

PITFALLS OF CLIMATE-RELATED DISCLOSURES

A paper by CDP for the SEIm project

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This project has received funding from the European Union's Horizon2020 research and innovation programme under grant agreement No 649982

We are grateful to Chris Weber and Jakob Thoma from Zdii for their comments which considerably helped in shaping and improving this paper.

ABOUT SEI METRICS PROJECT

This report was published in the context of the H2020 “Sustainable Energy investment Metrics” project. This project has received funding from the European Union’s Horizon 2020 research and innovation programme under grant agreement No 649982. The project aims to develop a climate performance framework and associated investment products that measure the exposure of financial portfolios to the 2°C economy. The metrics, benchmarks, and tools will enable investors to align their portfolio with decarbonization roadmaps. The project runs from March 2015 to March 2018 and mobilizes over €2.5m in funding. Consortium members in the project include the 2° Investing Initiative, CIRED, WWF Germany, Kepler-Cheuvreux, Climate Bonds Initiative, Frankfurt School of Finance & Management, CDP, WWF European Policy Office and the University of Zurich.

INTRODUCTION

With over 13 years of experience in collecting corporate climate disclosures, CDP has been at the forefront of the climate-related reporting landscape and its evolution into common practice. We now facilitate disclosure from over 5500 companies spanning 91 countries and covering over half of the world’s market capitalization, doing so on behalf of 827 institutional investors representing in excess of US\$100 trillion in assets.

The Financial Stability Board (FSB) has set up the Task Force on Climate-related Financial Disclosure (TCFD) to “develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders”, i.e. ‘users’ of climate-related disclosure. High quality disclosure to users relies upon clear principles of best practice. In this paper we draw from CDP’s historical insight, examining three high-level challenges (illustrated in Figure 1) facing would-be users of climate-related disclosures, connected with the quality, the completeness and actionable data to mitigate emissions and climate risk. We then discuss solutions that can be further considered for adoption in order to strengthen TCFD’s disclosure recommendations. CDP has committed to adopt the future TCFD recommendations as part of its own Climate Disclosure programme.

Figure 1: Three key challenges posed to users of voluntary climate disclosures



CHALLENGES IN CLIMATE-RELATED DISCLOSURE

Challenge 1: disclosure quality

Voluntary disclosure, while supported by large audiences of stakeholders, as well as protocols, reporting structures and guidelines, can only go so far in securing quality disclosure, due to:

- A. Lack of enforcement against below standard responses (e.g. disclosures lacking relevance, clarity, and confidence on information provided). This leads to the commonplace usage of boilerplate disclosures, and feeds the discloser's desire to present the company in the best light possible, leading to irrelevant and/or non-material disclosures.
- B. A range of available reporting practices clouding comparability between companies as well as year-on-year comparisons (this is, lack of consistency in time undermining comparability). This includes reporting boundaries, consolidation approach variability, direct vs. indirect business activity, and temporal boundaries. For example, Shell, Total, and ConocoPhillips use an operational control boundary for their GHG emissions inventories; ExxonMobil and Chevron use an equity share boundary; BP uses a unique boundary encompassing all consolidated entities as well as their share of equity-accounted entities other than BP's share of Rosneft. This makes it challenging to compare emissions performance between these companies.
- C. Confidentiality concerns affecting company's ability in providing relevant, specific, comparable and timely information, as disclosures that are seen to compromise competitiveness, particularly for forward looking strategies and financial information, are given as a reason not to disclose.
- D. Complexities in combining contextual, financial and non-financial information – comparable data points may not actually give the inherent risk/opportunity profile of the investment as this will vary across markets, geographies, and regulatory environments - undermining relevancy, balance, comparability and reliability of information. Qualitative information (e.g. on strategies for transitioning) give context, meaning and balance to disclosed information. No one metric, though, can give a full climate profile of a company.
- E. Averages can lie and compromise relevancy, clarity, consistency, comparability and objectivity of information. Ranges can be as important as averages as many climate-relevant indicators can take a wide range at company level. For instance, an average oil production breakeven price of \$30/barrel can obscure the fact that 20% of assets lie above \$60/barrel. Data and information can be cherry-picked to 'prove' preconceptions and support self-fulfilling analyses (both by disclosers and by users). Therefore, in certain cases, it is critical to request primary and/or granular data that in turn can be analyzed and modified by users. Comparability and consistency is not helped by the wide-ranging approaches and methodologies for risk assessment and translation into financial figures and impacts.
- F. Segmentation – companies within the same sector aren't always directly comparable, because different companies have different business lines and may be involved in other sectors as well. For example, power utilities may consist of a selection of renewable generation, fossil fuel generation, transmission, distribution, engineering, consumer services, etc.

