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The political challenges of implementing environmental regulations

By Angelo Katsoras

Introduction

A growing number of countries and companies are being prompted by mounting public pressure and institutional investors to adopt increasingly tighter environmental regulations.

The main challenge for these countries will be to implement environmental policies able to stem global warming in the long term without having an overly large impact on economic growth in the short term. This balancing act entails providing significant financial assistance to regions that will be adversely impacted at a time when many countries are already struggling with sluggish growth and overstretched budgets. Companies, especially in the energy sector, will face the double challenge of maintaining profitability and implementing robust environmental policies to preserve social acceptability.

Another looming risk is that differing views on climate policies will increase tensions between countries and spill over into trade policy.

Major investors forcing companies to take climate change seriously

More and more institutional investors and financial institutions are placing environmental concerns at the forefront of their business plans. The most prominent example of this is the Climate Action 100+, a group of investors managing assets worth more than $40 trillion. The group is leveraging its influence to pressure major corporations to curb emissions. Blackrock, which manages over $7 trillion in assets, recently joined the Climate Action 100+ and announced that it would begin exiting investments in coal production, introduce funds that ban fossil-fuel stocks, and vote against corporate management lagging behind on efforts to fight climate change.

The Energy sector is in the crosshairs

Owing to the high levels of greenhouse gases it emits, the fossil-fuel energy sector has come under particular scrutiny. From 2011 to December 2019, the number of U.S. shareholder climate-related proposals have almost doubled. Of these, 50% have targeted energy producers (oil, gas, utilities, and coal). Another 10% have targeted the financial institutions that lend to them.[1]

Alberta's oil sands have come under even greater pressure. Its higher carbon footprint relative to other types of oil production has caused a growing number of financial institutions to announce they will no longer invest or lend to this sector. These institutions include HSBC, BNP Paribas Group, Societe General of France, Blackrock and the Norway sovereign wealth fund. Jason Kenney, Alberta's premier, has responded by stating some of these very same companies invest in the Middle Eastern oil sector despite the bad human rights record of their host countries. He has threatened to ban these companies from doing business with the Alberta government.[2]

A growing number of oil majors now realize that tighter regulations and carbon taxes in one form or another are inevitable and are thus trying to adapt. Here are a few examples of this:

- Starting in 2024, ConocoPhillips will require that all projects be viable with a carbon tax of $40.[3]
- Repsol of Spain became the first oil and gas company to set a target of net-zero emissions by 2050.[4] Simply put, it aims ultimately to offset all the carbon that it releases via such measures as carbon capture technology, improvements in efficiency, and the purchase of carbon credits.
- Soon after, BP also pledged to reduce its emissions to net zero by 2050, and make plans to increasingly diversify into cleaner energy
- Shell committed to reduce its emissions 3% by 2021 and 50% by 2050. Executive compensation will now be based in part on the achievement of these targets.
- Canadian oil companies, too, are taking similar positions. Cenovus Energy aims to lower its emissions per barrel 30% by 2030, and has pledged to attain the goal of net-zero emissions within three decades. Canadian Natural Resources and Meg Energy have set similar targets. Meanwhile, Suncor's objective is to reduce emissions 30% from 2014 levels by the end of this decade.[5]

[1] "Carbonomics," Goldman Sachs, December 13, 2019
[2] "Global Financial Giants Swear off Funding and Especially Dirty Fuel," The New York Times, February 12, 2020
[3] "Green fortunes will be made as the economy is forced to decarbonise," The Telegraph, January 24, 2020
[4] "Companies are being called to account for climate risks," Financial Times, January 8, 2020
[5] "Varcoe: Suncor forges a path to lower emissions — and lower costs," Calgary Herald, February 7, 2020

Three factors—the growing focus on the environment, worries that demand for oil could fall in the coming decades, and the low fossil-fuel prices of recent years—have combined to turn certain investors away from this sector.

