Feedback on Proposals for reporting on Carbon Asset Stranding Risks

by TWG member Jane Thostrup Jagd

Thank you for providing this opportunity to bring forward my points of views on the above article.

I have to say that it has been a real puzzle for me to figure out, what the purpose of the article is. In my search I have also debated it with an array of my financial colleagues; to be sure I did not misunderstand something. My main problem is that it is stated in the Executive summary that "there are clear signals that investors and others are starting to recognize CASRs through divestment practice". My overall question is – which investors? I cannot find any. In my search I have also read all the references included in the memo, and all of them are either made by researchers, standard makers, or NGOs and have no input from investors. I do not see any investor being interested in what amount of fossil fuels (and thereby carbon) that may be left behind unburned – investors are as always purely interested in return on investment. Thus, in relation to extractive companies they are interested in:

- What quantities <u>will</u> be extracted – it is of no importance to the investor what quantities will be left behind (it would be like claiming that the investor in a car-producer, is interested in the cars the car-producer does not produce – that would be fairly odd)
- How oil price-sensitive is the company
- Are the capitalised assets overvalued, given the future income-potential

These three mentioned interesting elements are all already covered by the current IFRS regulation and practice, wherefore no new regulation is needed. In the following I will show how:

What quantities <u>will</u> be extracted?

It is important to notice that the IASB DP/2010/1 Extractive Activities is still "paused". Thus, today IFRS has no demand to report on what extractive reserves there might be – and it is therefore not all companies that provide this kind of information – and if they do, they do that very differently. The very different reporting of reserves is mostly due to:

- That it is really difficult to measure/estimate how much fuel there are in the wells – it is also difficult to estimate the future oil price and hence how much of the identified fuel in the well that will be "commercial" – thus, the future value is fairly unreliable.
- Most often are fuel drilling done via a bought licence/concession right, which most often is time restricted. In such situations is the fuel in the well not owned by the extracting company per se –

the extracting company just owns the right to drill for a given time period. Thus, to report on reserves, which the company do not own, is not in line with IFRS. (this important element is also highlighted in chapter of "Challenges…" – but for some reason it is not reflected upon).

- Most often are extractive companies the result of complicated ownership structures – often in the shape of JOs or JVs – and often with the local state as one of the partners. Some of these partners require high confidentiality – otherwise you do not get the contract. Thus, IMF's claim that extracting industries should be simpler than other industries, simply because the output is physical, is not shared. It is my experience that the reporting from extractive operations can be extremely complicated to get hold of – especially if the data is not covered by IFRS.

What the extractive companies do today to accommodate the investors' need for information about the expected future extracted quantities, and thereby their future possible income, the extracting companies usually provide investors with their targets of extracted barrels per day and perhaps even the expected ROI, ROIC or RONA or similar KPIs – all predictions made within a certain time limit. That is the best information they have, and that is already provided today – thus, no need to make new rules on this.

How oil price-sensitive is the company?

Most extracting companies are of course sensitive to oil price volatility – but often are oil price volatilities mitigated - at least to some degree - by using financial instruments. Today is the reporting of the financial instruments quite extensive (IAS 39) – some would even claim it is beyond what the regular investor can comprehend – thus, this is already covered. Also be aware, that for conglomerates is the sensitivity not necessarily straight-forward, as parts of the corporate may appreciate increasing oil prices, while others appreciate decreasing oil prices, wherefore the oil-price sensitivity is related to the "crack" between the consumption and extraction, which of course varies. But never the less, extractive companies, and other impacted companies, do already explain about their oil price risks, as this is already covered by IFRS 7. Thus, there is no need for more rules or reporting on this.

Are the capitalised assets overvalued, given the future income-potential?

For the investor to know whether the company really does have any assets that can bring any future value (Return on Investment), it is important that the capitalised assets are not overvalued, as they otherwise may incur a loss.

The first thing to notice is that the extracting companies do not capitalise "the future value" (which was just described as fairly unreliable). Given common IFRS rules, the extracting companies only capitalise assets based on cost, which is highly documentable. But it may very well be that some extracting companies have

overvalued capitalised exploration costs. In this relation do also read A.P. Moller-Maersk's comment to the IASB Discussion Paper DP/2010/1 on Extractive Activities[1] question 4, where it is explained why APMM think it is not prudent to capitalise exploration cost, before the exploration has been a success and a commercial field has been established and declared. This is unfortunately not the norm in the industry, which APMM actually considers to be in conflict with IAS 38. Thus, what could happen instead of having this debate of reporting of stranded carbon assets, we could/should have the discussion about why it is that some extracting companies do not follow IAS 38?

