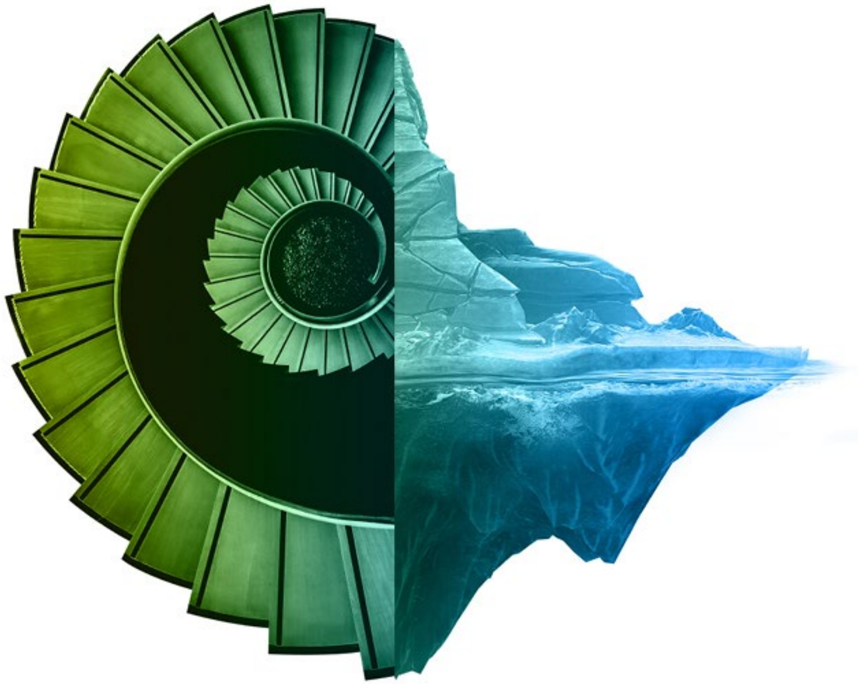

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It is a financial imperative to actively navigate the risks and opportunities that the carbon transition presents. It follows, therefore, that corporate strategy in relation to climate risks and opportunities is no longer appropriately housed solely in Environmental, Social and Governance (ESG) or sustainability function areas: best practice is now to embed climate change into the fabric of corporate governance and treat it as a core financial matter. Indeed, Australian corporate regulators are amongst the most active in the world in promoting climate-related financial disclosures.

Targeting net zero

Climate change is putting governance to the test. **Are Directors asking the right questions?**

Against this background, the impetus is now here for directors to reflect on what climate-related risks and opportunities mean for their fiduciary duties, and to take prudent steps to safeguard their organisations. We believe that a key early step is to update governance frameworks.

Guidance is gradually becoming easier to come by on how to do this, but we believe this is still a bespoke task, informed by:

- macro trends: a panoramic understanding of the forces at play, and the short, medium and long-term scenarios associated with climate change; and
- organisational stress testing: an interrogation of the strengths and vulnerabilities of existing governance frameworks to respond to these macro trends.

This document provides a high-level survey of key macro trends, and sets out a list of questions boards can ask, in order to inform board strategy.

Macro climate trends in Australia putting governance to the test

BENCHMARKING RISK STARTS WITH THE PARIS AGREEMENT

The Paris agreement adopts the goal of limiting the global average temperature increase to well below 2°C, and ideally no more than 1.5°C. It also signals the parties' agreement that global emissions should be reduced to net zero by 2050. While the agreement itself does not directly impose any obligations for businesses in Australia, it does give rise to a plausible future decarbonisation scenario. Scenario planning, and stress testing, against the Paris target is becoming increasingly mainstream in the corporate and financial sectors.

PROJECT APPROVALS UNDER SCRUTINY

Climate change is increasingly a factor in the assessment of planning and environment approvals, particularly in the mining sector. The last year has seen some high-profile project refusals, in which climate change was cited as a relevant factor, and the imposition of some unique climate change conditions on NSW mining projects.

DIRECTORS' DUTIES ENCOMPASS CLIMATE-RELATED RISKS

It is widely acknowledged in Australia that material climate change risks are relevant to a director's duty of care and diligence and the duty to act in the best interests of a company. Similar duties are owed by superannuation trustees and others in fiduciary relationships (eg fund managers).