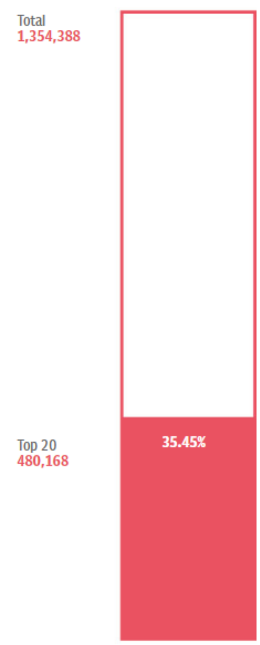
From this standpoint, oil companies are increasingly stuck between a rock and a hard place. On the one hand, more and more investors are wary of putting their money in oil stocks either because they want greener energy or because they worry that oil consumption will decline in the future. On the other hand, if oil companies substantially increase their funding of alternative energy they risk alienating investors who simply want a solid return on their investment. These investors fear that money will go into areas perceived as being less profitable and thus threaten their dividend payments. While most of the larger oil companies have the funds to balance these two competing interests for the time being, the same cannot be said for their smaller counterparts.

Complicating matters further, it is estimated that 20 fossil fuel energy companies alone are responsible for 35% of all the greenhouse gas emissions over the past 50 years or so. This list is dominated by state-owned oil companies which, account for well over half of current global oil production.[6] **Will institutional investors ultimately target these companies as well? And, if yes, how would their home countries react?**

The 20 firms behind a third of all global carbon emissions

Tonnes of carbon dioxide and methane contributed between 1965-2017, and the total %

	mtCO2e	% of total
Saudi Aramco, Saudi Arabia	59,262	4.38%
Chevron, USA	43,345	3.20%
Gazprom, Russia	43,230	3.19%
ExxonMobil, USA	41,904	3.09%
National Iranian Oil Company, Iran	35,658	2.63%
BP, UK	34,015	2.51%
Royal Dutch Shell, The Netherlands	31,948	2.36%
Coal India, India	23,124	1.71%
Permex, Mexico	22,645	1.67%
Petróleos de Venezuela, Venezuela	15,745	1.16%
PetroChina / China National Petroleum, China	15,632	1.15%
Peabody Energy, USA	15,385	1.14%
ConocoPhillips, USA	15,229	1.12%
Abu Dhabi, United Arab Emirates	13,840	1.01%
Kuwait Petroleum Corp, Kuwait	13,479	1%
Iraq National Oil Company, Iraq	12,596	0.93%
Total SA, France	12,352	0.91%
Sonatrach, Algeria	12,302	0.91%
BHP Billiton, Australia	9,802	0.72%
Petrobras, Brazil	8,676	0.64%



SOURCE: CLIMATE ACCOUNTABILITY INSTITUTE

Source: "Green fortunes will be made as the economy is forced to decarbonise," The Telegraph, January 24, 2020

Some analysts have even warned of the long-term risk of the fossil fuel sector being starved of capital before the global economy has managed in large part to transition to renewable energy sources. Despite growing investments in alternative energy, the International Energy Agency projects that fossil fuel's share of global energy demand will fall only from 81% in 2018 to 74% by 2040. While this projection could end up underestimating the rate of growth in alternative energy, it is important to note that past energy transitions to electricity or gasoline-fueled cars took several decades to realize. Indeed, The Financial Times estimates that even if every car built from this moment on was electric, it would take 15 years to replace the world's 1.3 billion vehicles.[7]

[6] "The Oil and Gas Industry in Energy Transitions," International Energy Agency, January 2020
[7] "Can the world kick its oil habit?," Financial Times, February 13, 2020

The EU's Ambitious Green Plan

Last November, the EU parliament proposed a bill to make the 27-nation bloc carbon neutral by 2050. If approved, the EU would be the world's largest economic bloc to officially adopt UN recommendations for all emissions to cease or be offset by mid-century. The EU's proposed target includes a 50-55% reduction in emissions from 1990 levels, up from the current target of 40%.[8]

Massive costs involved

The EU Commission has estimated that reducing emissions 40% by 2030 from 1990 levels would require additional spending of 260 billion euros annually.[9] Proposals to raise the target another 10-15 percentage points would likely add to the bill.

