

# PUBLICATION

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## Is It Time For All Businesses To Form A Climate Strategy?

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While the recent Democratic takeover of Congress has sparked considerable discourse concerning the prospect of U.S. climate change legislation, an equally important shift has taken place in the boardrooms of the once skeptical business world. Several influential corporations have begun to accept, if not embrace, climate change as a political reality and have begun to urge the Bush administration to move forward with a comprehensive mandatory policy to lower carbon and other greenhouse gas (GHG) emissions (1). Leaders of this business coalition include industrial heavyweights such as DuPont, General Electric, Duke Energy, Alcoa and PG&E Corp. Further, major emitting companies have already spent substantial amounts of time and resources developing climate strategies by assessing their potential exposure and risk, taking steps to reduce GHG emissions, and identifying new business opportunities that would emerge in a mandatory emissions reduction regime.

The business community's realignment on climate change policy is not so much the result of environmental stewardship as the result of strategic decision-making. Increasingly, companies and investors view emission caps as inevitable and understand that a failure to begin to implement emission reduction strategies now will result in future disadvantages in international competition, not to mention in missed opportunities to capitalize upon new and profitable economic ventures. Further, with only two years left in the Bush Administration, many business leaders are willing to hedge their bets that a U.S. climate program negotiated and implemented by the current Administration will be more flexible and predictable – not to mention less stringent – than a policy constructed later.

With the climate change debate moving toward the political tipping point, and with signs that legislation is increasingly likely, is it also time for mid-size, non-utility and non-fuel producing businesses to develop their own climate strategies? While fuel producers and electric utilities arguably have the largest stakes in the formulation of a GHG regulatory system, every emitting entity in the manufacturing, building and agricultural sectors may face new challenges and opportunities. Companies should assess these challenges and opportunities and contemplate development of both a long-term climate strategy and a more immediate policy engagement strategy.

## Potential Challenges and Opportunities Emerging from a Mandatory Regulatory System

While the types of obligations and costs imposed on companies by a carbon cap would vary depending on the type of regulatory system used, the method of emission allocation, as well as the location and stringency of targets, potential obligations and costs for all businesses include:

- Direct regulation of GHG emissions
- Increased energy costs
- SEC reporting requirements
- Effects in business relationships with businesses regulated by multinational, state or regional initiatives
- Potential investment opportunities

## Who Will Be Targeted By Regulations and How Are Non-Regulated Businesses Affected?

Regardless of whether reductions are targeted through a cap and trade system, carbon tax or intensity-based (2) system, a reduction regime must identify whether it will regulate upstream or downstream emitters. In an upstream regulatory system, fuel producers – extractors, processors and pipeline operators – are required to obtain allowances or pay taxes for emissions attributable to their products. The downstream users of this fuel are not directly regulated in their use but necessarily encounter increased costs. These costs would take the form of increased electricity and gas prices, theoretically in proportion to the producers' increased implementation costs. Upstream systems are generally lauded for their manageability, cost-effectiveness and ability to capture all economy-wide sources of emissions.

In contrast, a downstream regulatory system targets fuel-consuming emitters. A downstream scheme would likely begin at electricity-generating utilities and could also include any entities within the auto, building, manufacturing and agricultural industries. Generally such a system would take a "hybrid" approach through which it would impose different reduction targets and mechanisms on different fuel uses and different regulated economic sectors. Downstream approaches are generally supported for their ability to maximize reductions. Indeed, since a large percentage of emission reductions must necessarily take place at electrical power plants, it can be argued that an efficient regulatory regime should directly target these plants.

In both an upstream and downstream approach, non-regulated entities will primarily encounter costs in the form of increasing fuel and utility prices. These users would generally benefit from a point of regulation that would encourage the most cost-efficient reductions, as such efficiency would translate into comparatively lower transferred costs.

