Contractors Must Prep For FAR Council GHG Emissions Rule

By **Thomas Daley, Steven Rothstein and John Kostyack** (May 28, 2024)

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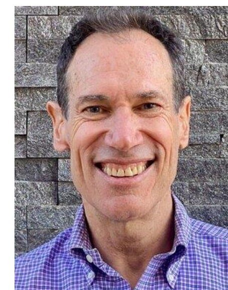

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Later this year, the U.S. Federal Acquisition Regulatory Council — composed of representatives from the U.S. General Services Administration, the U.S. Department of Defense, the National Aeronautics and Space Administration, and other federal agencies — is expected to finalize its proposed rule on the disclosure of greenhouse gas emissions and climate-related financial risk.

The proposed rule requires that "significant contractors" disclose their emissions from their operations and from their energy purchases — known as Scope 1 and 2 emissions. It requires "major contractors" to disclose these, as well as their supply chain and customer emissions — known as Scope 3 emissions.

The proposed rule also requires major contractors to complete an annual climate risk disclosure, and to set emission-reduction targets. The penalties for noncompliance are significant, as agencies must presume that a noncompliant contractor is "nonresponsible" and ineligible for award, although waivers are authorized.

Contractors should be actively developing a plan for meeting the requirements in the proposed rule. This article outlines four specific actions that contractors should be considering.

Determine whether your company is a significant or major contractor.

The first step in developing a plan for complying with the proposed rule is to determine whether, and to what extent, the rule applies to your company. As described above, the proposed rule creates two categories of contractors.

"Significant contractors" are defined as contractors that received between $7.5 million and $50 million in federal contract obligations in the prior federal fiscal year. "Major contractors" are defined as contractors that received in excess of $50 million in prior-year obligations.

This initial step is important, because the proposed rule is not applicable to contractors with less than $7.5 million in prior-year obligations, and it imposes materially different requirements on significant and major contractors.[1]

A number of comments submitted in response to the proposed rule asserted that the term "federal contract obligations" is not clearly defined, and requested that the FAR Council clarify the definition.

Notwithstanding that asserted ambiguity, the proposed rule states that federal contract obligations are "indicated in the System for Award Management," known as SAM.gov — which suggests that contractors can determine whether they are a significant or major contractor, or not subject to the rule, based on the information in SAM.gov.

That information, however, is not always completely accurate, and in certain situations, may be inconsistent with a company's internal sales data. In the event that a discrepancy arises, a company may need to reconcile the differences between the data in SAM.gov and the company's internal data.

This may involve determining whether a transaction or sale should be included as a federal contract obligation. This is particularly important when the company's data and the data in SAM.gov differ as to whether the company should be classified as a major contractor or a significant contractor.

The proposed rule contains limited exceptions for significant and major contractors. To the extent that a company meets one of the identified exceptions — e.g., for Alaska Native Corporations, universities, or nonprofit entities — it would not be required to comply with the requirements for significant or major contractors.

The DOD recently issued a class deviation that tracks Section 318 in the National Defense Authorization Act for fiscal year 2024 regarding disclosure of GHG emissions.[2] The class deviation states that DOD contracting officers may not require that any nontraditional defense contractor, as a condition of being awarded a DOD contract, disclose GHG emissions, unless such disclosure is necessary to verify a voluntary disclosure of the nontraditional defense contractor or is directly related to contract performance.

Although the class deviation limits the ability of DOD agencies to require disclosure of GHG emissions by nontraditional defense contractors "as a condition of being awarded a DOD contract," the limitation does not apply to all defense contractors, nor does it prohibit civilian agencies from requiring disclosure of GHG emissions as a condition of award.

Moreover, DOD agencies can still require that nontraditional defense contractors disclose GHG emissions, so long as it is not a condition of award, and can require sustainability disclosures that include GHG emissions as a deliverable during contract performance.

Decide whether subsidiaries will report at the entity level or the parent level.

The proposed rule allows a company that is part of a larger organization to meet the applicable requirements itself or through its immediate or highest-level owner.

An "immediate owner" is an entity that has direct control of the offeror in a federal procurement. A "highest-level owner" is the entity that owns or controls an immediate owner of the offeror, or that owns or controls one or more entities that control an immediate owner of the offeror.

Companies should carefully consider whether to report at the entity level or the parent level, as there are advantages and disadvantages associated with both approaches.

For instance, reporting at the parent level might be more efficient and cost-effective, particularly when a company is part of a corporate organization in which there are multiple significant or major contractors subject to the proposed rule.

