Decarbonisation and the evolving role of corporate boards

Corporate Boards need to step up to meet the challenges of the carbon constrained world

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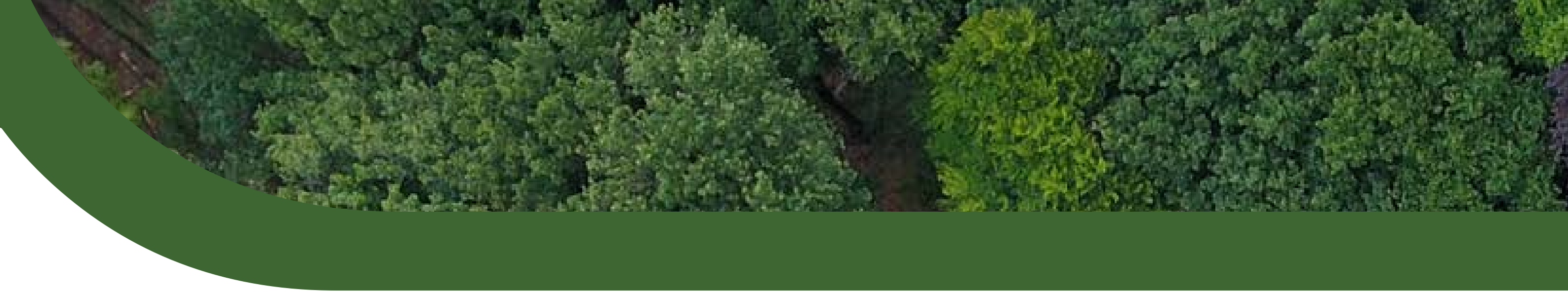

From Regina Mayor

As climate change concerns take root, there is all round confusion on how corporates should react. Without question the future points to clean energy. However, the pathways for the energy providers and users remain unclear. Despite accelerated investments for a better part of the past decade, renewable energy contributes to only about ~17 percent of the overall energy basket. To keep the global economic juggernaut moving, investments will be required even in the fossil fuel sector to ensure an orderly transition while staying on course to meet climate goals. Absent that, there is a great risk of the economy spinning out of equilibrium.

That risk of disequilibrium seems to be playing out, at least in the short run. In response to climate action pressures as well as perceived financial risks to new investments, global oil and gas majors are sharply cutting back capital outlays. National oil companies may step up investments, but keeping pace with the post--pandemic demand would be challenging. A similar situation is playing out in coal markets where traded coal prices have trebled over the past year, but that may not correspondingly spur new investments. Indeed, the declarations at CoP 26 point to the end of unabated coal emissions.

The economic engines are no longer operating in their usual ways. All this points to the need for energy suppliers and users to focus more on accelerating their respective transformations. The resultant changes will cut deep and will require continuous balancing of short term and long term priorities. This is why Corporate Boards actively need to steer this difficult journey, complementing the role of the executive more than ever before.

Regina Mayor

Global Head – Energy
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From Anish De

ENRich 2021 is taking place well within a month of COP26. The Glasgow Climate Pact has kept alive the goal of keeping global warming within 1.5 degrees, but only just. The updated Nationally Determined Contributions (NDCs) have marked only modest step-ups against the needs and will keep the world well above the failure limit of 2 degrees.

However, COP26 has ended with a sliver of hope. The parties have agreed to retain the 1.5 degrees target and reconvene in Egypt next year to update the goals. The Glasgow Pact also pointed to the end of unabated coal emissions. US and China have agreed to work together to cut down methane emissions sharply. The Glasgow Financial Alliance for Net Zero, a consortium of 450 financial firms committed to achieving Net Zero emissions, now represent USD 130 trillion in total assets.

For corporates across the world, there are some key takeaways from these developments. Foremost among them is that climate goals will keep ratcheting up, and hence present goals and regulations cannot serve as a guide. Instead, corporate plans have to be much more ambitious on decarbonisation goals. Secondly, funding will be available for viable businesses that work on a high decarbonisation bar. Conversely, financing will be a challenge for high carbon initiatives, even if financially viable.

