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Is it Time to Disclose Climate Risks?

Definition of "Material" a Moving Target

By Steven P. Solow and Karl R. Heisler

"Climate change is a serious long-term challenge that has the potential to affect every part of the globe." — THE GLENEAGLES COMMUNIQUÉ ON CLIMATE CHANGE, ENERGY AND SUSTAINABLE DEVELOPMENT (JULY 8, 2005)

At the G8 summit where that communiqué was issued, a small but noticeable shift occurred in U.S. policy on climate change. The President, in a brief appearance with British Prime Minister Tony Blair, stated that it was time to "get beyond the Kyoto period and develop a strategy forward" that included the United States. In an earlier interview on British television, President Bush stated that the United States recognized climate change as an issue "we've got to deal with" and that human activity was, "to some extent," to blame.

As demand for greenhouse gas (GHG) measures moves from debate to inevitability, corporations are looking for cost-effective and responsible climate change strategies.

This article describes how some top corporate managers, in their public disclosures, are reacting to these developments, particularly to numerous shareholder campaigns for corporate transparency related to climate risks.

PRESSURE TO DISCLOSE

Analysts and investors increasingly believe that businesses actively engaged in GHG reduction and energy conservation are better managed and more likely to provide good returns on investment. A 2004 Goldman Sachs analysis, for example, ranked leading energy related businesses on their GHG targets and performance, giving the highest ranking to those that set and were reaching GHG reduction targets. Reflecting analyst recommendations, investors are now demanding climate-risk disclosures.

In its last climate change reporting survey, the Friends of the Earth concluded that the "2003 proxy season saw record votes in favor of shareholder resolutions dealing with climate change." This trend continued into 2004, when the Rose Foundation for Communities and the Environment called for environmental disclosure reforms that would enable investors to evaluate climate change liabilities that may surface long term.

This year is no different. As the Coalition for Environmentally Responsible Economies recently recognized, "oil and gas companies, electric power producers, real estate firms, manufacturers, financial institutions and automakers were the focus of a record number of global warming resolutions filed by shareholders for the 2005 proxy season."

Although corporations currently are not required to disclose climate risks, several major corporations have decided it is in their best interest to do so. Utility giants Southern Company, American Electric Power, Cinergy, and TXU have already released reports on shareholder risks associated with climate change. Duke Energy, Exelon, J.P. Morgan, General Electric, Ford Motor Company, among several other corporations, have disclosed new climate change policies or initiatives.

DEVELOP AND UTILIZE AN ENVIRONMENTAL MANAGEMENT SYSTEM

A robust environmental management system (EMS) can be a powerful tool to evaluate climate risks. Properly designed, it can capture the information necessary to reveal climate impacts traceable to specific areas of operations. Specifically, it should allow a corporation to:

- Identify and measure GHG emissions.
- Develop GHG management and energy conservation plans.
- Monitor the use of GHG-related products and services (fuels, electricity supply and demand).
- Gauge ability to respond to future GHG regulatory regimes.
- Quantify GHG emission reductions or removal enhancements.
- Validate and verify GHG-related assertions.
- Project the impact of new "green" technologies.
- Evaluate emerging GHG trading markets.
- Assess the assumptions used to determine all of the above.

ALONG WITH IDENTIFYING RISKS, COMPANIES ARE TAKING STEPS TO MANAGE THEM IN ANTICIPATION OF MANDATORY GHG REGULATION.

This list should provide a basis for discussions with environmental managers who are familiar with the corporation's actual GHG emissions and potential reductions. In terms of Sarbanes-Oxley, C-level officers should be able to rely on their EMS to provide "adequate disclosure controls and procedures" to account for climate risks. In addition, experience has shown that close management of potential environmental liabilities leads to lower costs on labor, energy, and material resources. Your EMS is the key to a "green" bottom line.

DETERMINE MATERIALITY

The second step is to determine what information related to climate risks should be disclosed and how to disclose it.

U.S. securities law requires the disclosure of any information that has a "material" impact on the corporation's finances. The SEC relies on case law that generally holds a fact material if a reasonable investor would take it into account in making a decision in connection with an investment. As reported by the Government Accountability Office, the SEC recently took the position that "disclosures about the impact of potential greenhouse gas controls are not necessarily required ... because controls do not appear imminent at the federal level ..."

At the same time, however, the SEC warned that "there may be circumstances in which a company can identify a material impact and must disclose it in the filing."

