

# A looming imperative

Across developed economies, pressure is building on companies to disclose environmental and climate change risks, warn **Prajakt Samant** and **Adam Topping** – with regulation surely just a matter of time

In September 2007, New York State Attorney General Andrew Cuomo subpoenaed a number of executives from major US energy companies under a powerful but little-known piece of 1921 New York legislation called the ‘Martin Act’, to assess whether their Securities and Exchange Commission (SEC) filings sufficiently disclosed financial risks posed to investors by climate change. Two companies, Xcel Energy and Dynegy, subsequently reached agreements with Cuomo to disclose further environmental risks in their SEC filings.

Xcel is one of the largest utility emitters of greenhouse gases (GHGs) in the US. In August 2008, the company agreed to include in its 10-K annual filings several analyses of environmental risks that could result in material financial costs to its business. These can be summarised as follows:

- risks from the current and future international regulation of GHG emissions;
- risks from international climate change-related litigation;

- risks posed by the physical impacts of climate change (such as an increase in sea level); and

- a climate change risk and emissions management analysis. This needs to contain a statement from Xcel, detailing its stance on climate change, projected increases in GHGs emitted from planned coal-fired generation projects, and actions it proposes taking to reduce its climate change risk and to adapt to its physical impacts. Xcel also will need to state how past climate change strategies have worked. Lastly, corporate governance actions concerning climate change will need to be detailed.

The Xcel agreement was closely followed by a similar deal with Dynegy in October 2008, which addressed substantially the same issues.

This climate change disclosure imperative has arisen as a result of a new, increasingly trenchant, class of investor that is conscious of the environmental and financial effects of climate change. Such investors argue that, without further extensive environmental risk reporting, they may be left exposed to real and serious risks. However, the corollary of this is that filings to the SEC should be based only on hard, objectively calibrated facts, as opposed to unquantifiable and intangible environmental risks, which may or may not occur.

Companies now face a dilemma: whether or not to take pre-emptive action with extensive environmental risk disclosure. Where these disclosures are not made, investors may view the companies in which they have their shareholdings as ‘out of touch’, and could instead invest in a competitor. There is also the possibility that non-disclosing companies risk upsetting regulators and/or could face shareholder action for filing statements with the SEC which omit key environmental and climate change information.

However, the lack of an objective standard of disclosure and perceived lack of certitude – as regards envi-



Pointing the finger – Andrew Cuomo goes after big emitters

ronmental data, future projections, and what the extent of climate change impact could be – can make companies reluctant to undertake such disclosures.

A significant lobby still backs increased environmental risk disclosure and is expecting the SEC to offer a concrete solution. In response, in June 2008, the SEC launched its ‘21st Century Disclosure Initiative’, a “wide-ranging internal effort to fundamentally rethink financial disclosure”. In response, the Investor Network on Climate Risk (INCR), a network of investors geared towards a greater understanding of the financial risks posed by climate change, sent a letter to the SEC demanding better disclosure on risks associated with climate change and other related risks. The INCR’s letter sets out the arguments for a change in environmental risk reporting. The INCR states: “Any modernisation of the SEC disclosure system should respond to the strong and growing needs of investors for better corporate disclosure of climate risks.”

While many companies produce voluntary reports containing some environmental risk information, there are also companies that “do not provide all the information that investors require”, the INCR says. This produces inconsistencies, with some companies voluntarily providing information and others choosing not to do so. The INCR letter argues that: “Reporting must be consistent and must support comparisons among companies.”

In January 2009, the SEC produced a report on its findings from its disclosure initiative. However, it fails to mention anything about environmental risk reporting. In its introduction, the SEC report references a survey conducted by the SEC’s Office of Investor Education and Advocacy and states that: “many investors do not actually read disclosure documents. Instead, they gather information that is contained in these documents from other sources.” The focus of the SEC report is therefore on modernising the way in which financial



Time to come clean in corporate disclosures?



information is reported and presented to the SEC, rather than the actual content of that information.

So, how is this trend manifesting itself outside the US? At the date of writing, there have not been any high-profile legal demands made of individual UK companies to make environmental risk disclosures to the extent of Dynegy and Xcel. However, the UK has not been oblivious to climate change associated risks, and has sought to address the issues through legislation, primarily the 2006 Companies Act and the 2008 Climate Change Act (CCA).

**U**nder the Companies Act, companies in the UK are required to prepare and file annual reports and accounts with the UK companies registrar. These annual reports and accounts must contain a directors' report, which details the names of the directors and the company's principal activities in the course of the year, as well as proposed dividends and other required disclosures.

