CLIMATE CHANGE

A financial turning point

What does climate change mean for oil and gas companies and what practical options do they need to respond to? *Tara Schmidt* and *Paul McConnell*, Principal Consultants at ERM, explain the ramifications of the Task Force on Climate-Related Financial Disclosures (TCFD).

Today, it is difficult to miss announcements from the world's largest oil and gas companies on their responses to climate change. Take, for instance, Shell's plans to become the world's largest power company in the next 15 years, or Eni's pledge to reach net-zero carbon emissions by 2030, among many others. Yet despite these ambitious targets, climate-related resolutions from activist shareholders doubled between 2014 and 2018. Indeed, BP's Annual General Meeting (AGM) in May was dominated by investors' questions on climate change.

What is happening and why?

Climate-related shareholder pressure is not new. Many oil and gas companies have responded with investments in renewables and carbon emissions reduction, starting in large part with BP's 'Beyond Petroleum' initiative 20 years ago. But, if we look a little deeper, the key question underlying these resolutions has fundamentally changed. Two decades ago, the key question from shareholders was: 'How are companies managing their impact on the environment'. Today, it is: 'How is the environmental and climate change agenda going to impact companies' financial performance, and are they resilient?'

Investors are pushing for greater transparency from the oil and gas majors, demanding to know how climate-related issues could ultimately impact revenues and costs. Advancing low-carbon technologies like electric vehicles could hit oil demand; policy risk is growing with intensifying, yet diverging, climate legislation and regulation around the world; and physical changes in climate threaten assets, operations and staff. It's clear we have hit a turning point – climate change is now a financial stability issue.

Managing risk

In 2015, Mark Carney, Chairman of the G20 Financial Stability Board (FSB), flagged climate change as the next potential major systemic risk to global economic stability. He declared that the risks driven by a more rapid low carbon transition mean the financial sector 'has a clear interest in ensuring the financial system is resilient to any transition hastened by those decisions'.

Consequently, pressure is mounting on investors, lenders and insurers to ensure they can effectively manage their climate-related financial exposure. In 2017, the FSB launched the Task Force on Climate-related Financial Disclosures (TCFD) – with a core focus on ensuring companies (both financials and corporates) have a robust strategy in place to mitigate climate-related financial risks and capture opportunities through the transition to a low carbon global economy.

The TCFD has set high-level recommendations for how companies should assess and respond to climate-related financial exposure (see **Figure 1**). The first step is to ensure appropriate governance over the issue in the organisation, eg at board or C-suite level.

Next, an assessment of the materiality of the risks should be undertaken, covering the four 'quadrants' of climate risk – markets and technology shifting; the company's reputation being harmed; physical risks such as increased flooding; and legal and policy challenges to the company's operation.

Third, the TCFD recommends assessing climate risk against a range of possible futures, or scenarios. Supported by this analysis, the company should evaluate the impacts on its business, and identify responses to mitigate risk or capture opportunity. Disclosure of this climate-related financial information is the final step in the process.

Since the TCFD's launch, a growing number of the world's largest pension funds, multinational banks, insurance companies and infrastructure investors are increasingly asking energy companies how resilient their financial performance would be in a low carbon world. In June 2019, the TCFD reported that 340 investors representing nearly

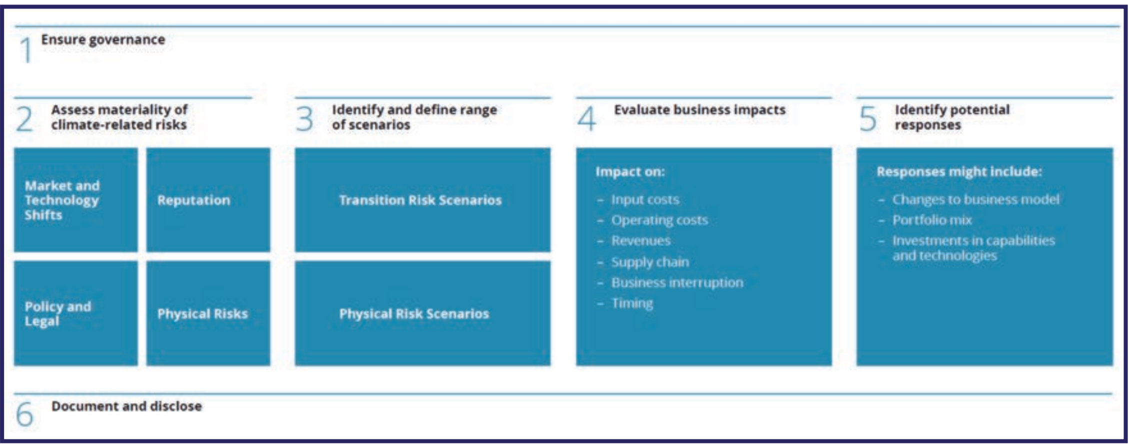

Figure 1: TCFD/ERM strategic approach, leveraging scenario analysis, to assess climate financial risks and opportunities

Source: G20 Financial Stability Board, Task Force on Climate-related Financial Disclosures (TCFD)

$34tn in assets under management were asking these questions to their investee companies, with this number expected to grow significantly over the next few years.

