FairPensions™

The campaign for **responsible** investment

FairPensions Response to DEFRA Consultation: Corporate reporting of greenhouse gas emissions

June 2011

Introduction

FairPensions supports mandatory carbon reporting for all large companies. We believe that throughout this consultation it is vital to bear in mind the policy objectives of better carbon reporting as outlined in this and previous government documents: namely to facilitate sustainable investment decisions as well as encouraging companies to monitor and reduce their emissions directly.

We understand that the government's preferred position is that companies should report on their carbon emissions, since it recognises the benefits this brings to companies themselves, their investors, the wider economy and society. Such reporting necessarily entails a cost. We support efforts to ensure that this cost is not disproportionate. But we would also caution against attempts to reduce the cost by limiting the scope or application of reporting requirements at the expense of the original policy objectives. We believe that Options 1 and 4 run this risk.

Having said this, there is also significant evidence that reporting brings benefits to companies and investors which may outweigh the costs involved. We believe that the impact assessment could do more to fully quantify the benefits of mandatory carbon reporting, thereby providing a more accurate reflection of the relative effectiveness of the four options.

Questions on the four options

1. Do you support Option 1 (enhanced voluntary reporting)? If you do, please explain why.

We do not support Option 1. For our reasons, please see our response to question 3.

3. Should corporate reporting of GHG emissions be made mandatory for some companies? If so, please explain.

Yes. If the benefits of carbon reporting are to be fully realised, investors need consistent, comparable information enabling them to assess the relative profiles of competing investment alternatives as well as the carbon liabilities of their portfolio as a whole. This can only be achieved through mandatory reporting.

Indeed, the experience of many years suggests that voluntary reporting will not deliver the necessary coverage or the necessary comparability. A 2010 study by Deloitte found that only 9% of companies surveyed were reporting their emissions in line with Defra's voluntary guidance. Only 37% included carbon data of any description in their reporting, with wide variations in the quality and extent of reporting.[1] Data from the Carbon Disclosure Project's 2010 survey of the FTSE 350 indicates that 31% failed to respond at all, and

[1] Deloitte, 'A survey of carbon reporting practices among UK listed companies', November 2010. http://bit.ly/ckP7f0

almost half failed to disclose any emissions data in their annual reports.[2] The CDP itself supports the introduction of mandatory carbon reporting.

We remain unconvinced that such a regime would be capable of driving this figure up to acceptable levels. Indeed, the impact assessment itself only assumes an additional 200 large companies would report under this option – significantly lower than the other options – with projected benefits of £4.6m. We would question whether this is an acceptable outcome; it certainly does not achieve the policy objective of giving investors comparable information across their holdings on which to base investment decisions.

Leaving this question aside, a voluntary approach remains unsatisfactory due to the longer timescales involved. As the evidence of CDP and Defra's existing guidance suggests, voluntary reporting at its best can only expect to deliver incremental improvements over many years – as opposed to mandatory reporting, under which all companies within the scope of regulations would begin reporting at the same time. This reduces certainty for both companies and investors and further delays the point at which the available data will be sufficient to inform sustainable investment decisions. Given the urgency of the climate problem, this delay is a serious concern and greatly reduces the practical value of improved reporting.

Research by FairPensions carried out in 2009 found that an overwhelming 86% of fund managers surveyed would welcome regulatory requirements on companies to report their emissions. Indeed, perhaps surprisingly, 72% also supported regulatory requirements for emissions *reduction*. Over half cited poor quality data from companies as a key barrier to the integration of climate risks into their decision-making.[3] Anecdotally, we also hear that both companies and investors find the existing proliferation of different reporting standards frustrating and unhelpful. Introducing a single mandatory reporting regime would streamline and simplify the process for companies who already report and for investors who use climate data. This benefit should be taken into account in the impact assessment.

