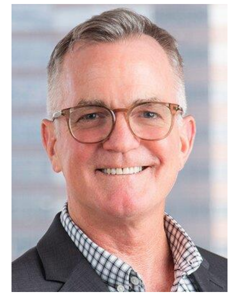
Why All Cos. Should Take Note Of Calif. GHG Disclosure Laws

By **David Smith** (October 10, 2023)



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The disclosure of greenhouse gas emissions and climate-related risks will shortly move from voluntary to mandatory in the U.S. thanks to California and the U.S. Securities and Exchange Commission.

The financial services sector, led by entities including BlackRock, has led the charge, insisting on such disclosures from companies in which they may potentially invest — or to shame the disclosures of their competitors.

But these same firms appear to think they themselves will not be burdened by the new mandates. The scope of the new laws and the reporting regimes on which they are patterned suggest otherwise.

As provided below, while financial services firms may have relatively modest direct operational carbon footprints, their investment portfolios reportedly include so-called financed emissions that are over 700 times those of their own operations. The reporting regimes require, and their underlying protocols recommend, disclosures by such firms based on the portfolios, not just their own operations.

The Legal Mandates: The SEC and California Legislature

The prospect of mandatory climate disclosures became real with the publication of a proposed rule by the SEC on March 21, 2022.[1] The proposed rule would apply only to publicly traded companies and consisted of two primary components: the disclosure of a regulated entity's GHG emissions and the disclosure of that entity's climate-related risks. Each of those disclosure categories is discussed below.

The proposed rule was then open to public comment, with a final rule estimated by March 2023. However, the proposed rule received an unprecedented amount of public comments, with strong concern regarding the cost of compliance and the speculative nature of some of the mandatory disclosures.

Multiple news outlets have reported on internal disagreement within the SEC as to the scope and specificity of some disclosure mandates included in the proposed rule, apparently delaying the adoption of a final rule. The latest estimate for the release of a final rule is this month, but the SEC has not committed to any particular schedule.

California has long prided itself on and heralded itself as pressing the limits and mandates related to climate, not only within the U.S. but also on the world stage. Disclosure mandates are no exception, and California was not going to be constrained by political wrangling or stalled timing at the SEC.

During this legislative session, two bills emerged and relatively quietly passed in the California Senate.

S.B. 253[2] largely mirrored the SEC proposed rule's GHG emissions disclosure mandate, though its application was not limited to publicly traded companies, while S.B. 261[3] addressed the disclosure of climate-related risks similar to that proposed in the SEC rule and also was not limited to publicly traded companies. The details of each bill's mandates and implementation are provided below.

Observers and pundits questioned whether the bills could pass in the California Assembly, given vocal and vigorous opposition by business interests. But both bills confounded predictions of doom at the last procedural hurdle in the Assembly — the Appropriations Committee — to advance to a floor vote. Despite opposition by California's own Department of Finance, both bills passed.

The final hurdle was whether Gov. Gavin Newsom would subject many thousands of public and private enterprises doing even minimal business in California to such unprecedented compliance and disclosure mandates.

Not only was the answer "yes," but Newsom also publicly confirmed on the world stage his intent to sign both bills, using a press conference in advance of the opening of an international climate summit in New York to do so, weeks in advance of his deadline to sign or veto the bills. This resolidified California's stature as a global climate standard-bearer.

GHG Emissions Disclosures

Both the SEC's proposed rule and California's S.B. 253 structure their emissions disclosure mandates in accord with the Greenhouse Gas Protocol.[4] Under the GHG Protocol, GHGs are categorized as "Scope 1," "Scope 2" or "Scope 3."

Scope 1 emissions are those directly emitted by the subject entity itself. These are emissions most directly subject to the control of the emitting entity itself based on its facilities and operations.

Scope 2 emissions are indirect emissions primarily composed of emissions related to the energy the subject entity consumes.

Scope 3 emissions are everything else, inclusive of workforce commute patterns, supply chains, business travel, fuel consumption, product distribution and transportation, and the ultimate end use of any product produced. The GHG Protocol specifically identifies 15 categories of upstream and downstream emissions sources.

