

What COP 15 means for business

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The multilateral climate negotiation process was tested to destruction in Copenhagen, but the US administration remains resolutely upbeat that the Copenhagen Accord is a concrete step forward, requiring real action by signatories including, significantly, developing countries. The European perspective of Copenhagen has been more jaundiced because the Accord says nothing about the future of institutional structures of the Kyoto protocol that has been a central driver of EU climate policy for the past decade. Since the US was not a participant in these mechanisms anyway, Americans do not feel this as a significant loss. But for European companies, the way forward on climate policy has become obscured rather than clarified by this latest round of negotiations.

Nevertheless, negotiations continue, and presumably some clarity will return. In the meantime, what can we say about how the outcome at Copenhagen affects business decision-making?

The stringency of targets coming out of Copenhagen will be a disappointment to those who believed in the power of international negotiation. The negative reaction to the Copenhagen outcomes from European business stems from the fact that many European companies have a direct stake in the future of international emissions trading. The fact that the previous rules of the game have been swept aside with such apparent ease by the Copenhagen Accord will (at least temporarily) dent the credibility of international policy as a basis for business-level decision-making.

The Copenhagen outcome certainly requires a re-calibration of expectations. It was already clear well before Copenhagen started that the negotiating environment was very different from that in Kyoto 12 years earlier. The outcomes suggest a far greater emphasis on the primacy of domestic legislation, implying that climate policy has become less multi-lateral as a result of Copenhagen. From an environmental perspective, the biggest casualty of a move towards greater unilateralism of climate policy is the potential weakness of emission reduction targets that may result from such a process. Finding ways to exert effective international pressure on the stringency of domestic climate targets will be the primary challenge in coming years and decades.

But from a business perspective, stringency is only

one aspect of the problem. Uncertainty over climate change policy is a key issue for companies, especially those for whom energy is a major component of their cost structure. Although they operate perfectly well in situations of market uncertainty, political risk is different because there is a lack of counter-parties able to trade the risk. Investment decisions that companies make, particularly in the energy sector and energy-intensive manufacturing industries, can be very susceptible to changes in policy. Reliability and transparency of policy-making, and moving towards a level legislative playing field are key priorities for business.

Given that enforcement mechanisms for domestic legislation tend to be more robust than for international policy, it could be argued that such a bottom-up process leads to a more reliable policy environment. Companies will often have had the chance to influence the design of policies and to develop an understanding of the ways in which they are likely to be changed in the future.

Whilst it may be business-as-usual for domestic climate policy, the prospects for international carbon markets have taken the most significant step backwards as a result of the Copenhagen Accord. No reference is made to the existing institutional structure for emissions trading, nor even a way forward for developing the future of emissions trading. There is a passing reference to the use of markets for funding reduced emissions from deforestation and forest degradation (REDD), but no specifics are set out on how this would relate to existing market mechanisms.

Economists are clear that carbon pricing will continue to be an essential component of climate policy if unabated fossil fuels are to be priced out of the market. In Europe, politicians have mostly taken this message on board, and emissions trading remains an important pillar of climate policy, albeit with constrained ambition levels. In the US, politicians have been reluctant to bite the carbon pricing bullet. Although a bill including a cap-and-trade scheme has passed the House of Representatives, pricing faces a tough challenge in the Senate.

Essential though it is, carbon pricing cannot do the whole job of climate policy. Whilst carbon pricing can stimulate investment in existing technologies by making them more cost-effective, carbon pricing tends to under-deliver investment in the development of new

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technologies. Other policy mechanisms are therefore required to bring new technologies to the point of commercialisation where they can be supported by the carbon price.

Such policies are already widespread. The EU has agreed a goal of meeting 20 per cent of its overall energy demand through renewable sources by 2020. It is up to individual member states to introduce legislation to deliver the investments required to meet this target. Other technology solutions being promoted at the EU level include support for demonstration of carbon capture and storage (CCS), although there are few specific proposals on the table on how these would be financed.

An important problem that arises out of this multiple-policy approach is dealing effectively with the negative consequences of policy interactions. A cap-and-trade scheme ensures that a certain level of emissions will be achieved at a certain date for the sources covered by that cap. Other policies applied to these same emissions sources will not alter the total level of emissions as long as the cap is unchanged. Subsidies provided to renewable energy, for example, will reduce emissions in the power sector, but total emissions in the cap-and-trade scheme as a whole will be unaffected unless the cap is reduced to compensate. The effect of subsidising one set of technologies is to shift emissions reductions around within the total cap-and-trade scheme 'emissions bubble', without having any effect on the size of the bubble.

The way to get round this problem is to ensure that whenever a new climate policy is enacted that is intended to reduce emissions within the boundary of the cap-and-trade scheme, the cap should be reduced by an equivalent amount to ensure the emission reduction actually takes place. Ideally, coordination of policies in this way would lead the carbon price to rise over time, overtaking and making redundant the individual technology subsidies. New abatement technologies could then compete under prevailing market conditions, allowing government-determined subsidies to act as temporary kick-start mechanisms rather than permanent crutches.

Political uncertainty around the international agreements also filters down into the regulations in the EU that have a direct impact on companies. For example, the EU has set a unilateral greenhouse gas reduction commitment of a 20 per cent reduction compared to 1990 levels by 2020, to be extended to much more ambitious 30 per cent reduction if other major parties take on comparable commitments. It is still unclear how and when this will be resolved.

Companies have to incorporate these risks into their decision-making, and will generally incorporate risk premiums into their investment decisions. These

risk premiums particularly affect capital-intensive technologies such as nuclear power and renewables, which are often more sensitive to variability in the price of carbon than fossil-fired generating plant.

This raises many important questions. Should governments attempt to protect companies from these risks? Or would this represent too much of a hidden subsidy to companies and transfer too much risk to tax-payers? Are companies in just as good a position as anyone else to predict (and influence) the outcome of international negotiations, or are these political risks that only governments are in a position to underwrite?

Copenhagen has dented confidence in the ability of governments to act collectively in the international interest. But it seems inevitable that the process will continue. Interest in the implementation of other countries' climate policy is legitimate because of the global impacts of each countries' emissions. Over time there will inevitably be considerable learning, not only technological, but also institutional. Copenhagen has already been a significant learning event in relation to the efficacy of international negotiations. Subsequent negotiations will reveal further information on countries' ability to deliver and enforce the emission reductions to which they have committed. In that sense, companies should treat climate policy as a risk-management exercise in the same way that they manage a whole range of other business risks. ■

UN Secretary-General Ban Ki-moon speaks with Felipe Calderón, President of Mexico, and Jens Stoltenberg, Prime Minister of Norway, during the final hours of the UN Climate Change Conference in Copenhagen, 18 December 2009

