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Why Companies Should Report Financial Risks From Climate Change

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How hard will it be for companies to meet the recommendations of the Task Force on Climate-related Financial Disclosures? Not as hard as many might think.

Investors and the rest of the world are watching to see how companies will respond to the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) commissioned by Mark Carney, governor of the Bank of England and chair of the G20's Financial Stability Board. Simply put, the TCFD is asking companies to report on their response to the risks and opportunities created by climate change. The TCFD emphasizes that these disclosures can be done in existing reporting formats (such as 10-Ks).

The Motivation for Implementing the TCFD Recommendations

Despite the voluntary nature of the TCFD recommendations, companies have several reasons to start implementing them. First is investor pressure: Investors need this information and are mobilizing to ensure companies take the recommendations seriously. For example, ShareAction, a U.K.-based NGO, and Boston Common Asset Management LLC have organized a campaign (representing $1 trillion in assets under management) to implement these recommendations at 60 of the world's largest banks. It is likely that many more shareholders will be clamoring for a response at upcoming 2018 annual general meetings.

Second, investors may be less inclined to invest in companies that do not implement the recommendations.

Third is self-interest: Companies that comply with the recommendations will have better strategies for adapting

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to climate change and will be better able to explain these to the investment community.

Fourth, the recommendations will likely lead to regulation; laggards will find themselves playing catch-up, perhaps under time pressure and great expense if they've done nothing to lay the groundwork for following the TCFD's recommendations. The stakes are high for investors, companies, and the world.

The Practicality of Implementing TCFD Recommendations

How hard will it be for companies to implement the TCFD's recommendations? Consider an industry that is among the most severely challenged by climate change: oil and gas. We examined the disclosures from 2016 of 15 the largest oil and gas companies by market cap listed on the New York Stock Exchange (NYSE): Anadarko, BP, Chevron, CNOOC, ConocoPhillips, Eni, EOG Resources, ExxonMobil, Occidental, Petrobras, PetroChina, Shell, Sinopec, Statoil, and Total. We reviewed each company's 2016 SEC Form 10-K (used by U.S. domiciled listed companies) or Form 20-F (used by companies based outside the United States that have listed equity shares on U.S. exchanges) and their sustainability reports.

This makes for a good test. How much more disclosure is being recommended by the TCFD than already exists today? The short answer is that while there is work to be done, oil and gas companies won't be starting with a blank sheet of paper. There are even a few that have already made good progress in adhering to the TCFD's recommendations. While we don't want to underemphasize some of the challenges, identified below, we also want to make it clear that the TCFD is not making recommendations that would be impossible to meet.

The TCFD report has four broad recommendations with the suggestion that companies provide these disclosures in their annual financial filings:

- **Governance.** Disclose the organization's governance around climate-related risks and opportunities.
- **Strategy.** Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.
- **Risk Management.** Disclose how the organization identifies, assesses, and manages climate-related risks.
- **Metrics and Targets.** Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

We explored three questions in our analysis:

1. To what extent were oil and gas companies already following the TCFD recommendations using existing guidance from the Securities and Exchange Commission (SEC), Global Reporting Initiative (GRI), and Sustainability Accounting Standards Board (SASB)?

2. If most (all) companies show a large gap in complying with the TCFD recommendations, would closing this gap result in increased legal liabilities from disclosure?

3. What needs to be done to facilitate adoption of the TCFD recommendations?

Three companies stood out. Eni, ExxonMobil, and Statoil provided the most robust disclosures. The disclosures made by the other companies were more limited and, in some cases, perfunctory. Eni, to some degree, addressed each of the four high-level disclosure recommendations. While it was the only company to do so, this shows that meeting the TCFD's recommendations can be done. The disclosures of these three companies taken together provide a good starting road map for all oil and gas companies.

Strategy disclosures in both SEC filings and sustainability reports were generally well done. With a few exceptions, companies provided information that indicated a focus on their long-term strategy even where climate risk was not specifically mentioned. Discussion of forecasts for energy usage 20 or 30 years into the future often accompanied detailed information related to development of biofuels, carbon capture and storage, natural gas fields, and investments in wind, solar, and fuel cells. However, few companies disclosed information about scenario analysis, including a "2-degree or lower" scenario — one in which companies are mandated to work toward maintaining the rise in global temperature to no more than 2°C above pre-industrial temperatures.