Given the overwhelming support for mandatory reporting from business leaders including the CBI and Aldersgate Group, from investors and from civil society, we are disappointed that voluntary reporting remains an option under consideration. We believe this highlights the need to avoid an overly dogmatic deregulatory approach under which the government insists upon deregulation even when business itself supports regulation. Such an approach seems neither proportionate nor business-friendly. The assumption that mandatory reporting will be introduced is built into the Climate Change Act and was supported by all major parties at the time of its passage through Parliament. To reverse this assumption now would call into question the government's commitment to tackling climate change as well as the credibility of recently-agreed ambitious national carbon reduction targets.

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[2] Carbon Disclosure Project, 2010, 'FTSE 350 Report'. https://www.cdproject.net/CDPResults/CDP- 2010-FTSE350.pdf

[3] FairPensions, 2009, *'Preparing for the Storm'*, available online at http://www.fairpensions.org.uk/research

4. If mandatory reporting is introduced, which would be your preferred option: 2, 3 or 4?

Our preferred option is Option 3 (mandatory reporting for all large companies). This is the only option which ensures the availability of comprehensive, comparable information. Private companies are increasingly of interest to institutional investors, and including them within scope would help investors to manage their exposure to climate risk more consistently across asset classes. Including large private companies is also a more consistent approach in relation to the government's other objective of encouraging major businesses to reduce their emissions. If the government rejects Option 3, our second preference would be for Option 2 – which, as the consultation paper observes, covers the companies "of most interest to investors and potential investors." Choosing one of these two options would be logical and in line with the policy objectives of mandatory reporting as outlined in this and previous government documents.

By contrast, Option 4 does not seem logical in relation to the government's stated policy objectives. The intent is to cover "the largest energy users", yet in fact the proposed criteria are based on a single aspect of the company's emissions which may not be representative of its overall risk profile. As the consultation paper notes, it "would not include companies with low UK electricity consumption but high emissions from other activities, such as transport, process emissions or high emissions from company's activities overseas." Yet these factors clearly impact a company's overall exposure to climate risk, and therefore its own footprint as well as the extent to which investors in that company need climate data to make informed decisions.

We believe there ought to be some consistency between the information to be provided (the 'what') and the criteria for which companies must provide it (the 'who'). If the 'who' is to be based on some measure of emissions (which, to be clear, is not our preferred option), this measure should at least be consistent with the categories of emissions which must actually be reported on. The consultation paper suggests that overseas emissions should be included in any mandatory reporting requirements, and that at least scopes 1 and 2 should be covered. UK electricity consumption is unlikely to be a reliable proxy for this full package of emissions. Basing the application of the requirements solely on a company's UK electricity consumption therefore seems somewhat arbitrary and would create a fundamental inconsistency in the reporting framework.

For example, Anglo American is a company registered in the UK, yet the vast majority of its business activities take place outside the UK. It is an energy intensive company whose investors will wish to be aware of its carbon liabilities. Yet it might not be covered by reporting requirements under Option 4.

As the consultation paper notes, this is the only option which fails to replicate existing Companies Act categories of company. It would therefore add an additional layer of complexity to the corporate reporting regime, as well as extending burdens to all companies – not just those actually required to report – due to the need to ascertain and demonstrate that their consumption falls below the reporting thresholds.

5. Do you have any comments on the economic analysis in the impact assessment? In particular, do you think the costs and benefits for the different options are reasonable?

It is difficult to make general comments about the impact assessment given the huge range between the highest and lowest estimates and the absence of a 'best estimate' in between. However, the estimates for the cost of reporting to companies appear excessively high (see below). We would argue that the assessment also significantly underestimates the benefits of better reporting, largely because as the impact assessment notes on page 9, "it was not possible to quantify/monetise the impacts associated with improved investor information, reputations, branding, and climate change exposure."

The high-end estimates in the impact assessment, which appear to show mandatory reporting as a significant potential burden on business, seem unrepresentative of the evidence. Defra's own research found that 26% of companies thought reporting was of net benefit to their business, rising to 53% when asked to make a more qualitative assessment including intangible benefits such as reputation. Companies in general did not feel that the cost of reporting was financially material. This would suggest that the high-cost, low-benefit scenarios are extremely unlikely, perhaps even unrealistic, and this should be acknowledged in the impact assessment.

