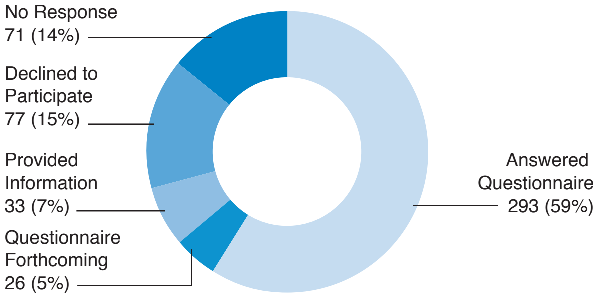
Executive Summary

Hard numbers on the costs of climate change create mood of urgency

Responses Status (CDP2)



The global expansion of the Carbon Disclosure Project (CDP) is firmly under way. Signatories, from Africa, Asia, Europe and North America, now represent over $10 trillion in assets – more than double last year's total. Responses from the FT500 Global Index companies are also up sharply, from 47% to 59%. Moreover, survey data are more diversified by industry, and more sophisticated in content, than previously. The total emissions from operations reported to CDP across all sectors equalled 2,886,033,085 tonnes of CO2 equivalent (CO2e), or roughly 13% of all emissions from fossil fuel combustion worldwide.

We believe that this escalation in scope and awareness – on behalf of both signatories and respondents – can be traced to an increased sense of urgency with respect to climate risk and carbon finance in the global business and investment community. This should not come as a surprise. Developments over the past 18 months have highlighted the social and economic costs of climate change and the risks and opportunities being created worldwide by emissions reduction policies.

Why the CDP Matters: Key Developments Since CDP1

- *Weather-related natural disasters caused about $70 billion damage during 2003 ($18.5 billion was insured).* For the first time, climate change was explicitly identified as being a factor. More extreme weather events should be expected in the future, according to leading reinsurers.
- *The effects of this will be felt in key sectors and commodity markets* – notably, the power, energy, insurance, transportation, heavy manufacturing and building/infrastructure industries, and the crude oil, gasoline, grain, soy and wheat markets. The application – and bundling together – of weather derivatives, catastrophe bonds and other environmental financial risk-hedging instruments is turning into a viable, but underutilized, risk-management option for many firms.
- *Mainstream pension trustees, analysts, bankers, insurers and fund managers have begun to appreciate the implications of climate change and greenhouse gas (GHG) policies in financial terms.* No longer can fiduciaries claim to be unaware of what is at stake. Taking climate risks into account is now becoming part of smart financial management. Failure to do so may well be tantamount to an abdication of fiduciary responsibility. FT500 firms can expect to come under greater pressure from shareholders as a result.
- *Carbon finance is now a reality.* Legislation favouring a shift to a low carbon intensity economy is now a fact of life for FT500 companies across the EU as well as in many parts of the US, Japan, Australia and Canada. In January 2005, over 14,000 entities will begin trading carbon in what promises to be the largest, most liquid carbon market in the world: the EU Emissions Trading Scheme (ETS). Approximately 29% of the FT500 companies contacted through the CDP are located in countries that are included in the EU ETS. In the US, more than 20 states have passed or proposed legislation on CO2 emissions, or have developed carbon registries, sequestration studies and similar measures.

- *The future 'cost of carbon' is a major headache for energy-intensive FT500 companies. Two-thirds of EU utilities expect wholesale electricity prices to rise by up to 20%.* According to one report, higher electricity prices across the EU will mean additional costs of almost €600 million ($720m) per year for the European steel industry, €500m for the pulp and paper business, and €260m for the cement, lime and glass industries. Our analysis indicates that even a 5% shift in energy prices could impact per share earnings by as much as 15% in certain industries. Energy risk management and energy efficiency initiatives are taking on a new strategic importance.
- *Pressure is growing on financial market authorities, fiduciaries, company directors and officers, and accounting bodies to incorporate climate risk factors into financial statements and offerings.* This is likely to result in greater pressure on firms to measure and disclose the risks they face. It now seems to be only a matter of time before "generally accepted carbon accounting principles" (GACAP)– are adopted at national and international levels. Climate litigation against major industrial emitters also looks increasingly likely.
- *The global carbon market has doubled in size in each of the past two years and is projected to reach $480 million in 2004.* Emissions trading is an important element of the corporate risk management equation, with more FT500 firms involved. Some 70 million tonnes of CO2e was traded during 2003 across all markets, against a total since 1996 of roughly 220 million tonnes. A hierarchy of credit quality is emerging. Increased cash flow from carbon finance can boost internal rates of return (IRRs) by as much as 15% for some projects.
- *FT500 firms are major participants in the global clean technology sector. Non-hydro renewables are expected to grow faster than any other primary energy source to 2030.* Worldwide, the growth in electricity from renewable energy is projected to rise by 9-10% annually. Over $2.5 billion has been invested in "clean tech" ventures over the past two years – a near quadrupling of the market. Europe aims to generate 50% of its energy needs from renewables by 2050. In the US, clean technology forms the cornerstone of both leading presidential candidates' environmental agendas.

What the CDP Responses Tell Us

CDP2 responses indicate that these trends have not gone ignored. More firms than last year consider climate change to present risks and opportunities to their business. More are quantifying GHG emissions and preparing to trade emissions. Corporate climate strategies are becoming more coherent and more comprehensive. The concept of 'GHG-Neutral' products and companies is taking root. Many firms have established multi-disciplinary teams to manage the climate risk file. The use of standardized measurement systems, such as the WRI/WBCSD GHG Protocol, is up. The number of banks reporting an involvement in renewable energy initiatives has more than doubled in the past year.

That said, worrying trends are also apparent. Certain greenhouse gas management tasks – approaches to supply-chain questions, assessment of life-cycle emissions, the integration of carbon costs into management accounting – are proving to be troublesome. The absence of greater regulatory certainty also appears to be holding some companies back. Significant differences in opinion remain within the same sectors on the importance of climate change to company business and competitiveness.

There are also many examples of "disconnects" between a company's response status and what is known publicly about its actual climate-change stance. Whether this is due to poor internal communications or a lack of interest on the part of the responder is open to speculation. Perhaps most alarmingly, several companies failed to respond to the CDP letter despite having a significant proportion of their outstanding common shares (over 10%) owned by signatories to the CDP letter.

The concepts of corporate leadership, transparency and brand value underpin approaches to climate change. These "soft" issues should not be taken lightly. Currently, some 85% of a company's true market value can be attributed to such "intangible value drivers". Leaders are seizing the initiative across the spectrum of activities that shape a company's true value and competitive potential as the shift to a low-carbon economy proceeds. To reflect this, we have created the Climate Leadership Index (CLI), comprising the 50 'best in class' responses to the CDP.