A big takeaway from developments over the year that have culminated at the COP26 is that the mitigation actions will largely devolve to corporates (there is marked reluctance to direct change to individual lifestyles including food or travel habits). However, the future will not be just about climate mitigation. With accelerated heating being a real prospect, focus of corporates has to shift to adaptation. Climate events have already become more frequent and are intensely disrupting operations and supply chains. Black swan events of earlier are now the order of the day, being used as the planning reference.

This new and changing normal on climate mitigation and adaptation for corporates, and the evolving role of the boards is our focus here.

Anish De

Global Sector Head – Power and Utilities, KPMG and **National Head** – Energy, Natural Resources and Chemicals, KPMG in India

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Climate response: falling well short of needs

We are heading towards an unsustainable and uncertain world.

Below 1.5°C
The Paris Agreement Target[1]

1.19°C
Where we are now (2020)[2]

1.8°C-2.4°C
Where we are headed (2100)[3]

The consequences of our (in) actions are causing more harm than ever.

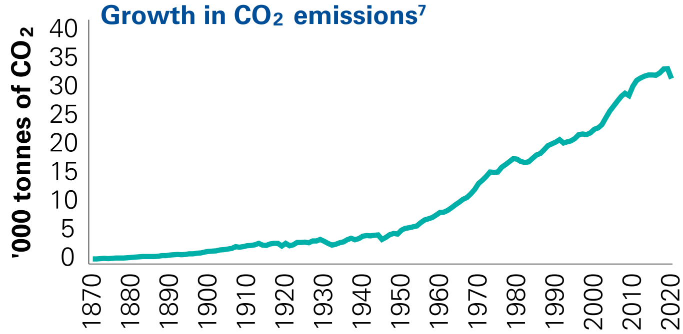
980
No. of catastrophic events in 2020[4]

USD 210 billion
Total losses in 2020[5]

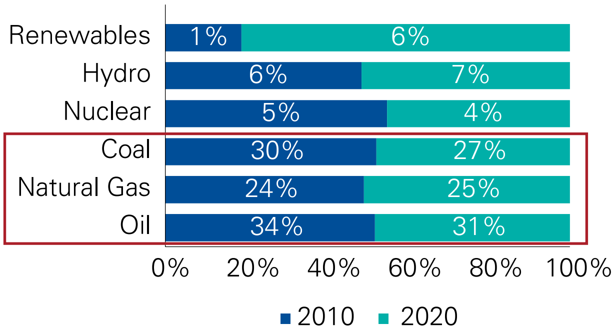
61%
Non - Insured losses[6]

The pace of energy transition has been sluggish, despite commitments from national governments across the globe.

Growth in CO_2 emissions[7]



Primary energy consumption by fuel[8]



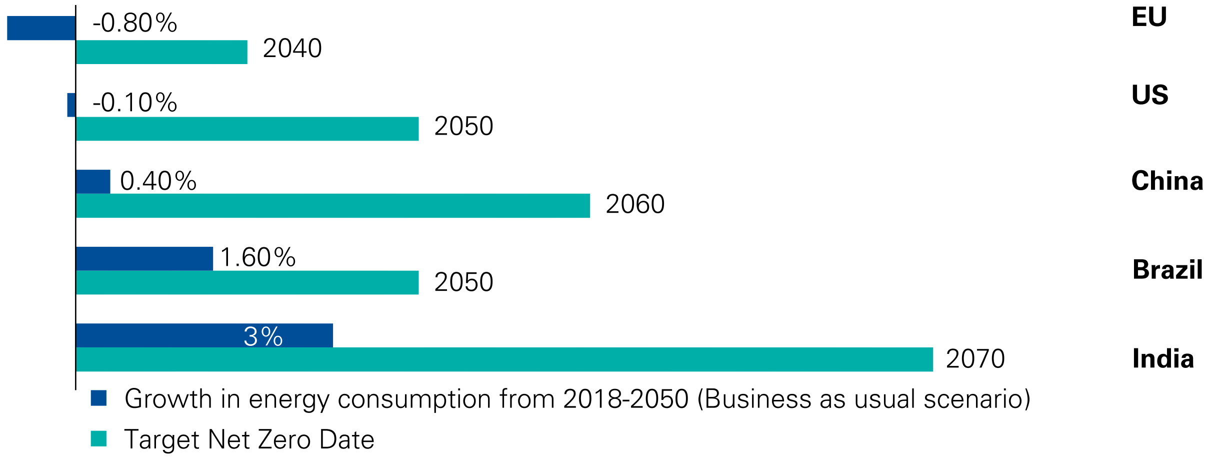
The scale of problem demands complete transformation of energy systems which requires strong action from almost all quarters, especially corporates

The shift towards renewables, although inevitable has been slow thus far.