But apart from this industry-problem on IAS 38, it must though be assumed that the industry do apply IAS 36 (impairment testing) on the commercial fields, thus for commercial fields it is assumed that assets are not overvalued. This was actually the most common reference/answer I got from my financial colleagues; they simply could not understand how the stranded carbon assets could be a problem, if IAS 36 is applied as it should be. But if Carbon Tracker & ACCA are right, when writing: "The IASB introduced IAS 36 – Impairment of Assets to ensure that assets are carried at no more than their recoverable amount, and to define how that recoverable amount is determined…The assumption that there will be no reduction in demand for carbon-intensive energy sources does not seem reasonable."[2] – then Carbon Tracker and ACCA also indicate that the companies are not applying ISA 36 in the right way. The law per se is fine as it is – but the application may need some adjustments - we just need to see some examples of the indicated misapplication, to be able to determine what to adjust.

Overall, to demand reporting on stranded carbon assets seems fairly arbitrary. It seems like the traditional life-cycle issues of assets and commodities for these special asset types (Oil rights and Capitalised exploration costs) are raised to have a special status – but why? The generic risks of all kinds of stranded assets (not just carbon assets) must be assumed to be part of the regular and traditional investor work; to estimate what the remaining payback time is of the investments and what risks this payback time may endeavour – including new laws and regulations, technological development, new fads and fashion etc. And given these conditions, and the investor's requirements for return on the investment and risk appetite, then the investor estimates whether to sell, buy or hold. That is the essence of the investor's job. Realising this can also explain why there are no such reporting requirements on any industry with input and/or outputs, which are bound to be outdated or obsolete.

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[1] http://www.ifrs.org/Current-Projects/IASB-Projects/Extractive-Activities/DPAp10/CL/Documents/APMOLLERMAERSKcommentonDPonExtractiveActivities.pdf

[2] Carbon Tracker & ACCA (2013) Carbon Avoidance? Accounting for the emissions hidden in reserves, p 15, http://www.accaglobal.com/content/dam/acca/global/PDF-technical/sustainability-reporting/tech-tp-ca.pdf

If we only talk about risks related to carbon effects from fossil fuels - why is it then only the Oil rights and the Capitalised exploration costs that are interesting as so-called "stranded" – what about the future value risks of all the machinery and equipment, which are relying on fossil fuels; including trucks, vessels, aircrafts, cars, utility providers, etc.? These assets are owned by most companies – thus, such a requirement will hit as good as all companies, and the risks will be very different depending on the scenario to come. If the risk simply is that the oil price drops, due to less use and/or potentially over-supply due to development of machinery and equipment using non-fossil fuels, then these fossil fuel consuming assets could be worth more, as the cost of using them is reduced, whereby the impairment test may be improving. It can also be that the value is decreasing more rapidly than originally anticipated, due to increasing public interest in CO_2-consumption per produced commodity. An extreme scenario could be that fossil fuels are forbidden in the entire world, and then the fossil fuel consuming assets are worthless. Thus, the risk profiles are right now not clear, since reliable predictions of oil prices do not exist (for good reasons, because then the market for Oil Price hedges would be dead – and that is surely not the current situation). But if the risk scenario becomes clearer and in disfavour of the asset values, then IAS 36 will/should ensure that the investor will be informed about the possible losses – simply because the assets must be impaired. Thus, there is no need for new regulation.

Thus, since CDSB are aiming at: "Our work is designed to provide clarity, trust in information and greater stability in financial markets." as stated on the internet-site – then what we could do is:

- to bring the current discussion on stranded carbon assets among researchers and NGOs more in line with the already existing regulation and practice
- discuss the fairly odd application of IAS 38 among some extracting companies, who capitalise exploration cost even before they know whether there is fuel in the explored well - and if so, whether it is commercial
- ask Carbon Tracker and ACCA to provide examples of the claimed misapplication of ISA 36 – only thereby can we figure out if the companies may need to change the way they do impairment testing (on all assets!!!)
- acknowledge the lack of interest among the investors

My conclusion is that this article will need significant re-work, if it is to provide clarity, trust in information and greater stability in financial markets.