Climate Change Risk Disclosure and Director Due Diligence

Scope and Purpose

This paper provides information on the emerging topic of climate change risk disclosure and its legal significance with respect to corporate governance. It has been prepared to help inform directors and officers of their due care and diligence requirements with respect to climate change risk.

The paper presents a view on current best practice in climate risk disclosure based on the work completed by the G20 Taskforce for Climate-related Financial Disclosure (**TCFD**) and the Australian-based Investor Group on Climate Change (**ICCG**). A framework for disclosure is recommended; organised around core principles, effective narrative and selection of appropriate metrics. A 3-step development pathway is proposed, in recognition of the fact that climate change risk disclosure is currently at an early stage of development and should evolve and mature with time.

The paper covers three parts:

Part A: Provides definitions and the legal context for disclosure.

Part B: Describes core principles for disclosure, the recommended reporting framework and a pathway to developing climate change risk disclosure over time.

Part C: Identifies key resources and recommended reading.

PART A: LEGAL CONTEXT AND DEFINITIONS

Policy and Legal Context

Climate change is now widely accepted and recognised as a financial problem, not purely an ethical or environmental issue. Given that climate change now presents material risks (and opportunities) it is best considered and managed in the context of **business strategy**, **scenario analysis** and **risk management**: a core function of high performance Boards.

Recent legal guidance over the duties of Directors with respect to climate change risk, gaps in D&O insurance and emerging claims[1] of inadequate corporate disclosure provide a compelling motive for board directors to undertake best endeavours in disclosing climate change risk in a full and frank manner, while acknowledging that climate change disclosures may be imperfect and evolving.

In 2016, Australian barristers Mr Noel Hutley SC and Sebastian Hartford-Davis presented a memorandum of opinion[2] on the extent to which directors are currently required to respond to climate change risks. The "Hutley Opinion" argues that ***climate change risks would be considered by a court to be foreseeable risks at the present time and as such, Directors who fail to consider climate change risks now, could be found liable for breaching their duty of care and diligence in the future.***

[1] Commonwealth Bank shareholders sue over 'inadequate' disclosure of climate change risks (Michael Slezak, The Guardian, 8 August 2017)

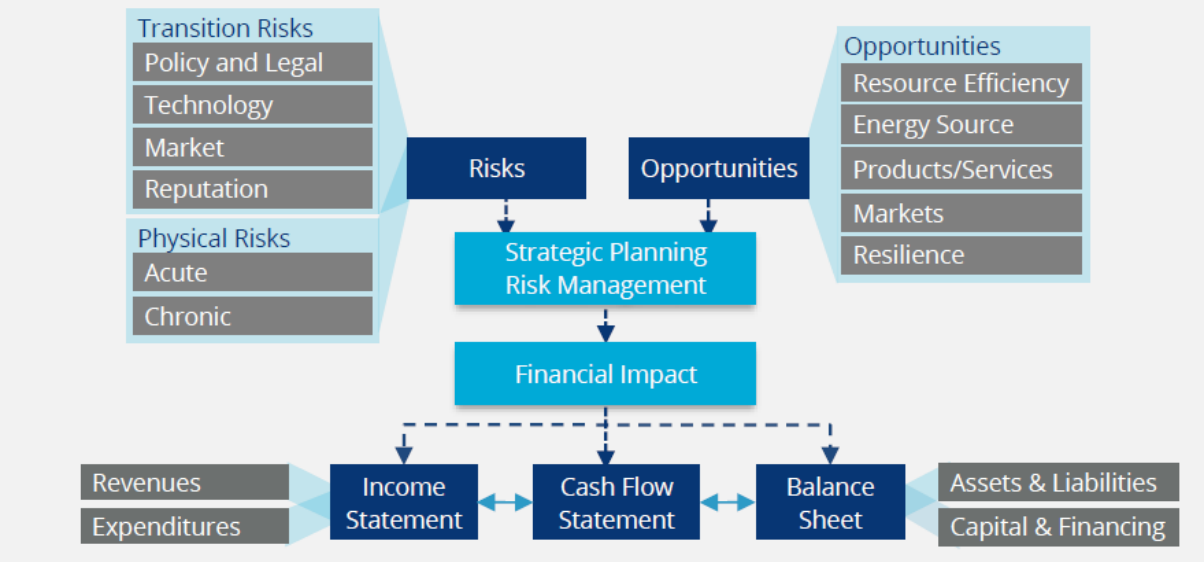
[2] Climate Change and Directors' Duties; Memorandum of Opinion (Hutley and Hartford-Davis, 7 October 2016)

