

## European Companies Look To Carbon Markets And Reduction Measures To Manage Their Emissions Exposure

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# European Companies Look To Carbon Markets And Reduction Measures To Manage Their Emissions Exposure

European companies plan to use short-term emissions abatement measures as well as the carbon markets to manage their carbon exposure, according to a survey of Standard & Poor's Ratings Services' portfolio of 500-plus rated corporate issuers. (For details, see section headed "Survey Methodology" at the end of the article.) Furthermore, it appears that respondent companies are now considering their carbon exposure strategy post-2012, when the more stringent Phase III of the EU Emissions Trading Scheme (ETS) comes into force. This is when carbon exposure is likely in our view to start to have a real impact on industry. Until now, according to our findings, the financial implications of complying with carbon legislation have been minimal for most companies.

In our survey, we canvassed the views of 513 corporate issuers that we rate on their current and anticipated future position in terms of their corporate carbon exposure. According to our analysis, the results indicate European companies increasingly believe that EU climate change policies will create both risks and opportunities. Moreover, a number of survey respondents indicate that by implementing a carbon management strategy now, they can generate an opportunity for sustainable competitive advantage and potentially bolster their company's creditworthiness. This may explain why, according to some replies, the stewardship of companies' carbon management programs now rests with senior executives and board directors.

Another possible reason for this level of stewardship, in our view, may be that climate change policies are now more likely to be on the political agenda. Certain governments are currently formulating a range of policies, standards, and regulations around greenhouse gas emissions (GHGs), energy consumption, and production that we feel could have significant and broad consequences for industry.

In the absence of a new legally binding international agreement on emission reductions post-2012, certain national and local governments worldwide are initiating bottom-up approaches and broadening the scope of regulation. Countries such as the U.K., for example, have their own carbon reduction legislative frameworks in place that will determine emission limits for different industry sectors over the short (one to two years), medium (two to four years), and long (four to six years) term. In the U.K., the Carbon Reduction Commitment covers small businesses and municipal facilities that fall outside the EU ETS. Recent announcements of carbon taxes in Ireland and France and the revisions to the EU Energy Tax Directive provide further evidence regarding governmental actions to curb carbon emissions through fiscal and regulatory mechanisms, in our view.