Globally, investment dynamics in energy sector are changing, and companies need to be better prepared to balance their investments across technology portfolios.

Stepping up on ambitions; actualisation will be key

Net Zero target dates are tied to expected growth in energy consumption across regions[9]



Governments, financing institutions, industry participants are coming together through alliances to collaborate and focus towards taking stronger actions

Finance	Energy transition	Energy access	Green technologies
Glasgow Financial Alliance for Net Zero	Beyond Oil and Gas Alliance	Global Energy Alliance for People and Planet	H2Zero Initiative
Alliance includes 450 financial firms responsible for assets over USD 130 trillion[10]	**Coalition of governments and key stakeholders to take measures towards a managed phase out of Oil and Gas**	**Alliance of philanthropic groups to accelerate scalable and equitable energy transitions in emerging economies**	**Initiative comprises of 28 companies across varied end-use sectors that have pledged to increase production and utilization of low carbon/green hydrogen[11]**

The pathway to achieving 1.5 degrees requires urgent action to halve the current emissions by 2030.

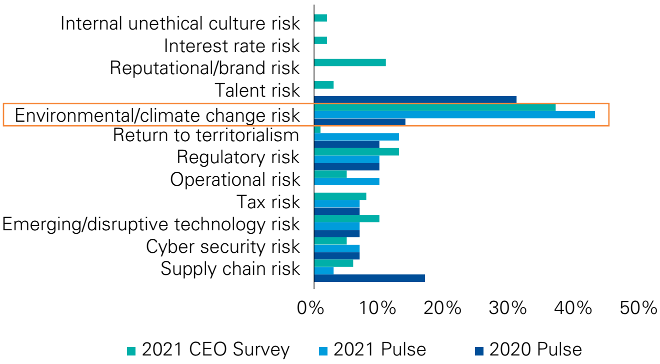
10 takeaways post COP26

1. **The 1.5 degrees goal for containment of global heating is hanging by a thread.** Global temperature prognosis suggests 1.8 -2.4 degrees by the end of this century, unless acted upon further.
2. **The energy transition is one of the keys to succeeding in reaching Net Zero.** 70 per cent of the Greenhouse gases (GHGs) emissions[12] are energy related.
3. **Coal phaseout will accelerate.** Unabated coal emissions will come under massive pressure despite the lack of alternatives for many countries. Growth economies dependent on coal will face huge challenges in making this transition.
4. **Emerging markets are essential for Net Zero.** This is where the future global growth is and these are the economies often dependent on coal and other high carbon resources.
5. **'Loss and damage' will play out as a key dimension.** Even as there is reluctance from developed nations to accept 'loss and damage' obligations, there will be acceleration of financial transfers and support for mitigation and adaptation actions.
6. **Climate goals and the decarbonisation bar will keep ratcheting up** every year as effects of global warming become more visible and pervasive. For corporates, the key will be to aim high to prevent being caught out by changing regulations.
7. **A large part of the mitigation support will be for corporate decarbonisation** (especially in the developing world). Corporates will typically be the main investors in decarbonisation projects, supported by government led programmes and banks/financial institutions.
8. **For corporates, the focus has to move to 'climate proofing' of businesses, and hardening of systems has to increase substantially,** given the limitations of current climate mitigation actions. Overall, climate adaptation actions of governments, society and corporates need acceleration given the current global heating outlook and its likely consequences.
9. **Investments have to take into account long term carbon costs and aspects like Carbon Taxes/Carbon Border Adjustment Mechanism (CBAM).** At COP26, IFRS announced the formation of International Sustainability Standards Board (ISSB) for developing comprehensive sustainability disclosure standards.
10. **Despite challenges and uncertainties there is a very significant opportunity in funding the energy transition.** The capital needs are very large and the convergence of global political and investor priorities because of climate change make this area very prospective, even as risks will require scrutiny.