Risks and Opportunities

Climate change risk refers to the potential negative impacts of climate change on an organisation. They are not limited to the physical risks of extreme weather or changing climate. There are also transition risks to consider and these can relate to **policy and legal** (e.g. onerous adaptation regulation, hostile legal precedence, insurance risk, etc), **technology** (e.g. costs to transition to lower emissions technology), **markets** (e.g. changing consumer behaviour) and **reputation** (e.g. increased stakeholder concern, shift in consumer preferences).

Climate change opportunity refers to the potential positive impacts related to climate change on an organisation. Efforts to mitigate and adapt to climate change can produce opportunities such as resource efficiency and cost savings, adoption of low-emission energy sources and development of new products and services.

Figure 1: Climate-related risks, opportunities and financial impact.



Source: TCFD (2016) Recommendations of the Task Force on Climate-related Financial Disclosures

Examples of climate change related risks and opportunities and their potential financial impacts are listed in Tables 2 and 3 of the Appendix.

Assessment of Materiality

The financial impacts of climate change on an organisation are driven by the specific risks and opportunities to which it is exposed and its strategic approach to managing those risks (i.e., through mitigation, transfer, acceptance, or control) or seizing opportunities. Once an organisation assesses its climate change risks and opportunities and determines its response, it can then consider actual and potential financial impacts on revenues, expenditures, assets and liabilities, and capital and financing.

Why Disclose?

The purpose of climate risk disclosure is to inform stakeholders as to the manner in which the organisation is managing climate change risk. These stakeholders include government, private operators, lessees, investors, insurers, policy-makers, regulators and the Victorian community. Stakeholders require decision-useful information rather than broad boilerplate statements on

climate change. The disclosure framework presented here assists in meeting the growing demand by investors, lenders and other stakeholders to access metrics and information needed to assess the financial implications of climate change in order to make better informed decisions.

It is recommended that a legal opinion be sought on any proposed disclosure to ensure it satisfies due diligence requirements and demonstrates the organisation's best endeavours to communicate climate change impact.

Where to Disclose?

The recommended and preferred method of voluntary public disclosure is the Annual Report in sections that focus on strategic priorities and performance metrics. The Annual Report should contain enough information to enable stakeholders to make an informed assessment of the organisation's financial position, its business strategies and future prospects.

In time, if the Department of Treasury model guidelines for an Annual Report are varied to include disclosure of climate change risk in the financial statements and risk attestations sections, the disclosures could be included in those sections. Alternatively, publishing a statement on the organisation's website may suffice as an interim measure.

PART B: DISCLOSURE FRAMEWORK AND PATHWAY

General Principles for Effective Disclosure

To underpin its reporting framework and help guide good quality disclosure, the TCFD developed the following set of seven principles. The principles are consistent with other accepted frameworks for financial reporting and taken together are designed to assist a Board in clarifying the linkages between climate change related issues and governance, strategy, risk management, metrics and performance targets.

1. Disclosures should present relevant information
2. Disclosures should be specific and complete
3. Disclosures should be clear, balanced and understandable
4. Disclosures should be consistent over time
5. Disclosures should be comparable among organisations within a sector, industry or portfolio
6. Disclosures should be reliable, verifiable and objective
7. Disclosures should be provided on a timely basis

