Ratings Event on the EU Emissions Trading Scheme

Germanwatch / United Nations Environment Programme Finance Initiative
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Summary

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On 2 April, 2004 Germanwatch together with UNEP-FI organized a "Ratings Event on the EU Emissions Tradings Scheme", hosted by the Bank für Sozialwirtschaft in Cologne, Germany. The meeting took place under chatham house rules - so the experts are not identified in the following summary. About 20 finance analysts, asset managers and sustainability rating analysts participated.

Climate Change - new challenges for the insurance industry

A representative of the insurance industry made the point that there are more and more indications of a changing climate. Two examples:

- Brazil experienced some months ago their first tropical storm ever.
- About 15 000 people died in Europe because of the hot summer last year.

As a result for insurers and reinsurers there is an increasing need to use future scenarios to calculate the premium (prospective underwriting). So far they used the past to calculate the premium. But climate change is increasingly not only seen as a challenge for the insurance side but also for the asset management of insurers.

The EU Emissions Trading System - Cornerstone of a cost-effective climate policy

A representative of the European Commission DG Environment commented on the aims and perspective of the EU emission trading scheme, just two days after the deadline for the finalising of National Allocation Plans (NAP):

The Kyoto Protocol is only a first step in climate regulation. From an economic point of view regulation is usually seen as risk - but there are opportunities as well.

The European Emissions Trading System (ETS) is the cornerstone of a cost-effective climate policy. In the long run climate protection will only be acceptable to society if it is done in a cost-effective manner. Kyoto regulates the trading between countries. The European Emissions Trading System regulates - within this framework - the trading between European companies. Due to ETS's fairly ambitious agenda, it comes as no surprise that there is some delay with the National Allocation Plans (NAPs). As of April 1st, five plans were received, which makes up one third of the member states. It is important to note though that none of the member states has said that they will not come up with a NAP. Once a NAP is submitted to the European Commission (EC), it is looked at and checked as to whether it meets the demands of the directive. The directive itself can be seen as a framework which leaves it up to member states on how to fulfil the directive's criteria, and how to implement the ETS. The EC will not compare the different plans, but each plan is checked on its own merits. The NAPs have to be in line with the spirit of the directive and its 12 criteria (Annex 3 of the directive). The European Commission can reject a plan in full or partly. Probably the two most important criteria:

a) Can the country show that it is going into the direction of Kyoto?

There is a variety of possibilities to show how to go into this direction. Limit of the variability is the supplementarity. Reality-check by governments is necessary: is squeezing of other sectors realistic? And is it consistent with policies in place?

b) Is it a simple system or is a certain degree of bureaucratisation taking place?

In relation to the German NAP, one important question will be: are benchmarks for different fuels coherent with the criteria of the directive? The NAPs (especially the German NAP) are not as stringent as the market believed they would be. After the announcement, the price dropped from € 13 Euro to € 8.6 per tonne CO_2.

The EC DG Environment has the lead in the check of the NAPs. All other relevant Directorate Generals are involved. In the end it will be a joint Commission decision.

On the 1st of January 2005 the ETS will start. In 2005 a first survey will take place, which will also include dialogues with the member states, NGOs, and the European Council of Ministers. Then - still in 2005 - a report on how the ETS is functioning will be released by DG Environment for the European Council. In addition in 2006 there will be a formal review. A relevant question will be: Will the system be extended to other gases or to other sectors (transport / aviation)? Taking into account the experience of the last couple of months another interesting question will be: Is there a need to harmonise the methodology of allocation? It is interesting to see that some governments and parts of industry which were against this harmonisation 15 months ago are now in favour of it.

The ETS does in no way set a limit on growth of participating companies. What it demands from growing companies is a carbon management strategy. E.g.: If companies want to use the Clean Development Mechanism (CDM), the implementation of these project needs time. If a company wants to implement CDM projects between 2008 and 2012, it has to act within the next 18 months. Or a company wants to reduce its carbon emissions perhaps by shifting its energy basis over to hydro-based energy system. All this needs time and an active carbon management strategy. It also requires banks and institutional investors to look at evaluating companies. There are plenty of economic opportunities for low-carbon economies and low-carbon technologies.

Overall, it is obvious that fighting climate change is cheaper than to let it happen.

It was announced that it is likely, that for the week following April 2, a compromise regarding the linking directive, which regulates project based emission trading, will be achieved.

The Future of international and EU climate policies depends on the question: Will trading be a success or not? For the longer term: Will the US participate? What about post 2012? It is important soon to start with the post 2012 framework, both within the EU and internationally. The EU Spring Council has asked the Commission to do an analysis regarding negotiating options for post 2012. These options will be discussed at the Spring Council 2005.

