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Climate Change

Issues for Policyholders

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In a ruling characterized as "one of its most important environmental decisions in years" and a "strong rebuke to the Bush Administration," the U.S. Supreme Court held this month that the U.S. Environmental Protection Agency has authority to regulate emissions of greenhouse gases ("GHG") that contribute to climate change. Linda Greenhouse, *Justices Say E.P.A. Has Power to Act on Harmful Gases*, New York Times, Apr. 3, 2007 (discussing *Massachusetts v. Environmental Protection Agency*, No. 05-1120 (U.S. Apr. 2, 2007)). The Supreme Court's ruling in *Massachusetts v. EPA* could trigger long-anticipated regulation of GHG emissions in the United States, dramatically changing the regulatory environment in which U.S. businesses operate.

The ruling follows a year in which climate change, also referred to as global warming, has figured prominently in the news. In January, 10 major companies called for caps on GHG emissions. Jeffrey Ball, *In Climate Controversy, Industry Cedes Ground — Support Grows for Caps on CO_2 Emissions; Big Oil Battles Detroit*," The Wall Street Journal (Jan. 23, 2007), at A1. One month later, former Vice President Al Gore won an Academy Award for his climate change documentary "An Inconvenient Truth." According to the The Wall Street Journal, the climate change debate "is shifting from science to economics," and "[t]he biggest question going forward no longer is whether fossil-fuel emissions should be curbed. It's who will foot the bill for the cleanup ... " *Id.*

Insurance products offer some opportunities to mitigate the many types of costs associated with climate change. This article provides an overview of the relationship between insurance coverage and climate change.

Efforts to Reduce GHG Emissions Are Gaining Momentum

Domestic and international efforts to regulate GHG emissions, as well as private sector initiatives, are already underway.

The Kyoto Protocol ("Kyoto") is the most expansive regulation of GHG emissions to date. It was negotiated in 1997 under the 1992 U.N. Framework Convention on Climate Change, an international treaty setting out multinational climate change goals. The Protocol became effective in February 2005 and established binding targets for emissions reductions to be completed by 2012. *See http://unfccc.int/resource/docs/con vkp/kpeng.html.* The United States is not a party to Kyoto.

Kyoto allowed industrialized countries to establish a "cap and trade" mechanism for emissions allowances under which companies are allocated a specific number of emissions credits; they can then sell their excess emission rights for a profit. *See* U.N. Framework Convention on Climate Change Kyoto | Mechanisms, *http:// unfccc.int/kyoto_mechanisms*. Companies also can invest in Clean Development Mechanism ("CDM") projects that help reduce emissions in developing countries and receive Certified Emission Reductions ("CERs") in exchange. The companies can then sell these CERs on the carbon trading market to companies in developed countries that need additional credits to meet their binding Kyoto targets. *Id.* The European Union Emissions Trading Scheme is the European Union's chief Kyoto compliance mechanism. *See* Europa | Emissions Trading Scheme, *http:// ec.europa.eu/environment/climat/emission.htm*.

In the United States, pressure for GHG regulation has been escalating. In early 2006, the U.S. Senate Commission on Energy and Natural Resources released a white paper recommending that Congress "enact a comprehensive and effective national program of mandatory, market-based limits and incentives on emissions of greenhouse gas emissions into the atmosphere." Sen. Pete V. Domenici and Sen. Jeff Bingaman, Design Elements of a Mandatory Market-Based Greenhouse Gas Regulatory System 1 (Feb. 2006), *available at http://energy.senate.gov/public/_files/ClimateChangeWhitePaper.doc*.

