



Managing climate risk in New Zealand in 2020

A tool kit for directors

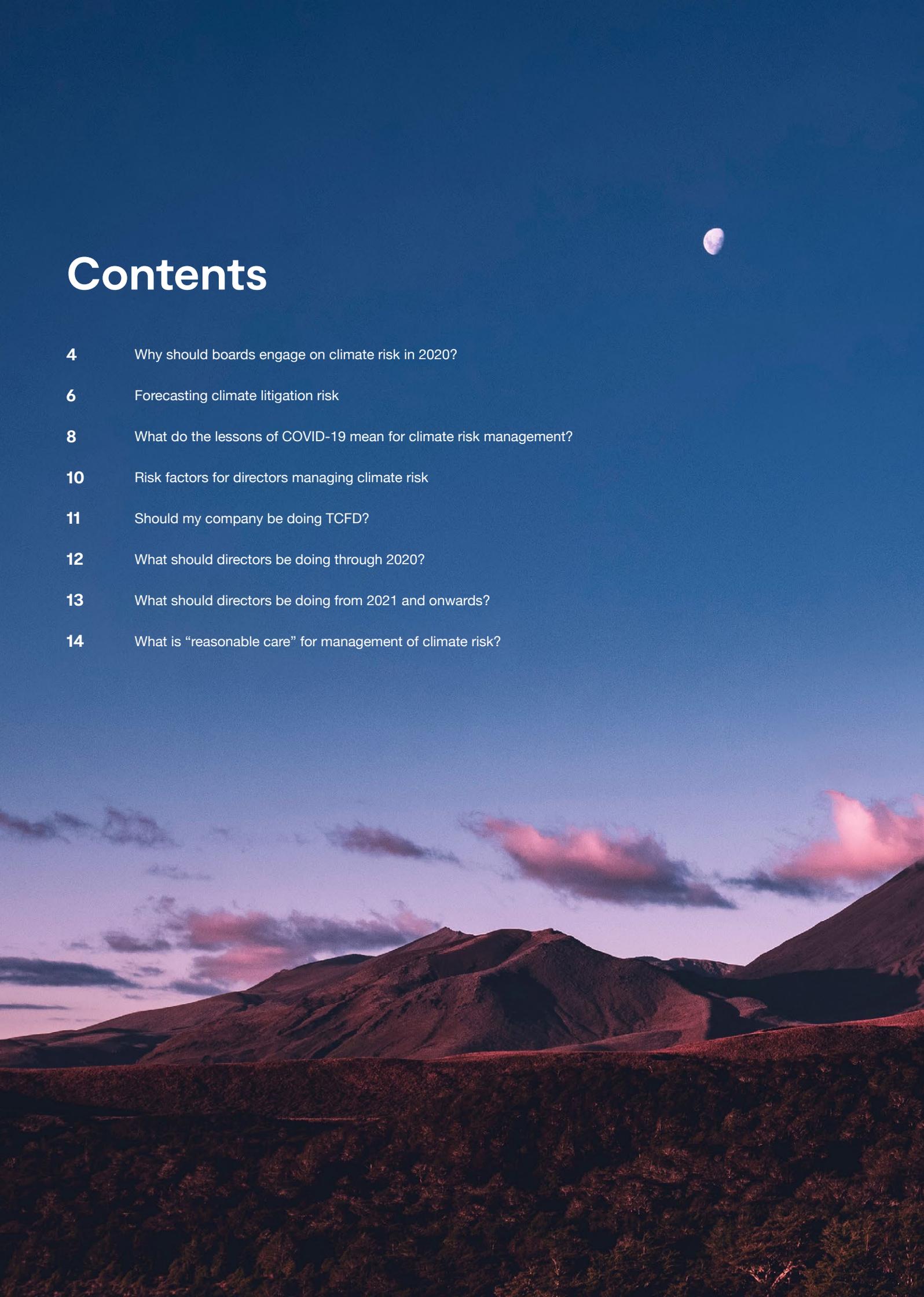


**The
Aotearoa
Circle**

Mā te Kaitiakitanga
ko te Tōnuitanga
Prosperity Through
Guardianship

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Management of climate risk is not about compliance: understanding climate risk is key to mid-long term strategy and resilience.



“Changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be.”



Mark Carney
Former Governor,
Bank of England

“We are witnessing a step-change in climate-related business risk. Climate change is no longer a mere environmental concern: for many, it presents a material financial risk.”



Daniel Kaldermis
Partner
Chapman Tripp



Nicola Swan
Senior Associate
Chapman Tripp

Why should boards engage on climate risk in 2020?

