



# Carbon Transparency

Public companies face rising pressure to disclose climate-change risks.

BY SEY-HYO LEE AND MARUSHKA BLAND

Scientists, governments, businesses and the public have begun to accept that global warming and other climate changes have ceased to be mere theoretical possibilities and may pose significant risks to the environment and the economy. Regulation of greenhouse-gas (GHG) emissions and other efforts to control these growing environmental concerns increasingly are impacting businesses, and investors are seeking more and better information on climate-change risks to make informed investment decisions. Facing the realities of proposed legislation, litigation and shareholder action demanding greater corporate transparency regarding GHG and the impact of global climate change, public companies are struggling to determine whether and how they should disclose the potential risks that climate change poses to their businesses, financial conditions and operating results.

### Disclosure Landscape

While the SEC hasn't yet issued any formal guidance on climate change and corporate disclosure, it's coming under increased pressure to require greater climate-change risk disclosure by public companies. In September 2007, Ceres (a national network of investors, environmental organizations and other public interest groups working with companies

and investors to address sustainability challenges such as climate change), along with Environmental Defense and a coalition of 20 institutional investors, managing roughly \$1.5 trillion in assets, submitted a petition to the SEC requesting that the SEC specifically address climate-change risk disclosure by public companies (see <http://www.sec.gov/rules/petitions/2007/petn4-547.pdf>). Because many

investors now consider climate-change risk to be part of the total mix of information they assess in making investment decisions, the petition requests that the SEC issue an interpretive release to make clear that existing SEC rules regarding the disclosure of "material" information (*i.e.*, information that a reasonable investor would consider important in deciding whether to invest) relating to a company's business should require climate-change disclosure. The petition also notes that existing accounting rules regarding material contingent liabilities may require climate-change risk disclosure.

Under existing SEC disclosure rules, a public company must report the material effects of regulatory compliance on its capital expenditures, earnings and competitive position as part of the discussion of the general development and the competitive position of its business. In addition, the company must disclose all material pending legal proceedings and must specifically disclose certain environmental litigation matters. Finally, the company must report all known trends, events or uncertainties reasonably likely to have a material effect on its financial condition and operating results. Among other things, the petitioners suggest that, under these rules, a public company should be required to disclose:

- GHG emissions levels;
- Physical risks of climate change, such as the effect of changes in weather on its business, facilities and workforce; and
- Financial evaluation of potential regulatory risk (*i.e.*, the effect of compliance with climate regulation on capital expenditures, earnings and competitive positions); and
- Any potential environmental litigation.

In addition, the petition requests that the SEC review the adequacy of existing disclosure and make further inquiries of registrants that have made no, or very little, climate-change risk disclosure. »

The SEC has yet to respond to the petition or several other prior requests of a similar nature.

Congress also is looking to the SEC to impose greater disclosure requirements on issuers of public securities. Like the Ceres petition, the most recent legislation—"America's Climate Security Act of 2007," introduced by Senators Lieberman and Warner in October 2007—would require the SEC to issue an interpretive release regarding climate-change risk disclosure, as well as new disclosure rules, as part of an overarching climate-change and clean-air scheme. The Lieberman-Warner bill was approved by the Senate Committee on Environment and Public Works on December 5, 2007, but no other major action has been taken.

Several regional initiatives to reduce GHG emissions, such as the Regional Greenhouse Gas Initiative, Western Climate Initiative and New England Governors/Eastern Canadian Premiers Climate Action Plan, have been adopted at the state and local level in the absence of federal GHG regulations or ratification of the Kyoto Protocol. A public company operating in a region that has adopted such a regulatory initiative likely would need to consider how compliance with these regulations will affect its business under existing SEC rules.

Additionally, litigation relating to climate change has increased, both lawsuits seeking damages and to compel action by GHG-emitting companies. Plaintiffs frequently target energy companies or industries with significant GHG-emissions levels, often basing their claims on a public-nuisance theory or an argument that the defendant company contributed to global warming by emitting GHG, thereby creating the conditions that gave rise to a given plaintiff's injuries. While litigation relating to climate change is not common, its prevalence may increase in the future, particularly as GHG regulation becomes more widespread.

Shareholder resolutions on climate-change disclosure constituted more than 10 percent of all resolutions filed in 2007.

