13 October 2015

The Extractive Industries Transparency Initiative
Members of the board
C / - EITI International Secretariat
Ruselokkveien 26
0251 Oslo
NORWAY

By email to: secretariat@eiti.org

To the EITI Board,

And to the EITI Secretariat,

RE: Climate Change and the Extractive Industries Transparency Initiative

We, the undersigned civil society organisations, write regarding specific inadequacies with the EITI's principles, standards and procedures in the context of their failure to take into account climate change impacts, and the consequences of necessary legal and policy reforms and associated risks to the fossil fuel industry.

The urgent need to address climate change is having a profound impact on national and international policy around the world. It will not be long before these international 'shifts' are translated into legal frameworks, which apply to the extractive industry. In recent times we have seen historic announcements made by major emitters such as the US and China[1] to reduce their emissions and in June 2015 the G7 announced its intention to end their dependence on fossil fuels and decarbonize their economies[2].

Major reforms will be required to ensure the world stays within a safe limit of 1.5 or 2°C of warming above pre industrial levels. In a 1.5 or 2°C constrained world, the significant reduction in the remaining global carbon budget means that many fossil-fuel extraction projects cannot proceed. It is thus of material interest to citizens, when holding their governments and extractive companies to account, whether or not extraction can proceed in this new environment. Thus, beyond the additional areas of concern outlined in this letter, we call on the EITI to modify its standard to ensure that fossil fuel companies disclose whether or not projects can proceed in a 1.5 or 2°C world.

For the purpose of this letter, we define 'climate risk' as including the following:

1. *The Carbon Bubble Risk*[3]: risk of decline in demand for, and price of fossil fuel commodities, impacts on cash flows, margins and returns on investment arising from

[1] http://www.theguardian.com/environment/2014/nov/12/china-and-us-make-carbon-pledge;
[2] http://www.project-syndicate.org/commentary/g7-summit-germany-zero-emissions-by-jeffrey-d-sachs-2015-06;
[3] http://www.telegraph.co.uk/finance/economics/11563768/G20-to-probe-carbon-bubble-risk-to-global-financial-system.html;

a limitation on burning one fifth to one third of existing fossil fuel reserves[4] and resources as required in order to remain within a safe warming limit;

2. *The law and policy risk*: risk associated with increasing implementation of laws and policies around the world associated with ensuring global emissions reductions necessary to remain within a safe warming limit, including removal of subsidies[5], renewable energy[6] and energy efficiency and phasing out high carbon investments by countries and de-carbonization and laws and policies to subsidize and support the implementation of renewable energy and energy efficiency around the world.

3. *The litigation risk*: risk associated with increasing likelihood of litigation against fossil fuel companies[7] and countries[8] related to compensation, loss and damage, breaches of international human rights obligations[9], corporate responsibility, misleading and deceptive conduct, breaches of fiduciary obligations[10], fraud and corruption.

4. *The solutions risk*: risk associated with emerging increased competition of the renewable energy markets including decreasing costs of solar PV[11] and battery storage[12], electric vehicles and government laws and policies to subsidize and support the implementation of renewable energy around the world.

5. *The financial risk*: the risk associated with the carbon bubble risk and impacts on pricing as evidenced by the recent drop in oil prices[13] causing decreased investments and knock on impacts associated with commodity prices.

The Extractive Industries Transparency Initiative (EITI) seeks to be a global Standard intended to promote open and accountable management of natural resources and seeks to strengthen government and company systems, inform public debate, and enhance trust. We consider that the current framework contains a number of shortcomings and that improvements should be made to ensure the initiative reflects the legal and economic realities of climate change in order to remain relevant in a rapidly changing geopolitical environment.

