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Developments Increase Pressure for Climate Change Disclosure Under SEC Regulations

→ **Environmental**

→ **Energy and Project Finance**

→ **Securities**

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In a recent, widely reported settlement, New York Attorney General Andrew Cuomo obtained the agreement of Xcel Energy, Inc., to provide extensive shareholder disclosure of the potential effects on its business of climate change and climate change regulation. While this settlement affected a large electric generation company, the logic of the settlement, when coupled with other regulatory actions and litigation discussed below, suggests that material climate change related risks affect many companies. Reporting companies' businesses may be adversely affected by (i) change or volatility in weather or sea level, (ii) requirements for review of greenhouse gas emissions in connection with most air permit applications, and (iii) costs imposed by government regulation on the use of fossil fuels in the production, distribution and use of a company's products. In light of these developments, we encourage companies to review their SEC reporting practices relating to climate change.

Background

SEC regulations do not explicitly require reporting of climate change impacts, but Items 101 (Description of Business), 103 (Legal Proceedings) and 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)) of Regulation S-K may trigger reporting requirements. As currently written, Item 101 requires the disclosure of the "material effects that compliance with Federal, State and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings, and competitive position" of the company. The cost of complying with the new or pending regulations is just the type of expenditure contemplated by this section. Item 103 requires disclosures regarding any material pending legal proceedings out of the ordinary course of business, including proceedings known to be contemplated by governmental authorities. Companies engaged in legal battles over permits for new facilities would be obligated to disclose the risks inherent in such litigation under this requirement. Item 303 requires a company to disclose "information necessary to an understanding of its financial condition, changes in financial condition and results of operations," including any known trends, demands, commitments, events or uncertainties affecting liquidity, capital resources or results of operations in a material way. The potential financial and non-financial impacts of climate change will need to be addressed once a company is aware of information that creates a reasonable likelihood of a material effect on its financial condition or results of operations.

The crux of these requirements is the materiality threshold, which the Supreme Court has defined broadly as the importance of the information to the "reasonable investor" in light of the total information available. Calls by investor groups such as Ceres (a national coalition of investors and environmental groups), CalPERS and CalSTRS speak to the significance investors are placing on climate change disclosures. These investors, representing over six trillion dollars under management, joined a petition by the New York Attorney General requesting SEC guidance that would clarify registrants' obligations under existing law and regulations and lay out the key elements of corporate disclosure of climate change related risks (Petition for Interpretive Guidance on Climate Risk Disclosure, available by [clicking here](#)). These groups are focusing on the impact of climate change and expected regulations on the reporting companies' basic business models. In this connection, CalPERS has issued environmental corporate governance guidance, which outlines the case for improved disclosure (The Global Principles of Accountable Corporate Governance, available by [clicking here](#)). The developments detailed below substantially increase the likelihood of a material impact on the financial health of companies and the regulatory risks of nondisclosure.

Xcel Settlement Agreement

On August 27, 2008, New York Attorney General Andrew Cuomo announced a first of its kind settlement agreement requiring Xcel Energy, Inc., to disclose in its Form 10-K filings the financial risk that climate change poses for the company. The Attorney General used his authority under antifraud provisions of the Executive Law (NYCLS Exec § 63(12)) and the “Martin Act” (NYCLS Gen Bus § 352) to commence an investigation into Xcel and four other companies regarding the adequacy of their disclosures to investors of risks related to their efforts to build new coal-fired power plants. Xcel voluntarily resolved the investigation by agreeing to disclose global warming risks in its Form 10-K filings for the next four years. Xcel agreed to expand and/or continue discussing current legislation or regulations and probable future laws and their material financial effect on the company; litigation or judicial decisions related to climate change that may have a material financial effect on the company; the physical impacts of climate change (including sea level increases, changes in weather conditions and extreme weather events) and the financial risks of such events to its operations; as well as the company’s current strategic position on emissions management and corporate governance concerning climate change and the possible financial risks to its business. Any public company whose stock trades on a New York-based exchange is now subject to the possibility of similar enforcement actions. Moreover, the terms of the settlement strongly suggest the scope of disclosure which should be considered by other public companies.

