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TRANSCRIPT

ESG Now Podcast

"California Dreamin' About Climate Disclosures"

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Bentley Kaplan:

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. In today's show, we are going to talk about America's golden state, California. And while it would be fun to talk about things like the Golden Gate Bridge or Yosemite or LA or In-N-Out Burger or Lake Berryessa's Morning Glory Spillway, today's episode is going to focus on something else that's unique about California – its role as the largest subnational economy in the world. And because of its economic heft, how decisions taken by the state's lawmakers can have impacts across the globe.

And in particular, we're going to discuss two bills in California that seek to improve and standardize how companies report their greenhouse gas emissions and the risks that they face from climate change. At the time of recording, these bills had passed through California's legislature and were awaiting Governor Gavin Newsom's signature. So as many companies and investors hold their collective breath, we're going to take a look at what's in these bills, what they ask of companies, and how they plug into ongoing regulatory developments in other parts of the world.

Thanks for sticking around. Let's do this.

In an interview with CNN host, Dana Bash on the 19th of September, California's Governor Gavin Newsom said, "The climate is in deep distress. Ask the folks out in California." And the folks out in California could definitely tell you about climate hazards, from hugely destructive wildfires like the Camp and Dixie fires to flooding caused by atmospheric rivers in both coastal and inland areas and to incremental, but long-term changes like sea-level rise, reduced rainfall and earlier snow melt, there is a lot going on. But the state's leaders and legislators are not waiting for things to slowly get worse.

Instead, they've moved on multiple fronts to mitigate climate change. California, through its Air Resources Board approved a set of rules in August 2022 that are designed to accelerate the adoption of zero-emission vehicles. The aim is to ensure that by 2035, all new cars and light trucks sold in California will be zero emission, with several intermediate milestones. And that carrot was paired with a stick in mid-September of this year when the state filed a lawsuit in the Superior Court in San Francisco against Exxon, Shell, Chevron, ConocoPhillips, and BP. And the key allegation in the suit is that these big oil and gas companies deceived the public about the risks of fossil fuels that are now resulting in climate change-related storms and wildfires and associated financial impacts.

And then California made it three for three with key climate-related bills that passed through the state Senate on the 12th and 13th of September, and it's these two bills that we are going to get stuck into on the show.

But before we do, I have to add the asterisks. At the time of recording, these bills had not been signed by Governor Newsom. So as of now, they are effectively bills and not laws. And should these bills become laws, they may well be legal action by its opponents to try and roll it back or to alter it in some way. So even though we're discussing the implication of these bills, there is the possibility that it's not going to roll out as currently written.

And with that out the way, let's do make this a discussion. And to do that, I brought in Zohir Uddin out of MSCI's London office. Zohir is the straightest of shooters, which is why he's the perfect guest for this topic. And first up, I asked him to break down California's two bills, very catchily named SB 253 and SB 261.

Zohir Uddin:

So last month we saw the California State Senate approve two pieces of climate-related legislation as part of what it was calling its climate accountability package. Now, this included two new Senate bills, which have been grabbing quite a number of headlines and a number of discussions. The first of these bills, Senate Bill 253, otherwise known as a Climate Corporate Data Accountability Act, requires all large companies, be they public or private, that do business in California to provide a detailed accounting of their greenhouse gas emissions.

The second of these bills, Senate Bill 261, known as the Climate Related Financial Risk Act. Now, this will require companies that also do business in California to prepare TCFD aligned climate related financial risk reports. Now, why are both these bills important? What's the significance of this Climate Accountability Act coming out of California? These bills will be the first comprehensive greenhouse gas emission disclosure regulations to come into force anywhere in the US, with more than 15,000 companies on a combined basis expected to be in scope of both of these two new rules.

California has the highest GDP of any US state and is the world's fifth-largest economy by size with nearly every major global corporation doing business in the state. So the significance of what this could mean for multinational companies in and outside of the US is quite clear to see.