Disclosures were weaker for Governance, Risk Management, and Metrics and Targets. The deficiencies were related to the 11 specific disclosure recommendations: failure to describe board oversight and management's role in assessing climate risks; processes to manage and mitigate climate-related risks; and metrics to assess climate risks. For example, companies described board composition and expertise, but only one provided details about board committee meetings to address climate risk. Companies discussed climate-related risks in the "Risk Factors" section of their SEC filing, but these disclosures lacked detail. With respect to Metrics and Targets, many of the companies disclosed their greenhouse gas emissions in terms of performance and future goals, but very few discussed how the targets related to business model and strategy.

Both Eni and Statoil disclosed the sustainability targets for CEO incentive compensation. Eni also disclosed that its Sustainability and Scenarios Committee discussed energy scenarios and renewable energies at six of its 10 meetings. Statoil described a board and executive climate risk assessment process, though not at the recommended level of detail. Eni, Statoil, and Exxon provided performance information and targets for greenhouse gas emissions, carbon intensity, and efforts to reduce flaring and methane emissions.

This analysis provides evidence that the TCFD objectives can be met within existing financial filings.

The Legality of Implementing TCFD Recommendations

In general, we found more information relevant to the TCFD's recommendations in voluntary sustainability reports than in official financial filings. Thus, companies are already disclosing information they are not required to. Why don't more companies report climate risk information in their official filings? One possible reason, litigation risk, is a red herring. As explained by Russell Picot, a special adviser to the TCFD, "…companies and lawyers have expressed concerns that scenario analysis could be interpreted as a forecast, and if proved inaccurate could lead to being sued by investors." Picot explained that the TCFD is not asking for a "financial forecast," only for companies to explain how their businesses might be affected under different scenarios.

Two companies in our study appear to share Picot's views on scenario analysis and legal risk. Eni described how the company assessed recoverability of the carrying value of assets using the International Energy Agency (IEA) 450 Scenario (a 2-degree scenario) in the Risk Factors section of its Form 20-F. Statoil's Form 20-F described the sensitivity analysis of the company's project portfolio using the IEA 450 Scenario, but not in great detail.

Similarly, in the Management Discussion and Analysis section of ExxonMobil's Form 10-K, the company disclosed information about their processes to evaluate impairment of assets or project viability under a wide range of fact patterns, including changes in business climate, laws, and regulations. Even though ExxonMobil did not specifically address 2-degree scenarios, the fact that both Eni and ExxonMobil disclosed information about circumstances that might affect the value of assets and viability of projects in their SEC filings suggests that scenario analysis of asset impairment due to climate change is a first step that companies can take toward embedding the TCFD recommendations into financial filings.

General counsels at many companies may be tempted to reject Picot's point of view and advise their companies to follow the recommendations of the TCFD in their voluntary — and largely unaudited — sustainability report. Our view is that the TCFD's recommendations will have their full impact when the bulk of the information is included in an official financial filing. Information here gets greater scrutiny, is subject to better internal controls and procedures, in reality poses no legal risk, and is more credible to investors.

Advice on Implementing TCFD Recommendations

Below is a simple, three-step process for oil and gas companies, and companies in general, to meet the spirit of the TCFD's recommendations.

First, the board of directors should direct executive management to adopt the recommendations of the TCFD. This can be done as part of a "Statement of Significant Audiences and Materiality." The board should evaluate and take a position on climate risk by stating whether society as a whole is a significant audience and how it will evaluate the company's short-, medium-, and long-term efforts to mitigate risks and leverage opportunities.

Second, executive management should develop a plan for how it can meet the TCFD's recommendations, starting with the four categories and then drilling down to the more specific recommendations in each one. In doing so, they can learn from what has been done by Eni, ExxonMobil, Statoil, and eventually others. Recognizing the liability concerns, in the early stages the focus should be on what goes into the sustainability report.

Third, executive management should develop a plan for how it can shift the emphasis of its TCFD-related reporting from the sustainability report to its official and mandated financial filing. This will improve the quality of the information, as well as making clear how these disclosures are related to present and future financial performance.

Do companies have to do this? Not yet and not now. Will regulators require it? Probably not soon in most jurisdictions. But will investors be putting pressure on companies to do so? Yes, they will and they already are.

This pressure will only increase as evidence mounts that how a company deals with climate change will determine its ability to deliver value for its investors — and the world at large.

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