To deal with the costs, the EU has proposed 1 trillion euros to help its members attain carbon neutrality by 2050. This, in theory, includes significant compensation for business sectors, countries and individuals that will be negatively impacted, at least initially, by the new regulations.

However, only 7.5 billion euros, which the EU has earmarked as seed funding to generate further investment, is classified as new money. The rest will be diverted from other sectors.[10] The European Commission has indicated that half of the investment will be redeployed from other EU budgetary items. National governments will contribute another 100 billion euros, and 300 billion euros will come from the private sector.[11]

Deciding on how to redeploy EU budgetary funds will inevitably raise tensions among member states. This will be magnified by Brexit, as the UK accounted for 11.26% of the EU's net budget contributions in 2018.[12] Recent media reports have estimated that the UK's departure from the EU could more than double Germany's annual contribution from 15 billion euros in 2020 to 33 billion euros in 2027 and that the Netherlands could see its net annual payments balloon from about 7.5 billion euros to 13 billion euros.[13] These estimates do not take into account the potential additional costs of the green plan.

The risk is that most Northern European countries will veto proposals that significantly raise their national contributions, while Southern and Eastern governments will block proposals that include major cuts to their funding. The EU's budget is approved by unanimity, which gives each member state veto power.

Over the longer term, the transition to a carbon-neutral economy entails both opportunities and risks for the EU. Under the positive scenario, the EU will leverage this transition to become a global leader across a wide range of environmental technologies. Under the negative scenario, continental Europe's historical tendency to favour more centralized and bureaucratic approaches will stifle innovation—a risk highlighted by the fact that Europe has produced very few of the world's cutting-edge companies in the past few decades.

United States: A house divided

On the issue of the environment, the United States is divided along regional and partisan lines.

While the Trump administration is in the process of pulling out of the Paris Agreement, 24 states have pledged to maintain the Paris target of reducing emissions at least 26% from 2005 levels by 2025. If the Democrats regain the White House, they have promised to re-enter the agreement. The United States is currently set to formally withdraw from the deal on November 4, the day after the 2020 U.S. presidential election.

Another prominent example of this divide is the Trump administration's efforts to revoke California's authority to set higher auto mileage standards than those formulated by federal regulators. Another 14 states and the District of Columbia have followed California's lead. This dispute is currently being litigated in the courts.

