



# NZPC, 2018

NEW ZEALAND  
PRODUCTIVITY COMMISSION

Te Kōmihana Whai Hua o Aotearoa



## Low-emissions economy

August 2018



The Productivity Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders.



# **Low-emissions economy**

**Final report**

**August 2018**

## The New Zealand Productivity Commission

Te Kōmihana Whai Hua o Aotearoa<sup>1</sup>

The Commission – an independent Crown entity – completes in-depth inquiry reports on topics selected by the Government, carries out productivity-related research and promotes understanding of productivity issues. The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. The New Zealand Productivity Commission Act 2010 guides and binds the Commission.

You can find information on the Commission at [www.productivity.govt.nz](http://www.productivity.govt.nz), or by calling +64 4 903 5150.

**How to cite this document:** New Zealand Productivity Commission. (2018). Low-emissions economy: Final report. Available from [www.productivity.govt.nz/low-emissions](http://www.productivity.govt.nz/low-emissions)

Date: August 2018

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### Disclosure

The Chair of the Productivity Commission, Murray Sherwin, has a financial interest in the forest sector via part ownership of a forestry block.

ISBN: 978-1-98-851923-4 (print)

ISBN: 978-1-98-851924-1 (online)

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<sup>1</sup> The Commission that pursues abundance for New Zealand.

Robust and transparent measurement and reporting reduction. Improving the disclosure of emitted and a level will assist decision making and enable reduction

(New Zealand Productivity Commission, 2018)

Second, disclosure enables investors to make decisions across investment opportunities that accurately reflect the climate risk of those choices (LSEG, 2018). Without accurate and comparable information, investors may incorrectly value assets or investment opportunities, also resulting in misdirected finance or stranded assets. Disclosure therefore helps to increase investor understanding of, and demand for, low-emissions investments. Box 7.3 highlights the demand for better future-focused disclosure in New Zealand.

#### Box 7.3 The demand for future-focused disclosure in New Zealand

As part of the ReportingNZ project led by the McGuinness Institute in conjunction with the External Reporting Board (XRB),<sup>72</sup> preparers and users of reports published by for-profit entities were surveyed about extended external reporting (EER). EER comprises all information beyond mandatory requirements, and includes topics such as ESG strategies and impacts (including GHG emissions).

Key messages included that:

- future-orientated information is an emerging requirement because it “delivers better decision making for existing and potential investors, government and other stakeholders”;
- users in particular want to be able to “make decisions based on timely, reliable, relevant and comparable EER information”, with a focus on “reporting on goals, strategies and targets”; and
- independent assurance is critical because it “inspires trust which enables companies to build good relationships with stakeholders, including suppliers, consumers and the wider public” (McGuinness Institute & XRB, 2018, p. 3).

Demand is substantial, as is recognition of the need for, future-focused disclosure in New Zealand: 85% of preparers and 96% of users indicated future orientation was an important or very important disclosure. However, only 56% of users thought it was being reported on well. Users consider this type of information when making investment decisions, understanding company strategies and future prospects, and making judgements about the operations and wider impacts of a company.

Disclosure can take many different forms, but a key distinction is between rules-based reporting and principles-based reporting. Rules-based reporting compels reporting entities to report according to specific and prescribed requirements. In contrast, principles-based reporting focuses on providing general guidelines for reporting entities to follow. The latter requires more judgement on behalf of reporting entities, but allows for reporting to provide the best available information that is meaningful for the entity in question, rather than focusing on compliance. However, the distinction between the two types of regimes can be somewhat artificial (B. Bennett et al., 2006), and best-practice disclosure may be most effectively captured by a blend of the two approaches (Responsible Investment Association Australasia, pers. comm. 20 June 2018).

### Avenues for climate-related financial disclosure

The two main avenues for climate-related financial disclosure are through voluntary reporting frameworks, or through mandatory government requirements.

#### Voluntary reporting frameworks

Numerous voluntary frameworks exist for the disclosure of non-financial (including climate change) risk, building on an ESG approach (section 7.2). Most are principles-based, and include the Integrated Reporting Framework, the Global Reporting Initiative, the Climate Disclosure Standards Board Framework, and the UN Global Compact. Many New Zealand organisations report against these, with Integrated Reporting noted

<sup>72</sup> The XRB is an independent Crown Entity responsible for establishing a trusted accounting and assurance standards framework.



industry-developed reporting requirements is unlikely to allow for the type of consistent and credible reporting required for investors to make adequately informed decisions across different opportunities.

