



HOUSE OF LORDS

## Economic Affairs Committee

### Corrected oral evidence: UK energy supply and investment

Tuesday 15 March 2022

4.05 pm

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Members present: Lord Bridges of Headley (The Chair); Viscount Chandos; Lord Fox; Lord Griffiths of Fforestfach; Lord King of Lothbury; Baroness Kramer; Lord Livingston of Parkhead; Baroness Noakes; Lord Rooker; Lord Stern of Brentford.

Evidence Session No. 8

Heard in Public

Questions 106 – 117

#### Witness

[I](#): Simon Redmond, Senior Director, S&P Global Ratings.

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## Examination of witness

Simon Redmond.

Q106 **The Chair:** Welcome to this meeting of the Economic Affairs Committee. Would you like to introduce yourself?

**Simon Redmond:** I am a credit analyst at S&P Global Ratings. A key part of my role as Sector Lead is the formulation of our global assumptions for oil and gas, and our analysis of oil and gas companies. Secondly, since the start of this year, I have been acting as Head of Analytical Governance for our Sustainable Finance Practice.

Q107 **The Chair:** Thank you very much. Your coming to talk to us is very timely. To start with a basic question, how is the current crisis affecting your perception of and the pricing of risk in energy markets overall? Talk us through what you are seeing in the short term and from looking to the medium term.

**Simon Redmond:** If I may, in terms of pricing risk, we're thinking about credit quality, my focus is on oil and gas producers. Needless to say, if they can sell their products for a higher price, they look better. The interesting question is what they will do with the excess cash flow, if you will, and where they will invest it. For my colleagues looking at power generation companies in the UK and elsewhere, the questions are different. In terms of credit risk, last year S&P took a more conservative view of the oil and gas industry, mostly in terms of its long-term prospects as a result of the energy transition, but also to factor in the lower profitability that we had observed over time and the higher volatility that we are arguably seeing an example of right now. We took the view that, if the industry was riskier, all things being equal, some companies might need a lower rating, if their balance sheets looked the same. As a result, we downgraded many of the supermajors globally.

I guess the question now arises whether we will be upgrading them again as a result of higher prices? The short answer is not necessarily. We see the outlook as being—I do not want to say a classic market spike, but we are clearly seeing an overreaction in markets if Brent moves to \$137 and then comes back below \$100 in a matter of a week. There appears to be a de facto market overreaction. There is inherent uncertainty about where things will go, but high prices and low prices are a characteristic of the oil and gas production industry and something that we seek to factor into ratings. We still see the enduring challenges for the sector—you could say the existential challenges for the sector—as a result of the energy transition and climate change. Clearly, in the short run, the industry's characteristics of high volatility remain with us.

**The Chair:** I assume you look in a slightly different way at oil majors that have a credible transition plan, in your mind. Can you set out how you judge what a credible transition plan is for those big oil majors?

**Simon Redmond:** First and foremost, when we think about their ratings, the reality is that most cash generation flows from their oil and gas

activities and will continue to do so for many years. Therefore, particularly when prices are rather high, as they are at the moment, they have the capacity, as I mentioned a moment ago, to choose where they can invest. This is something of a turnaround from 2020, when the decisions were “Where can we cut?” rather than “Where can we invest?” That sets a backdrop to the rating. Put simply, that is why we have A or AA ratings on some of these large, diversified, international majors.

To your question, over time we need comfort that they can sustain the same type of business risk profile and the same kind of cash flow visibility. As you know, we can argue that there is a transatlantic split in terms of the strategies the companies are adopting, but there are also clearly differences in Europe. Some companies are actively targeting to reduce their hydrocarbon production while targeting to maintain their cash generation at the same time. Others are, as they would describe it, going with the market and recognising that oil demand is likely to remain somewhere around 100 million barrels a day for some time. Therefore, there will be demand in the market and they will need to continue those projects, even as they develop material assets outside of oil and gas such as power generation, offshore wind and so on.

In our analysis, when we think about oil and gas companies moving into the utility and power generation space, it is important to recognise that not all utilities are equal. We see transmission networks as having very strong credit characteristics, as they are essentially a regulated asset base, and then merchant assets at the other extreme. In our view, they have a broadly similar risk profile to the oil and gas industry. The fact that an oil and gas major is investing in power generation—not necessarily to the same extent if there are contracts for difference, as in the earlier discussion—but essentially as an exposure to power rather than as a regulated return, it is not inherently a massive change in their risk profile, as a first approximation. Obviously you have some benefits from diversification and so on. This is the way we are thinking about the transition at the moment, but the simple fact is that, for the time being anyway, the ratings hinge on their legacy businesses.