## How Will Allowances be Allocated?

Perhaps a more important question for non-regulated entities is the manner in which allowances are allocated. Regardless of whether regulations are imposed upstream or downstream, regulated entities will urge free allowances of emissions to themselves, as opposed to an auction through which entities buy allocations and revenues are recycled to lower taxes or invest in technology. The general rationale behind free allocation of allowances is that a regulated entity should not have to pay allowance costs and then subsequently have to pay reduction costs to meet those allowances. The dangers behind free allowances are the potential economic windfalls for recipients and resulting market distortions.

It is likely that any cap system would, at least in the beginning, freely allocate allowances. If all allocations are granted exclusively to covered entities, entities further downstream from the point of regulation may be subject to bearing disproportionate costs of regulation – in the form of transferred costs – without sharing in benefits of allocation and the direct incentives to reduce emissions. Therefore, unregulated entities have an interest in lobbying for allocation schemes that contemplate a balancing of financial interests, such as setting aside a portion of allowances for non-regulated entities that undertake projects to reduce emissions.

## Who Will be Subject to SEC Disclosure Requirements?

Another emerging consideration for entities is whether they have a present duty to assess and disclose to shareholders any potential financial effect that carbon caps would have on their business. Many fuel producers, utilities and insurers have already implemented analytical evaluations of the potential exposure they face from compliance with future emission regulations. Indeed, nearly all of the electric utilities and seventy-five percent of oil and gas companies are already reporting climate risks (3).

SEC guidelines require that a public corporation disclose any information that has a material impact on the corporation's finances. If in fact the U.S. does move toward a mandatory emissions cap or tax, such a cap will

likely create new considerations of financial exposure and opportunity, not only for oil and gas and power companies, but also for downstream industries to whom costs are transferred and opportunities presented. Accordingly, entities that are unprepared to evaluate and report the effects of GHG regulation on their respective businesses could face a number of problems, ranging from SEC and shareholder actions to strained relations with climate-conscious banks and insurers.

## What are Some Emerging Economic Opportunities?

In addition to the potential of increased costs for businesses, a mandatory reduction system and emerging carbon market also have the potential to create dynamic growth opportunities. For example, a trading system would allow companies who are able to efficiently cut their emissions to sell those emission reductions on the open market. Similarly, carbon sink "offset" provisions would allow farmers and foresters to earn revenue from growing and selling GHG reduction credits. Further, if the U.S. system is linked internationally, it could embrace elements similar to the Kyoto Protocol's joint implementation (JI) and clean development mechanism (CDM), whereby companies can invest in new projects abroad and credit any reductions from those projects to their allocation portfolio.

More immediately, companies may find myriad economic opportunities in investments in new types of alternative energy. The House of Representatives has already passed a bill rescinding as much as \$14 billion in subsidies and tax breaks from the oil industry (4). It is anticipated that considerable portions of these funds will be transferred to research and production efforts for new fuel sources, including ethanol, biofuels, renewables and nuclear energy. Such incentives would provide enormous opportunities to pursue profitable investments in non-carbon energy sources.

## Conclusion

With the fast-changing political landscape of the climate debate and with the reasonable possibility of impending legislation, it may be time for all businesses – not just major energy companies – to evaluate the potential effects that a mandatory carbon reduction system would have on their respective profitability, growth strategies and risk forecasts, and to become engaged in the national and state public policy processes. Such early initiative will allow companies to not only mitigate any serious financial impacts but also to capitalize on numerous opportunities.

(1) See ["Major Businesses and Environmental Leaders Unite to Call for Swift Action on Global Climate Change – U.S. Climate Action Partnership Cites Environmental and Economic Benefits."](#)

(2) An intensity-target system of regulation would require reductions in percentages of GHGs emitted per unit of economic output (Gross Domestic Product) and is generally considered less burdensome than an emissions cap. Senator Jeff Bingaman (D-NM) has proposed a bill that would initially regulate emissions through this type of system. See National Commission on Energy Policy, "EIA: Bingaman Climate Bill Poses Little Economic Pain," Jan. 12, 2007.

(3) See Friends of the Earth, "Fourth Survey of Climate Change Disclosure in SEC Filings," Sept. 2005.

(4) See Washington Post, "House Repeals Tax Breaks for Big Oil," Jan. 19, 2007.