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BEFORE

THE SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT
OF THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

REGARDING

CLIMATE DISCLOSURE: MEASURING FINANCIAL RISKS AND OPPORTUNITIES

October 31, 2007

Chairman Reed, Ranking Member Allard, and Members of the Subcommittee, I am Mindy Lubber, President of Ceres and Director of the Investor Network on Climate Risk (INCR), and it is a privilege to testify before you today regarding this critical issue.

Ceres is a national coalition of 100 institutional investors, environmental groups and other public interest organizations working with leading U.S. companies to address sustainability challenges such as climate change. INCR is a group of 60 institutional investors representing $4 trillion in assets focused on the business risks and opportunities posed by climate change.

This testimony is focused on three key points:

- Climate risk disclosure is essential for investors, because climate risk is clearly a material risk that companies should be disclosing in Securities and Exchange Commission (SEC) filings.
- Current climate risk disclosure by U.S. companies is still inadequate and not at the levels investors need to make informed investment decisions.
- Companies that provide full disclosure of climate risks and opportunities see significant benefits.

In addition, the testimony covers:

- Why climate risk is an important financial issue for investors and companies;

- How investors are pushing for better climate risk disclosure from companies, including voluntary disclosure and shareholder resolutions; and

- The September 18, 2007 "Petition for Interpretive Guidance on Climate Risk Disclosure" that was sent to the SEC.

The SEC should provide interpretive guidance because climate change poses wide-ranging financial risks—climate risks—to companies across a wide spectrum of industries. Energy-intensive businesses face risks from anticipated national greenhouse gas regulations, as well as from emerging and existing state and international regulations, that will make greenhouse gas emissions more costly. Insurers and other companies face risks from climate-related physical impacts such as prolonged drought, melting permafrost, wildfires and other severe weather events. Litigation related to climate change is another risk, especially for large greenhouse gas emitters.

At the same time, climate change also offers significant opportunities for investors and companies, such as investing in and developing clean technologies and renewable energy, selling carbon credits, or capturing new markets. Opportunities that are not pursued can turn into risks for companies, when their competitors pursue such options. This is in evidence already in the automotive sector, where automakers that have focused more attention on cleaner, more fuel-efficient cars are gaining market share.

Climate risk is an important financial issue recognized by the largest investment banks and institutional investors in the U.S. and abroad

In the last few years, climate risk has become a top-tier investor and business issue, as demonstrated by new reports about regulatory and physical risks; Wall Street research reports on climate risk exposure and new business opportunities; and institutional investor responses to climate change. Climate risk *disclosure*, however, has not kept pace with these developments, as discussed later.

Companies, investors and money managers are in the business of examining how market shifts—whether as a result of regulatory change, consumer preference shifts, or other market movers—affect share value, earnings, future cash flow projections, and capital investment decisions. The risks and opportunities posed by climate change *today and in the future* are becoming increasingly apparent. Regulatory risks posed by legislative proposals, if passed into law, are expected to add costs to doing business in many sectors. For example, one analysis suggests that U.S. electric power companies that have not prepared for a future cost of carbon associated with carbon regulations could see earnings losses[1] of up to 17%, whereas companies with less polluting fuel mixes could see financial gains of up to 15%—real bottom-line impacts for investors and company managers.[2]

Physical risks resulting from rising sea levels, changing weather patterns, and warming climates are happening faster than expected and are being felt by businesses and their investors today. For example, 2007's hot, dry summer left Alabama rivers so hot (in excess of 90 degrees) and low that the state had to shut down a nuclear power plant. At least four pulp and paper mills also had to suspend wastewater discharges for days at a time to avoid violating their discharge permits, reducing revenues for shareholders and putting employees out of work.

Likewise, thawing permafrost (frozen ground necessary for oil & gas infrastructure) has already caused serious impacts in Alaska, and the 800-mile Trans-Alaska Pipeline, which carries about 17% of the nation's oil production, has been threatened. New pipeline supports have been

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[1] EBITA: Earnings Before Interest, Taxes, Depreciation, and Amortization

installed in an attempt to guard against heaving or collapse as the permafrost thaws. Replacing the supports is estimated to cost about $2 million per mile, a hefty price tag for the shareholders of the oil & gas companies that operate the pipeline.

