

FAO: The Conduct Committee
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

22 June 2015

Dear Sirs

Climate change disclosures of companies in the oil and gas, and coal sectors

1. ClientEarth¹, The Carbon Tracker Initiative², CDSB³ and CDP⁴ are submitting this letter to the Financial Reporting Council (“FRC”) as we believe many companies in the oil and gas and coal sectors (referred to in this letter as “fossil fuel companies”) are not satisfying existing mandatory reporting requirements by failing adequately to report on climate risk (as defined below).
2. As the independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment, the FRC has been authorised by the Secretary of State for the Department of Business Innovation and Skills (BIS) to exercise functions with a view to ensuring that company accounts and financial and other reports comply with the law and relevant reporting requirements.
3. As we explain more fully below, climate change and its associated policy and technology responses present material risks for fossil fuel companies (we refer to these risks in this letter as “climate risk”) – but very few companies adequately address these risks in their corporate reports. It is vital that this information is disclosed 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.
4. This letter is structured as follows:
 - **Section 1** provides an overview of the climate risks that today’s fossil fuel companies face.
 - **Section 2** sets out the applicable law and guidance relevant to the reporting of climate risk by fossil fuel companies, and demonstrates that these existing mandatory reporting requirements require fossil fuel companies to disclose climate risk.

¹ ClientEarth is a leading environmental law NGO with offices in London, Brussels and Warsaw. We are lawyers who use the law as a tool for tackling key environmental challenges such as climate change.
<http://www.clientearth.org/>

² Carbon Tracker Initiative is a financial think-tank that analyses the long-term financial risks to public companies from the transition to a low carbon economy. <http://www.carbontracker.org/>

³ CDSB is an international consortium of business and environmental NGOs committed to advancing and aligning the global mainstream corporate reporting model to equate climate change-related and environmental information with financial capital by offering companies a framework for reporting these with the same rigour. www.cdsb.net

⁴ CDP is an international NGO that provides the only global environmental disclosure platform for companies to report climate change and greenhouse gas emissions information to investors and other stakeholders. CDP acts on behalf of 822 institutional investors with assets of US\$95 trillion. www.cdp.net

- **Section 3** concludes by urging the FRC to exercise its functions to ensure corporate reports from fossil fuel companies satisfy the levels of disclosure required by law.

Section 1 – Climate risks facing fossil fuel companies

Meeting the required carbon budget will impact fossil fuel companies

5. In recent years, climate change policy experts and finance professionals have become increasingly focused on the need to limit fossil fuel emissions according to a “carbon budget”. At the same time, internationally recognised norms have coalesced around the goal of preventing warming beyond 2°C above pre-industrial levels.
6. The carbon budget associated with this goal limits society to burning one fifth to one third of existing fossil fuel reserves and resources – this will result in drastically reduced demand for fossil fuels and knock-on price impacts.
7. The risk to fossil fuel companies from climate change is that preventing warming of more than 2°C above pre-industrial levels will cause declines in the demand for, and price of, their commodities, impacting cash flows and margins and jeopardising returns on the highest cost projects.
8. The pressure to prevent the most dangerous effects of climate change will severely impact fossil fuel companies business because fossil fuel combustion is the primary source of anthropogenic greenhouse gas (“GHG”) emissions. This pressure is evident from the direction of travel of climate change legislation and policy at all levels of government, globally, and the development and deployment of new low-carbon technology renewables and lower-cost energy sources.

Direction of travel of climate change legislation and policy

9. First, the direction of travel of climate change legislation and policy is clear; the world is acting to limit the most dangerous effects of climate change, defined by scientists and policy-makers as warming beyond 2°C above pre-industrial levels. At the international level, this limit is encapsulated in the non-binding Cancun Agreement, agreed to by 193 countries⁵. The most recent Conference of the Parties held in Lima under the United Nations Framework Convention on Climate Change submitted a decision document draft recognising the need for net-zero emissions by 2050 (or 2100 at the latest).⁶
10. All around the world, countries are tracking their progress in reducing carbon-intensive energy demand in accordance with the 2°C goal. In October 2014, the European Union agreed to a binding emissions reduction target of 40% below 1990 levels by 2030, with an ultimate goal of achieving sufficient reductions by 2050 to meet Europe’s pro rata share of emissions reductions necessary to limit warming to 2°C.⁷ Roughly a month later, the United States and China, the two largest global emitters of GHGs, pledged additional

⁵ Report of the Conference of the Parties on its sixteenth session, held in Cancun from 29 November to 10 December 2010 <http://unfccc.int/resource/docs/2010/cop16/eng/07a01.pdf>. Notably, since the goal is to prevent dangerous climate change, the Cancun Agreement recognises the emerging scientific evidence that the limit might have to be reduced to 1.5°C above pre-industrial levels.

