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CLIMATE CHANGE

Utilities Face Disclosure Requirements

By Thomas P. Conaghan

On Feb. 2, 2010, the U.S. Securities and Exchange Commission (SEC) issued a release to give public companies, including investor-owned utilities, interpretive guidance regarding the SEC's existing disclosure requirements relating 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 the existing federal securities laws and regulations. The SEC's release makes it clear that companies other than those in industries considered to be most at risk for greenhouse gas (GHG) regulation (*e.g.*, electric utilities, oil and gas producers, and manufacturers) need to consider how they might be affected. By implication, then, utilities should be especially sensitive to whether a GHG-related development can be material and should be disclosed.

Materiality

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 take into account subjective sensitivities that certain investors have to issues such as climate change. Materiality of potential events depends at any given time upon a balancing of both the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.

The SEC's release does not create any new disclosure requirements. Instead, it merely reflects the agency's position that the federal securities laws require disclosure of information that is "material" to all investors and that current disclosure requirements already provide a basis for disclosures related to climate change, to the extent the requisite materiality standards are met.

The SEC also reiterated its view that disclosure controls and procedures should not be limited to disclosure specifically required.

Filings

The SEC's guidance on climate-change disclosure covers a variety of regular securities filings for registered public companies, including quarterly Form 10-Q and annual Form 10-K reports. Four key segments of these reports may require incorporation of disclosures.

Description of Business. This segment can include discussion and disclosure of the effect that environmental protection and compliance may have upon the company's capital expenditures, earnings and competitive position.

Legal Proceedings. Companies are required to briefly describe any material pending legal proceeding beyond routine litigation, expressly including any proceeding that arises under federal, state or local environmental laws that would have a material financial effect. This is generally defined as an amount exceeding 10 percent of the consolidated current assets of the registrant and its subsidiaries, or monetary sanctions of more than $100,000.

Risk Factors. This encompasses a review of the most significant risk factors that make an investment in the registrant speculative or risky. Companies must clearly state the risk and specify the effect it could have. Existing regulations make clear that failure to disclose meaningful climate-related risk factors potentially could expose companies to additional liability for forward-looking statements that are unrelated to climate change.

MD&A. Management's Discussion and Analysis of Financial Condition and Results of Operations (the MD&A) is a report segment intended to provide material historical and forward-looking information that lets investors see through the eyes of management and assess the registrant's financial condition and results of operations. It requires identifying and disclosing known trends, events, demands, commitments and uncertainties that are "reasonably likely" to have a material effect on financial or operating performance. If management cannot determine "reasonable likelihood," disclosure is required.

Climate Considerations

Given the applicable standards of materiality, the SEC guidance defines the following four areas as examples where climate change may trigger disclosure requirements in the relevant segments of a utility's securities fillings.

Legislation and Regulation. Disclosure should be made of any material estimated capital expenditures for environmental control facilities for the current and succeeding fiscal year, plus such additional years as are material. Registrants should assess whether climate change legislation or regulation is reasonably likely to have a material effect on their financial condition or results of operation. Specific items that could be covered include costs of, or profits from, trading allowances or credits under a "cap-and-trade" system, cost-of-capital expenditures to comply with a cap-and-trade regime, and costs passed on from upstream suppliers that are affected by climate change regulation.

International Accords. If similar material impacts are expected from treaties or international accords relating to climate change (*e.g.*, such as the Kyoto Protocol, the EU Emission Trading System, or other international activ-

Climate-related issues, if material to a company's business, must be disclosed.

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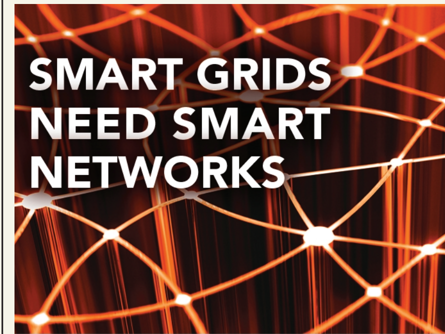
ities in connection with climate change remediation), companies should consider disclosure.

Indirect Consequences. Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for registrants. These developments may create or decrease demand for existing or new products or services, or decrease demand for existing products or services. For utilities this particularly relates to fuel sources, whether decreased demand for fossil fuels or greater use of renewable energy sources. Risks do not have to be quantifiable to be material. For example, public perception that a utility is responsible for GHG emissions could affect its reputation, business operations or financial condition.

Utility Considerations

The cumulative impact of all these scenarios is considerable, but hypothetical. Nevertheless, actual events from the past six months alone conceivably could fall into the category of material climate-change considerations that utilities should disclose. The following is just a partial list:

- *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—likely a prelude to greater regulatory action.
- The number of states that have implemented combined GHG reduction/renewable energy expansion programs, often tied to renewable energy portfolio standards (RPS), now has reached 30, along with the District of Columbia.
- RPS requirements plus smart metering and other energy efficiencies funded in the *American Recovery and Reinvestment Act* and the Obama Administration's first two budgets may cut electricity demand even as utilities must spend more on GHG reduction.
- The U.S. Second Circuit Court of Appeals, in *Connecticut v. American Electric Power*, potentially opened the way for claims in tort for the abatement of utilities' GHG emissions as a public nuisance under Federal or State laws.
- The Administration's proposed 2011 federal budget calls for phasing out of tax subsidies for fossil fuels (including coal), while at the same time expanding the amount of tax credits made available in the ARRA for qualifying renewable energy projects.



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Physical Impacts. Climate change itself may have a material impact on a registrant's personnel, physical assets, supply chain and distribution chain. For utilities such factors can include the effects of greater storm intensity or wider temperature extremes on facilities or operations. As one hypothetical example, warmer temperatures could reduce demand for residential and commercial heating. Registrants whose businesses may be vulnerable to severe weather or climate-related events should consider whether this creates material risks that should be disclosed.

The impact of these and other factors will differ for each investor-owned utility. But, the time to consider what to disclose is now, particularly under current federal securities disclosure requirements. Ignoring ongoing climate-change developments could bring a comment from the SEC that the climate-related disclosures in a utility's SEC filings are inadequate in light of existing disclosure rules. ■

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