**Q108 Lord Livingston of Parkhead:** First, I declare my role as a non-executive director at S&P Global. On the point that Simon just made about short-term spikes, is there actually an argument for the industry as a whole—I am not talking about particular companies—that this short-term spike will hasten the long-term decline of hydrocarbons, because it will encourage more green production and, in the meantime, there is pressure on the energy sector in the western world to go back to investing, rather than just farming the existing investments? So although there is obviously a very strong positive in the short term, is this actually hastening the end of the cash generation from hydrocarbons because of what it will do to the long-term market?

**Simon Redmond:** That is a very fair point. There was discussion and media reporting around the time of the Covid lockdowns about whether that was the start of the end for hydrocarbons and fossil fuels. Perhaps in some ways it was, but it clearly was not in terms of the price dynamics

that we are seeing at the moment. At that point—this is why I mention it—people were arguing about whether there will be one last hurrah for the oil and gas world, particularly oil prices. As my colleagues at S&P Global Platts would put it, the best cure for high oil prices is high prices, and vice versa—we saw that in action in 2020. When we think about oil, we think primarily about transport, and it is a very fair observation that if people have a choice to move away from a diesel or a gasoline or petrol car towards buying an electric vehicle or a hybrid, this perhaps tips that decision for them.

**Lord Livingston of Parkhead:** I am referring in particular to the governmental level, where Governments will be looking to say, “Supply of hydrocarbons is both insecure and expensive. Therefore, we have to go back to investing in our own and hurry with local energy sources, which tend to be green”. The Governments will put in a much stronger investment programme, even if they were not that green-minded before, because they see that, as it stands, it is insecure and unaffordable.

**Simon Redmond:** I will give some context for the kind of prices that European power producers have to pay for gas now: in dollars per MMBtu, we are looking at a futures curve of around \$40, while the average in 2020 was \$3. So the shift in the price is really extraordinary, even for hydrocarbon prices.

Clearly there is a question not just about the price but about the availability of supply. That is arguably a more fundamental point that gives pause for thought. We are of course aware of the context in terms of flows coming from Russia. That combination of price and energy security is arguably persuasive, but of course the issue is, as ever, one of timing: you cannot suddenly create a load of solar farms. Therefore, the transition is exactly that; it is not an overnight flick of a switch.

**Lord Griffiths of Fforestfach:** Can you clarify this idea of the short-term spike? Looking at the geopolitical situation, the Russians had a slightly threatening position before the invasion. They were seen to get on very well with the Chinese. It seems to me that actually there is a case for a long-term spike, not just a short-term one, unless you assume that government will invest so much in renewables, or something like that, that you could have an effective switch. Let us assume for a minute that we can rule that out and that that will proceed, but at a slower pace; is there not a case for saying that, in putting a framework around this, we should be thinking on a longer-term horizon in which risk has considerably increased?

**Simon Redmond:** I agree: risk has increased. On the price-spike observation, we could perhaps differentiate between the oil and gas markets. Here of course I caution that we are talking about commodity prices and markets, and uncertainty is inherent. On gas markets, I am thinking particularly about Europe. Oil markets are obviously essentially global—you put the oil on a tanker and transfer it—whereas although you can obviously put LNG on a tanker and transfer it around, that is a much smaller percentage of the market, so the arbitrage is different. Henry Hub

prices in the US are clearly nowhere near the \$40 MMBtu that I mentioned. Therefore, the challenge in Europe is to secure sufficient gas to refill storage, which is not actually so low at the moment, for next winter.

Depending on the reality of gas flows out of Russia, if they continue, as they did during the Cold War, gas prices arguably may come back down, although, as I say, they will remain well above the levels they had been at for many years. Alternatively, if you have a material stoppage in gas supplies to Europe, it is difficult to model what the outcome could be. Of course, there are intermediate steps, perhaps if the flows through Ukraine come under strain. So high gas prices could persist in Europe for a number of years, although there are clearly other scenarios as well.

