

Institutional investors' expectations of corporate climate risk management



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As institutional investors, we are major shareowners and bondholders in many of the world's companies and significant investors in other assets such as infrastructure, real estate and private equity. We are concerned about the short and long-term impacts of climate change on our investments. We also recognize the parallel economic and energy security benefits of improved energy efficiency and diversification away from high carbon fuels. We believe that a rapid transition to a low-carbon economy is the best way to create jobs and foster economic growth over the long-term.

We acknowledge the scientific evidence that identifies greenhouse gas emissions as a contributor to changes in the world's climate, and recognise that climate change could result in profound negative consequences for human society, the global economy, and the world's natural systems. Climate change presents material risks and opportunities for investors and companies, both from physical changes to the climate and from efforts by governments and others to encourage the transition to a low-carbon economy.

In order to fulfil our fiduciary duty to safeguard the long-term interests of our clients and beneficiaries we believe that it is essential to take action now that will result in substantial reductions in global greenhouse gas emissions within a timeframe that minimises the risk of serious impact. So we support and encourage companies' efforts to participate in the transition to a more efficient, less carbon intensive economy; and to increase its resilience in the face of physical changes in the global climate.

We will engage with the companies in which we invest to encourage them to minimise the risks and maximise the opportunities presented by climate change and climate policy. We will also encourage companies to improve their governance and disclosure of climate risks and opportunities.

The following indicates the key climate change-related practices that investors expect companies to undertake based on our understanding of best practice management of climate change risks and opportunities. It also outlines the actions that investors are prepared to undertake on this topic.

We recognise that much action on climate change is not easily reduced to generic expectations, but depends on practices and technologies relevant to particular industries and business activities. We also recognise that not all companies conduct emissions intensive activities, or have highly emissions intensive supply chains. We will work to support and encourage companies that are most vulnerable to climate change and/or with the most carbon intensive activities and supply chains in their efforts to develop and implement these more specific best practices.

We acknowledge that there are different and evolving understandings of best practice. Thus, where companies have alternative views of best practice, we encourage them to communicate them to us.

We expect companies to take the following steps:

- **Governance.** Clearly define board and senior management responsibilities and accountability processes for managing climate change risks and opportunities;
- **Strategy.** Integrate the management of climate change risks and opportunities into the company's business strategy;
- **Goals.** Make commitments to mitigate climate change risks: define key performance metrics and set quantified and time-bound goals to improve energy efficiency and reduce greenhouse gas emissions in a cost-effective manner; and set goals to address vulnerabilities to climate change;
- **Implementation.** Make a systematic review of cost-effective opportunities to improve energy efficiency, reduce emissions, utilize renewable energy and adapt to climate change impacts. Where relevant, integrate climate change considerations into research and development, product design, procurement and supply chains;
- **Emissions inventories.** Prepare and report comprehensive inventories of greenhouse gas emissions; data should be presented to allow trends in performance to be assessed and it should include projections of likely changes in future emissions;
- **Disclosure.** Disclose and integrate into annual reports and financial filings, the company's view of and response to its material climate change risks and opportunities, including those arising from carbon regulations and physical climate change risks;
- **Public policy.** Engage with public policy makers and other stakeholders in support of effective policy measures to mitigate climate change risks. Ensure there is board oversight and transparency about the company's lobbying activity and political expenditures on this topic.

Investors will take the following steps:

- **Analysis.** Analyze material information on climate risk and opportunity and integrate this information into their investment decision-making, consistent with their fiduciary duty;
- **Inquiry.** Discuss material climate change risks and opportunities in their dialogue with companies in order to understand their impact on company value, and to support company efforts to develop responsive strategies;
- **Monitoring.** Support initiatives to monitor alignment with these expectations by companies, based on information published in company reports and other reporting channels, such as their responses to the Carbon Disclosure Project (CDP);
- **Engagement.** Recognise achievements when assessing companies' strategies. Where companies do not appear to be following good practice in management of climate change risks and opportunities, seek to understand the reasons why, and encourage appropriate responses;
- **Collaboration.** Support monitoring and company engagement activities by collaborative investor initiatives including those undertaken by relevant investor networks (including IIGCC, IGCC, INCR, AIGCC, CDP and the PRI) in order to minimise the burden on companies and investors. This will include the development of sector specific disclosure frameworks for the most materially affected sectors;
- **Public policy.** Support global climate change and clean energy policies that enable effective and economically efficient mitigation of climate change risks and adaptation to a changing climate.

