

# Climate Change Update: Debate Is Really about Three Big Pocketbook Issues

## Summary

Today, the U.S. Senate begins debate on cap-and-trade legislation sponsored by Senators John Warner (R-VA) and Joe Lieberman (I-CT). Our longstanding view that binding federal law that establishes mandatory surcharges on greenhouse gas (GHG) emissions is unlikely to pass before late 2009 or early 2010 is now the consensus expectation. Environment and Public Works Committee Chair Barbara Boxer (D-CA) has threatened for months to urge Senate Majority Leader Harry Reid (D-NV) to withdraw Warner-Lieberman from the Senate Floor if it is substantially “weakened” by amendments this week, an easy out if, as we expect, too many pro-warming lawmakers get cold feet about legislating surcharges to household energy costs during an election year. Even some of the Senate’s most vocal advocates for a U.S. carbon market have recently referred to Warner-Lieberman as a “dress rehearsal” for next year’s debate. Vote counts alone are enough to reach this conclusion: overcoming White House opposition would require 67 Senate votes of support, well in excess of the estimates from our Washington sources, which range from a conservative (but perhaps realistic) 47 to (perhaps optimistic) 59 ayes.

**On a dynamic basis, this range is itself a sea change.** After all, climate change legislation drew 43 and 38 supporters, sequentially, the last two times it came before all 100 U.S. senators. Investors should expect this localized (Washington) warming trend to continue with November’s elections. All three remaining mainstream presidential candidates have committed to binding GHG controls, and we remind investors that the energy politics of the House and Senate are likely to lurch leftward with the impending retirement of a large number of both chambers’ and both parties’ senior energy policymakers. Many of these members hail from states and districts with significant leverage to heavy industry, refining and petroleum, and coal extraction. Our research shows that, irrespective of party affiliation, most of these seats will be filled by successors likely to offer similar advocacy for their home state industries. But next year’s new arrivals will not have their predecessors’ influence over Congressional decisions at the committee level, where chairmanship is largely driven by seniority, improving “greener” lawmakers’ odds of filling top decision-making slots.

**It is eminently possible that the Senate does not vote at all.** Sources anticipate that Republicans will call Democrats’ bluff, rather than being tarred as obstructionists, and we expect limited opposition to an initial “motion to proceed” with debate on the Warner-Lieberman bill. This does not suggest, however, that debate ever proceeds to the point where 60 senators agree to end debate and proceed to a final vote. The best face-saving move for Senate Democrats is the most likely one: a weeklong, symbolic debate over a very full “tree” of amendments constructed largely to waste time. Why? Because neither party stands to gain, politically speaking, from a showdown on the Senate Floor. The pace and implications of global climate change are scientific matters, but, as we discuss below, we would suggest that Washington’s political debate concerning the structure of market-based GHG controls revolves around three big pocketbook issues: U.S. voter economic well-being, differential economic impacts borne by different U.S. industrial sectors, and global trade impacts across national economies.

## Key Points

- **Big pocketbook issue No. 1: it’s the economy, Mr. Smart Guy.** In an election year, energy policy--like most issues--tends to revolve around voters’ economic health. In the last year alone, our year-ahead estimates of household gasoline, electricity, and heating costs have climbed from approximately 8.5% of disposable personal income (DPI) to slightly more than 11.25% on a national-average basis, weighting by state rather than population (every state gets two Senate votes, so this is our political barometer). This concerns many lawmakers who recall that the 1979 oil shocks that sent the economy into a recession coincided with energy costs rising to more than 8% of DPI. We would suggest that making an apples-to-apples comparison with the 1979-1981 oil shocks may be an oversimplification, in large part because disposable incomes and transportation demand for energy have increased as interest rates have fallen, while logistics use of energy as a proportion of total cost has decreased with greater supply chain efficiency. Overall, the petroleum intensity of U.S. GDP has fallen by about 50% on a real basis (by about 87.5% in nominal terms) during the ensuing three decades but, at lower income levels, larger home sizes, longer commutes, and limited improvement in vehicle fuel economy--in tandem with housing-related cash and credit woes--could provoke the ouster of any vulnerable politician who dares to advocate higher energy prices in the name of environmental stewardship.

