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Business News

## **Green Effort Gets Energized**

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Earlier this month, **ConocoPhillips** (COP) became the first domestic oil company to join the U.S. Climate Action Partnership, a corporate call-to-arms aimed at reducing greenhouse gas emissions.

It's surprising that two massive oil companies -- the U.K.'s **BP** (BP) being the other -- are signatories of USCAP.

But what's shocking is the first of 16 recommendations made by the partnership: The U.S. Congress "needs to enact legislation as quickly as possible" to cap emissions.

Generally, corporate America loathes having business decisions taken from the hands of the free market, especially those that could revolutionize the very nature of the economy.

That Conoco and BP, like other corporate behemoths including **Alcoa** (AA) , **GE** (GE) and **DuPont** (DD) , are actually begging the federal government for help is evidence of the complexity surrounding environmental issues.

"We recognize that human activity, including the burning of fossil fuels, is contributing to increased concentrations of greenhouse gases in the atmosphere that can lead to adverse changes in global climate," said Jim Mulva, Conoco's CEO, in a press release announcing his company's plans.

## All Going Green

Until recently, big business has insisted that emissions reductions be voluntary. What, then, converted these companies into believers in government intervention?

For one thing, companies are realizing they will be affected by some sort of emissions control no matter how much of a fuss they make. Under voluntary controls, little progress toward emissions reduction has been achieved, aside from a handful of hybrid cars cruising clogged highways, feeding on a cocktail of unleaded gasoline spruced with ethanol.

According to Peter Fusaro, president of Global Change Associates and a leading consultant on energy and environmental markets, Americans are finally beginning to pay attention to things like global warming, a pro-environment media barrage (including Al Gore's documentary *An Inconvenient Truth*), and ubiquitous military battles that always seem to wind through oil fields in the Middle East.

The pressure on businesses from consumers and shareholders is becoming acute, and the sentiment is passing through to the political sphere. On April 2, in a blow to the Bush administration's energy policy, the Supreme Court ruled that the Environmental Protection Agency must regulate carbon dioxide emissions under the Clean Air Act. Climate change is also on a short list of key issues being addressed as the U.S. heads into next year's presidential election.

The other factor convincing companies to support federal activism is their fear of the unknown. A host of regulatory options have been introduced that would have widely varying consequences for companies that emit greenhouse gasses.

One nightmare scenario is an outright tax on carbon emissions, which could seriously stymie U.S. economic growth and be particularly burdensome for the energy and transportation sectors.

Another regulatory option is a network of state greenhouse gas programs, all with their own emissions caps. In 2003, then-New York Gov. George Pataki convinced eight other Northeastern states to support a regional cap-and-trade system.

Scheduled to go into effect in 2009, the program would cut greenhouse gas emissions 10% below 1990 levels by 2010. California Gov. Arnold Schwarzenegger has proposed a similar program that would lower emissions by as much as 25% over the same period.

Companies worry that operating under varying state systems would be impossibly complicated. For example, the automobile sector would have to build cars for the strictest emissions environment, because it couldn't easily build different cars to fit different state rules.

Additionally, competitors operating in different states could be given competitive advantages depending on where they operate. Refiners with operations in traditionally oil-friendly states like Texas may have lower emissions caps than refiners in stricter states like California.

"Businesses are now in the awkward position of seeking federal protection from the states," said Terry Tammimen, director of the Climate Policy Program at the New America Foundation, a Washington-based public policy group.

## Turning to Trading

Meanwhile, companies no longer can be confident that their capital investments won't trip over future environmental legislation. This trend has played out in recent weeks when Kohlberg Kravis Roberts disclosed a proposal to acquire Texas electric utility **TXU** (TXU) . To get the support of environmentalists, KKR agreed to remove eight coal-fired power plants from TXU's 11-plant expansion plan.

Even though coal remains the cheapest source of fuel for power plants, its future in the grand energy policy scheme is too uncertain to make future coal investments exceptionally attractive.