Additionally, some companies face legal pressure directly related to their disclosure practices. In September 2007, New York State Attorney General Andrew Cuomo launched an investigation of five large energy companies—AES, Dominion Resources, Dynegy, Xcel Energy and Peabody Energy—subpoenaing them to produce internal documents relating to their analysis of climate risks and the disclosure of such risks to investors. In letters accompanying the subpoenas, the attorney general questioned whether the companies' plans to build coal-fired power plants posed undisclosed financial, regulatory and litigation risks that their investors should know about, particularly given that the plants' main emission, carbon dioxide, has been linked to global warming. In his letter to Xcel Energy, Cuomo cited Xcel's failure to disclose its projected carbon-dioxide emissions or to thoroughly evaluate the potential impact of future GHG regulation, making it difficult for investors to make informed decisions.

While Attorney General Cuomo has not yet taken action against any of the companies, this investigation could be the first of many in an effort to compel GHG-emitting companies to disclose the potential risks of their businesses to investors. In the near future, the investigation may induce greater voluntary disclosure, as demonstrated by Xcel's more extensive discussion of climate change risk in its 2007 Form 10-K.

Investors also are demanding more information about climate-change risks from companies directly. According to the Ceres petition, almost 50 shareholder resolutions on climate-change disclosure and emissions policies were filed before September 2007, constituting more than 10 percent of all resolutions filed. This too has encouraged many companies, such as Xcel and Exelon Generating voluntarily to disclose climate-change risks and GHG-emissions levels in their annual and quarterly SEC filings.

### Disclosure Considerations

In light of competing pressures for increased disclosure of climate-change risk, public companies may benefit from guidance and an established structure within which they can evaluate, analyze and disclose the impacts of climate change and the risks it poses to their businesses. If the SEC were to act on the Ceres petition's recommendations, it would provide the familiar framework of the SEC's existing rules for assessing and disclosing the environmental, regulatory and climate-change risks facing affected companies.

In the past, the SEC has used its interpretive authority to require greater disclosure under the existing rules for specific events and new risks, such as requiring Y2K and Euro Conversion risk disclosure in the late 1990s. By leveraging off the framework of existing disclosure rules and providing guidance on material disclosure items, the SEC might make it easier for companies to address and respond to heightened climate-change disclosure demands.

As an added benefit, companies also may derive some positive public-relations benefits from expanded disclosure. Transparency with regard to climate-change risk and GHG emissions may engender better relations with the investment community, as well as with social and environmental groups.

Despite the guidance that an SEC »

## CLIMATE CHANGE DISCLOSURE TOOLKIT

In its 2006 publication, *Managing the Risks and Opportunities of Climate Change: A Practical Toolkit for Corporate Leaders*, environmental investment coalition Ceres recommended initial steps that public companies might take to assess and report their exposure to climate change risks.

❑ **Step 1:** Create a climate management team and develop a board oversight committee responsible for climate change considerations.

❑ **Step 2:** Measure and inventory GHG emissions—both direct (*i.e.*, from operations, property holdings and manufacturing) and indirect (*i.e.*, from consumer use of products, electricity use, employee travel)—from operations, electricity use and products. The Greenhouse Gas Protocol, for example, offers one methodology for GHG accounting that a company could use in measuring and reporting its emissions.

❑ **Step 3:** Benchmark against other companies within and outside the industry. Consider disclosure, climate-friendly and GHG mitigation strategies, GHG emissions levels and green practices when making this comparison. Also consider potential improvements to the company's environmental policies and strategy.—*MTB*

interpretive release would provide to companies grappling with climate-change risk disclosure, effective disclosure nonetheless may prove to be difficult in practice. Evaluating potential regulatory risk and related compliance costs is particularly difficult, given that many GHG regulations still are evolving and no federal regulations exist. As differing schemes develop, companies may be subject to overlapping and inconsistent regulatory requirements. Disclosure of regulatory risk might become increasingly onerous if a company must consider all jurisdictions in which it may be subject to regulation.

In addition, while the physical or regulatory risk of climate change may be somewhat identifiable, assessing the effects of such risk and quantifying potential harm inherently are speculative. The lack of a standardized methodology for evaluating climate-change risk poses a significant obstacle to meaningful disclosure. While there have been public efforts to establish a global standard for GHG accounting and reporting, such as the Greenhouse Gas Protocol (<http://www.ghgprotocol.com>), no methodology has been universally, or even nationally, adopted. As a result,

reducing climate-change risk to the economic impact it may have on a company's business, which is ultimately the information that investors are interested in, is a challenging endeavor. Even a company seeking to disclose voluntarily must first decide how to translate its emissions levels, regulatory risk and climate-change risk into more concrete data reflecting the impact these may have on the company's financial and competitive positions. Determining climate-change risk may require considerable commitments of time, money and other resources by reporting companies, particularly given the highly technical nature of GHG regulations and the effects of climate change.

