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LEGAL ALERT

March 16, 2010

SEC Warms to Climate Change

Introduction

The Securities and Exchange Commission (the “SEC”) adopted in a 3-2 vote interpretive guidance (the “Interpretive Guidance”) related to public company disclosure standards in connection with climate change. The SEC emphasized in its open meeting that it was not establishing legal requirements or changing existing rules but rather providing guidance under various pre-existing standards of federal securities law. Further, the Commissioners made clear that they were not weighing in on the global warming debate. This action follows years of petitions that called upon the SEC to both clarify climate-related disclosure obligations under existing law and begin close evaluation of current disclosure practices.

Backdrop

The SEC’s actions also come in the wake of other recent regulatory, legislative and legal developments related to climate change. For example:

- Climate-change-related legislation is currently pending in Congress that would, among other things, limit greenhouse gas (“GHG”) emissions through a “cap and trade” system of allowances and credits;
- On January 1, 2010, the Environmental Protection Agency began to require large GHG emitters to collect and report data with respect to their GHG emissions;
- Companies with operations in Kyoto-signatory countries whose capital expenditures are materially impacted by complying with the treaty are obligated to disclose this information;[1]
- In March 2009, the National Association of Insurance Commissioners set forth a uniform standard for mandatory disclosure by insurance companies to state regulators of financial risks due to climate change and actions taken to mitigate them;[2] and
- Eight state attorneys general, the City of New York and three land trusts brought suit in 2005 against the five largest electric utilities in the U.S. on grounds they contributed to the “public nuisance” of global warming. To date, three energy companies under investigation for GHG emissions disclosure have settled and as a term of their settlement are required to make climate-related disclosures in their public filings.[3]

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[1] The Kyoto Protocol is a protocol to the International Framework Convention on Climate Change with the objective of reducing GHG emissions. It was adopted for use on December 11, 1997 and entered into force in February 2005. As of December 2009, 189 countries have ratified the protocol. The United States is the only developed country that has not ratified the treaty.

[2] See www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopted.htm.

[3] XCel Energy reached a settlement agreement with New York’s Attorney General in August 2008, Dynegy Energy Inc. in October 2008 and AES Corporation in November 2009.

On February 2, 2010, the SEC released the final version of the Interpretive Guidance. The Interpretive Guidance is effective immediately and should be considered by companies in preparing their periodic filings, including Forms 10-K and 10-Q. In the Interpretive Guidance, the SEC points out several specific examples of ways in which climate change may trigger disclosure required by existing SEC rules and regulations. In particular, the guidance clarifies the responsibilities of companies to disclose, where material:

- the impact of federal and state legislation and regulation regarding climate change;
- the impact on their business of treaties or international accords relating to climate change;[4]
- the indirect consequences of regulation or business trends as creating new opportunities or risks for public companies as well as the impact on a company's reputation depending on the nature of the company's business and its sensitivity to public opinion; and
- the physical impacts of climate change.[5]

Overview of Rules Requiring Disclosure of Climate Change Issues

The following summarizes what the SEC signaled as the most pertinent existing disclosure rules that could require disclosure related to climate change.

Item 101 – Description of Business

Item 101 of Regulation S-K requires a description of the "general development of business," including plan of operation. Item 101(c)(1)(xii) expressly requires disclosure regarding certain costs of complying with environmental laws. This provision likely will apply to corporations operating in U.S. or overseas jurisdictions that have adopted GHG emissions limits.

Item 103 – Disclosure of Legal Proceedings

Item 103 of Regulation S-K requires disclosure of any material pending legal proceedings to which it is a party or to which its property is subject, including proceedings "known to be contemplated" by governmental authorities.[6] Instruction 5 to Item 103 provides specific requirements that apply to the disclosure of certain environmental litigation.

Note that climate change has already generated litigation, including suits compelling a regulatory agency to act,[7] suits where private entities seek relief other than regulator action,[8] suits seeking to compel private

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[4] Among those international accords companies should consider are the aforementioned Kyoto Protocol and the European Union's GHG Emissions Trading System "(ETS)".

[5] Among the most powerful examples is the economic devastation wrought by the 2004-2005 hurricane season, including the estimated $45 billion cost to insurers and reinsurers after Hurricane Katrina. The Interpretive Guidance points to a 2007 Government Accountability Office report stating that 88% of all property losses paid by insurers between 1980 and 2005 were weather-related.

[6] *See* 17 C.F.R. § 229.103 (2005).

[7] *Massachusetts v. EPA*, 127 S.Ct. 1438 (2007).

defendants to take climate change into account,[9] and suits against private defendants and their insurance carriers.[10]

Item 503(c) – Risk Factors

Item 503(c) of Regulation S-K requires issuers, where appropriate, to disclose the most significant factors that make their business or securities offerings speculative or risky. This disclosure could include a discussion of the impact of existing or pending regulations relating to climate change. Risk factors might also discuss the risks associated with physical changes due to climate change or the potential damage to the company's reputation related to climate change.