It is important that proactive industry and NGOs maintain political support for climate policies. It is important that other industries, which were silent in the ET debate, become more vocal. NGOs were somewhat silent in Brussels after the decision for the ET directive of December 2003. Another important question is: Who will be the next commissioner (DG Environment)? It was also discussed that very few NGO have capacity on ET. This voice is missing. Different participants - also from the DG Environment - see the need of NGO capacity building.

The EU ETS directive represents binding legislation. Those who do not act on it will be brought to court. The EC reserves the right to enforce and streamline the NAPs (the EC has the right of initiative). The EC will make use of its role as guardian of the treaties. From the legal point of view, there is no doubt that the EC can "fight". And citizens could bring the EC to court, if it does not do so. The material side is more problematic. The criteria are relatively vague. The EC has to have good reasons to reject a NAP or a part of it.

If countries are late with their NAP and a company would have no allocation, it has reason to be sorrowful. The risk of late action of the governments sits on the shoulders of companies. If states do not allocate, companies could go to court.

One point for discussion was, what happens if Russia ratifies only in 2009, the Kyoto Protocol enters into force and the EU isn't on Kyoto-track then? It was consensus that the "Kyoto" Targets are - by EU decision - legally binding for EU member countries, whether Kyoto enters into force or not. And if a member state would say "wait and see", it would face a legal risk within the EU and - if the Kyoto protocol enters into force - also on international level.

Another question was: If the second allocation process is based on grandfathering, wouldn't this reverse the incentive system of the instrument? The answer made clear that there is not yet a clear view on 2006 allocation method. And that this is one of many considerations which have to be taken into account.

It was also asked whether the commitment periode reserve (CPR, Kyoto Protocol) will also be relevant for the EU System. It could be a severe restriction to trading, as the trading actors never know when they come under the 90% line.

The DG Environment representative denied that border tax adjustments could be an interesting instrument in relation to non-Kyoto states. He saw it as questionable whether they would conform to the WTO rules; and he asked whether it would send the right signal to China and others, that climate policy is such a burden, that you need a border tax adjustment?

From the side of insurance industry it was stressed that the question is not only: What are the costs of action? But also: How much will we have to pay for inaction, especially for climate change related damage?

It was noted that the criteria of the Global Reporting Initiative focus on the more direct impacts for lending and asset management. Three or four criteria will be related to carbon. It is interesting to look at the European Investment Bank which has put an internal price on carbon risk.

Another part of the discussion focused on aviation. In the UK there is some momentum to bring aviation into the system in 2008. Also in DG Environment there are similar considerations. Some participants stressed the role of aviation for global climate change. It was argued that if aviation is not addressed properly, in 2050 this sector alone might be responsible for 50% of emissions.

In case of the inclusion of aviation into the ETS, the DG Environment wants the allowances to be backed up by Assigned Amount Units (AAUs). A possible first step could be to include in 2008 only the national flights and only CO_2 fully in the system. If then already other gases or flights would be included, this would mean that the aviation sector - at least for these emissions outside the Kyoto system - would be able to buy, but not sell other part of flights (and other gases).

Some participants noted that the approach how companies view the ETS is changing. In the beginning the question was: Does the company have the relevant information? Then the focus changed to: what is the risk of new carbon regulation on global, national and regional levels? And now the focus is shifting again: How does the company use the challenge to get an advantage? So the focus shifted from addressing risks to opportunities. Companies that respond quickly and effectively can look to benefit economically and improve their shareholder value: impacted sectors need to move from carbon risk to carbon opportunity.

But it was also noticed that still a lot of companies are looking at the risk, rather than the opportunities and strategic positioning. Their comparative position in 15 years is decided by their action today. One participant concluded: "Today's decisions of RWE and EON make up the energy mix of the future. In the future their shareholders might ask: Why are they so wrongly positioned?"

Another financial analyst responded that only the 2006 decision for NAPs after 2008 will be relevant for the fuel mix, not the NAP for 2005-2007. Only a few new installations will be built in the German electricity sector before 2008.

Reactions of finance sector and rating agencies on the ETS

There was a consensus that it was important that the Carbon Disclosure Project - the most important project in this field - established a formula and developed twice a call to companies to report the climate and carbon risk. But so far nothing happens if companies do not report. How to make the received information relevant for companies (did they give the information? what is the content?), for the public and for asset management was seen as a point for further discussion.

There was an interesting debate as to whether it would be necessary to have a high carbon price to reach the adequate shift of investments. So a study indicates, that in the UK the cost of carbon would have to be higher than 13 Euro to shift investments from coal to gas. The counter argument was that a low price would mean that climate policy is possible and has no or a very limited negative effect on the economy. It would be easier to get stronger targets (e.g. for the next NAP)

Consensus was that it is important to see why the carbon price is low. It is a different story whether it is because of a big potential to reduce emissions without high costs or whether the carbon price is low because of NAPs which are not adequate to reach the Kyoto targets.