⁶ <http://unfccc.int/resource/docs/2014/cop20/eng/10a01.pdf#page=2>

⁷ http://ec.europa.eu/clima/policies/2030/index_en.htm

emissions reductions. The United States announced an economy-wide target of reducing its emissions by 26%-28% below its 2005 level in 2025, while China targeted a peaking of emissions in 2030 and an increase in non-fossil fuel use in primary energy consumption to 20% by 2030.⁸ The agreement was “mindful of the temperature goal of 2°C”⁹.

11. The 2°C limit has already been recognised in national laws. In the UK, the Climate Change Act 2008 sets the target for reducing UK GHG emissions to 80% below 1990 levels – a level based upon an assessment of the UK’s pro rata share of emissions reductions necessary to limit warming to 2°C.¹⁰
12. Sub-national governments have also recognised the 2°C goal. New York State has established a climate action plan that aims to reduce the State’s GHG emissions by 80% from 1990 levels by 2050,¹¹ based largely on scientifically-vetted pathways to the 2°C goal.¹² The State of California has developed a de-carbonisation pathway to meet similar goals within its borders; California’s Governor has recently increased its emissions reduction target to 40% reduction from 2005 emission levels by 2030 in order to put the State on a path to achieving a ratable share of emissions reductions necessary to limit warming to 2°C.
13. Even utilities have recognised the trend and the reductions necessary to avert dangerous warming. Germany’s largest utility, EON, announced a \$5.6 billion write-down of its fossil fuel holdings, and will pursue a renewables-only strategy in the core business.¹³ In the US, NRG Energy recently announced a plan to reduce carbon dioxide emissions by 90% by 2050, a transformation approximating to its ratable share of emissions reductions necessary to limit warming to 2°C.¹⁴

Development and deployment of new low-carbon technology renewables and lower-cost energy sources

14. The impetus to prevent dangerous warming is not limited to governmental or private commitments to cut emissions. A significant further trend is the growth in the increasingly competitive renewables market. Recent research from major investment banks indicates that the combination of falling costs for solar PV and battery storage, the increasing competitiveness of electric vehicles, and the rising costs of electricity supply are making the use of home solar systems with fully-electric vehicles increasingly competitive, with forecasted payback periods of between 6-8 years by 2020.¹⁵ Bernstein research forecasts that solar plus battery storage is or will become cheaper than retail energy

⁸ <http://www.whitehouse.gov/the-press-office/2014/11/11/us-china-joint-announcement-climate-change>

⁹ <http://www.whitehouse.gov/the-press-office/2014/11/11/us-china-joint-announcement-climate-change>

¹⁰ <http://www.theccc.org.uk/2008/12/01/ccc-recommends-a-minimum-34-cut-in-greenhouse-gas-emissions-by-2020-1st-december-2008/>

¹¹ <http://www.dec.ny.gov/energy/44992.html>

¹² http://www.dec.ny.gov/docs/administration_pdf/irchap2.pdf

¹³ Tino Andresen, “EON Banks on Renewables in Split from Conventional Power,”

<http://www.bloomberg.com/news/2014-11-30/eon-banks-on-renewables-with-plan-to-spin-off-conventional-power.html>

¹⁴ <http://www.njspotlight.com/stories/14/11/20/nrg-sets-ambitious-target-of-90-cut-in-greenhouse-gas-emissions-by-2050/>

¹⁵ See e.g., <http://energydesk.greenpeace.org/2015/04/27/comment-the-solar-storage-energy-revolution-is-arriving/> (citing reports by Deloitte, HSBC, Citigroup, Deutsche Bank and Barclays)

supply in a number of large markets by 2018.¹⁶ These transformations increase the probability that countries will meet their emissions targets; given the gravity of overshooting those targets, fossil fuel companies need to consider the how those targets will affect their business.