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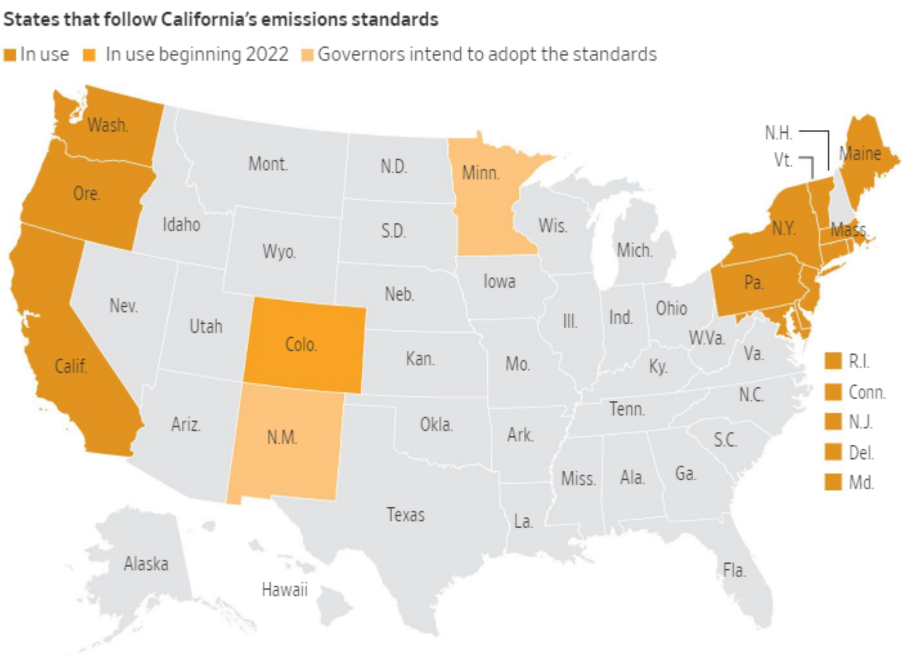
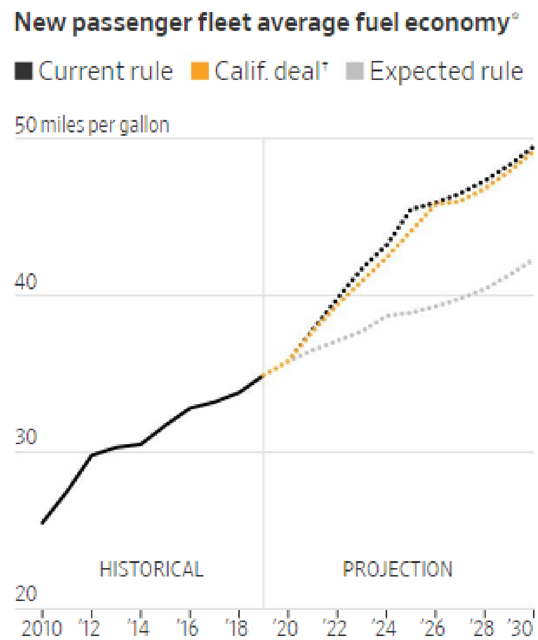
[8] "The EU's Green Deal is full of ambition but needs more detail," The Economist, December 14, 2019
[9] "Plan to Kickstart EU's Green Deal Comes With $1 Trillion in Cash," Bloomberg, January 9, 2020
[10] "EU's eye-catching green measures are not quite what they seem," Financial Times, January 27, 2020
[11] "EU lays out 1 trillion-euro plan to support Green Deal," Associated Press, January 14, 2020
[12] "Brexit Is Finally Here. Now What?," Geopolitical Futures, January 29, 2020
[13] "Germany's annual EU budget bill set to double to €33bn," Financial Times, October 27, 2019





Source: "The Auto Industry Wanted Easier Environmental Rules. It Got Chaos." Wall Street Journal, February 3, 2020

Further, while the Republicans remain mostly opposed to federal carbon taxes, there are indications that this position could change down the road. According to a recent poll, almost 7 in 10 Republicans under the age of 45 believe that human activity is causing the climate to change.[14]

Adding to the momentum for an eventual change of heart on the Republican side is an organization called the Climate Leadership Council. It supports a carbon tax which would refund all the money earned back to Americans, and a border tax targeting countries with lax environmental standards. What makes this environmental group different from others is that it is led by President Ronald Reagan's treasury secretary James A. Baker and secretary of state George P. Shultz. Its growing list of supporters includes four former Federal Reserve chairs, 15 former chairs of the presidential Council of Economic Advisers and 12 major corporations, including ConocoPhillips, Procter & Gamble, JP Morgan, Goldman Sachs and Bridgewater Associates, one of the world's largest hedge funds.[15]

Do carbon taxes equal protests?

Economists and policymakers have long argued that the best way to fight climate change is a carbon tax. This would help pay for environmental damages, encourage people to use less energy, and make it easier for cleaner alternatives to emerge.