### F7.8

Voluntary reporting frameworks (such as the guidelines provided by the New Zealand Stock Exchange) provide a positive foundation for firms to disclose climate-related risks. Yet their lack of coverage across the economy, and varying reporting requirements, means that they will not be sufficient to drive behaviour change across the New Zealand economy.

## Interpreting existing requirements as requiring disclosure

In New Zealand, company reporting requirements are mainly set out in the Companies Act 1993. For listed firms, the Financial Markets Conduct Act 2013 also applies. These both then interact with the standards developed by the XRB (developed under the Financial Reporting Act 2013). As the XRB explains:

[T]he law states which types of entities must prepare financial statements that apply XRB standards, publish financial statements and obtain assurance on them. The XRB standards themselves then state *what* and *how* entities must report (XRB, 2018).

While the Companies Act does not explicitly oblige reporting about climate change, it may be possible to interpret some of the requirements about the content of the annual report as covering climate risk. Specifically, Section 211(1)(a) requires that the annual report must

describe, so far as the board believes is material for the shareholders to have an appreciation of the state of the company's affairs and will not be harmful to the business of the company or of any of its subsidiaries, any change during the accounting period in—

- (i) the nature of the business of the company or any of its subsidiaries; or
- (ii) the classes of business in which the company has an interest, whether as a shareholder of another company or otherwise.

Climate risk could be considered to be information material to shareholders (or potentially harmful to the business of the company) (EY, 2018b). In an analysis of climate risk disclosure practices in Australia, Foerster et al. (2017) investigated whether such an interpretation could be made of similar reporting requirements contained within Australia's Corporations Act 2001. They note that the contents of the Director's Report could be interpreted as including an analysis of climate risk, including the requirement to

contain information that members of the listed entity would reasonably require to make an informed assessment of: the operations of the entity; the financial position of the entity; and the business strategies and prospects for future financial years. (Foerster et al., 2017, p. 163)

However, the authors conclude that climate-related risks are not consistently perceived as material financial risks, even by large emissions-intensive Australian businesses. This means that climate risk is unlikely to be reported under standard guidance, and particularly unlikely to be reported in the consistent and credible manner necessary for investors to make informed decisions across different investment opportunities. New research by the McGuinness Institute (2018) also supports this view. They found that even for significant New Zealand entities, reporting of climate change (including risk, costs, targets and initiatives), was low. For example, across all significant entities identified, only 42 (11%) provided information about climate risk, and only 5.5% provided information about specific goals to reduce future emissions.

It is therefore unlikely that existing requirements will adequately incentivise necessary disclosure of climate risk. As the Insurance Council of New Zealand submission contends,

[i]t could be argued that such measures are not necessary because Boards already have a fiduciary duty to report to their shareholders about liability, impaired assets and bad debts, all of which can be adversely affected by climate change impacts. Even if this is the case, it is evident that few companies



do report these risks or take a sufficiently long view, and certainly there is no consistent, clear and comparable reporting. (sub. 104, p. 4)

### F7.9

Existing financial reporting requirements, including those in the Companies Act 1993, will likely be insufficient to adequately incentivise the disclosure of climate risk in a consistent and credible way.

## Establish new government-mandated reporting requirements

Given the arguments against solely relying on voluntary reporting mechanisms, or existing reporting requirements as detailed above, additional mandated climate-related disclosure requirements will likely be needed in New Zealand. Some submitters supported this view, including the Guardians of NZ Superannuation (sub. 32), the Energy Management Association of New Zealand (sub. 70), the NZ Institute of Forestry (sub. 73), Meridian Energy (sub. DR253) and Z Energy Ltd (sub. DR377). Esperance Capital (sub. DR184) and Chartered Accountants Australia and New Zealand (sub. DR208) opposed mandatory disclosure.

Reporting can be made mandatory through primary or delegated legislation. Delegated legislation includes regulations and rules made by other parties (such as officials) by powers delegated to them by Parliament (McGee, 2017). As shown in the international examples above, climate-related disclosures may be enacted under primary legislation. However, in New Zealand, the possibility of issuing a financial reporting standard (a form of delegated legislation) via the XRB is also worth considering.

