Coffee Break Briefing

Taskforce for Climate-related Financial Disclosure
SCENARIO ANALYSIS

IMS CBB #4

Level of prior knowledge of subject recommended

Our Coffee Break Briefing series are designed to provide clients with some quick guidance on key sustainability topics.

These briefings are supported by our detailed, 32-page, Sustainability Handbook available on request: info@imsplc.com

Instant Expert

(read this bit while your coffee is brewing)

What is TCFD?

The Task Force for Climate Related Financial Disclosure (TCFD) is an organisation set up by the Financial Services Board (FSB) to encourage voluntary reporting on the risks and opportunities that may arise as a result of climate change. The view by leading investors and asset managers is that assets, projected revenues and other financial data may be overstated or understated as the data does not currently take climate-related risks and opportunities into account.

How does scenario analysis fit in to TCFD?

n order to think about how climate-related risks and opportunities may impact an organisation's future and value, the TCFD recommends that companies consider where these could be material in the future and carry out climate "scenario analysis" to look at how the organisation may be impacted under a variety of potential climate futures. A scenario, for example, which limits global warming to 1.5 degrees by 2100 is likely to result in a lot of political and regulatory changes which limit the use of fossil fuels, or increase the costs of carbon. Conversely, in a scenario where we do nothing to halt global warming and temperatures increase to 4 degrees above pre-industrial levels by 2100, it is extremely likely that there will be increased meteorological events such as wild fires, storms and sea level rise.

> **"Changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset"**
>
> Ex-Governor of the Bank of England, Mark Carney

What are the benefits of scenario analysis?

Climate-related risks and opportunities will impact businesses in different ways. Using climate models to understand the expected physical climate changes in a particular location, or legislative changes in a particular jurisdiction can help organisations to model how those changes may impact upon the business and to consider whether their strategies are resilient enough to adjust to an uncertain future.

How should I use this paper?

The purpose of this Coffee Break Briefing is to provide a short paper to facilitate your TCFD discussions, highlighting key points but eliminating the detail. It is part of a three-part series on TCFD produced by IMS consulting.

The White Paper can be used to dig deeper in exactly how to respond to scenario analysis and the IMS Case Studies paper delves into TCFD reporting produced by specific companies to show how other organisations are responding to the recommendations.

Please find below the links to this series:

1 COFFEE BREAK BRIEFING

2 WHITE PAPER

3 CASE STUDIES

Short Summary

(hopefully, your coffee will still be hot at the end)

In our view, TCFD climate related reporting is likely to become a reporting requirement in the UK, France and the EU, certainly for some sectors and organisations.

Why is TCFD so important?

The TCFD is gaining traction as a climate related reporting tool. 340 investors with nearly $34 trillion in assets under management are asking companies to report under the recommendations and influential asset managers such as BlackRock are asking the companies they engage with on behalf of clients to report in line with TCFD recommendations. 29% of DOW 30 companies adopted TCFD guidelines in 2019 and as at 31 March 2019 39% of FTSE100 companies had mentioned TCFD in their reporting. The IMS view is that climate-related considerations will become embedded within business strategy going forward.

What are the recommendations?

The TCFD outlines eleven recommendations for reporting, split into the four key areas, as outlined below (extracted from the TCFD's 2019 Status Report). We have found from discussing TCFD with our clients, that identifying the risks and opportunities and considering a variety of scenarios is where most organisations tend to struggle – i.e. the strategy section of the recommended disclosures.

RECOMMENDATIONS AND SUPPORTING RECOMMENDED DISCLOSURES

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.	a) Describe the organization's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	b) Describe the organization's processes for managing climate-related risks.	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
	c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

Dive into Detail

(you may want a croissant for this bit – or maybe a biscuit...)

That's a good background, but how do I actually go about reporting under TCFD?

