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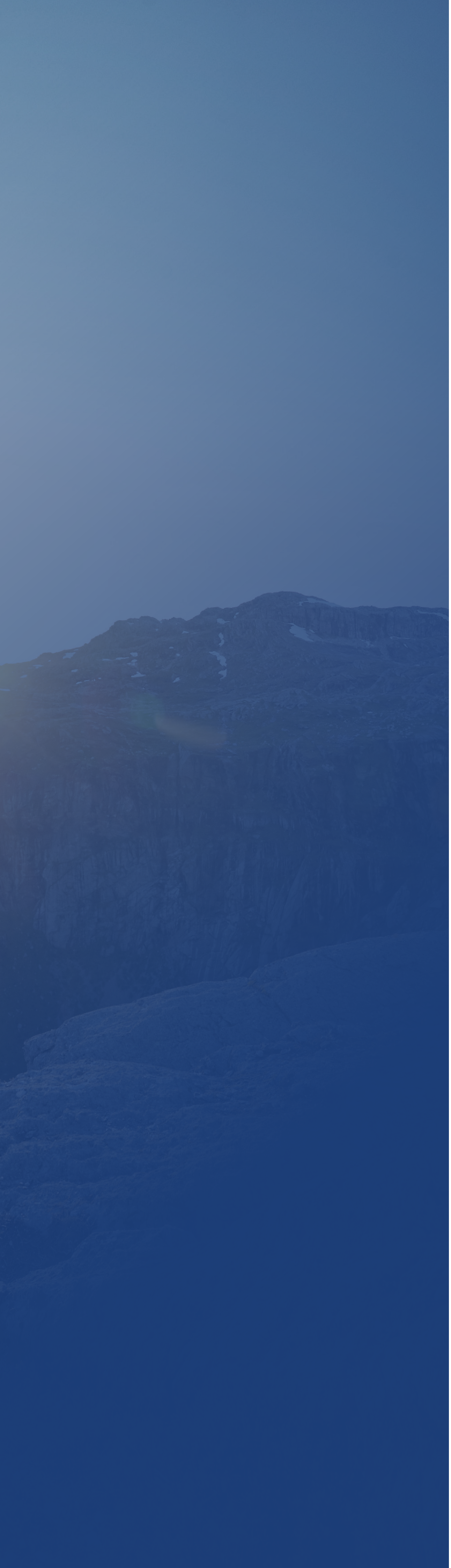
CLIMATE CHANGE: SUCCEED IN A NET-ZERO FUTURE



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The big picture

The risks associated with climate change go way beyond the purely environmental. In this briefing we consider at a high level the political, regulatory and commercial pressures arising from climate change and examine the opportunities and rewards for corporates leading the charge into a net-zero future.

The shift to a net-zero economy is accelerating. Across geographies and sectors, stakeholders are judging corporates by both their contribution to climate change and their efforts to mitigate its effects. Climate change demands are certainly keeping business leaders up at night.

- In a 2021 global survey, KPMG International found that 1,325 CEOs rated environmental/climate change risk as one of the biggest threats to business growth.
- The World Economic Forum found in a survey of 1,000 experts and decision makers in 2021, found that "climate action failure" is the most impactful and second most likely long-term global risk. Climate action failure was also identified as the number one driver of other global risks.

The race is on for corporates to understand their environmental impact and to not only mitigate risk, but convert risk into opportunity.

Evidence for climate change

- Carbon dioxide levels in the air at their highest for 650,000 years: up almost 50% since the industrial revolution[1]
- 2011-2020 was the warmest decade on record contributing to droughts and mass migration[2]
- Global average sea levels have risen 18cm over the past 100 years: causing erosion, flooding and more dangerous hurricanes and typhoons[3]

Risks

Risks relating to climate change are growing for all businesses, not just those in high-emission producing sectors. But corporates can contribute to a thriving and sustainable economy and to their own security, growth and profitability by weighing weigh up the risks, and identifying where they can reduce or negate their greenhouse gas emissions.

Like many environmental and social issues, risks associated with climate change rarely have solutions that are simple or immediate. There is a need for companies to take a nuanced approach to balancing climate risk mitigation measures with other economic, environmental and social impacts, while also meeting regulatory expectations and having regard to profitability and growth. Companies need to find ways of effectively communicating with stakeholders, regulators and communities about how they propose to balance these sometimes competing considerations.