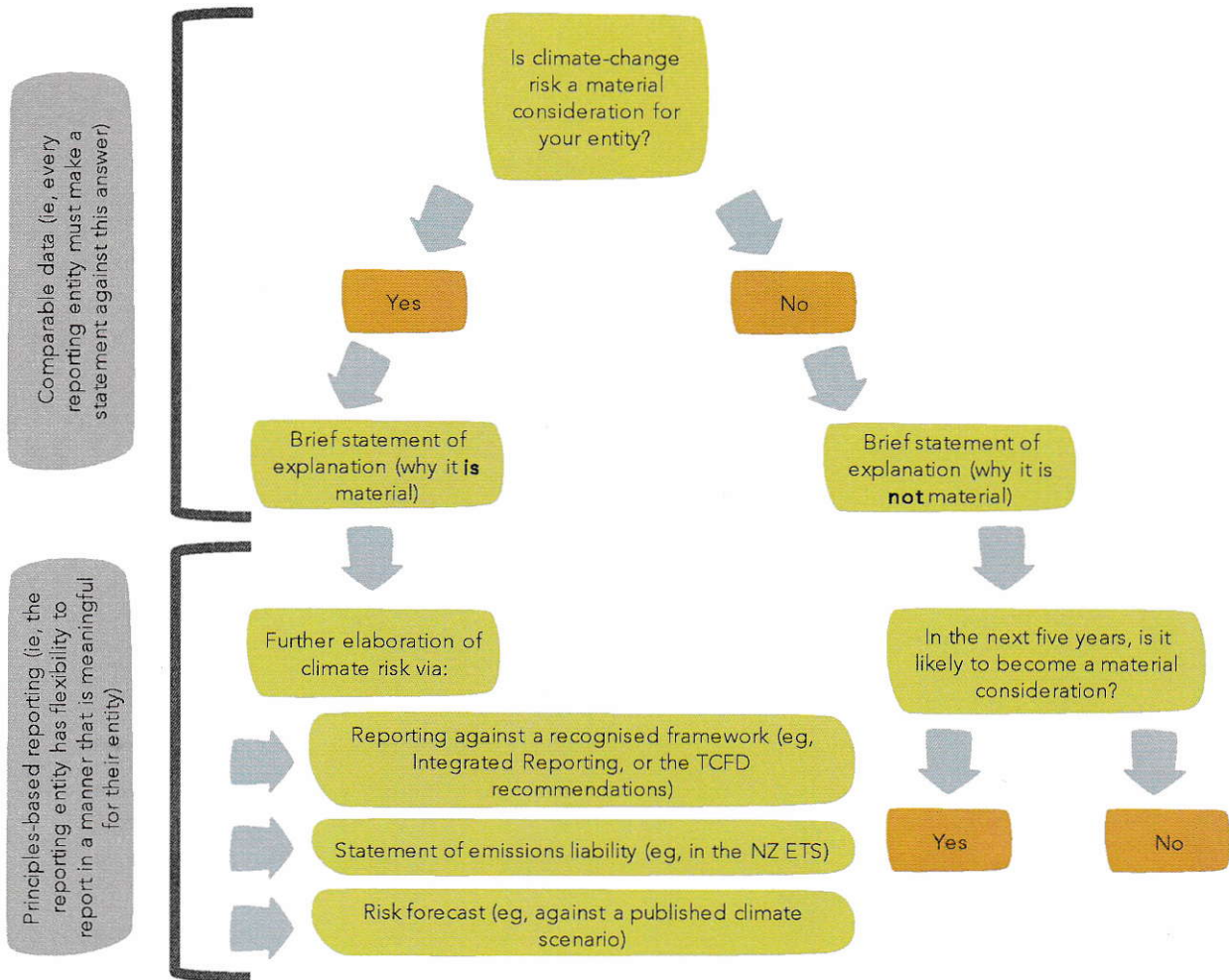
Under section 17(2) of the Financial Reporting Act 2013, the Governor-General can authorise the XRB to issue financial reporting standards relating to matters such as an entity's governance, strategic direction and targets and, under section 17(2)(iii), "the social, environmental, and economic context in which an entity operates". Climate-related disclosure fits neatly into this definition and would comprise an accounting standard (as opposed to an auditing and assurance standard). Accounting standards determine the reporting requirements for three main types of entities: for-profit, not-for-profit, and public-sector entities. These standards apply to entities in different ways based on a tier system (relating to the entity's size and purpose). Climate-related disclosure would need to be allocated to a particular tier or group of tiers, and consider aspects of materiality and administrative burden.