In October 2007, an amendment to the Companies Act came into force, which required all companies (other than small companies) to include a business review in the directors' report. It must contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company. Moreover, quoted companies must include information about environmental matters (including the impact of the company's business on the environment), to the extent necessary for an understanding of the development, performance or position of the company's business. This, arguably, could include information on climate change matters. If a company does not believe environmental issues are relevant to its business review, it must explain why.

On 26 November 2008, the CCA became law in the UK and created a legal framework for cutting emissions and adapting the UK to climate change. The CCA places targets (set against a 1990 baseline) on the UK to achieve an 80% reduction in carbon emissions by 2050, with an intermediate reduction level of 26% by

2020, which goes beyond the EU-wide target of 20% by 2020 (rising to 30% if a successor to the Kyoto Protocol is agreed).

The CCA does not as yet specifically require UK companies to make an explicit climate change risk disclosure. However, it does set firm deadlines by which various actions must have been taken by the UK government. These include requirements that it must, by 1 October 2009, have issued guidance on how companies should report their GHG emissions and, by 6 April 2012, have made regulations requiring companies to disclose information on GHG emissions resulting from their activities, or to have laid before Parliament a report explaining why such regulations have not been made.

None of the developments above currently impose detailed environmental risk reporting obligations on UK companies. However, they do have the potential to place a significant weapon in the investor's armoury for the purpose of analysing a company's environmental performance. For example, a shareholder may be encouraged to bring a claim against the directors of a company if a material environmental disclosure was not made in the directors' report which, upon coming to light, led to a significant drop in the share price.

Elsewhere in Europe, there also have not been any high-profile legal demands made of individual companies for environmental risk disclosures comparable to the Dynegy and Xcel examples in the US. In the EU, a large number of companies are willing to publish (on a voluntary basis) information on climate change risks and opportunities, GHG emissions and plans to reduce emissions in their annual reports. However, very few companies are willing to provide emissions forecasts. Despite the fact that many companies may undertake forecasts for regulatory and other

## With so many companies already disclosing environmental risks, it seems possible that at some stage a form of disclosure may become a legal requirement

purposes, these forecasts are generally seen as too commercially sensitive and speculative to be made public.

At a landmark summit in Strasbourg in December 2008, leaders from across the EU reached final agreement on a climate change and energy package that is intended to help transform Europe into a low-carbon economy and increase its energy security. The package imposes various binding targets on EU member states to be achieved by 2020, including cutting GHG emissions by 20%, generating 20% of energy from renewable sources, and reducing energy consumption by 20%.

The European Commission considers

these targets to be both technologically and economically possible. Moreover, it expects them to stimulate business opportunities for a vast number of companies across the EU. In order to achieve these targets by 2020, EU governments may choose to impose clear and unequivocal standards of environmental disclosure on companies operating in their territory. Consequently, these standards may help to foster a culture of compliance and a results-driven effort seriously to tackle environmental risks, making EU-wide emissions targets and disclosures more achievable.

**A**nother influence on the developing standards of climate risk disclosure by companies worldwide is the Carbon Disclosure Project (CDP). The CDP is an international organisation active across the globe, pushing for greater climate change risk reporting. The CDP is comprised of hundreds of institutional investors, managing trillions of dollars worth of assets. It operates by issuing information requests to companies to disclose, among other things, GHG emissions, as well as their strategies for dealing with climate change risks.

While the CDP information requests are voluntary, many companies willingly provide information. For example, in the US, more than 330 of the S&P 500 index of companies, along with a further 400-plus of the largest companies in France, Germany and the UK combined, all answered the CDP information requests for 2008. With so many companies already disclosing environmental risks, it seems possible that at some stage a form of disclosure may become a legal requirement, following a uniform, recognised standard.

The Xcel and Dynegy agreements in the US, the implementation of environmental legislation in the UK, the development of EU-wide emissions reduction targets, and the activities and effect of international organisations such as the CDP, along with increasing investor concern, have all served to ensure that environmental and climate change risk reporting issues have gained greater prominence on the international political agenda. All of these factors seem to make it more likely than not that some form of mandatory climate change disclosure will become a reality in the medium term, although precisely what form such disclosure will take, and how it will vary from region to region, country to country, and sector to sector, remains to be seen.

At present, the methodologies for calculating climate change risk remain unclear, and the timeframes for the implementation of new rules still seem distant. However, those companies not already measuring and reporting climate change risks may be better positioned to cope with proposed legal and regulatory changes if they start taking steps to adapt to a shifting framework sooner rather than later. **Prajak Samant is a partner and Adam Topping is an associate in international law firm McDermott Will & Emery's energy group, based in London. E-mails: psamant@mwe.com and atopping@mwe.com**