Role of ETS for financial rating

Again and again it was stressed by different actors that one needs to differentiate between SRI ratings and financial ratings and the related agency methods. Climate Change is clearly a big theme for SRI rating. But financial raters so far have had little opportunity to evaluate the risks of the ETS (apart from some surveys undertaken by some market participants). Without the knowledge of the NAPs it was impossible to calculate accurately the legislative risk. This might change now.

One financial analyst questioned whether the NAPs were really relevant to the shareholder value. There were no big jumps after the release of the NAPs. The effect of ETS should be seen in relation to other events. The ETS and its financial implications (with the current price signal) is nothing compared to a 5% rise in the price of oil, for example. Others mentioned that in Spain there was quite a jump down of the share value of the biggest utility company after the change of government which was interpreted as a signal for a more stringent climate policy and NAP.

Another financial analyst argued, we shouldn't underestimate the speed the financial sector can take. So far - without the relevant regulation - there was no need to act for the financial sector (different for SRI). And also the litigation risk is today more concrete than only 12 months ago. Especially companies with a big share of emissions and with a record of undermining climate science could be at risk.

Methodology of carbon rating

There was consensus among financial analysts that it is not enough to include only the absolute emissions of a company in the rating. There is a need to include at least the relative emissions. Some participants added that investment cycles also need to be incorporated.

Financial analysts noted that some major utilities are not transparent when it comes to their environmental reporting. Quite a few published their last environmental reports in 2001. Others enlarge their reports but not in terms of finance relevant topics. Only half of the utilities within the FT 500 reported their CO_2 emissions.

A SRI rater reported the new trend that front runners of main stream analysts increasingly use their data.

One analyst argued that the ETS - in spite of the not satisfying NAPs of many EU states - might nevertheless send a signal that CO_2 emissions are material. High emissions result from wasting too much energy and producing in an inefficient way, which is now material. US SO_2 trading showed that a price decrease in SO_2 allowances was due to the fact that introducing a SO_2 market was the right signal to inefficiency.

Many participants saw the necessity that national accounting laws need to be compatible with international accounting standards to make information comparable. This is a necessity in the case of ETS also because there seems to be quite a consensus that allowances have to be included in balance sheets. A part of the debate centred on the question with what market price carbon has to be accounted. Most participants think that it should be the current market price. Definitely both amounts and price of allowances influence the value of companies somehow. But there was a debate to what extent this will happen.

One important question was why credit raters didn't participate in this event? It was felt that they recognise it as an issue, but so far they don't have the internal knowledge to deal with it. Maybe they only want a debate as soon as they can present an answer to the obvious questions. One analyst argued: "I also wouldn't be prepared to come without a solution. But: in 6 months they will be here."

Many argued that one effect of the EU ETS in the near future might be that the rating of a part of the carbon risk will shift from SRI to main stream rating.

But it was also recognised that for financial raters only financial effects are relevant - it doesn't matter whether the rating has a positive effect on the climate performance of a company or not. So the ability to pass on prices to pay for industry and companies to clients and consumers could at least partly undermine the environmental effect of financial rating. E.g. if power prices - calculated with marginal prices - double, companies with high carbon risk might profit, as long as they are able to shift these high prices to the customers. Again it was mentioned that for SRI raters not only direct financial effects, but a broader set of indicators will be relevant.

Summary - some important takeaways:

- There are more and more signs that climate change is already happening - e.g. first tropical storm in Brazil. Climate change will not disappear, but alter everything!
- For that reason, companies that want to grow need a carbon management strategy. Already the next 18 to 20 months are critical in this respect (for the 2008-2012 period).
- So far the risks are stressed very much, but companies and the financial sector should also look at the opportunities of ETS and other climate policy instruments. Especially the financial sector can react very quickly.
- It is a very important fact that carbon will now have a market price - even if some NAPs will not be as strict as expected.
- Climate events can change public perception quickly.

- Don't blame climate change for unemployment. Energy efficiency (and partly renewable energies) can create many jobs.
- Mainstream credit raters were not joining the event. Clearly regulative risk (ETS) will be an issue for them, but probably they do not yet know how to deal with it. Other aspects, like the oil price, are certainly more important for them. But climate will play a role.
- Climate change is a mid- or long term issue - for credit raters the quarter is the long term.
- However, 15% of the biggest companies are owned by pension funds with their inherent long term perspective.
- The big pension funds might be the key.

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