EPA Actions

On July 30, 2008, EPA Administrator Stephen Johnson issued an Advance Notice of Proposed Rulemaking (“ANPR”), representing the United States Environmental Protection Agency’s (“EPA”) response to both the Supreme Court’s decision in *Massachusetts v. EPA*, 127 S. Ct. 1438 (2007) and a number of pending petitions to regulate greenhouse gas emissions from most mobile and stationary air pollution sources under Sections 111, 202, 213, and 231 of the Clean Air Act (42 U.S.C. §§ 7411, 7521, 7547, 7571). The ANPR includes extensive analysis of the science related to climate change and the staff’s analysis of the science strongly suggests that the science supports an endangerment finding that would mandate regulation of emissions from cars and trucks under Section 202 of the Clean Air Act. The analysis applied by the staff to mobile sources is, as the staff points out in inviting comment on the issue, equally applicable to stationary sources, and we expect that resulting regulation under the Clean Air Act, if not superseded by legislation, will cover most commercial and industrial sectors.

Both Senator McCain and Senator Obama have pledged to take early, dramatic action to curtail emissions of greenhouse gases. Accordingly, the next administration seems likely to embrace aggressive policies to limit greenhouse gas emissions, and the EPA agency staff has outlined a broad array of apparently workable mechanisms to do so. Legislation remains likely, but its timing and form will depend upon the form of the administrative action and the makeup of Congress and the new Administration.

Four days after issuing the ANPR, EPA proposed regulations under the Safe Drinking Water Act program governing underground injection of carbon dioxide for carbon capture and sequestration. The Safe Drinking Water Act regulates underground injection wells for the purpose of protecting groundwater quality. The proposed regulation would create a new Class VI category of injection wells to take into account the unique characteristics of carbon dioxide injection.

Judicial Developments

Two recent developments in cases involving challenges to permits for coal-fired power plants suggest that the new source review (“NSR”) program under the Clean Air Act will be applied to permits for new facilities and major modifications to sources of carbon dioxide emissions under the Clean Air Act. In *Friends of the Chattahoochee, Inc. v. Couch*, Dkt. No. 2008CV146398 (Ga. Super. Ct., Fulton County, June 30, 2008) (“*Longleaf Energy Associates*”, the Georgia Superior Court held that an air pollution permit for a new coal-fired power plant can only be issued after the permitting authority considers whether the plant proposes to implement “best available control technology” for carbon dioxide emissions. The court reasoned that carbon dioxide is a pollutant “subject to regulation” under the

Clean Air Act, and therefore a major new source of carbon dioxide would be subject to a best available control technology ("BACT") analysis under the Prevention of Significant Deterioration program. If widely adopted, the Georgia court's decision would result in making both traditionally regulated sources (such as power plants and heavy industry) and heretofore unregulated sources (such as the boilers for schools and large apartment buildings) subject to requirements for review, approval and installation of BACT for carbon dioxide, regardless of whether EPA limits emissions under other sections of the Clean Air Act.

In the second case, the Environmental Appeals Board ("EAB") specifically requested supplemental briefing in an order in *In re Deseret Power Electric Cooperative*, PSD Appeal No. 07-03 (EAB June 16, 2008). The order strongly suggests that the EAB is inclined to reach the same result as the Georgia court. Should the EAB adopt the reasoning in *Longleaf Energy Associates*, the decision would be binding on EPA and would have national applicability, unless reversed on appeal.

State and Regional Climate Change Initiatives

Many states have already adopted broad-ranging climate change action plans that include measures affecting all sectors of the economy: energy production and use; commercial, residential and industrial buildings and operations; industrial processes; land use and transportation; agriculture; forestry; and waste management. In the absence of federal regulation of greenhouse gas emissions, several Northeastern and Mid-Atlantic states established the Regional Greenhouse Gas Initiative ("RGGI"). The participating states have partnered under RGGI to address greenhouse gas emissions from power plants and stabilize those emissions at current levels through 2014 with a 10 percent reduction by 2019. RGGI will be implemented through a cap-and-trade program, with its first compliance period beginning on January 1, 2009, whereby states will cap and reduce the amount of carbon dioxide (CO₂) that certain power plants are allowed to emit. The first of the quarterly uniform regional auctions for the CO₂ allowances each state will be offering for sale will occur on September 25, 2008. Similarly, in February 2007, governors in five Western states formed the Western Climate Initiative ("WCI") to develop regional strategies to address climate change, including the design of a market-based mechanism to achieve emissions reductions. The initiative has since been joined by several other U.S. and Mexican states and Canadian provinces as partners and observers. The Draft Design Recommendations and Draft Essential Requirements of Mandatory Reporting were announced in July 2008.