These are some of the risks businesses may have to address in the battle to manage climate change.

Project viability

- Disruption to continuity of supply chains and day-to-day operations
- Ongoing costs associated with carbon laws and taxes
- Setup and ongoing costs associated with setup of lower-carbon business models

Government/legal/taxation

- Increasing legal action against capital projects
- Increased compliance burden from constantly evolving domestic environmental regulation and carbon pricing and related compliance regimes (eg emissions trading)

Obsolescence

- Fossil fuel stranded assets not realising their full value as demand shifts to renewables

Lawsuits

- Increased litigation risk for governments and businesses relating to allegations that climate change and its attendant costs is caused by the actions or inactions of these governments and businesses

Financial

- Access to capital under greater scrutiny as institutional investors and asset managers take account of climate risk in investment and project finance decision making

Protection

- Investors' international treaty protection could be impacted as modern bilateral and multilateral treaties increasingly contemplate environmental conduct
- Insurance refusal is growing particularly for fossil fuel and power companies

Reputational

- Market and reputational risk resulting from consumer or employee backlash, exacerbated by social media and other campaigns

Opportunities

Climate change, for all its negative connotations and risks to businesses, can also bring investment opportunities for those businesses that can quickly and effectively adapt to a net-zero future. According to CDP, climate change 'A List' companies outperformed a reference index by 5.3% per year. It means corporates that futureproof their operations, engage with governments, regulators and NGOs, practice strong governance, integrate climate change risks into their wider risk management activities and measure their impact are putting themselves in a good position to thrive in a net-zero environment.

Mitigation benefits

Project viability

Revenue

Access to capital

Reputation

Longevity/ future proofing

New markets

Innovation

Attraction/ retention of talent

Consumer loyalty

Favourability for investment

Key considerations for 2022

1. **Setting greenhouse gas emissions targets – and delivering on them.**

   This requires detailed factual investigation, and a close understanding of options for reduction or elimination, both those that are available now, and the potential areas that may be available following further technological development or change at an industry/sector level. National targets and associated regulatory regimes may change swiftly but at different levels, and global companies will need to adapt despite this complexity. Companies need to balance the expectations of their stakeholders and communities, with caution not to lean towards over-ambition they may not be able to deliver.

2. **Energy transition**

   The energy sector towers over all others in its importance to achieving net zero by 2050, comprising 76% of the world's human caused greenhouse gas emissions. The International Energy Agency's 'net zero emissions by 2050' scenario in its May 2021 report, assumes that the basis of meeting net zero targets by 2050 relies on the energy sector meeting them too. Globally, we are seeing the energy transition gaining pace, with traditional hydro-carbon companies diversifying their portfolios with renewable energy assets such as offshore wind or solar. This journey has wide ranging implications for the various established market participants as well as incumbents of the global energy sector, including increased opportunities for companies which actively consider their potential to decarbonise.

3. **Climate as only one aspect of the environment**

   It is clear that climate change impacts interact with, and may exacerbate, other environmental impacts and issues. Globally, we are seeing an increasing focus on transition to a more circular economy, a focus on curtailing loss of biodiversity, and continued exploration of clean air and water including by reference to human rights. The risks associated with environmental degradation are similar to the risks arising from climate change. Companies are right to be paying attention to, and investing in, their response to climate change. We see increased opportunities for companies that enhance their efforts by having regard to their broader environmental impacts as well.

2
The current regulatory environment

Climate change-related regulation is vast, with businesses and consumers facing looming shifts in regulation as states strive to decarbonise their economies as the damage caused by climate change becomes clear. According to LSE to date, there were more than 2000 different laws and policies relating to climate change across 200 countries.

However, climate change laws lack uniformity. This is due to the unique effects of climate change on different geographies, and political will, influenced by voters and pressure groups in each country. Despite variations in national climate change policies, it is increasingly evident that companies of all types come under greater scrutiny globally. For businesses, the challenge is in navigating regulations and keeping on top of change.

One of the central themes of climate change regulation concerns climate-related (and more wide reaching ESG) disclosure obligations which drive to increase transparency in the business word. In particular, the Task Force on Climate-related Financial Disclosures (**TCFD**) recommendations and recommended disclosures which were endorsed by the G7 in the summer of 2021, have experienced a shift from being a voluntary framework, to compliance becoming mandatory in some jurisdictions such as the New Zealand, the UK and Switzerland. Other countries are considering uptake of the TCFD framework or other climate-disclosure mechanism. Therefore, it is without a question that corporates will face a continuous increase of disclosure obligations directed at virtually all sectors. Other noteworthy developments in this space include the EU's proposed Corporate Sustainability Reporting Directive (**CSRD**) which is envisaged to expand and replace the existing Non-financial Reporting Directive Framework (**NFRD**), which was already aligned with the TCFD framework.