In the absence of federal regulation, regional, state, and city regulations have emerged. For example, the governors of seven northeastern states signed the Regional Greenhouse Gases Initiative ("RGGI"), which created a market-based carbon trading system similar to the EU's Emissions Trading System. *See* Regional Greenhouse Gas Initiative, *http:// www.rggi.org*. The member states are Connecticut, Delaware, Maine, New Hampshire, New Jersey, New York, and Vermont. An eighth state, Maryland, will join the initiative by June 30, 2007. In 2006, California became the first state to enact comprehensive global warming legislation, The California Global Warming Solutions Act of 2006, Assembly Bill 32. Moreover, the mayors of more than 200 American cities have signed the U.S. Mayors' Climate Protection Agreement, a nonbinding agreement that requires the participants to try to lower the carbon emission levels in their cities to meet the Kyoto targets and to seek fed-

eral and state legislation regulating carbon levels. Tom Walsh, *Risk Alert: Climate Change: Business Risks and Solutions*, at 8 (Marsh, Apr. 2006) ("Marsh Report").

The private sector is not waiting for regulation to start reducing GHG emissions. The Chicago Climate Exchange ("CCX"), which describes itself as North America's only "legally binding" GHG registry and trading system, requires its more than 200 members to reduce their GHG emissions by a certain percentage each year. CCX's voluntary membership includes companies such as IBM, DuPont, and Rolls Royce. Many have joined not just for "green bragging rights," but because they believe Congress eventually will regulate emissions and that they will be ahead of the game by undertaking the emissions monitoring and reduction that CCX membership requires. Abrahm Lustgarten, *For Sale: Pollution*, Fortune (Aug. 24, 2006), *reprinted at* money.cnn.com. Ten CEOs of major U.S. companies, including General Electric, Alcoa, and DuPont, urged mandatory caps on GHG emissions. Steve Mufson, *CEOs Urge Bush to Limit Greenhouse Gas Emissions*, The Washington Post (Jan. 23, 2007), at A6.

The call for regulation will undoubtedly be fueled by the U.S. Supreme Court's 5 to 4 decision earlier this month in *Massachusetts v. EPA*, in which Justice John Paul Stevens, writing for the majority, ruled that the Clean Air Act is "unambiguous" and "authorizes EPA to regulate greenhouse gas emissions from new motor vehicles in the event that it forms a 'judgment' that such emissions contribute to climate change." Slip op. at 25-26. The decision originated from a petition filed in 1999 requesting that EPA regulate GHG emissions from new motor vehicles. EPA denied the petition in 2003 on the ground that it lacked authority to regulate GHGs and that, even if it had the authority, it would be unwise to regulate them at the time. *Id*. at 6-10. The Court explained that "[u]nder the clear terms of the Clean Air Act, The EPA can avoid taking further action only if it determines that greenhouse gases do not contribute to climate change or if it provides some reasonable explanation as to why it cannot or will not exercise its discretion to determine whether they do." *Id*. at 30.

Insurance and the Costs Of GHG Emissions and Regulation

The climate change risks and losses confronting policyholders and insurers undoubtedly will include those covered under traditional first-party property or third-party liability insurance products as well as new risks and losses arising from emerging GHG regulation and emissions trading. Insurers typically respond to newly identified risks and losses by increasing premiums, changing existing coverage, and offering new products and services. Examples of these responses to climate change are described below. *See generally* Andrew Dlugolecki, *A Changing Climate for Insurance* (Association of British Insurers, June 2004) ("ABI Report"); Evan Mills, Richard Roth & Eugene Lecomte, *Availability and Affordability of Insurance Under Climate Change* (Ceres, Dec. 2005) ("Ceres Report").

First-Party Property and Business Interruption Risks

If predictions of increased frequency and severity of hurricanes, floods, typhoons, and other natural disasters are correct, the costs of property damage and related business interruption losses — particularly in coastal and other disaster-prone areas — will continue to rise. In 2005, more hurricane-related insured losses were reported — namely $49.2 billion — than in any other season on record. Marsh Report, at 4. Predictably, losses of this magnitude have triggered extensive coverage litigation concerning, for example, whether storm damage is caused by flood (which is often excluded from homeowners' coverage) or by wind (which is generally an insured peril). Together, losses and litigation have triggered market-wide changes, including revisions to policies, withdrawal from certain geographic markets, and, of course, premium hikes. For example, as a result of offshore oil producers sustaining insured losses of $10 billion in the 2005 hurricane season, their insurance premiums rose by 500%. Evan Mills and Eugene Lecomte, *From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change,* at 4 (Ceres, Aug. 2006).

