Climate Change:

The Heat Is ON

From reporting to trading, utilities try to meet new expectations.

By Douglas W. Smith and Kyle W. Danish

On the issue of global climate change, most utilities have devoted their attention to tracking developments in Washington, D.C., following the rising and falling fortunes of legislation that could result in federal greenhouse gas (GHG) reporting or regulatory requirements. For the most part, utilities have taken comfort in the resolutely anti-regulatory stance of the Bush administration on greenhouse gas emissions. Yet more and more, utilities are finding their inside-the-Beltway focus shaken by an array of outside-the-Beltway activities, ranging from state climate legislation to shareholder proxy actions and the threat of climate change tort suits.

This constellation of state, local, and shareholder activities is creating new pressures on utilities to take steps now to begin addressing their GHG emissions and their exposure to future regulation. Indeed, for all major industries, implementation of some kind of strategy on climate change is becoming a new criterion of corporate social responsibility.

Major utilities are responding to these pressures in a variety of ways. Many are taking inventory of their emissions and identifying internal mitigation opportunities. Others are participating in voluntary reporting programs or high-profile climate "leadership" groups, announcing voluntary limits on their GHG emissions, or exploring the emerging international emissions trading market.

Mushrooming State Climate Policies

Increasingly, states and municipalities under both Republican and Democratic leadership are establishing their own greenhouse gas regulatory or reporting programs. According to the *New York Times*, state legislatures have passed at least 29 bills in the last three years addressing climate change.

A number of the state policies are aimed at power plants:

- Massachusetts has imposed a requirement on the six highest-emitting power plants to reduce their rate of carbon dioxide (CO_2) emissions to 1,800 lbs/MWh by 2006.
- New Hampshire is requiring generators to reduce their CO_2 emissions to 1990 levels by 2010.
- Oregon requires all new power plants built in the state to have a CO_2 emissions rate 17 percent lower than the most CO_2-efficient power plant in operation in the United States. Plants may comply either "on-system" or through the purchase of CO_2 emission credits.
- The governor of Washington announced that the state might require any new power plant to offset 20 percent of its CO_2 emissions. And, in 2001, the city of Seattle passed a resolution directing municipal utility Seattle City Light to reduce or offset all of its CO_2 emissions.
- California has enacted the first-ever U.S. law requiring the development of standards limiting GHG emissions

from motor vehicles. Under the law, the standards will apply to model-year 2009 cars.

States are pursuing regional approaches as well, as the governors of California, Oregon, and Washington have pledged to work cooperatively on climate policies. In addition, work has begun on an ambitious climate change program for the Northeast. The governors of New York, Connecticut, Vermont, New Hampshire, Delaware, Maine, New Jersey, Pennsylvania, Massachusetts, and Rhode Island—six of whom are Republicans—have agreed to develop a regional GHG cap-and-trade program by April 2005. The first phase of the program will focus on the utility sector.

Non-regulatory programs also are multiplying among the states. Even as the Bush administration labors to revamp the federal voluntary greenhouse-gas reporting program, also known as the "1605(b) Program," nearly a dozen states and even a handful of localities are moving ahead with their own reporting programs. As large and visible emitters, utilities are likely to face substantial pressure to participate in the voluntary program of each jurisdiction in which they operate.

In addition, a determination by the Environmental Protection Agency (EPA) that it lacks any regulatory authority under the Clean Air Act to address climate change likely will open the door for more states and municipalities to develop climate programs.

The emergence of multiple state and local climate programs could have significant implications for utilities. Although some efforts are under way to coordinate regional, state, and local climate change programs, those programs are likely to vary significantly. Diverse policies could present real problems for utilities. Electricity grids and markets increasingly are becoming regional, if not national in scope. For utilities doing business in multiple states and regions, a patchwork of different state and regional climate policies will complicate business planning and could have significant implications for competition. Moreover, inconsistent state and regional policies related to emissions accounting and crediting systems could inhibit the development of cost-saving emissions trading markets. For these reasons, the proliferation of inconsistent state and local policies eventually could give rise to calls from regulated entities for national greenhouse gas legislation.

The Rise of a Shareholder Movement

Another recent development for utilities is the rise of a shareholder movement aimed at forcing a more progressive corporate response to climate change. A loose coalition of state pension funds, religious funds, and green activists are making the argument that a company's response (or failure to respond) to the risks and opportunities associated with climate change and climate change policies can have a material bearing on shareholder value.