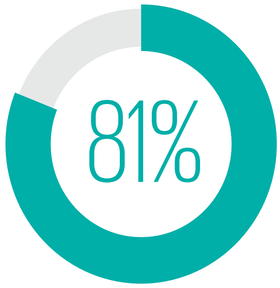
Corporate leadership recognises climate change as the top risk for business

Climate change remains top risk for energy CEOs.[13]

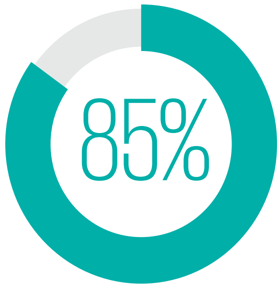
Which of the following risks pose the greatest threat to your organisation's growth over the next 3 years?



The leaders now recognise the opportunity disruption brings.[14]



Rather than waiting to be disrupted by competitors, my organisation is actively disrupting the sector in which we operate

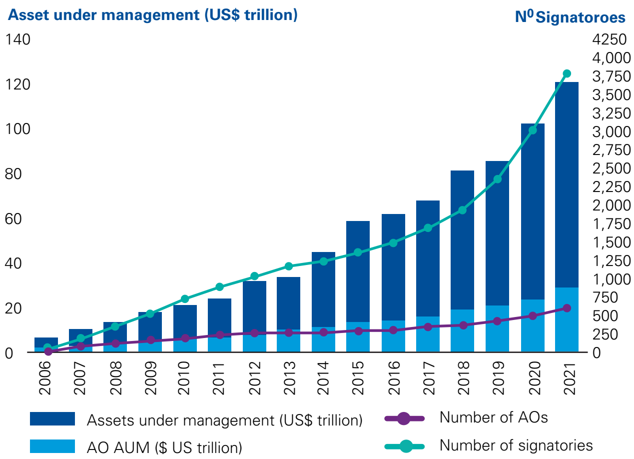


We see technological disruption as more of an opportunity than a threat

Globally, investors are increasingly committing to integrate Environmental, Social and Governance (ESG) aspects into their investment strategy. This is evidenced by growth in signatories for 'Principles for Responsible Investment' (PRI).[15]

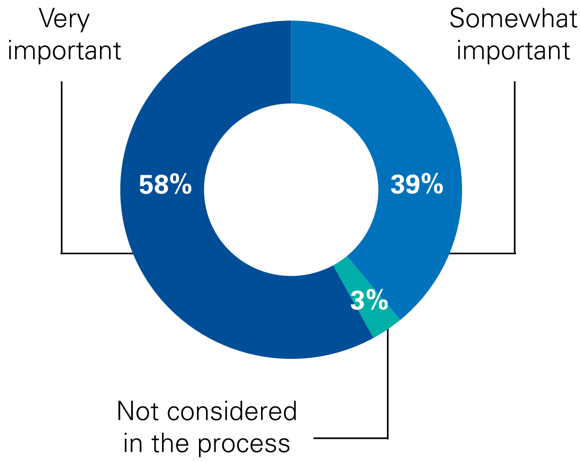
PRI signatory growth in 2020 - 2021

AUM, total number of signatories and number of asset owner signatories all increase



** Total AUM include reported AUM and AUM of signatories provided in sign-up sheet that signed up by end of March of that year.*

Majority of institutional investors consider climate change to be a key factor influencing their investment decision.[16]



Decarbonisation as a global priority - What changes for corporates?

Corporates will likely be the principal delivery agents of decarbonisation. Non-corporate users are less responsive to mandates – however, they respond better to incentives. Corporate leadership must plan respective transitions, as well as protect against the effects of climate change. This will often imply entire transformations of product markets, technology, capability, culture, etc. The ambitions should be large and beyond compliance.

Strategic investment decision should be backed by data driven analysis with a whole system view. Apart from the risk of ratcheting regulation, corporate leadership will be under pressure from investors, employees, communities and consumers to go beyond the mandates and to drive decarbonisation plans to fruition. The boundary between supply and demand side is blurring and corporations have to make the first move to leverage the changing supplier-consumer dynamic to their advantage. Actions have to be urgent, but not a knee-jerk.

