Carbon Tracker Initiative comments on SASB's Proposed Changes to Provisional Standards

Dear Sir/Madam,

We welcome the opportunity to provide comment to this consultation.

With regards to specific standards, we have restricted our comments to:

- TA04-08-01 and EM0201-16, which relate to the sensitivity of hydrocarbon/coal reserve levels to future price project scenarios that account for a price on carbon emissions for Oil & Gas – Exploration and Production and Coal Companies, respectively;
- EM0101-24 and EM0201-18, which relate to the influence of price and demand for hydrocarbons/coal and/or climate regulation upon capital expenditure strategy for Oil & Gas Exploration and Production and Coal Companies, respectively.

Comments on update to standard TA04-08-01 (applies also to EM0201-16)

Usefulness of Sensitivity Analysis

- In our view, the most novel and significant contribution of the FSB-TCFD's recommendations is scenario analysis. However, we also recognise that for many companies, scenario analysis is not yet a process with which they are adequately familiar.
- We view sensitivity analysis – of a company's net present value to different relevant commodity prices, for example – as a potentially useful bridge to more complete scenario analysis that will come in time. Indeed, the TCFD's recommendations also recognised this[1].
- Against this background, we welcome the update of language of these standards to include a sensitivity analysis of a company's reserves against different scenarios.
- We also endorse SASB's intention to anchor companies' sensitivity analyses in a common set of scenarios, and believe that the IEA scenarios may form a useful starting point.[2]
- However, the pricing levels in these scenarios do not allow for a sufficiently broad sensitivity analysis. In the year 2025, the oil price levels of the IEA's 450 and Current Policies Scenarios vary between approximately $90 per barrel and $120 per barrel, not a particularly wide range and significant higher than current oil prices.[3] As an empirical matter, this will result in companies testing the economic recoverability of their proven and probable reserves against prices that are higher than those currently used in the SEC's Standardized Measure of Oil and Gas (SMOG), which uses the rolling twelve-month, first day of month, price average.
- This latter point has already presented some challenges regarding companies' scenario analysis. For example, companies including Royal Dutch Shell and Statoil have claimed to have performed scenario analysis against the IEA's 450 Scenario. In reality, their attempts have often been a simple substitution of their planning commodity price assumptions with the 450 Scenario prices. As a practical matter and given the current low oil price environment, the 450 Scenario prices are typically higher than companies' planning assumptions. This leads to

[1] FN 48 of the FSB-TCFD "Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures. See https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf.
[2] We recognise that the Proposed Changes acknowledges that these scenarios will be updated annually.
[3] Source: IEA World Energy Outlook 2016

the counter-intuitive result that companies' NPV is *higher* under the 450 Scenario – a scenario in which oil and gas demand is *lower* than the companies' planning assumption/base case.

- We would therefore see value in SASB standardising the sensitivity analysis to include a defined and wide range of prices. For example, prices increasing in increments from $20 per barrel through $160 per barrel. Carbon Tracker applied similar sensitivity analysis to a subset of oil and gas companies, comparing a "business-as-usual" portfolio of assets with a 2°C-compliant portfolio of assets.[4] Such analysis is simple to undertake and can provide the market with a snapshot of exposure to volatile commodity prices.
- The use of a standardized range would be objective in the sense that it would cover a range of potential price outcomes (both higher and lower than prevailing market prices) and provide a useful supplement to current reserves guidance provided by SMOG. In this regard, only a specified price range could provide this, as IEA scenario prices are higher in all cases than current prevailing market prices.
- Discount rates similar to those mandated under SMOG could be used.
- We believe this change could be made for both Oil & Gas Exploration and Production and Coal Operations sectors.
- Finally, we note that a robust sensitivity analysis has been considered by accounting standard-setters in the past (see, e.g., 2010 IASB Discussion Paper on Extractive Activities (DP/2010/1).

