ESG, climate change risk and disclosure

by **TIM NELSON** *Associate Professor of Economics, Griffith University*

- Before adopting a non-financial reporting framework, organisations should undertake a materiality review to determine the issues that are important to each stakeholder of an organisation.
- Task Force on Climate-related Financial Disclosures disclosure requires companies to document their approach to risk management and how this considers climate change risk
- An emerging issue related to non-financial reporting, with a focus on climate change, is the way in which companies participate in the public policy and political process.

Over the past several years, there has been increased focus on the environmental, social and governance (ESG) issues facing publicly listed companies. At the same time, there is a related push for companies to ensure they retain their 'social licence' in an environment of declining institutional trust. A key, often overlooked way in which companies can consolidate these trends into a strategic framework is the use of 'sustainability' or non-financial reporting. This article considers such reporting through the specific lens of climate change risk and the recent framework for reporting released by the Task force on Climate-related Financial Disclosures (TCFD).

ESG (ESG) reporting: In theory and practice

Simon Longstaff, executive director of the Ethics Centre notes that when corporations were first created in the 1800s, negative public sentiment was driven by concerns that directors would hide behind the 'corporate veil', and companies would not act in the long-term interests of their customers and society more broadly.[1] Increasingly, investors and civil society see non-financial or ESG reporting as a key way of demonstrating that directors are fulfilling their obligation to act in the best *long-term* interests of the company. ESG reporting allows the company to show it is contributing to greater long-term shareholder value by retaining its social licence. Reporting on how the company is improving non-financial indicators by aligning its strategy with longer-term societal value creation facilitates this.

Activist investors are increasingly agitating for greater adoption of non-financial disclosure. Gilbert and Tobin note that in the last twelve months, seven of the ASX50 have had an ESG-related shareholder resolution lodged at their AGM.[2] While climate change is a significant focus for investors, there have also been resolutions related to human rights and public policy and political donations and influence.[3] Companies with strong ESG disclosure frameworks and good stakeholder engagement frameworks are less likely to experience such activism because civil society engagement facilitates an effective alignment of strategy, risk management and disclosure.

Non-financial reporting frameworks

There are a range of frameworks that companies can adopt including the Global Reporting Initiative (GRI) and Integrated Reporting (IR). But these are *reporting* frameworks. Without a broader strategic focus, they risk being ‘add-ons’ to a company’s disclosure, rather than a key part of its strategic focus. In this context, the most important step is considering what issues are important. The easiest way to ensure alignment between the risk register, strategy and external stakeholder perceptions is through the use of a ‘materiality review’. A materiality review is effectively a process for determining the issues that are important to each stakeholder of an organisation: investors; customers; employees and civil society (for example, business associations, consumer groups, environmental advocates). The process allows an organisation to determine what it should be measuring (for example, air emissions, waste, impact on communities etc) given the *materiality* of issues to its stakeholders.

Within this materiality review, companies can utilise the United Nations Sustainable Development Goals (SDGs) as a key way of ensuring that they define their ‘social purpose’. The 17 SDGs are objectives that sovereign nations have agreed should be pursued by governments, civil society and business. They include generic objectives such as ‘no poverty’ but also very specific objectives such as ‘affordable and clean energy’.[4]

The TCFD framework and climate risk

Climate change risk can be broken into two main categories: mitigation risk and adaptation risk. Mitigation risk relates to the impacts of greenhouse emission reduction policies (for example, carbon pricing) and consumer trends towards low-emissions products and services (for example, Green Power). Adaptation risk relates to the impacts of physical climate changes (for example, sea level rise).

The Taskforce for Climate-Related Financial Disclosures was established to consider a framework through which companies could report on the way in which these risks were being addressed.[5] The key components of such disclosure are: strategy; scenario analysis; governance; risks and opportunities; and key metrics and targets.

Strategy

The most important component of any strategic discussion is demonstrating that the business understands how climate science, public policy and technology development are likely to impact its operating environment. The scientific consensus and internationally agreed convention is that anthropogenic climate change should be limited to no more than two degrees Celsius above pre-industrial levels.[6] Sovereign nations are required to update 'Nationally Determined Contributions' that contribute to this overarching goal. In Australia, the current commitment is for greenhouse emissions to reduce by 26–28 per cent of 2005 levels by 2030. But over the long term, the 'two-degree' goal may imply a 'carbon budget' of no more than ten gigatonnes of emissions in Australia between 2015 and 2050.[7] This is around 20 years of emissions at current levels. This may have material impacts on businesses with large Scope 1 and/or Scope 2 emissions (see Key Metrics and Targets discussion below).

A Greenhouse Policy Framework is a useful tool to articulate how climate science, public policy and technology evolution is likely to impact a business. The policy should articulate an understanding of the risks and opportunities presented by climate change mitigation and adaptation and key activities the business intends to undertake to transition towards a low-emissions future. A good example of such a policy is the Westpac Climate Change Action Plan.[8]

Scenario analysis

This is probably the most important component of the TCFD framework. Climate change mitigation policy is unlikely to be implemented in a linear fashion. Gradual emission reductions are likely to become more rapid as technology improves and facilitates more cost-effective abatement.[9] The scenario analysis undertaken by AGL is a good example of how companies can disclose the impacts of different emission reduction trajectories. Importantly, AGL disclosed both the positive impacts but also the potential material negative impacts on its coal-fired power station operations.[10]

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Governance

The governance of climate change risks and opportunities is a key area of focus for investors. There is an expectation that directors and companies have strong governance frameworks in place. Key questions relate to how the board establishes a framework (including potential board sub-committees) and how this is then implemented by management. Importantly, directors do not need to be 'climate scientists' but do need to ensure they have asked the right questions and availed themselves of the relevant expertise of key technical specialists.[11]

Risks and opportunities

Identifying risks and opportunities requires the governance and strategic framework to be aligned with the company's risk register. TCFD disclosure requires companies to document their approach to risk management and how this considers climate change risk. As noted previously, risk management requires both *mitigation* risks and *adaptation* risks to be identified and relevant treatments disclosed.