Item 303 – Management Discussion and Analysis ("MD&A")

MD&A serves as a vehicle for disclosing the critical subjects facing corporate management and the future challenges ahead, financial and non-financial, direct or indirect. This disclosure could include the impact of pending climate change legislation or regulation if reasonably likely to occur and to have a material effect on the company.

Foreign Private Issuers

The Interpretive Guidance highlights the disclosure obligations of foreign private issuers governed under Form 20-F which largely parallel those required under Regulation S-K.

Financial Disclosure Considerations

In a footnote to the Interpretive Guidance, the SEC also points out that companies should consider any financial statement implications of climate change issues in accordance with applicable accounting standards, including Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 450, Contingencies, and FASB Accounting Standards Codification Topic 275, Risks and Uncertainties.

Sample Climate Change Disclosure

As companies begin to incorporate the SEC guidance into their own public disclosure, it is helpful to examine existing disclosure in the marketplace. According to a recent study, in 2008 less than 10% of companies in the financial sector discussed climate change in their annual 10-K filings.[11] Given the SEC's

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[8] *See California v. General Motors Corp.*, No. C06-05755 MJJ, slip op. (N.D.Cal. Sept. 17, 2007) (seeking compensation under public nuisance law against sources of GHG emissions allegedly attributable to defendant's products); *see also Connecticut v. American Electric Power Co.*, 406 F.Supp. 265 (S.D.N.Y. 2005) (seeking a commitment to reduce GHG emissions).

[9] *Northwest Environmental Defense Center v. Owens Corning*, 434 F.Supp.2d 975 (D.Or. 2006).

[10] *Comer v. Murphy Oil*, No.1:05cv436 LG-RHW (S.D.Miss. Aug. 30, 2007) (seeking payment from oil companies for a corporation's contribution to global warming after Hurricane Katrina).

[11] *See* Kevin L. Doran and Elias L. Quinn, *Climate Change Risk Disclosure: A Sector by Sector Analysis of SEC 10-K Filings from 1995-2008*, 34 N.C. J. Int'l L. & Com. Reg. 699 (2009).

release of the Interpretive Guidance, the number of companies making climate change related disclosure is expected to increase significantly.

Companies should also pay attention to the climate change information they have submitted in the marketplace through voluntary disclosure platforms such as the Carbon Disclosure Project (the “CDP”). The CDP leverages its data and processes by making its information requests and responses from corporations publicly available. To the extent information on business risks and opportunities presented by climate change and GHG emissions is available on such sites, companies may want to consider if disclosure should be made in a company’s publicly filed disclosure documents as well.

As such, review of existing disclosures will assist companies in all sectors who may be required to make such disclosure going forward. The following is a sample of existing climate change disclosure:

Sample Risk Factor Disclosure

> ***We are subject to physical and financial risks associated with climate change.***[12]
>
> There is a growing consensus that emissions of GHGs are linked to global climate change. Climate change creates physical and financial risk. Physical risks from climate change include an increase in sea level and changes in weather conditions, such as an increase in changes in precipitation and extreme weather events. We do not serve any coastal communities so the possibility of sea level rises does not directly affect us or our customers. Our customers' energy needs vary with weather conditions, primarily temperature and humidity. For residential customers, heating and cooling represent their largest energy use. To the extent weather conditions are affected by climate change, customers' energy use could increase or decrease depending on the duration and magnitude of the changes. Increased energy use due to weather changes may require us to invest in more generating assets, transmission and other infrastructure to serve increased load. Decreased energy use due to weather changes may affect our financial condition, through decreased revenues. Extreme weather conditions in general require more system backup, adding to costs, and can contribute to increased system stresses, including service interruptions. Weather conditions outside of our service territory could also have an impact on our revenues. We buy and sell electricity depending upon system needs and market opportunities. Extreme weather conditions creating high energy demand on our own and/or other systems may raise electricity prices as we buy short-term energy to serve our own system, which would increase the cost of energy we provide to our customers. Severe weather impacts our service territories, primarily when thunderstorms, tornadoes and snow or ice storms occur. We include storm restoration in our budgeting process as a normal business expense and we anticipate continuing to do so. To the extent the frequency of extreme weather events increases, this could increase our cost of providing service. Changes in precipitation resulting in droughts or water shortages could adversely affect our operations, principally our fossil generating units. A negative impact to water supplies due to long-term drought conditions could adversely impact our ability to provide electricity to customers, as well as increase the price they pay for energy. We may not recover all costs related to mitigating these physical and financial risks.

[12] Xcel Energy Inc., Annual Report (Form 10-K) (Feb. 26, 2010).

We may be subject to legislative and regulatory responses to climate change, with which compliance could be difficult and costly.[13]

Legislative and regulatory responses related to climate change and new interpretations of existing laws through climate change litigation create financial risk. Increased public awareness and concern may result in more regional and/or federal requirements to reduce or mitigate the effects of GHGs. Numerous states have announced or adopted programs to stabilize and reduce GHG and federal legislation has been introduced in both houses of Congress. Our electric generating facilities are likely to be subject to regulation under climate change laws introduced at either the state or federal level within the next few years.