Financial materiality for fossil fuel companies

15. A 2°C limit would have material consequences for the use of fossil fuels. Relying on scientific estimates of climate sensitivity to various emissions pathways, Carbon Tracker's 2011 report concluded that, to have an 80% chance of limiting warming to 2°C, no more than 20% of existing fossil fuel reserves and resources could be burned.¹⁷ That conclusion is broadly consistent with analysis from the International Energy Agency and the Intergovernmental Panel on Climate Change.¹⁸ In 2013, Carbon Tracker stress-tested the findings of its 2011 report and showed that even using a higher 3°C limit and lower probabilities of success still left excess fossil fuel reserves and resources.¹⁹ A recent study from University College London concluded that, to have a mere 50% chance of meeting the 2°C goal, as much as one third of oil reserves, half of gas reserves, and over 80% of current coal reserves should remain unused through 2050.²⁰
16. The above studies make clear that business as usual for fossil fuels is incompatible with a 2°C limit. This mismatch is most critical with respect to company investment decisions – in a carbon-constrained world the highest cost projects will not be needed. In 2014, Carbon Tracker cross-referenced the volume of oil and coal needed in a carbon-constrained world with the estimated cost of potential future projects, identifying over \$1.2 trillion in potential capital expenditure through 2025 that would be uneconomic in a carbon-constrained world.²¹ Carbon Tracker's 2014 survey of CDP disclosures by fossil fuel companies found that while the majority (99%) recognize climate-related regulation as a risk, only a minority apply this knowledge in their risk management measures through 2°C scenario analysis and project stress testing and none, so far, have revealed the results of their 2°C scenario analysis and stress testing.
17. In addition, any carbon-constrained world would likely have knock-on impacts on commodity prices. Research by HSBC suggests that the greatest effects on fossil fuel companies stem not from declines in demand, but from declines in commodity prices –

¹⁶ <http://blogs.barrons.com/techtraderdaily/2015/04/08/solar-will-triumph-by-2018-breaking-the-subsidy-dependence-says-bernstein/>

¹⁷ James Leaton, *Unburnable Carbon - Are the world's financial markets carrying a carbon bubble?* at 6 (2011). Carbon Tracker's carbon budget was grounded in peer-reviewed scientific literature on emissions and warming pathways. See Malte Meinhausen *et al.*, "Greenhouse-gas emission targets for limiting global warming to 2°C," 458 *Nature* 1158 (2009).

¹⁸ A comparison of the IEA, IPCC and Carbon Tracker carbon budgets is available at: <http://carbontracker.org/wp-content/uploads/2014/08/Carbon-budget-checklist-FINAL-1.pdf>.

¹⁹ Even in a world where carbon constraints are relaxed to provide a mere 50% chance of limiting warming to 3°C above pre-industrial temperatures, all existing reserves and resources still cannot be burned. Carbon Tracker, *Unburnable Carbon 2013: Wasted Capital and Stranded Assets*, <http://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-2-Web-Version.pdf>

²⁰ McGlade and Ekins, 517 *Nature* 187, Letter "The geographical distribution of fossil fuels unused when limiting global warming to 2C," Jan., 8 2015.

²¹ By uneconomic, we mean that, over their useful lives, the projects are unable to generate cash flows sufficient to cover an internal rate of return for shareholders.

potentially up to 40-60% of company market cap in a 2°C scenario.²² The recent dramatic price declines in oil and gas markets show how even minor mismatches of supply and demand can cause drastic re-pricing.

Section 2 – Relevant legal reporting requirements

18. Section 414A Companies Act 2006 (“CA 2006”) has introduced a new requirement for companies incorporated in the UK to prepare (in addition to its annual directors’ report) a strategic report for each financial year. This requirement came into effect on 1st October 2013.
19. This letter addresses three components of the strategic report that are relevant to the reporting of climate risk by fossil fuel companies:
 - main trends and factors likely to affect future development, performance and position (quoted companies);
 - description of principal risks and uncertainties (all companies);
 - information about environmental matters, social, community and human rights issues (quoted companies).