We appreciate that extraction of resources may in some circumstances lead to economic growth and social development. However, because of the increasing consequences of climate change, the sound management of a country's fossil fuel resources is becoming more and more important and under scrutiny. There is thus an urgent need for a substantial increase in the levels of transparency of the sector, including a focus on subsidies, in order to assist with policy development to ensure the phasing out of coal, oil and gas at a rate commensurate with that suggested by the science. We consider that disclosure related to 'climate risk' should be included as a requirement, in addition to the current EITI disclosure of tax payments,

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[4] http://www.carbontracker.org/report/wasted-capital-and-stranded-assets/;
[5] The World Trade Organization defines a subsidy as *'any financial contribution by a government, or agent of a government, that is recipient-specific and confers a benefit on its recipients in comparison to other market participants'* (WTO, ASCM, 1994)
[6] http://unfccc.int/files/bodies/awg/application/pdf/technical_summary_on_tem_on_re_for_webposting.pdf;
[7] http://thinkprogress.org/climate/2015/06/10/3667580/south-pacific-climate-change-lawsuit/;
[8] http://www.theguardian.com/environment/2015/jun/24/hague-climate-change-judgement-could-inspire-a-global-civil-movement;
[9] http://www.theguardian.com/environment/2012/apr/24/climate-change-human-rights-issue;
[10] https://www.responsible-investor.com/home/article/pf_cc/;
[11] http://www.theecologist.org/blogs_and_comments/commentators/2967633/the_7_trillion_solar_tsunami_in_our_midst.html;
[12] http://www.energydigital.com/utilities/3900/Tesla-batteries:-the-beginning-of-how-technology-will-transform-the-electric-grid;
[13] http://www.reuters.com/article/2015/07/31/us-usa-oil-results-idUSKCN0Q51Y520150731

licences, contracts, production and other key elements around resource extraction. Not disclosing this type of critical information will increase the risk of distrust, weak governance, and potentially also conflict.

Against this background, as recently as 22 June 2015, a letter was sent to the UK Financial Reporting Council Conduct Committee[14] from London based Law firm, Client Earth, together with the Carbon Tracker Initiative, the Carbon Disclosure Project and the Climate Disclosure Standards Board, which complains that many companies in the oil, gas and coal sector are not currently satisfying mandatory reporting requirements by failing to report on 'climate risk' (**ANNEX 1**).

We acknowledge that the EITI appreciates the need to evolve to improve transparency in natural resource governance and we make these recommendations to assist with the evolution of this useful initiative.

As a final note before going to the substance of this Submission, we request for the purpose of transparency that this letter be circulated to all members of the Board and is posted on the web site of the EITI.

The EITI Principles

Having regard to the EITI Principles, in particular Principles 1, 3, 4 and 9, we consider the following:

On Principle 1: The prudent use of natural resource wealth as an engine for sustainable economic growth that contributes to sustainable development and poverty reduction will be significantly impacted by measures to address climate change. It is difficult to overstate the consequences for a resource-rich country's development when taking into account ability for a project to go ahead or not under the constrained economic consequences created by a 1.5, or 2°C policy-world. Such matters are profoundly material to the citizens of such countries. If enhanced transparency on these matters is not built into the EITI frameworks there is an increased risk that resources will not be managed properly, enhancing the risks of negative economic and social impacts.

On Principle 3: We agree that the benefits of resource extraction occur as revenue streams over many years and can be highly price dependent. However failure to take into consideration the impacts on potential projected resource extraction in the context of 'climate risk,' will give rise to serious price volatility in relation to fossil fuels, and substantial risk for extracting companies and their investors. This risk is further mapped over to society in consumer countries, who currently lack credible evidence of production risk associated with a 1.5-2°C policy world. For example, transparency of information that will inform knowledge as to whether a project can or cannot go ahead – because it would, or would not, be economically viable over its lifetime under these circumstances - is absolutely crucial to enable a genuine process of free, prior and informed consent.

On Principle 4: Public understanding of government revenues and expenditure over time, in particular in relation to the provision of subsidies to the fossil fuel industry will inform public debate and inform choice of appropriate and realistic options for sustainable development. In this context, it should be noted that the current international processes provide multiple fora for including provisions to phase out subsidies for fossil fuels. Transparency of subsidies provided on a project-level basis would be critical to inform all constituents as to the economic viability of projects in a carbon-constrained world.