On the oil side, my reading is that the market reacted fairly aggressively to both the soft sanctions and the threat of hard sanctions on Russian oil. Clearly there were cargoes that were not purchased for a number of reasons: refiners did not want to take them, or whatever, until there was more clarity. That initial risk premium has arguably come out of the market, although it may return. Therefore, on oil supply globally, the dynamics are slightly different, as I mentioned: Europe is reliant on piped gas, largely from Russia, whereas, at the end of the day, oil can clearly be moved and traded globally.

Even if the 4 million barrels or so a day of exported Russian oil were to be somehow removed from the market permanently, or for a period of time, that would be hugely disruptive, particularly as demand continues to grow. Then, of course, as I mentioned, simplistically, high oil prices are the cure for high oil prices. We would expect to see some demand destruction—I might not drive as much, or whatever it might be—and, more importantly, we might see more of a supply response. That is why I could quite easily make a case for stronger gas prices for a year or two, perhaps even longer.

On the oil side, there is a case for the natural mechanisms of supply and demand, if you will, rebalancing perhaps a little sooner. But, to be clear, you cannot remove even a portion of Russian production from the global market—10% of global supply or volumes—without it having a huge impact.

**Viscount Chandos:** If it is a long-term spike, surely the risk to the oil and gas sector is reduced, but the risk to the rest of the economy is increased?

**Simon Redmond:** You are quite right to characterise this by asking whose risk we are looking at. For the oil sector, high prices are of course great in the short run—it makes more money, and there are various rules of thumb to estimate how much more different companies will be able to generate.

On the earlier point, inevitably if the alternatives to petrol cars are now cheaper, both in buying the asset in the first place and in charging it, that

decision becomes more likely, and the uncertain user may switch over. So that clearly leads to oil demand destruction over a longer period of time. That said, again, our colleagues at Platts Analytics would say that, for every extra million or so electric vehicles that go on the road, oil demand only declines by an estimated 20,000 barrels a day or so. So in the context of oil demand probably growing by a million barrels or so a day, on a reasonable view, over the next few years, it would take a lot of electric vehicles to have an impact—but of course we are seeing that ramp up all the time.

**Q109 Baroness Kramer:** In many ways, you have answered much of the question that I was given to ask, which is how you evaluate risk in the energy transition. So could you help me with some clarification? For any private investor, the S&P rating is very important, in evaluating both whether it wants to invest and at what price. Can you give us a sense of the timeframe in which you are working? When you respond to us, are you looking at a three-year, five-year or 20-year horizon? We are talking about transition, so the horizon actually matters.

**Simon Redmond:** Thank you for the difficult question. We argue that there is no time horizon on a credit rating. If a straight corporate company issues a one-year or a 10-year bond, all other things being equal we will assign the same rating to that instrument. The point I was making, maybe to give a fuller answer, was about our detailed modelling, when we focus on a shorter time horizon, typically of three years or so. You run the model for a bit longer, but you focus on the nearer term.

Why is that? We feel that it is appropriate to give more weight to the nearer term, because we have more visibility and there are fewer divergent scenarios over the nearer term. We therefore feel more comfortable, when we sit in our rating committee, drawing a conclusion about how things can evolve in the nearer term.

That said, as I explained earlier, it does not mean that we do not factor in longer-term risks such as the energy transition, and it does not mean that we will not continue to weight our ratings in the oil and gas sector, potentially increasingly over time, as a result of those inherent uncertainties.

To get into rating mechanics for a moment, if I may, we take a view on financial risk—simply put, how well a company's cash flow covers its debt, in which more debt implies a weaker profile—and we look at business risk. The business risk is the engine of cash generation. What I have been describing is how we have taken a more conservative view on the engine of cash generation, particularly over the long term, for oil and gas companies, whereas I just accept that their credit metrics will look very strong in the short term.

**Baroness Kramer:** That is helpful to me. If you were to take an oil and gas company and ask what it will look like 30 years from now, if it has not changed you would say that it is an entity with stranded assets. That has to become a major factor in evaluating the risk at some point. You

also look at new technologies, of which hydrogen is an example. Again, that is not going to be a major revenue generator over the short term, but by the time we hit the 20-year mark, it could be a major, key player. Can you help us to understand the risk profile of transition, as it will clearly shape a lot of the recommendations that we make? I will stop there and let others pick up the issues.