Corporations will have to tailor the implementation to suit regional priorities in the near term, even as they focus on a global decarbonisation agenda in the long-term. Long range planning and action, difficult as it is, will be necessary, but coupled with short term agile actions. Organisations should be prepared for short-term ambiguity on the road towards decarbonisation.

Credibility of actions is important rather than announcements. It is important to stay clear of the spectre of 'greenwashing'. This requires goals to be backed by viable action plans, tangible actions and measurement. Setting clear goals backed by the right Key Performance Indicators (KPIs) that meet business and regulatory needs is of great importance.

Technology will be a key enabler in the decarbonisation journey for factual and credible reporting on emissions and other ESG related KPIs. Some of this will be hard. For example, measuring Scope 3 emissions in the extended supply chains is particularly difficult, and yet is very important. Furthermore, corporates need to go beyond reporting and focus on enabling decisions and frontline actions on mitigation and adaptation. This will not be possible without induction of large-scale technology.

The road to implementation will be fraught with uncertainties. Big changes will be required to products, processes, facilities, supply chain and delivery mechanisms. Organisations should focus on empowerment of frontline staff and young professionals as the 'change leaders.' Boards need to drive internal communication more effectively to manage initial resistance.

Regulatory attention

- Is my industry likely to face more direct action from regulators? If so, what could the potential actions be?
- Is my company business plans aligned to the changing needs of the regulators?

Consumer focus

- Are my customers likely to differentiate based on climate responsiveness of my company?
- What is the likely positive and negative impact of such differentiation?

Investor priorities

- How are investors looking at my company in their portfolio?
- Is there a penalty or premium based on my climate responsiveness?

Supplier risks

- Will my suppliers get impacted either directly or indirectly by climate change impact or the regulations?
- What implications it could have on the topline and bottom-line of the company?

New reporting standards are progressively becoming rigorous

In recent years ESG has come to be a central focus for investors and regulators. However, the variations in operating context of the corporations, makes it difficult for investors and other market participants to objectively evaluate and acknowledge the intangible value created by the corporations.

To address this issue and protect the interests of Paris agreement and honour Sustainable Development Goals (SDGs) through performance evaluation, the World Economic Forum (WEF) in association with Bank of America and a leading professional services firm has released a set of ESG metrics which are consistent, standard, comparable, and harmonised across geographies. These metrics will also support in evaluating SDG's performance and associated NDCs. Additionally, on 3 November 2021, IFRS Foundation has formed International Sustainability Standards Board (ISSB), an independent, private-sector body to develop and approve IFRS Sustainability Disclosure Standards (IFRS SDS). The proposed standards would be high in quality, understandable, enforceable, and globally acceptable. These complementary set of standards are intended to support investors and participants of capital markets through provision of transparent, and comparable information for making informed decision. The foundation for the development of standards would be Climate Disclosure Standards Board (CDSB), Task Force on Climate-Related Financial Disclosures (TCFD) recommendations, Value Reporting Foundation Framework and WEF ESG metrics to showcase the importance of interoperability between financial and non-financial reporting.

Adding to these, the IFRS Foundation has also published two publications, Climate-related Disclosures Prototype and its supplement to set the tone and ensure that boards realize the investors' seriousness.

Bringing different perspectives together- Shaping the ISSB and IFRS Sustainability Disclosure Standards[17].

World Economic Forum

WEF: 'A core set of common metrics and disclosure on non-financial factors'

Task Force on climate-related Financial Disclosures — The Financial Stability Board's TCFD contributes 'a framework to help public companies and other organisations disclose climate related risks and opportunities'