[14] http://documents.clientearth.org/wp-content/uploads/library/2015-06-24-en-coll-dcooke-letter-with-carbon-tracker-to-financial-reporting-council.pdf;

On Principle 9: The commitment to encouraging high standards of transparency and accountability in public life, government operations and in business should lend support to the proposals made within this submission.

We note that the current Principles of the EITI are completely silent on the issue of climate change. Having regard to the special and unique position of fossil fuel extraction within the broader extractives sector, such that the fossil fuel industry is currently undertaking actions which are threatening the survival of humanity on earth, we would propose that a new principle be adopted by the EITI specifically applicable to the fossil fuel industry as follows:

> *We recognize the unique nature of climate change and its impacts on fossil fuel extraction and the urgent need to enhance transparency within this, the largest sector of the extractive industries. We acknowledge that significant law and policy reform related to removal of subsidies, carbon taxes and levies and impacts on revenues and expenditures arising from un-extractable resources and whether or not concessions will be allocated and exploited will emerge in coming years. Enhanced transparency related to these matters will be crucial to inform public debate and inform choice of appropriate and realistic options for sustainable development, including the decision-making process about whether or not to extract.*

<u>Candidate Countries</u>

As EITI Candidate Countries must meet requirement 1, we consider that several amendments should be made to the standard in relation to the way in which civil society groups are engaged, ensuring certain expertise is represented within the multi stakeholder group and to ensure important issues associated with 'climate risk' are considered prior to a country becoming a compliant country.

Requirement 1 – effective oversight by the multi stakeholder group

Paragraph 1.3 of the Standard states:

> *The government is required to commit to work with civil society and companies, and establish a multi-stakeholder group to oversee the implementation of the EITI.*

Sub paragraph (a) states:

> *The government, companies and civil society must be fully, actively and effectively engaged in the EITI process*

Sub paragraph (d) states:

> *The government must refrain from actions, which result in narrowing or restricting public debate in relation to implementation of the EITI.*

Sub Paragraph (f) states:

> *In establishing the multi-stakeholder group, the government must:*
>
> > *i. ensure that the invitation to participate in the group is open and transparent;*

Sub paragraph (g) states:

> *The multi-stakeholder group is required to agree clear public Terms of Reference (ToRs) for its work.*

In relation to paragraph 1.3 we submit as follows

1. There should be an enhancement and improvement of the Standards that ensure the inclusion of civil society groups with specialised expertise on relevant topics concerning climate change such as climate risk, climate law and climate science.

2. The multi-stakeholder group should enhance outreach activities with civil society groups[15] including civil society groups with expertise in climate risk, climate law and climate science; and with local communities and indigenous peoples living in close proximity to extractive industry sites including building capacity of such communities; and

3. The terms of reference for the work of the multi-stakeholder group should include consideration of matters related to climate risk, climate law and climate science.

Paragraph 1.4 of the Standard states:

> *The multi-stakeholder group is required to maintain a current workplan, fully costed and aligned with the reporting and Validation deadlines established by the EITI Board. The workplan must:*
>
> > *………encouraged to explore innovative approaches to extending EITI implementation to increase the comprehensiveness of EITI reporting and public understanding of revenues and encourage high standards of transparency and accountability in public life, government operations and in business;*

Sub paragraph (f) requires that the workplan must:

> *………..consider extending the detail and scope of EITI*

In relation to paragraph 1.4 we submit that, developing innovative approaches, extending the EITI to become more comprehensive and ensuring high standards of transparency and extending the detail and scope of the EITI supports our proposal that the EITI should build into its framework and standards, provisions to ensure that climate change considerations are taken into account, in particular related to climate risk, climate law and climate science.

Compliant Countries

In addition to the importance of building in climate change related considerations to the EITI framework related to Candidate Countries, we would propose that the EITI also review its Standards insofar as they relate to Compliant Countries.

Requirement 3 of the Standard sets out the contextual information about the extractive industries that EITI Reports should contain.