Taking a page from the playbook of the anti-tobacco and anti-apartheid movements, these groups have advocated shareholder resolutions targeted at major energy companies. In 2003 shareholders filed 23 resolutions requesting that companies report on the economic risks and opportunities associated with potential—or, in the view of most of the proponents, inevitable—future greenhouse gas regulation. In the utility sector, advocates have succeeded in getting resolutions considered by shareholders of American Electric Power, Cinergy, PG&E, Southern Co., TXU, and Xcel. These resolutions have garnered 20 to 25 percent support of the shareholders. The proponents have claimed a moral victory in these results, asserting that support for shareholder resolutions on social and environmental matters typically have garnered less than 10 percent of proxy voting.

These shareholder resolutions have attracted coverage in the *Wall Street Journal*, *New York Times*, and on CNN. Typically, resolutions have asked the targeted company to prepare a report to shareholders on: (1) the economic risks associated with the company's past, present, and future emissions of greenhouse gas emissions, and the public stance of the company regarding efforts to reduce these emissions; and (2) the economic benefits of committing to a substantial reduction of those emissions.

Though the corporate climate-change responsibility movement may have started among the activist ranks, there is increasing evidence that it is taking hold among conventional institutional investors. In a number of instances, Institutional Shareholder Services (ISS), the nation's largest advisory service for institutional and corporate investors, has issued recommendations that institutional shareholders vote in favor of these resolutions. In 2003, ISS recommended in favor of climate-change resolutions aimed at American Electric Power, ChevronTexaco, Exxon Mobil Corp., General Electric, Southern Co., and TXU. In the case of one of these ISS-endorsed resolutions, the *Wall Street Journal* concluded that the extent of shareholder and ISS support "suggested that mainstream institutional investors, and not just an environmentally focused fringe, voted for it."

A letter sent in November 2003 by a group of institutional shareholders to the 500 largest companies in the world (by market capitalization) shows more evidence of the growing interest of the traditional finance community in this issue. The letter requests that these companies release "investment-relevant" information about their GHG emissions. The group of institutional shareholders sending the letter has assets of more than $9 trillion under management and includes such firms as

Merrill Lynch Investment Managers.

Another sign that concern about corporate climate policies is moving from the bumper-sticker crowd to the pinstripe-suit crowd is the increased scrutiny from the insurance industry. An official from a leading provider of directors-and-officers liability insurance, Swiss Re, told the *Wall Street Journal* that the company is surveying its corporate customers to assess their climate-change planning. Christopher Walker, a U.S.-based managing director for Swiss Re, explained that the company is considering withdrawing policies for companies it deems inadequately prepared for future regulation. Walker claims that companies that fail to prepare for climate regulation may expose themselves to later lawsuits by shareholders.

Implicit in this activity by the more traditional financial community is concern about a bottom-line issue—namely, the extent to which utilities are positioning themselves to deal with the economic impact of future regulation. The possibility of future greenhouse gas controls casts a long shadow over utility balance sheets, particularly because power plants are capital-intensive and have long life spans. For utilities and their investors, the possibility of future carbon constraints has critical implications for decisions about retrofitting older coal-fired power plants, for example. In addition, possible carbon constraints could substantially affect the future value of new plants investors are considering today.

Are Lawsuits Next?

According to a July 2003 article in the *Financial Times*, a number of lawyers have their sights set on emitters—not merely for poor investment planning, but also for the damages from climate change itself. A tough-talking new international group, the Climate Justice Programme, is threatening to bring tort class actions against companies and asserts that "the potential compensation for climate change impacts would make the tobacco payouts look like peanuts."

As a matter of law, suits pinning responsibility for climate-related damage on individual emitters would face numerous obstacles. Establishing causal links between particular entities and particular impacts, apportioning responsibility, and determining who should be compensated and by how much—all would be significant challenges for tort or nuisance-based climate litigation.

Still, even weakly substantiated lawsuits could have an impact on the defendants in the court of public opinion. No company will be eager to answer charges that its actions have contributed to rising sea levels, the spread of diseases, more violent storms, longer-droughts, crop failures, or other projected climate-related harms. Furthermore, no company will be eager to bear the costs of defending such suits.

How Utilities Are Responding

Cumulatively, the various state and local initiatives amount to a new kind of outside-the-Beltway pressure system on utilities to demonstrate their readiness and ability to manage the risks—and, in some cases, opportunities—associated with operating under potential future carbon constraints. In other words, utilities are facing new expectations that they will implement a prudent corporate climate-change risk management strategy. Leading U.S. utilities are responding to this challenge in a variety of ways, ranging from undertaking internal risk assessments to participating in the emerging international emissions trading marketplace.

Many utilities are taking steps to inventory their emissions and, in the process, are identifying their lowest-cost internal mitigation opportunities. PacifiCorp has taken the further step of assigning a "shadow" internal price to its carbon dioxide emissions. In setting the shadow price, PacifiCorp has attempted to forecast the timing and stringency of potential future climate policies.