The devil is in the details, however. While there is growing public support to tackle climate change, getting people to immediately pay more carbon-related taxes is a risky endeavour at a time when many are struggling to make ends meet and economic growth is sluggish in many countries. Two recent events illustrate the problem clearly:

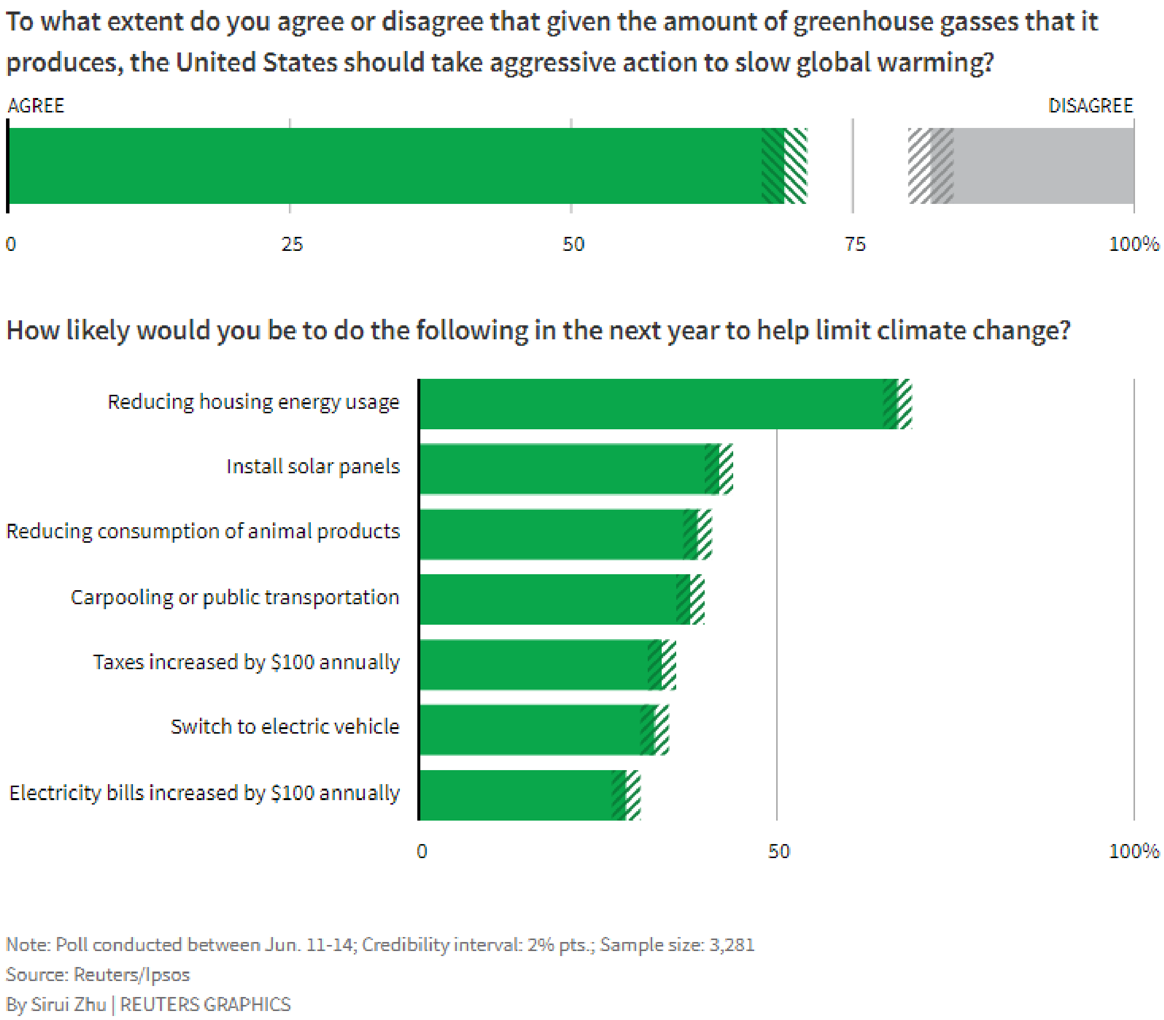
- The 2018/19 yellow vests protests in France were sparked by an increase in fuel taxes meant to pay for the deficit and new environmental measures. The hike was intended to also support France's goal of banning the sale of petrol and diesel cars by 2040. Raising the tax more sharply for diesel only added fuel to the fire, as the government had long incentivized people to buy diesel vehicles on the false belief that they were more environmentally friendly. The fact that the government had recently cut taxes for the wealthy did not help matters. Macron was forced to back off, and his popularity has stagnated at between 30% and 35% ever since.
- The 2017 "fuel price escalator" controversy arose when British authorities sought to raise fuel prices by more than the rate of inflation. The move triggered a series of angry protests by truckers that, in the end, forced the government to reverse course.[16]

