Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Climate-related Financial Disclosure**	**Meeting**	AASB August 2023 (M197)
Topic:	**Approach to the baseline of IFRS S2—Internal carbon prices**	**Agenda Item:**	09.2
		Date:	24 July 2023
Contact(s):	Siobhan Hammond shammond@aasb.gov.au	**Project Priority:**	High
		Decision-Making:	High
		Project Status:	Development of an exposure draft

Objective

1 The objective of this paper is to present staff analysis and recommendations on the Board's proposed approach to the cross-industry internal carbon prices disclosure requirements in the baseline of IFRS S2 *Climate-related Disclosures*.

2 Staff will develop an Exposure Draft for the Australian-equivalent standards to IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 based on the Board's decisions at its August and September 2023 meetings. At a later stage, staff will consider whether any consequential changes to the non-authoritative guidance accompanying IFRS S1 and IFRS S2 would be needed (see Agenda Paper 7.1).

Structure

3 This paper is structured as follows:

(a) Summary of staff recommendation (paragraph 4)

(b) Background (paragraphs 5-8)

(c) What is internal carbon pricing? (paragraphs 9-12)

(d) Staff analysis (paragraphs 13-25)

(e) Staff recommendation and questions to Board (paragraphs 26-**Error! Reference source not found.**)

(f) Appendix A—Extracts from IFRS S2 *Climate-related Disclosures*.

Summary of staff recommendation

4 Staff recommend that, for the cross-industry metric related to an entity disclosing its internal carbon price in paragraph 29(f) of IFRS S2, the Board aligns with the baseline of IFRS S2. That is, for the purpose of developing an Australian equivalent to IFRS S2, staff recommend that the Board does not remove the cross-industry internal carbon prices disclosure requirements from the baseline of IFRS S2.

Background

5 In June 2023, the International Sustainability Standards Board (ISSB) issued IFRS S2, which includes cross-industry disclosure requirements relating to the carbon prices an entity uses when considering its climate-related risks and opportunities (see Appendix A—Extracts from IFRS S2 *Climate-related Disclosures* for relevant extracts from IFRS S2).

6 In the joint response to the ISSB's Exposure Drafts on [Draft] IFRS S1 and [Draft] IFRS S2, the AASB and AUASB noted that, overall, stakeholders agreed with the proposals relating to internal carbon prices. However, the submission also acknowledged that:

(a) stakeholder feedback highlighted concerns about the clarity of the proposed definition; and

(b) some stakeholders disagreed with it because, in their view, such a disclosure requirement goes beyond what would be required for general purpose financial statements.[1]

7 As part of its redeliberation of [Draft] IFRS S2, the ISSB made no substantive changes to the disclosure requirements or the definition relating to internal carbon prices (see Appendix A).

8 As some stakeholders disagreed with the proposals and questioned the usefulness of information about an entity's internal carbon prices, staff think it is important for the Board to consider whether to depart from, amend or add to the baseline of IFRS S2 in developing the proposed Australian equivalent.

What is internal carbon pricing?

9 Carbon pricing is a flexible process by which entities price the cost of their carbon dioxide emissions into their financial decisions, encouraging entities to reduce their emissions. In essence, internal carbon pricing recognises the cost of the environmental damage caused by greenhouse gas emissions to the emitter.

10 Staff understand that many entities have started considering carbon pricing in their business operations and investment decisions to help them prepare for a low-carbon future and avoid investing in carbon-intensive activities.

11 Whilst carbon pricing can take different shapes and forms, staff understand that one of the most widely used approaches is internal carbon pricing, which includes a real or shadow (hypothetical) cost of carbon, offsetting and internal carbon taxes or levies.

12 Internal carbon pricing can help entities measure, model and manage the financial and regulatory risks posed by existing and potential Government carbon pricing regimes. It can also help identify risks such as missing net zero targets and opportunities like business partners and suppliers that can help the business reduce emissions.

1 For example, a few of these stakeholders referred to internal transfer prices used by entities, which are not required to be disclosed by entities applying IFRS Accounting Standards. These stakeholders questioned the difference between internal carbon and internal transfer pricing and how the costs and benefits of disclosing internal carbon pricing differed from disclosing internal transfer pricing.