Now, although the definition of what doing business in California can seem somewhat vague, it's expected that both of these Senate bills will take quite a broad view of the phrase based on what we've seen in other state regulations. So, for example, in the California Franchise Tax Board's definition for doing business in the state. Now, this includes any company or entity that engages in any transaction for the purpose of financial gain within California. So again, we can read the writing on the wall and say that these bills will have quite a large scope in terms of companies being required to meet these obligations.

Bentley Kaplan:

Okay. To recap, California has two bills. One, SB 253 is looking to mandate the reporting of greenhouse gas emissions for large companies that have got operations in California. And bill number two, SB 261, is looking to mandate the reporting of climate related financial risks that a company faces. Zohir also said that if these pass into law, then they might be considered de facto national law. And the reason for that is because of the size of California's economy. If the state were its own country, it would be among the world's five biggest economies. And because so many of America's companies have some of their operations in California and depend on its markets, this puts them in scope for its regulations.

So sure, part of the reason why these regulatory developments are making the news and will be on investors' radars is because of their reach. But really, what is adding emojis and exclamation marks to this announcement is in the detail and what specifically companies will be required to report.

Zohir Uddin:

I think what's important is to look under the lid of both of these two new bills and what they contain and how they differ from existing voluntary or mandatory standards. I think when you're looking at the first one, Senate Bill 253, so this is the one on greenhouse gas emissions, but the core of this bill is the requirement for companies in scope to disclose their full carbon footprint on an annual basis.

Now, this bill will also require somewhat down the line a requirement for companies to get external assurance on a limited basis, firstly on their disclosures, and this should be from an independent third-party assurance provider. Now, the bill will capture any public or private company earning over one billion US dollars in revenue, and that's nationwide, which is also doing business in the state of California. This includes any financial institutions that meets the criteria.

Now, the bill will mandate disclosure of a company's Scope 3 emissions. This should be in line with the Greenhouse Gas Protocol standard for Scope 1. And Scope 2, emissions will need to be reported from 2026 onwards for the previous year's data. Whereas for Scope 3, companies will have an additional year to report. And this is required from 2027 onwards only. Now, considering the challenges that companies currently face in calculating their Scope 3 emissions, especially across their entire value chain, the bill will also allow companies to source help from third party vendors in using estimated data such as industry average emissions and proxy data in their Scope 3 emission calculations.

Now let's look at Senate Bill 261. So the main goal for this bill is the requirement for companies to prepare a climate related financial risk report, hopefully in alignment with the recommendations of the task force for climate related financial disclosures to TCFD, which will disclose their exposure to climate risks and the actions they're taking to adapt or reduce those risks.

Now, similar to Senate Bill 253, this would also capture any public or private company, but with a lower revenue threshold of $500 million. So it's likely to bring in a larger number of companies in scope. This will also include any financial institutions that meets this criteria. Now, in terms of timelines, the first climate risk reports by companies are due before 2026 and then every two years or bi-annually thereafter. And as I mentioned, these reports should be in line with the recommendations outlined by the TCFD and now the ISSB, the International Sustainability Standards Boards, as these were finalized earlier this year. Now looking a little bit further down the line, the developments in California and these two bills come as the SEC continues its own work on developing its climate-related disclosure rules for US companies, following the release of their initial proposals in March of last year.

Bentley Kaplan:

Right. Well, I hope you got all of that. If you didn't, I've got your back. That's what I'm here for. That and corporately sanctioned dry humor. Now, basically the state's bill requiring the reporting of climate-related financial risk includes companies earning half a billion dollars in revenue and not only will companies need to report risk, but detail their exposure to that risk. Sure, wildfires are a problem in California, but what does it mean for your business specifically? And then companies are also going to need to detail what steps they're taking to deal with those risks. As Zohir points out, SB 261 may not be the TCFD, but it certainly rhymes.