In other words, climate risks are not material except when they are material. The definition of "material" in the climate change context is a moving target. That means companies need to routinely assess their relation to climate change issues. GHG controls may not be imminent, but few would dispute the fact that they are inevitable. Christine Todd Whitman, a former Administrator of the Environmental Protection Agency, recently stated that "it's going to happen over time, and it's going to happen because the multinational corporations are going to want to see it."

What is material to one industry may not be material to another. The Friends of the Earth survey noted above concluded that "the fact that some companies are already reporting climate risks to their shareholders suggests that climate change is a material business risk and/or opportunity in each of the five sectors surveyed."

Under this theory, climate risks may be more material for the electric utility sector in light of the fact that just over 90 percent of the largest publicly-traded utilities surveyed addressed them in their SEC filings, but less material for the automotive sector in light of the fact that just over 20 percent of automakers surveyed addressed them.

But the trend is clear. Corporations are moving toward climate risk disclosures — either in response to shareholder demands or simply as a matter of corporate policy. Corporations that decide to disclose often avoid the materiality conundrum by referring to climate risks as "significant," "substantial," or "far-reaching."

In any event, once the decision is made to disclose, three primary vehicles are used in making disclosures.

• "Regulation S-K Item 101, Description of Business" requires the disclosure of the material effects that compliance with environmental laws may have on capital expenditures, earnings, and competitive position. Item 101 might be triggered by any one of several international, federal, and state regulatory regimes that are calling for GHG reductions.

• "Regulation S-K Item 103, Legal Proceedings" requires a description of "any material pending legal proceedings, other than ordinary routine litigation incidental to the business." Item 103 might require the disclosure of any pending or known-to-be-contemplated climate change litigation.

UTILITY GIANTS SOUTHERN COMPANY, AMERICAN ELECTRIC POWER, CINERGY, AND TXU HAVE ALREADY RELEASED REPORTS ON SHAREHOLDER RISKS ASSOCIATED WITH CLIMATE CHANGE.

• "Regulation S-K Item 303, Management Discussion and Analysis (MD&A)" requires the disclosure of "any known trends or uncertainties" that may have a "material" impact on the company's financial condition. The MD&A, which carries with it a rebuttable presumption of disclosure, might prompt the disclosure of any one of several climate risk uncertainties, from energy markets impacted by voluntary GHG reductions, to the impact of the Kyoto Protocol on multinational partners, to a potential national carbon tax.

Experience has shown that a corporation that locates climate risk disclosures in footnotes or other lesser known areas of SEC filings may wind up with its name in lights. The Rose Foundation for Communities and the Environment, for example, recently released a report entitled "Fooling Investors and Fooling Themselves." The report objected to climate risk disclosures that, in its view, "aggressively interpret ambiguities in the law."

In this regard, at least from the shareholder perspective, the type and rigor of the climate risk disclosure may distinguish a well-managed corporation — one that recognizes the opportunities in a carbon-constrained future — from a corporation that fails to convey the longer term outlook.

CONSIDER FURTHER MOVES

The third step is to consider taking a proactive stance on climate change in light of the climate risks identified in Step 1 and disclosed — or not — on the basis of Step 2.

Some corporations be-lieve that GHG regulation of some kind is inevitable and have positioned themselves as thought and action-leaders in this area. For example, several publicly-traded corporations have recently taken climate change positions that they claim are better for the environment and better for their investors. Duke Energy [See "The Case For a Carbon Tax," on page 54] has called for a national tax on carbon dioxide emissions. American Electric Power advocates a voluntary cap-and-trade regime. Southern Company promotes technology-based solutions. General Electric announced it will double its investment and sales in environmental technologies by 2010. Exelon acknowledged that "limitations on greenhouse gas emissions will prove necessary."

These corporations have taken their positions despite the disagreement that still exists about which type of GHG regulatory regime best accommodates environmental and business needs. At a minimum, the costs and benefits of differing GHG regimes (traditional command-and-control regulations, cap-and-trade programs, property rights in environmental resources, and environmental taxes) deserve scrutiny in coordination with any forward-looking business plan.

Any move towards disclosure should be made in a considered manner. Again, a robust EMS should guide you through this process. Obtain the best available data on actual business operations. The goal should be accurate disclosures. Also, consider the context of any disclosures or lack thereof. An extensive disclosure on climate risks by another company in your sector could raise the potential for investor or SEC scrutiny of your own corporate filings.

Consider carefully what your position on climate change is. A well thought-out and forward-looking corporate policy on this issue can be an important part of risk-mitigation and business planning. It can avoid controversies over disclosure obligations, reduce GHG emissions and energy consumption, and identify new savings and business opportunities.

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