Using a delegated approach for climate-related disclosures offers many benefits, most notably the ability to provide greater detail and regulatory flexibility as opposed to the tight prescriptions of a requirement laid out in primary legislation (NZPC, 2014b). A standard could allow for a blend of rules and principles-based reporting, as shown in Figure 7-7<sup>76</sup> (which outlines a potential decision-tree approach for a climate-related standard on a comply or explain basis). In this blended approach, the vital comparable data for investors (ie, the more rules-based approach) is contained within the statement about materiality of climate risk. The main part of the standard (where the substantive disclosure occurs) is principles-based.

A predominantly principles-based approach, supplemented by information required of all reporting entities, is useful for numerous reasons. The base information allows for comparability and benchmarking, but the principles-based approach allows for flexibility for the entity to tell their own story about climate risk (eg, by the choice of reporting framework that is most suitable for that entity) (CDSB, 2016). The value of this blend was specifically noted by Meridian Energy (sub. DR253, p. 18):

Given the range of frameworks available internationally, we would suggest that firms retain some discretion regarding the use of a particular framework, provided that certain critical information is included as mandatory.

<sup>76</sup> This example focuses on the risk to the entity, but it is feasible that a complementary standard could also be developed about whether the entity was a significant contributor to climate change.

**Figure 7-7 Climate-related disclosure decision tree****Notes:**

1. The test for materiality can be summarised as whether it would have impacted decision making had it been known.
2. About risk forecasting, Matikainen (2017b) notes that any issued guidance should include information on common scenarios given the need for forward-looking analysis.

A principles-based approach is valuable for investors because it provides a level of confidence in the sophistication of the understanding of climate-risk by that entity (Responsible Investment Association Australasia, pers. comm. 20 June 2018). It also avoids unnecessary regulatory burden, because the inherent flexibility via the blend of a rules and principles-based approach allows for integration with other reporting frameworks and mechanisms for ESG reporting (ie, beyond climate change). This need for a holistic reporting framework across extended external reporting topics (and in a way that does not create undue reporting burden) was a notable theme of submissions (External Reporting Board, sub. DR164; Esperance Capital Ltd, sub. DR184; and Chartered Accountants Australia and New Zealand, sub. DR208).

It is important that climate-related disclosure should occur in the "mainstream annual financial filings" (TCFD, 2017, p. iv) so that it is audited and publicly available. Such disclosure is also needed to elevate the status of climate-related financial disclosure.

In New Zealand, only financial statements are required to be filed on the Companies Office register (and are audited), as compared to the wider annual report. Yet many significant entities in New Zealand do file their complete annual report (including their financial statements), and this "highlights an opportunity for government to require all companies that are currently required to file their financial statements to instead file their complete annual report" (McGuinness Institute, 2018, p. 49). Whether through such a requirement or otherwise, it will be important that climate-related disclosures occur in a manner that ensures their verifiability and accessibility will be important.



Before issuing a standard, the XRB carries out an extensive process of consultation. The Commission understands that the Ministry for the Environment (MfE), the XRB and the Ministry of Business, Innovation and Employment are currently discussing how climate-related financial disclosure requirements may be enacted in New Zealand. The numerous issues to consider (such as the relevant tier of entities required to disclose, and the specific wording of the standard) will also require substantial engagement with industry.

#### F7.10

A standard issued via the External Reporting Board under section 17(2)(iii) of the Financial Reporting Act 2013 is the most suitable avenue for climate-related disclosure in New Zealand.

#### R7.4

The Government should implement mandatory (on a comply or explain basis), principles-based, climate-related financial disclosures by way of a standard under section 17(2)(iii) of the Financial Reporting Act 2013. These disclosures should be audited and accessible to the general public.