And then in the state's bill calling on companies to report their emissions, California has narrowed the net a little. You'll need to be hitting a billion dollars in revenue for this one to matter. And if you're enjoying that kind of cheddar, then not only will you need to report on Scope 1 and 2 emissions, but Scope 3 as well, including for financial institutions. Ahem, crib notes – Scope 1 emissions are your company's direct emissions, sources that you control. Scope 2 emissions are basically what comes from energy use - your purchased electricity, or heat or cooling. And then Scope 3, is everything else. Any emissions up and down the value chain – you don't control them, but you depend on them for your parts, or to run your office, or for transporting supplies. And it is a big deal that California is calling on companies to A, report their Scope 3 emissions, B, start doing it by 2027, and C, needing these disclosures to be independently verified. And rest assured, we'll come back to that in a little bit. I've got a climate specialist pacing impatiently in the next segment.

But before we get there, I had to ask Zohir one last thing that would probably be on the minds of the thousands of companies that these two new bills might be impacting. Especially for US companies that have already been facing proposed rules from the SEC on climate risk and emissions reporting. Because the SBs 253 and 261 are not just a replication of what the SEC is considering – as Zohir told me in a longer recorded conversation, California's bills may not have the same breadth in terms of climate risk reporting, or the same level of detail, but they are happening over a much faster timeline, and have the added kicker of enforceability.

So would California's new bills just be adding another report to add on to the ever-growing list of requirements from multiple regulators covering multiple topics? Another annex to try and squeeze into the annual report? And from a company and investor perspective, what comes next?

Zohir Uddin:

Now, when looking at both of these California bills in an international and global context, it's important to see where they differ and where they fit into the wider regulatory reporting landscape that companies need to be aware of. When you're looking at the ISSB, so this is the International Sustainability Standards Boards, these were finalized over the summer after 18 months of deliberation, and these will introduce for the first time a globally accepted set of climate and sustainability reporting standards, and they go live at the beginning of next year.

Now, Senate Bill 261 helpfully makes reference to the ISSB standards and states that if you comply with the reporting requirements under the ISSB, then you satisfy the obligations under the Senate Bill 261. However, there is a crucial difference, especially with the frequency of reporting. Senate Bill 261 attempts to reduce the reporting burden for companies by permitting them to report on a biannual basis rather than on an annual basis. Whereas in most of the international jurisdictions and under larger economies, including the ISSB, this is required annually.

So in terms of what can we expect regarding next steps, both bills are now waiting to be signed into law by the Governor of California, Gavin Newsom. Now, speaking during Climate Week in New York, he's already indicated his full intention to sign both of these bills and he has until the middle of October to sign these bills into force. Now, following this, they will then go to a body called the California Air Resources Board, who will then put in place the actual reporting and monitoring process for companies. The Resources Board will also be ultimately responsible for drafting the implementing regulations.

It's important to note that failure for companies to file the mandated reports required by these bills would subject them to quite hefty penalties, up to 500,000 US dollars per year for violations of Senate Bill 253. So this is the one on greenhouse gas emissions and up to 50,000 US dollars per year for violations of Senate Bill 261. This is the one on the climate risk reporting.

As we anticipate both of these new bills coming close to the finishing line over the coming weeks, investors and other users of climate data will be waiting eagerly for a lot of this information to start coming online. Now, the California bills should also be seen in the context of the wider disclosure and regulatory framework that we are seeing and will continue to see emerge and evolve in 2024. Regulators are putting increasing focus on disclosure requirements for companies. And not just disclosure, but also subsequent action by those companies to act on the information being disclosed.

Bentley Kaplan:

So before we close out this episode, I wanted to spend just a little bit more time going a little bit deeper into California's SB 253 bill. This is the one calling for more emissions reporting because requiring Scope Three reporting would definitely be pushing many companies quite aggressively forward on their disclosure journey. Paging through annual reports and sustainability numbers, you'll probably notice that Scope Three is often not mentioned and quite rarely disclosed. To give you an idea of that, we can look at some data. Taking a global sample of companies or our MSCI ACWI, Investible Markets Index, and taking a subset of companies within that that don't have climate targets that were approved by the SBTI or the Science-Based Targets initiative, you end up with a pretty sizable 2,500 companies.

