INVESTOR BRIEFING

MARCH 2017

DRILLING DOWN:

WHY SANTOS MUST IMPROVE ITS CLIMATE RELATED FINANCIAL DISCLOSURES

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IN THIS INVESTOR BRIEFING, MARKET FORCES MAKES THE CASE FOR GREATER CLIMATE-RELATED FINANCIAL DISCLOSURE BY SANTOS LTD, IN SUPPORT OF A NON-BINDING VOTE ON THE FOLLOWING SHAREHOLDER RESOLUTION AT THEIR 2017 ANNUAL GENERAL MEETING.

RESOLUTION

STRATEGIC RESILIENCE FOR 2035 AND BEYOND

That in order to address our interest in the longer term success of the company, given the recognised risks and opportunities associated with climate change, we as shareholders of the company request that routine annual reporting includes further information describing: (a) Governance: the roles of the board and management in the oversight, assessment and management of climate-related risks; (b) Strategy: the climate-related risks and opportunities and asset portfolio resilience of the company's businesses, operational strategy and financial planning to various climate scenarios, including both 1.5°C and 2°C pathways; (c) Risk Management: how climate-related risks are incorporated into the company's risk management framework; (d) Metrics and Targets: the targets used by the company to manage climate-related risks and performance against those targets; (e) Public Policy: the company's public policy positions related to climate change, including those of industry bodies of which it is a member.

INTRODUCTION

In November 2016, the Paris Agreement entered into force, thereby committing 195 countries to limit the increase in the global average temperature to well below 2°C above pre-industrial levels, with an ambition to pursue efforts to limit warming to 1.5°C [1].

In describing the transition risks posed by the Paris Agreement, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) stated, "rapidly declining costs and increased deployment of clean and energy-efficient technologies could have significant, near-term financial implications for organisations dependent on extracting, producing, and using coal, oil and natural gas"[2].

Shareholders are concerned whether or not Santos ('the company') is adequately managing the risks posed to its long-term viability by the ongoing transition in the energy sector. Capital allocation decisions made today will determine the company's long-term strategic position; hence new capital expenditure should take into account the complete spectrum of climate-related risks.

GOVERNANCE

According to the company's Climate Change Policy[3], its vision is to "lower the carbon intensity of its products". Though reducing emissions intensity is necessary, even the company's peers recognise that "in the long run, emissions from the use of natural gas will also need to decline in the 2°C world"[4]. The company's Climate Change Policy is now over eight years old (issued December 2008). Although it is subject to a three yearly review, it should be updated to reflect the outcomes of the Paris Agreement and the latest climate science.

Despite claiming that 'climate change risk' is incorporated into the company's centralised enterprise-wide risk management program[5], these risks are not deemed to be material business risks in the 2016 Annual Report[6]. This stands in contrast to the view of the Australian Prudential Regulatory Authority (APRA) that recently described some climate risks as "distinctly financial in nature"; and that many of these risks are "foreseeable, material and actionable now"[7]. Santos, by omission, categorises the transition risks from climate change as distinctly non-financial, which should be concerning to investors.

Governance responsibility for climate change issues currently rests with the Environment, Health, Safety and Sustainability Committee (EHSS) yet its charter does not mention climate change. By demoting climate-related risks to simply an environmental issue, the company ignores the systemic threat that regulatory and technology risks pose to the energy sector.

"In the long run, emissions from the use of natural gas will also need to decline in the 2°C world." BHP Billiton, 2015

Noel Hutley SC opined in October last year that "company directors certainly can, and in some cases should be considering the impact on their business of climate change risks – and that directors who fail to do so now could be found liable for breaching their duty of care and diligence in the future"[8]. Santos directors must ensure that climate risk is adequately considered and disclose those risks to investors.

The company should provide more explanatory information to investors on those roles and teams charged with the identification and assessment of climate-related risks. The company should consider whether those employees are appropriately incentivised, and whether they are sufficiently empowered to challenge capital investment decisions. Furthermore, the company should explain how incentives provided to executives for "reserve replacement" and "2P undeveloped to developed reserves conversion cost" are consistent with various climate and policy pathways. In order to demonstrate the commitment to the company's climate change 'vision', it would be logical to incentivise executives to reduce emissions intensity and/or overall emissions.

