

Paris-aligned accounts to drive Paris-aligned behaviour

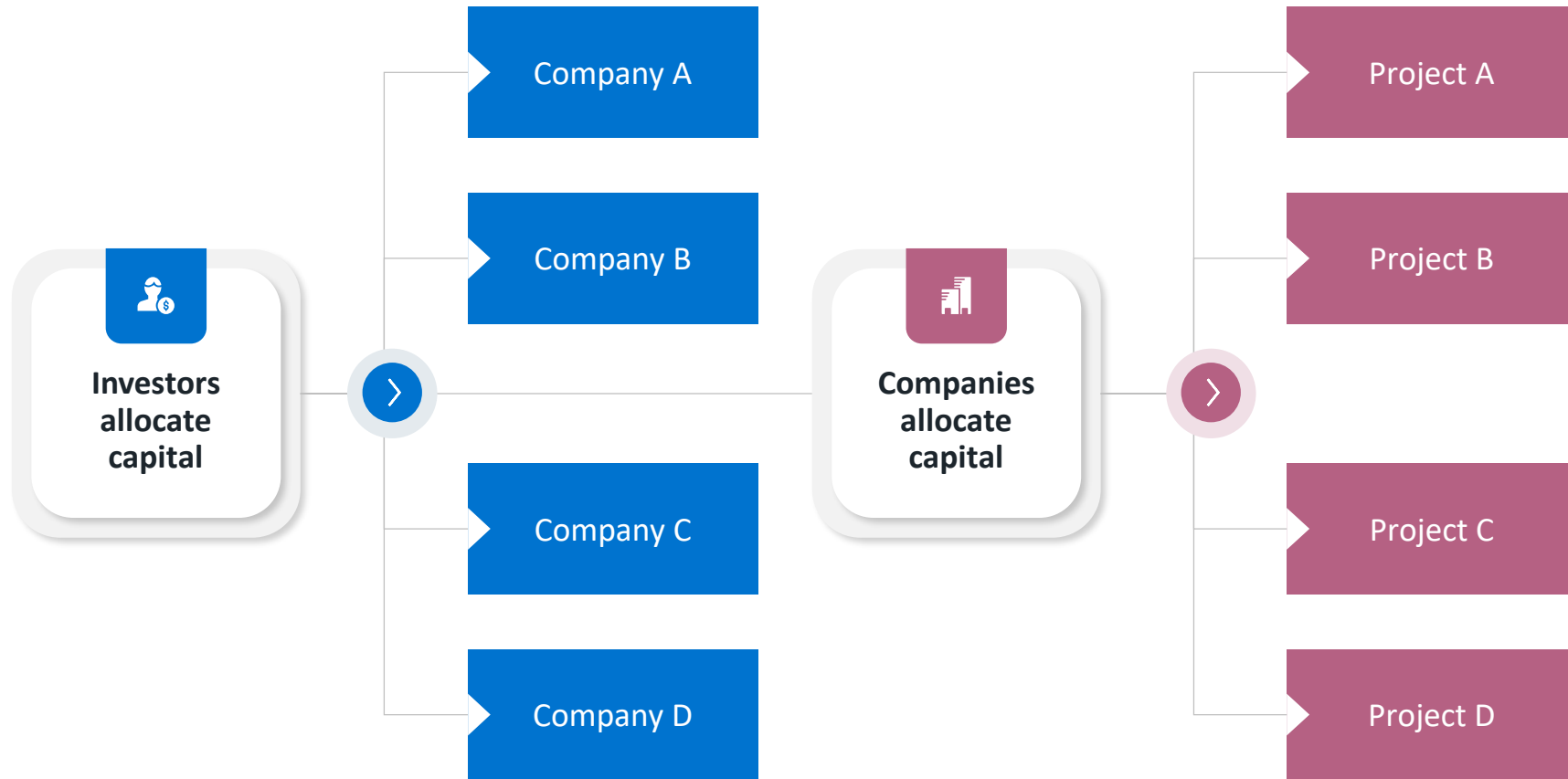
Sarasin & Partners, October 2020

Natasha Landell-Mills



Capital allocation is what matters

A framework for identifying leverage points

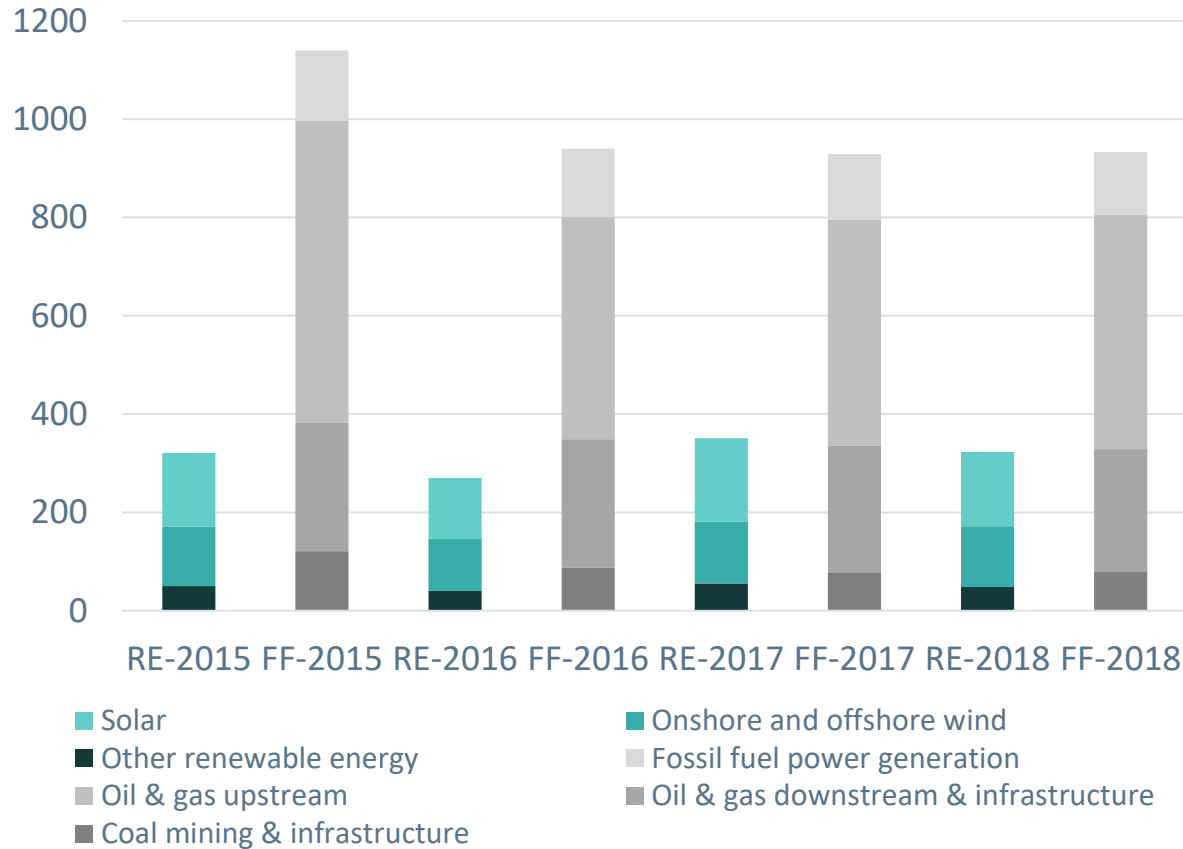