Protesting against higher fuel prices has become a global phenomenon. Since 2000, demonstrations have been held in many other countries, including Egypt, Sudan, Mexico, Nigeria, Iran, Ecuador, Spain, and Brazil.

[14] "Are Republicans coming out of the closet on climate change?" Washington Post, February 4, 2020
[15] "The fastest way to cut carbon emissions is a 'fee' and a dividend, top leaders say," Washington Post, February 13, 2020
[16] "Donald Trump tells it as it is to the rank hypocrisy of the Davos crowd," The Telegraph, Dec 13, 2019

While more Americans and Canadians are worried about climate change than before, many are still opposed to paying more taxes for the environment:

A poll commissioned by the Canadian Broadcasting Corporation in mid-2019 found that, while nearly two thirds of Canadians saw the fight against climate change as a top priority, half of those surveyed would not be in favour of paying more than $100 in taxes annually to support the cause.[17] Another poll (see below) found that more than two thirds (almost 70%) of Americans, including a majority of Republicans, wanted the United States to take "aggressive" measures to combat climate change, but that only one third would support an environmental tax of $100 a year.[18]



Source: "Americans demand climate action (as long as it doesn't cost much)," Reuters, June 26, 2019

How high do carbon taxes have to go to make a difference?

In order to help limit global warming to no more than 2 degrees Celsius by 2030, the IMF is pushing for large-emission countries to introduce a carbon tax that would rise to $75 a ton by 2030.[19] If implemented, however, the tax would translate into an average 43% spike in household energy bills over the next decade. Currently, the average carbon tax levied by IMF member states is only $2 a ton.[20]

Ideally, the best way to avoid a carbon backlash is to increase carbon taxes while lowering other taxes to keep the overall tax burden unchanged. However, most governments have proven unable to resist the temptation of using this new revenue for various special projects. To its credit, the IMF supports the idea of the extra revenue raised from the tax going to compensate citizens via cash transfers or tax cuts.

[17] "Canadians are worried about climate change, but many don't want to pay taxes to fight it: Poll," CBC, June 18, 2019
[18] "Americans demand climate action (as long as it doesn't cost much)," Reuters, June 26, 2019
[19] "Fiscal Policies to Curb Climate Change," IMF Blog, October 10, 2019
[20] "Energy bills will have to rise sharply to avoid climate crisis, says IMF," The Guardian, October 11, 2019

Canada is one of the rare countries that has at least partially followed the above recommendations by passing a law stating that 90% of the revenues from a carbon tax will be returned to individual households in the provinces where the revenues are collected. Canada's Paris Agreement target is to reduce greenhouse gas emissions 30% from 2005 levels by 2030.[21] In his most recent throne speech, Prime Minister Justin Trudeau pledged to achieve "net-zero" emissions by 2050.

Will differing environment regulations worsen trade tensions between countries?

European Commission President Ursula von der Leyen recently warned in a speech at the World Economic Forum that China and other large fossil-fuel producers must find a way to price carbon at home or risk being hit by the EU with a carbon tax on their exports: "It is not only a climate issue; it is also an issue of fairness towards our businesses and our workers. We will protect them from unfair competition."[22]