To circumvent these scenarios, many companies and strategists, including those behind USCAP, are throwing their weight toward a cap-and-trade system that would apply market fundamentals to the greenhouse gas emissions regulatory process.

The main component of the system is a financial market in which emissions credits, measured in tons of greenhouse gasses, are bought and sold. Firms that are unable to meet their emissions quota must buy credits in the marketplace.

Large numbers of credits would be more expensive than small lots of credits. A company trying to buy too many credits may be outpriced, and thus unable to do so. These companies would have to either reduce their emissions output or cease operations. The system encourages companies to emit less greenhouse gases, but it gives companies a way to ease into the program without overburdening the economy.

Companies that have the technological ability to reduce their emissions or help others cut theirs can actually make money by doing so. For example, many utility companies like USPAC member **Duke Energy** (DUK) convert natural gas and coal into electricity and release their CO2 into the air.

By re-engineering their plants so that their CO2 is injected into the ground, they can sell credits for the emissions they don't produce. In this way, a cap-and-trade approach encourages companies to change out dirty processes for clean ones.

Businesses tend to support this approach over taxes or other emissions-control programs because it reduces the overall economic cost of adhering to environmental regulation. Inefficient businesses like coal-fueled power companies would have little recourse under a flat-tax system, and many would likely be forced to close their doors. Under cap-and-trade, these businesses can continue operating by purchasing emissions credits on an exchange.

## Giant Footprints

Europe already has a functional emissions cap-and-trade program. Emissions credits are traded on the **IntercontinentalExchange**. Because CO2 emissions in the U.S. are the same as in Europe or the developing world, emissions trading offers a rare opportunity to create a pure global marketplace. As the Kyoto Treaty and other global agreements lure more participants to cap-and-trade, the global market will increase in size and liquidity.

The global "carbon footprint" -- a measure of CO2 emissions -- is currently 26 billion tons and growing, Fusaro said. Commodity markets are generally six to 20 times the size of the physical market (the actual amount of commodities like gold or oil produced), giving the global carbon market a potential size of 520 billion tons.

If emissions credits were worth roughly \$30, as Fusaro suggests, the emissions market could reach \$15 trillion in scope, dwarfing the size of the crude oil commodity market. These numbers are eye-catching for the financial firms and energy companies that would have access to the millions of dollars in potential profits via trading in emissions contracts.

Many questions remain concerning the logistics of a national cap-and-trade system, let alone a global one. The fight over choosing the major points of entry for greenhouse gas emissions is heating up, according to Eron Bloomgarden, U.S. director for EcoSecurities, a carbon-credit origination firm.

It is unknown whether legislation will ultimately place emissions caps on companies that produce hydrocarbons, such as oil companies, or companies that burn hydrocarbons, such as automobile companies.

The fact that BP and Conoco are members of USCAP while **Ford** (F) and **General Motors** (GM) are not may provide some light on this issue. This suggests that integrated oil companies might see a greater opportunity to profit from a cap-and-trade system than automobile companies do.

As the emissions market matures, it is likely that all relevant sectors will have to carry their burden of greenhouse gas emissions. "Even office buildings produce large amounts of greenhouse gasses, so ultimately real estate companies will have carbon caps as well," Fusaro said.

As more subsectors become stakeholders in the emissions market, the cost borne by individual companies will decline.

Fusaro says that federal cap-and-trade legislation should be expected sooner rather than later. "Financial firms and other stakeholders know there is money to be made in emissions trading, and they want this market now," said Fusaro.

In this case, now is hardly a figure of speech. Legislation regarding complex issues like climate change tends to not get passed during election years.

"We have a six-month window to get this passed, after which it will be too late," Fusaro said.

If companies are as urgent as Fusaro believes they are to build a nationwide emissions system, the U.S. soon may see advancements made on the environmental front, setting it on a new course toward real greenhouse gas emissions reductions.