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Climate risk reporting: *bridging the compliance gap*

As demands grow for companies to incorporate environmental risk into their strategy, delegates at a recent conference heard that non-compliance is drawing unwelcome attention from regulators. *Christian Doherty* reports.

A recent event in London focused on the impact of climate change on the business world, from investing in renewables to the prospects for a true carbon market. Delegates attending the *Financial Times* Climate Finance Summit, part of Clean Energy Week, heard from regulators, investors, academics and corporate leaders about how they are addressing, leading and managing change.

One of the most powerful presentations at the event focused on how climate risks are affecting corporate reporting strategies. Alice Garton (pictured above) has been at the forefront of efforts in this area in her role as Company and Financial Project Lead at ClientEarth, a non-profit organization of environmental lawyers.

Headlining a session called "Climate Change Disclosure and Liability: Implications for Companies and Investors," Garton outlined how recent developments in climate litigation will affect companies that are in the process of adapting to the ongoing energy transition, away from fossil fuels and toward sustainable and renewable energy.

She explained: "The cases can be divided into three main categories: failure to mitigate risk, failure to manage risk, and failure to adequately disclose and report on risk."

The last category was the focus of Garton's talk and she broke the issue down further into four risks companies will need to focus on in the coming years.

1) INCONSISTENCY BETWEEN INTERNAL WORKINGS AND EXTERNAL STANDARDS

Garton cited a recent case in the US where a company's internal assessments of its climate risk varied significantly from what it was telling the markets and regulators. The New York Attorney General was able to prove this by subpoenaing evidence that demonstrated that the company's consultants had warned that increased climate regulation would have "severe impacts on the company – and, indeed, reduce its sales in the US by 30% or more."

2) MISREPRESENTATION OF FORWARD-LOOKING CONDITIONS

In 2016, an energy company continually insisted to its investors that none of its proven hydrocarbon reserves would become stranded. The resulting overstatement in the value of its reserves caused the company a major headache and resulted in a significant write-down. "The company now faces a class action shareholder lawsuit for making false statements on its climate risk over a six-month period," Garton reported. In another example, an energy company "cherry-picked" energy scenarios that were favorable to it, and this gave a misleading impression of the strength of the business.

3) MISREPRESENTATIONS ON COMPLIANCE WITH REGULATORY STANDARDS

There have been a number of high-profile corporate scandals in recent years that illustrated the need to comply with the highest regulatory standards. But Garton warned that greater awareness of the issue isn't enough without action.

"Anyone with experience at a senior level in large companies knows that the vast majority of the board's time is spent on core financial matters – not environmental compliance," she said. "As the energy transition bites and the materiality of environmental standards increases, regulators, investors and consumers expect companies to catch up. So expect to see these types of actions becoming more common."

> "Most companies accept that climate poses serious financial risk."
>
> **Alice Garton, ClientEarth**

4) MANDATORY FILINGS DIFFER FROM VOLUNTARY DISCLOSURES

The last 15 years have seen most environmental risk reporting done on a voluntary basis, through initiatives such as CDP (formerly known as the Carbon Disclosure Project). This reflected the fact that most environmental risks were only considered important

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to certain stakeholders and didn't meet the materiality standard for mainstream financial regulations.

"That has changed in the last few years now that most accept that climate poses serious financial risk," said Garton. "Companies and advisers need to look at where they currently disclose their risks and move them into mainstream filings, where appropriate."

She pointed to two recent examples in the UK where major corporates were reported to the Financial Reporting Council for failing to provide a fair review of the impact of climate change on their risks. "Notably, in one case, directors told CDP they considered a number of risks to be either highly likely or virtually certain – and the magnitude of the impact to be medium to high – but failed to disclose those risks in their annual report. They've now corrected that and improved the report, but the message is clear."

Garton concluded that a broader approach that incorporated not only better management of risks, but also of their reporting, was now the minimum expected of corporates across the world.

CARBON TRADING

Another session, "Emissions Impossible? Carbon Markets and other Regulatory Mechanisms," heard from EY's Mathew Nelson. As Global and Asia-Pacific Leader for Climate Change and Sustainability Services, he was ideally placed to look at the progress made on carbon trading – the process whereby countries can buy and sell permits and credits to emit carbon dioxide, which has been a central pillar of the European Union's efforts to slow climate change.

In his view, the central aspiration of the current wave of climate change regulation – to limit any global temperature increase to two degrees – was an ambitious target.

"What does a two-degree world look like?" Nelson pondered, explaining that just achieving that would require bridging an enormous gap in emission reductions. "The gap is huge – twice the size of current US greenhouse gas emissions – so we need something more to supercharge the effort," he said.

Should this involve the carrot or the stick? Nelson believed a middle ground offered the best scenario, despite the claims made for the effectiveness of emissions trading schemes. "There have been many challenges as schemes have matured," Nelson pointed out, with politics often to blame. "The complexities of making a global carbon market work are clear; national schemes all differ in their makeup and fitting them together with the complex policy incentives attached is no easy task."

There is, however, greater awareness of the potential benefits of trading schemes – they can be engines of growth and productivity, not just a business cost – and Nelson welcomed the increased momentum surrounding the issue. And there seems no doubt that, with more attention being paid to better management and reporting of climate risk, progress is more likely.

"We see more enthusiasm and effort going into developing these schemes, and that has to be a good thing," he concluded. ■

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