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THE CUBICAL

February 27, 2024 - Re-visiting *"As Goes California ..."*

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Back in August 2021, I devoted an entire edition of The Cubical to a focus on the regulation of process safety. While this edition mostly focused on the regulation of process safety at the federal level, I did take note of innovations and advancements by Contra Costa Health Services, the environmental and public health agency for a county in California that is home to several refining and petrochemical facilities. While speculating on whether these innovations and advancements might migrate eastward, I referenced a phrase commonly heard in the environmental affairs arena: "As goes California, so goes the rest of the country."

In this edition of The Cubical, I have returned to the "As goes California..." theme. In this edition, I focus mostly on California's approach to climate-related disclosures and accounting for environmental impacts throughout the value chain. California's legislature and regulatory agencies have been quite active in these areas over the last several years. In many ways, they have moved well ahead of the federal government and most other states. In the articles that follow, I discuss some of California's recent initiatives. At the end, I wrap up this edition with a final thought or two.

Leaving the SEC in its Wake: California's New Climate Disclosure Legislation

The federal Securities and Exchange Commission made a big splash when it published *The Enhancement and Standardization of Climate-Related Disclosures for Investors* Proposed Rule (referred to herein as the "SEC Climate Disclosure Proposal") nearly two years ago. As written, the SEC Climate Disclosure Proposal would establish certain requirements for the disclosure of climate-related risks by publicly traded companies. Perhaps most significantly, large publicly traded companies would be required to disclose emissions of greenhouse gases ("GHGs") related to their respective operations. Disclosures of direct GHG emissions (so-called "Scope 1" emissions) and indirect GHG emissions from purchased electricity ("Scope 2") would be required. In addition, disclosures of indirect emissions throughout the value chain ("Scope 3") would be required if they are material, or if they are the subject of reduction targets.

Since its publication, the Climate Disclosure Proposal has languished in SEC's notice and comment process. Anticipated dates for promulgation of a final climate disclosure rule have been pushed back several times. Once a final rule is promulgated, legal challenges are almost certain to follow. Several recent legal developments have increased the risk that a final climate disclosure rule might not withstand such legal challenges. Most notable among these are the emergence of a robust "major questions doctrine" as a result of the U.S. Supreme Court's opinion in *West Virginia v. EPA,* and the prospect of *Chevron* deference to agency interpretations of governing statutes being overturned or substantially limited by a ruling in *Loper Bright Enterprises v. Raimondo*, which is pending before the Supreme Court.

While the Climate Disclosure Proposal continues to languish in administrative purgatory, the California General Assembly has moved full steam ahead with its own set of climate disclosure initiatives. On October 7, 2023, Senate Bills 253 and 261 were signed into law by Governor Gavin Newsom. SB 253, also known as *The Climate Corporate Data Accountability Act*, establishes GHG emissions disclosure requirements analogous to the GHG emissions disclosure requirements in the Climate Disclosure Proposal. SB 261 establishes requirements for the disclosure of climate-related financial risks that follow along the lines of similar provisions in the Climate Disclosure Proposal.

In contrast to the Climate Disclosure Proposal, SB 253 and 261 are already law. In addition, the reach and scope of SB 253 go beyond the Climate Disclosure Proposal in many respects. Unlike the Climate Disclosure Proposal, the reach of SB 253 and 261 is not limited to publicly traded companies. SB 253 applies to all companies doing business in California that generate more than $1 billion in annual revenue. SB 261 applies to all such companies that generate more than $500 million in annual revenue. In another departure from the Climate Disclosure Proposal, SB 253 has no materiality qualifier on the requirement to disclose Scope 3 emissions. All companies to whom SB 253 applies must disclose their Scope 1, Scope 2, and Scope 3 emissions. For these reasons, SB 253 and 261 have - at least for now - mostly replaced the Climate Disclosure Proposal as the primary focus of those interested in the regulation of climate-related disclosures.

It should be noted that while judicial challenges to a final SEC climate disclosure rule are expected, SB 253 and 261 are currently facing legal headwinds of their own. A group of trade organizations recently filed suit in U.S. District Court for the Central District of California challenging the constitutionality of these laws. The challengers claim that these laws impermissibly compel speech in contravention of the 1st and 14th Amendments, violate the Dormant Commerce Clause, and violate the Supremacy Clause by legislating on subject matter reserved for the federal Clean Air Act. This

lawsuit was just filed at the end of January, so for now, it is difficult to say where all of this will go. Stay tuned!

California *Zeroes* in on Carbon Offsets

SB 253 and 261 are only two in a series of recent legislative initiatives in California relating to the disclosure of climate-related information. SB 253, and its companion piece of legislation, SB 261, mandate certain climate-related disclosures. Another recent piece of legislation, AB 1305, mandates certain disclosures relating to the purchase and sale of voluntary carbon offsets ("VCOs"), and to "net zero," "carbon neutral," or similar-type claims ("Carbon Reduction Claims"). AB 1305 establishes requirements for the content of such disclosures.