Implementing increased climate-

Without particular guidance from the SEC, climate-change risk disclosure might be a burdensome task.

change risk disclosure requirements within the existing SEC disclosure framework could provide what would become a well-traveled path for public companies to follow as they, the SEC and the investing public deal with the impact of climate change. However, to ensure effective and adequate compliance, any heightened disclosure obligations should be supplemented with specific guidance regarding the kind of information to be disclosed and the type of evaluations to be conducted by reporting companies. For example, when the SEC issued its interpretive release requiring increased Y2K risk disclosure, it enumerated several potential issues for reporting companies to consider and disclose, such as the company's general plans for addressing Y2K issues relating to its operating systems and the total dollar amount the company estimates would be spent to remediate any Y2K issues. Without particular guidance from the SEC, increased climate-change risk disclosure might prove to be a burdensome task for public companies.

### Practical Guidance

Even in the absence of formal guidance, companies in targeted industries will face the need to consider whether to make voluntary disclosures. These include companies with high GHG-emission levels, such as utilities and power generators; companies with operations in countries that have ratified the Kyoto Protocol or in U.S. regions with formal GHG regulations; and those that might be directly affected by climate change. Utilities and power generators, to the extent they emit GHG, may want to consider disclosing their past, current and predicted emissions levels, as well as the potential effects of compliance with any GHG regulations that they are, or will be, subject to.

If the SEC in fact issues the suggested interpretive release, or if the SEC, state or other governmental authorities implement further disclosure requirements, »

the potential consequences of a company's failure to disclose climate-change risk could include the initiation of an SEC investigation or civil action, the creation of private rights of action, or state and local enforcement. And regardless of whether any of the climate-change disclosure rules become mandatory, failure to make adequate climate-change risk disclosure could lead to investor dissatisfaction and defection.

Should a company decide to disclose voluntarily, or should the SEC issue the proposed interpretive release in the near future, a disclosing company can use existing corporate structures to assess and disclose climate-change risks. For example, a company could supplement an existing disclosure committee with one or more environmental specialists or consultants. The committee could then evaluate environmental and climate-change information from the different business units of the company, determine what information would be material, and require disclosure in the same manner that it evaluates and discloses other material information about the company.

A company's initial steps toward adequate climate-change disclosure include forming a management team and board committee to focus on the issue; measure companywide GHG emissions; and benchmark its performance and practices against its industry peers (*see sidebar, "Climate Change Disclosure Toolkit"*).

The company also could determine the physical, regulatory and financial risk to fixed assets, products and competitive positioning that climate change generates. Physical risk might include, among other things, the effect of changes in weather on a company's performance, as well as the health of the workforce and the cost of adaptation to the changing climate. With regard to fixed-asset risk, the company might consider exposure, age and projected life, energy use, fuel-switching capabilities and proximity to the coastline. Product risk might include an assessment of energy demand and fuel use, energy efficiency and low GHG alternatives. Finally, the company could evaluate its competitive risk, considering its ability to respond to changing regulations and new markets and the introduc-

tion of climate-friendly products.

As GHG-emissions regulation becomes more common, and climate change continues to progress, the effect of climate change and GHG-related regulatory developments on a company's business is becoming an important consideration for investors and corporate executives alike. Investors increasingly are demanding more information about climate-change risk, and public companies feel rising pressure to disclose such risk. Regardless of whether the SEC or another federal, state or local government authority adopts additional climate-change disclosure requirements, public companies, particularly those in the utility and energy sectors, will need to consider whether, and how, to respond to mounting public pressure to make climate-change risk disclosure more transparent. ■

*Sey-Hyo Lee is a partner in the corporate and climate change practices at Chadbourne & Parke LLP and Marushka Bland is an associate at the firm. They are reachable at 212-408-5100.*

**Did you receive *SPARK* last month?**

**If not, visit [www.pur.com](http://www.pur.com) to see what you missed. Complete the order form to ensure this month's issue arrives via e-mail.**

*SPARK is an electronic newsletter exclusively available to Fortnightly subscribers.*