**Simon Redmond:** This ties to the earlier question in the way we think about transition and evaluate some of these newer business models. Some of these business models that are apparently new to oil and gas companies are, in fact, not so new. Companies such as Shell and Equinor have been trading American power for many years. It is not new; they are merely talking about it as part of their integrated business model in a far more dynamic way now.

When it comes to hydrogen, some of the inherent risks are in trying to model a relatively new technology. It is obviously the most abundant element in the universe, but it is a relatively new technology in terms of power generation and storage. Last year, we published extensively on the prospects of hydrogen, and things have already moved on quite dramatically. I saw a report about a month ago of a plant in Spain that is supposed to be up and running in a few years, an electrolyser producing green hydrogen, where the costs are being signalled at €1.5 a kilogram. Particularly with gas prices where they are now, that is very competitive. I appreciate that the plant is not running yet and that there are all sorts of execution risks in getting it running, which is all normal, but just on the viability of hydrogen, both as a fuel to abate hard-to-abate industries and as a storage solution, candidly it is far more probable now than I would have said it was 18 months ago.

I tell that story to make the point that when we try to factor in what you could argue was more equity risk than credit risk, these are things we need to keep on top of, to put it simply. From a credit perspective, I am happier looking at a business model that involves contracts for difference on an offshore power plant, which provides greater visibility of revenue and, more importantly, cash generation, than I am thinking about just how rapidly these hydrogen plants will ramp up.

**Baroness Kramer:** That is about certainty, but to some extent you tend to be a lagging indicator, if I picked that up correctly.

**Simon Redmond:** It is a question of certainty. By definition, you only get certainty with the effluxion of time.

Q110 **Lord Fox:** I am fascinated by price versus demand destruction or re-creation. I am interested in whether you also model what I would call inertia. In other words, even if something is priced the same, it needs to be priced less for change to happen. Do you have any thoughts on that?

**Simon Redmond:** Are you thinking particularly of shifts in transport and so on?

**Lord Fox:** Yes, but you also used the example of methane to hydrogen.

How much cheaper would hydrogen need to be in order for things to happen, for example?

**Simon Redmond:** Again, I am not the power analyst, but for hydrogen to be a viable technology in the UK or elsewhere, you would need the whole value chain. That is the challenge. The example that I was speaking of—of course there are plenty of others, but this is potentially the largest plant in the world—has some economies of scale and an investment decision appears to have been made. The point is that usage of the hydrogen is on site, I think, in steel manufacturing. As steel is a hard-to-abate sector, ArcelorMittal is taking a decision in this case to scale up and get the plant working. The offtake is there; that is the point I am trying to make.

Thinking of the market more broadly, do I have an inertia factor for you? No, I do not. I guess that is the honest answer.

**Q111 Lord King of Lothbury:** I would like to pick up some of the issues that Baroness Kramer raised on the transition. You said earlier that oil and gas would have a role to play for many years. First, do you think the UK Government have set out a credible transition path that would make it possible for your companies to think carefully about the investment that would be needed in the transition from here to net zero? Secondly, what risks do your oil and gas companies worry about that the Government might be able to diminish by setting out a clearer policy framework?

**Simon Redmond:** On the UK-specific framework, I noted in the transcript of an earlier session that the concept of dual running had been recognised. At the end of the day, we cannot just switch over from fossil fuels to other sources of energy. There will be dual running, which you could argue is inherently inefficient, but what else can you do? Again, if you do not mind, my focus is on those oil and gas producers and the extent to which they have visibility on things such as carbon pricing and licensing rounds. This reduces risk and uncertainty, which is clearly important from a credit perspective.

As an aside, when we speak to a number of international oil players about country risk, we usually try to have a discussion about sub-Saharan Africa but quite often they will bring up fiscal changes in the North Sea as a source of risk and uncertainty when they are trying to plan for longer-term development. It is a question of regulatory visibility and fiscal visibility.

An issue that touches on the stranded asset point that was mentioned earlier is decommissioning expenses. These are a key consideration for the industry, obviously, but also for companies. If they need to decommission their facilities earlier, that implies more cash out earlier. Equally, making investment decisions—if it is not as clear as it could be—what the decommissioning framework and timing are likely to be—is potentially an issue. So as some of these assets run off, obviously there are decommissioning obligations, and the way they can be dealt with is something that we can reduce uncertainty around. That can be a positive

step in terms of these companies' planning and ultimately our view on their ratings.