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[15] As per requirement 1.3(g)(ii)

Paragraph 3.2 of the Standard states:

> "*The EITI Report must describe the legal framework and fiscal regime governing the extractive industries.*
>
> *a) This information must include a summary description of the fiscal regime, including the level of fiscal devolution, an overview of the relevant laws and regulations, and information on the roles and responsibilities of the relevant government agencies.*
>
> *b) Where the government is undertaking reforms, the multi-stakeholder group is encouraged to ensure that these are documented in the EITI Report."*

Climate risk includes risk associated with increasing implementation of laws and policies around the world associated with ensuring global emissions reductions necessary to remain within a safe warming limit, including removal of subsidies and phasing out high carbon investments by countries and laws and policies to subsidize and support the implementation of renewable energy and energy efficiency around the world.

Much further development and law reform is expected following the UNFCCC COP 21 conference in Paris and a new climate agreement ("Paris Agreement") with legal force. Indications related to the 'direction of travel' have been provided throughout many country's Intended Nationally Determined Contributions (INDCs) and these contributions and submissions to the UNFCCC concerning Parties efforts to mitigate and adapt to climate change will be ongoing.

EITI reports should include laws related to climate risk, climate law and policy and reform related to climate mitigation and adaptation occurring at the relevant national, regional or international level insofar as it is of relevance.

Paragraph 3.6 states:

> *"Where state participation in the extractive industries gives rise to material revenue payments, the EITI Report must include:*
>
> *…………..*
>
> *b) Disclosures from SOE(s) on their quasi-fiscal expenditures such as payments for social services, public infrastructure, fuel subsidies and national debt servicing."*

It should be noted by the EITI Board that multiple international fora now endorse a call for removal of subsidies. Increased emphasis on the impact of removal of subsidies on the industry, investments and commodities will be an important item to ensure is included in Reporting and compliance.

On the issue of 'material payments', and the question as to 'what is material' the Oxford definition of materiality refers to the 'quality of relevance or significance' of the thing said to be material[16]. We submit that materiality should not only be considered in the context of value or an amount paid but also in relation to the activity for which payments are being made, and in particular whether or not that activity will in fact take place, both as highly relevant and significant considerations. For example, policies developed to ensure a 1.5-2°C world will generate circumstances of profound public-interest materiality, whereby there is a

[16] http://www.oxforddictionaries.com/definition/english/materiality

high likelihood that to be able to stay within a constrained carbon budget, most, if not all, new exploration for fossil fuels would have to be ruled out.

Paragraph 3.8 states:

> *"The multi-stakeholder group is encouraged to include further information on revenue management and expenditures in the EITI Report, including:*
>
> *…………..*
>
> *c) Timely information from the government that will further public understanding and debate around issues of revenue sustainability and resource dependence. This may include the assumptions underpinning forthcoming years in the budget cycle and relating to projected production, commodity prices and revenue forecasts arising from the extractive industries and the proportion of future fiscal revenues expected to come from the extractive sector."*

We would consider that this provision of the Standard clearly supports the proposals made that 'climate risk' is a relevant consideration for inclusion in the EITI Reporting process.

Paragraph 3.11 of the Standard relates to beneficial ownership and states:

> *a) "It is recommended that implementing countries maintain a publicly available register of the beneficial owners of the corporate entity(ies) that bid for, operate or invest in extractive assets, including the identity(ies) of their beneficial owner(s) and the level of ownership. Where this information is already publicly available, e.g. through filing to corporate regulators and stock exchanges, the EITI Report should include guidance on how to access this information."*

We would urge the board to take the issue of beneficial ownership forward from being a "recommendation" to be a "requirement" of the standard. Given the level of corruption found across the extractives sector in so many countries, it is self-evident that legitimate players should disclose who their owners are – further that legitimate companies should not have any problems with being required to do so.

Requirement 4 of the Standard provides for the production of comprehensive EITI Reports that include full government disclosure of extractive industry revenues, and disclosure of all material payments to government by oil, gas and mining companies.

Paragraph 4.1(b) provides for information related to revenue streams and we would submit that the following revenue streams should also be included in the Standard:

- Carbon taxes including taxes (or levies) on emissions or extraction, and bunker fuels; and
- Repayment of climate finance received, for example via the Green Climate Fund.