Investors engage to shift capital deployment on the ground

Companies continue to invest vast sums into fossil fuels

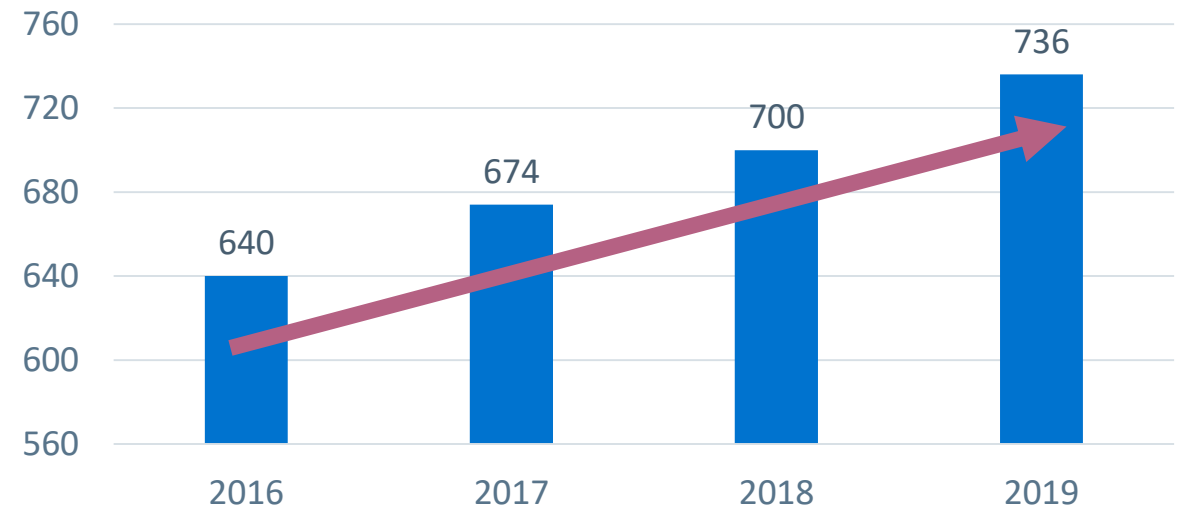
This is *shareholder* capital

 Global renewable (RE) and fossil fuel (FF) investment 2015-2018 (US\$ bn)