Comments on update to standard EM0101-24 (applies also to EM0201-18)

Importance of focusing on demand-side impacts for companies

- We agree that it is important for oil and gas companies to disclose to investors how changing patterns in demand for their products might impact both their capital expenditure strategy and their decisions to explore, acquire and develop new reserves.
- Fossil fuel companies face a complex array of risks and this extends to their exposure to climate-related financial risks. However, in the context of "transition-related risks"[5] the adverse effects from climate change are really a tributary leading to impact on demand for their products, i.e., market risk.
- According to the 2016 World Energy Outlook, the difference between the IEA's New Policies Scenario and its 450 Scenario indicates material reduction in oil, gas and coal demand. By 2040, the 450 Scenario contains 30%, 23% and 52% less demand for oil, gas and coal, respectively, than the New Policies Scenario. This trend should be reflected in companies' forward-looking strategic approach.
- While the industry's proven reserve base might appear low risk, every dollar released from proven reserves that is reinvested into new resources merely shifts value forward, often by 10-20 years. This transfers the risk to future projects that are at greater risk from market, policy and technology changes.
- It is therefore critical that companies discuss how their capital expenditure strategies are impacted by a scenario consistent with 2°C and that at least one scenario is used as a reference point to allow for comparability of disclosure across a sector.

[4] See https://www.carbontracker.org/wp-content/uploads/2017/08/Sense-Sensitivity_Full-report2_28042016.pdf

[5] The FSB-TCFD outlines the taxonomy of climate-related risks, which includes physical, transition and liability risks. See https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf.

The need for a reference scenario

- Standard TA04-08-01 outlines the importance of standardising prices against which companies should test. We believe that this should also be the case for companies' consideration of future demand pathways.
- Both financial authorities and investors considering portfolio risks may want an assessment of the total exposure of listed or owned companies. This will prove difficult to achieve if scenarios with differing assumptions are applied across different companies. Moreover, investors seeking to differentiate companies based on transition risk exposure will find it difficult to compare company outlooks if each company uses its own scenario. While company-produced scenarios could yield insights into how management views the company's prospects (a valuable disclosure of management's views if accompanied by proper disclosure of assumptions) the use of different assumptions and models will not yield comparable outputs.
- Comparability and consistency are core principles for decision-useful disclosure and flow naturally from the use of a reference scenario of which *detailed demand pathways* are a fundamental attribute.
- Carbon Tracker's work has demonstrated that it is possible to compare future demand profiles with a forward-looking view of supply. This can be done at the project-level, which then allows for aggregation to the company-level.[6]
- This is not to say that this scenario is the most likely to emerge. Indeed, one certainty is that the future will not unfold precisely as any scenario anticipates. However, analogous to the U.S. SEC's use of the 12-month rolling average spot price for the SMOG measure of quantities of proven reserves, a reference 2°C scenario can assist in market appreciation of companies' relative exposure to plausible future risks.

Company use of a proxy carbon price

- Standard EM0101-24 references the potential utility of companies discussing how exogenous factors such as a carbon tax "may differently affect price and demand, and thus the registrant's capital expenditure decision making."
- We agree with the principle of companies needing to better consider decision-making implications of future climate change-related trends.
- With regard to the implications upon fossil fuel companies of a carbon tax, we would note three things:
    - First, discussions among fossil fuel companies of carbon price impacts are typically obscure because of a lacking clarity as to how the tax is applied. For example, is the tax applied only to operational emissions or lifecycle emissions? We would stress the need for companies to be transparent about the processes used and application of modelling the impacts of changing carbon taxes.
    - Second, many oil and gas company analyses appear to apply the carbon tax to the overall project cost in sanctioning processes. We believe that this is not necessarily useful since only a carbon tax much higher than is generally considered would have a meaningful impact on the per barrel cost. Our internal estimates suggest that the per barrel impact of a $40/tCO2 carbon tax, for example, would impose an additional $1-$2/bbl increase on operational costs (assuming it was not passed on to consumers).

[6] For further detail of Carbon Tracker's methodology, see https://www.carbontracker.org/time-machine-climate-risk-bringing-future-forward-2%CB%9Ac-scenario-analysis/ and https://www.carbontracker.org/wp-content/uploads/2017/02/TCFD-Phase-II-CTI-Response-FINAL.pdf.

This increase falls within the commodity price volatility already considered by the company.

- Third, we believe that modelling of carbon tax implications is most useful in assessments of tipping points in the relative costs of different technologies. For example, what is the tax required to make alternative/renewable technologies competitive with oil and gas and thus serve as an economic substitute and erode demand for oil and gas? Indeed, the standard references the impact upon demand and we highlight the potential usefulness of this element for oil and gas companies to assess climate-related business impacts.