Despite Calif. Delays, Climate Disclosure Rules Are Coming

By **David Smith** (July 18, 2024)

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Having backfilled a nearly $50 billion budget deficit, California's governor and legislative leaders remain at odds about funding for and the timing of implementation of the state's unprecedented climate disclosure mandate laws.

Funding uncertainty, litigation and a conspicuous weakening and tabling of the corresponding proposed federal rule have caused many to speculate — and many likely to hope — that Gov. Gavin Newsom would narrow the breadth, and delay the timing, of required disclosures.

While there has been no definitive change to the laws as adopted, funding remains in abeyance, and Newsom is proposing a two-year delay in implementation. The respective laws' authors, one of whom chairs the powerful Senate Budget Committee, oppose any delay.

The inescapable reality, however, is that with funding for necessary new staff and resources withheld, even proponents of the laws concede the initial deadlines are now out of reach.

At the federal level, although the proposed rule by the U.S. Securities and Exchange Commission has been voluntarily stayed by the agency pending resolution of litigation challenges, Democratic lawmakers and interest groups are calling for ongoing vigilant enforcement of climate-related disclosures based upon preexisting guidance.

Thus, irrespective of the exact timing in California, the genie is out of the bottle.

Other states are actively considering adopting the California model. The European Union forges ahead unabated establishing standards and metrics that the U.S. may have no choice but to adopt.

And business-to-business peer pressure is cited by many companies as the primary driver for them activating their climate risk-management regimes — regardless of strict regulatory mandates.

Legislating via the California State Budget

It is not unprecedented for California's governor and legislative leadership to substantively legislate via the state budget adoption, even — and especially — on particularly controversial matters.

The final budget is largely negotiated behind closed doors, components are not publicly vetted nor debated in legislative committees, and the entire package is subject to a single, comprehensive vote — take it or leave it. As long as a single party maintains supermajorities in both chambers, there is no avenue for the minority party to derail any agreements.

When Newsom signed the two California climate disclosure mandate laws last session, he included in a signing statement vague reference to concerns over cost of compliance and implementation timing — leading many to adopt a wait-and-see posture, hoping the law would be softened via the budget process in 2024.

Indeed, when the governor issued his initial budget proposal on Jan. 10, his proposal failed to provide funding for the new agency staff at the California Air Resources Board that would be required to comply with the law's mandates and implementation.

By that time, however, the author of one of the bills, Sen. Scott Weiner, had been elevated to chair of the Senate Budget Committee. In response to concern and speculation voiced over Newsom's failure to propose funding for the laws, Weiner made clear that he would not support any softening of the climate laws' requirements or extension of the timing of implementation.

Concern was largely quelled when the standard annual update to the budget proposal, the "May revise," provided funding for implementation of the laws. Full funding for implementation of both disclosure regimes was confirmed in a summary report of the consensus agreement of the governor and legislative leaders prior to budget adoption.

Specifically, the agreement provided that the initial new funding for CARB staff would be borrowed from the state's Greenhouse Gas Reduction Fund, and, beginning in the 2026-2027 budget, the borrowed funds would be repaid, with the ongoing costs of implementing the disclosure mandates to be paid from new accounts created by the respective laws with revenue generated by fees on regulated entities subject to the respective disclosure mandates.

But that appropriation never made it into the two primary budget bills signed by Newsom in late June. Instead, late on a Friday afternoon, the administration filed with the Department of Finance revisions to the climate mandate laws delaying their implementation by two years in a budget trailer bill.

Similarly, funding for the laws, if any, would also be addressed in a trailer bill. Trailer bills designed to implement the finalized budget must be adopted by the end of August. It appears that Newsom's shift in position caught Weiner and his counterpart, Sen. Henry Stern, unaware. They remain on record opposing any delay.

However, even strong advocates of the laws in the Capitol point out that one of the bills, S.B. 253, regarding emissions disclosures, requires CARB to have prepared implementing regulations by Jan. 1, 2025 — less than six months from now.

With CARB having to await funding appropriation before beginning a vetting and hiring effort for the specialized staff necessary for the task, few, if any, view that legislative deadline as viable. And advocates for a delay point out that the initial deadline is just the first domino pushing out the remaining implementation deadlines commensurately, as discussed below.

Disclosure of Greenhouse Gas Emissions

S.B. 253 mandates the disclosure of greenhouse gas emissions by entities doing any level of business in California, and that have at least $1 billion in annual revenue enterprisewide — i.e., including from operations outside California.

The law mandates disclosure of Scope 1 emissions, directly caused by the entity; Scope 2 emissions, indirectly caused by the entity's energy consumption; and Scope 3 emissions, attributable to everything else in the entity's operations, both upstream and downstream, including corporate travel, employee commute patterns, supply chains and product distribution. The reported emissions are subject to verification assurance by qualified third-party experts.