Staff analysis

13 At its February 2023 (M193) meeting, the Board decided on the following set of criteria to apply when considering departing from, amending or adding to the baseline of IFRS Sustainability Disclosure Standards:

(a) requirements in IFRS Sustainability Disclosure Standards do not adequately address Australian-specific matters and there is, or is likely to be, diversity in practice warranting Australian-specific requirements or guidance (see paragraph 14);

(b) requirements in IFRS Sustainability Disclosure Standards will not deliver user benefits that outweigh any undue cost or effort for preparers (see paragraphs 15-17);

(c) requirements in IFRS Sustainability Disclosure Standards will not achieve international alignment or else will conflict with global sustainability reporting practices (see paragraphs 18-24);

(d) the Board identifies equivalent disclosure requirements in Australian legislation that already meet the objectives of the IFRS Sustainability Disclosure Standards and would result in duplicate disclosure or reporting for Australian entities (see paragraph 25); and

(e) transitioning from existing Australian practices to requirements in IFRS Sustainability Disclosure Standards will impose additional costs and/or time when compared with international counterparts, warranting deferral of the application date.[2]

Meeting the needs of Australian stakeholders

14 Per paragraph 6, feedback on the Exposure Draft on [Draft] IFRS S2 and ED 321 *Request for Comment on ISSB [Draft] IFRS S1 and [Draft] IFRS S2* overall, stakeholders were supportive of the proposals related to internal carbon prices.

Cost versus benefit

15 In paragraph BC107 of the accompanying Basis for Conclusions to [Draft] IFRS S2, the ISSB cited a TCFD-led public consultation in June 2021, which found that only 42% of respondents found internal carbon price-related metrics to be very useful for their decision making. That is, the ISSB acknowledged in the Basis for Conclusions to [Draft] IFRS S2 that internal carbon price-related metrics are not as useful to investors as the other cross-industry metrics for greenhouse gas (GHG) emissions, physical or transition risk, climate-related opportunities and capital deployment.

16 Staff performed a search of academic literature to identify whether evidence exists to support the usefulness of internal carbon price disclosures. We note that published research is currently focused on identifying whether an entity has made the disclosure rather than on whether users find that disclosure useful. However, while staff could not identify evidence that supported the usefulness of internal carbon price disclosures, we acknowledge that overall stakeholder feedback to the Exposure Draft on [Draft] IFRS S2 indicated that such a disclosure would likely be useful.

2 Treasury will be the Government body responsible for establishing the effective date for mandatory climate-related financial disclosure in Australia. At a future Board meeting, staff will consider what amendments need to be made to the baseline of IFRS Sustainability Disclosure Standards to align with Treasury's final position (when it is known).

17 Given the narrow scope of the related requirement—it would only apply if an entity were using internal carbon pricing—staff are of the view entities are unlikely to see a significant increase in preparation costs from these requirements.

International alignment

New Zealand Climate Standards

18 Paragraph 22(g) of Aotearoa New Zealand Climate Standard 1 *Climate-related Disclosures* (NZ CS 1) states that an entity must disclose metrics relating to internal emissions price (being the price per tonne of CO_2e used internally by an entity). Appendix A to NZ CS 1 provides further clarity and defines internal emissions price as "a monetary value on GHG emissions that an entity uses internally to guide its decision-making process in relation to climate-related impacts, risks and opportunities."

19 The disclosure requirements and definition relating to internal emissions price in NZ CS 1 are simplified compared to IFRS S2. The main difference is that NZ CS 1 does not require an entity to disclose whether and how it applies internal carbon prices in its decision-making, whereas IFRS S2 does.

20 However, staff do not believe this difference creates any significant misalignment. Staff are of the view that entities would likely disclose the same information about their use of internal carbon prices regardless of whether they were applying NZ CS1 or IFRS S2.

European Sustainability Reporting Standards (ESRS)[3]

21 Disclosure Requirement E1-8 – Internal carbon pricing (or paragraphs 59-60) of the Exposure Draft on ESRS E1 *Climate change* ([Draft] ESRS E1) requires an entity to disclose whether it applies carbon pricing schemes and if so, how they support the entity's decision-making and incentivise the implementation of climate-related policies and targets. In addition, to meet that requirement, paragraph 60 of [Draft] ESRS S2 requires an entity to disclose information about:

(a) the type of internal carbon pricing scheme, for example, the shadow prices applied for capitalised expenditure or research and development (R&D) investment decision making, internal carbon fees or internal carbon funds;

(b) the specific scope of application of the carbon pricing schemes (activities, geographies, entities, etc.);

(c) the carbon prices applied according to the type of scheme and critical assumptions made to determine the prices, including the source of the applied carbon prices and why these are deemed relevant for their chosen application. The entity may disclose the calculation methodology of the carbon prices, including the extent to which these have been set using scientific guidance and how their future development is related to science-based carbon pricing trajectories; and

3 Note that the ESRS have not yet been finalised or issued at the time this paper was prepared and as such the ESRS requirements referred to in this staff analysis are subject to change. However, staff note that the ISSB is working together with the European Financial Reporting Advisory Group (EFRAG) to develop guidance on how an entity can meet both the requirements in the ESRS and the ISSB. Consequently, staff do not expect that there will be substantive changes to the related requirements in the ESRS such that they would conflict with the requirements in IFRS S2.

(d) the current year approximate gross GHG emission volumes by Scopes 1, 2 and 3 in metric tonnes of CO_2e covered by these schemes, as well as their share of the undertaking's overall GHG emissions for each respective Scope.