In the U.S., investment banks are waking up to these risks, and there has been a rapid increase in the last two years in the number of Wall Street reports analyzing climate risk and opportunities. In just the past 12 months, climate-related research reports have been prepared by firms such as Citigroup, Goldman Sachs, JP Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley and UBS.

These reports are evidence that climate risk is viewed not only as an environmental risk but also as a financial one, since major banks are now using their financial models to estimate the impacts of climate change on earnings per share, future cash flows, and capital investment decisions. Several rating agencies and banks have shifted stock ratings or buy/sell/hold decisions based on a company's relative climate risk exposure and preparedness.

A Lehman Brothers report explains that climate risk has become a core business and investor issue:

> "In the world of business and finance, climate change has developed from being a fringe concern, focusing on the company's brand and its Corporate and Social Responsibility, to an increasingly central topic for strategic deliberation and decision-making by executives and investors around the globe."[3]

A Morgan Stanley report strongly supports the need for improved climate risk disclosure:

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[2] Sanford C. Bernstein & Company, Bernstein Research, U.S. Utilities: The Implications of Carbon Dioxide Regulation, October 2007.

[3] John Llewellyn, Lehman Brothers, The Business of Climate Change: Challenges and Opportunities (February 2007), p. 1.

> "Even though climate change is a long-term trend, financial markets need to price in the risks today. Investors therefore need to review their long-term growth, inflation and risk projections in light of climate change."[4]

These investment banks have responded to the needs of their clients, institutional investors, who in large numbers have pushed for increased climate risk disclosure for the last four years. The Investor Network on Climate Risk (INCR) has grown from 14 to 60 investors in that time. INCR members now represent $4 trillion of assets under management, and include asset managers and some of the nation's largest institutional investors: CalPERS, CalSTRS, State Street Global Advisors, AIG Global Investment Group, F&C Asset Management, the NY City and NY State Comptrollers, and the California Treasurer and Controller.

The Carbon Disclosure Project (CDP), which conducts an annual survey seeking climate risk disclosure from 2,000 of the largest companies worldwide, is sent on behalf of 315 institutional investors representing $41 trillion. S&P 500 companies are among the companies surveyed. A sampling of signatories includes some of the world's largest financial companies and investment banks: Barclays Group, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC Holdings, Mitsubishi UFJ Financial Group, Morgan Stanley Investment Management, and State Street Corporation. Globally, two other groups of institutional investors are focused on this issue: Institutional Investors Group on Climate Change (U.K.) and Investor Group on Climate Change (Australia/New Zealand).

Although climate risk has become a top-tier investor and business issue, the information provided by voluntary disclosure does not come close to meeting investors' needs. Investment banks have begun tackling this issue, but their reports focus mainly on regulatory risks, because

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[4] Elga Bartsch, Morgan Stanley, The Economics of Climate Change – a Primer (October 3, 2007), p. 1.

corporations are disclosing little or no information about physical risks, litigation risks, and strategic analysis of climate risk and emissions management.

Ways in which investors seek voluntary climate risk disclosure and the limits of that disclosure

In the absence of mandatory federal disclosure guidance, a large number of investors are seeking better disclosure by writing to companies and filing shareholder resolutions. These investors are simultaneously seeking mandatory disclosure guidance from the SEC, because "[e]ven as corporate disclosure of the business impacts of climate change is increasing, it remains intermittent, inconsistent and incomplete," according to Connecticut State Treasurer Denise Nappier, principal fiduciary of the $23 billion Connecticut Retirement Plans and Trust Fund.

In the U.S., large institutional investors have written letters to groups of companies whose operations or products result in high greenhouse gas emissions. For example, in July 2005, 15 U.S. investors managing more than $550 billion of assets wrote to 43 of the country's 50 largest investor-owned electric power companies, requesting that they report within a year ways in which future greenhouse gas limits are expected to affect their bottom lines, as well as steps they are taking to reduce those impacts and improve their competitive positioning.

Twenty leading U.S. investors sent a similar climate-disclosure request letter to 30 insurance companies in December 2005. "Shareholders need to know if the companies they own are adopting strategies that will enable them to survive, or even thrive, as greenhouse gas limits begin taking effect," said California State Treasurer Phil Angelides, a board member of CalPERS and CalSTRS, two of the country's largest public pension funds, which signed both letters.

Three issues severely limit the usefulness of voluntary disclosure for investors. First, companies decide whether to answer the CDP questionnaire or disclose using other means, and too many companies do not disclose.