AN IMPENDING WAVE OF CLIMATE LITIGATION

A wave of climate change litigation is predicted, driven by public frustration with government policy, better resourcing in the public interest sector and increasing physical impacts seen as being caused by climate change.

Litigants are pursuing claims through public law challenges (such as judicial review of project approvals), actions under financial and corporate law, tort law claims and human rights claims.

While much of the litigation has, and will, continue to target governments, a rise in legal action against corporates is also predicted (see, for example, Justice French's comments in the AFR on 5 February 2020).

TRADE WINDS ARE BLOWING

The EU is sending clear signals that it will be looking to make action on climate change a condition of trade, either through the terms of an Australia/EU free trade agreement, or via border tax adjustments.

REGULATORS DEMAND DISCLOSURES

ASIC, ASX and APRA have issued guidance material indicating that corporate disclosures must adequately address climate-related financial risks, and have endorsed the framework set out in the Taskforce on Climate-Related Disclosures (TCFD) Final Report. These regulators have also indicated they will be stepping up surveillance of disclosure practices in relation to climate-related financial risks.

POLICY UNCERTAINTY A MAJOR ISSUE

Directors are concerned Australia's policy settings do not map out a clear pathway to decarbonisation. Directors cite climate change and energy policy as more important policy priorities than tax reform and productivity growth, over both the short and long term (AICD Survey, February 2020). This lack of policy clarity creates uncertainty for companies and their boards. The proposed Technology Investment Roadmap, in its current form, does not substantially reduce this uncertainty.

SHAREHOLDER RESOLUTIONS GARNER MATERIAL SUPPORT

We've seen a sharp increase in shareholder resolutions on climate change at AGMs in Australia. Resolutions are typically driven by advocacy groups Australian Centre for Corporate Responsibility and Market Forces. Although they often fail, some resolutions garner relatively high support (up to 30–40%) and can dominate AGM agendas. In April this year, and for the first time in Australia, a climate-related shareholder resolution received majority support despite opposition from the board.

'BEST PRACTICE' IS SHIFTING RAPIDLY

The benchmark for 'best practice' continues to move. This is driven by climate science becoming clearer and impact data becoming more accessible, along with increasing accuracy in climate modelling and forecasting technology, and internationally recognised disclosure guidelines (including the framework set out in the TCFD Final Report becoming more mainstream.

Testing corporate strategy questions for boards to ask

What are our legal duties in relation to climate change, and what is our strategy to manage compliance?

It is recommended that organisations explore duties widely, because climate-related legal obligations can arise under legislation and common law principles which have no obvious connection to climate change (eg. consumer laws).

Soft law frameworks (rules, principles and guidelines setting out standards of corporate behaviour, which often act as a precursor to hard law) may also be relevant to this assessment. A recent complaint lodged with the Australian OECD National Contact Point by Friends of the Earth against a major Australian bank alleging that it has contravened the OECD Guiding Principles for Multinational Organisations in connection with fossil fuel lending practices, provides an example of how these frameworks might apply in relation to climate change.

Once the spectrum of common law, statutory and 'soft law' duties have been mapped out, boards can work with the management team to develop:

- a compliance framework to ensure that relevant duties in relation to climate change are being fulfilled; and
- a strategy to evidence compliance with these duties.

What are the particular physical and transition risks that may impact our organisation, and how are we managing them? What is the impact on our insurances?

Relevant risks might include, for example, chronic physical effects (eg reduced surface or groundwater availability), acute physical risks (eg bushfires and increased storm severity), asset stranding, technological change, customer sentiments, regulatory risk, litigation risk, reputational risk, transition risk, financial risk, and shareholder activism.

There may be relevant **primary risks**, such as direct physical effects of climate change on assets, as well as **secondary risks**, such as the impacts on export markets. Further discussion on relevant categories of risk, and the scenario analysis approach to assessing risks, is contained in Chapter B of the TCFD Final Report.

We suggest that materiality of risk is also important, as materiality will inform the resources required to respond to the risk.

A related line of inquiry is the predicted impact of physical phenomena on insurance costs (and insurability) as insurers obtain a clearer understanding of the likely physical impacts of climate change.