I am sorry, did I touch on the second point about risks that the companies could face?

**Lord King of Lothbury:** Shall I be a bit more specific and give you an example? In the last couple of weeks, we have seen something that was unexpected—a sharp rise in prices—and Governments are responding with their energy strategies. So if I were sitting in an oil and gas company, I might say, "Governments may change their policies in such a way as to try more quickly to get to net zero. On the other hand, they won't have access to, say, oil or gas from Russia in the way that we had thought, as a Europe-wide response, so maybe in the short run there is more need to rely on the oil and gas that we are generating"—because presumably your oil and gas companies are producing outside Russia. So these go in slightly different directions, and that creates a lot more uncertainty.

What do you see in the companies that you monitor and follow all the time? Is there concern now? Do they want clearer guidance from Governments as to the nature of the transition? It is very easy to switch on the radio in the morning and hear people saying, "We mustn't rely at all on Russian oil and gas". Some people will then say, "We have to use more oil and gas, even coal, in the short run". Other people say, "No, we must switch very quickly to renewables", without any consideration of back-up supplies for intermittency and so on. It is very hard to find a coherent presentation of a transition path.

The question that I put to you is: what do the companies you monitor want to see from government by way of a policy framework to put in place now—allowing for flexibility down the road—to guide companies both in both renewables and in oil and gas in following a sensible transition path?

**Simon Redmond:** For the record, obviously I cannot make a policy recommendation here, but I hear the point and I shall try to answer what we are hearing. Above all, whether as a bond investor or as a company, as you well know, the extent to which uncertainty in the future can be addressed, alleviated or mitigated is key.

The challenge for companies, investors and, I imagine, the Government is that we do not know how fast the transition is moving. In other words, in terms of the regulatory framework and so on, it is not just a question of managed decline, because clearly there may be further licensing rounds, albeit with a few more bells and whistles. Ultimately the question is: when we speak to the companies that we rate about where they are choosing to invest, what level of certainty do they have about investments in the UK, Europe, the US or elsewhere, and what risks are they attempting to address as they make choices about where they deploy capital?

As I say, I am very cautious about steering away from any comment on policy.

Q112 **The Chair:** I shall put the two questions slightly differently. A number of western European Governments are now saying that they want to see greater investment in oil and gas and, for example, the development of LNG infrastructure. Do you think those big oil majors will find it difficult to finance those, given that insurers like AXA will restrict insurance; that a number of banks—here I declare an interest in Banco Santander—are committed to scaling back exposure to oil and gas and to getting to net zero by 2050; and that the IEA, in its own scenario, says there should be no more investment in new oil and gas fields or in new LNG infrastructure?

Putting all that together, do you think there will be any difficulty in them financing those, given that, first, obviously these oil and gas majors are making a lot of money and, secondly, if they cannot get it from banks, they can always go private?

**Simon Redmond:** Thank you. I am more comfortable answering the financial questions. The short answer is that, as you say, these companies are generating meaningful cash flows and, as I said at the beginning, we are interested to see what they are doing with them. They have financial frameworks, but ultimately this is an exceptional situation. By that, I mean: are they going to invest more in renewables and accelerate their renewable strategies, or are they going to double down on some oil and gas investments and/or just give it to shareholders? The third thing that they could do with it is to reduce debt.

On the funding point, in March 2020, at the height of the Covid lockdown and with the oil price crashing, the supermajors that we have been talking about went to the bond markets and raised \$23 billion. That was at a time when the energy transition risks were apparent but, more importantly, the sector was also going through a crisis, or at least a crunch. Access to capital is something that we constantly reflect on but, candidly, it is much more a question of the pricing of capital at the moment.

The funding strategies of some European oil and gas companies explicitly focus on sustainable instruments; there have been statements about only going into the sustainable bond markets. Now, of course, it is difficult for an oil and gas company to arrange a green use of proceeds bond, but, in terms of sustainability links, that has certainly been done by Repsol and will be actively pursued by other companies. Of course, the investor has to be on the other side of the deal to buy the instrument, but that access to capital, for what at the end of the day is still a primary industry, is still available.

We talk to our colleagues in the banking sector who say the pledges of companies to wind down their exposure to coal are still ongoing, and doubtless oil and gas will come. Again, though, typically the banks are

acting as intermediaries in some of these deals, so they are not even holding them on their balance sheets, as I understand.