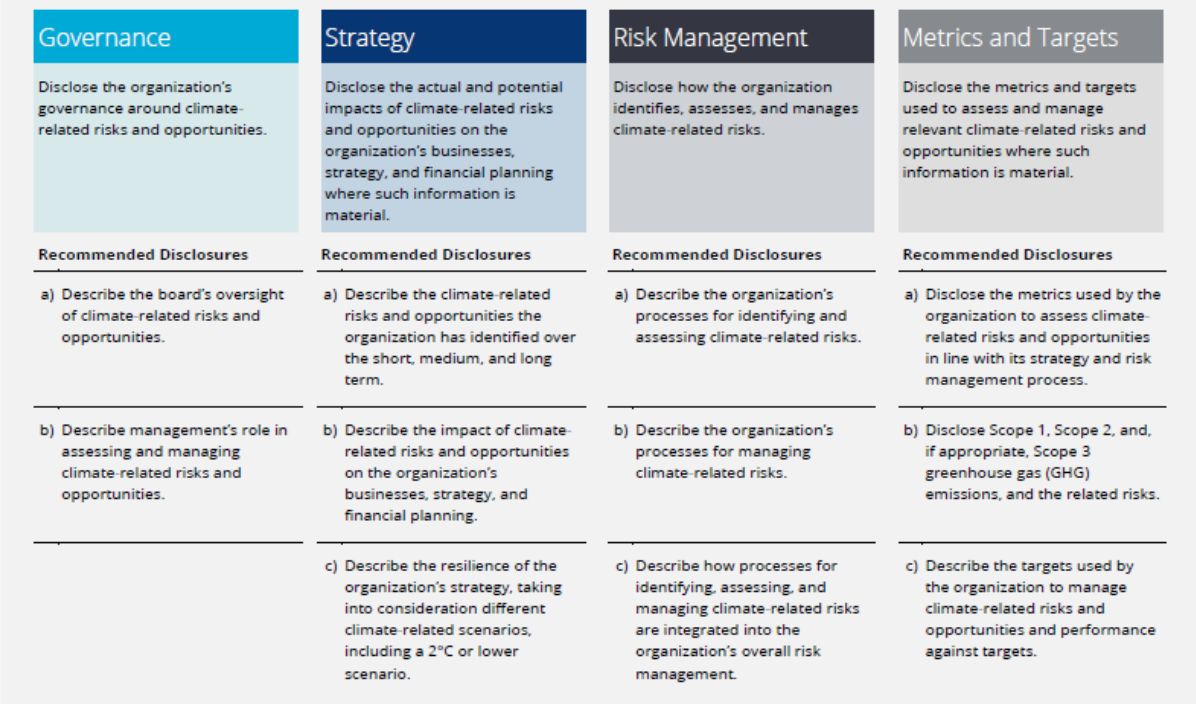
Disclosure Framework

The TCFD disclosure framework (**Figure 2**) is currently recognised as international best practice. Climate-related risks, opportunities and their financial impacts are the focus for disclosure and are made across four key business areas: **governance**, **strategy**, **risk management**, and performance **metrics and targets**. TCFD's disclosure framework is applicable to all sectors and organisations (public and private) and aims to promote informed decisions related to investment, asset management, lending and insurance underwriting. When properly implemented, the recommended

financial disclosures show that board directors were diligent in considering and reporting foreseeable risks and meeting their duty of care requirements.

Scenario analysis also features as an emerging method for understanding risks and opportunities around climate change and for informing strategic responses. The TCFD recommends that organisations test their business model against the **2-degree** warming limit agreed under the UNFCCC in Paris in 2016.

Figure 2: TCFD Recommended Framework for Disclosing Climate Change Risk.



Source: TCFD (2016) Recommendations of the Task Force on Climate-related Financial Disclosures

Narrative and Metrics

The ICCG's recommended method for framing and presenting disclosure consists of two parts: a '**climate narrative**' which is informed by '**climate metrics**'. These two complementary elements, used together with the **principles** of effective disclosure will help demonstrate an organisation's best endeavours to achieve a full and frank disclosure.

The climate narrative provides essential context for communicating the organisation's deliberations, beliefs, processes, actions and future plans in response to climate change. The components of a climate narrative include **organisational context**, **governance arrangements**, **climate journey** to date, an **explanation of risks and opportunities** and corresponding **actions and priorities**. The narrative shows that the organisation is **forward-looking** and knows where its heading in the future.

Access to **metrics and targets** will assist stakeholders to understand how the organisation measures and monitors climate-related risk and opportunities. It allows stakeholders to better assess the organisation's general exposure to climate-related issues and its progress in managing or adapting to climate change. Historical metrics should be provided where possible to allow **trend analysis**; along with publication of the methodologies used to calculate metrics. The organisation should disclose

the targets used to manage climate-related risks and opportunities and performance against these targets.