Source: Climate Policy Initiative, 2019

 Total financing for fossil fuels (US\$ bn)



Source: Rainforest Action Network, 2020

- 35 global banks: \$2.7tn for fossil fuels since Paris
- Outside energy, substantial reinvestment into fossil-fuel intensive activities, e.g. transport, materials, heavy industry

How to change capital deployment?

Accounts are the overlooked lever in the system



Accounts act like an altimeter; a gauge for capital and performance.

They tell you whether you are going off course...or whether you are going to crash



Accounts are an overlooked lever in the financial system

They drive decision making – where to deploy capital



Where climate risks are left out:

Too much investment into activities that harm the climate

Too little investment into activities that protect the climate

Risks to company and planetary prosperity



Example: coal-fired power company

Paris-aligned accounts drive better capital allocation



More future stranded asset risk

ACCOUNTS IGNORING DECARBONISATION

- Depreciated assets over 30-50 years (to 2050+)
- Assume rising demand for power into the future in line with GDP
- Asset retirement obligations after 2050+
- Lower annual depreciation charge (+ PROFITS)
- Future cash flows underpin asset valuations (NO IMPAIRMENTS)
- Manageable present value liability and low provisioning (+ PROFITS)

Impact: Higher profits & Higher capital
More reinvestment into coal-fired power

Until the numbers are aligned with Paris, capital deployment won't be



Less future stranded asset risk

PARIS-ALIGNED ACCOUNTS

- Depreciated assets over 10-20 years (retired before 2040 in line with expected local rules)
- Assume consumers to shift to renewables & energy efficiency curtails demand
- Asset retirement obligations brought forward to 2030/40
- Higher annual depreciation charge (- PROFITS)
- Future cash flows are lower and at risk (higher WACC) (ASSET WRITEDOWNS)
- Increased present value of liability and higher provisioning (- PROFITS)

Impact: Lower / no profits & impaired capital
No reinvestment into coal-fired power

TCFD alone will not be enough

Actions to date...and impacts



TCFD focuses on narrative disclosures: Governance, strategy & disclosures

But financial statements drive strategy
IIGCC Briefing 2018



Investor coalition actions:

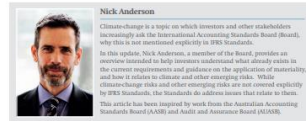
- Audit firm letters January 2019
- Letters to Audit Committees: Shell, Total, BP, CRH, Rio [Eni]
- Outreach to IASB, FRC, FCA, EC



Impacts

- FRC (Oct 2019): material climate risks must be considered
- IASB (Nov 2019): which standards are impacted
- Company assumptions adjustments & impairments
- IAASB statement

November 2019
In brief
IFRS' Standards and climate-related disclosures



What is this publication about?
The International Accounting Standards Board (IASB) is often asked why IFRS Standards don't mention climate change. While the global climate-change does not feature in our requirements, IFRS Standards do address issues that relate to climate-change risks and other emerging risks. The Board is also updating its non-mandatory guidance on management commentary where it would expect companies to address material environmental and social issues, complementing the information in financial statements.

In April 2019 the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AASB) issued a joint guidance, 'Climate-related and other emerging risks disclosures covering financial statements accounting using AASB/IFRS Practice Statement 2'. The focus of that publication was to illustrate how qualitative external factors, such as the industry in which the company operates, and investor expectations may make such risks 'material' and warrant disclosure in the financial statements, regardless of their financial impact.

Core Elements of Recommended Climate-Related Financial Disclosures



- Governance**
The organization's governance around climate-related risks and opportunities
- Strategy**
The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning
- Risk Management**
The processes used by the organization to identify, assess, and manage climate-related risks
- Metrics and Targets**
The metrics and targets used to assess and manage relevant climate-related risks and opportunities

- Asset lives & depreciation
- Asset values;
- Fair value;
- Financial instruments;
- Provisions
- Contingent liabilities

Engagement: BP

June 2020 announcement



Engaging since 2016:

Shareholder Resolution; Letters to Chair and Audit Committee



Goal:

Paris-aligned accounting to deliver Net Zero strategy

2019 Annual Report:

Deloitte identified climate risks as key audit matter; called out commodity price assumptions not consistent with Paris

