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DISCLOSURE

The Floods Are Coming. What More Will Investors Be Told?



BY TOM MOUNTEER

For over a decade, public companies' disclosures about the effect of global warming on their businesses have been under scrutiny. Companies have made statements about the effect in periodic SEC filings and in their corporate social responsibility reports. Activists have pored over those statements, urged corporate boards to require greater transparency, and sued companies they thought dissembled. As a result of this scrutiny, public companies' disclosures have evolved.

Since early 2010, SEC guidance has informed these disclosures. That guidance, among other things, directs companies to describe how weather-related effects caused by global warming might affect them. 2017 brought an avalanche of new severe weather event-related scientific findings. Noteworthy among them, the risk of coastal flooding seems to be much greater than appreciated just a few years ago.

One reasonably expects public companies with substantial coastal operations to address 2017's findings in this spring's SEC filings. A business with its physical operations concentrated along the coastline, such as

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petrochemical businesses with operations along the Gulf coast, would be hard-pressed to turn a blind eye to 2017's findings. Disclosures by insurers have already drawn scrutiny. To the extent their risk of loss is increased due to coverage of coastal property, will their disclosures draw even more scrutiny this spring? What about other sectors that haven't drawn scrutiny, for example coastal hotel and resort operators, will their disclosures come to grips with 2017's findings?

More Frequent and Severe Coastal Flooding

Scientific understanding of global warming's effect on weather patterns continued to progress in 2017. There are now thousands of studies documenting how human greenhouse gas-emitting activities have changed surface, atmospheric, and oceanic temperatures; melted glaciers; reduced snow cover; shrunk sea ice; caused sea levels to rise; and increased atmospheric water vapor.

A dominant theme from the past year's scientific findings is the more immediate and pervasive risk of coastal flooding. Sea level rise, normal tides, coastal inundation due to storm surges, and increased precipitation during storm events contribute to the increased risk.

The risk begins with sea level rise. In early November, the U.S. Global Change Research Program released the Fourth National Climate Assessment. It found that global mean sea level rose about seven to eight inches

since 1900. A substantial portion of that sea level rise occurred since 2000, and another six to fourteen inches of sea level rise is expected by mid-century.

In mid-summer, the Union of Concerned Scientists released a report on “chronic inundation” under normal tide conditions as a result of projected sea level rise. The UCS defined “chronic inundation” as flooding that occurs 26 times per year on average (or, on average, every other week). The UCS considered communities that experience flooding over more than 10 percent of their land area (excluding wetlands and lands protected by federal levees) as “chronically inundated.” The UCS examined which coastal communities will become chronically inundated over the coming decades under three different sea level rise projections.

By 2035, or less than two decades from now, the UCS found that, using only moderate sea level rise projections, nearly 170 coastal communities (almost twice as many as currently) will be chronically inundated as a result of normal tides. Most of these communities will be in Louisiana and Maryland. By 2060, the number of chronically inundated communities jumps to 270, and by the end of the century, 490.

The UCS’ projections did not take into account storm surges. Earlier in the summer, however, a group of Princeton and Rutgers researchers reported on “amplification factors,” which are a function of the frequency distribution of storm surges and the amount of local sea level rise. These researchers believe that the Intergovernmental Panel on Climate Change’s previous estimate of the amplification effect was too simple and so it applied different probability distributions to project increased flooding as a result of sea level rise. They estimated a median 40-fold increase in the expected annual number of local, 100-year flood events along the U.S. coast by 2050.

The increased precipitation that results from global warming combines with sea level rise, normal tides, and amplified storm surges to increase the coastal flooding risk. A presentation at the fall meeting of the American Geophysical Union in New Orleans reported that, while there was no clear scientific evidence that global warming made Hurricane Harvey’s *occurrence* more likely, global warming increased the severity of its impacts. Maximum moisture content of the air increases between 6 and 8.5 percent per degree of warming. Putting aside the inundation caused by the storm surge, global warming made the precipitation of Hurricane Harvey about 15 percent more intense.

Disclosure Obligations

A number of SEC rules require public companies to disclose material risks to their businesses in their periodic reports. In February 2010, the SEC issued guidance on how these rules apply to risks arising from climate change. The 2010 guidance did not change the underlying “materiality” standard for risk disclosure, so only climate change-related risks that are material to the business must be disclosed. Despite the Trump Administration’s abrupt about face on nearly all Obama-era climate change policy, so far the SEC’s 2010 guidance remains intact.

The SEC’s 2010 guidance specifically recommended that businesses vulnerable to the effects of severe weather, including floods or hurricanes, consider disclosing material risks, including interruption to their

businesses, potential property damage, and indirect financial and operational impacts from disruption to operations of major customers or suppliers. The guidance also noted that the preponderance of property losses paid by insurers were weather-related.

Most would not characterize the SEC’s application of its 2010 guidance as rigorous. In the fall of 2016, the SEC sent letters to two big oil and gas companies pointing out inconsistent statements in their filings. One of those letters sought clarification of the company’s statements regarding how the “uncertainty of physical risks” might lead to “reduction/disruption of production capacity.”

For the past many years, the climate change disclosures of public companies operating fossil fuel-fired power plants have received the most scrutiny chiefly because of then impending legal reductions on their carbon emissions. Given 2017’s findings, coastal power plants may come under scrutiny from a different perspective – potential business interruption and property damage risk resulting from the power plants’ coastal location.