Value reporting foundation

Formed by the merger of the SASB and <IR>

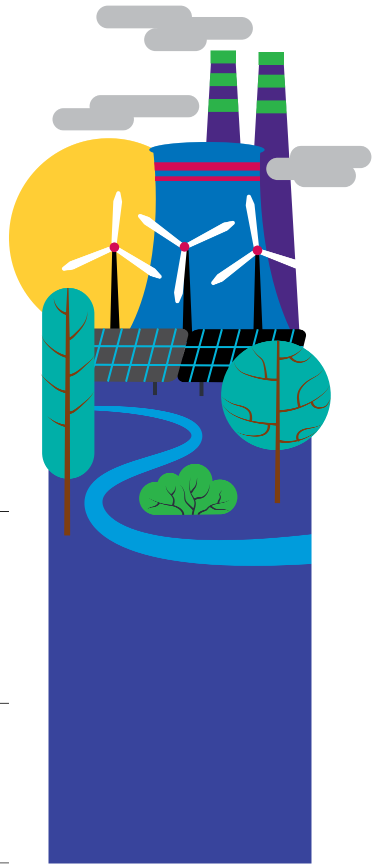
Sustainability Accounting Standards Board — SASB contributes 'a complete set of globally applicable industry standards'

Integrated Reporting Framework — <IR> aim is to 'improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital'

Climate Disclosure Standards Boards — **CDSB** contributes 'climate change related information of value to investors in mainstream financial reports'

IFRS Foundation

International Sustainability Standards Board (ISSB)



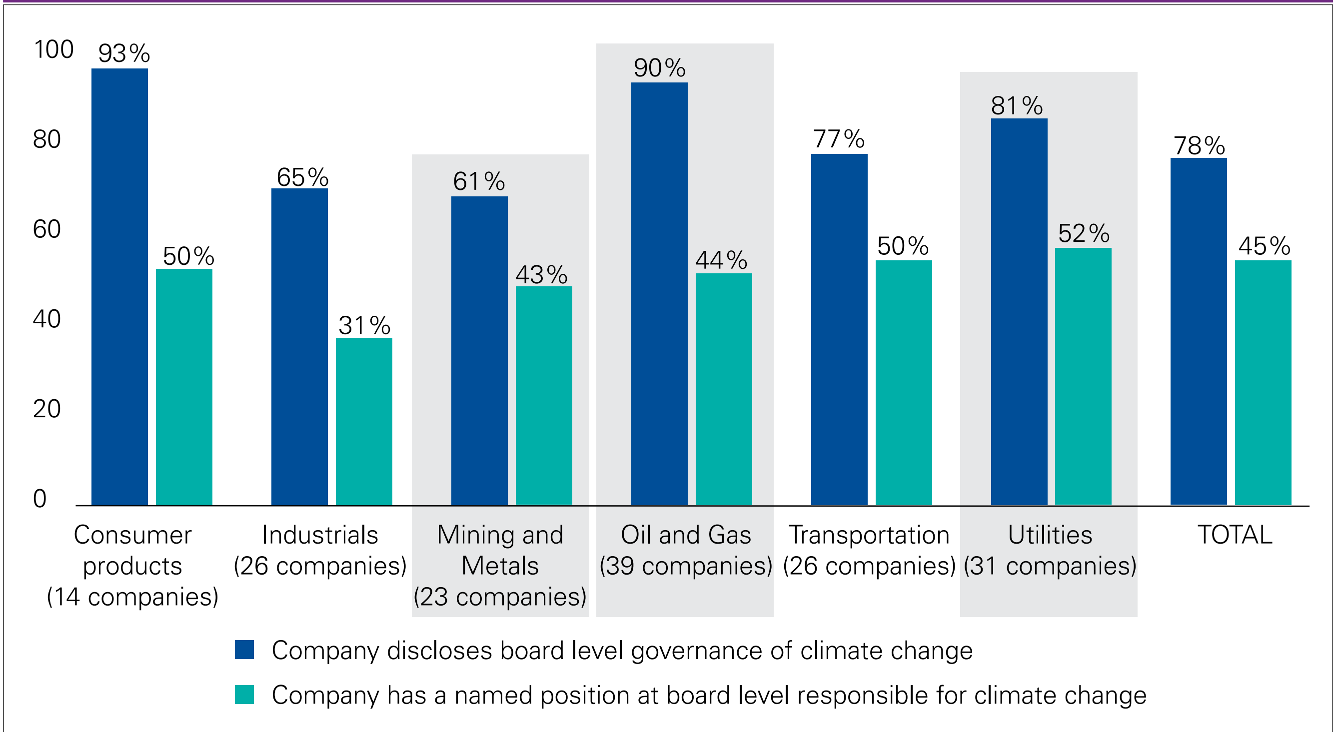
CEOs now increasingly recognise the role they need to play to ensure both total shareholder return and total societal return[18].