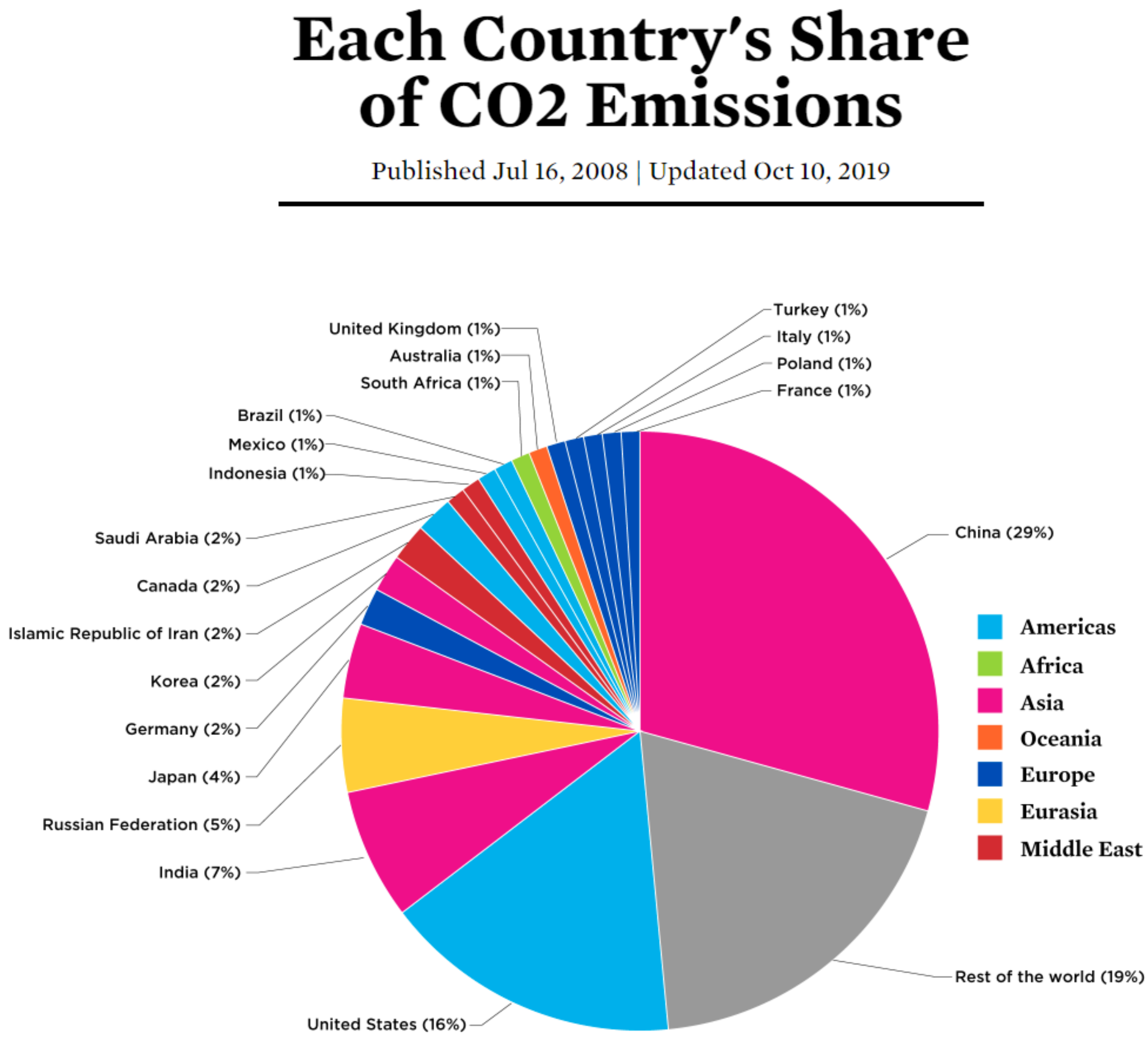
However, it is important to note that the EU has long been plagued by slow economic growth and still bears the economic and political scars of the 2008 financial crisis. Consequently, it is unlikely to want to overly escalate trade tensions with either the United States or China in the near term. This point is reinforced by the fact that the Eurozone's GDP grew just 0.1% in the fourth quarter of 2019.

