February 15, 2008

Climate Change Policy Update
Week of February 11-15, 2008

Commentary: *This week's hearing in the Senate Finance Committee was notable for the broad level of agreement around the idea that a federal cap-and-trade program should incorporate some form of trade sanctions for imports from countries that do not have an absolute emissions cap . . . California continues to move closer to design of its state program under AB 32. The CA Public Utilities Commission (CPUC) is recommending a cap-and-trade program for the utility sector and eschewed "upstream" regulation of natural gas in favor of downstream energy efficiency measures. However, the CPUC recommendations did not reach such key design issues as allowance allocation and offsets . . . The Congressional Budget Office once again concluded that a carbon tax is the best climate policy, and that a cap-and-trade program with a safety valve would rank second. The CBO identified significant shortcomings with the kind of "Carbon Fed" alternative proposed in the Lieberman-Warner bill . . . Banks and financials continue to make statements indicating new plans to consider GHG regulatory risk in their investments in the energy sector, and to undertake new investment in clean energy and energy efficiency. This week saw such announcements from the Bank of America and a group of funds meeting at the UN Institutional Investor Summit on Climate Risk.*

Congress

- **Senate Finance Committee Hearing Addresses Competitiveness, Offset Provisions In Lieberman-Warner Bill.** At a Senate Finance Committee hearing on the effects of the Lieberman-Warner cap-and-trade bill on international competitiveness, Chairman Max Baucus (D-MT) said that the legislation should ensure that emerging economies do not gain a competitive advantage by not taking action to reduce GHG emissions. Chairman Baucus noted, however, that this possibility should not be used by the U.S. as a reason for delaying action on climate. The Lieberman-Warner bill contains a provision requiring importers of carbon-intensive goods from nations without an absolute emissions reduction goal to submit emission allowances. Because some groups have raised concerns that this provision would violate World Trade Organization (WTO) rules, Chairman Baucus said that he wants to make the Lieberman-Warner program as "bulletproof" as possible. Jennifer Haverkamp, an attorney with the environmental group Environmental Defense and former assistant U.S. Trade Representative under President Clinton, said that the provision might not be bulletproof, but that it could be fortified by allowing the Executive Branch broad discretion to alter the provision if WTO challenges are filed. Martin McBroom, representing the utility AEP, and Abraham Breehey, from the International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers and Helpers called for strengthening the provision. The hearing also addressed the use of offsets under the Lieberman-Warner bill. Kjell Olav Kristiansen, of the Point Carbon news and consulting firm, said that the use of offsets should be expanded to allow offset credits from projects in nations that have not imposed mandatory emission reduction targets; in its current form, the Lieberman-Warner bill only allows use of allowances from other cap-and-trade programs.

- **Climate Issues Reach Deeper into Congressional Hearings on Related Energy Subjects.** The Energy and Water Subcommittee of the House Appropriations Committee held a hearing this week on alternative fuels and new transportation technologies. Continuing a trend noticeable in Congress, some of the witnesses' testimony, notably from Oak Ridge National Laboratory and Toyota, assessed the climate implications of technology decisions - calling out the climate benefits of plug-in hybrid vehicle technologies, for example, only when the electricity used is generated from low carbon fuels. The hearing provided a good picture of the search for petroleum-use reduction strategies in the transportation sector.

Administration

- **DOE Climate VISION Program Members Report GHG Reductions.** U.S. companies belonging to the DOE's Climate VISION Program reported a 1.4 percent emissions reduction from 2005 to 2006. The program, which includes companies from the oil and gas, electricity generation, and coal sectors, is a voluntary greenhouse gas emissions reporting initiative established by the Bush Administration in 2002. Program participants pledged to reduce their greenhouse gas emissions intensity by 18 percent between 2002 and 2012. The report indicated that the participants were on track to meet the President's goals by 2012.

States and Cities

- **California Agencies Recommend Cap-and-Trade for Power Sector, Combined with Renewable Energy and Energy Efficiency Measures.** The California Public Utilities Commission (CPUC) and California Energy Commission (CEC) delivered to the California Air Resources Board (CARB) their proposed recommendations for implementing the state's AB 32 legislation, which establishes state-wide limits on GHG emissions. The agencies recommended a cap-and-trade program for the state's power sector, combined with aggressive renewable energy and energy efficiency measures. The recommendations suggested that the point of regulation for the power sector be entities delivering electricity to the California grid, which would address emissions associated with power imported from neighboring states. The recommendations also called for distributing allowances through a mixture of free allocation and auction – and the use of at least some portion of auction proceeds to fund energy efficiency and renewable energy programs. The agencies proposed that CARB exclude natural gas providers from the cap-and-trade program during its early years, and instead address natural gas emissions through energy efficiency measures. The recommendations also were noteworthy for issues that they did not reach but instead postponed, including the particular formula for allocating allowances among power companies and whether and how to incorporate offset projects in the California program.