## Emissions And The Bottom Line: A Delayed Impact

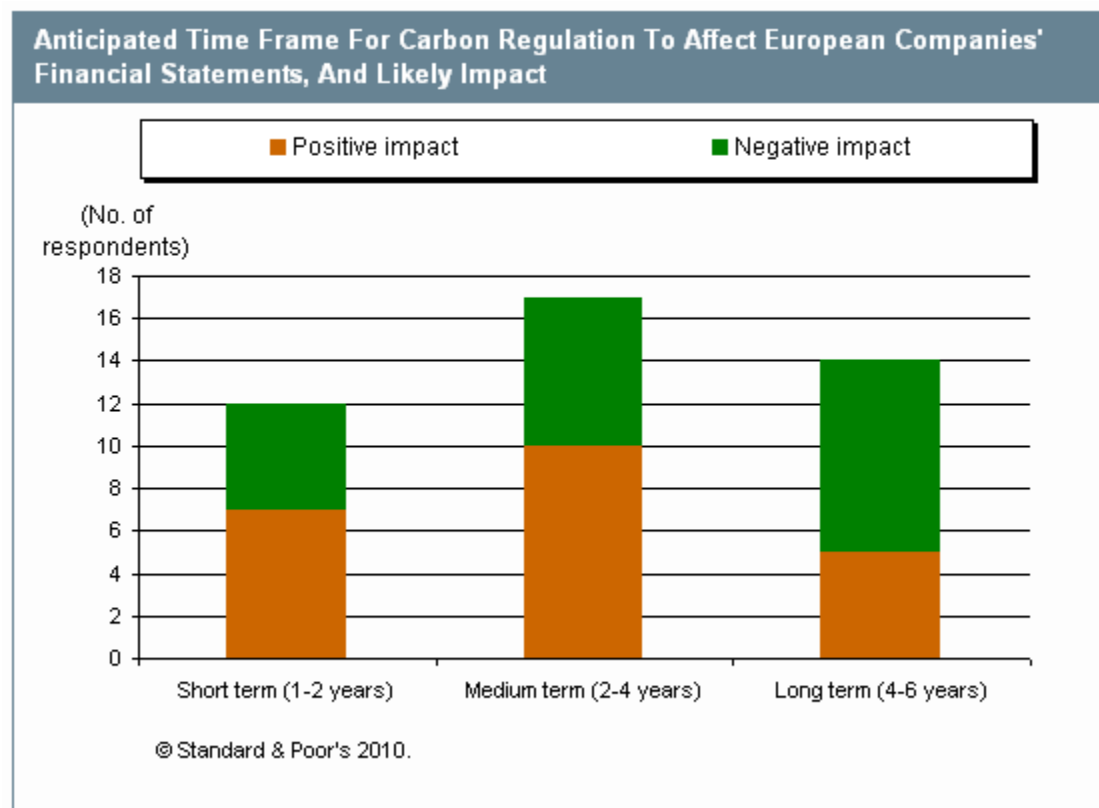
According to our survey, emissions are becoming an accountable item for a significant number of companies. About 40% of respondents indicate that they fully account for carbon in their financial statements and annual reports. However, a similar percentage do not factor carbon emissions into any of their corporate financial calculations at all, which suggests there is still some way to go before European companies comprehensively integrate carbon reporting into their normal financial statements. Just over 20 per cent have just started looking into the issue, which in our view indicates that industry is beginning to move toward that type of assessment.

Companies holding back on their measurement of carbon exposure costs could, we believe, be due to a lack of accounting-specific information on the subject. One respondent comments that there is a lack of comprehensive guidance on accounting issues related to emissions trading schemes and the allocation of EU Allowances (EUAs, otherwise known as GHG emission rights). In the absence of specific standards, there is a certain degree of variation in the accounting approaches taken within industry sectors. Overall, one-third of responding companies account for the treatment of allowances on their financial statements and there is an equal split between recording allowances as either inventory or intangible assets.

With respect to the short-term financial impact of complying with emissions legislation, our survey reveals a fairly benign picture at present. About 60% of respondents say that the cost of carbon regulation (that is, the amount of allowances required to cover net emissions multiplied by the current carbon price) is currently positive. Furthermore, they anticipate that it will likely remain positive for the next three years (see chart 1). With some notable exceptions, the historical impact on credit quality has therefore been minimal since the EU ETS was introduced in 2005.

With the start of Phase III of the EU ETS from 2013, however, most industry sectors expect their carbon cost positions to turn negative. This may explain why some companies are already implementing carbon strategies and plan to carry forward a net surplus of their current EUAs, and may thus be able to cover their short positions when the more stringent emission reduction regulations are introduced. Such strategies may help to protect companies from the detrimental credit impact of longer term carbon exposure.

**Chart 1**



Significantly, the overwhelming majority of respondents (about 90%) say that their current level of carbon exposure

does not significantly affect their ability to raise finance. For around 7% of companies, there is a financial gain from carbon exposure in the form of carbon revenues. Only 4% claim that carbon exposure levels are having an adverse effect on their fund-raising capability. This may suggest, in our view, that lenders and investors have yet to fully incorporate carbon exposure risk into their funding decisions.