STRATEGY

The company limits discussion of climate-related risks and opportunities, and their impacts on its businesses, strategy and financial planning to its submission to the CDP [9]. As per TCFD guidance[10], these should be incorporated into mainstream financial reporting.

Despite identifying 'Regulatory and licence to operate risks' as material business risks in its annual report[11], the company's discussion of the regulation of carbon emissions – including the Paris Agreement – is excluded from the annual report, and limited elsewhere. The company's cursory analysis of 'international agreements', and 'cap and trade schemes' provided in its submission to the CDP[12], does not provide convincing evidence to investors that the company is attune to the breadth of regulation globally, and particularly in its LNG export markets.

The company has identified a number of physical climate risks, including changes in average precipitation, sea level rise and tropical cyclones[13]. Further disclosures should be made about the threats to specific projects and permits. For example, the company should disclose how susceptible flagship projects like GLNG are to sea level rise. The company should also discuss the threat posed by flooding to its coal seam gas (CSG) fields.

By omission, the company seemingly does not see developments in renewable energy and battery storage technologies as risks to its business. The company should disclose the risks renewable energy and battery storage poses to LNG demand in Asian growth markets, particularly how that informs capital investment decisions.

'Capital expenditure decisions, particularly those pertaining to exploration, should be viewed through the lens of viable scenario analyses.'

The company identified carbon capture and storage (CCS) as an opportunity arising from climate change, given its experience with the Moomba project. If the company sees CCS as a genuine opportunity – the latest science suggests that it's a necessity to limit warming to 2°C[14] – then further disclosure is required on the planning, costs, timeframes and metrics for measuring success.

Santos claims to model "the impact of carbon price scenarios and integrates a cost of carbon into business planning and decision making"[15], yet little of this information is disclosed. The company should conduct ongoing scenario analyses, using various policy pathways, including those employed by its peers (i.e. IEA450), as well as more aggressive policy pathways, consistent with limiting warming to 1.5°C or 2°C. The assumptions upon which these analyses are based are vitally important to investors, and must be disclosed. Capital expenditure decisions, particularly those pertaining to exploration, should be viewed through the lens of viable scenario analyses.

Unlike some oil companies with significant renewable energy investments, Santos is currently not in a position to decide between investing in new or old technology. Rather, that decision should be made by investors, as dividends will be increasingly preferred to further capital expenditure.

RISK MANAGEMENT

As previously mentioned, despite claiming that 'climate change risk' is incorporated into the company's centralised enterprise-wide risk management program[16], it does not qualify as a material business risk. This may be a result of misclassification or a fundamental flaw in the risk assessment process. Perhaps climate risks are categorised as 'Natural Environment' rather than 'Legal and Financial'. It could also be the result of an underestimation of the likelihood of climate risks occurring, or the consequences are not quantified sufficiently. Perhaps the company believes its management controls effectively mitigate climate risks. The company should disclose how individual climate risks – be they physical, legal or transition risks – are classified in their risk framework. If the company is confident that climate risks are not material – then it should explain that decision to investors.

'Acquisitions and exploration expenditure should be weighed against the likelihood of assets becoming stranded before the end of their economic life.'

The company should provide further information on how its risk management framework influences capital investment decisions. Acquisitions and exploration expenditure should be weighed against the likelihood of assets becoming stranded before the end of their economic life. Acquisitions and exploration expenditure should be weighed against the likelihood of assets becoming stranded before the end of their economic life. Given that oil major Shell believes that oil demand could peak in just five years[17], investors will soon prefer greater dividends, to increasingly risky capital expenditure.

Santos' Oil Price Projections:

2017	2018	2019	2020	2021	2022
60.00	70.00	80.77	82.79	84.86	86.98

Santos has incurred impairments of more than US$8 billion in the last three financial years, due largely to the low oil price environment. Given the company's optimistic future oil price assumptions (see table above)[18], investors are not convinced that a predicted peak in oil demand, partially brought about by policies to address carbon emissions, does not constitute a material business risk.