Disclosure Pathways

Climate change risk disclosure is currently at an early stage of development and is expected to evolve over time. A 3-step pathway from baseline through to advanced disclosure has been prepared for a general context, to show a cumulative, evolving climate journey in which narrative and metric features accrue over time to achieve a mature corporate position on climate change. The advanced disclosure represents the most mature organisational context and ultimate direction for the evolution of future climate change risk reporting.

Table 1: Pathways to climate change risk disclosure; including narrative and metric features

Baseline:

Narrative contains:

- A statement of organisational (corporate) position on climate change, including governance arrangements
- Recognition of climate science
- Developing strategy and risk management as it relates to climate change
- Developing investment strategy
- Developing relationship to state-wide policy
- Identification of risks, opportunities, key priorities and actions

Metrics include:

- Identification of KPIs which are sensitive to climate
- Climate metrics including extreme weather events
- Developing carbon footprint, waste and water use
- Engagement activities
- Climate change adaptation capex

Intermediate:

includes baseline disclosure features plus…

Narrative contains:

- Identification of most vulnerable assets/services/ programs
- Integration of state-wide policy and targets
- Climate science update
- Case studies showcasing adaptation strategies
- Scenario analysis and 2 degree alignment

Metrics include:

- Expansion of KPIs
- Carbon footprint, avoided emissions
- Reduction in greenhouse gas (GHG) emissions, water usage, waste management
- Utility, water and waste costs
- Storm severity and frequency, maintenance costs associated with extreme weather damage
- Investment and development metrics
- Developing trend analysis

Advanced

includes intermediate disclosure features plus…

Narrative contains:

- Long term-vision to reduce exposure to risk
- Links to government policies and forward trajectories
- Contains specific investment actions and outcomes
- Goal to shift market mix to stronger position
- Adaptation risks and opportunities are seen as important
- Bold and focused engagement with policy makers and stakeholders
- Future proofed for a 2 degree outcome
- Intergovernmental Panel on Climate Change (IPCC) Sixth Assessment (due 2022) considered and incorporated into strategy.

Metrics include:

- Established KPIs and trend analysis
- Climate-related risks associated with land use (eg catchment health, biodiversity and ecological systems)
- Water consumption
- Cost of investment in mitigation activities
- Value generated from offsets
- Cost of investment in reducing energy & fuel consumption, cost savings from projects, pay-back periods by projects
- Transition to zero net emissions
- Established trend analysis

Part C: Recommended Reading

Barker, S. (2015) *Directors' personal liability for corporate inaction on climate change*. Governance Directions vol. 68.

Barker, S. (2016) *A new COP on the beat – heightened expectations for corporate sustainability governance and disclosure*. MinterEllison Client Note.

Commonwealth of Australia (2017) *Carbon risk: a burning issue*. Senate Inquiry to Economics Reference Committee

de Wit, E (2017) *Climate change risks: What do you need to disclose?* Governance Directions, vol.69, no.2.

Hutley, N and Hartford-Davis, S.(2016) *Climate change and Directors' duties: Memorandum of Opinion*.

Investor Group on Climate Change (2017) *Transparency in Transition: A Guide to Investor Disclosure on Climate Change*

Simic, M. (2017) *Climate change on the corporate governance landscape*. Governance Directions, vol.69.

Subramaniam, N (2016) *Climate change risk disclosure: A challenging frontier*. Governance Directions, vol.69.

Summerhayes, G (2017) *Australia's new horizon: Climate change challenges and prudential risk*. Address to the Insurance Council of Australia Annual Forum, Sydney.