## **Firms Take A Proactive Approach To Meet Tighter Regulation**

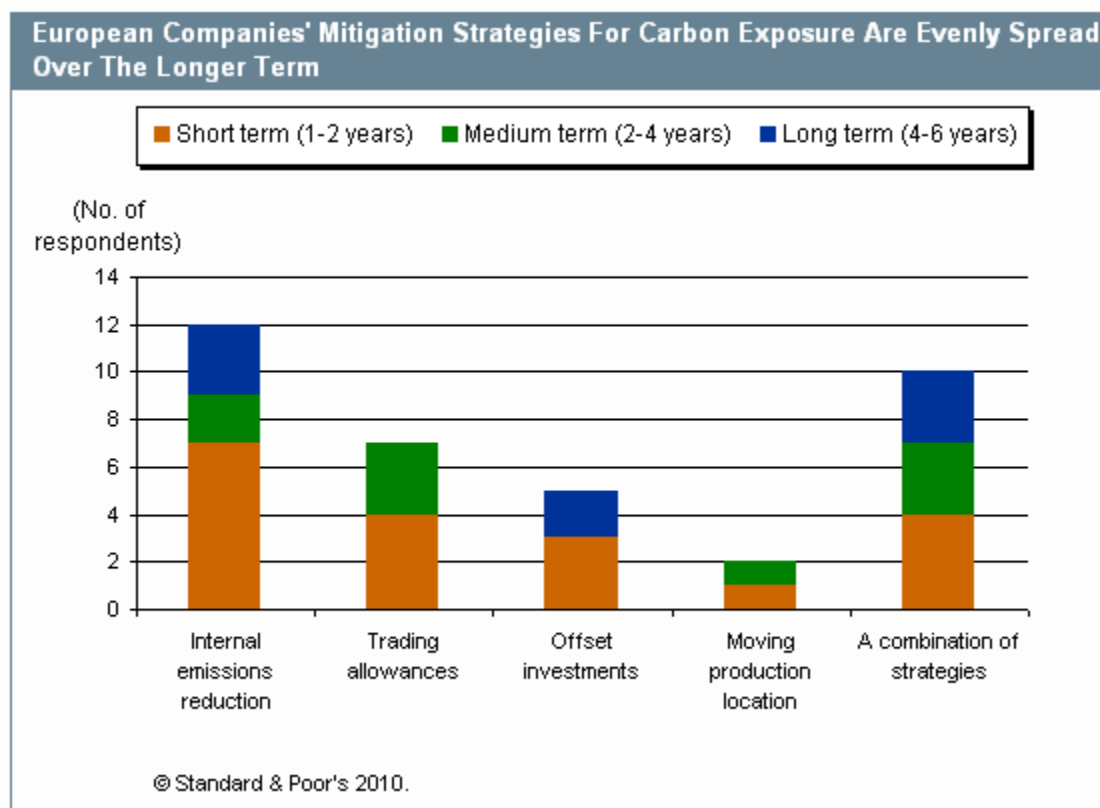
Regardless of their current position, the respondents from our portfolio of rated European companies anticipate that the regulatory regime post-2012 will be more restrictive in terms of emissions allowances. Moreover, they foresee increasing pressure from regulatory bodies in terms of carbon emission reductions. To prepare for this more stringent regulatory regime, companies appear to be developing flexible carbon exposure mitigation strategies to cover the next five to six years (see chart 2).

In the short term (one to two years), these mitigation strategies appear to center on investing in projects that reduce in-house CO<sub>2</sub> emissions from industrial processes and improve energy efficiency. In addition, respondent companies say they plan to take full advantage of their ability to offset up to a certain limit their emissions by purchasing carbon credits from qualifying projects under the Kyoto Protocol. Companies also plan to take advantage of their allocated emission rights until 2012 and their ability to carry forward potential surpluses into Phase III of the EU ETS.

Over the medium term (two to four years), the survey reveals an anticipated shift among companies to trade allowances and move production to locations with less restrictive climate change regulations in the absence of integrated global carbon markets and a global carbon price.