Second, unlike disclosures in SEC filings, which are available to all investors, companies decide whether to keep their CDP responses private. This is a significant problem, because CDP signatories have access to these private responses, but millions of individual investors and other institutional investors that are not signatories to the CDP cannot analyze these responses, which contain information that is material to investment decisions.

Finally, companies decide what to disclose, how to measure risks, and how to describe mitigation activities. Most importantly, unregulated disclosure is not standardized. An analysis of the CDP responses of the S&P 500 finds that, "while most S&P500 respondents can identify regulatory and physical risks associated with climate change, few have attempted to quantify these risks in dollar terms or have discussed them in securities filings."[5]

Although shareholder resolutions help improve corporate climate disclosure, they are an inefficient method of obtaining high quality disclosure from all U.S. companies

Due to the lack of climate risk disclosure by companies, investors have filed over 150 shareholder resolutions with U.S. companies in the past several years to seek such information from companies, especially power companies, automobile manufacturers, insurers and other businesses with significant risk exposure from anticipated climate regulations and other climate-related impacts. These resolutions and subsequent engagements with companies produce positive results, including new corporate climate change policies, reports, and support for national climate policy from unexpected sources like electric power companies.

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[5] Carbon Disclosure Project Report 2007: USA S&P 500, authored by RiskMetrics Group, p. iii.

However, shareholder resolutions are inadequate for addressing a problem that affects most companies and sectors. Resolutions only allow investors to engage with one company at a time, and resolutions must be re-filed with some companies for several years before they agree to shareholder requests: an inefficient, slow process for improving climate risk disclosure.

Because climate change represents a newer and vastly different type of risk than those which companies usually manage, it often goes unaddressed by companies. Proposals addressing climate change commonly urge companies to report on their operational and product-related CO_2 emissions, or to address the regulatory and physical risks the company faces. Of course, shareholder votes on these resolutions are advisory in nature—such votes do not force a company to take specific actions.

Despite this, the SEC often limits investors' rights to file resolutions related to climate change by omitting them from proxy voting. A resolution may be omitted if the SEC finds the proposal addresses "ordinary business" issues that are properly under the control of management, and not an issue for shareholders or the board to consider. Such approvals are often subject to inconsistent handling by SEC staff.

This leaves shareholders with no recourse if a company is unwilling to engage with shareholders on the climate issue. Such exclusions make it difficult for investors to assess climate change risks in their portfolios. The inconsistency in applying the "ordinary business" exclusion should be addressed by the SEC in order to ensure fair and accurate assessments of risk, as well as consistency in financial reporting.

These resolutions cannot take the place of uniform, consistent guidance on corporate disclosure of climate-related risks. The significant financial risks and opportunities posed by climate change, and investor requests for SEC guidance on climate risk disclosure, should compel the SEC to examine this issue promptly and produce the requested guidance.

How investors seek SEC guidance to improve climate risk disclosure

A group of U.S. investors has been working since 2003 to persuade the SEC, through meetings with Commissioners and Staff, to improve climate risk disclosure. On March 19, 2007, more than 60 investors (including one dozen companies) representing over $4 trillion in assets called on the SEC to issue guidance on which material issues related to climate change companies should disclose in SEC filings.

In part due to the lack of SEC guidance, a group of 14 institutional investors and other groups, including CalPERS, CalSTRS, and the Connecticut Treasurer's Office, developed the Global Framework for Climate Risk Disclosure to encourage standardized climate risk disclosure and to make it easy for companies to provide this information, and for investors to compare companies. Released in October 2006, it offers companies guidance on disclosing emissions data, physical and regulatory risks, and strategic management of climate risk using SEC filings and other common disclosure mechanisms. Investors who created the Framework are asking companies to use it, and they are asking securities regulators and governments to ensure that corporate climate risk disclosure in financial statements adheres to the Framework.

Benefits for companies that assess and disclose their climate risk and opportunities

Companies are increasingly discussing climate risks and opportunities internally and with investors. While some companies are not acting to address the issue, others are taking steps to disclose risks to investors, reduce emissions, and take advantage of strategic opportunities. When companies track their emissions and disclose climate risk, they also tend to reduce their emissions and continue to seek out further opportunities to do so (e.g., by investing in efficiency and clean energy technologies, processes and products). These actions offer cost savings to companies, reputational advantages, better employee retention, and other significant benefits.