Environment-related risks dominate the **Global Risks Report** for the third year in a row, accounting for three of the top five risks by likelihood and four by impact. “Of all risks, it is in relation to the environment that the world is most clearly sleepwalking into catastrophe”.

World Economic Forum



Legal opinions in the UK, Australia, New Zealand and Canada all say the same thing: directors’ duties of due care and diligence require them to think through climate-related financial risk when making decisions. In NZ, the **Aotearoa Circle/Chapman Tripp October 2019 opinion** (Daniel Kalderimis and Nicola Swan) confirms that because climate change presents a foreseeable risk of financial harm to many businesses, directors need to factor it into their risk management and strategy.



Court rulings are delaying major infrastructure projects globally where climate change considerations have been ignored. In the last two years, climate concerns have scuppered plans for a third runway at Heathrow Airport, a NSW open-cast coal mine, and a major Polish coal-fired power plant.



At least 14 shareholder resolutions were filed in Australia in 2019 seeking climate change action from ASX 200 listed issuers, including against major banks, insurers and energy companies. We expect similar shareholder activism here.



Major household names have been subject to litigation in New Zealand seeking court orders to reduce their GHG emissions or cease their operations. This follows similar litigation trends overseas where climate litigants have targeted major brands.



New Zealand’s first provisional emissions budget for 2021 – 2025 has been released and budgets for subsequent periods will be proposed by July 2021. In the meantime, Emissions Trading Scheme reform is coming down the pipe at pace, with major changes to the Emissions Trading Scheme passed in June 2020. These reforms are intended to increase the cost of emissions-intensive goods and services to drive behavioural change towards a lower emissions economy.



COVID-19 presents an opportunity to help transition the economy to a low-emissions economy. Governments will face increasing pressure to align stimulus packages with climate change response.



Climate change impacts are already locked in, with quickly increasing public awareness of likely future damage. The pace at which boards will need to confront this challenge is ramping up.



An organisation that takes “business as usual” steps to govern, manage and respond to climate risk is almost guaranteed to be seen, from the viewpoint of a court in 2030, to have underestimated the risks and what is required. This is not a function of bad faith. Rather, businesses have not had to respond to such a large scale, complex change in the world before now.



Changes in social values are lead indicators for litigation risk. Social and consumer expectations of business engagement with climate change are constantly evolving. Commitments to achieve emission reductions and/or offset emissions and use of new low emissions technologies provide hard examples of consumer expectations hitting the bottom line.



TCFD-style climate-related financial risk reporting is likely to become mandatory in NZ for listed issuers, banks, general insurers, asset owners and asset managers. Climate Change Minister James Shaw signalled in May 2020 that reporting could also extend to large emitting private companies and public entities. Current indications are that entities with a March balance date will first need to report for the year ending 31 March 2023 (30 September 2023 for September balance dates).

Action in response to climate risk is no longer optional: it is expected

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

The global Taskforce on Climate-related Financial Disclosures (TCFD) recommended in 2017 that listed issuers, banks, insurers, asset owners and asset managers publicly disclose their climate-related financial risks – both transitional and physical.

- TCFD disclosure is being widely adopted globally by companies and regulators. It encourages organisations to disclose:
 - their governance arrangements around how they will manage climate-related risks and opportunities, and
 - the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy and financial planning, and the metrics and targets used to assess and manage them.

Forecasting climate litigation risk

Complex litigation where lots of people have suffered major harm can lead to unexpected results – especially where society wants someone ‘to blame’. In these types of cases, corporate defendants may well face liabilities they did not expect.

- New Zealand judges will face huge pressure in future to ‘do something’ to address the increasing losses and injustices from harms caused by climate change.
- Defendants will find it difficult to justify not having done more to prevent the serious damage that will result from climate change. This reflects a number of factors:
 - Corporate decisions are likely to be assessed – even if not intentionally – with hindsight, in the context of the pressures from climate change on society in the next 10–15 years from climate change. As Justice Mallon identified in *Strathboss Kiwifruit Ltd v Attorney General* [2018] NZHC 1559 at [347], “*If a lack of care has caused harm, it is tempting to say the harm was foreseeable and a duty of care should be owed*”.
 - It will be difficult to resist ‘backwards causality’, i.e. where the damage – and the risk – has become ‘obvious’ in hindsight. As Justice Thomas has explained in the context of the GFC, “*eliminating hindsight requires a degree of intellectual rigour which is probably seldom achieved*”.
 - History is never truly objective but is open to differing interpretations. What matters is what seems important after the event – this means that details, nuances and context that can seem important at the time can be overshadowed by a subsequent narrative that seems clear and obvious.
 - Future plaintiffs will point to the existing reports warning of damage to come (e.g. **the IPCC’s 2018 Special Report on Global Warming of 1.5°**), regardless of the actions taken by a defendant vis-à-vis its competitors. Decisions to continue down the same path without acknowledging or managing material climate risk will become easier to challenge.
 - Directors’ duties of reasonable care and diligence are open-textured and susceptible to interpretations that keep pace with social expectation. What is reasonable is an inherently social assessment.
 - Expectations of directors’ knowledge of climate change science, likely local impacts and possible damage will continue to rise. What is ‘reasonably foreseeable’ is different now (especially since the release of the IPCC’s Special Report) than it was even 5 years ago.

