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Internal price on carbon – a short summary

Access to relevant information is essential for the financial system to contribute to sustainable development. Sustainability-related information can contribute to financial stability, consumer protection and efficient markets.

Prices convey information. From a social point of view, the price of carbon emissions is too low in large parts of the world, with social costs greatly exceeding the cost to the polluter.[1] When the price is too low, important information is lost. Emissions become too large. And the necessary investment for transitioning to a low carbon economy don't materialize. In addition, firms with business models built on a low carbon price can be vulnerable if the price were to be raised to a more socially efficient level. International as well as national climate targets point to a need for raising the cost of emitting carbon dioxide and other greenhouse gases.[2]

The cost of carbon emissions is getting increasing attention as a risk that firms need to assess, manage and disclose. One approach that is mentioned as a possible tool for managing transition risks (and possibilities) is that firms use an internal price of carbon – i.e., setting an internal price tag for emissions that may differ from the market price – and disclose this price.[3] The disclosed price should be the one that the firm actually uses internally, for example when making investment decisions. Using an internal price on carbon is thus a way for a firm to taking into account future policy responses to climate change and to integrate climate-related issues in their strategy and business development.

The use of internal carbon pricing has been advocated by, among others, the UN, the Task force on Climate-related Financial Disclosure (TCFD) and the Carbon Disclosure Project (CDP), see below. In a report from 2019 the Swedish public pension fund AP7 och the International Chamber of Commerce Sweden also advocate introducing such a measure.[4] A number of firms around the world already report an internal price on carbon, on a voluntary basis.

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[1] See Carbon Pricing Leadership Coalition (2017).
[2] See OECD (2018).
[3] Importantly, the internal price on carbon can be higher that the statutory cost of carbon emissions in the firm's jurisdiction.
[4] See AP7 and ICC Sweden (2019).

Firms can also go further and disclose information about how they use the internal carbon price in their decision-making and to what extent it affects their decisions. There are firms that use an internal price as an indication, while other firms use the measure to set up an internal levy reflecting the difference between the market price of emissions and an assessment of the social cost of emissions. The revenue from such a levy can be used for specific measures within our outside the firm, to offset the climate effects of the firm's emissions.

Pros and cons of disclosing an internal carbon price
Using and disclosing an internal carbon price brings several advantages. As discussed above, it can be a tool for firms to proactively change their business model to manage transition risks. It can also make it easier for investors and other third parties to identify which firms have business models that are vulnerable to future policy responses to climate change, and which firms are adapting their business models to ensure resilience to transition risks. During 2017 the asset manager Schroders developed a model for assessing how firms' profits can be affected by tighter climate-related regulation. Shroders estimated that for almost half of global listed firms revenues could be affected by more than 20 percent, if the cost of carbon emissions would rise to 100 USD per tonne CO2.[5]

It can be hard for external parties to observe what internal price a firm actually uses in its business operations, and whether it has any real effects on the firm's decisions. If a firms reports a high internal carbon price but actually uses a lower price, or if the internal price does not have a real effect of the firm's decision-making, the information loses its desired effect and could contribute to greenwashing.

During 2019 Exxon was taken to court in the US, accused of misleading investors by reporting a kind of internal carbon price that was higher than the price actually used by the firm for its long term planning. In the end, Exxon was not convicted, but the case shows that there might be serious consequences for firms that misuse carbon price disclosure, either through legal repercussions or through reputation risk.

Recommendations from others regarding internal carbon pricing

Task force on Climate-related Financial Disclosure, TCFD
TCFD was appointed by the Financial Stability Board (FSB) with a task to develop a framework for disclosure of climate-related financial risks and opportunities.

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[5] https://www.schroders.com/en/ch/asset-management/literature/climate-change-dashboard/carbon-var/

TCFD emphasize that an internal price on carbon can be used as a tool for, among other things,

- identify risks and opportunities,
- create incentives to drive change toward increased energy efficiency and reduced costs,
- steering investment decisions

Within the context of their disclosure recommendations, TCFD argue that firms, when relevant, should disclose:

- the internal price of carbon used by the firm,
- measures linking to climate-related opportunities, for example revenues from products and services that are adapted to a low carbon economy.

TCFD does not prescribe a particular level for the internal carbon price.

The TCFD status report from June 2019 contains some examples of the kind of information firms have disclosed about their internal carbon prices.

The European Commission
During 2018 the European Commission published additions to its previous recommendations about how firms can report the information required by the EU directive on non-financial reporting. The purpose of the recommendations is to contribute to improved comparability of disclosures.

In the non-binding guidelines on what information firms should report regarding material risks and their management, the European Commission states that it is important for investors and other interested parties to get information about how a firm identifies climate-related risks, what material risks a firm has identified and how these are managed. One of the points raised in the guidelines is that firms can report how scenarios and/or an internal price on carbon is used for risk management.

The European Commission does not prescribe a particular level for the internal carbon price.

Carbon Disclosure Project, CDP
CDP is an international, non-profit organisation promoting that investors, firms and cities, through measuring and understanding their environmental impact, should undertake measures that contribute to a sustainable development. CDP supports firms and cities in the work to disclose information about environmental impact and collects the information at the global level. More than 8 400 firms and cities report information through CDP.

According to CDP, an internal carbon price is a multi-faceted tool and firms can use it for different purposes. It can be a tool for

- assessing and managing CO2-related risks,
- identifiy CO2-related opportunities, and
- drive change in a firm’s business activities.

Assigning a financial value to risks and opportunities and using a consistent, standardized measure for measuring them, can make it easier for firms to integrate climate-related issues, such as transition, into the firm's business strategy.

Since firms can integrate an internal carbon price into their decision making in different ways, CDP emphasize that investors, to fully understand the firm's risk management, also need to know why and how a firm uses the measure. This is about understanding the firm's purpose when using the internal price, how it is applied to firm-level decision making and to what extent it has an impact on the decisions made by the firm.

CDP has since 2013 demanded that firms disclose if and how they use an internal price on carbon. In 2018 approximately 1 300 firms reported that yet were using, or would within two years be using, an internal price on carbon, up from 150 firms in 2014.

CDPdoes not prescribe a particular level for the internal carbon price.

UN Global Compact
The UN Global Compact was founded in 1999 in conjunction with the World Economic Forum that year, on a request from UN secretary general Kofi Annan. The purpose was to develop a number of international principles related to sustainability, for firms to adhere to. The resulting principles relate to human rights, labour rights, environment and governance/corruption. The principles that firms should

- support a principle of caution when dealing with environmental risks,
- take initiatives to promote environmentally responsible behavior,
- encourage development and dissemination of environmentally friendly technology.

The UN Global Compact calls on firms to

- set an internal price on carbon that is high enough to have a material impact on investment decisions,
- publically emphasize the importance of political measures for the pricing of carbon,
- in public reports communicate the above.

Firms are called on to use an internal carbon price of at least 100 USD for tonne. In other words, firms are not only asked to disclose an internal price, but to use a price above a specified level. This recommendation is hence more far-reaching than the recommendations of the organisations discussed above.

References and suggested reading

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