Requiring the disclosure of Scope 3 emissions has been the point of greatest opposition and controversy given the admitted speculation and imprecision of quantifying such emissions as to any given business venture. Anonymous news sources have reported that the debate within the SEC as to whether to soften the mandate relative to Scope 3 is a primary reason for the delay of the final rule.

Such speculation as to the SEC potentially softening the Scope 3 mandate was one reason California was adamant its law would not compromise. The only concession relative to Scope 3 that California Sen. Scott Wiener, the lead sponsor of S.B. 253, was willing to make to advance the bill through the Assembly was delaying the disclosure of Scope 3 emissions to one year later than Scopes 1 and 2.

As for the implementation of S.B. 253, unlike the SEC proposed rule, the law will mandate disclosure by both public and private companies with annual revenues of at least $1 billion. Those revenues can originate anywhere globally and need not be tied to California. The trigger of "doing business in California" is minimal, not even requiring a physical footprint in the state — transacting business is enough, according to the bill's author.

And as for companies that do not hit the revenue threshold, they are not off the hook. If they are in the supply chain or otherwise transact business with an entity that is subject to the disclosure mandate, that reporting entity will likely demand from the smaller business the data necessary to make accurate disclosures as part of their Scope 3 emissions.

If this regime appears duplicative and redundant, it is. One entity's Scope 1 and Scope 2 emissions will also be another entity's Scope 3 emissions. The extent of overlap and duplication is by design under the GHG Protocol; it is not a glitch or oversight.

With Scope 3 included in the disclosure mandate, vast numbers of businesses will be affected and have to assess and provide the requisite emissions data notwithstanding falling short of the statutory or regulatory compliance triggers. Under S.B. 253, the disclosure of Scopes 1 and 2 will commence in 2026 and Scope 3 in 2027, all in accord with yet-to-be-drafted implementing regulations by the California Air Resources Board mandated by the law.

Climate-Related Risk Disclosures

California's S.B. 261, mandating disclosure of climate-related risks, defines such risks as follows:

"Climate-related financial risk" means material risk of harm to immediate and long-term financial outcomes due to physical and transition risks, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health.

The disclosure of such risks under both California's S.B. 261 and the SEC's proposed rule is patterned on the June 2017 Recommendations Report by the Task Force on Climate-Related Financial Disclosures.[5] The TCFD risk-disclosure regime has been recognized globally and is utilized in disclosure obligations by the European Union, among others.

While much attention has focused on the quantitative metrics required for strict emissions disclosures under the GHG Protocol, it may be that for many reporting entities, the risk disclosure mandate will prove much more burdensome. Given the mandate's narrative and qualitative character, some entities have been relatively dismissive of it.

But the scope of "climate-related financial risk," as defined in S.B. 261 as quoted above, is extremely broad. Companies with facilities, operations, workforces, supply chain dependencies, and other critical factors in multiple locations domestically and globally may have to compile massive amounts of data related to weather patterns and predictions, extreme heat sensitivity, drought vulnerability, increasing flood risk, power outage interruptions, insurance costs and coverage availability, and innumerable other contingencies.

Such factors multiply with each additional asset or operation subject to assessment for potential disclosure. Additionally, the risk report required by S.B. 261 must not only identify all such risks, but must also address what the reporting entity is doing to address or lessen such risks.

While it remains unclear how broadly the disclosure mandate will apply under the SEC's final rule, S.B. 261 forgoes the preparation of any California-specific implementing regulations and instead requires full compliance with the TCFD Recommendations Report and any subsequent updates.

The "doing business in California" trigger is the same minimal hook, as in S.B. 253 discussed above, and the revenue threshold requiring disclosure is half that of S.B. 253 — $500 million. The initial reports required by S.B. 261 must be made publicly available on the entity's website on or before Jan. 1, 2026, and biennially thereafter.

Compliance Obligations for the Financial Services Sector

When we think of GHG emissions and climate-related risks globally, we tend to envision billowing smokestacks from fossil fuel-burning industrial facilities, 18-wheel tractor-trailers spewing diesel exhaust overhead and petroleum-fueled automobile tailpipes.