In that situation, the companies may elect to make a single annual climate disclosure and set overall emission-reduction targets at the parent level, rather than having to do so for each individual entity within the organization.

The proposed rule does not include provisions governing how agencies will use contractors' emissions data in procurement decisions, but future rules and policies may reward those with lower or less intense GHG emissions. Thus, a company that has lower or less intense GHG emissions than the other companies in the corporate organization may be competitively disadvantaged by having to use the overall GHG emissions for its highest-level owner.

In other words, a company with relatively low GHG emissions may benefit from reporting at the entity level, rather than the parent level — even if more work is required to do so.

Start or build on the process of inventorying and disclosing GHG emissions and meeting other requirements.

The proposed rule provides that the Scope 1 and 2 requirement is expected to become effective one year after the final rule is published. By contrast, the requirements for Scope 3 emissions, annual climate risk disclosures and emission-reduction targets are expected to become effective two years after the final rule is published.

The one- and two-year implementation timelines will arrive quickly for companies that have not started to prepare for the final rule. For example, a contractor that has not previously completed a GHG inventory will need to:

- Review and understand the relevant accounting standards and methods;
- Determine organizational and operational boundaries;
- Choose a reporting and base year;
- Gather data aligned to that year;
- Develop a GHG inventory management plan to formalize and standardize data collection procedures; and
- Determine the associated GHG emissions.

Scope 3 emissions are notoriously challenging to calculate, and thus reasonable estimates are common. There are 15 categories of Scope 3 emissions that cover the entirety of a company's supply chain, including upstream and downstream activities, which can make it difficult to collect reliable data.

Moreover, the proposed rule currently requires that emission reduction targets be validated by the Science Based Targets Initiative, or SBTi, which is an organization that develops standards, tools and guidance regarding how companies can set targets that are aligned with reaching net-zero emissions by 2050 or earlier.

Obtaining SBTi validation can be a separate task that typically involves back-and-forth between the applicant and SBTi regarding the applicant's targets. Although there have been efforts to remove the SBTi requirement from the final rule, it may include a requirement for third-party validation of emission-reduction targets, and contractors will need to build time into their compliance schedule for obtaining such validation.

The importance of starting to plan for compliance is underscored by the mandate in the

proposed rule that a significant or major contractor that is not in compliance with the requirements when they become effective generally must be presumed to be nonresponsible.

A contracting officer may overlook a contractor's noncompliance with the final requirements only when the noncompliance resulted from circumstances beyond the contractor's control; the contractor has demonstrated a substantial effort to comply; and the contractor has made a commitment to comply as soon as possible on a publicly available website.[3]

Thus, being in compliance with the final requirements when they become effective could be a critical competitive discriminator for contractors.

Incorporate compliance with the proposed rule into your company's overall responsible business strategy and climate-related disclosure plan.

The proposed rule is only one of the climate-related risk reporting requirements to which a company may be subject.

The U.S. Securities and Exchange Commission recently issued its climate disclosure rules requiring disclosure of material Scope 1 and 2 emissions, although those rules are currently stayed. And there are existing GHG disclosure requirements in Europe and a growing list of countries around the world.

California also has requirements for certain companies to disclose Scope 1, 2 and 3 emissions. And other states, including Washington, New York and Illinois, are considering laws that would require disclosure of GHG emissions.

Contractors, therefore, should consider whether, in addition to the proposed rule, they are subject to other reporting requirements, and, if so, seek to develop efficiencies where there is overlap between requirements.

Although companies may not have already begun inventorying and disclosing GHG emissions and developing an overall climate and responsible business strategy, many companies are already doing so. Indeed, nearly 75% of companies in the S&P 500 made climate risk disclosures in 2022.

Additionally, contractors that disclose GHG emissions may benefit competitively from doing so, because federal agencies in certain procurements — e.g., Alliant 3 — have started to include evaluation criteria that are favorable to offerors that are publicly disclosing their GHG emissions.

Companies can also find this process can be beneficial for their investors, customers, employees and stakeholders. For all of these reasons, it is time for contractors to start actively planning for compliance with the proposed rule.

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[1] In the proposed rule, the FAR Council estimated that approximately 98% of SAM-registered federal contractors would be below the $7.5 million threshold.

[2] See Class Deviation 2024-O0009, Prohibition on Required Disclosure of Information Relating to Greenhouse Gas Emissions (Feb. 25, 2024). Additionally, there is an open DFARS case (Case No. 2024-D021) that seeks to implement section 318 of the NDAA for FY 2024 regarding disclosure of GHG emissions.

[3] The proposed rule also allows agencies to waive the requirements for emergencies, national security or other mission-essential purposes.