Key metrics and targets

Metrics are a key way in which investors are able to consider the risks and opportunities on particular businesses and industries. Disclosure of emissions data is an important aspect of this. The *National Greenhouse and Energy Reporting Act (NGER)* requires large energy producers and consumers to disclose their energy production, consumption and associated greenhouse gas emissions. This is a useful framework for companies to adopt in presenting their emissions data within a TCFD context.

Scope 1 emissions relate to the direct emissions produced by a business activity (for example, burning coal to make steel). Scope 2 emissions are less obvious but equally important as they relate to the emissions associated with consuming electricity that has utilised fossil fuel combustion. Other important concepts include ‘equity’ footprints that reflect the emissions associated with non-operated equity investments and ‘supply’ footprints that reflect the emissions associated with supplying customers with products and services.[12]

Investors are increasingly expecting that targets be used to drive performance improvement. The ‘We Mean Business’ framework is a useful tool for considering how to implement a science-based target.[13] ANZ’s climate change statement is a good example of how metrics can be used to reduce risks – the bank has committed to only finance new electricity generation technologies if their emissions profile is below 0.8 tonnes per megawatt-hour of electricity produced.[14] But most importantly, targets and metrics are of little use if they are not aligned with remuneration. Targets should be reflected in management's remuneration framework.

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An emerging issue: Public policy advocacy

An emerging issue related to non-financial reporting, with a focus on climate change, is the way in which companies participate in the public policy and political process. Investors are increasingly concerned that companies are engaged in explicit or implicit ‘astroturfing’ or underhanded advocacy. Best practice requires companies to disclose the positions they hold on key material public policy issues, the organisations they fund (for example, industry associations) and how the positions of these organisations may differ from their own and the approach they take to reconcile the two.[15]

Conclusion

There is a significant opportunity for companies to utilise non-financial ESG reporting to drive alignment between strategy, risk and societal expectations. Companies that achieve this will be better placed to retain their 'social licence' to operate over the long-term, allowing directors to demonstrate they are acting in the long-term interests of the company. The TCFD framework is a good example of a disclosure framework that allows companies to demonstrate they are addressing the risks and opportunities associated with climate change. Most importantly, it is critical that companies align strategy and remuneration frameworks in this context.

Notes

1 https://aicd.companydirectors.com.au/membership/company-director-magazine/2018-back-editions/march/thinking-the-unthinkable
2 https://www.gtlaw.com.au/insights/shareholder-activism-report-2018
3 See for example: https://accr.org.au/wp-content/uploads/ACCR-Investor-Briefing-Qantas-Airways-1.pdf
4 For a full list of these goals, see https://www.un.org/sustainabledevelopment/sustainable-development-goals/
5 The Taskforce was global in nature and chaired by Michael Bloomberg (see https://www.fsb-tcfd.org/). Only three Australian companies are considered to have made disclosures that are consistent with the recommendations of the TCFD (see https://www.smh.com.au/business/companies/lip-service-call-for-investors-to-step-up-action-on-climate-risk-20180901-p5017x.html)
6 This was agreed by sovereign nations at the 21st Conference of the Parties in Paris in December 2015.
7 See https://www.climatecouncil.org.au/wp-content/uploads/2018/06/CC_MVSA0143-Briefing-Paper-Australias-Rising-Emissions_V8-FA_Low-Res_Single-Pages.pdf
8 See https://www.westpac.com.au/about-westpac/media/media-releases/2017/28-april/
9 For example, emission reductions in the electricity sector are significantly more economic than five years ago due to the rapid reduction in renewable technology costs (see https://www.sciencedirect.com/science/article/pii/S1040619017303500)
10 See Powering a Climate Resilient Economy (available through: https://www.2018sustainabilityreport.agl.com.au/)
11 See Centre for Policy Development opinion on directors' duties and climate change (https://cpd.org.au/2016/10/directorsduties/)
12 See https://www.emeraldinsight.com/doi/pdfplus/10.1108/20408021111162173for a checklist relating to metrics, targets and strategy development.
13 See https://www.wemeanbusinesscoalition.org/
14 See http://www.anz.com/resources/4/9/49dc76c2-d4b5-465e-aa02-7bf1f5714cad/anz-climate-change.pdf?MOD=AJPERES
15 There has been sustained focus by ACCR in Australia on this issue (see https://accr.org.au/wp-content/uploads/ACCR-Investor-Briefing-Origin-Energy.pdf as an example). However, it is also a significant focus globally (see https://www.ft.com/content/4b25f48c-49b7-36e1-a009-6d1bc2808e55)

Tim Nelson can be contacted at t.nelson@griffith.edu.au.