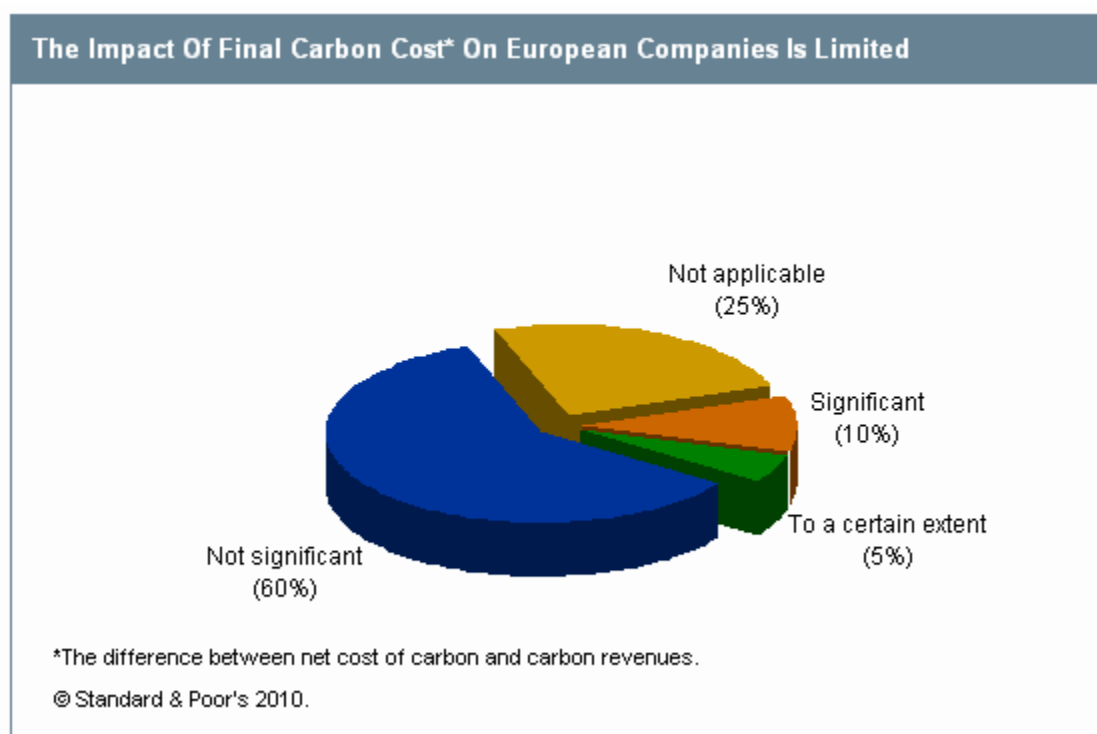
However, our survey data indicates that in the long term (four to six years) more companies intend to expand their carbon offset investment strategies, implement systems to buy allowances on a regular basis, and continue to reduce internal emissions. In our view, this may be indicative of an increasing move among European companies that over the foreseeable future they will need to mitigate their carbon exposure, and hence support credit quality, through a combination of trading allowances and carbon offset investments. Even those respondents that do not have an active EUA trading strategy in place at present say that they will have to enter the emissions market after 2012 to cover their short carbon positions.

Chart 2



Nearly 60% of survey respondents state that the final cost of carbon exposure (that is, the difference between the net cost of carbon and carbon revenues) has had no significant effect on their company to date (see chart 3).