After inventorying emissions, participation in emissions reporting programs builds capacity for emissions management and signals seriousness about overall climate risk management. At the direction of the president, the Department of Energy is taking steps to upgrade the 1065(b) program, and many utilities are planning to participate in the reformed program. However, for reasons discussed above, utilities also may face pressures to participate in one or more of the various state and local reporting programs currently under development.

Participation in climate leadership groups offers utilities the opportunity to demonstrate to the public a proactive stance on this issue. A large number of utilities are participating in Power Partners, the industry's partnership with the Department of Energy that aims to promote voluntary emission reduction activities. To further distinguish a progressive stance on climate change, some utilities also have joined multi-company groups that emphasize additional proactive steps. For example, Cinergy, We Energies, the FPL Group, and American Electric Power have joined EPA's Climate Leaders program, under which members commit not only to rigorous reporting obligations but also to the development of specific emission reduction goals.

A further means of distinguishing a company in the eyes of the public is to join a climate leadership group established by an environmental organization. Entergy has joined seven companies from other industries in becoming a member of Environmental Defense's Partnership for Climate Action. Currently, the World Wildlife Fund-U.S. is soliciting companies to join its PowerSwitch! group, for which a utility member must both support binding national limits on carbon dioxide and commit to: (1) ensuring that at least 20 percent

of its electricity sales come from renewable energy; (2) increasing energy efficiency by at least 15 percent by 2020; or (3) retiring the less efficient half of its coal generation by 2020.

A few major utility companies have taken the additional step of voluntarily adopting a corporate GHG limit:

- **Entergy.** The first major company to adopt such a limit committed in 2001 to stabilizing its GHG emissions at 2000 levels through 2005. Pursuant to this goal, Entergy has financed 34 internal emission-reducing projects, and it expects more than 1 million tons of CO_2-equivalent reductions by 2005. Entergy also has completed or initiated 11 external offset projects, resulting in another 650,000 tons of CO_2 equivalent reductions by 2005.
- **DTE.** It aims to reduce its emissions by five percent from 1999 levels by 2005.
- **American Electric Power.** The company has committed to capping its CO_2 emissions at the average of 1998-2001 levels and to reduce or offset its emissions by a cumulative 10 percent over the period 2003-2006.
- **Cinergy.** Committed to reducing its GHG emissions to an average of five percent below 2000 levels from 2010 to 2012. The company has announced that it will spend $21 million between 2004 and 2010 on projects to reduce or offset its emissions. Environmental Defense is providing oversight to Cinergy in its initiative.
- **The FPL Group.** The latest company to announce a voluntary emission reduction goal has pledged to reduce its GHG emissions 18 percent per kilowatt-hour from 2001 to 2008.

The above examples do not include a range of other climate-friendly activities companies are implementing, including commitments to renewable energy and demand-side management programs. Indeed, many companies implementing such activities could be doing more to quantify and take credit for the sizable emission reductions resulting from such activities.

Several utilities also are exploring the growing international emissions trading market. These utilities have several motivations, including learning-by-doing, shaping future policies, and obtaining what may be valuable future rights at what are, for now, very low prices. Many utilities have undertaken bilateral trades. Entergy, for example, purchased and retired allowances from Denmark's climate program in 2001. In addition, 25 utilities have invested in PowerTree, an initiative that will fund carbon sequestration projects in the United States and distribute the rights to the sequestration to the investor-members.

Finally, a number of utilities are examining possible membership in the Chicago Climate Exchange (CCX). Through the CCX, companies that commit to a particular schedule of GHG emissions reductions can participate in a voluntary international emissions trading exchange in which credits will be available for compliance purposes. The baseline for a CCX member's emissions target is the member's average annual emissions during 1998 to 2003. Each member commits to reducing its emissions 1 percent below its baseline during 2003, 2 percent below its baseline during 2004, 3 percent below its baseline during 2005, and 4 percent below its baseline in 2006. Companies with declining emissions could be in a position to make money in the Exchange. For now, one utility—American Electric Power—has joined DuPont, Waste Management Inc., Ford Motor Co., Motorola, IBM, International Paper, and a number of other major corporations in launching the CCX.

Irrespective of the current status of climate-change politics in Washington, D.C., utilities face increasing pressure from other sources to demonstrate their readiness for the risks and potential opportunities of future greenhouse regulation. As shown above, leading U.S. utilities are already meeting this challenge in a number of ways. F

Doug Smith is a member in the Washington, D.C., office of Van Ness Feldman P.C. and was general counsel of the Federal Energy Regulatory Commission from 1997-2001. Kyle Danish is a senior associate in the Washington, D.C., office of Van Ness Feldman P.C. and one of the leaders of the firm's Climate Change practice. Contact Smith at dws@vnf.com and Danish at kwd@vnf.com.