“Companies that do not (adequately) respond to climate change face legal risk, ranging from the possibility of being sued for breaching human rights or, as climate change becomes a financial issue rather than an ethical one, for breaching directors’ duties and corporate disclosure and financial risk management laws.”

Chief Justice Winkelmann,
Justice Glazebrook, Justice France
(2019) “*Climate Change and the Law*”,
Asia Pacific Judicial Colloquium,
May 2019.

Humankind is notoriously bad at predicting the future. This has implications for how well we assess risk, especially over the medium and long term, and the best ways to competently do so.

Climate change risk is under-appreciated in part because of inherent human biases in appreciating risk:



“Corporations also face significant challenges arising out of climate change such as disrupted supply chains, physical damage to assets, changed market demand, and possible suits for breaching human rights or financial risk management laws. Such challenges could be sudden and catastrophic or gradual onset.”

Chief Justice Winkelmann,
Justice Glazebrook, Justice France
(2019)



Optimism bias:

We are unrealistically optimistic about our own future prospects.



Confirmation bias:

If we are motivated to believe something, we may seek out evidence that supports that view, and minimise data that contradicts it.



Group think:

Individuals are reluctant to criticise the group. Be wary of over-reliance on perceptions of ‘market practice’ or climate action: social norms can change rapidly.



Outcome bias:

The fact things turned out OK causes us to underestimate how close they came to going badly wrong.

What do the lessons of COVID-19 mean for climate risk management?

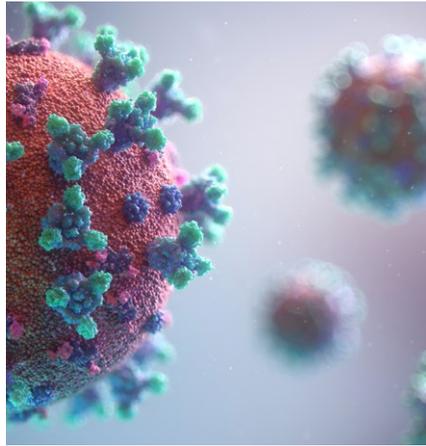


Expectations of business continuity have likely heightened.

New Zealand is both closer to the world – video conferencing is now the norm – but much further from it – our working bubble within our tightly closed border will be New Zealand’s distinguishing feature of 2020. There may be lessons here for climate change. Market access and trading conditions that we take for granted are already changing due to rapidly changing physical conditions, geopolitics or consumer sentiment.

‘Black swans’ – low probability but high magnitude events that appear obvious in retrospect – do happen. And climate change is more grey than black because we all know it is happening. What we don’t know is exactly how its impacts will be felt.





Tipping points are real. COVID-19 cases grow exponentially from a certain point. The scientific community has warned for many years that climate change effects may similarly face dramatic acceleration.



COVID-19 has illustrated that risks can manifest indirectly as well as directly. Many businesses have been impacted not only by the physical threat of COVID-19 but by the regulatory response; other businesses have been impacted not by their own situation but by that of their suppliers, customers or consumers.



Big risks will hit simultaneously: customers are hit, employees are hit, suppliers are hit, funders are hit, regulators are hit.



We must learn from COVID-19: it represents an important opportunity to redesign our economy to deal with climate change.



Risk factors for directors managing climate risk

Should my company be doing TCFD?



Likely that expectations on directors will increase over time



“Climate change is no longer an ethical issue. As a material financial risk, directors are accountable under care and diligence duties to take account of the financial consequences of climate change...”

Chief Justice Winkelmann, Justice Glazebrook, Justice France (2019)



Evolving levels of knowledge as to what climate risk actually means (especially non-physical, ie. transition risk)



Expectations are different for every business



Difficulty of identifying, measuring and calibrating long-term risks that can manifest indirectly



Companies naturally prioritising short term risks



Likelihood of changing behavioural norms given social justice expectations from future generations

Government has signalled that listed issuers, banks, general insurers, asset managers and asset owners are expected to be subject to formal TCFD reporting for the 2022 – 2023 year.