Challenge 2: completeness

More than 5,600 companies, representing close to 60% global market capitalization, disclosed environmental information through CDP in 2015. This covers almost a fifth (17%) of global greenhouse gas emissions, as well as a broad range of both qualitative and quantitative climate-related disclosures. Nevertheless, there are numerous companies failing to disclose climate-related information, for two key reasons:

- G. Lack of clear business case for disclosure – Companies are not always clear on the business case for disclosing climate-related information. Benefits of public disclosure broadly include risk mitigation, the identification of business opportunities, including efficiencies in the use of energy and natural resources and brand and reputational benefits from being environmentally responsible. Public disclosure, namely through specific programmes such as CDP, can also provide a platform to demonstrate companies' current actions, achievements and future plans to a wide range of relevant stakeholders: shareholders, future investors, consumers or policy makers. Whilst a company may not start off with all the information requested in hand, working through each disclosure can help a company create their own internal systems and strategies, providing a framework for their climate change policies and actions. Despite the benefits, companies can currently avoid public disclosure in many countries because it is not mandated.
- H. Lack of capacity to disclose - Disclosure is a journey and companies considering it for the first time will likely not be starting off with all the necessary staff, processes, systems and information in place. But the very act of getting started will initiate a change process internally that leads to the measurement, reporting, management and ultimately action to improve year on year. Companies' staff and systems for non-financial data collection and reporting are usually much smaller than for financial reporting and have to deal with competing disclosure requests on a multitude of topics (e.g. environmental, social, and governance issues). As long as these requests are voluntary, this is likely to be considered a non-priority and under-resourced area of corporate management.

Challenge 3: Using disclosure to act on emissions and mitigate climate risk

The act of disclosure has helped preparers of data to measure, understand, and manage their performance on climate-related issues¹. Disclosure is more than the data provision to specific users of information. It triggers a change process within companies². For example, 89% of companies disclosing to CDP report emissions reduction activities and \$54 billion in identified cost savings in the process. However, disclosure may not demonstrate full climate risk mitigation by failing to show:

- I. Alignment with the low-carbon transition – emission reduction activities and investments can be used to show a positive trajectory while not necessarily aligning with the transition to a better than 2-degree world as agreed in the 2015 Paris agreement. In transitioning to a low-carbon economy, there will be risk exposure from transitioning as well as from not transitioning. Companies particularly exposed to the transition often prefer to be up-beat about their actions,

¹ For reference please see some of the CDP case studies at <https://www.cdp.net/en-US/Results/Pages/case-studies.aspx>.

² Blanco et al. reported that “we find that firms often experience benefits from the measurement and disclosure process that are both different and greater than expected, and those benefits are both operational and strategic in nature. We conclude that such benefits, when they occur, are more diverse than often realized.” See Blanco, Christian; Caro, Filipe and Corbett, Charles J. (2016) “An inside perspective on Carbon Disclosure”, March 2016, available at <http://tinyurl.com/jlaxpq2>

failing to flag specific transition risks. Companies lagging behind are often dismissive about the significance of their climate risks, often by focusing on the very short-term impact of those risks in order to downplay them. In both cases they fail to disclose relevant information about their risk assessment, risk management practices and risk mitigation, which are fundamental components for an effective transition to a low-carbon economy.

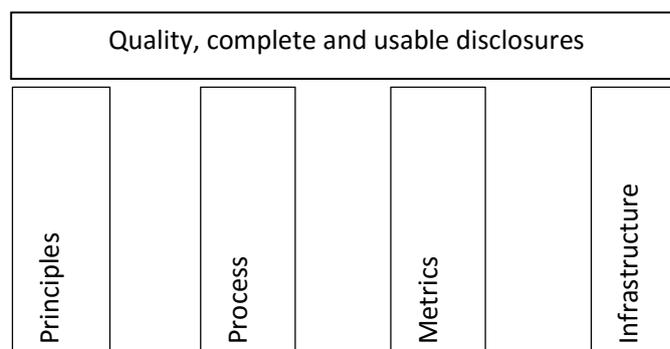
There is also considerable variability in climate risk disclosures which can undermine its usability and reflect:

- J. A lack of clearly defined use cases of disclosed information and volumes of use – preparers of information do not always get clear signals on how their information is used by providers of capital, policy makers and insurers. This can weaken the business case for disclosure and action (e.g. target setting).
- K. Differing horizons – investment and risk horizons vary depending on sectoral activities and geographical presence; investors come in many forms, some with short term horizons to whom longer term climate risk may seem unlikely or irrelevant. This leads to differing and contradicting requirements: short-term investors might reinforce corporate perspectives that up to 5 year horizons are sufficient to meet their requirements, whereas pension funds and long-term investors, may consider the typically short corporate time horizons insufficient to address climate change challenges.