- **Regional Air Quality Agency Proposes Carbon Fee For Emitters.** The California Bay Area Air Quality Management District (BAAQMD), a northern California agency responsible for regulating air quality in the San Francisco Bay region, proposed charging emitters a fee based on their CO_2 emissions. BAAQMD said the carbon fee would have the dual benefits of paying for the agency's operations and giving emitters incentive to reduce their CO_2 emissions. A BAAQMD spokesman said the program would help prepare the region's emitters for regulation under the pending statewide GHG emissions cap. If passed, the fee will apply beginning July 1 and would likely be removed when the planned statewide cap-and-trade program under AB 32 goes into effect.

- **California Registry Approves First Forest Offset Projects.** The California Climate Action Registry (CCAR) certified two carbon offset projects located in private forests in the state. The projects, located in Mendocino and Humboldt Counties, have the capacity to store 60,000 and 77,000 tons of CO_2 equivalent annually. The projects are the first trades of carbon offsets from forestry that comply with the California Climate Action Registry's certification protocols, which were adopted by the California Air Resources Board (CARB) last year. As part of the certification process, both offset projects were required to provide proof of permanent easements on the land, adopt sustainable forest management techniques, and undergo a third-party audit. CCAR is a non-profit voluntary registry for GHG emissions that encourages voluntary actions to decrease GHG emissions. CCAR has developed protocols that provide guidance for determining GHG inventories in a number of industries and sectors.

Industry

- **Duke CEO Criticizes Auction of Allowances Under Lieberman-Warner.** At a Cambridge Energy Research Associates conference, Duke Energy CEO Jim Rogers criticized the increased auction of allowances under the Lieberman-Warner bill, stating that an auction amounted to a tax that would increase electricity prices and penalize coal-dependent states. He said that he had approached Sen. Hillary Clinton (D-NY) and Sen. Barack Obama (D-IL), the leading Democratic presidential candidates, about restoring some amount of allowance allocations to industry. Previously, both Senators have publicly called for an auction of 100 percent of allowances as part of their campaign platforms.

- **Bank of America Announces Plans to Include Cost of CO_2 Emissions in Utility Industry Financing.** The Chairman of Bank of America, Kenneth Lewis, announced this week that the financial institution will begin to consider the future regulatory cost of CO_2 emissions for risk assessment and underwriting of utilities. In remarks at an industry conference, he indicated that the bank will consider CO_2 emissions as a liability, using a cost of \$20-40/ton of CO_2, because "regulation of GHGs is coming." In addition, Chairman Lewis called for a predictable regulatory environment and further clean energy development. This announcement follows a similar one last week by Citi, JPMorgan Chase, and Morgan Stanley. The three banks released guidelines for an approach to assessing GHG regulation in the U.S. electric power sector (see last week's VNF Climate Change Weekly Update).

- **Climate Change Offset Provider Blue Source Expands into Canadian Market.** U.S. based Blue Source, LLC, the holder of several hundred million U.S. carbon credits, announced the acquisition of the Canadian offset marketer Baseline Emissions Management Inc. Blue Source anticipates that the acquisition will provide an entrée for the company into Canada's provincial trading markets, particularly in Alberta. The acquisition will result in the creation of a new entity, Blue Source Canada, to serve businesses in Canada.

- **Climex Partners Plan to Create Carbon Exchange Across Europe.** The Climex Partners, an entity resulting from an agreement among several carbon exchanges, and Vertis Environmental Finance have agreed to create a carbon exchange with operations in both Western and Eastern Europe. The trading platform will offer over-the-counter trading in Kyoto Protocol Clean Development Mechanism Certified Emissions Reductions, Kyoto Protocol Emission Reduction Units, European Union Emissions Trading System EU Allowances, as well as voluntary credits.

Studies and Reports

- **Investment Leaders Adopt Action Plan To Consider Climate in Investment Decisions.** In conjunction with the Institutional Investor Summit on Climate Risk (Summit) held at the UN, a group of 49 pension fund officials, asset managers, and other investment leaders announced a nine-point action plan for incorporating climate change risks and opportunities in investment decisions. The action plan seeks to promote investment in energy efficiency and clean energy technologies; increase corporate climate risk disclosure; and reduce the emissions impact of real estate portfolios and investments. As part of the plan, the group, representing \$1.75 trillion in assets, pledged to collectively invest \$10 billion in clean technology; reduce energy use in real estate holdings by twenty percent; and push the Securities Exchange Commission to require corporate disclosure of material risks from climate change. (See the "International" section below for further information on the Summit.)

- **Congressional Budget Office Concludes that Trading Program with Price Controls is More Efficient.** The Congressional Budget Office (CBO) released a study, *Policy Options for Reducing CO_2 Emissions*, evaluating various market-based approaches to achieving U.S. CO_2 reductions against three criteria: (1) efficiency; (2) ease of implementation; and (3) ease of integration with programs in other countries. The nonpartisan study contains no recommendations, but does point out that a "carbon tax could offer significant advantages" over a cap-and-trade program. Noting the greater interest of policy-makers in cap-and-trade programs, the study finds that incorporating an allowance price ceiling, referred to as a "safety valve," would help ensure that a cap-and-trade program approximates the advantages of a carbon tax. The study also concludes that a safety valve is superior to alternative forms of cost containment, including banking, borrowing, or a "circuit breaker" – in which an outside authority can step in to modify the stringency of a cap based on high allowance prices. The Lieberman-Warner bill incorporates all three of the latter mechanisms, including a "circuit breaker"; it would empower a "Carbon Market Efficiency Board" to intervene in the allowance price market. With regard to the environmental implications of a safety valve, the CBO explains that addressing climate change would require deep reductions in emissions over a long period, "but ensuring that any *particular* limit was met in any *particular year* would result in little, if any, additional benefit (avoided damage.)" (Emphasis in the original.") The CBO study was requested by Sen. Jeff Bingaman (D-NM), Chairman of the Senate Energy and Natural Resources Committee, and does not evaluate any specific legislation. The CBO study is available at www.cbo.gov.