The first step is to ensure that you have Board level engagement, without this it is unlikely that you will get where you need to be. Once this is in place, you can set about considering what climate-related risks and opportunities may be material to your organisation and then look at how these risks and opportunities change under a variety of scenarios.

How do I identify risks and opportunities?

It is likely you will have already considered climate-related risks and opportunities as part of your business thinking, however more detail will likely be required for TCFD reporting.

Risks and opportunities can be physical risks which arise from changes in weather, temperature or sea level rise, or transitional risks which arise from changes in policy, legislation, reputation or market and technology.

You should focus on the risks and opportunities that may become material for your business as this is what will be important for stakeholders.

RISKS AND OPPORTUNITIES

Climate-related risks can be divided between:

Physical risks such as increased wildfires, tropical storms or chronic changes in temperature and sea level; and

Transitional risks which arise from potential changes in policy and legislation, technology, or markets and technology. A summary of the typical categories of climate-related risks and opportunities an organisation should consider when applying scenario analysis can be found below, extracted from the TCFD Technical Supplement on the Use of Scenario Analysis.

MARKETS AND TECHNOLOGY SHIFTS

Policies and investments to deliver a low carbon emissions economy.

- Reduced market demand for higher carbon products/commodities
- Increased demand for energy-efficient, lower-carbon products and services
- New technologies disrupt markets

REPUTATION

Growing expectations for responsible conduct from stakeholders, including investors, lenders, and consumers.

- Opportunity to enhance reputation and brand value
- Loss of trust and confidence in management

POLICY AND LEGAL

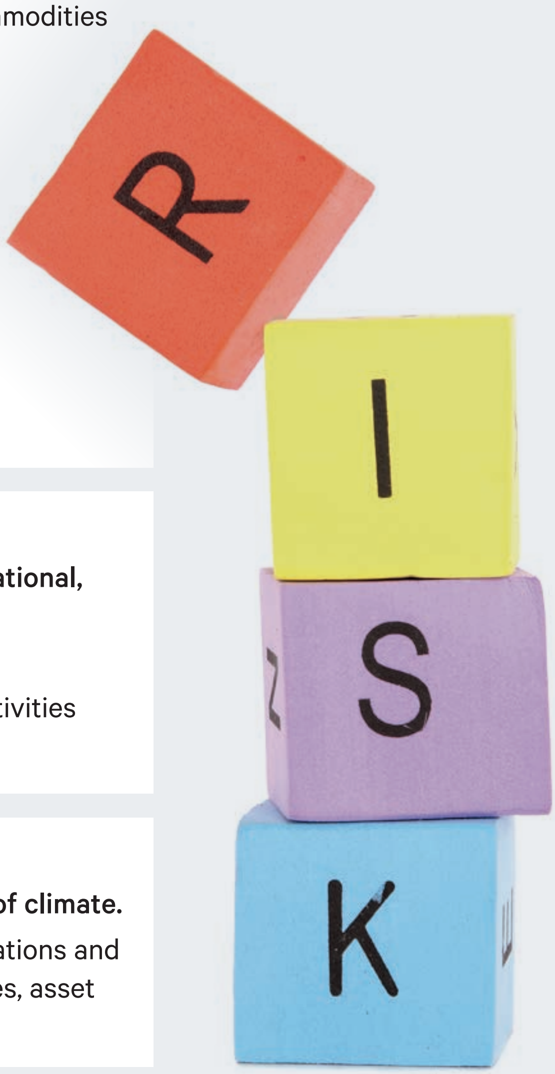
An evolving patchwork of requirements at international, national, and state level.

- Increased input/operating costs for high carbon activities
- Threats to securing license to operate for high carbon activities
- Emerging concern about liabilities

PHYSICAL RISKS

Chronic changes and more frequent and severe extremes of climate.

