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# Mandatory U.S. Greenhouse Gas Regime is Now Taking Shape

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Contrarians are usually right. They don't follow the crowd, nor do they follow conventional wisdom. Most change is made by contrarians. Just when everyone thought we would have to wait another five years for U.S. action on climate change legislation, action is now taking place at the federal level. Although it won't be this year when the focus is still on red and blue states, green is the color of next year. It will be bipartisan, It will be a real reduction. And it will have industry hollering that it can't make the deadline.

Well, I went to an engineering school called Carnegie-Mellon, and what I know is that engineers can do the impossible. They tweak things.They just need the regulatory certainty that is lacking in the United States today. Once that's in place, watch the industry not only comply, but overshoot targets, as it did in the first five years of the acid rain program (1999 -2000) when emissions were 30 percent under mandates.

Which brings us to what the mandates will be. The targets have to be hard caps, not the reallocation scheme in the European Union, which really mucked up the carbon markets in April 2006 when countries got more allocations. (In Europe this spring, carbon trading crashed from 30 Euros to 11 in one week). They have to be more than “modest,” which is what recently has been circulating in Washington, D.C. And most importantly, they need to be long lasting. That means a regulatory schema of 20, 40 or 60 years. Why so long? So the industry has a baseline and benchmark that mirrors the life of new power plants.

It also needs to go after tail pipe emissions. Mobile sources were not part of previous U.S. regulatory programs because the EPA lab in Ann Arbor, Michigan couldn't accurately model mobile sources. But that was over ten years ago, before the era of geopositioning satellites, remote sensing and advanced information technology.

## Corporations Need the Federal Regulatory Guidance

The third wave of environmentalism is being created by Corporate America and the Pentagon. They both see the need for regulatory certainty and take the long view on the issues. When investment is made in a power station, it is made for decades. The capital markets need the regulatory certainty to create the market incentives for innovation and environmental remediation. The Pentagon sees new technology as a means to reduce its bills and become more efficient. It funds research in fuel cells, battery storage, biofuel, and hybrid technology. A confluence of these two powerful forces in America is significant, especially as many of our energy policies are now framed as national security issues too.

Business ingenuity is needed to successfully tackle climate change, but it seriously needs a strong policy framework that gives the market the long-term certainty about what those guidelines will be. That creates a market with a long-term value for carbon emissions reductions and incentivizes new technologies. Markets have the power to extend and promote investment in innovation. In effect, this is a bipartisan issue which no one party can own, and is much longer term time frame than Kyoto which ends in 2012.

## Chicago Climate Exchange Starting to Gain Traction

I recently attended the third annual meeting of the Chicago Climate Exchange which likes to boast that it is the only exchange that trades all six greenhouse gases. The good news is that the exchange has recently passed 200 members and traded over three million tons of $CO_2$ reductions in May 2006. Prices reached an all time high of almost $5 per ton then. Recent prices are in the $4 range. While a major corporate member like Cargill just recently joined, the exchange still lacks the engagement of two largest components of energy and environmental financial markets, i.e., the need for market makers from financial institutions and major energy companies. No New York bank or large energy company like BP, Shell or Chevron is a member yet.

I still think that a major exchange such as NYMEX, CBOT or CME will either buy CCX or launch its own platform for trading to succeed. Although the CCX uses the ICE electronic platform, I don't see it being effective in the United States. Conversely, it is highly effective in the European carbon trading scheme where European Climate Exchange, CCX's sister exchange, is the dominant exchange there.

The recent hook up of NYMEX and CME looks like an unstoppable powerhouse. In that, you have the dominant energy exchange and the dominant financial futures exchange (CME) with both floor and electronic trading offering on a common trading platform. These two exchanges also sit at the center of the two U.S. mercantile commodity markets, New York and Chicago. I would put my money on this combination rather than CCX as the U.S. exchange when the U.S. regulatory scheme takes shape in 18 months. CCX will probably be acquired by either, or both, of these powerful exchanges. Today, most emissions trading is still bilateral and can be cleared on exchanges as well.

**Wall Street Ready to Roll**

In the recent EPA auction, there was more participation from Wall Street as JP Morgan Chase and Morgan Stanley were action in purchasing vintages. Today, Morgan Stanley is the largest emissions trader of SO2 credits. We also saw some energy hedge funds active in that auction as well. In the 35 regional emissions markets in the United States, hedge funds trade $SO_2$, $NO_X$, $CO_2$ and recs (renewable energy credits). The point is that Wall Street trading desks are poised to extend their commodity trading platforms into carbon emissions trading on a grander scale when we have the rules in place. Regulatory certainty drives the GHG market more than any other.

**Dovetails with U.S. Energy and Environmental Policy Agenda**

Politicians from both sides of the aisle are starting to gravitate to a more centrist position on climate change vis a vis a more balanced U.S. energy and environmental policy. Katrina was a wake up call for Americans. A couple more years of higher energy prices and hurricanes on the U.S. Gulf Coast may be all that it takes for U.S. voters to coalesce around a real energy and environmental agenda as a campaign issue in 2008. Usually these issues rate number five or six as priorities with political focus groups. But with politicians as diverse as Senators Clinton and Lugar, Rudolph Guilani, New York Mayor Bloomberg, and of course, Al Gore, all speaking out on energy and environmental issues, it may be the time that new thinking on energy and environmental issues percolate to the top of the political agenda as the dominant national issue in 2008.

A new industry is about to be born. It will balance energy and environmental needs. It is now wrapped in national security as energy dependency has ascended as a top public policy issue once again. It is about clean technology, renewable energy, energy efficiency and emissions reductions. It is bipartisan, the way Washington and domestic politics used to work. And the triple bottom line is that it will create jobs for Americans, balancing energy and environmental needs. It will truly renew America!

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Peter C. Fusaro has worked on energy and environmental issues for 31 years starting with lead phasedown of gasoline in 1975, DSM in the 1980s, hybrid cars in the 1990s, and global warming issues since 1900. Global Change Associates and UtiliPoint® International are now undertaking a joint study of what the impacts will be of a mandatory U.S. greenhouse scheme. For more information on that study, please contact Carmen Cook, VP, Marketing, Energy Hedge Fund Center at carmen@energyhedgefunds.com or 212-222-3775.

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