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Carbon Zero and the Board

The pursuit of carbon neutrality has forced challenging board discussions about companies' medium and long-term strategies. Increasingly, investors, customers and other stakeholders expect companies to set – and meet – carbon reduction goals. Investors, in particular, are pushing for standardized climate and sustainability metrics from companies. Forthcoming SEC rulemaking is likely to mandate such disclosures, including with respect to greenhouse gas emissions. Looking ahead, as climate metrics become widely available, and as carbon reduction commitments become operational requirements, boards will need to proactively communicate how climate change and the transition away from carbon will impact their business outlook and planning. Already, the market has rewarded companies that are well-positioned to transition to a carbon-constrained operating environment, and is starving fossil fuel production projects of necessary capital.

Within this context, directors must now grapple with near-existential questions of whether and how to transition into a low or no-emission future. Some companies may choose to proceed on course, with long-term wind-down and liquidation in mind. More frequently, boards will work with management to assess the conversion of products and operations to more sustainable alternatives. Increasingly, boards are considering whether and how to diversify into new business lines that are more resilient to climate stressors or a changing regulatory environment. All of these decisions lead to a host of disclosure, regulatory and stakeholder concerns.

Energy producers, in particular, must grapple with the increased pressure concerning carbon emissions. Their boards must decide whether to continue to fully exploit existing and new carbon-based energy assets, or instead reorient into greener energy sources. In the right circumstances, companies have sold or spun off environmentally unfriendly assets, such as PSEG's sale of its fossil fuel plants. Most recently, activist hedge fund Third Point has proposed a break-up of Royal Dutch Shell to permit investors to choose whether to own renewables or legacy oil and gas. Companies in carbon-intensive industries can harness similar strategic transactions to segment assets based on climate performance, akin to prior waves of transactions that segmented businesses by profit margins and growth rates. Interestingly, Royal Dutch Shell has rejected the proposed break-up as value destructive.

In this new operating environment, boards must ensure they have sufficient climate and carbon competency. Targeted recruiting and education can strengthen a board's ability to appropriately oversee the strategic, operational, disclosure and stakeholder engagement challenges associated with the carbon zero transition. A failure to adequately prepare runs the risk, in the immediate term, of attracting activists like Engine No. 1, which successfully obtained seats on Exxon's board after highlighting missteps in the company's response to climate change. In the longer term, companies with climate-competent managements and boards will be better prepared to transition and thrive in a carbon-constrained future.

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