METRICS AND TARGETS

Santos does not disclose the metrics and targets used to assess climate-related risks and opportunities. Though the company claims to model the impact of carbon price scenarios into business planning and decision-making, the company does not disclose to investors the carbon prices used in such analyses. Additionally, the company should disclose the impact of carbon pricing on its portfolio.

Given the company has identified 'international agreements', and 'cap and trade schemes' as key climate risks[19], it should disclose the metrics and targets by which such regulatory risks are measured.

The company should also disclose the metrics it uses to determine the efficiency and uptake of renewables and battery storage in LNG export markets, in order to adjudge the impact on future gas demand.

The company's greenhouse gas emissions (GHG) and energy consumption reporting is better than that of its immediate Australian peers. It should, however, disclose its emissions performance project by project, in order for investors to compare performance of assets across the portfolio.

> "The oil and gas sector has been identified as the single largest source of methane emissions." Global Methane Initiative, 2015

As at March 2017, the company has an emissions intensity target of less than 70kt CO_2e/mmboe, which it achieved in 2014/15[20]. Though reducing emissions intensity is necessary, the company must recognise that emissions from natural gas must also decline in the long-term. The company does not discuss how it will achieve this, despite citing CCS as an opportunity – one which the company has long since abandoned.

The oil and gas sector has been identified as the single largest source of methane emissions[21]. A key source of this is through flaring, yet the company does not have targets to reduce flaring, despite the commitments of some of its peers to eliminate the practice altogether by 2030[22]. The company should implement targets to reduce flaring over the short, medium and long-term.

Finally, the company claims that fugitive methane emissions account for just 0.0067% of production[23]. This low level of reported methane emissions contrasts with unconventional gas developments in the United States, where fugitive emissions have been measured between 2 to 17% of production[24]. Even conservative estimates of 1.4% in the United States are significantly larger than the levels claimed by Santos. The company should ensure that fugitive methane emissions are adequately measured and disclosed, by supporting a comprehensive, independent audit of gas emissions.

PUBLIC POLICY

The company does not disclose its donations or membership fees paid to political parties, despite total proceeds to all parties totalling $134,584 in 2015/16, and $168,742 in 2014/15. The company should provide an itemised account of all funding to political parties in its annual report.

The company's support of the 'CEO Statement on Business and Climate Change and the Paris Negotiations'[25] was a welcome contribution to the national conversation on climate policy. Given the age of the company's climate change policy, and the developments since it was last reviewed in December 2014, explicit support of the Paris Agreement at a policy level is the logical next step.

'APPEA actively campaigned against the carbon price and the Renewable Energy Target.

The company has not disclosed its position on individual climate policy mechanisms, though it claims to "actively contribute to climate change policy, advocating for environmentally effective and economically efficient action to facilitate long-term investment"[26].

The company is a member of several industry bodies, including the Australian Petroleum Production and Exploration Association (APPEA). APPEA actively campaigned against the carbon price[27] and the Renewable Energy Target (RET) in Australia throughout 2014[28], which seems to be at odds with the company's support for "environmentally effective action". The company should seek to ensure that the industry bodies of which it is a member, accurately reflect its views as much and as often as possible.

RECOMMENDATIONS

Market Forces has discussed those areas where Santos can improve its climate-related financial disclosures. Though each of the TCFD recommendations are vitally important to investors, those where the company seems particularly deficient are its Strategy, and Metrics and Targets.

In conclusion, the company must:

- Perform and disclose scenario analyses based on multiple policy pathways, including those consistent with limiting warming to 1.5°C or 2°C;
- Disclose all the risks and opportunities that climate change poses to its businesses, strategy and financial planning;
- Disclose the metrics and targets by which its assessment of risks, and planning for the transition to a low-carbon economy can be adjudged;
- Ensure executives are appropriately incentivised to manage the transition to a low carbon economy;
- Ensure consistency in its public position on climate policies, including those of the industry bodies of which it is a member.

Market Forces moves this shareholder resolution with the intention to increase the company's resilience to regulatory and market changes that can be foreseen as international action is taken to limit global warming in accordance with the climate goals established by the Paris Agreement. Market Forces recommends investors vote in favour of this shareholder resolution.

REFERENCES

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