When it comes to climate reporting, these are the kids sitting at the back of the class making jokes about the teacher, right?. And of these 2,500 companies, 80% of them reported their Scope 1 and 2 emissions, which is pretty decent. But when we looked at Scope 3 disclosures, it slid down to 50% of companies that reported on any upstream emissions and just 27% that are reporting on Scope 3 downstream emissions.

So if Scope 3 disclosures are a bit of a luxury in the corporate reporting world and California's SB 253 aims to turn that luxury into a given, it's probably a good time to ask why these disclosures are so hard to come by? To do that, enter David Bokern from MSCI’s Zurich office and part of our Climate Risk Center. And when I asked David what the big deal about Scope 3 is and why companies aren't reporting it more regularly, he gave me a sweet sympathetic smile and then laid it out as simply as he could.

David Bokern:

Many companies are hesitant to come up with a Scope 3 emission reporting because it is much more complex than Scope 1 and 2 emission estimates. It's not only the complexity. It's also the very concept of Scope 3 emissions. If you are a vehicle manufacturer, you want to start with one car. In theory, you would need to know for each screw that goes in this car where the screw was built with which materials? And in the end, what carbon footprint is attached to this screw? And you would need to know this not only for the screw, but for every part that goes into the car. So for each part that you built into this car, you would need to do this footprinting.

Obviously, this is not very realistic that you have all this information. So the company needs to come up with some assumptions, fall back to an average screw or fall back to an average car part in order to be able in the first place to come up with a rough estimate for just a single product. The same is true for downstream emissions. Scope 3 splits up in both the upstream part, so everything that comes in the value chain before the company and everything. Then also the downstream part, which everything that comes after the company has sold a certain product.

For our vehicle or for our car, that would mean that you would need to estimate the lifetime emissions of this car. Every car has maybe different lifetime emissions depending on the driving style of the owner and depending also on how long this car is actually driven. So on the lifetime mileage of this car. Companies can't really measure this. They don't really know this, so they need to take assumptions. I've just given you a small example and it's much more complex than that. And Scope 3 is hard. It's hard to estimate, there's no doubt about that.

Bentley Kaplan:

Okay, so Scope 3 emissions are estimates. They have to be, and as David told me, with evident restraint, reported Scope 1 and Scope 2 emissions are also estimates. Very few, if any companies are physically recording their actual emissions. Instead, they're working from very well-established proxies that they can use to provide a trusted and reliable estimate. So, the use of estimated Scope 3 emissions by companies looking to meet the requirements of SB 253 isn't particularly new, but it's because actually putting together these estimates is devilishly complex.

Figuring out your upstream emissions means looking at something as simple as a screw and trying to work out what greenhouse gas emissions were released in every step that made the screw and got it to you. And then doing the same for everything in your office, your factory, your mine, your farm, your shop, you name it. And as complicated are your downstream emissions, trying to figure out what happens to your product after you sell it and all the emissions that result thereafter.

And unlike Scope 1 and 2, there aren't really off the shelf estimates that you can plug into your company. It's going to take a lot more work, both for the companies that are putting these reports together and the third parties that will be needed to provide assurance.

So in many ways, California's new bills are asking companies to reach, to really stretch themselves. It'll take effort and application to report on both a company's contribution to climate change and the risk it faces from a changing climate. For some investors though, it's maybe a development with less ambiguity because having more information about a company's exposure to physical climate and transition risk might be just what the Governor ordered.

And that is it for the week. A massive thanks to Zohir and David for their take on the news with an ESG twist. Thank you very much for tuning in. I know that of late, we've got some whipper-snappers running around the studio making the show a better place with their energy and verve, but I think you'll agree it's okay to balance out their enthusiasm with the measured tones of an ESG Now veteran. But I digress. I must remind you to please send some stars our way if you're enjoying the show. Positive reviews are what get us up in the morning. Mike will be back again next week, so tune in to see what he's got planned. In the meantime, take care of yourselves and those around you.

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