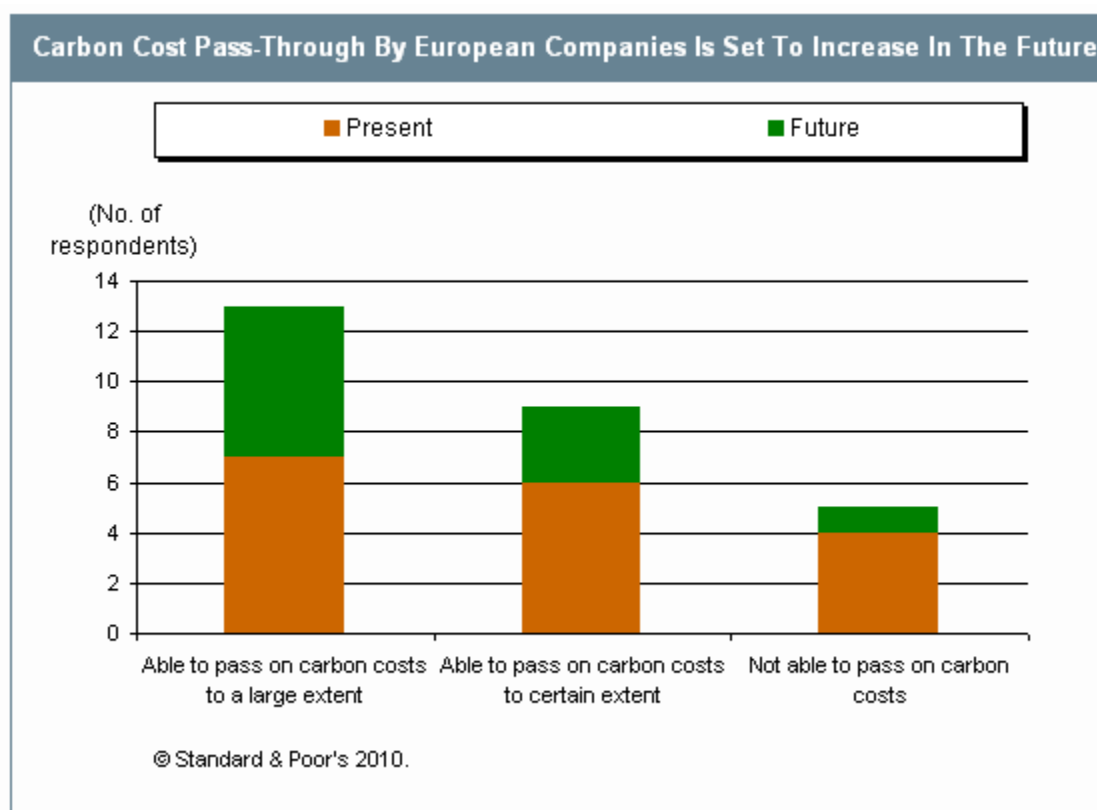
**Chart 3**



This lack of impact, we believe, could be down to the favorable allocation of allowances in the early stages of the EU ETS. The survey results also suggest that, at present, carbon costs are not entirely being passed on to end consumers as there is a net benefit from carbon allowances. However, we anticipate that over the medium term, EU decisions on carbon leakage (the movement of production to countries with less stringent carbon legislation), reduced free allowance allocations to less-exposed industries, and the availability of substitute products are likely to reduce this net benefit.

In the longer term, we believe companies will be exposed to negative net carbon costs--that is, the difference between total emissions (the amount of allowances a company needs to purchase) and the number of free allowances allocated under the relevant trading scheme. That said, we think that companies will seek to mitigate this exposure, since our survey responses show that companies expect to increase their carbon revenues by passing on more net costs to end consumers (see chart 4). Eventually, according to the majority of respondents, the aim is to pass on 100 per cent of carbon costs. Whether this can be achieved or not will, in our view, ultimately be a key factor in determining the credit impact of future carbon exposure.