What are the opportunities in our sector, and what is our strategy to capture these opportunities?

The net zero transition will present opportunities as well as risks. Relevant opportunities will vary from sector to sector but might include, for example:

- market recognition for leadership in climate change mitigation/adaptation;
- income from carrying out carbon abatement projects and selling carbon credits;
- increased energy efficiency and reducing cost of resources;
- stimulating innovation through developing less carbon-intensive products and services;
- more resilient supply chains not reliant on price-volatile fossil fuels;
- leveraging the increasing private and public investment in renewable energy and other low-emissions projects;
- tapping into increased demand for eco-friendly products and infrastructure; and
- access to climate-oriented finance (green bonds).

1 2 3

Testing corporate strategy questions for boards to ask

How are we embedding climate change risk management into our business?

Embedding climate-related risks and opportunities into core business and financial decision-making is not a 'one size fits all' matter, but might include, for example:

- incorporating climate-related risks and opportunities into due diligence frameworks for new investments;
- ensuring that climate-related risks and opportunities are assessed through a financial (in addition to ESG) lens;
- conducting scenario analysis in relation to existing assets, portfolios and strategies, and documenting how corporate decisions respond to scenario analysis; and
- making organisational changes to ensure that core financial and strategy decision-makers are informed about, and give regard to, material climate-related financial risks and opportunities.

4

How do we compare against our industry peers? Where do we want to sit relative to our peers?

Benchmarking performance against industry peers can be a helpful exercise to sense-check company policies and strategies. Being out of step with competitors may increase the risk of becoming a target of public interest litigation.

Organisations increasingly undertake climate-related disclosures in accordance with the TCFD Final Report. These reports, as well as individual climate change statements, policies and strategies, can be helpful sources of information on industry trends. There are also a number of websites which publish lists of companies and their performance, including, for example:

- companies that have signed up to the Science-based Targets Initiative can be viewed here;
- CDP (an environmental not-for-profit) consolidates sustainability data from, and rates the performance of over 8,000 companies based on climate change action and disclosures; and
- As You Sow publishes the Carbon Clean 200 list, which similarly identifies companies excelling on climate action.

5

What are the best practice frameworks for identifying, analysing and disclosing climate risk, and should we adopt them?

The endorsement of the TCFD Final Report by ASX, APRA and ASIC strongly signals that Australian corporate regulators consider it best practice to adopt the TCFD recommendations in relation to climate risk disclosures. In February 2020, the Governance Institute of Australia published a practical guide to reporting on climate-related risks and opportunities.

However, this is a high level blueprint for disclosure and there are likely to be, in each industry, more granular, and more tailored, data sets, analytical techniques, disclosure tools and stress testing frameworks available to support climate risk and opportunity analysis.

We recommend that boards ask subject-matter experts within their business what best practice looks like, and what resources are available to support this practice.

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Testing corporate strategy questions for boards to ask

Are we in step with the expectations of key stakeholders, and if not, what is our strategy to address this misalignment?

Key stakeholders, such as shareholders, financiers, consumers, business partners, employees, insurers and the community, are demanding more of businesses in relation to climate change. Recent trends demonstrate the importance of stakeholder alignment:

- Climate-related shareholder activism is on the rise. Recently, some of the world's largest investors, including AXA, PIMCO and Australian Super have exerted pressure on major companies to take steps to address climate risk. This trend looks set to continue in 2020, with Climate Action 100+, a global investor movement with $50B funds in management predicting a surge in shareholder activism in 2020. Divestment is also a significant issue, with major oil companies now flagging divestment as a material risk in their securities disclosures. In late 2019, the climate divestment movement reached the milestone of $16 trillion in funds moved out of fossil fuel industries.
- As consumers increasingly look to use their buying power to drive climate action, companies are launching new products to appeal to climate conscious consumers.
- Australian insurers are increasingly vocal about the impact of climate change disasters on insurance premiums in the future, and have called on organisations and government to focus on climate resilience planning.
- Employees are also looking to speak out on climate risk. Notably, from late 2019, Amazon's employees have been petitioning and striking, demanding Amazon achieve zero emissions by 2030 and limit trading with significant emitters.