22 Appendix A to [Draft] ESRS E1 also provides the following definitions:

(a) Internal carbon price—a price used by the entity to assess the financial implications of changes to investment, production, and consumption patterns, as well as potential technological progress and future emissions abatement costs.

(b) Internal carbon pricing scheme—an organisational arrangement that allows the entity to apply carbon prices in strategic and operational decision making. There are two commonly used types of internal carbon prices. The first type is a shadow price, which is a theoretical cost or notional amount that the undertaking does not charge but that can be used in assessing the economic implications or trade-offs for such things as risk impacts, new investments, net present value of projects, and the cost-benefit of various initiatives. The second type is an internal tax or fee, which is a carbon price charged to a business activity, product line, or other business unit based on its GHG emissions (these internal taxes or fees are similar to intracompany transfer pricing).

23 The proposed requirements in ESRS E1 are more detailed than those in IFRS S2. However, the definitions used in both are similar and in applying the proposed Disclosure Requirement E1-8, an entity would likely meet the cross-industry internal carbon prices disclosure requirements in IFRS S2. Staff are of the view that entities would likely disclose the same information about their use of internal carbon prices regardless of whether they were applying ESRS E1 or IFRS S2.

Global Reporting Initiative (GRI) Standards[4]

24 Staff did not identify any specific requirements in the GRI Standards relating to internal carbon prices. However, staff note that GRI 11: Oil and Gas Sector 2021 and GRI 12 Coal Sector 2022 recommend entities in those industries report on the internal carbon pricing assumptions that have informed the identification of risks and opportunities due to climate change. Staff note that the Global Sustainability Standards Board (GSSB)—the standard-setting body of the GRI—has commenced a project for Climate Change Standards which will, in part, look at potential alignment with related requirements in the ESRS and IFRS S2.

Interaction with existing Australian legislation

25 Staff have not identified any internal carbon price-related requirements within Australian legislation or regulation for Australian entities.

Staff recommendation and questions to Board members

26 Staff acknowledge that not all stakeholders agreed with the proposed cross industry internal carbon prices disclosure requirements in [Draft] IFRS S2. Staff also acknowledge the TCFD-led public consultation, which indicated that internal carbon prices disclosures are not always useful for decision making.

4 See Agenda Paper 4.1 for further detail.

27 However, staff consider requiring entities to disclose information about internal carbon pricing could provide greater transparency and accountability about how an entity assesses its climate-related risks, identifies its opportunities and prepares for future climate regulations.

28 As noted above, an entity using internal carbon pricing in managing its operations is expected to have access to the necessary information to comply with the disclosure requirements, so there are unlikely to be significant barriers to disclosing the required information.

29 For these reasons, staff do not consider there to be any compelling reasons supporting a departure, addition or amendment to the baseline of IFRS S2. Therefore, staff recommend the cross-industry internal carbon prices disclosure requirements in IFRS S2 be retained in the proposed Australian approach to climate-related disclosures without amendment.

Questions to Board members

Q1: Do Board members have any questions about the information provided in this paper?

Q2: Do Board members agree with the staff recommendation in paragraph 29 to retain the cross-industry internal carbon prices disclosure requirements in IFRS S2 in the proposed Australian climate-related financial disclosure requirements without amendment?

Appendix A—Extracts from IFRS S2 *Climate-related Disclosures*

To help the Board understand the changes made to the proposals in the Exposure Draft on [Draft] IFRS S2, the extracts below show the changes the ISSB made in finalising IFRS S2. Added text is underlined and deleted text is struck through.

…

Climate-related metrics

29 An entity shall disclose information relevant to the cross-industry metric categories of:

…

(f) *internal carbon prices*—the entity shall disclose:

(i) an explanation of whether and how the entity is applying a ~~the~~ carbon price in decision-making (for example, investment decisions, transfer pricing and scenario analysis); and

(ii) the price for each metric tonne of greenhouse gas emissions the entity uses to assess the costs of its greenhouse gas emissions;

…

Appendix A
Defined terms

…

Internal carbon price	Price used by an entity ~~entities~~ to assess the financial implications of changes to investment, production and consumption patterns, and of ~~as well as~~ potential technological progress and future emissions-abatement costs. An entity can use ~~Entities'~~ internal carbon prices ~~can be used~~ for a range of business applications. Two ~~There are two~~ types of internal carbon prices that an entity commonly uses are: ~~used by entities.~~ (a) ~~The first type is~~ a shadow price, which is a theoretical cost or notional amount that the entity does not charge but that can be used to understand ~~in assessing~~ the economic implications or trade-offs for such things as risk impacts, new investments, the net present value of projects, and the cost and benefit of various initiatives; and (b) ~~The second type is~~ an internal tax or fee, which is a carbon price charged to a business activity, product line, or other business unit based on its **greenhouse gas** emissions (these internal taxes or fees are similar to intracompany transfer pricing).

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