- Increased business interruption and damage across operations and supply chains with consequences for input costs, revenues, asset values, and insurance claims



Top Tip

When thinking about the risks and opportunities it is important to consider whether they have the potential to be material in the future as this is where disclosures are recommended under TCFD. The definition of materiality as set out in IAS 1 is a useful starting point:

“items are material if they could individually or collectively, influence the economic decisions that users make on the basis of the financial statements”

What about scenario analysis?

Scenario analysis, as applicable to climate change, is looking at how the world may change under a variety of different potential futures and considering what this may mean for an organisation. The risks and opportunities you will have identified will be more likely or less likely, and will have more or less of an impact under a range of different scenarios.

Where climate change is limited to 2 degrees or lower by 2100 it is likely that there will be a lot of regulatory changes and the cost of carbon will increase (i.e. there will be more transitional changes). Where climate change is not limited and results in a 3-4 degree increase by 2100 it is likely that there will be more dramatic meteorological events and sea levels will rise (i.e. there will be more physical changes).

Many organisations will select a 2 degree or lower scenario (as recommended by TCFD) and one or two others, usually including a business as usual scenario (i.e. where climate change is not limited). You may want to start your TCFD journey with a 2 degree scenario and work toward additional scenarios as your TCFD reporting expertise develops.

According to the TCFD's Technical Supplement on the Use of Scenario Analysis, Scenarios should be

Plausible (i.e. possible and credible)
Distinctive (i.e. clearly differentiated and not variations on a theme)
Consistent (i.e. should not overturn evidence of current trends and positions)
Relevant (i.e. should contribute specific insights)
Challenging (i.e. should explore alternate future events)

Where do I find the information to know what is expected to happen under different scenarios?

Organisations such as the IEA and IPCC have looked at the global implications of various climate scenarios and provide models which include projected information about expected changes. Some focus on how policy and regulation may change under transitional scenarios and some focus on the physical impacts of climate change.

Whilst there has been criticism that these models and the data provided within them may lack the granular data required for business analytics, they can be a useful starting point on which to develop your modelling. You may also wish to develop in-house modelling capabilities, depending on your capacity and expertise. Whichever scenario you apply it is important to outline the time horizons which you have considered and that you set out the parameters and assumptions applied so that investors and other stakeholders can clearly see how scenario analysis has been applied.

There is a huge number of climate scenarios that can provide data for your analysis

- IEA 2DS
- IEA 450
- IEA B2DS
- IEA SDS
- Deep Decarbonization Pathways Project
- Greenpeace Advanced Energy [R]evolution
- IRENA Remap
- RCP 2.6
- RCP 4.5
- RCP 6.0
- RCP 8.5

How will my scenario analysis develop over time?

TCFD reporting is a journey which is expected to increase in complexity over time as your organisation develops the skillset to report on climate related risks and opportunities and also as TCFD guidance is refined. You may wish to start with a limited number of scenarios and variables and focus on a qualitative analysis before working toward a more complex quantitative form of scenario analysis that provides comment on the financial implications of various scenarios. There is an expectation from the TCFD that companies who already have significant experience of scenario analysis will move straight to a quantitative analysis.

What will the impact be on your revenues, expenditures, assets and liabilities and capital and financing?

QUANTITATIVE → TIME → QUALITATIVE

And what about describing our strategy's resilience?

Once you have considered the risks and opportunities that affect your organisation under a range of scenarios, it is necessary to consider whether your organisation's strategy is flexible enough to adapt to them.

If there are gaps in resilience it is important to outline how your organisation will address these. This gives comfort to stakeholders that climate-change considerations are built into business thinking.

That's a lot of information!

Feeling overwhelmed? Don't worry, that's normal. The best thing to do is to make a start. If you look at our case study paper you will see that some companies make a start by looking at some risks and opportunities that they think may be material but have not quite got to scenario analysis just yet. Whilst TCFD is likely to become the next big thing in environmental reporting, you can start now by building climate-related thinking into your governance structure and start to think critically about how climate change may impact upon your business. A gap analysis is a useful roadmap to navigate toward full disclosure.

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