Two key themes reflected in this legislation are: (i) the necessity of disclosing the protocols used to estimate carbon emission reductions; and (ii) the importance of identifying whether VCOs or Carbon Reduction Claims have been subject to independent third-party verification. AB 1305 does not mandate which specific emission estimation protocols must be used. Nor does it necessarily require that VCOs or Carbon Reduction Claims be independently verified. Nonetheless, the message sent by this legislation is clear: To reap the full benefits associated with their use, organizations must show their work. And the VCOs that are sold, marketed, or used, as well as the Carbon Reduction Claims that are made, must withstand scrutiny.

AB 1305 also taps into an emerging, yet underappreciated, issue in the world of ESG and carbon disclosures. Namely, what happens when it becomes apparent that stated carbon reduction goals will not be met? Such unmet expectations can arise in a variety of ways. New and more robust information may emerge to suggest that the emissions estimates associated with a carbon reduction project were overstated. Or a carbon reduction project may just go sideways due to technological limitations or a lack of necessary additional financing.

AB 1305 addresses this contingency in several ways. First, marketers and sellers of VCOs are required to disclose "details regarding accountability measures if a project is not completed or does not meet the projected emissions reductions or removal benefits...." Second, marketers, sellers, and users of VCOs must disclose the details of the specific "protocols" used to estimate emissions reductions or removal benefits. The term "protocols" is defined to include methodologies "used to conservatively account for uncertainty and activity-shifting and market-shifting leakage risks..." associated with offset projects. Finally, entities making Carbon Reduction Claims must disclose information regarding how interim progress towards a stated carbon reduction goal is being measured.

The requirement to disclose information regarding interim progress hints at one more important issue: If a carbon offset or reduction project is going sideways, *when* must this be disclosed? Can the reporting entity wait until the date established for achieving a particular target has passed? Or must the disclosure be made well in advance? Many carbon offset and reduction projects take several years or more to implement. It is entirely conceivable, if not likely, that the failure to meet a particular milestone will become apparent well in advance of the established date for achieving it. AB 1305's interim progress disclosure requirements tilts the field in the direction of early disclosure.

Environmental Impacts Throughout the Value Chain: SCAQMD's Warehouse Indirect Source Rule

One or the more interesting aspects of California's recently enacted package of carbon disclosure legislation is the focus on Scope 3 emissions. The push towards "widening the aperture" by requiring emissions disclosures that go beyond a disclosing entity's operations is a discernible and growing trend. And in California at least, this trend is extending beyond the realm of carbon-related emissions. A primary example of this can be seen in a regulation promulgated by California's South Coast Air Quality Management District ("SCAQMD," the California regulatory agency charged with responsibility for regulating air quality in and around most of Greater Los Angeles and Orange County) known as the Warehouse Indirect Source Rule (also known as the "ISR" or Rule 2305).

Rule 2305 regulates particulate emissions associated with warehousing operations. Under this rule, certain large warehouse operators are required to report on the annual number of truck trips in and out of their respective facilities. Truck trip counts serve as surrogate measures of particulate emissions (primarily from truck diesel engines). These counts are used to determine the number of "compliance obligation points" an individual warehouse operator must accumulate in order to meet the requirements of the rule. Compliance obligation points can be accumulated by engaging in emission-reducing actions such as acquiring "zero emission" ("ZE") or "near zero emission" ("NZE") trucks, arranging for deliveries from ZE or NZE trucks, or installing and operating charging stations for electric vehicles.

Rule 2305's Scope 3 emissions reporting requirements are centered around a relatively simple surrogate measure - truck trip counts. Over time, Scope 3 emissions reporting requirements are likely to extend beyond straightforward surrogate measures to include more rigorous and robust emissions estimating protocols. Such protocols will likely require significantly greater input from vendors, customers, and service providers throughout the value chain. As with many other emissions reporting and disclosure initiatives at the federal and state levels, Rule 2305 has been the subject of on-going judicial challenges. Still the same, business of all types and sizes should begin preparing for the flurry of questionnaires and information requests that are sure to start flying in all directions as Scope 3 emissions reporting requirements - for all types of pollutants - become more commonplace.

Re-visiting *"As Goes California..."* Final Thoughts

To bring this all back to the "as goes California..." theme, even back in August 2021, I remarked that I've always thought that this phrase is a bit of an exaggeration. More specifically, I've always thought that the use of this phrase to describe inevitabilities was misguided. Having said that, I do believe that this phrase serves as a useful reminder that the environmental regulatory landscape in California always bears watching. The Golden State has always been an environmental regulatory innovator. And quite often, it has moved with considerable speed on emerging environmental issues. Sometimes California's innovations are adopted, sometimes they are not, and sometimes the picture is somewhat muddled. However, what happens on the "Left Coast" is always worth one's attention.

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