Examples of reporting to date include:



Reporting within 2019
Annual Report (Australia)



Reporting within 2019
Annual Report



Standalone 2020
TCFD Report



Meridian.

Standalone 2019
TCFD Report



Standalone 2019
TCFD Report (Australia)



ENERGY

Reporting within 2020
Annual Report



Reporting within 2020
Annual Report



AIR NEW ZEALAND

Committed to
TCFD reporting



Mercury

Reporting within 2020
Annual Report



Downer

Relationships creating success

Reporting in 2019
Sustainability Report



Rabobank

Reporting within 2019
Annual Report



SANFORD

Committed to
TCFD reporting

What should directors focus on first?



Start the TCFD conversation.



Start by identifying the top three or four risks to your business: accept that you won't spot every risk.



Make sure you have expertise in place – eg. a board sub-committee, responsibility within the senior leadership team, and good internal skills.



Consider actions your company could take now to reduce its exposure to physical, legal and commercial risks on the horizon from climate change.



Ensure reporting is consistent: check that material climate-related financial risks are being disclosed alongside other material risks.



See guidance from the **World Economic Forum**, the **TCFD Research Hub** and from **NIWA** on New Zealand specific climate scenarios to identify specific risks.



Don't assume you're immune from climate risk impact. Are your major consumers or suppliers themselves likely to be affected by climate change?

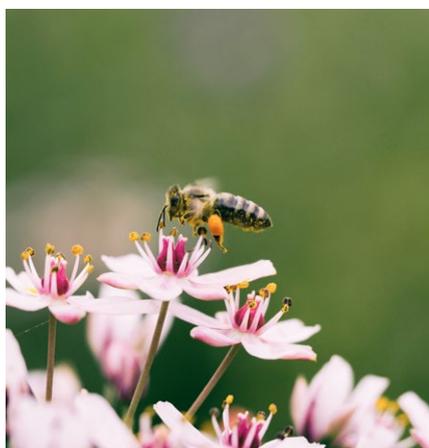


What should directors do in the next five years?



Changes in social values are lead indicators for litigation risk. Track the views of your consumers to see if they increasingly support, or criticise, your business actions on climate change. This data will determine your litigation risk more quickly than traditional risk advice.

Future-focused scenario analysis will be increasingly important. But try to move the conversation from predicting your future to being resilient irrespective of exactly how the future turns out. This is likely to favour values-based approaches to strategy.



Take climate risk seriously and comprehensively throughout your business, and re-evaluate plans and strategy as information changes. Expect adverse impacts to worsen, while remaining open to spotting opportunities.



Focus on resilience. Create time, space and budget for staff to tackle climate risk. Build in redundancy where possible.



Recognise the increasingly measurable impact of climate-related financial risk on company and asset valuations.

What is ‘reasonable care’ for management of climate risk?

Courts’ expectations of ‘reasonable care’ will likely increase over time. Building resilience will become an aspect of taking ‘reasonable care’. COVID-19 is accelerating our understanding of what resilience means for business, but it will translate to climate change risk. Courts will expect resilience to have been built in.

Guidance for New Zealand directors to demonstrate ‘reasonable care, diligence and skill’ in assessing climate-related financial risk

	Guidance on what ‘taking reasonable care’ means for 2020	Key Questions for board to ask
<p>Get the business organised to manage climate risk</p>	<p>The business will be expected to have clear responsibility for management of climate risk at executive and board level.</p> <p>Understand that climate risk management may be different to management of other risks (e.g. cyber). For example, it is likely to hit across the business (similar to COVID-19), its impacts are not likely to be sudden but are increasingly certain, and it cannot be fully insured.</p> <p>Identify how mature your business is in managing climate risk (e.g. the Sustainable Business Council’s Sustainability Governance Maturity Matrix).</p>	<ul style="list-style-type: none"> • Who within the executive and the board is accountable for managing climate risk? • Where are our most likely blind spots when managing this risk? • How is climate risk different to other risks for our business?
<p>Identify climate-related financial risks</p>	<p>Work out the key risks for your business and focus on these, but don’t ignore the rest. Keep this assessment current.</p> <p>Assess the likely impact of climate change on your own suppliers and customers. How will this then impact your business?</p> <p>Physical risks</p> <ul style="list-style-type: none"> • Understand New Zealand’s specific physical risks identified in the first National Climate Change Risk Assessment and using NIWA’s latest modelling (projections and online mapping tool). • Investigate scenario analysis options for your business, eg. resources from NGFS, FCA (UK), CMSI and IIGCC. <p>Transition risks (law, market, consumers)</p> <ul style="list-style-type: none"> • Understand the risks of the Zero Carbon Amendment Act, New Zealand’s first emissions budget, and Emissions Trading Scheme reform on your business. • Keep updated on the fast-changing regulatory environment, including TCFD and Zero Carbon Act reporting, and COVID-19 recovery. • Actively monitor market shifts linked to consumer climate concerns or perceptions. 	<ul style="list-style-type: none"> • What are the top 3 – 4 climate-related risks facing our business in the next 10, 20, 30 years? • Have we worked through a scenario analysis of our major physical and transition risks? • Do we have processes to flag new risks as they develop? • What would set our business apart if our industry was targeted by climate litigation?

