Will the Next Bubble Be Made Out of Carbon?

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Concerns about the impact of carbon emissions are beginning to bleed onto the balance sheets of energy companies, even in this country where strategic engagement on the issue has consistently lagged the rest of the world.

According to the International Energy Agency (IEA) in its 2012 World Energy Outlook, "No more than one-third of proven reserves of fossil fuels can be consumed prior to 2050 if the world is to achieve the 2-degree C goal, unless carbon capture and storage (CCS) technology is widely deployed."

The outlook for such a deployment of CCS seems unlikely at this point, given the numerous uncertainties about its efficacy, safety, and cost.

Likewise, Victoria Johnson, writing for the New Economics Foundation, has said that as much as "80 percent of declared proven fossil fuel reserves are unburnable" due to concerns about climate stability. Indeed, the IEA report says that if we remain on our present course "all the allowable CO2 emissions would be locked-in by energy infrastructure," by the year 2017 — just four years from now. The Carbon Tracker Institute agrees with the 80 percent assessment: 565 gigatons allowable out of 2,795 gigatons of global reserves, but estimates that we have between 11 and 16 years to change our ways. Still, that's not very much time.

Should we begin to respond to that signal in any meaningful way, which seems increasingly likely, there are going to be a lot of stranded assets, which will have serious repercussions on the valuations of these companies. Just looking at oil alone, at today's prices, U.S. proven reserves are worth over $2 trillion. Likewise, America's coal reserves are worth over $8 trillion should today's prices apply to all of it. And natural gas reserves are currently worth $2.4 trillion. All told that is over 80 percent of last year's US GDP. So if 70 to 80 percent of all this energy proves to be unusable, what is that going to mean for the companies that own it?

According to a study performed by HSBC, in a low-demand-for-coal scenario, coal company cash flows could be expected to drop by 44 percent. Indeed, as the corporate responsibility and environmental advocacy group As You Sow points out, "If laws and regulations are adjusted to recognize this limitation, the vast majority of fossil fuel companies will be left with stranded assets in the form of unburnable reserves and underused infrastructure. Importantly for shareholders, the majority of such companies will be overvalued, presenting the risk of a 'carbon bubble.'"

Having lived through a tech bubble, followed by a housing bubble, can our economy afford another one? There is no question that the impact of a bubble of this magnitude, should it burst, would ripple through the worldwide economy with serious consequences.

In order to raise awareness of this issue, As You Sow put together a shareholder resolution for Consol Energy, a large-scale producer of both coal and natural gas operating in the Appalachian Basin. The proposal asked, given "the increasing likelihood of material impact," about the company's plans and strategy to address this concern.

"Shareholders request Consol to prepare a report on the company's goals and plans to address global concerns regarding fossil fuels and their contribution to climate change, including analysis of long- and short-term financial and operational risks to the company and society."

In a supporting statement, the resolution asked the company to perform "an analysis of various scenarios the company deems likely or reasonably possible, such as restrictions on carbon emissions allocated by geographic regions or fuel types… in which a portion of its reserves or infrastructure are at risk of becoming stranded assets."

The company argues that it has already addressed this issue in its corporate sustainability report, but, argues, As You Sow, the report "does not address the risk of carbon constraints or the potential for stranded reserves, nor does it offer any goals and plans to address carbon regulations or other constraints." And while the report, and now the company's website, acknowledges the risks associated with these constraints, they do not attempt to quantify those risks.

At the end of the day, a full 20 percent of the voting shares, representing $1.2 billion in the value of Consol, signed onto the resolution.

According to Danielle Fugure, president and chief counsel of As You Sow, "The global overvaluation of fossil fuel-based energy companies creates the risk of a 'carbon bubble' that is estimated to be an order of magnitude larger than the housing bubble that devastated the U.S. economy. This vote underscores that shareholders are becoming increasingly jittery about the financial risks climate change poses to unprepared companies."

Clearly, Consol, one of the largest producers of coal from underground mines, with a large portion of its asset value being tied to its proven reserves, is only being singled out as an example of how vulnerable this industry, and by extension, its investors are in the light of dramatic changes that are taking place in the energy economy.

This was not the first such shareholder resolution and it most likely won't be the last.

Twenty-eight percent of investors in PNC Financial, representing some $5.4 billion in shareholder value, supported a resolution asking that company to assess its exposure to climate change risk across the spectrum of its operations including lending, investing, and financing.

Resolutions of this nature are only possible thanks to a ruling made by the Securities and Exchange Commission (SEC) in February, reversing previous policy and allowing resolutions like this one to remain on the proxy ballot. This ruling, which was made specifically with regard to the PNC resolution, follows the adoption in 2010 of climate disclosure guidance, which includes the following language:

"Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State, and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material."

The document also requires disclosure of related risk factors, including "a discussion of the most significant factors that make an investment in the registrant speculative or risky."

Then there is the insurance industry, which paid out $35 billion in private losses last year, $11 billion more than the previous decade's average. This industry, which is inherently conservative, has been slow to action in response to a situation that poses such a grave risk to its financial health. But that is beginning to change. Take the case of Eli Lehrer, a former Heartland Institute vice president with an insurance background. He left the right-leaning group and helped start the R Street Institute, an organization financed largely with insurance industry money, conservative in all respects except that it supports a carbon tax to combat climate change.