Considering Disclosure

RGGI and many other state initiatives are currently in effect. There is an unambiguous current obligation to disclose if the impact of regulation is material. The Georgia and EAB cases suggest that the Clean Air Act new source review program could now be applied to initial permitting and modification of all stationary sources emitting more than 250 tons of carbon dioxide per year (a boiler for an average-size apartment building would exceed such emissions standards). Although that issue is being litigated in a number of fora, these developments also suggest that major sources already subject to NSR will now need to account for carbon dioxide in permitting new facilities and modification. While no implementing regulations for carbon dioxide are in effect, the broad outlines of a BACT review are well settled, and disclosure by affected reporting companies seems warranted, again subject to materiality standards. Because neither the law nor carbon dioxide standards in the area are well settled, regulatory delay and continued litigation can also be expected.

The exact form of regulation that will arise from the ANPR or climate change legislation is still fairly speculative and difficult to describe except in broad terms. However, whether it takes the form of traditional emissions standards or a cap and trade program, the ultimate effect will be to put additional costs on emissions of carbon dioxide and other greenhouse gases, either through a transparent pricing mechanism, such as an auction price, or through the costs to reduce emissions through fuel or energy source switching or capture and sequestration of greenhouse gases. Estimates of the likely price vary widely from expected pricing in the low single digits per ton for the RGGI program to as high as \$50 per ton (the current price in the European market is around 24 Euros for the December 2008 compliance period and 29 Euros for the December 2012 compliance period). The effect of the carbon price on a company's business model should be the major focus of disclosure.

To measure the impact of carbon pricing, companies need to consider three tiers of impacts. Tier one emissions are direct emissions from the company's operations, including generating steam and electricity for its own use and the use of fossil fuels, as in its vehicle fleets. Tier two emissions comprise the direct emissions arising from third-party generation of electricity used by the company. Most companies, however, also need to consider what are called tier three emissions, which include emissions caused by their supply chain, their distribution system and the users of their products. Costs all along the supply chain will be affected by the price of carbon, and consumer appeal of a company's products (such as automobiles) will be affected by the change in cost of operation caused by carbon pricing. Many excellent tools have been developed to help companies assess their "carbon footprint," but many companies will have to build systems to collect the needed data, especially for third tier effects. Even though legislation or regulations directly affecting many reporting companies may not be in effect for 12 to 18 months, being prepared to make effective disclosure may require a fairly long lead time.

Reporting companies not only should assess their own potential liabilities, costs and permitting issues, but also should compare their business model with those of their competitors to see if they will be comparatively advantaged or disadvantaged. While a full discussion is beyond the scope of this bulletin, a thoroughgoing review of a company's emissions will often identify opportunities to reduce those emissions and save costs at the same time. Not only can energy-efficiency measures have a rapid payback, but emissions reduction projects can generate saleable renewable energy credits and carbon credits.

Finally, Attorney General Cuomo's action shows that enforcement has begun. Even if the SEC continues to defer action on climate change disclosure, other state officials may find climate change enforcement politically appealing.

Conclusion

Actions by the EPA, judicial decisions driving the EPA toward regulation of greenhouse gas emissions, and the expansion of state laws and enforcement regarding greenhouse gas emissions will require many companies to reevaluate their current climate change disclosures. Under existing SEC disclosure requirements, clarification of the reach of existing laws and regulations to include greenhouse gases may have a material effect on companies that are subject to permitting requirements or other direct regulation. Coming regulation of greenhouse gas emissions will have the effect of pricing those emissions and will disadvantage companies whose operations and supply chain impacts are more carbon intensive than their competitors. Under existing SEC regulations, such risks may now rise to the level of materiality that they must be disclosed to investors.

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