- **Big pocketbook issue No. 2: GHG emissions are linked to economic output.** Despite increasing energy and GHG efficiencies of U.S. GDP, two inescapable problems for lawmakers remain: (1) the balancing act across the diverse regional resource bases and industrial sectors that make up the U.S. economy, and (2) the fact that most industrial sectors rely heavily on fossil fuels (and therefore are responsible for GHG emissions). First, without even considering end users of energy, extractive industries are already at loggerheads. The cheapest domestic energy source, coal, has the greatest political constituency behind it but also the greatest vulnerability under legislation like Warner-Lieberman. Petroleum extraction is a mixed bag for companies that produce both oil and natural gas, not only because natural gas is currently priced at about a 50% Btu-adjusted discount to oil, but also because methane delivers approximately 50% of the carbon footprint (Btu-per-GHG-unit) of coal-fired power. Petroleum refining, however, like the rest of manufacturing, smelting, and heavy industry, must pass through any carbon surcharge (approximately \$0.075 per \$10 per metric ton CO<sub>2</sub> equivalent for regular gasoline, by our numbers). Agricultural use of fossil fuel, in conjunction with carbon emissions that may be released by changes from land use, also could inject significant carbon surcharges into variable costs. If one considers the regional profile of emitters in geographic terms, it begins to look like “coal, corn and cars vs. the [East and West] coasts.” In financial terms, adding imputed carbon costs to explicit fuel costs rewards high-gross-margin businesses, like professional services, and doubly punishes low-gross-margin businesses, like manufacturing. Winning 60 votes in this context may best be accomplished by rebalancing economic sectors and financial impacts by giving affected emitters free “allowances” (carbon credits) rather than requiring them to purchase them each year at an open auction. Growing numbers of allowances, however, lead to less efficient market pricing for GHG emissions. Investors should not expect a “full auction,” however. Revisions of Warner-Lieberman have increased the allocations of free allowances to a growing number of parties to win greater political support in what has been known in recent weeks among some sources as the “Salazar Principle,” after Senator Ken Salazar (D-CO), who is reputed to have championed larger allowances.
- **Big pocketbook issue No. 3: climate change is about global trade.** We have already noted that Western European economies have made no secret of their self-interested goals in advocating global carbon pricing, as it may help them stem balance-of-trade disadvantages associated with energy and manufacturing by rewarding differentially greater energy and GHG efficiencies than the nations that export to them. As the EU proceeds towards plans to require inbound aircraft to purchase emissions allowances under the Emissions Trading Scheme (ETS) in 2012, the discussion of backing one country into another country’s carbon costs is no longer theoretical. Ultimately, we believe the architecture of a post-Kyoto framework is likely to incorporate some mechanism for expediting trade-related recourse against noncompliant economies. At its most elegant (but unlikely), this trade-related solution could be a floating “carbon exchange rate”; more likely, it might take the form of tariffs or surcharges on an SIC code basis. Either way, we see signs that U.S. lawmakers are currently headed away from a resolution of the problem and towards a diplomatic challenge. Both the Warner-Lieberman cap-and-trade bill and the Senate Energy Committee’s alternative, offered by Senators Jeff Bingaman (D-NM) and Arlen Specter (R-PA), include trade-related recourse against noncompliant economies, largely in the name of protecting U.S. jobs from going overseas; but neither bill enables emitters to meet their compliance obligations by sourcing a significant number of “offset” credits from overseas projects. U.S. emitters are split on the issue; manufacturers who have already offshored their production fear surcharges could hurt their margins, but refiners and coal-fired power plants would benefit from the ability to meet their compliance obligations without retiring plant ahead of its useful life, and at lower cost than U.S. projects, and could exploit their higher GHG efficiencies relative to emerging markets. Ironically, we have observed that one of the forces changing political sentiment regarding climate change controls has been a growing concern by some policymakers that U.S. noncompliance with global GHG protocols will make the U.S. an “island” excluded from global trade. We expect this protectionism to eventually abate, but the implication of the status quo would be a steeper discount for overseas offsets and a generally higher carbon price facing U.S. emitters.

## Risks

The legislative agenda is subject to change at the discretion of each chamber’s leadership

\*Closing price of last business day immediately prior to the date of this publication.

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