While the prospect of an EU environmental border tax could raise tensions between Europe and the United States, the main conflict would ultimately be between the developed and developing world. **This is because a border tax enacted by the EU, the United States or any other developed country would end up targeting mostly developing countries accused of having lower environmental standards.**

How to share burden of de-carbonization will be source of growing tension between the developed and developing world

China's carbon footprint is a perfect case in point. Many people in the developed world insist that China should do much more to control greenhouse gas emissions. They rightly point out that China has overtaken the United States as the world's top carbon emitter since the mid-2000s. It now accounts for 29% of global carbon dioxide emissions, compared with 16% for the United States, about 10% for the EU, and 7% for India.[23]

[21] "Most Canadian households will get back more than they pay from carbon tax, PBO finds," Financial Post, February 4, 2020
[22] "Davos 2020: Ursula von der Leyen warns China to price carbon or face tax," Financial Times, January 22, 2020
[23] "China, not America, will decide the fate of the planet," Financial Times, January 27, 2020



Source: Union of Concerned Scientists, October 2019

However, China has countered that its emissions per person are still much lower than that of the United States. Indeed, the average American is still responsible for more than twice as much carbon dioxide being released into the atmosphere than his/her Chinese counterpart.

It has been pointed out, also, that much of the reduction in emissions by the developed countries has been due to the fact that many of them have outsourced their emissions (i.e., factory production) to emerging countries. Moreover, the rich pollute overwhelmingly more than the poor do. In fact, the 10% richest people of the world generate almost half of the world's carbon emissions.[24]

[24] "Davos 2020: We need to talk about (sustainable) growth…," Deutsche Bank Research, January 13, 2020

Per capita CO2 emissions on a country basis

Rank	Country	CO_2 emissions (per capita)
1	Saudi Arabia	16.3T
2	Australia	16.2T
3	United States	15.0T
4	Canada	14.9T
5	South Korea	11.6T
6	Russian Federation	9.9T
7	Japan	9.0T
8	Germany	8.9T
9	Poland	7.7T
10	South Africa	7.4T
11	Islamic Republic of Iran	7.1T
12	China	6.4T
13	United Kingdom	5.6T
14	Italy	5.4T
15	France	4.5T

Source: Union of Concerned Scientists, October 2019

Fatih Birol, Executive Director of the International Energy Agency, recently summed up the wide perception gap that persists between much of the developed and developing world in the following statement: "The coal-powered plants in Europe are generating electricity for the fourth television set in the kitchen, whereas in India it is providing electricity for the refrigerators for parents to keep medication for their children."[25]

Conclusion

To recap, the main geopolitical challenges that countries face in implementing more stringent climate regulations are as follows:

- The environmental policies must be able to stem global warming in the long term without having an overly large impact on economic growth in the short term. The weaker a country's economic growth, the greater the odds of a political backlash and of the environmental regulations in question being diluted or even reversed by an existing or new government.
- Implementing environmental programs that require significant financial investments in the short term at a time when many governments are already grappling with overstretched balance sheets. This includes getting public support from a citizenry that agrees climate change is a major problem, but is not necessarily in favour of paying a climate-related tax. **Attempting to thread this needle will likely mean continuing with easy money policies (QE and low interest rates). Some governments may decide to fund green projects via government bonds.**
- How the financial burden of environmental regulations should be shared among countries will generate tensions.
    - This risks widening the political divide between the EU countries that contribute the most funds to the EU budget and those that are net recipients and struggling economically.
    - Disagreements between developing and developed countries will be especially difficult to resolve. Poorer countries argue that they have historically contributed a far smaller volume of greenhouse gas emissions than richer industrialized countries have and that, consequently, they should be given much less stringent targets and significant financial assistance.
    - A carbon border adjustment tax implemented by Europe and some day even by the United States would likely target mostly developing countries and almost certainly be met with counter-tariffs.

[25] "Davos's green colonialism decried by poorer countries – but the West will crush them anyway," The Telegraph, January 24, 2020

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