Climate change has triggered not only increases in premiums but also a change in premium-calculation methodologies. Munich Re has stopped using traditional retrospective analysis to calculate weather-related exposure and has adopted a new model that takes into account recent trends in carbon dioxide levels and hurricane frequency, and estimates how those trends will interact in the future. Munich Re, Topics: Climate Change 16-17 (2006/1), *available at www.munichre.com/publications/302-04915_en. pdf?rdm =66684*. Marsh reports that, in calculating first-party property coverage premiums, insurers are evaluating: 1) the frequency of storms in the company's region, 2) whether the company and/or its main suppliers are in disaster-prone areas, 3) the structural integrity of company property, 4) the extent of a company's emergency provisions in case of a power outage, and 5) whether other emergency plans are current. Marsh Report, at 21. Policyholders should be prepared to address these issues in the underwriting and renewal of their property policies and might be able to save premium dollars if they take steps to ensure business continuity.

Insurers also are modifying traditional property policies to encourage construction of "green buildings," built with sustainable materials, and/or powered by renewable resources like solar panels. Among other benefits, green buildings can reduce the risk of business interruption during weather-related catastrophes. The Harmony Resort on the island of St. John, for example, weathered four hurricanes with no loss of power or hot water because it relies on solar energy. By contrast, neighboring facilities were disrupted for weeks or months. A. Deering and J.P. Thornton, *Solar Technology in the Insurance Industry: Issues and Applications*, National Renewable Energy Laboratory, Golden, CO (June 2005), at 14. Fireman's Fund plans to

introduce a product with a provision for replacing damaged property with "improved green and/or energy-efficient property." Mills & Lecomte, at 20. It will also introduce a rate credit for certified green buildings. *Id.*

Third-Party Liability Risks

Businesses may not only face the possibility of climate-related damage to their own property and business, but may also face potential liability to third parties. Some observers have suggested that climate change could become a mass tort on the order of asbestos. Roberto Ceniceros, *U.N. climate report stirs liability fears*, Business Insurance (Feb. 5. 2007), at 21. Companies already have been targeted in lawsuits alleging that they are responsible for climate change and are therefore liable for personal injury and property damage allegedly caused by such climate change. One example is a class action by Mississippi homeowners who suffered property damage due to Hurricane Katrina. *Id.* at 1. A second example is a suit brought by the attorney general of California against General Motors, Ford, Toyota, Honda, Chrysler, and Nissan seeking to hold them liable for damage to California's environment based on the common-law nuisance doctrine. *Id. See* Complaint for Damages and Declaratory Judgment, *People of the State of California v. General Motors Corp.* (N.D. Cal. filed Sept. 20, 2006). Thus far, commentators have suggested that plaintiffs in these lawsuits will find it difficult to prove causation.

Such lawsuits have the potential to reignite the pollution coverage wars of the last 30 years. Climate change claims could trigger policies that predate pollution exclusions and policies marketed to cover pollution liabilities; they also are likely to prompt litigation over whether GHGs constitute pollutants under policies containing variants of a "pollution exclusion." A comment in Justice Antonin Scalia's dissent in *Massachusetts v. EPA*, may be prescient: "[i]t follows [from the majority's analysis] that *everything* airborne, from Frisbees to flatulence, qualifies as an air pollutant. This reading of the [Clean Air Act] defies common sense." *Massachusetts v. EPA*, slip op. at 10 n.2 (dissenting opinion of J. Scalia). Justice Scalia quoted with approval the EPA's conclusion that "[t]he term 'air pollution' as used in the regulatory provisions cannot be interpreted to encompass global climate change." *Id.* at 12 (citation omitted).