Our financial results may be adversely impacted by global climate changes.[14]

Atmospheric concentrations of carbon dioxide and other greenhouse gases have increased dramatically since the industrial revolution, resulting in a gradual increase in global average temperatures and an increase in the frequency and severity of natural disasters. These trends are expected to continue in the future and have the potential to impact nearly all sectors of the economy to varying degrees. Our initial research indicates that climate change does not pose an imminent or significant threat to our operations or business, but we will continue to monitor new developments in the future.

Potential impacts may include the following:

Changes in temperatures and air quality may adversely impact our mortality and morbidity rates. For example, increases in the level of pollution and airborne allergens may cause an increase in upper respiratory and cardiovascular diseases, leading to increased claims in our life, health and disability income business. However, the risk of increased mortality on our life insurance business is partly offset by our payout annuity business, where an increase in mortality results in a decrease in benefit payments.

Climate change may impact asset prices, as well as general economic conditions. For example, rising sea levels may lead to decreases in real estate values in coastal areas. Additionally, government policies to slow climate change (e.g., setting limits on carbon emissions) may have an adverse impact on sectors such as utilities, transportation and manufacturing. Changes in asset prices may impact the value of our fixed income, real estate and commercial mortgage investments. We manage our investment risks by maintaining a well-diversified portfolio, both geographically and by sector. We also monitor our investments on an ongoing basis, allowing us to adjust our exposure to sectors and/or geographical areas that face severe risks due to climate change.

A natural disaster that affects one of our office locations could disrupt our operations and pose a threat to the safety of our employees. However, we have extensive Business Continuity and Disaster Recovery planning programs in place to help mitigate this risk.

[13] *Id.*

[14] Principal Financial Group, Inc. of Iowa, Annual Report (Form 10-K) (Feb. 17, 2010).

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Sample MD&A Disclosure

Xcel Energy has adopted environmental leadership as a primary focus, forming the cornerstone of our strategic initiatives. Xcel Energy believes that our environmental leadership meets customer and policy maker expectations, while appropriately managing long-term customer costs, and, in turn, creating shareholder value.[15]

GHG Emissions

As one of the nation's largest electric generating companies, Xcel Energy is committed to addressing climate change through efforts to reduce its GHG emissions. Xcel Energy has adopted a methodology for calculating CO_2 emissions based on the recently issued reporting protocols of The Climate Registry. Xcel Energy is a "founding reporter" under The Climate Registry. As third-party CO_2 reporting protocols continue to evolve, Xcel Energy expects additional changes in reporting methodology and reported CO_2 emissions. Starting in 2011, Xcel Energy will also report GHG emissions to the EPA under the agency's newly adopted GHG reporting rule.[16]

Sample Legal Proceedings Disclosure

Three recent court cases addressed the question of whether power plants that emit greenhouse gases constituted public nuisances that could be held liable for damages or other remedies. In one case (in which Edison International, the parent company of SCE, is a named defendant): a California federal district court dismissed the plaintiffs' claims. In the other two, federal courts of appeals permitted the suits to go forward. Each of these differing results remains subject to appeal and thus the ultimate impact of these cases remains uncertain. SCE cannot predict whether these recent decisions will result in the filing of new actions with similar claims or whether Congress, in considering climate legislation, will address directly the availability of courts for these sorts of claims.[17]

Moving Forward

As a result of the Interpretive Guidance, public corporations should consider the following as “next steps” moving forward:

- Determine whether their business generates emissions and disclose current direct and indirect GHG emissions levels;
- Estimate and disclose projected direct and indirect GHG emissions levels;
- Detail the potential physical impacts of climate change on business and operations;
- Analyze the material legal and financial effects that current and prospective climate-related regulation may have on business and operations;

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[15] Xcel Energy, *supra* note 12.

[16] *Id.*

[17] Southern California Edison Co., Annual Report (Form 10-K), (Mar. 1, 2010).

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- Determine the indirect consequences of regulation or business trends related to climate change, including reputational impacts;
- Monitor disclosure in the marketplace;
- Address shareholder requests to include climate change in disclosures and operations;
- Review prior public disclosure to determine if it is adequate or needs to be revised or updated, or if new disclosure should be made;
- Inquire as to whether the company has the proper insurance policies to cover potential liability imputed to directors and officers as a result of climate change;
- Stay abreast of legislative, regulatory and judicial developments; and
- Evaluate strategies for reducing, offsetting or limiting emissions and global warming.

As more is discovered about the impact of climate change, legislators, institutional investors and advocacy groups are expected to raise awareness of climate change issues and potentially look for more in-depth information from companies regarding their role in the global environmental community. Companies should be aware of these changes and take care in drafting their public disclosure.

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If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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