"Environmental and social sustainability is the starting point and the premise of our growth" **- Hironori Kamezawa, President & Group CEO, Mitsubishi UFJ Financial Group**

"CEOs are under increasing pressure from stakeholders to deliver on ESG goals and to actively address societal issues. It's crucial in today's landscape that businesses and their leadership teams show real-world examples of their dedication to building back better" **- Jane Lawrie, Global Head of Corporate Affairs, KPMG International**

"As we have talked about our purpose, and galvanised around it, that has raised our ambition level. It's made us more growth oriented. It's helped us innovate even faster" **- Penny Pennington, Managing Partner, Edward Jones**

Corporate boards have initiated measures for driving board level governance for climate change. The adoption of such measures, however, remain low for Energy and Natural Resources (ENR) companies compared to other sectors[19].



Boards as stewards - Why boards should show the way?

For the corporate world, it is time to own up and act on climate change, and **corporate boards carry the principal fiduciary responsibility** for making that change happen. As focus converges on actions that truly help in carbon abatement (as compared to, say, externalizing the emissions), boards have to motivate and assist the executive in setting clear goals, formulate viable strategies and bring in the right levels of governance for their attainment.

This is not just about managing risks. **Climate change related risks are both a threat and opportunity** for long term survival of corporations. Climate change is evolving into a governance issue driven by complex and hard-hitting scientific, social, policy, financial and macro-economic parameters.

Short term value maximization can no longer be seen in isolation as a business objective; **long term profitability as well as sustainability are the keys to survival.** Boards have a major role to play in protecting shareholders and stakeholder interests, considering the probable disruptions and risks in the offing.

Regulatory pressure will ratchet up and boards will be accountable for compliance. The new proposed IFRS Sustainability Disclosure Standards will only increase the linkages and nexus between sustainability and financial reporting. This will increase compliance burden on companies who are not prepared for new climate order.

Boards have to assume a key role in strategy formulation and then in overseeing its effective and agile implementation. This includes driving a culture through the organisation to ensure alignment and enablement. It is a collective fiduciary responsibility, beyond the basics of company's operations, but an integral part of the board's daily imperatives and obligations. It will call for much higher levels of engagement and commitment, and may call for a different framework for board roles in the new reality.

Key Focus Areas	What boards can do?
1. Defining the energy transition roadmap	
Set the energy transition vision for the organisation	• Take ownership of and inculcate a common sense of corporate purpose within the organisation • Link ESG initiatives with strategic levers such as Vision, Mission, Business Plan etc.
Seizing opportunities created by climate change	• Oversee effective management of climate related risks and opportunities • Ensure accountability of climate responsive decisions, many of which may bear returns in the long run.
2. Steer the ESG agenda	
Increased reporting and transparency on ESG issues	• Ensure integrated reporting and disclosure of material climate risks, opportunities and growth drivers through financial filings to all concerned stakeholders- shareholders, regulators and policy makers.
Improve climate competency	• Ensure board includes members with expertise in managing climate change risks for the organisation • Independent assessment on executives' skills related to climate change.
Institute governance mechanism	• Integration of climate considerations into board committees and to track the performance • Define the role played by executive, non-executive and independent directors.
Incentivise executive leadership	• Remuneration structures of the CEO and leadership team linked with KPIs for the achievement of climate strategy and emissions reduction targets • Establish incentives and metrics for attracting, retaining and rewarding diverse talent across the organisation using both financial and non-financial KPIs.
3. Set the tone for cultural transition	
Actively engage with key stakeholders on climate related issues	• Act as stewards to drive engagement with key stakeholder groups including activists, Non-Governmental Organisations (NGOs), investors, academicians, sector experts etc. to stay informed about the climate related risks and opportunities.

How boards should approach the challenge?

Boards have to transform themselves to integrate and embed climate into existing board structures through separate committees or external advisory forums. This will drive regular focus and closer scrutiny of climate related matters.