Several examples of good voluntary climate risk disclosure illustrate why it benefits companies by raising their awareness of climate change and by leading them to address risks and seize opportunities. Entergy, a major electric utility company serving the Southeastern U.S., has provided excellent climate risk disclosure in the wake of Hurricane Katrina. Climate risks to communities and companies in the Mississippi Delta are a material risk—Entergy itself sustained recovery costs of about $1.48 billion from Katrina and Rita, which doesn't include revenue losses due to the hurricane, which is estimated in the hundreds of millions. In its disclosure, Entergy points to the troubling findings of the Intergovernmental Panel on Climate Change's (IPCC) recent report on climate change adaptation, which indicates that much of Entergy's customer base and "billions of dollars of investment" could be severely impacted due to future loss of wetlands, storm surges, and sea level rise. Entergy also sees opportunity in the national response to climate change—namely regulations that may benefit less carbon intensive generators like themselves. The company discloses its emissions data dating back to 1990.

Wisconsin-based Johnson Controls is another leader in corporate climate disclosure. Johnson Controls reports on the opportunities it sees in designing and manufacturing products that help maximize energy efficiency in buildings, cars, and batteries, but also points out financial risks from climate impacts. The company has publicly communicated its climate change strategy, stating that it intends to reduce its emissions by 18% by 2012 and has an overall goal to reduce the carbon footprint not only of its own operations, but also of the customers who buy its products.

Between 1990 and 2004, DuPont reduced its energy usage by over 7 percent and GHG emissions by 70%, increased production by over 33%, and experienced cost savings of over $2 billion. When General Electric announced its EcoMagination program in 2005, the company expected to have $20 billion in sales of "green" products by 2010. Last year, the program had $15 billion in sales, and they now have $50 billion in back orders and are on track to "blow away" their original estimation of $20 billion by 2010.

Finally, AIG has disclosed information about its business impacts from the physical effects of climate change. AIG suffered after-tax catastrophic losses of $2.44 billion from Hurricanes Rita and Katrina, an indication of the future losses firms can anticipate as climate change creates ocean temperature increases in many parts of the world that scientists believe will lead to more intense and frequent hurricanes. The company publicly discloses both short and long-term physical effects of climate change, from increased occurrence of drought to rising sea levels. AIG discusses how this will impact its business—by affecting its customers as well as assets, like its Stowe, Vermont ski resort—and what measures the company can take to adapt to these changes through modifying their underwriting process, among other approaches. AIG also reports that predicted increased severe weather events could lead to steeper rates and more limited coverage.

Why the SEC should provide guidance on climate risk disclosure

Because voluntary disclosure cannot adequately provide investors the information they need, the SEC should provide guidance on climate risk disclosure. Without SEC guidance, climate reporting rates in SEC filings will remain low in every sector the utilities sector. Because many industries affected by climate change do not raise the issue in their SEC filings, investors face significant difficulty in assessing the true long-term value of their portfolios.

For example, SEC climate risk disclosure rates for the largest companies in three affected industries are low: 28% in petrochemicals, 19% in insurance, and 26% of auto manufacturers.[6] Disclosure rates are low in the insurance industry, despite the industry's acute exposure to sea-level rise and more intense hurricanes and wildfires, all of which scientists tie to global warming. Moreover, disclosure occurs in various places in corporate filings (Description of Business, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Notes to Consolidated Financial Statements) and is difficult to compare from company to company. Also, the quality of the reporting is generally low. In one industry—electric power—most companies mention climate change in their filings, but they do an inadequate job of assessing the risks and opportunities.[7]

Petition to the SEC for Interpretive Guidance on Climate Risk Disclosure

A group of investors, state officials, and others sent a petition to the SEC on September 18, 2007, which builds on requests over the past four years, seeking a measured and reasonable approach to improving climate risk disclosure, in which companies analyze whether the climate risks they face are material.[8] If regulatory, physical or litigation-related risks are in fact found to be material, companies then disclose information about those risks in quarterly and annual securities filings. Specifically, the petition "requests that the Commission issue an interpretive

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[6] Michelle Chan-Fishel, Friends of the Earth, Fifth Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies (October 2006) at 1, available at http://www.foe.org/camps/intl/SECFinalReportandAppendices.pdf.

[7] *See Id.* at 22-28.