Increasingly, countries are enshrining their climate pledges in national law. The EU recently passed the EU Climate Law, which implemented a legally binding EU Net Zero target and a 55% emission reduction target for 2030. Perhaps of more importance however, are the follow-on regulatory changes which are necessary to translate these pledges into the existing regulatory landscape. In the EU, this would be the 'Fit for 55 Package' which increases the EU's climate ambitions in line with its new targets through existing regulatory instruments, and by way of new instruments such as the proposed EU Carbon Boarder Adjustment Mechanism (CBAM) – a defacto carbon tax on certain products imported to the EU Single Market.

A wide range of businesses and industries will be affected by the ever-changing regulatory landscape, whether this be through enhanced climate-related disclosure obligations becoming mandatory, carbon taxes increasing or becoming more expansive in the activities they cover, or emission trading scheme allowances continuing to expand and evolve. Already over 60 countries, cities, states and provinces have implemented or are planning to implement carbon pricing schemes, with a fairly balanced distribution between emissions trading systems (such as the EU ETS) and carbon taxes.

3

Climate change-related litigation

Over the past years both companies and governments have been facing a rapid increase in climate change-related litigation. While cases in the US have a predominant focus on claims against companies, in Europe the majority of actions are brought against governments. In the Asia-Pacific region there is a mix of types of claim. Globally, financing, contracts, human rights, and adequate disclosures as well as government action or inaction are all under scrutiny.

However, while certain trends are developing, these actions are brought in various jurisdictions may have very different outcomes – as many decisions are very specific to the national law of the country.

Claims against companies

Climate change actions brought against companies continues to be a significant feature of climate litigation in the US under various traditional and more novel legal theories such as public nuisance, examples can also be found elsewhere as well. One prominent example can be seen in Milieudefensie et al. v. Royal Dutch Shell plc – which has been subject to a judgment by a Dutch court, on the grounds that the greenhouse gas emissions associated with the business, climate change and resulting harm from climate change deprives Dutch citizens of their basic human rights, and therefore compels Shell to increase the speed of its net emissions reductions.

Companies are also grappling with increased complexity in obtaining project approvals, arising both from third party challenges and also from increased regulator focus on regulation and reduction of emissions, and climate change impacts.

Claims against governments

There is a growing trend in the number of cases being brought against governments for failing to adhere to their national and international commitments. In particular, climate change considerations are starting to feature more frequently in investment treaties, as investors attempt to enforce state compliance with climate commitments. The most notable decision was by the Dutch Supreme Court which found the Dutch government to have breached its human rights obligations towards its citizens. While these decisions don't affect corporations directly, any related increase in regulatory or legislative activity, and ambition, will result in increased requirements being placed on companies.

Claims against directors

Directors who fail to consider and address climate change risks may be held personally liable for breaching their duty of care. This may arise where companies make allegedly false disclosures about their contribution to climate change, or where they fail to comply with regulatory requirements on reporting and emissions.

Claims against investors and funds

Banks, institutional investors, asset managers, insurers and other capital market players are under pressure, both from shareholders and regulators, to ensure that funds are invested securely, and that finance and insurance flows to those businesses committed to a lower-carbon future. A financial institution which invests in a project that adversely impacts the climate could face legal action alongside the offending client. Additionally, immediate business risks are already present relating to the mortgages and insurance on homes and businesses susceptible to flooding and investments in countries impacted by extreme weather events. ESG-related investment practices, including concerns over potential "greenwashing", have become a priority of securities regulators and focal point of claimants as well.

Climate change and arbitration

National courts, rather than arbitration, remain the forum of choice for disputes aimed at mandating or changing climate-related policy. A central reason for this is the publicity associated with national court proceedings, which is viewed as an effective tool in galvanising public support for environment-related issues. This is in contrast with the private and contractual nature of international commercial arbitration. Nevertheless, international arbitration stands to be a significant forum for climate change disputes.