Past disclosures by two other commercial sectors – one sector that’s already been closely scrutinized and another that hasn’t – provide an interesting context for considering what we might see in this spring’s filings. Insurers that face exposure for coastal property loss have already drawn scrutiny. Hotel and resort operators with valuable properties in coasting settings haven’t drawn much scrutiny yet. Will they be drawn into the fray by 2017’s findings?

For insurers, severe weather brought about by global warming is just one of a litany of risks that cause them to make payments to their insureds. Add it to earthquakes, hailstorms, explosions, fires, war, acts of terrorism, natural disasters, cyberattacks, and wide-impact pandemics. A general disclosure that the insurer “may be subject to increased losses from catastrophes and other weather-related events” (or “occurrence of one or more catastrophic events could have an adverse effect on our results of operations and financial condition”) may suffice to cover their increased exposure to pay outs due to coastal flooding.

It’s interesting to note that even putting aside flood coverage exclusions in their policies, insurers who underwrite property-related losses have already disclosed greater “claims relating to potentially changing climate conditions, including higher frequency and severity of weather-related events.” Some already draw the specific connection to global warming. “Climate conditions may be changing, primarily through changes in global temperatures, which may increase the severity of natural catastrophes and the resulting losses in the future.”

Some property insurers’ past disclosures have already been transparent with regard to their planning for losses likely to arise from global warming. Disclosures can describe fairly general business planning practices. “The company regularly reviews emerging issues, including changing climate conditions, to consider potential changes to its modeling . . . to help determine the need for new underwriting strategies.” They may also disclose that their “catastrophe models may be less reliable due to the increased unpredictability in frequency and severity of severe weather events.”

One property insurer has been transparent about the specific underwriting changes it’s made in response to these risks. It disclosed that it limited writing home-

owners policies in “certain coastal geographies,” “ceased writing new homeowners business in Florida,” and put “tropical cyclone deductibles” in place for “a large portion of coastal insured properties.”

Property insurers frequently find refuge in the uncertainty and unpredictability of severe weather events. They warn “the nature and level of catastrophes in any period cannot be predicted,” or we “cannot predict the impact of changing climate conditions.”

To date, hoteliers have had little to say about global warming’s effect on their business. The annual filing of one of the world’s largest hotel chains (operating, presumably, a fair number of coastal properties) mentions neither climate change nor global warming. A couple of its peers at least use the term “climate change” in their SEC filings. Of those, one acknowledges “disruptions caused by severe weather” (without mentioning cause) could “make travel to a particular region less attractive or more difficult.” The other simply lumps floods in with other disasters (earthquakes, tsunamis, tornados, hurricanes) that could threaten its business.

Is There More to Say?

It’s hard to fault any company for acknowledging the unpredictability of the weather. None of 2017’s scientific findings overcome that enduring truth. What the 2017 findings do, however, is increase confidence in the likelihood of more frequent and more severe coastal inundation. While we may be no closer to predicting the when and where, we know that coastal flooding will occur more frequently and be more severe.

Perhaps the following is a fair summary of 2017’s findings and could be the basis for considering disclosure in this spring’s filings: Recent scientific reports predict that global warming is likely to increase both the occurrence and severity of coastal flooding. Sea level rise, the effect of normal tides, storm surges, and increased precipitation during storm events – all of which are attributable to global warming – combine to create this risk. While there remains uncertainty with respect to the where and the when, these reports establish that coastal flooding will be both more frequent and more severe.

Based on this scientific disclosure, what additional business-risk disclosure companies provide will depend on the materiality of more frequent and more severe coastal flooding on their financial condition and results of operations.

Petrochemical businesses clustered along the Gulf Coast — walloped last year by Hurricane Harvey —

might have more to say this spring. The potential for damage to be done to their physical plant, power outages, the inability of employees to get to work, interruption of shipments, etc. are foreseeable outcomes of more frequent and severe coastal flooding. Some companies with refining operations in the region have already disclosed steps they have taken to harden their operations against storm surges. In this spring’s filings, other may follow their lead.

Will the hotel and resort sector have more to say this spring? The materiality of the greater risk of coastal flooding will depend, of course, on the locations of the hotelier’s properties, whether they own the real estate or just operate the hotel, those properties’ contribution to the company’s total revenue, etc. It could be that the contribution of coastal properties to the company’s total revenue makes coastal flooding an immaterial risk. The proportion of coastal properties relative to the overall owned and operated hotel portfolio could mean that the revenue interruption due to more frequent and more severe coastal flooding — or even damage or destruction of owned properties — would not have a material effect on a company’s financial results. Or, they could be confident in insurance recovery for any flood-related losses.

All that could be true, and yet hotel companies might find this to be the year to be transparent with their investors about their assessment of the risk of increased coastal flooding. In light of 2017’s findings, this could be the year hoteliers end their relative silence about global warming. They might choose this as the year to explain why they regard the risk as immaterial. Geographic diversification or ample insurance coverage could mean that interruption of operations at (or damage to) even several coastal resorts simultaneously would not have a material effect on their financial results for any particular fiscal period. Investors might find the disclosure of that assessment meaningful.

Even property insurers whose disclosures have been more transparent to date might acknowledge 2017’s findings in this spring’s filings. Without retreating from their position that weather is inherently unpredictable, they might concede that, even with the unpredictability, and depending on their underwriting practices, best projections suggest they may suffer more frequent and more severe loss from coastal flooding. If they take that step, then they may take the next step of being more transparent about the changes in their underwriting practices to account for this more certain loss. Investors might find greater transparency on that front meaningful as well.