Chart 4



## Carbon Management May Point The Way To Competitive Advantage

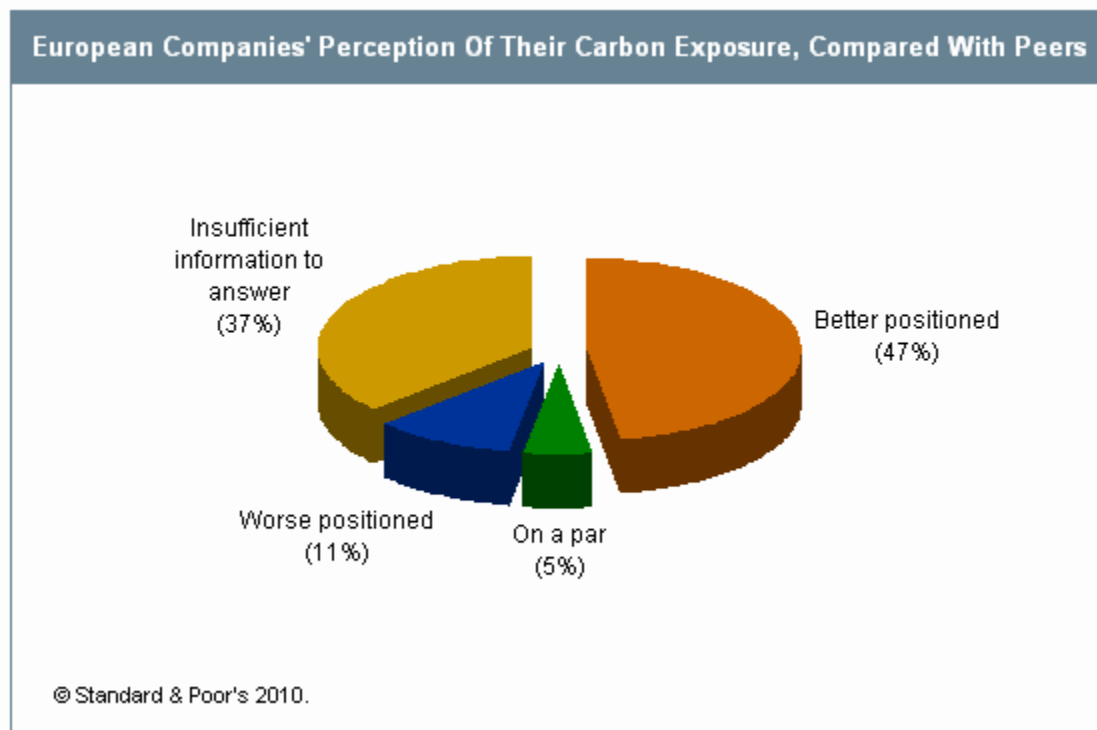
In the current economic downturn companies are looking to leverage the most cost-effective solutions, and the survey shows that carbon management is starting to play a big part in this strategy. One respondent comments that in their view the incremental cost of creating a carbon management strategy is trivial in comparison to its potential value in acquiring competitive advantage.

From our survey responses, it appears that an increasing number of European companies view carbon as a tradable commodity and that the carbon market is fast becoming an important tool for all industry sectors affected by climate change legislation. Against this background, our survey indicates that some respondent companies are looking to manage the financial and credit risks presented by tighter carbon regulations and to identify opportunities for earning additional revenues. In addition, it appears that they see obtaining green credentials and creating new brands as representing a competitive advantage.

Almost one-half of our survey respondents claim that they are better positioned than their competitors in terms of carbon exposure (see chart 5), with one company claiming a carbon footprint 20 times lower than that of its closest peers, which it views as strengthening its overall business position. The company expects this situation to be reinforced by the implementation of Phase III of the EU ETS and other new national regulations covering carbon emissions, such as the proposed carbon tax in France. Moreover, a number of survey respondents believe that a price on carbon can give an edge to top industrial players that are able to produce more with less energy and/or

GHG emissions, and to offer products that enable their customers to do the same. Some respondents claim that this fosters R&D both at the production stage and during the product life cycle (that is, from product creation to utilization).