DISCLOSURE RECOMMENDATIONS

We list here recommendations that we believe would directly respond to the challenges listed above, delivering improvements in disclosure quality, volumes (completeness), and actionability. These recommendations cover disclosure principles, implementation, the specifics of what to report (indicators & metrics) and the infrastructure to facilitate reporting and data use (see Figure 2).

Figure 2: Pillars for good quality disclosure - key recommendation areas to address key disclosure challenges



Principles

Recommendation 1: discuss and adopt a set of fundamental principles and use them to define the rest of the standard setting process.

The principles of quality disclosure that the TCFD outlined in its Phase 1 report³ largely mirror CDP and CDSB⁴ principles and learnings for high quality transparent disclosure and which we recommend are adopted. This includes:

1. Present relevant information. For example, a utility company presenting its car fleet emissions reduction target, representing less than 1% of its total GHG emissions, is totally irrelevant. However, the presentation of its emission targets for electricity generation emissions, coupled with CAPEX implications of their achievement, could be relevant information for investors.
2. Be specific and complete. For example, companies often report their targets without specifying a base year, base year emissions, operational boundary⁵, or target years, for example “we commit to a 50% reduction of our GHG emissions”. This lack of specificity and completeness of target related information does not allow users to understand their future mitigation objectives.
3. Be clear, balanced, and understandable. For example, some companies may choose to report their corporate GHG emissions based on equity share, operational control, financial control, or on

³ [TCFD Phase 1 report](#), April 2016

⁴ [Climate Disclosure Standards Board](#) (CDSB) is an international consortium of business and environmental NGOs, offering companies a [framework for reporting environmental information in mainstream reports](#) with the same rigor as financial information.

⁵ Operational boundaries as per GHG Protocol, this is, Scope 1, 2 and 3.

multiple bases. Companies should clearly state in their reporting what is their boundary and consolidation approach, as users may wish to compare their emissions to competitors with a different boundary and consolidation approach. Whatever boundary is selected, the reasons for that decision should be thoroughly explained, in order to present a balanced and understandable picture of GHG emissions data.

4. Be consistent over time. For example, understanding companies' GHG performance over time requires consistent reporting practices.
5. Be comparable among companies within a sector, industry, or portfolio, for example, the majority of electric utilities reporting to CDP report emissions intensity normalized by megawatt hour (MWh), yet a few chose instead to use other less common or appropriate metric denominators like 'Gcal' or 'hours worked'.
6. Be reliable, verifiable, and objective. For example, GHG emissions should be provided based on reliable information and data collection systems, which can be subject to external, third party verification and should be disclosed in an objective and factual way (e.g. stating the actual figure up to its significant figures instead of reporting the amount of cars in the street it represents).
7. Be provided on a timely basis. For example, companies frequently disclose on climate-related matters on an annual basis, a frequency that is considered adequate by most for provision or update of data to the market. In order to enhance comparability, climate information is ideally published for the same period and at the same time as financial information.

Implementation Process

Recommendation 2: Focus on disclosure recommendations that are essential for, as well as ready for, mandatory disclosure.

Mandatory climate reporting requirements are necessary to level the playing field and bring the laggards up to the desired standard of measurement, management and reporting. Disclosure recommendations must lend themselves to be mandated and adopted under different national financial reporting regimes. As a pre-requisite, the TCFD must confirm the objective of the disclosure recommendations. Then, to ease adoption, start with a principle-based reporting framework under which standards, protocols, structure, frameworks, guidance, taxonomies and metrics of disclosure can be adopted and varied yearly without changing the regulatory landscape. Examples of this include IFRS 7 and IFRS 9.

Recommendation 3: Use clear standards, protocols, structure and frameworks that embody these accounting and reporting principles.

This will support consistency and comparability across markets. It also brings climate-related disclosure in line with financial disclosure, for streamlining of preparation of data and to allow easier collection and comparison by users of disclosure information. Having a clear protocol and timeline for when companies can amend their submitted responses, and a deadline after which they would have to re-report updated information (in light of changing boundaries for example) for previous years in the next year's submission (restatements), has been important to ensure the consistency and reliability of historical data. It is also necessary that some of these standards, protocols, structure and frameworks might address sector or industry-specific issues that are particularly material and relevant for those sectors and industries.