Again, I do not sit here actively concerned about access to capital for some of the largest players. It is of course a different story if we are talking about North American shale, for example, where access to both equity and debt financing has been more challenging, although less so now. I am happy to elaborate, but I think that is the story.

- Q113 **Baroness Noakes:** Could I shift on to the taxonomies and their impact on investment in energy transition? To what extent do taxonomies, when they are developed, encourage investment in the transition to net zero? Could you explain what account is taken of these taxonomies, if any, in the processes of rating at S&P?

**Simon Redmond:** Any framework that provides a level playing field and/or a clear set of rules is typically helpful. It enables the company raising the finance, the investor and the observer—that is, the rating agency—to talk the same language. It falls into the same category as accounting rules: if you know the way a company is obliged to treat a given type of investment or liability, you can get to the nub of the matter and the economic reality without having to spend too much time analysing what the exact differences are between what this company is calling green and that company is calling green.

I do not want to say that it short-circuits the work, but there is an extent to which you can get further down the curve because of the common understanding. As I say, whether it is accounting, TCFD or the taxonomy, these are all things that can improve visibility, facilitate communication and, hopefully, ultimately enable better understanding.

**Baroness Noakes:** Are they used within S&P?

**Simon Redmond:** To the extent that there is a framework—

**Baroness Noakes:** As an information source?

**Simon Redmond:** Indeed. I guess they are used, but they are used by us because they are used by the companies that we look at.

**Baroness Noakes:** How important would it be to have international congruence of taxonomies? There are signs that some will be developed in different territories—the EU, the UK, the US and other markets—not necessarily in exactly the same way.

**Simon Redmond:** Again, I will perhaps lean on my accounting background. The extent to which there is the same set of rules means, as I say, that people understand one another better. That simply helps. You could say that to some extent it does not matter which side of the road you drive on so long as everyone is driving on the same side. That is not to say that we cannot cope with differences, because clearly there are differences—for example, in disclosure—and we have ratings criteria to deal with that. Clearly, if everyone is reporting their asset retirement obligations in the same way, that helps. I think that is the main point.

**Q114 Lord Rooker:** I want to ask you about the forthcoming introduction of financial disclosures. Do you think they will be effective? Can they be actively used to encourage the transition to net zero? What needs to be done in designing the disclosure framework to encourage that? What about international comparability with similar systems? What difficulties will arise?

**Simon Redmond:** To be clear, this is about the UK's introduction of TCFD rules as an obligation. First, the TCFD guidelines are global. S&P was a member of the TCFD taskforce; in fact, I personally contributed to a few of the preparer forums, so I am aware of the process. We also published our own TCFD framework. The TCFD process, and the fact that the UK is making it mandatory for large listed companies, is a huge step forward. Again, to the point of consistency and ease of comparability, it is very important for analysts and, frankly, for companies when they are comparing themselves.

As ever, there is always a next step; there is always something else that can help. By way of example, the way scope 1, 2 and 3 emissions are disclosed in the scope of consolidation leaves room for, if not interpretation, then application in different ways. For example, if a company has a joint venture—it does not own 100% of an asset, but owns 30% or so—either it can equity-account that and basically ignore the emissions associated with that asset, or it can include them. These kinds of inconsistencies are hardly new to us; we have the same issue when we are just looking at a company's accounts. It means that the disclosure needs to be sufficient that we understand what the number we are looking at means—in other words, we understand the assumptions that have gone into that number. That is important.

You mentioned the word "effective". I think we expect the relevant companies to adopt these. We have the idea of "comply or explain", so it will be very important that we understand how companies are using the opt-out, if they do, but equally how they are applying the principles. However, there is some great stuff there in the scenario analysis, which again has its drawbacks but is still a great step forward in terms of being able to have a conversation with a company and understanding the way it has worked through some of these scenarios and the risks of the transition.

**Lord Rooker:** I would like to follow up on that question out of curiosity; this is not part of my brief and it is not an area that I am familiar with. Does the system allow for taking account of different companies, or indeed the same company in different countries, moving to net to zero while goods are being imported and exported that contain energy? Is that taken into account at all?

**Simon Redmond:** This relates partly to the scope of consolidation and the value chain. Again, my colleagues in sustainable finance spend a lot of time talking about the whole value chain rather than just the entity that you are focused on. As a matter of definition, it will be important to

understand exactly how companies have addressed the kind of issue that you raise—where it is material, of course.