The more immediate risk that businesses are likely to face will arise from investors and shareholders taking issue with management responses to and plans for climate change. Marsh Report, at 9-11. *See also* Mercer Investment Consulting, Press Release: Responsible Investment Factors Considered Important to Asset Performance (March 13, 2006).

Investor and shareholder scrutiny of management responses to climate change is facilitated by the public availability of relevant information, particularly through the Carbon Disclosure Project ("CDP"), described as "the largest registry of corporate greenhouse gas emissions in the world." *www.cdproject.net/aboutus.asp.* CDP allows investors to download corporate responses to its climate surveys from the Web site free of charge. It also rates companies in a "Climate Leadership Index" based on six factors: 1) strategic awareness, 2) management awareness 3) emissions management and reporting, 4) emissions trading, 5) emissions reduction programs in place, and 6) establishment and responsibility, of targets. Innovest, Carbon Disclosure Project 2005 at 14 (Sept. 14, 2005), *available at www.cdproject.net/ reports.asp.*

Marsh warns that shareholders also are voicing concerns about how companies prepare for GHG regulation, disclose information about GHG emissions, and investigate climate-related risks. Marsh Report, at 9-10, 13. In 2006, more than two-dozen climate-related shareholder resolutions were filed with U.S. companies requesting disclosure of financial risks and plans related to GHG emissions. Many were withdrawn when management acceded to the shareholders' requests. Sally Roberts, *Climate Change Concerns Raise Questions On D&O*, Business Insurance (August 14, 2006), at 28. If these issues give rise to shareholder lawsuits, D&O coverage for companies and their directors and officers might be triggered, and insurers may seek to avoid coverage by claiming that climate change is an excluded pollution-related loss. Sally Roberts, *Cover May Hinge on Status of Carbon Dioxide as Pollutant*, Business Insurance (Aug. 14, 2006), at 28.

D&O insurers, like Swiss Re, also are looking at climate-related preparedness and disclosures in the underwriting process. They are considering whether companies have appropriately allocated management responsibilities, set up independent committees to address climate change risks, monitored and disclosed GHG emissions, and planned for future regulatory scenarios. *See* ABI Report, at 11; *see also* The Climate Group | Swiss Re – Corporate, Reinsurance, *www.theclimategroup.org/index.php?pid=428.* Marsh suggests that policyholders assign the task of addressing climate change issues to specific directors and board members, adopt company-wide policies to monitor emissions and address potential risks, keep clear records of any risk management actions taken, and disclose information related to risks and actions to shareholders. Marsh Report, at 15-16, 22-24.

Regulatory Risks

GHG regulations, whenever promulgated, undoubtedly will impose significant costs on businesses. The Economist has noted that "the cost of meeting a specific emission target can be astronomical if ... firms do not have enough time to adjust or if they have long-lived capital assets." *Oh No, Kyoto*, The Economist (Apr. 5, 2001), *available at www.economist.com/displaystory.cfm?story_id=561509.* Companies operating in countries bound by the Kyoto Protocol already must comply with emissions limitations or risk enforcement actions, which could force companies to incur defense costs and expose them to fines. Insurers can be expected to take the position that costs of regulatory compliance and costs related solely to enforcement actions are excluded from standard coverage. Marsh Report, at 11.

Transactional Risks

Companies involved in emissions trading also face financial risks associated with such trading. These include lawsuits from counterparties for failure to deliver credits, political risks such as instability in developing host countries, performance risks associated with the emissions reduction technology, and noncompliance risks, including fines resulting from missed targets. Marsh Report, at 28. Insurance products are being developed to guard against these risks. One example is the credit delivery guarantee ("CDG"), which provides coverage for non-delivery of carbon emission credits due to a specified event such as an operational problem or project insolvency. *Id*. at 30. Swiss Re, for instance, offers insurance to buyers against the possibility that a seller does not deliver Certified Emissions Reductions. *See* The Climate Group | