



AODP Feedback to IIRC Consultation Draft

Background

AODP is the world's only independent disclosure framework for Asset Owners and their ability to manage climate risk. Unfortunately, AODP does not currently have sufficient resources to offer a comprehensive submission, however we have highlighted its major concern regarding the future of companies and their shareholders being able to smoothly transition to the low carbon economy.

The climate test

AODP believes that for any integrated reporting framework to be successful it must pass "The Climate Test". Climate change, and carbon specifically, is the first large scale externality to be priced. It represents a unique risk for companies and their shareholders being long term, high impact but also high certainty. Additionally, the cost of mitigation for climate change is known with unusual accuracy for such a long term risk – extensive analysis through Stern, Garnaut, McKinsey and others has provided relatively high degrees of accuracy for carbon mitigation by sector. This set of risk attributes has simplified the way that companies and their shareholders need to view climate risk by reducing it to the likelihood and probability of various scenarios leading the low carbon economy. These scenarios might be direct like an ETS or more intrinsic like improvements in innovation leading to product substitution that are driven by increased investment from large asset owners. Once these probabilities have been estimated by the company or shareholder then the necessary expected value risk can be calculated and an appropriate mitigation or hedging strategy can be decided.

The sheer scale of assets exposed to climate change risk, both regulatory and physical, demands that the IIRC framework ensure adequate reporting of the risks and uncertainty associated with these externalities and the rate at which they are repriced by regulators or investors. Additionally it should provide mandatory guidance for investors by their companies as to how those risks might materialise and what the company's position might be if they did.

The most important accounting standard relating to this issue is IAS36 relating to impairment of assets. This standard defines the circumstances by which a company's tangible asset values are assessed.

In the case of climate change, all high emitting assets are highly capital intensive and long term in nature. This means that they are greatly exposed to changes in regulation over a long period of time and other economic changes that will produce similar intrinsic impacts on those assets. There is no long term forward tradable market for carbon anywhere in the world and so estimating the potential liabilities is difficult and IAS36 provides little guidance to companies or investors except that it allows companies to use its own assumptions for the calculation of forward liabilities in the absence of a credible external data point. In practice this means that companies are allowed to assume 'business as usual' forecasts for those projections despite their being considerable evidence that the low carbon



economy appears likely at some point and may well materialise during the lifespan of those long term high carbon assets.

This area is where the IR framework must capture the risks to the deterministic accounting data in a way that the existing accounting frameworks do not yet do so. At present, the IR framework does not provide any suitable guidance for integration of such potential externality pricing risk that would allow investors to compare the reported data under the accounting standard with at least acknowledgement by the company of the level of potential risks to the accuracy of those asset values. Such stronger guidance would ensure that analysts and investors rightfully questioned the accounting values providing additional reporting value for the investors.

Segregating investors

The draft framework has in Chapter 3 its guiding principles. Here it describes the principal user group as 'providers of financial capital' to describe investors as a whole. There is a major issue with this definition as it does not acknowledge that investors are often very different. There are investors whose role is to take a very short term view and there are other investors, mainly the large asset owners, whose objective is to maximise risk and return over the long term. These large asset owners consist of the pension funds, insurance companies, sovereign wealth funds, endowments and foundations. They often 'provide' fund managers with capital to invest. In theory these two groups are aligned but in practice this is far from the case and the IR framework must recognise this dysfunctional nature of the financial system in designing its reporting framework. AODP recommends significant overhaul of those aspects of the framework where there is opportunity to ensure companies report longer term sustainability issues alongside the matching accounting values as in the IAS36 example above. Short term stock traders may look to interpret accounting values in a way that provides them with trading arbitrage or other trading opportunities that may have zero relevance to the long term value of the company.

Therefore, there should be greater accent on the longer term providers of financial capital. Areas such as 1.5 "Inform the allocation of financial capital that supports value creation over the short, medium and long term" are completely flawed in their approach as most financial capital is not allocated in the short term and should never be so in a world where we are looking for increased sustainability. This goes to the heart of what we are trying to achieve in a more sustainable financial system – there are externalities (qv the 'climate test') that markets or regulators have not yet priced. We do not expect companies or investors to account for these externalities for ethical or moral reasons but on simply capital allocation and risk grounds. The climate test for IR must drive the companies to take reasonable account of the changing nature of this pricing and declare their calculations for the assumptions so that longer term investors can drive their consideration into the investment holding decisions. For example, a near certain increase in the actual or intrinsic price of carbon will render certain high carbon assets as stranded during their lifespan. The few short term allocators of financial capital (eg some hedge funds) in the market have no incentive to account for this uncertainty and indeed may be incentivised to act against any move to price the uncertainty. It is surely part of the IR purpose to drive the long term allocation of capital by the asset owners by recognising the reporting issues relating to long term sustainability and giving precedence to long term capital managers.

Thus all references to providers of financial capital should be reframed more advantageously and prescriptively to the long term and processes distinguished where integrated data is supporting long



term decision making. Ultimately, whilst carbon may be the first externality to have significant pricing that impacts an entire portfolio, other stakeholders and capital types are also impacted and this principal of assessing, recognising and managing uncertainty should flow through the framework. The outcome will be better capital decisions because of fewer risk repricing impacts on companies and their shareholders – business models will become more sustainable if it anticipates these desirable changes in externality pricing within the lifespan of its investments thus allowing any major restructuring to occur without undue asset stranding or total loss.