It is unfortunate that the stated 'intangible' benefits of reporting remain unmonetised and are therefore not reflected in the headline figures. 'Intangible' need not mean 'unmeasurable': companies readily quantify goodwill and other equally nebulous assets, and Defra itself is pioneering efforts to quantify 'natural capital.'[4] However, if it is concluded that quantifying these factors is indeed impossible, it should be made clear that the government's decision will be a qualitative one based on a full consideration of all relevant costs and benefits, and will not be determined by the headline figures in the impact assessment. We are concerned that the present application of 'one-in, one-out regulation', which places great weight on a numerical assessment of costs and benefits yet does not quantify some of the most important benefits of the proposed policy, is unlikely to produce an optimal decision.

We are particularly concerned that the impact assessment appears to show that Option 4 is by far the most attractive option. We do not believe that this constitutes an accurate reflection of the relative costs and benefits of the three proposed mandatory options. There appears to be a mismatch between the methodology of the impact assessment and the government's stated policy objectives. The impact assessment privileges benefits associated with direct energy efficiency savings at company level – an approach which inevitably

[4]Defra, 2011, Natural Environment White Paper, p34-43

suggests an approach based on energy consumption thresholds. No attempt appears to have been made to quantify the long-term benefits to investors – and, indeed, to companies themselves – of better management of climate risk across the board, despite the government's recognition that this is a key objective and benefit of improved reporting. We welcome the consultation paper's solicitation of evidence from investors, but are concerned that this still seems to focus on the internal costs and benefits associated with the act of data collection itself, rather than the wider economic and business benefits of managing climate risk – and, conversely, the costs of being unable to manage this risk effectively.

We recognise that this is inherently difficult to quantify, but believe that it should be possible to make some upper- and lower-bound estimates based on the available data. This would be far preferable to giving these benefits a value of zero, an approach which leaves any cost-benefit analysis fundamentally flawed. Recent analysis has suggested that climate policy could contribute as much as 10% to overall portfolio risk, with the economic cost expected to amount to $8 trillion by 2030.[5] This does not even cover the physical impacts of climate change, which are already significant and growing. These factors therefore have the potential to dwarf any impacts resulting from improved energy efficiency. Of course, reliable information on companies' GHG emissions is not a sufficient condition for addressing and mitigating these risks – but it is a *necessary* condition. This in turn suggests that the potential costs of climate risk should be factored into the analysis of voluntary and 'business as usual' options.

Organisational boundaries

6. Do you agree that a company should specify which approach it is using to set its organisational boundary?

7. Do you agree that a company should (where possible) report on all their emissions within the chosen organisational boundary, including those that occur in their operations overseas? If you don't agree, can you explain which emissions you think a company should report?

8. Do you agree that, if it isn't possible for a company to report on emissions within their organisational boundary (because of data problems, etc) then a company should clearly state the extent to which it has been able to report?

We agree in all cases. For emissions data to be meaningful to its potential users, including investors, the parameters of reporting must be clear and transparent.

Regarding the flexibility for companies to choose which approach they take to setting their organisational boundary, we would highlight the need to ensure

[5] Mercer, 2011, 'Climate Change Scenarios: Implications for Strategic Asset Allocation'

that this does not become a 'loophole' enabling companies to play down the level of their emissions, thereby making information less useful and comparable. If this approach is to be followed, we agree that transparency is crucial to ensure that any significant gaps in reporting are clearly signposted and accounted for. Where reporting has not been possible due to data constraints, we would consider it good practice for companies to give estimates wherever possible - albeit with a clear indication that they are estimates only – and to provide the basis on which such estimates were made.

Regarding overseas operations, given that both company operations and investment activity transcend national boundaries, there would seem to be little reason for restricting reporting to activities taking place in the jurisdiction in which the company happens to be registered. Such an approach fails to give investors meaningful information about the risk profile of their investee companies, or indeed to give the company itself meaningful information about its progress in achieving emissions reductions across its operations. As indicated above, this is one reason why we believe Option 4, with its sole focus on UK electricity consumption, is inconsistent with the policy objectives of reporting. Again, the extractive industries are one practical example of companies whose significant impacts are incurred overseas. It is these impacts which both directors and investors need information about; by contrast, the emissions generated by the company's UK-based head office are unlikely to be a material concern.