June 2020: Aligning accounts with Paris

Lowered commodity prices due to decarbonisation; \$13-\$17.5bn impairment – almost 20% equity wiped out

Sept 2020: Strategy overhaul

- Fossil fuel production will fall 40% by 2030
- Increasing capital deployed to renewables

Proof of concept

- ✓ Climate change has material impacts for accounts
- ✓ Accounts can be aligned with Paris
- ✓ The auditor can alert shareholders where not Paris-aligned
- ✓ Changes to accounting leads to shift in capital away from fossil fuels



Progressing strategy development, bp revises long-term price assumptions, reviews intangible assets and, as a result, expects non-cash impairments and write-offs

Release data: 15 June 2020

Engagement: Shell



Investor letter to Shell’s Audit Committee and auditor, EY, in Nov 2019 seeking affirmation that the accounts incorporate material climate risks

Impact

Reduction in commodity price assumptions

Changes to critical accounting assumptions (long-term oil and gas prices) explicitly linked to climate risks, resulting in impairments

EY: energy transition/climate risks part of Key Audit Matters



Shell’s oil and gas price assumptions come down as we have engaged



Extract from EY report to shareholders

UPDATING OUR UNDERSTANDING OF SHELL’S BUSINESS AND ITS ENVIRONMENT

Our global audit team has deep industry experience through working for many years on the audits of large integrated international oil and gas companies. Our audit planning starts with updating our view on external market factors, for example geopolitical risk, **the potential impact of climate change and the energy transition, commodity price and major trends** in the industry. Building on this knowledge, we updated our understanding of Shell’s strategy and business model. This was achieved through the review of external data, enquiry, analytical procedures, observation and visiting several of Shell’s operating units.

In planning our 2019 audit, we were mindful of the fact that the outlook for both oil and gas commodity prices continued to narrow. Refining margins remained under pressure due to a number of factors, including the energy transition. The fundamentals of cost control, capital spending, operational excellence, cash flow and capital return continued to be a focus in the industry. **Climate change and the energy transition are becoming increasingly important for the sector. As part of our audit, we assessed whether Shell’s energy transition assumptions used in setting oil and gas commodity price assumptions and refining margin assumptions were reasonable in the light of the commitments that Shell have made with respect to decarbonisation in accordance with the Paris Agreement.** Our updated understanding of Shell’s business and the environment in which it operates informed our risk assessment procedures.

Engagement: Shell

Investor letter to Shell's Audit Committee and auditor, EY, in Nov 2019 seeking affirmation that the accounts incorporate material climate risks



Shell's oil and gas price assumptions come down as we have engaged



Impact

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- Changes to critical accounting assumptions (long-term oil and gas prices) explicitly linked to climate risks, resulting in impairments
- EY: energy transition/climate risks part of Key Audit Matters

Extract from EY report to shareholders



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Impact: Total SA



Total lowered its oil price in its 2019 Annual Report from \$80 to \$70 – impaired c\$0.5bn (net income)

Assume \$70 for 5 years and then fall to \$50 by 2050 *in line with Paris* (and IEA's Sustainable Development Scenario) – previously it rose into the future

Sensitivity is non-linear:

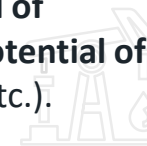
10% reduction in the oil price (to \$63 in 2025) would lower net income by \$1.6bn

10% reduction in gas price would lower net income \$1bn

\$2.6bn would amount to 23% hit to 2019 Net income

Oil demand should continue to grow in the medium term, in context of sustained growth in global energy demand and despite the gradual electrification of transport and efficiency gains in thermal engines.

Crude price would then follow a downward trajectory from 2030 onwards to converge towards 50\$2018/b in 2050, due to the impact on demand of policies compatible with the Paris agreement and the production potential of certain major producing countries (US, Saudi Arabia, Brazil, Russia, etc.).



Total SA, 2019 Annual Report and Accounts; Note to Financial Statements on impairment

Conclusions

- What matters in the end is capital allocation: more needs to go towards climate solutions, less to fossil fuels
- Accounts act as the altimeter in company cockpits: They tell you if you are on a sustainable flight path
- Paris-aligned accounts help to ensure the company allocates capital in a way that is consistent with a net zero pathway
- Trying to change capital allocation without changing the accounts is akin to ‘pushing water uphill’
- Auditors play a critical role: auditors should sound the alarm when accounts are not calibrated for a net zero pathway
- Shareholder action:
 - Engage with Audit Committees & auditors: Paris-alignment is expected [this means 2050 net zero pathway]
 - Vote against audit committee directors & auditors when the Paris test is not met
 - Regulatory outreach: Material omissions? Mis-representation?

Important information

If you are a private investor, you should not act or rely on this document but should contact your professional adviser

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