[8] Petitioners are California Public Employees' Retirement System; California State Controller, John Chiang; California State Teachers' Retirement System; California State Treasurer, Bill Lockyer; Ceres; Environmental Defense; F&C Management; Florida Chief Financial Officer, Alex Sink; Friends of the Earth; Kentucky State Treasurer, Jonathan Miller; Maine State Treasurer, David G. Lemoine; Maryland State Treasurer, Nancy K. Kopp; The Nathan Cummings Foundation; New Jersey State Investment Council, Orin Kramer, Chair; New York City Comptroller, William C. Thompson, Jr.; New York State Attorney General, Andrew M. Cuomo; New York State Comptroller, Thomas P. DiNapoli; North Carolina State Treasurer, Richard Moore; Oregon State Treasurer, Randall

release clarifying that material climate-related information must be included in corporate disclosures under existing law."[9]

It must be emphasized that petitioners *do not* seek an onerous new disclosure routine. Because climate risk varies between sectors and can change because of quickly evolving regulatory regimes and scientific information about the physical risks of climate change, general guidance from the SEC—as suggested by the petition—is appropriate, so companies can determine for themselves if they face material risks. This disclosure would give investors a baseline for comparison between companies and adequate information to make investment decisions.

Petitioners believe current law requires disclosure of material climate risks

The SEC's existing disclosure regulations speak in expansive and flexible terms that reflect the broad range of information investors consider when they assess corporate value. For many companies, climate risk clearly meets the standard of materiality established by the SEC and the courts, and falls directly within several of the specific disclosure requirements of Regulation S-K.

The fundamental principle underlying the Commission's disclosure requirements is that a public corporation must fully and fairly disclose all facts about its performance and operations that would be material to a shareholder's investment decision. This disclosure obligation springs from the core requirement of the 1933 and 1934 Acts that investors receive financial and other significant information concerning securities offered for public sale. Under both Supreme Court

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Edwards; Pax World Management Corporation; Rhode Island General Treasurer, Frank T. Caprio; and Vermont State Treasurer, Jeb Spaulding.

[9] File No. 4-547, Request for Interpretive Guidance on Climate Risk Disclosure (September 18, 2007), *available at* http://sec.gov/rules/petitions.shtml, p. 2.

and Commission precedent, the existence of significant investor demand for information helps to guide the determination of whether that information is material and hence required to be disclosed. "A fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[10]

The Supreme Court has made clear that the determination of whether a fact is material is a holistic inquiry that cannot be reduced to a simple numeric formula. Determinations of materiality require "delicate assessments of the inferences that a 'reasonable investor' would draw from a given set of facts, and the significance of those inferences to him . . . ."[11] In Staff Accounting Bulletin No. 99, Commission Staff reiterated this principle and rejected the practice of using a simple numeric threshold for determining whether an omission or misstatement in a financial statement is material.[12] Instead, Staff have made clear that the question of what information is material must take into account both quantitative and qualitative factors. This interpretation of materiality is also supported by the Financial Accounting Standards Board (FASB).[13]

The steadily growing demand from investors for information about climate risk described above demonstrates that "reasonable investors" exercising human judgment increasingly consider climate risk part of the total mix of information they assess to make investment decisions. Members of the Investor Network on Climate Risk have repeatedly requested SEC

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[10] SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 12, 1999) (quoting TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976)).
[11] *TSC Industries*, 426 U.S. at 450.
[12] *See* SEC Staff Accounting Bulletin No. 99, *supra* note 10.
[13] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2: QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION 45 (1980), *available at* http://www.fasb.org/st/.

action to clarify the need for climate risk disclosure.[14] Corporate leaders themselves have also recognized the critical importance of climate risks, in the form of both regulatory developments and physical risks, to the global economy.[15]

The financial markets have judged that climate risk is important to investors' ability to assess corporate operations and performance. This judgment, along with the importance of climate risk for many companies' financial prospects, compels the conclusion that material climate risk should be disclosed under the Commission's regulations. The Commission should promptly issue guidance that clarifies that climate risk demands the same careful attention and disclosure given to other forms of risk.

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[14] *See, e.g.*, Letter from Bradley Abelow, Treasurer, State of New Jersey et al. to SEC Chairman Christopher Cox (June 14, 2006), available at http://www.ceres.org/pub/publication.php?pid=98.
[15] *See, e.g.*, the United States Climate Action Partnership's list of corporate members, available at http://www.us-cap.org/about/index.asp.