But what about financial services firms — do they face compliance burdens? Indeed they do, due to so-called financed emissions within their investment portfolios.

The hue and cry for verifiable and transparent emissions disclosures largely originated with, and has continued to be driven by, the financial services sector, including major investment funds and large banks.

This has sparked widespread political debate about whether financial institutions should have a role in fostering lending and investment practices that improve social norms and dynamics globally, or whether their purpose is limited to maximizing the returns of investors. But little attention is given to the compliance of such entities with these rules.

While the physical carbon footprint of financial services firms themselves — i.e., their Scope 1 and Scope 2 emissions — is likely to be relatively modest, at least one authority — CDP, formerly the Climate Disclosure Project — reports that the financed emissions attributable to such firms' investment portfolios "are over 700x larger than reported operational emissions."[6] The 2020 Time to Green Finance report by CDP found that 49% of financial institutions do not conduct any analysis of how their portfolio affects the climate.

The GHG Protocol, the foundation for both California's S.B. 253 and whatever the SEC's ultimate emissions mandate may be, specifically identifies investments as a category of downstream Scope 3 emissions. Thus, the Scope 1, Scope 2 and potentially Scope 3 emissions of the assets and projects the financial firm invests in or supports become Scope 3 reportable emissions for the financial services firm itself.

Additionally, the Implementing Guide for the TCFD Recommendations Report[7] regarding the disclosure of climate-related risks has specific guidance regarding climate-related disclosures for banks, insurance companies, asset owners and asset managers. As for each of these financial services operators, the report specifies guidance as to governance, strategy, risk management, and metrics and targets. Additionally, there are across-the-board recommendations as to "carbon footprinting and exposure metrics."

It may be that those financial services firms pressing for public disclosure by companies in which they do, or propose to, invest count on utilizing those same disclosures to populate the disclosures they themselves will have to make.

However, it is likely that many of the companies to which they will look for verified data on emissions and risks will be private and thus not subject to SEC disclosure, and they may have insufficient annual revenues to trigger the California laws. This dynamic reveals that the breadth of the reporting mandates addressed herein — and those that will inevitably be adopted elsewhere — is likely to be exponentially more vast than the thousands of companies that meet the threshold triggers on the face of the laws and regulations.

Even when not directly subject to a reporting mandate itself, it is highly likely that any given business enterprise may be part of the supply chain for, contract with, lease facilities to or from, or otherwise sufficiently transact business with another entity that is subject to a reporting mandate. Accordingly, entities are already beginning to experience lease clauses, supply contract addenda and other contractual mandates for the provision of verifiable data related to reporting obligations to which the contracting entity is not itself subject.

Conclusion

In presenting and discussing these and other climate-related mandates, we find that the overwhelming reaction tends to be either "compliance is still years out" or "we really don't see how these apply to us."

Both responses are likely shortsighted, if not outright mistaken.

The trend of mandating disclosures by force of law is now upon us, and incremental triggers or applicability thresholds are unlikely to provide much long-term cover. As noted, vastly more companies than those directly subject to today's reporting mandates will be required to supply the requisite verified data and/or assessment of risk, such as those in the financial services sector courtesy of financed emissions.

Further, even though the present mandates are just for disclosure, public release of the underlying data and assessments will inevitably lead, directly or indirectly, to reduction mandates, whether by direct regulation or public shaming and reputational exposure relative to competitors.

Whether intending to publicly disclose in the near term or not, all companies should begin formulating a plan and implementation team for assessing, verifying, communicating and eventually reducing GHG emissions and climate-related risks.

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[1] https://www.sec.gov/news/press-release/2022-46.

[2] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB253.

[3] https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202320240SB261.

[4] https://ghgprotocol.org/.

[5] https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.

[6] https://cdn.cdp.net/cdp-production/cms/reports/documents/000/005/741/original/CDP-Financial-Services-Disclosure-Report-2020.pdf?1619537981.

[7] https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Implementing_Guidance.pdf.