7

Do we have the necessary skills and resources available to tackle this issue?

Climate change issues have typically been addressed within sustainability, HSE and/or ESG teams. Today, it is an issue requiring attention from a multidisciplinary team of experts within the business, including senior commercial, financial, strategy and legal professionals. For example, the Harvard Business Review recently stated the most important person in a company to address climate change is the CFO, noting that 'today, smart organisations are shifting their sustainability responsibilities toward the finance function'.

Taking stock on the mix of capabilities available within the organisation, and whether these ought to be augmented with external consultants or legal advisers, or through recruitment, may be an important step to take.

A related line of inquiry is whether a change in the allocation of capex or opex is justified having regard to the materiality of climate-related risks and opportunities. A number of companies and fund managers have recently made major announcements about step changes in their investment priorities to meet emissions targets.

8

How regularly do we review and refresh our climate change strategies?

Boards are expected to remain informed on up-to-date techniques for translating a complex series of inputs into financial and non-financial risks and opportunities, and to ensure that they are regularly revisiting what constitutes 'best practice'.

It may be advisable to build into governance frameworks a requirement that climate-related governance and disclosure practices come under review regularly (eg annually), to ensure they do not become out of step with the market.

9

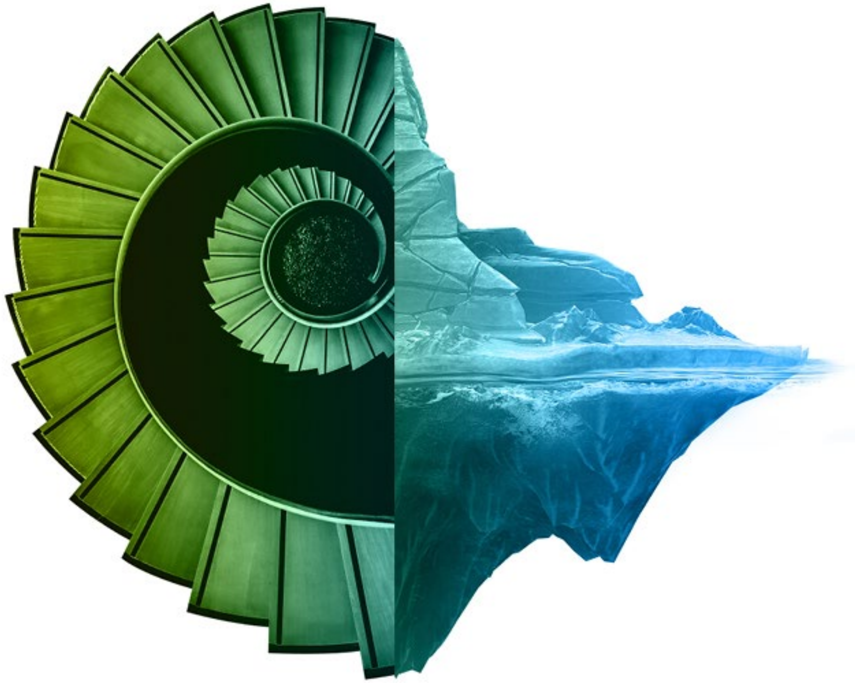
Where to from here?

As climate change risks and opportunities have grasped the attention of company directors, we have increasingly worked on these matters directly with board members in collaboration with senior members of in-house legal teams.

Some actions you may consider over the coming months:

- Surveying the landscape: mapping out the scope of common law and statutory legal duties in relation to climate-related risks;
- Developing or refreshing policies: developing climate change and sustainability policies that reflect best practice, including due diligence policies for investment decision-making;
- Upskilling your board: briefing boards, in-house counsel and managers in relation to evolving risks and opportunities and practical steps they can be taking;
- Assessing whether climate-related market disclosures are triggered, finalising these disclosures and reviewing stakeholder inquiry handling processes;
- Seeking support ahead of AGM season to refresh plans to respond to shareholder resolutions on sustainability issues; and
- Enhancing documentation practices: improving the documentation of internal deliberations in relation to climate-related risks and opportunities.

We would be pleased to discuss how Allens can support the development of your organisation's climate change governance framework and strategy.



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