Q115 **Lord Fox:** This is probably a stupid question. Having worked with lots of companies that had joint ventures, I know that consolidation was always a challenge. Surely to some extent a carbon tax circumvents the need, because it is built into the finances of the total enterprise.

**Simon Redmond:** I might need to take that question away to think it through, but if the entity that is equity-accounted is subject to a carbon tax, that will be reflected in the financials of that entity, as you say.

**Lord Fox:** But if all the entities in all the operations are subject to carbon tax, the whole issue is built into the numbers, rather than having to worry about—

**Simon Redmond:** The disclosure.

**Lord Fox:** The disclosure, yes.

**Simon Redmond:** In terms of the financial impact, yes, they either do or do not pay the tax, but then we are talking about accounting disclosure and emissions disclosure. In terms of a carbon tax, it will of course depend on how that tax is applied, but if a company is disclosing emissions through its value chain—so scope 3 as well—it will not necessarily pay carbon tax on the scope 3 emissions, if I can put it that way.

Q116 **Lord Stern of Brentford:** We are nearly out of time, so please give a short answer to what is not necessarily a simple question about financial regulation and stress testing. Are our financial regulators overestimating or underestimating climate change risks in their analysis of financial stability?

**Simon Redmond:** I can give you a short answer, but it may not be terribly helpful, unfortunately. I discuss this issue with my banking colleagues in the context of capital availability, but it is not really my area of expertise. At this point, our understanding is that the stress tests that have been run, or are being run, are unlikely to have a dramatic impact on the companies that we focus on in the team. But, of course, it depends which of the pillars the regulators ultimately choose to employ. As I say, I am happy to put this to one of my colleagues, but this is not in my wheelhouse, as they say.

**Lord Griffiths of Fforestfach:** I have recently been interested to read that independent commentators, some of them colleagues here in the House of Lords, are quite enamoured with the regulation of banking as a model for the regulation of this area. I take a different position. The regulation of banks by the PRA and the FCA has become enormously complex and has created, through regulation and compliance, a whole new industry or bureaucracy, which has grown up around it, instead of assigning risks to these different assets—I think that the banking system quite likes that, in a way, because it can sort of negotiate things. If you

had a simple rule on equity, you could actually sort the problem at the stroke of a pen. The banks would not like it, but recommending this model of complexity and bureaucracy would be a great mistake. That is just a comment.

**Simon Redmond:** I am sorry to duck the question, but I am probably not best placed to look at the comparison with banking regulation. I can say, perhaps as a lay man, that there is perhaps greater visibility on some areas of banking than there is on commodities, but I will probably have to leave it there, I am sorry.

Q117 **Lord King of Lothbury:** If the last two years have taught us anything, they have taught us that we live in a world of what you could call radical uncertainty. Are you not struck by the fact that the public sector seems to focus almost exclusively on the risks from climate change and not others? When you assess the ratings of companies, do you not have to give as much weight to other sources of risk—pandemics and geopolitics—as to those associated with climate change? That is not to play down the risks from climate change; it is to say that there are also other risks that cannot be ignored.

**Simon Redmond:** I could not agree more. In very basic terms, what does a credit rating speak to? I know that I do not need to explain this, but it speaks to the probability of default and the capacity and willingness to meet financial obligations, which is not the same thing as an ESG score or a climate assessment. As you quite rightly say, those may be material risk factors for certain sectors and certain companies. I will give an example. We have an A-minus rating on BP and a double A-minus rating on Chevron in our portfolio, not because we think that Chevron's ESG credentials are better, but primarily because Chevron has a much less leveraged balance sheet than BP. So the financial risk that I touched on earlier is obviously a key component of a credit rating assessment.

That said, if some companies are successful in managing their transition away from oil and gas strategically and are able to generate meaningful cash flows from other revenue streams and businesses, over time the relative strength of those businesses—the engine that generates the cash flow—may start to outweigh a difference in terms of the balance sheet. But, as I say, I fully agree: we spend a lot of time talking about climate risk, in terms of physical and transition risk, internally and with investors, but clearly the credit rating speaks to a lot more than that.

**Lord King of Lothbury:** That is very helpful. Thank you.

**The Chair:** We will end almost exactly on time. That was a very good session. Thank you for coming in.