

Inspired thinking



US climate change policy: headed for 'cap and trade'?

Climate change is clearly the most important environmental challenge facing the world today, and it now appears to be firmly on the agenda of the 110th Congress of the United States. The power shift in Congress after the November 2006 elections (with the Democrats now controlling both the Senate and the House of Representatives) has opened a little wider the once firmly shut window through which federal climate change legislation might be tabled. Most crucially, the new Speaker of the House, Nancy Pelosi, is keen to bring climate change legislation to the House floor imminently, and several key Senate committees are now headed by strong proponents of federal legislation in this area. In addition, in April of this year, the US Supreme Court rebuked the Bush administration's inaction on climate change and ruled that: a) carbon dioxide and greenhouse gases (GHGs) are air pollutants under the Clean Air Act, and; b) the Environmental Protection Agency has the authority to regulate these emissions from new cars and trucks under that law.

During the first seven months of this year, US lawmakers proposed over 125 bills, resolutions and amendments addressing a wide range of climate-change-related subjects such as GHG monitoring and reporting, GHG emissions reduction programmes, international climate change negotiations, and funding for climate science and climate-friendly technologies research, among others. If enacted into law, many of these proposals have the potential to deliver important environmental benefits. In addition, many could provide vital support to the budding renewable energy and environmental technology sectors that offer potential solutions to climate change.

However, it is the market-based 'cap-and-trade'¹ proposals that, if well crafted, are the most likely to deliver significant GHG emissions reductions at the least economic cost. While a small number of state and regional cap-and-trade programmes have already been initiated, industry support for a federal programme seems to be growing. Recent months have seen numerous calls for cap-and-trade legislation from industry executives from companies as diverse as GE, BP, Duke Energy and Lehman Brothers.

The major cap-and-trade bills proposed to date include the:

- **Climate Stewardship and Innovation Act of 2007 (S. 280)**. Introduced by Senators Lieberman and McCain, this is a revised version of bills that the senators introduced in the 108th and 109th Congresses. It proposes regulating the electric generation, transportation, industrial and commercial sectors (representing about 85% of US GHG emissions), capping their GHG emissions at 2004 levels by 2012, declining to about 1/3 of 2004 levels by 2050. Emissions allowances would be allocated at no cost. The bill would allow for 15% of reduction requirements to be met through GHG credits from foreign sources, sequestration, and reductions from non-covered entities.
- **Climate Stewardship Act of 2007 (H.R. 620)**. Introduced by Olver and Gilchrest, this bill is largely identical to its companion bill in the Senate, the Climate Stewardship and Innovation Act of 2007 (see above), although calls for more stringent long-term emissions reductions – about 1/4 of 2004 levels by 2050.

- **Global Warming Pollution Reduction Act (S. 309).**

The most stringent proposal being debated, this amendment to the Clean Air Act was introduced by Senators Sanders and Boxer. It would require economy-wide reductions of GHG emissions to 80% below 1990 levels by 2050, in three stages beginning in 2010. Interestingly, it gives the Environmental Protection Agency (EPA) discretion to design the precise regulatory regime (one of the options being cap-and-trade). The bill also contains a number of additional regulations including emissions standards for power plants, emissions standards for new vehicles, renewable portfolio standards for electricity suppliers and national quotas for renewable fuel use for transportation.

- **Electric Utility Cap and Trade Act of 2007 (S. 317).**

This bill would regulate GHG emissions from electricity generators over 25MW only. It was introduced by Senators Feinstein and Carper and caps the GHG emissions of affected facilities at their 2006 levels beginning in 2011, declining to 2001 levels by 2015. After that, the emission cap would decline 1% annually until 2020, then 1.5% per annum thereafter – to about 40% below 2001 levels by 2050. Emissions allowances would be both allocated and auctioned. This bill also allows for reduction requirements to be met with credits obtained from foreign sources.

- **Global Warming Reduction Act of 2007 (S. 485).**

The bill would require the reduction of GHG emissions to 1990 levels by 2020, annual reductions of at least 2.5% each year between 2021 and 2030, and annual reductions of at least 3.5% each year between 2031 and 2050. Introduced by Senators Kerry and Snowe, it would direct the EPA to design an economy-wide cap-and-trade programme, giving it discretion over sectors to be covered.

The bill also includes provisions regarding vehicle emissions standards, renewable transportation fuel quotas, energy efficiency standards, and national targets for renewable energy (referred to as renewable portfolio standards).

All of the proposals would impose mandatory caps on the emissions of the six major GHGs specified in the United Nations Framework Convention on Climate Change (UNFCCC): carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride. However, they differ in the sectors covered, the nature and stringency of the caps, and method of distributing allowances. In addition, all of these bills fail to address how they will link up with (if at all) the various state and regional GHG cap-and-trade initiatives currently being designed and implemented in the absence of federal legislation.

Many agree that it is now just a matter of time before federal climate change legislation – a cap-and-trade system, in particular – is enacted in the US. The diversity of proposals on the table will no doubt ensure a lively debate in the coming months. However, the persistent intransigency (although somewhat softened in recent months) of President Bush and many Republicans on the climate change issue, and uncertainty regarding a post-Kyoto global climate change agreement, will most likely prevent any real action by Congress until after the 2008 election.

From an investor perspective, while the broad direction of US climate change legislation seems clear, the uncertainties around its precise nature, scope and timing make it difficult to take informed investment decisions regarding companies that may be exposed to policy in this area.

1 'Cap and trade' is an administrative approach used to control pollution that provides economic incentives for achieving emissions reductions. A limit (cap) is set (usually by a government) on the total amount of a specified pollutant that can be emitted. Emitters are given credits (also known as allowances), which represent the right to emit a specific amount of that pollutant. Emitters that pollute beyond their allowances must buy credits from those who pollute less than their allowances (the trade) - or face large fines.

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