International

- **UN General Assembly Debate Discusses Post-Bali Agenda.** At United Nations (UN) headquarters in New York, the UN General Assembly held a three-day debate, titled "Addressing Climate Change: The United Nations and the World at Work", as a follow-up to the meeting of parties to the United Nations Framework Convention on Climate Change (UNFCCC) in Bali, Indonesia late last year. At the Bali meeting, governments committed to a new round of negotiations on an agreement for reducing global GHG emissions with the aim of producing a new agreement by the end of 2009. The General Assembly debate this week focused on developing a roadmap toward that global agreement. At the debate, Yvo De Boer, Executive Director of the UNFCCC Secretariat, announced that an organizational meeting to set the working agenda for parties to the UNFCCC will take place in Bangkok, Thailand from March 31 to April 4.

- **UN Conference Focuses on Emerging Carbon Markets.** The UN held a second event this week, the Institutional Investor Summit on Climate Risk (Summit), that focused on the risks and opportunities presented by climate change in the corporate context. Ceres, a coalition of investors and environmental groups, sponsored the event and conference attendees included over 480 financial experts, investors, and government and corporate leaders. Panelists at the Summit reviewed the prospects for a cap-and-trade program in the United States, which some experts believe could result in a $1 trillion carbon market by 2020. Other issues discussed included clean energy production, corporate climate change mitigation and adaptation strategies, and renewable energy.

- **UN Agency To Help Farmers in Developing Countries Attract Carbon Finance.** The United Nations International Fund Agricultural Development (IFAD) is looking to assist developing countries' efforts to sell UN-endorsed carbon credits generated from the agricultural sector. Emission reduction projects from agricultural sources in developing countries often fail to attract carbon finance because the projects are too small. By bundling small individual projects, developing countries might be able to create viable projects for generating credits under the Kyoto Protocol's Clean Development Mechanism. IFAD is planning to work with the private sector to determine how small farms in developing countries can benefit from carbon finance. In the past, IFAD's approximately $500 million in awards and grants have primarily supported climate change adaptation efforts.

- **Major Emitters Hold Informal Climate Talks in Tokyo.** Twenty countries that account for approximately 70 percent of global GHG emissions gathered in Tokyo for the Sixth Informal Meeting on Further Actions against Climate Change. Topics discussed at the two-day meeting included development of a new international framework to replace the Kyoto Protocol and mechanisms for assisting developing countries to mitigate the impacts of global warming. Representatives from the US, EU, China, India, and Japan, among other countries, attended the meeting. Sponsored by the Japanese Foreign Ministry, the informal meetings have been held annually in Japan since 2002.

- **Russia, the Ukraine to Join Kyoto International Transaction Log System.** The two countries are expected to join the International Transaction Log, the electronic system for registering transfers of credits under the Kyoto Protocol, in the next two to three months. Thirty-eight developed countries are eligible to participate in the trading scheme, but only Japan, New Zealand, and Switzerland are currently approved to trade credits on the platform. In order to link to the trading system, countries must create their own emissions registries and obtain UN approval. Russia and the Ukraine are expected to have significant surplus credits under the Kyoto Protocol, and therefore could be significant sellers.

- **Japan, Russia Reach Agreement to Begin Bilateral Climate Talks.** Ministers from Japan and Russia agreed to discuss ways to fight global warming, with the first round of talks to be held on February 27 in Tokyo. The talks are likely to include discussion of Japan's possible purchase of emission credits from Russia to help Japan meet its Kyoto Protocol obligations. The purchase would take place under the Kyoto Protocol's emissions trading mechanism and would likely include a request by Japan that Russia use proceeds from the transaction to fund domestic environmental protection programs. Japan has previously reached a similar agreement for the purchase of 10 million emission credits with Hungary and is currently negotiating to purchase additional credits from Poland and the Czech Republic.

- **China Remains Opposed to Binding GHG Targets.** Chinese Ambassador to the UN, Yu Qingtai, reiterated his country's opposition to binding emission targets for developing countries. Ambassador Quigtai said that the principles of the UNFCCC should remain the foundation for post-Kyoto Protocol negotiations. Those principles include the principle of "common but differentiated responsibilities," under which developed countries should take the greater burden to achieve emission reductions. China sees itself as a developing country and, as such, has resisted a mandatory absolute limit on its emissions. The ambassador further noted that China would be open to sectoral approaches to reducing emissions that focus on sharing best practices and technology transfers from developed to developing countries.