In addition, the UN Principles on Responsible Investment (PRI) will make it mandatory in 2020 for their 2,300 signatories, representing more than $83tn in assets, to report on stress-testing of their investment portfolios against a low carbon or 2°C scenario.

Implications

As the world's most powerful investors increase their climate scrutiny, the questions faced by oil and gas companies will change. Reporting on carbon foot-printing and environmental impact, long demanded by socially responsible investors, will no longer suffice. Mainstream institutional investors are not interested in climate-related disclosure in and of itself. Rather, their key concern is in ensuring oil and gas companies are financially resilient to the multitude of risks they face – not just carbon costs, but technological advances, policy changes, reputational risks and physical climate change impacts, which will vary greatly across a number of markets, geographies, timeframes and oil and gas asset life cycles.

To add to the challenge, investors want to maximise their financial returns while minimising these risks, requiring oil and gas companies to walk a fine line between their business growth strategies and climate-related strategic responses. Fortunately, the TCFD approach can offer a robust financially-focused framework for oil and gas companies to demonstrate both their climate resilience and growth options to investors.

Practical response options

The key measure of success to this financial challenge is integration – investors want to be assured climate risk has been integrated into the company's own financial decision-making and strategic planning processes. This requires defining the best fit-for-purpose framework for a company, leveraging their own in-house resources, capabilities and processes. While the TCFD has set high-level recommendations for how companies should assess and respond to climate-related financial exposure (as per **Figure 1**), the actual approach is adaptable to an oil and gas company's own specific needs.

Depending on where companies are on their own journey, they can undertake a number of practical options in beginning to integrate climate-related financial decision-making into their own framework.

Portfolio screening – For oil and gas companies early in the journey, screening across their corporate portfolios for climate-related financial exposures is a practical start to demonstrate the robustness of growth strategies to investors, lenders and insurers. Some of the world's largest financial institutions (eg pension funds, multinational banks, insurance companies) are just at the start of this journey themselves – with thousands to hundreds of thousands of investment assets to screen for climate risk. Oil and gas companies will be at an advantage in preparing a solid response to these investors' impending questions:

- Identifying how the company could be financially exposed to climate-related issues.
- Leveraging, in investors' views, a breadth of plausible scenario outlooks.
- Engaging across the business to integrate climate into the company's strategic planning processes.

Portfolio screening avoids the trap of only considering financial exposure to carbon and commodity prices, and allows companies to demonstrate to their investors a more holistic risk assessment to ensure climate resilience.

Asset analysis – For oil and gas companies who have already screened their asset portfolios for climate-related financial exposure, another challenge from investors typically follows – how to better demonstrate the resilience of these assets? Where investors, lenders and insurers are focused on real assets (eg infrastructure investors, commercial banks), this question is of particular interest. Answering it begins to define what the strategic response options are to maximise financial returns (and limit risk of debt default). And, assessing potential climate-related financial impacts down to an asset-specific level can provide even stronger evidence of resilience to climate risk.

Strategic response – Last, but not least, the key question from investors is how the oil and gas company will be able to ensure its strategy remains robust in responding to changing climate change risks and opportunities. A number of practical tactics may be undertaken:

- Monitoring the market for market-leading indicators and signposts (eg battery cost breakthroughs for electric vehicles) and how the company will respond (eg further investment into the power sector, and slowing investment in key oil markets that could be impacted).
- Integrating climate risks and opportunities into financial models at an asset, at business unit (BU) or even corporate level; and creating investment cases for asset and corporate resilience.
- Leveraging insights from climate financial risk integration into financial models, into financial decision-making and strategic planning.

Some banks are already moving into this phase of work, integrating climate financial risk into their financial models and updating pricing of loans/cost of debt to account for future potential climate financial impacts on oil and gas developments.

Looking ahead

Since its launch in June 2017, nearly 300 corporates have already endorsed the TCFD recommendations. Over the next five years, the TCFD expects climate-related financial disclosures to continue to grow substantially, with oil and gas companies at the heart of this trend. Moving forward, a number of sustainability reporting mechanisms are incorporating climate-related financial assessments into their reporting frameworks – including the CDP, whose coverage includes the world's top 25 largest publicly-listed oil and gas companies.

As the number of disclosures grow, the TCFD expects investor consensus to converge on how to best assess and address climate-related financial risks and opportunities. Consequently, oil and gas companies who take the practical steps to engage on this today, are likely to better prepare for their investors' expectations tomorrow. Furthermore, early engagement means turning an existential threat for oil and gas companies into a business opportunity for those willing and able to respond comprehensively to climate-related financial risk. ●