The FRC has provided guidance on the content of the strategic report in its June 2014 “Guidance on the Strategic Report” (the “FRC’s Guidance”) which provides further explanation in relation to each of these components.

20. This letter also addresses the overall purpose of the strategic report, namely to inform members of the company and help them assess how the directors have performed their duties under S172 CA 2006.
21. Recognising that there is variability in corporate reporting, many fossil fuel companies are not satisfying mandatory reporting requirements by failing adequately to report (some or all) of the components of the strategic report outlined in Paragraph 19 above.

Main trends and factors likely to affect future development, performance and position (quoted companies)

22. For quoted companies, the strategic report must “to the extent necessary for an understanding of the development, performance or position of the company’s business, include the main trends and factors likely to affect the future development, performance and position of the company’s business” (S414C(7)(a) CA 2006).
23. The FRC’s Guidance²³ on this provision explains that trends and factors affecting the business may arise either a result of the external environment in which the entity operates or from internal sources. The FRC’s Guidance states that the strategic report should cover “significant features of its external environment (e.g. the legal, regulatory, macro-economic and social environment) and how those influence the business”.

²² Spedding et al., “Oil and Carbon Revisited: Value at risk from ‘unburnable’ reserves,” available at:

https://stateinnovation.org/uploads/asset/asset_file/1499/Oil_and_carbon_revisted.pdf

²³ Paragraphs 7.17 to 7.22.

24. The FRC's Guidance also provides that the strategic report should set out "the directors' analysis of the potential effect of the trends or factors identified on the development, performance, position or future prospects of the entity."
25. As Section 1 of this letter demonstrates, climate risk is a main trend or factor which is likely to affect the future development, performance and position of every UK incorporated fossil fuel company because it will cause declines in the demand for, and price of, their commodities. This will impact cash flows and margins and jeopardise returns on the highest cost projects. In view of the long timeframe for investment decisions of fossil fuel companies, this trend should be considered by fossil fuel companies now. Accordingly, every UK incorporated fossil fuel company should be addressing climate risk in their strategic report, in accordance with S414C(7)(a) CA 2006.

Description of principal risks and uncertainties (all companies)

26. For all companies, the strategic report must contain "a description of the principal risks and uncertainties facing the company" (S414C(2)(b) CA 2006).
27. The FRC's Guidance²⁴ on this provision provides that "[d]irectors should consider the full range of business risks, including those that are financial in nature and those that are non-financial ... A risk or uncertainty may be unique to the entity, a matter that is relevant to the market in which it operates, or something that applies to the business environment more generally. Where the risk or uncertainty is more generic, the description should make clear how it might affect the entity specifically."
28. The FRC's Guidance further provides that "[a]n explanation of how the principal risks and uncertainties are managed or mitigated should also be included to enable shareholders to assess the impact on the future prospects of the entity."
29. As Section 1 of this letter demonstrates, climate change is principal risk and uncertainty facing every UK incorporated fossil fuel company and should therefore be addressed in the strategic reports of all UK incorporated fossil fuel companies pursuant to S414C(2)(b) CA 2006.
30. Whilst the FRC's Guidance states that "the risks and uncertainties included in the strategic report should be limited to those **considered by the entity's management to be material** to the development performance, position or future prospects of the entity", climate risks are material to every fossil fuel company and therefore it would be appropriate for the FRC to scrutinise all fossil fuel companies on this basis.

Information about environmental matters (quoted companies)

31. For quoted companies, the strategic report must also include (to the extent necessary for an understanding of the development performance or position of the company's business) "(i) information about environmental matters (including the impact of the company's business on the environment) ... and (iii) social, community and human rights

²⁴ Paragraphs 7.24 to 7.28.

issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies" (S414C(7)(b) CA 2006).

