Investor Briefing

Complaints filed against SOCO International PLC and Cairn Energy PLC

ClientEarth has submitted regulatory complaints to the FRC alleging that two oil and gas companies have failed to disclose climate-related risks to investors

ClientEarth has requested intervention by the Financial Reporting Council (**FRC**) in relation to what we say is inadequate disclosure in company annual reports of climate-related risks.

The complaints were made against SOCO International PLC (**SOCO**) and Cairn Energy PLC (**Cairn**), both upstream oil and gas exploration companies listed on the Main Market of the London Stock Exchange.

Other than the mandatory disclosure of greenhouse gas emissions for which each company is responsible:

- SOCO makes no mention of climate-related risks facing the company and does not even mention the term *climate change* (or anything similar); and
- Cairn identifies climate change (as opposed to climate related risk) as an issue in its corporate responsibility materiality matrix, but does not adequately disclose the relevance of climate related risk to its business model and strategy..

This briefing outlines:

- the legal requirements for reporting climate-related risks;
- the content of the complaints made against each company;
- the companies' public responses to date; and
- the reasons why the FRC must properly oversee reporting of climate-related risks for the benefit of investors.

This briefing also suggests questions that investors could ask the FRC about its oversight of corporate climate risk disclosures.

Investors support improved climate risk disclosures

Investors are increasingly requesting additional disclosures of climate-related risks. Initiatives include:

- supporting shareholder resolutions at BP, Shell, Glencore, Anglo American and Rio Tinto;
- backing CDP's enhanced information request (822 investors with over USD95 trillion); and
- joining investor coalitions relating to climate change issues and engaging with companies and sectors (IIGCC, Montreal Carbon Pledge etc.).

Investors are demanding more regulatory oversight

In August 2016, 130 investors with more than USD13 trillion in combined assets under management, recommended that G20 leaders 'prioritise rulemaking by national financial regulators to require disclosure of material climate risks.'[1]

This comes at a time of increasing regulatory scrutiny in various jurisdictions of corporate climate risk disclosures illustrated by:

- the Financial Stability Board establishing a Task Force on Climate-related Financial Disclosures;
- the New York Attorney General's 2015 settlement with Peabody Energy Corporation now requiring improved climate change disclosures after a two year investigation into the company; and

[1] http://investorsonclimatechange.org/wp-content/uploads/2016/08/FinalWebInvestorG20Letter24Aug1223pm.pdf

- the New York Attorney General's (and others) current investigation of Exxon Mobil for potentially misleading investors about climate risks to the company.

The complaints in respect of SOCO and Cairn are the first submitted to a UK regulator in respect of specific failures to report climate-related risks.

Accordingly they represent an opportunity for the FRC to demonstrate a robust approach to ensuring adequate corporate climate-related risk disclosures.

Climate-related risks

Climate change poses clear and material risks to oil and gas exploration and development companies. These include:

- *transition risks* (i.e. the business and financial risks arising from the transition of the world economy to a lower carbon intensity over the coming years); and
- *physical risks* (i.e. the risk of the physical impacts of climate change – extreme weather, sea level rise, water scarcity etc. – damaging the economic value in the business).

These climate-related risks could expose oil and gas companies to increased operating costs, increased capital costs, the potential for stranded assets (e.g. exploration licences, oil and gas reserves or resources or infrastructure required to develop them), reputational damage and/or reduced market valuation.

As financial risks to the business, physical risks and transition risks must be disclosed so that investors can adequately factor these considerations into investment decisions.

Expected standard of reporting

The annual report should be fair, balanced and understandable and provide the information investors need to assess the position and performance, business model and strategy of a company. The annual report is not a marketing tool – the information contained should paint a picture of the company which balances the good with the bad.

By failing to report on climate-related risks, we consider that the annual reports of both SOCO and Cairn fail to provide:

- a *fair review of the company's business*[2] and a proper account of the *main trends and factors likely to affect the future development, performance and position of the company's business*[3]; and/or
- a proper description of the *principal risks and uncertainties facing the company.*[4]

We argue that these reporting failures prevent shareholders from assessing how the directors have performed their duty to promote the success of the company.[5]

Cairn's reporting

Cairn's annual report makes only two brief statements about climate change which both refer to the Paris Agreement and emissions management and controls becoming increasingly important to any future production.

It is impossible to discern from its annual report how important Cairn's directors consider climate-related risks to be from these limited disclosures, or what the impact of these risks will be on the company's operations and strategy. However, Cairn's CDP response shows its directors are monitoring these risks and that their thinking is much more developed than the annual report would suggest. Its CDP response states that the directors consider many of the risks from climate change to be 'likely', 'highly likely' and 'virtually certain' and the magnitude of impact of many of those risks to be 'medium' and 'high'.

