further information about ongoing operational emissions management; asset portfolio resilience to the International Energy Agency's scenarios; low-carbon energy research and development and investment strategies; relevant strategic key performance indicators and executive incentives; and public policy positions relating to climate change.

The resolutions were supported by company management and passed with over 98% of the vote at those companies AGM's in 2015. BP and Shell have responded to these resolutions this year by disclosing further analysis of their performance in a carbon-constrained world. BHP Billiton has also voluntarily undertaken a similar exercise.[20]

Additional resolutions were filed by the "Aiming for A" investor coalition with three of the world's largest integrated miners, Anglo American, Glencore and Rio Tinto in 2015. They have again been supported by company management and will be voted on at those companies' AGMs in the next month.

In the US, on 22 March 2016, the federal Securities and Exchange Commission (**SEC**) denied ExxonMobil's request to exclude a shareholder proposal made under Rule 14a-8 of the Securities Exchange Act of 1934, requesting that:

"Shareholders request that by 2017 ExxonMobil publish an annual assessment of long term portfolio impacts of public climate change policies, at reasonable cost and omitting proprietary information. The assessment can be incorporated into existing reporting and should analyze the impacts on ExxonMobil's oil and gas reserves and resources under a scenario in which reduction in demand results from carbon restrictions and related rules or commitments adopted by governments consistent with the globally agreed upon 2 degree target. The reporting should assess the resilience of the company's full portfolio of reserves

[18] UNFCCC, 2015. Climate Financial Risk Disclosure Stepped up at COP21. [Online] Available at: http://newsroom.unfccc.int/financial-flows/climate-risk-disclosure-stepped-up-at-cop21/, [Accessed 17 March 2016].
19 The Kay Review of Equity Markets and Long Term Decision Making, July 2012, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf page 10.
20 http://www.bhpbilliton.com/~/media/5874999cef0a41a59403d13e3f8de4ee.ashx

and resources through 2040 and beyond and address the financial risks associated with such a scenario".

The SEC ruled that the above proposal was not too vague or uncertain and accordingly not excludable by the company. It also rejected the company's argument that the proposal had already been substantially implemented by the publication of a 2014 report in which the company stated its belief that none of its proven hydrocarbon reserves are, or will become, stranded through 2040.

The move by shareholders to seek greater disclosure from companies they own demonstrates the importance of carbon risk to investors globally. It also shows that investors are willing to use their influence and legal rights to seek further and additional disclosure where companies provide inadequate information on this emerging category of financial risk. Active stewardship, particularly on environmental issues, is a trend that we consider will only increase with time. It is a worthwhile mechanism to improve corporate governance and in turn, the long term financial viability and sustainability of the companies that have a significant impact on the entire financial system.

Please do not hesitate to contact Sophie Marjanac or Alice Garton for further information on anything contained in this submission.

Yours sincerely,

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ClientEarth
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Sophie Marjanac
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Attachment A - Letter from ClientEarth and CarbonTracker to the Conduct Committee of the FRC dated 22 June 2015

Attachment B - Letter from Stephen Haddrill, FRC Chief Executive to the Audit Committee Chairman dated 15 December 2015