Guidance for companies

The following summarizes investors' understanding of best practice in the management of climate change risk and opportunity. It draws on the experience of leading companies as well as various best practice frameworks (see appendix).

1. Governance. Clearly define board and senior management responsibilities for managing climate change risks and opportunities.

For many companies climate change is a strategic issue (see next). Boards should ensure that they have a clear view of the risks faced by the company, and embed them in their risk management process. Boards are also encouraged to actively explore opportunities to gain strategic advantage through improved efficiency and new markets for low carbon products and services. Many companies have designated a board member, or a board committee, with responsibility in this area. As with other strategic priorities, executive management should be accountable for executing strategy and rewarded for success.

Where climate change is not a top rank strategic issue, it often remains important for corporate responsibility and business efficiency reasons. Here the challenge is to ensure the managers give climate change and carbon management sufficient priority. There is evidence that many companies have profitable opportunities to improve energy efficiency but do not pursue them because of lack of management focus or other internal obstacles. In these cases, the role of the board is to ensure that the organisation has a governance structure that ensures action on climate change receives sufficient priority.

2. Strategy. Integrate the management of climate change risks and opportunities into business strategy.

In many business sectors climate change is a strategic issue. For example, in the oil and gas sector, carbon pricing, concerns about energy security, and discovery of new reserves are driving a strategic shift to natural gas. Elsewhere in the power sector, there are large opportunities for companies to build positions in markets for new technologies in energy efficiency, smart grids and renewable energy. In many sectors, changing weather patterns are creating new risks associated with extreme weather events – storms, floods, droughts. When coupled with increasing demand and resource scarcity, these factors can lead to high input prices and insecurity of supply.

These climate change-related risks are likely to create winners and losers both between business sectors and within them. Understanding climate change impacts and associated energy and resource cost and availability risks is important for sustainable long-term value creation. Where these issues are material, it is important that companies develop a robust strategic analysis of these risks and opportunities and communicate it to their investors.

3. Goals. Make commitments to mitigate climate change risks, define key performance metrics and quantified and time-bound goals to improve energy efficiency and reduce greenhouse gas emissions.

In order to reduce their carbon emissions, many companies with emissions intensive activities have made a public commitment to reduce their absolute carbon emissions or carbon emissions intensity over time. In many cases this is backed by published targets for energy efficiency and emissions reduction. Good targets are far enough into the future to allow the mobilisation of sustained investment in carbon reduction; but close enough to be within the time horizons of current managers. Very long-term targets (e.g. 30 years) or very short-term ones (1 year) have more limited value. Good targets have explicit baselines, timelines, and quantities and cover the majority of the company's activities. Most companies express targets in terms of carbon intensity or energy efficiency, but many have committed to absolute reductions. In order to achieve their targets, many companies create subsidiary goals which are allocated to individual business units. To be effective, targets should be integrated into the company's performance management system, and affect the performance pay of relevant staff.

4. Implementation. Make a systematic review of cost-effective opportunities to improve efficiency and reduce emissions. Where relevant, integrate climate change considerations into research and development, product development, and in the supply chains.

There are a variety of ways in which companies achieve their climate change goals. For operational energy efficiency, there is strong emphasis on ensuring that action is systematic and that progress is monitored. One approach is for companies to conduct a comprehensive review of energy efficiency investment opportunities; to prioritise identified opportunities based on return on investment (e.g. via a marginal abatement cost curve); and then to implement an annual plan of implementation. Another complementary approach is to include a shadow carbon price in the standard company investment appraisal process for new projects.

For many companies the biggest opportunities to reduce emissions are not in their own operations but in the use of their products; climate change is likely to shift demand in sectors such as autos, appliances and building products from low-efficiency to high-efficiency products, and companies should be alert to the risks and opportunities this will bring. In other sectors, particularly retail, emissions through the supply chain may be many times greater than the direct emissions of the business itself. To implement change in these areas, consideration of climate change should be integrated into research and development, product design, sourcing, and supply chain processes, with potential cost savings and brand enhancement opportunities.

5. Emissions inventories. Prepare and report comprehensive inventories of greenhouse gas emissions; data should be presented to allow trends in performance to be assessed and it should include projections of likely changes in future emissions.

In order to manage carbon emissions effectively it is important to have an inventory of their sources within the business. There are established standards for constructing such inventories (GHG Protocol Corporate Standard and ISO 14064). It is important that companies construct accurate inventories of their direct (Scope 1) and indirect energy (Scope 2) emissions. Many companies also construct estimates of indirect emissions (Scope 3) arising from products, supply chains and other activities related to the business.