Task Force on Climate-related Financial Disclosures (2016) *Recommendations of the Task Force on Climate-related Financial Disclosures*

Task Force on Climate-related Financial Disclosures (2017) *Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures*

The Climate Institute (2017) *Corporate Responses to the 1.5-2^{o}C Paris Agreement Climate Objectives*

Appendix: Examples of Climate-Related Risks and Opportunities and their Potential Financial Impact

Table 2: Examples of climate-related risks and their potential financial impact

Type	Climate-Related Risks	Potential Financial Impact
Transition Risks	**Policy and Legal**	
	– Increased pricing of GHG emissions – Enhanced emissions-reporting obligations – Mandates on and regulation of existing products and services – Exposure to litigation	– Increased operating costs (e.g. higher compliance costs, increased insurance premiums) – Write-offs, asset impairment, and early retirement of existing assets due to policy changes – Increased costs and/or reduced demand for products and services resulting from fines and judgments
	Technology	
	– Substitution of existing products and services with lower emissions options – Unsuccessful investment in new technologies – Costs to transition to lower emissions technology	– Write-offs and early retirement of existing assets (e.g. diesel generators, out-dated infrastructure) – Research and development (R&D) expenditures in new and alternative technologies – Capital investments in technology development – Costs to adopt/deploy new practices and processes
	Markets	
	– Changing customer behaviour – Uncertainty in market signals – Increased cost of raw materials	– Reduced demand for goods and services due to shift in consumer preferences – Increased production costs due to changing input prices (e.g. energy, water) and output requirements (e.g. waste treatment) – Abrupt and unexpected shifts in energy costs – Change in revenue mix and sources, resulting in decreased revenues – Re-pricing of assets (e.g. land valuations, securities valuations)
	Reputation	
	– Shifts in consumer preferences – Stigmatisation of sector – Increased stakeholder concern or negative stakeholder feedback	– Reduced revenue from decreased demand for goods/services – Reduced revenue from decreased production capacity (e.g. delayed planning approvals, delayed investment) – Reduced revenue from negative impacts on workforce management and planning (e.g. employee attraction and retention) – Reduction in capital availability
Physical Risks	**Acute**	
	– Increased severity of extreme weather events such as fire and storms.	– Reduced revenue from decreased production capacity – Reduced revenue and higher costs from negative impacts on workforce (e.g. health, safety, absenteeism) – Write-offs and early retirement of existing assets (e.g. damage to property and assets in "high-risk" locations) – Increased operating costs (e.g. inadequate water supply) – Increased capital costs (e.g. damage to facilities) – Reduced revenues from lower visitation – Increased insurance premiums and potential for reduced availability of insurance on assets in "high-risk" locations
	Chronic	
	– Changes in precipitation patterns and extreme variability in weather patterns – Rising mean temperatures	

Source: TCFD (2016) Recommendations of the Task Force on Climate-related Financial Disclosures

Table 3: Examples of climate-related opportunities and their potential financial impact

Type	Climate-related Opportunities	Potential Financial Impact
Resource Efficiency	– Use of more efficient modes of transport – Use of more efficient production and distribution processes – Use of recycling – Move to more efficient buildings – Reduced water usage and consumption	– Reduced operating costs (e.g. through efficiency gains and cost reductions) – Increased production capacity, resulting in increased revenues – Increased value of fixed assets (e.g. highly rated energy efficient buildings) – Benefits to workforce management and planning (e.g. improved health and safety, employee satisfaction) resulting in lower costs
Energy Source	– Use of lower-emission sources of energy – Use of supportive policy incentives – Use of new technologies	– Reduced operational costs (e.g. through use of lowest cost abatement) – Reduced exposure to future fossil fuel price increases – Returns on investment in low-emission technology – Reputational benefits resulting in increased demand for goods/services
Products and Services	– Development of climate adaptation and insurance risk solutions – Development of new products or services through R&D and innovation – Ability to diversify business activities – Shift in consumer preferences	– Increased revenue through new solutions to adaptation needs – Better competitive position to reflect shifting consumer preferences, resulting in increased revenues
Markets	– Access to new markets – Use of public-sector incentives Resilience	– Increased revenues through access to new and emerging markets (e.g. partnerships with governments, developers) – Increased diversification of financial assets (e.g. green bonds and infrastructure)
Resilience	– Participation in renewable energy programs and adoption of energy efficiency measures – Resource substitutes/diversification	– Increased market valuation through resilience planning (e.g. infrastructure, land, buildings) – Increased reliability of offer and ability to operate under various conditions – Increased revenue through new products and services related to ensuring resiliency

Source: TCFD (2016) Recommendations of the Task Force on Climate-related Financial Disclosures