

To Disclose or Not to Disclose? What is Climate Change's Impact on Your Utility?

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In recent years, institutional investors and social activists have called for public companies to address in their securities filings the impact of climate change on their businesses.

While a few companies have provided limited climate change disclosure in the past, the practice has not been adopted widely, and the level of disclosure largely has been limited to environmental compliance. Now, however, the United States is moving toward ambitious programs simultaneously to reduce greenhouse gas (GHG) emissions while dramatically expanding reliance on renewable energy sources:

- The American Clean Energy and Security Act of 2009 (ACES), which contained cap-and-trade and GHG-reduction mechanisms, is before the Senate after having been passed by the House of Representatives in 2009.
- The Environmental Protection Agency in December 2009 issued its finding that current and projected concentrations of emissions combining six GHGs, including carbon dioxide, threaten public health and welfare—a possible prelude to greater regulatory action.
- Most states have implemented renewable energy expansion programs, often tied to renewable energy portfolio standards (RPSs) that vary by state. Some of those states have adopted some level of GHG-emissions control through state and regional agreements, including, for example, the Regional Greenhouse Gas Initiative.

Each initiative has a potentially substantial impact on the finances and operations of investor-owned utilities (IOUs). Government mandates for meeting RPS and GHG-reduction targets will require additional IOU capital investment and the assumption of new technology and regulatory risk. At the same time, demand for electricity generated by the existing fleet owned by utilities could be reduced as more renewable energy output comes online. Such operational risks translate into risks for utility investors and raise questions on how to assess the degree of risk.

SEC Guidance

On Feb. 2 the U.S. Securities and Exchange Commission (SEC) published Release Nos. 33-9106 and 34-61469 to give public companies interpretive guidance to apply the SEC's existing disclosure requirements to climate change matters. The release gives an overview of existing climate change disclosure obligations and a framework for public companies to use in evaluating the climate-related issues that, if material to a company's business, must be disclosed under existing federal securities laws and regulations. It states the existing

standards for determining materiality and reviews the rules that may require disclosures related to climate change in such SEC filings as quarterly Form 10-Q and annual Form 10-K reports and registration statements.

Climate change might trigger disclosure requirements in risk factors, business description, legal proceedings and management discussion.

The standard for determining the materiality of information (including climate-related matters) under the federal securities rules is whether there exists a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision. This standard does not reflect subjective sensitivities that certain investors have to issues such as climate change. For contingent or speculative information or events (such as pending legislation), materiality depends on balancing the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.

In this light, the SEC's interpretative guidance highlights the following four areas as examples where climate change may trigger disclosure requirements in a company's risk factors, business description, legal proceedings and management discussion and analysis:

- **Impact of Legislation and Regulation.** With respect to existing federal, state and local laws that relate to GHG emissions, companies should disclose any material estimated capital expenditures for environmental control facilities as part of an assessment of whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the registrant's financial condition or results of operation. The release emphasizes that companies other than those in industries traditionally considered most at risk by cap-and-trade and GHG legislation (e.g., electricity, oil and gas and heavy manufacturing) need to consider how they might be affected indirectly by potential legislation and regulation.
- **International Accords.** Companies should consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change, such as the Kyoto Protocol, the EU Emission

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Trading System (ETS) and other international activities in connection with climate change remediation.

- **Indirect Consequences of Regulation or Business Trends.** Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies by creating demand for new products and services or reducing demand for existing ones. Companies should be prepared to assess and disclose the impact of both, whether it involves increased demand for green products and renewable energy output or decreased demand for goods that produce significant GHGs.
- **Physical Impacts of Climate Change.** Climate change itself can have a material effect on a company's business and operations through impact on personnel, physical assets, supply chains and distribution chains. This can include the impact of changes in weather patterns (such as increases in storm intensity, rising sea levels and temperature extremes), changes in the availability or cost of natural resources, or increased insurance risk from extreme weather. Companies whose business may be vulnerable to such events should consider whether they constitute material risks and require disclosure.



Management Assessment

The SEC's release makes it clear that companies other than those in industries considered most at risk of GHG-emissions control legislation or developing regulations (for example, electric utilities, oil and gas producers, as well as heavy manufacturing) need to consider how they might be affected indirectly by potential legislation and regulation. By implication, then, IOUs should be especially sensitive to whether a GHG-related development can be material and should be disclosed. This is particularly true in the management discussion and analysis (MD&A) required in the Form 10-K annual report.

Companies must identify and disclose in the MD&A known trends, events, demands, commitments and uncertainties that are "reasonably likely" to have a material effect on their financial condition or operating performance. Under previous SEC guidance restated in the release, known trends and other uncertain events do not need to be disclosed if they are not reasonably likely to occur. If management cannot make that determination, however, disclosure is required unless management determines that if the event or trend

occurred it would not be reasonably likely to have a material impact on the company's financial condition or operations. Companies also should address in the MD&A when material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, and provide where possible an indication of the time in which resolution of the uncertainties is anticipated.

Utility Impact

This disclosure determination is not being made in a vacuum. IOUs have continuing investment needs to upgrade aging infrastructure and address decreasing generation reserves, which may be impacted further by required spending to comply with GHG regulation. This could create upward pressure on revenue requirements and retail rates in a tough economic climate. Utilities have less usage volume by which to earn a return (a situation that expanded use of renewable energy and energy efficiency measures may exacerbate) at the same time costs and risks are increasing.

What should utilities say to investors about the implications of this situation? If utilities invest in significant GHG reduction, will they recover those costs sufficient to maintain the utility's financial quality? To answer such questions, it seems likely that companies should consider helping investors assess certain key factors:

- **Materiality:** the impact of a GHG-reduction mandate must be material compared to the utility's overall rate base, revenues and sales volumes,
- **Regulatory risk:** the certainty and timing of any cost recovery mechanism,
- **Regulatory balance:** the likelihood that utility regulators (and the investment community) will do a peer comparison of return-on-equity performance for utilities that have greater GHG-reduction demands, along with assessment of any incentives and cost-recovery mechanisms,
- **Innovation:** the risk that a utility's implementation of GHG reduction may or may not meet expectations or targets, and
- **Cost recovery:** the likelihood of whether IOUs can get regulator approval to use the various cost-recovery tools available for required investment, such as decoupling retail rates from volume sales, or capitalization of program costs by allowing a bonus rate of return on the un-depreciated amount over part of the useful life of the GHG-reduction measures.

The impact of these and other factors will differ for each IOU. The time to consider what to disclose is now. As the SEC's release emphasizes, the current federal securities disclosure requirements already provide a basis for disclosures related to climate change to the extent the requisite materiality standards are met. Ignoring current developments could increase the likelihood of receiving a comment from the SEC that the climate-related disclosures in an IOU's SEC filings are inadequate in light of existing disclosure rules. **■**