Boards leadership will involve many dimensions:

- Organisational culture and performance metrics
- Maintaining and enhancing climate competence within the board as well as within the organisation
- Translating commitments into material changes- move beyond tokenism
- Risk and opportunity assessment
- Disclosures and compliance
- Investment planning and technology selection.

Organisations need to do more than what the regulation demands and move beyond compliance. They need to comply with and exceed industry standard for key issues such as sustainability/ESG reporting, disclosures, climate responsive investments etc. Indeed, for true corporate leadership, boards should set the bar high and ensure that the slew of actions that follow adhere to the core principles set by the board. While the details will be many, here are two guardrails that we recommend:

- *Don't Harm: Managing environmental impacts related to own business*
- *Don't be Harmed: Preventing/limiting damage to business because of external environmental impacts.*

Aligned to these two principles, **boards have to set very clear directions to guide thought and action at every level.** To ensure that the guidance is indeed being followed, boards need to find ways to maintain regular dialogue with peers and key stakeholders such as policy makers, regulators, customers, investors, shareholders etc. This will help anticipate future requirements in terms of regulatory obligations, due-diligence, reporting etc.

As decarbonisation accelerates, it is clear that business goals and sustainability goals have become indistinguishable. **Boards have to ensure that sustainability and climate aspects are brought into day-to-day operations** by integrating sustainability and non-financial targets into the existing incentive structure.

Board roles - some questions that need facing

1. What skills would boards need to deal with the climate challenges effectively?
2. Who should be on the boards of the energy organisations?
3. How should boards be structured to effectively steer the energy transition and climate agenda?
4. How should boards evolve a strategic view on the complex and dynamic situation related to climate?
5. What is a 'whole system view'? How can boards take a 'whole system view' in responding to climate change?
6. 'Science based targets' – how would it work in a corporate set-up?
7. What should be the board's role in defining the organisation's energy transition roadmap?
8. How can boards ensure urgent climate actions? How should boards incentivise executives for driving energy transition and climate resilience of the business?
9. How will boards deal with the dichotomy of short-term and long-term preservation with respect to climate actions?
10. How should board's conflicts on climate (including with executive leadership) be resolved?

Specific priorities for boards of energy organisations

The energy sector continues to power the world on the back of fossil fuels. With ~ 70 percent[20] of carbon emissions being attributable—directly or indirectly to the energy sector, there is an enormous amount of pressure on traditional energy organisations to transform rapidly. In the past year, corporate boards have often witnessed turmoil on account of judicial and investor activism. Valuations of global corporations that deliver much of the energy in the world today have taken large hits, especially in 2020. The recent tightening of energy supplies and prices have, however, pointed to the criticality of the energy sector in keeping the world going.

The energy sector cannot be an adversary in fighting climate change; it has to be an ally. Energy delivery networks will remain central to climate response and decarbonisation, be it through Renewables, Electric Vehicles, Green Hydrogen or just to ensure that the lights are on or back up again quickly post a weather event. The sector has to be co-opted in switching rapidly to low carbon delivery systems. This is a challenge because the chain from production, transmission, storage and consumption of low carbon energy tends to be very different from fossil fuel based systems. That challenge has to be acknowledged and met squarely.

Energy companies have to walk a tight rope, simultaneously meeting increasing demand with changing resource portfolios while ensuring affordability. There will be costs and challenges from the pace of the transition and especially the large scale systemic changes that are required. Delivery systems need 'hardening' to minimize the impacts and disruptions from more frequent and intense climate events. These present risks, but as we have previously mentioned, also present opportunity. Irrespective, this remains a key obligation that the energy system has to gear up for.

Boards have to steer the energy organisations in meeting the demands of climate change. This includes taking a strategic view of asset portfolios, ensuring reliability and resilience of delivery systems, etc. Along with providing the necessary steering and governance to corporate actions within energy organisations, ***boards may have to assume an external role in engaging with policy makers, regulators, civil society, and the wider stakeholder community.*** This is not a role they have typically played in the past but, given the nature of the challenges of climate change and the centrality of energy organisations in dealing with them for an orderly and effective energy transformation, this may indeed be the need of the hour.

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