<p>Assess for likelihood and consequences</p>	<p>Climate-related risks are likely to have a high impact, and a high probability of occurrence, but will materialise over a longer time frame. Do take actions in the short-term that start to address how your business will respond to the longer-term risks. Abrupt responses if a high impact climate change risk occurs are likely to be more costly and disruptive.</p> <p>Court expectations of directors will likely require demonstration of strategic insight, stepping back and asking questions, and not relying entirely on traditional risk management processes. Accept that traditional risk management may well set a starting point only for your overall response.</p>	<ul style="list-style-type: none"> • Have we reflected the latest science on the likelihood of climate impacts in our own planning? • Have we considered managing our risks as a whole, rather than in isolation, on the assumption that climate change will hit over multiple parts of the business at the same time? • What can we be doing in the short term to mitigate the major, highly likely, but long term risks from climate change?
<p>Get advice</p>	<p>Awareness of climate risk is advancing in leaps and bounds. What is reasonable knowledge for a board might be more than you expect. (e.g. ASIC regulatory guidance now references climate change as a systemic risk).</p> <p>Reducing future litigation risk may involve getting better advice, and freeing up resource to allow for more hard thinking on uncertain but high impact risks.</p> <p>Focus on getting the best scientific information available, and have it turned into implications for the organisation in terms that everyone can understand. Make this a long term investment in capability, no matter how hard or how uncomfortable.</p> <p>Get advice early on any necessary translation of climate risk in financial accounts.</p>	<ul style="list-style-type: none"> • Are we sufficiently skilled within the business to identify the key risks and opportunities from climate change? • Are our existing advisers (accounting, investment, legal, insurance) sufficiently expert to spot climate-related issues for our business? • How can we use external expertise to improve our resilience to climate change?
<p>Act</p>	<p>Courts will likely expect a focus on resilience as a part of taking 'reasonable care'.</p> <p>Specific sectors will be blamed more than others – e.g. litigation overseas and in New Zealand has focussed on large corporates, financial services providers, utilities, and energy companies.</p> <p>Don't just add climate change to the risk register and move on: empower your business to take decisions on the biggest climate-related concerns for the business.</p> <p>Don't rely entirely on TCFD disclosure – follow through: a disclosure mechanism is no substitute for an holistic risk management regime. Directors will ultimately be judged on their actions.</p> <p>Changes in social values are lead indicators for litigation risk. Track the views of your customers / consumers to see if they increasingly support, or criticise, your business actions on climate change. This data will determine your litigation risk more quickly than traditional risk advice.</p> <p>Use two reference points – a more standard risk management approach, and a challenger view from outside the organisation – to generate a focus on strategy, options, resilience, and stakeholder engagement.</p>	<ul style="list-style-type: none"> • Have we followed through on commitments (whether explicit or implicit)? • Is our ongoing reporting laying a foundation for allegations of passivity or greenwashing? • Have we focussed on specific, measurable and achievable goals and systematically measured our progress against them? • Do the businesses' actions reflect where the Board has decided to position it in the market? • Do our customers increasingly support or challenge our actions on climate change?
<p>Report if required</p>	<p>While TCFD reporting is likely to transform requirements for listed companies to disclose climate-related financial risk, lifeline utilities are already being asked to report under the Zero Carbon legislation and listed companies are already required to disclose sufficiently material information via the NZX Listing Rules.</p> <p>Privately held companies may find it useful to conduct internal TCFD-style analyses to be ready for increasing questions from lenders and investors.</p> <p>TCFD-style disclosure requires disclosure of forward-looking information. Consider whether this overlaps with continuing disclosure obligations or expected communications to key investors.</p>	<ul style="list-style-type: none"> • Are our disclosures consistent? • Ask the big TCFD questions: <ul style="list-style-type: none"> – Which future climate scenarios will be most useful for our planning? – How can TCFD disclosure support our strategy and brand? – Which metrics are we and our competitors likely to be measured against?

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