32. The FRC's Guidance²⁵ explains that "[t]here can be a strong relationship between the development, performance, position or future prospects of an entity and some or all of [these] matters ..., particularly over the longer term. This may be because a particular matter gives rise to a principal risk or uncertainty or because the entity has gained a competitive advantage from its policies and responses to such matters. The relative importance of the matters will depend on the sector in which the entity operates and its strategy and business model."
33. The FRC's Guidance goes on to state that "the strategic report should include information on a matter described [in S414C(7)(b)] when its influence, or potential influence, on the development, performance, position or future prospects of the entity's business is material to shareholders", and "Information on any of the matters described ... that is not considered necessary for an understanding of the development, performance, position or future prospects of the entity's business should not be included in the strategic report. Where the directors wish to put this information in the public domain, it should be located outside the strategic report, for example in a separate sustainability or corporate social responsibility report which could be located online."
34. As set out in Section 1 of this letter, climate change is a material environmental matter, as well as a social, community and human rights issue, that is necessary for an understanding of the development, performance and position of every fossil fuel company and should therefore be reported in the strategic report in accordance with S414C(7)(b) CA 2006 (and not simply addressed in a separate sustainability or corporate social responsibility report).

The purpose of the strategic report

35. When companies disclose the specific content requirements outlined above, it should be borne in mind that S414C(1) CA 2006 provides that "the purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duties under section 172".
36. S172 CA 2006 requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
 - the likely consequences of any decision in the long term;
 - the impact of the company's operations on the community and the environment; and
 - the desirability of the company maintaining a reputation for high standards of business conduct.

If fossil fuel companies do not report adequately on climate risk in their strategic reports, this prevents company members from being able to properly assess whether the directors have complied with their duty under S172 CA 2006.

²⁵ Paragraphs 7.30 to 7.37.

Compliance with UK Corporate Governance Code (listed companies)

37. In addition to the context provided above as to the purpose of the strategic report, reporting requirements for fossil fuel companies are becoming more comprehensive.
38. For quoted companies with a premium listing, Rule 9.8.6 of the Listing Rules requires a statement in the annual financial report indicating how the company applies the principles of The UK Corporate Governance Code (the “Code”). For reporting periods beginning on or after 1 October 2014, the Code contains additional reporting requirements which will impact on climate change disclosures from quoted companies with a premium listing.
39. Paragraph C.2.1. of the Code requires the directors of relevant companies to confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are managed or mitigated. Furthermore, Paragraph C.2.2 states the directors should explain in the annual report how they have assessed the company’s prospects, over what period they have done so and why they consider that period to be appropriate.

Section 3 – FRC’s exercise of statutory function

40. We believe that many fossil fuel companies are not satisfying these mandatory reporting requirements by failing to adequately report on climate risk.
41. Other regulators have already begun to take steps to assess and address systemic climate risks. For example Mark Carney, Governor of the Bank of England, recently indicated in a letter to the Environmental Audit Committee that the Bank was “deepening and widening” its enquiry into financial stability risks from carbon assets becoming “stranded” in a low-carbon scenario²⁶ and the Prudential Regulation Authority (“PRA”) is preparing a Climate Change Adaptation Report with a target date for completion of July 2015 on (1) the impact of climate change on the PRA’s objectives (with a focus on insurance) and (2) the role of insurance regulation in supporting adaptation to climate change.²⁷ In addition, the G20 has asked the Financial Stability Board to conduct an inquiry into the financial risks flowing from efforts to reduce emissions.²⁸
42. With a view to ensuring that company reporting complies with the law and relevant reporting requirements, we urge the FRC to develop a strategy to ensure that reports from fossil fuel companies satisfy the level of disclosure required by law in relation to trends likely to affect a company’s business, and risks and uncertainties associated with climate change. CDSB’s newly launched “Framework for reporting environmental information and natural capital” sets out an approach for reporting financial information which may assist FRC consider how companies should respond to these reporting requirements.

ClientEarth, The Carbon Tracker Initiative, CDSB and CDP would welcome the opportunity to engage in additional dialogue with FRC in relation to the contents of this

²⁶ <http://www.ft.com/cms/s/0/189f21d8-7737-11e4-a082-00144feabdc0.html#axzz3asfUJkxS>

²⁷ <http://www.bankofengland.co.uk/pru/Documents/about/praletter020614.pdf>

²⁸ <http://www.telegraph.co.uk/finance/11563768/G20-to-probe-carbon-bubble-risk-to-global-financial-system.html>



letter and would like to offer assistance to the FRC in developing an appropriate strategy to ensure climate change considerations are effectively dealt with in reports from fossil fuel companies.

Yours faithfully,

Alice Garton

Company and Financial Project Leader
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