**Chart 5**



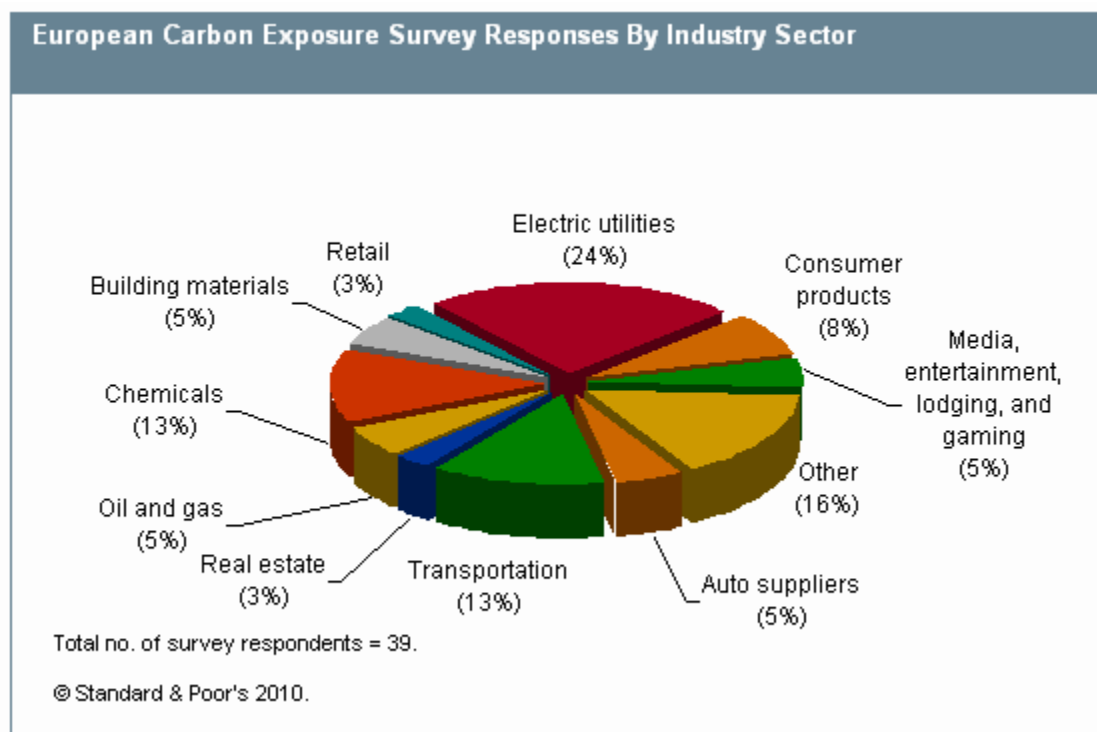
Over the next 12-18 months, Standard & Poor's anticipates examining more closely verified GHG emissions data in relation to all companies that we rate. With European companies likely to face new and more stringent climate change regulations within the next two years, some businesses appear to be investing in robust and flexible data management systems. While carbon exposure has so far not created too many challenges for corporate Europe, as the views of the respondents to our survey indicate, this situation could be about to change.

## Survey Methodology

In this survey, the views of 513 corporate issuers rated by Standard & Poor's were canvassed on their current and anticipated future position in terms of their corporate carbon exposure.

The results cover a wide variety of industry sectors. They include those sectors that have obvious high carbon exposure--electric utilities, chemicals, building materials, and oil and gas. They also encompass sectors that, due to the nature of their activity, are not directly exposed to carbon legislation to the same extent--auto suppliers, for example. The response rate of 39 completed questionnaires is close to 8% of the sample population, which is above average for this kind of survey and therefore statistically valid in our view. Furthermore, the spread of responses is reasonably broad across all industrial sectors (see chart 6).

**Chart 6**



The following definitions associated with carbon exposure were provided with the questionnaire:

- Gross carbon costs: The amount of emission allowances a company needs to surrender for compliance purposes multiplied by the price of such allowances.
- Net carbon cost: The difference between total emissions (the amount of allowances a company needs to purchase) and the number of free allowances allocated under the relevant trading scheme.
- Carbon revenues: The level of allowance costs passed through to the final consumer ("recovered costs") multiplied by sales.
- Final cost of carbon: The difference between the net cost of carbon and carbon revenues.
- Cost of carbon regulation: The amount of allowances required to cover net emissions multiplied by the current carbon price.

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