Climate-related scenario analysis

What is scenario analysis?

Climate-related scenario analysis provides a structured way for management to consider how climate-related risks and opportunities could impact their business model and strategy. It can help management to understand the potential implications for business and financial performance over time and identify strategies to be resilient in these different futures and to take advantage of opportunities presented.

Scenarios typically take uncertainty of the future as a given in reviewing risks and opportunities. Scenario analysis is not a form of sensitivity analysis and does not rely on probability.

Scenario analyses are characterised by answering 'what-if' questions and therefore do not aim to forecast or predict (by assessing likelihood). To answer the what-if questions, scenario analyses provide results based on a number of assumptions of a plausible future following a certain pathway.

Typically, the outcome of climate-related scenario analysis will depend to a large extent on regulatory, societal and supplier responses – e.g. assumptions over who bears the cost in a particular scenario. So, scenario analysis would need to consider both the transition and physical impacts but also how different parties respond to those impacts.

Scenario analysis can be qualitative, quantitative or some combination of both. Qualitative scenario analysis explores relationships and trends for which little or no numerical data is available. Quantitative scenario analysis can be used to assess measurable trends and relationships.

Presenting scenario analyses in an annual report

If management is using scenario analysis, it may be useful to present this in its annual report. When presenting scenario analyses, management will need to carefully describe the assumptions and method of preparation so that users are not confused by the scenarios presented. For example, if management is assuming that a majority of the costs of a climate-related measure are borne by consumers, then this would need to be explained.

Scenario analysis can help investors assess the possible exposures on a business in a range of hypothetical circumstances, but will not generally be designed to reflect management's views of the most likely scenarios and hence by their nature may be different from the assumptions underlying the financial statements as required by the applicable accounting framework. Nevertheless, management need to consider if the assumptions underlying the financial statements are in sync as appropriate with the company's strategy and the climate-related matters discussed elsewhere in the annual report.

Example

An energy producer might consider several transition risk scenarios that might reflect a combination of:

- climate-related government actions (e.g. carbon tax);
- economic changes (e.g. the price of electricity generation decreases substantially due to the high level of renewable generation); and
- social changes (e.g. consumers select renewable energy when possible, even if prices are slightly higher).

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