## 7.6 Other supporting actors for the low-emissions transition

### Central banks and financial regulators

Central banks and financial regulators play an important role in financial regulation and monetary policy. This is relevant to climate policy given the risks to market stability from an unpredictable or abrupt transition, and the potential opportunity for improved financial and macroeconomic stability if climate change is adequately factored into investors' decision-making (section 7.2 and Ryan-Collins & van Lerven, 2017). Monnin (2018) explains:

Climate change is a significant risk for our societies and transitioning to a low-carbon economy a key challenge we must meet. Central banks must not stand on the sidelines in this process. They need to safeguard financial stability by taking appropriate measures to strengthen financial market resilience vis-à-vis climate-related risks, and they need to align their policies with the shift in investments that the transition to a low-carbon economy requires (p. 13).

A role for central banks or financial regulators is to assess the exposure of their domestic financial system to climate risk (Monnin, 2018). This is complementary to, but more high-level than, the assessment of climate risk required through disclosure at the firm or investor-level. Once climate stress-testing occurs, central banks and regulators can then determine whether any changes are required, such as ensuring climate-aligned financial regulation or conducting other activities such as corporate bond purchases (Campiglio et al., 2018; Matikainen et al., 2017).

Many central banks have either recently conducted, or are in the process of conducting, such reviews. For example, the Bank of England's Prudential Regulation Authority has written to local and international banks operating in the United Kingdom to ask them how they are thinking about, and managing, climate risk. A report outlining the banks' responses is expected in 2018 (Bank of England, pers. comm. 11 October 2017).

In a review of the Dutch financial system, De Nederlandsche Bank concluded that the financial sector has considerable exposure to high-emissions sectors. In response, it intends to "embed climate-related risks more firmly in financial supervision with the aim of ensuring sustainable financial stability" (DNB, 2017, p. 4). The Swedish Financial Supervisory Authority, Finansinspektionen, also commissioned a report on "how environmental and climate change may affect financial stability in the long run, and which measures may be needed to dampen the negative effects on the financial system" (Bowen & Dietz, 2016, p. 5).

New Zealand currently has no whole-of-economy understanding of the level of financial exposure to climate risk. This lack of understanding is a substantial information deficit. As Monnin (2018, p. 5) contends, this "information is not only crucial for regulators, but also for financial market participants to adequately reflect climate-related risks in their investment decisions". One particularly suitable avenue to rectify this



- F7.9** Existing financial reporting requirements, including those in the Companies Act 1993, will likely be insufficient to adequately incentivise the disclosure of climate risk in a consistent and credible way.
- F7.10** A standard issued via the External Reporting Board under section 17(2)(iii) of the Financial Reporting Act 2013 is the most suitable avenue for climate-related disclosure in New Zealand.
- F7.11** Central banks can play an important role in assessing the exposure of financial systems to climate risk, particularly in relation to risks of financial instability.
- F7.12** Institutional investors, such as pension funds and insurance companies, represent a large potential source of finance for the transition to a low-emissions economy. There do not appear to be any major barriers to New Zealand institutional investors finding adequate low-emissions investments of a suitable type.

## Recommendations

- R7.1** Any decisions made by the Government about the model or structure of the New Zealand Venture Investment Fund should be informed by further analysis of the potential for giving priority to low-emissions investments, and whether (and if so, how) an investment exclusion should apply to high-emissions investments.
- R7.2** A Green Investment Fund (GIF) has potential to stimulate some of the technology and infrastructure needed to achieve the low-emissions transition in New Zealand. In work to establish a GIF, the Government should clearly identify the market failure that it seeks to address. The Government should specify the GIF's mandate, financing approach and funding source, expected duration, institutional structure (including its degree of independence), desired minimum rate of return, relationship to existing infrastructure and clean technology funding sources, and scale of investment (wholesale or retail).
- The Government should also state how the GIF will work in conjunction with any other initiatives for providing infrastructure or low-emissions technology finance.
- R7.3** The Government should endorse the recommendations of the Task Force on Climate-related Financial Disclosures as one avenue for the disclosure of climate risk.
- R7.4** The Government should implement mandatory (on a comply or explain basis), principles-based, climate-related financial disclosures by way of a standard under section 17(2)(iii) of the Financial Reporting Act 2013. These disclosures should be audited and accessible to the general public.
- R7.5** The Government should align its project and programme funding so that it discourages high-emissions, path-dependent activities, and encourages low-emissions, path-dependent activities. This alignment should be supplemented by work to define what constitutes low-emissions investment, with the aim of identifying a clear taxonomy.