Indicators and metrics

Recommendation 4: Use a suite of indicators

There is no single, silver bullet indicator for a single user, let alone different user types. A systemic view is necessary as no one indicator measures climate performance or climate risk adequately. Thus, there is a need for a suite of metrics capturing current performance, future plans (e.g. capex), business strategy, exposure to physical climate risks and low carbon transition risks, etc. Some of these indicators might have sector, industry or activity specificity. Likewise, the indicators should encompass a mix of narrative, asset and performance indicators. Narratives should support and explain to the users the evidence substantiated in the numbers and clearly articulate the links between different areas of reporting.

Recommendation 5: Encourage development of meaningful, comparable scenario analysis for climate risks

Given the long term nature of climate-related risk, scenario analysis is a natural tool for both assessing risk and disclosing on it. By disclosing on their performance and resilience under a 2°C compliant scenario, companies can demonstrate their preparedness for the energy transition and associated risks to their business model. Current examples include Carbon Tracker's Carbon Sensitivity Analysis for fossil fuels⁶, and how carbon prices, commodity prices, technology prices, and product demand drivers will affect their business model viability under a 1.5, 2 and 2.7-degree scenario, in keeping with COP21 aims and the best case under the current INDCs.

Disclosures on scenario analysis for climate risks should include quantification of risk in monetary terms, such as revenue at risk. The development, adoption and evolution of acceptable climate risk evaluating methodologies should be taken as a priority.

Recommendation 6: Design disclosures to be relevant, scalable and cost effective for company size, segment and geography

Adapting to new or evolving reporting requirements can be costly and time-consuming, both for large organizations where data gathering and sign-off can be a multi-year process, and in smaller organizations with limited budgets and potentially less experience in reporting non-financial information. While reporting requirements will need to change over time, stability is key to reducing burden and has the added benefit of maintaining historical comparability of data.

Infrastructure supporting disclosure

Recommendation 7: Require a common reporting standard (e.g. XBRL taxonomy) for disclosure

Collecting and collating data in a common format maximizes usefulness to users. Having all disclosure via a consistent and generally accepted standard, or meta-standard that can be used as reference rather than one-off industry creations or requirements designed for specific jurisdictions is advisable. In this way, specific industries can not decamp into their own space and provide only the data they want to, so as to avoid material disclosures, e.g. on stranded assets, capital expenditure etc. If not, divergence would pose issues for investors, for transparency, and for standardization. A proper taxonomy defines both a reporting structure and layout. A separate paper focuses on and provides further details about the benefits of digital corporate reporting using XBRL.

⁶ See <http://www.carbontracker.org/report/fossil-fuels-stress-test-paris-agreement-managed-decline/>

Recommendation 8: Use a repository and evaluating body to ensure compliance and quality of disclosure

As climate and financial data begin to be reported in mainstream filings, accessibility to the data will become critical for a wider awareness of climate-related financial exposure of companies. A data repository, ideally based on open data principles, can potentially benefit the accessibility and diffusion of the data collected, as well as the public scrutiny of its quality⁷.

An evaluating body, making use of this repository, should define clear methods of ensuring that disclosures are done to a high standard, meeting the principles of quality disclosure. Disclosures should be subject to a yearly analysis process, based on the data in the central repository, in order to determine if: the data structures within which they are provided are appropriate; if further narratives or structured data should be provided in face of users needs; if new areas of disclosures are needed; etc. This necessary evolution of the disclosures format or structures should attend and balance the needs of the companies, as highlighted in Recommendation 6, above.

Recommendation 9: Provide guidance on disclosure and articulate business benefits of disclosing

Independent of company size, companies need guidance and interpretation notes on disclosure requirements. Providing these to the market is fundamental for an appropriate and correct uptake, independently of whether disclosure is voluntary or mandated. The guidance can and should include an overview of the company roadmap to disclosure, giving useful insight to reporting entities on the typical journey through data collection, reporting and managing climate risk. This is especially important for new entrants who might otherwise be overwhelmed – and will be particularly important in certain geographies less used to climate disclosure. Examples of materials provided to reporters and users of information include:

- a) CDP's [climate change reporting roadmap](#), which takes new responders through the CDP questionnaire to move from a basic response towards complete disclosure;
- b) articulating why companies should disclose and the benefits of doing so;
- c) [examples](#) CDP has gathered of different use cases by buy-side, sell-side, index providers and other investors on how they use the disclosure by companies.

⁷ An example of such a repository is EDGAR the Electronic Data Gathering, Analysis, and Retrieval system of the U.S. Securities and Exchange Commission (SEC). EDGAR also performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law (see <https://www.sec.gov/edgar/aboutedgar.htm>). EDGAR is the central data source of then many other applications build on the data it makes publicly available.