<u>Gases to be reported</u>

9. Do you agree that companies should be required to measure and calculate emissions from the six GHGs covered by the Kyoto Protocol?

Yes.

<u>Activities to be measured and reported</u>

10. Do you agree that companies should be required to measure, or calculate, and report on all their scope 1 and scope 2 emissions? If not, which emissions do you think a company should measure, calculate and report and why?

Yes. We agree that reporting must cover all scope 1 emissions and must not be limited to those covered by the CRC. The inclusion of scope 2 emissions is also crucial since scope 1 will be of limited relevance to companies in many sectors whose emissions may nevertheless be significant.

11. Do you think that companies should be required to measure and report on any of their scope 3 emissions (in addition to scope 1 and 2)? If so, can you specify which ones you think should be required?

Whilst we recognise that scope 3 emissions can be more complex to calculate, we believe there are various dangers in excluding scope 3 emissions from reporting requirements altogether.

Firstly, this approach creates a further incentive for companies to outsource, thereby shifting emissions 'off-balance sheet' without achieving any material reduction in actual emissions associated with the business. We would suggest that emissions from outsourced operations are one crucial scope 3 emission which could and should be included in reporting requirements. Particularly if a company's contractors are themselves covered by reporting requirements, it would not seem unreasonable to require that an estimate of 'outsourced' emissions be given in that company's reporting. It would also aid transparency if year-on-year figures were accompanied by a brief narrative statement of the main drivers behind emissions trends: for instance, if an apparent fall in emissions was due to the outsourcing of a particular activity.

Secondly, as the consultation paper recognises, "for some organisations, especially those that have relatively low scope 1 and 2 emissions, understanding the level of scope 3 emissions is essential to properly understanding the environmental impact of the business." Scopes 1 and 2 may be peripheral to a firm's core business, and information on scopes 1 and 2 may therefore be of limited use to directors and investors. One example of this is financial services itself: scopes 1 and 2 might cover the emissions associated with a firm's offices, such as lights and printing, but these are peripheral to the firm's core business, ie. the financing of more or less carbon-intensive companies and projects.

In previous submissions[6] we have advocated that investors themselves should be required to report on their portfolio emissions, in order to increase visibility to the ultimate beneficiaries whose money they manage. This will help demand for more sustainable investment approaches to be transmitted up the investment chain; currently, consumers lack the necessary information to factor this into to their choice of pension provider, bank or insurer.

Some investors have already undertaken this exercise, including the Environment Agency Pension Fund and the London Pension Fund Authority.[7] We recognise that under the present situation, where investors must calculate their investee companies' emissions from scratch, making this a mandatory requirement might be an unreasonable burden. However, if and when mandatory reporting is introduced for the companies concerned, the exercise will become a much simpler one. We would therefore suggest that in the short-term, investors could be encouraged to report on portfolio emissions on a voluntary basis, with mandatory requirements phased in once mandatory

[6] Christian Aid & FairPensions, 2009, Joint Response to Consultation on draft guidance for how to measure and report your carbon emissions. Available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/DEFRAsubmission.pdf.pdf

[7] http://www.environment-agency.gov.uk/static/documents/Utility/Responsible_Investment_Review.pdf and http://www.lpfa.org.uk/investment/responsibleinvest.aspx

reporting by investee companies has bedded down. Based on existing evidence in relation to companies in general (see response to question 3), we do not believe that voluntary reporting alone will ultimately be sufficient to produce the necessary levels of transparency and market information.

More generally, we would encourage Defra to consider sector-specific guidance or agreements with particular sectors in which scope 1 and 2 emissions are peripheral to firms' core business. Indeed, the government might consider a 'hybrid' option whereby mandatory reporting on scope 1 and 2 was combined with 'enhanced voluntary reporting' measures in relation to scope 3. Examples of relevant sectors might include those whose major contribution to climate change lies in the products they sell rather than the production processes themselves (although these processes may also be significant emitters), such as car manufacturers. On this point, see also our response to question 15.