4

Climate change risk management

Five steps towards better climate change risk management

Corporates are finding ways to future-proof their businesses in preparation for a net-zero world. Irrespective of your sector, it is essential to understand how climate change affects your business (and those businesses in which you invest) from a commercial, regulatory and reputational perspective.

Step 1: Stay on top of key developments

Companies should be part of the ongoing climate change dialogue; they need to ensure that their business models are viable for the transition to a net-zero world and that they are equipped to take advantage of opportunities. Rather than simply reacting, companies should participate actively in the development of solutions and keep on top of new developments.

Step 2: Focus on compliance

As scrutiny increases, disclosure is becoming critical in order to demonstrate compliance and avoid litigation. Understanding your organisation's contribution to climate change is important, as is documenting and presenting this information. In countries where regulators enforce general environmental laws in relation to climate change impacts, businesses will need to manage climate risk and document their compliance, to minimise the potential for prosecution or other enforcement.

Step 3: Take a globally coordinated approach to climate change mitigation and an agile mind set

Many global companies find it challenging to take a consistent approach to climate change, both operationally and in reporting, in light of the different regulatory regimes in each jurisdiction. However, developing a coordinated global approach can enhance ability to adapt swiftly to regulatory change, economic circumstances and competitive activity.

Step 4: Treat climate change like any other major risk

Embed climate change into the wider business strategy to focus the corporate mind on addressing and maintaining strong governance over climate-related activities. Responsibility for climate change risk must be clearly allocated and risk appetite agreed and reviewed. Companies should review their contracts to ensure alignment with the company's climate commitments and disclosure obligations. In addition, companies must continue to identify, measure, monitor and report financial risk arising from climate change, developing appropriate tools and metrics and running risk scenarios.

Step 5: Embrace the opportunities from climate change

It is easy to think of climate change as creating problems rather than opportunities. There are, however, significant opportunities for corporates that are committed to tackling the effects of climate change and which are compliant and transparent in their commercial activities.

By adhering to higher standards, with transparent disclosures, businesses will have greater access to finance to drive innovation. Increased public disclosure of climate change risks and insurance-based solutions can further support investment into critical infrastructure. A low-carbon future won't happen overnight, but traditional companies and funds have a vital role to play in the transition, helping governments meet ambitious clean targets while maintaining economic growth.

Climate change action plan

Risk/opportunity	Key question	Your next steps
Business risk/ opportunity	Are your operations and supply chain future-proofed to thrive in an era of climate change, including appropriate provisions in your contracts? Does your governance structure support key decision makers to obtain and consider all the relevant information to make timely decisions in this complex and fast-evolving area?	
Stranded assets	Have you calculated the future value of all assets and projects, factoring in potential challenges to their viability?	
Access to capital	Do you have a sustainable financing strategy that meets current and future demands on sustainable practices – such as the Equator Principles?	
Access to investor protection	Can you reassure investors that your business is likely to meet current and future challenges, like stakeholder activism, litigation and trade treaty requirements?	
Insurance refusal	Will all your businesses be able to acquire necessary insurance – if not, what steps can you take to protect your investment?	
Transition risk	Do you have a net-zero transition plan?	
Market/ reputational risk/ opportunity	Are you engaging with communities, NGOs and the media to practice sustainable development and maintain your social licence to operate?	
Disclosures	Are you reporting on your activities in line with the climate-related disclosure of the jurisdictions your business operates in?	
Compliance/ enforcement risk	Are you keeping on top of emerging regulations worldwide and factoring these into your strategy?	

Endnotes

1. https://www.weforum.org/agenda/2021/03/met-office-atmospheric-co2-industrial-levels-environment-climate-change/ – 25 October 2021
2. https://public.wmo.int/en/media/press-release/2020-track-be-one-of-three-warmest-years-record – 25 October 2021
3. https://sealevel.nasa.gov/faq/13/how-long-have-sea-levels-been-rising-how-does-recent-sea-level-rise-compare-to-that-over-the-previous/#:~:text=Over%20the%20past%20100%20years,about%206%20to%208%20inches – 25 October 2021

HSF Climate Change Contacts

To find out more contact your local expert listed below or visit www.hsf.com/climatechange for further information on our services.

How we can help

We can help you to take control and thrive in this increasingly complex landscape. Taking a holistic approach, we combine our in-depth knowledge of global political and regulatory agendas and trends, international and national laws, and sector expertise to advise on risk mitigation strategies. We also counsel and defend clients in litigation and in contentious and non-contentious regulatory proceedings.

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