More specifically, the statements in the annual report:

- imply the Paris Agreement is the first relevant development in climate change policy and legislation, which it is not;
- only relate to one component of climate risk (regulatory risk) and make no reference to the other physical and

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[2] S414C(2)(a) Companies Act 2006
[3] S414C(7)(a) Companies Act 2006
[4] S414C(2)(b) Companies Act 2006
[5] S172 Companies Act 2006

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transition risks identified in Cairn's CDP response; and
- imply any impact will be limited to operational emissions and do not refer to the implications for demand for Cairn's products.

Both statements appear in the corporate responsibility section of the annual report. Cairn's response to ClientEarth's complaint states: 'We continually identify corporate responsibility priorities and our 2015 annual report featured climate change in the comprehensive materiality matrix.'[6]

As a material financial risk to the business, we have submitted to the regulator that climate risk should be disclosed in the core business information and risks sections of the annual report.

SOCO's reporting

Other than the mandatory disclosure of greenhouse gas emissions for which the company is responsible, SOCO's annual report does not mention the term *climate change* (or anything similar). The annual report makes no reference at all to the company facing any risks associated with climate change.

In response to ClientEarth's complaint, SOCO told the Financial Times that its board had decided that, in keeping with its sector peers, it would not include climate change as 'a separate risk among the principal risks to the company's strategy in 2015.'[7]

We believe that this is an unsatisfactory response which does not conform to the current legal requirements.

The information that must be disclosed is judged in terms of its materiality to the business or its shareholders rather than the activities of peer companies. Company directors must exercise reasonable care, skill and diligence in their role and this requires directors to proactively identify and monitor risks to their own business (not merely by reference to sector peers).

[6] http://www.ft.com/cms/s/0/6fcf1090-67b7-11e6-a0b1-d87a9fea034f.html#axzz4IoFtikbh
[7] http://www.ft.com/cms/s/0/6fcf1090-67b7-11e6-a0b1-d87a9fea034f.html#axzz4IoFtikbh

It's unclear to what peers SOCO is referring but other companies in the oil and gas exploration sector – including the comparable Tullow Oil Plc - do disclose information on climate risk (although we do not endorse the adequacy of that information).

Why is this a problem?

As the critical document explaining a company's performance to investors, it is vital that all relevant information (particularly risks to the business) is described in its annual report.

Proper reporting is a fundamental precondition to investors exercising their fiduciary duties through well informed and balanced decision-making.[8]

There is a catalogue of climate-related risks for the oil and gas exploration sector – each of which could have negative impacts on operational and financial performance. In our opinion, Cairn and SOCO's failure to disclose to investors relevant climate-related risks does not meet the standard of disclosure required by law. This means that investors cannot fully evaluate the investment case, or the potential of each business to deliver value over time.

What happens now?

Following ClientEarth's complaint, the FRC should carry out a review in accordance with its Operating Procedures. We will be kept informed of the outcome of the FRC's decision.

The FRC can impose sanctions which include issuing either a Committee Reference or a Press Notice to publically communicate the outcome of the investigation and the corrective action required of the company following FRC investigation.

Ultimately the FRC can apply for a court order forcing the company to prepare a revised report (and the costs of this can be recoverable from the directors personally).

[8] Donald MacDonald, 27 April 2016. Letter to Financial Times: 'Shareholders and public entitled to full disclosure on climate change issues.'

The complaints brought by ClientEarth offer a timely opportunity for the FRC to send a clear message that climate risks must be treated like any other risk to capital, and properly disclosed.

Natasha Landell-Mills, Head of Stewardship
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The need for FRC oversight

A requirement to disclose material risks to a company's business exists in most G20 jurisdictions. It is clear that for companies in certain sectors, compliance with the legal requirement to report material risks means reporting on climate-related risks.

It is not possible for investors to monitor the adequacy of the corporate disclosures of every company in their portfolio. As the regulator responsible for ensuring that company reports comply with the law and relevant reporting requirements, the FRC shares this burden of oversight.

Proper enforcement of statutory reporting requirements is a crucial part of investors being able to exercise their stewardship responsibilities. Therefore investors should, in their own engagements with the FRC, emphasise the necessity of adequate corporate disclosure of climate-related risks, and the need for the FRC to ensure compliance. They may also wish to support the complaints against SOCO and Cairn. We suggest the following questions for investors to ask of the FRC.

Questions for the FRC

What procedures and initiatives does the FRC have in place to monitor the adequacy of disclosures around climate-related risks?

Does the FRC's monitoring of climate-related risks have a sector focus (e.g. oil and gas exploration)?

How does the FRC plan to assimilate the findings of the Task Force on Climate-related Financial Disclosures into its own monitoring acitivities?

How does the FRC coordinate with other financial regulators in the UK (Prudential Regulation Authority, Bank of England, Financial Conduct Authority etc.) to address the systemic financial risk from climate change?

How does the FRC coordinate with other national financial and corporate reporting regulators?

Further information

ClientEarth is continually monitoring the corporate disclosures of carbon intensive companies. Where investors identify reporting failures in their own engagement with companies, we encourage you to let us know so that we can assist with addressing these concerns.

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