Conclusion / recommendations

Having regard to the above, we consider that the EITI provides an important potential global forum in which comprehensive information can be provided to ensure countries and their citizens are able to make informed choices about whether or not to go ahead with projects in an increasingly carbon-constrained world. These are matters of profound public interest materiality. Such matters also represent some of the most important risk factors requiring the immediate attention of the industry, and its investors. Such disclosure could also provide an invaluable back-up to consuming countries and their citizens with respect to risk of supply, which will be critical to the management of the necessarily rapid phase-out of fossils fuels.

In summary, we make the following recommendations:

1. Development of a new Principle of the EITI, focusing on the special and unique position of the fossil fuel sector within the broader extractive industries in the context of climate change;

2. Enhance the Standard in relation to the way in which civil society groups are engaged, ensuring certain expertise is represented within the multi stakeholder group and to ensure important issues associated with 'climate risk' are considered prior to a country becoming a compliant country;

3. Undertake reform to the contextual information that EITI Reports contain, in particular ensuring the disclosure of :

    a. Descriptions of the legal frameworks and fiscal regimes governing the extractive industries, including relevant laws and regulations and reforms associated with climate change; and

    b. Whether or not, each project is economically viable, over its expected lifespan, under global carbon budget constraints that would be imposed by policies coming into play that would hold the global mean temperature rise to 1.5°, or 2°C. Such disclosures should include a summary economic explanation of the basis for a project's viability, or not. This summary should include disclosure of subsidies and tax concessions;

4. Undertake amendments to the Standards concerning revenue streams to include carbon taxes including taxes (or levies) on emissions or extraction, bunker fuels; and repayment of climate finance received.

This letter is supported by the following organisations and networks:

350.org
Abibimman Foundation
Asia Indigenous Peoples Pact
Association Actions Vitales Pour Le Développement durable
Ateneo School of Government
Carbon Market Watch
Center for Indigenous Peoples Research and Development
Center for International Environmental Law
Centro Mexicano de Derecho Ambiental
Change Partnership
Climate Action Network (CAN) International
Climate Justice Programme
EcoEquity
EKOenergy
Federation of Community Forestry Users Nepal
Forests of the World
Friends of the Earth Europe
Greater Access Reconstruction and Justice Action Network Nepal
Germanwatch
Global Catholic Climate Movement
Global Citizens Initiative

Greenpeace International
Grupo de Financiamiento Climatico America Latina y el Caribe
Heinrich Boll Foundation
Leave it in the Ground Initiative
Market Forces
Nepal Federation of Indigenous Nationalities
NGO Coalition for Environment, Nigeria
Oil Change International
SONIA for a Just New World
Stop Mad Mining Network
SustainUS
Tebtebba (Indigenous Peoples' International Centre for Policy Research and Education)
Tree Adoption Uganda
WWF International

ANNEX 1

Letter dated 22 June 2015 from Client Earth, Carbon Tracker Initiative, Carbon Disclosure Project and the Climate Disclosure Standards Board to the UK Financial Reporting Council Conduct Committee[17]

[17] http://documents.clientearth.org/wp-content/uploads/library/2015-06-24-en-coll-dcooke-letter-with-carbon-tracker-to-financial-reporting-council.pdf;

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. ClientEarth[1], The Carbon Tracker Initiative[2], CDSB[3] and CDP[4] 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.

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[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 2ºC 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 2ºC 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 2ºC above pre-industrial levels. At the international level, this limit is encapsulated in the non-binding Cancun Agreement, agreed to by 193 countries[5]. 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 2ºC 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 2ºC.[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 1.5ºC 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 2ºC"[9].

11. The 2ºC 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 2ºC.[10]

12. Sub-national governments have also recognised the 2ºC 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 2ºC 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 2ºC.

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 2ºC.[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

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[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 2ºC 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 2ºC, 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 3ºC 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 2ºC 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 2ºC 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 2ºC scenario analysis and project stress testing and none, so far, have revealed the results of their 2ºC 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 3ºC 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 2ºC 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 Guidance[23] 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 Guidance[24] 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 Guidance[25] 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 scenario[26] 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/pra/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,

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