Leading companies segment their carbon inventories by business unit, region and business activity. This enables more targeted action plans and risk assessments.

In order to plan ahead and anticipate future risks, leading companies forecast their expected future emissions trends.

6. Disclosure. Disclose in annual reports and financial filings, the company’s view of and response to its material climate change risks and opportunities, including those arising from carbon regulations, and physical climate change risks.

A large number of companies now report their carbon emissions and assessment of climate change risks and opportunities in their public reports, regulatory filings, and to the Carbon Disclosure Project – including the sector-specific disclosure modules developed for the Electricity utilities, Oil and Gas, and Automobiles sectors. They also report on related topics via other investor-led disclosure projects relating to water and forests impacts, and make use of reporting standards such as the Global Reporting Initiative to prepare comprehensive sustainability reports. Some companies are integrating such sustainability (ESG) data into their annual financial reports, and there appears to be a trend towards integrated reporting.

Such reporting enables investors to identify any material financial implications associated with climate change and to include this information in their investment decisions. Many investors also use this information as the basis for discussion with company managers and boards. It is important that the data reported to investors is reliable, whether via external assurance or internal processes. It is also very useful for data reported on an equity basis to be segmented by region, business activity or unit. This allows for a more precise assessment of risk. Finally, it is helpful to investors for companies to quantify where feasible the costs and returns on their investments in energy efficiency, GHG emission reductions and climate-related business opportunities.

7. Public policy. Engage with public policy makers and other stakeholders in support of cost-effective policy measures to mitigate climate change risks and support low carbon investments. Ensure there is board oversight and transparency about the company’s lobbying activity and political spending on this topic and related energy and regulatory issues.

Many companies participate in the policymaking process. When carried out in a constructive way, such involvement can be extremely useful in order to help governments understand what policies and regulations will work best from a business point of view. It is important, however, that political activities are governed appropriately, are consistent with companies’ public positions in this area, and that they are transparent – preferably through the publication of policy positions on companies’ websites and disclosure of political activities and spending.

We also encourage companies to work collaboratively with other stakeholders, through means such as supporting research, joining sectoral groups, and endorsing key business statements on climate action.

Appendix

Further information on climate change management best practice

- Ceres (2006) Global Framework for Climate Risk Disclosure
- Ceres (2010) Business for Innovative Climate and Energy Policy (BICEP) Principles
- Ceres (2011) 21st Century Corporation: A Roadmap for Sustainability
- Ceres (2011) Disclosing Climate Risks: A Guide for Corporate Executives, Attorneys and Directors
- GHG Protocol (2007) Corporate Standard
- IGCC and AIST (2009) A climate for change II – A trustee’s guide to addressing climate risk
- IIGCC (2008) Global Climate Disclosure Framework for Electric Utility Companies
- IIGCC (2009) Global Climate Disclosure Framework for Oil & Gas Companies
- IIGCC (2010) Global Climate Disclosure Framework for Automotive Companies
- ISO (2009) ISO 14064 Greenhouse gases – Specification with guidance at the organization level for quantification and reporting of greenhouse gas emissions and removals
- World Resources Institute (2011) Adapting for a Green Economy: Companies, Communities and Climate Change

Organizations involved in investor action on climate change

- Carbon Disclosure Project
- Ceres
- Institutional Investors Group on Climate Change (Europe)
- Investor Group on Climate Change (Aus and NZ)
- Investor Network on Climate Risk (North America)
- Principles for Responsible Investment
- UNEP Finance Initiative
- World Business Council for Sustainable Development
- World Resources Institute

About



About IGCC

The IGCC represents institutional investors, with total funds under management of approximately \$700 billion, and others in the investment community interested in the impact of climate change on investments. The IGCC aims to encourage government policies and investment practices that address the risks and opportunities of climate change, for the ultimate benefit of superannuants and unit holders.

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About IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration on climate change for investors. IIGCC brings together European investors to engage with policymakers, companies and investors on addressing long-term risks and opportunities associated with climate change. The group currently has over 70 members, including many of the largest pension funds and asset managers in Europe, representing assets of around \$10 trillion.

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About INCR

The Investor Network on Climate Risk (INCR) is a North American network of institutional investors focused on addressing the financial risks and investment opportunities posed by climate change. INCR currently has 100 members with more than \$10 trillion in assets. INCR is a project of Ceres, a coalition of investors and environmental groups working to integrate sustainability into the capital markets.

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