The drafting of implementing regulations is the immediate task, but was on hold through the early part of 2024, given the lack of funding in Newsom's initial budget proposal. Many wonder whether CARB can now hire the appropriate staff and craft the regulations by the statutory deadline of Jan. 1, 2025.

Scope 1 and 2 disclosures with limited assurance are due in 2026. Scope 3 disclosures with no assurance are due in 2027. In 2030, the required assurance levels increase to reasonable for Scopes 1 and 2, and limited for Scope 3. The forthcoming CARB regulations are to specify the specific deadlines for reporting and procedures for compliance.

Shortly after the adoption of S.B. 253, the U.S. Chamber of Commerce, the American Farm Bureau Federation and others filed suit in the U.S. District Court for the Central District of California to invalidate the law as, among other things, unconstitutionally compelled speech in violation of the First Amendment.

The challengers filed a motion for summary judgment to invalidate the law on May 24, alleging that the law requires entities to make speculative disclosures that, as to Scope 3 alone, could cost as much as $1 million annually to assess and estimate. Oral argument on the motion is set for Sept. 9.

Federally, while the proposed SEC rule also included disclosure of all emissions, after an unprecedented amount of public comment, Scope 3 emissions were dropped from the final rule. Business interests have sued to invalidate the SEC rule as unconstitutional and unduly burdensome; the Sierra Club and the Natural Resources Defense Council initially sued over the removal of Scope 3 disclosures, but have since withdrawn their challenge.

Opponents of S.B. 253 are not only pushing for the implementation delay, but want Newsom to scrap Scope 3 disclosures. Citing the SEC precedent, opponents say that Scope 3 disclosures remain speculative and prohibitively costly. The laws' proponents counter that the SEC's abandonment of Scope 3 makes it all the more imperative that California stay the course.

Disclosure of Climate-Related Material Financial Risks

California's S.B. 261, a companion to S.B. 253, requires the disclosure of climate-related material financial risks. The law applies to entities doing any business in California with enterprisewide annual revenues of at least $500 million. The initial reports are due in 2026 and biennially thereafter.

S.B. 261 requires disclosures to track with the Task Force on Climate-Related Financial Disclosures' June 2017 Recommendations Report. However, in 2023, the founding board of TCFD, the Financial Stability Board, determined that the TCFD had concluded its work and disbanded it. The TCFD recommendations were then incorporated into two new global reporting regimes under the International Sustainability Standards Board.

At this point, S.B. 261 disclosures are limited to the TCFD recommendations. Those disclosures are grounded on four pillars: governance, strategy, risk management, and metrics and targets. S.B. 261 disclosures must not only identify qualifying risks, both physical and transitional, but must also articulate the reporting entity's intended strategy to mitigate and adapt to those risks.

The federal SEC rule also includes mandatory disclosure of climate-related material financial risk, but those disclosures are not directly tied to the TCFD recommendations, or any other recognized disclosure standard. Rather, the rule specifies its own qualifiers and parameters with which disclosing entities must comply.

To date, less attention has been paid to disclosure of financial risks relative to emissions disclosure. This is, at least in part, due to the fact that financial risk disclosures are much more subjective, being narrative and qualitative, making them much less likely to be strictly enforced.

Conversely, GHG emission disclosures are numeric and quantitative, rendering them much more susceptible to challenge and verification — which is, in part, why many climate advocates and legislators voiced outrage over the SEC dropping Scope 3.

However, the environmental litigants' decision to drop their legal challenge to the SEC rule was accompanied by a statement that they intended to focus their attention and resources on ensuring the enforceability of financial risk disclosures. This new focus and scrutiny could have dramatic regulatory implications for disclosures under the SEC rule, and disclosures under S.B. 261.

Conclusion

At this point, both funding and the timing of implementation of California's climate disclosure laws remain open questions, but there has been no authoritative proposal to abandon Scope 3 disclosures.

Newsom has filed formal amendments that would push back implementation by two years across the board. Senators Weiner and Stern remain steadfast in opposing any delay. Those tasked with on-the-ground implementation point to the calendar and the ongoing funding delay, and leave the obvious implausibility of meeting statutory deadlines to the observer.

Many entities potentially subject to one or more of the disclosure mandates have taken a wait-and-see posture with regard to beginning the necessary enterprisewide assessment and analysis required to make both GHG emissions and financial risk disclosures under whichever law may apply. The prudence of such a judgement remains in question.

Even if the timing slides, mandates from the EU forge full speed ahead, other states are likely to adopt regimes similar to California, and companies across the economy cite peer-to-peer competition and consumer demand as necessitating climate proactivity.

For entities beginning to make the assessments and efforts to prepare legally compliant reports, marshaling all relevant data and processes to generate the report can take over a year. Additionally, the required third-party attestation can be even more time-consuming than the initial assessment and quantification of emissions.

Litigation challenges and partisan blustering from both sides of the aisle notwithstanding, climate-related mandates on business are a present reality, and companies of all sizes and platforms should be assessing their inevitable path to and cost of compliance.

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