Of course, some scope 3 emissions, such as business travel, are relevant to all sectors. As the consultation paper notes, emissions from business travel by rail or air are relatively easy to calculate. We would therefore suggest that business travel is an example of a scope 3 emission which could be included in any mandatory reporting regulations.

<u>What companies should report</u>

12. Do you agree that companies should specify in their directors' reports the company's total annual amount of GHG emissions in CO2e broken down by direct emissions (scope 1) and indirect energy (scope 2)?

Yes. It would also be helpful for this information to be accompanied by a brief narrative summary of the main sources of emissions underlying these figures (ie. which activities are responsible for the bulk of the firm's GHG emissions), and of the factors underlying any trends over time (see response to question 11 above). We would suggest that Defra could encourage this approach as best practice.

13. Do you agree that companies should specify an intensity ratio?

Yes. Not including this information has the potential to unfairly disadvantage companies whose total emissions have risen due to business growth and company success, but whose intensity ratio may have reduced due to action taken to 'green' the business. Of course, absolute figures are also necessary to enable investors to judge their absolute level of exposure to climate risk across their portfolio. We therefore agree that both total emissions and intensity ratios should be required by any regulations.

14. Should companies specify a base year when they report their annual emissions?

Yes.

15. Is there any other information which you think a company should report?

In some sectors, whose direct emissions may be relatively low but whose products are responsible for significant emissions, it would be helpful to encourage reporting on a product basis. This would provide valuable consumer information to aid those who wish to make sustainable choices. A similar approach could also be applied to our suggestion for reporting by investors of portfolio emissions, thus enabling consumers to make an informed choice between the different funds on offer.

Assurance and verification

16. If reporting is to be made mandatory, should companies be obliged to seek some kind of assurance or verification on their emission report? If not, could you explain your thinking.

17. Is internal verification of greenhouse gas emissions sufficient, or should external third party assurance be sought? If the latter, should it be limited or reasonable?

It is essential that emissions data is verifiable and robust. Anecdotally, we are told that one of the main reasons investors do not make greater use of companies' narrative reporting on environmental and social issues is the lack of verification, which makes this information an unreliable basis for investment decisions. The same problem seems likely to apply to GHG emissions reporting if no verification requirements are introduced. This would jeopardise the likely benefits of mandatory reporting and this needs to be offset against any increase in cost to business as a result of assurance.

Ideally, the starting point should be to require the same level of assurance as financial information - ie. external audit to a reasonable assurance standard. As we have argued in our response to BIS' consultation on narrative reporting, if better reporting aims to encourage investors to integrate climate risk into their decision-making, then the information must be as robust and reliable as the financial metrics on which investors traditionally base their decisions.

We believe this argument is compelling in principle, but recognise the practical difficulties arising from the need to reduce regulatory burdens in line with government policy. External assurance would clearly increase the overall costs of mandatory reporting to business; we would not wish to see this jeopardise the introduction of mandatory reporting itself by making the proposals appear prohibitively burdensome.

If external audit is rejected for this reason, we would suggest as a minimum that internal assurance should be required, with guidance to the effect that full external assurance is best practice for those companies who can afford to do so. In addition, companies should be required to disclose the methodology behind their calculations and the assumptions on which they are based. This would enable investors to satisfy themselves of the data's reliability, and therefore to have confidence in it as a basis for investment decisions.

Inevitably, this approach transfers some of the costs of assurance onto investors themselves. However, this is still likely to be preferable from an investor point of view to the current situation, whereby companies report using a variety of different standards and many do not report at all. Moreover, if the information is to be used in the way the government intends, the costs of assurance must be borne somewhere. The alternative – that the information is not verified anywhere in the investment chain, and is less utilised as a result – simply transfers costs to society through failure to meet climate change objectives.

Another approach would be to phase in external audit requirements over time. For this as with other issues (such as which firms should be covered by reporting requirements and the extent to which scope 3 emissions can be included – see above) we believe it would be helpful for the government to set a timetable for review – after, for example, two or three reporting cycles – to reassess its assumptions about costs and benefits and consider whether there is scope for requirements to be strengthened.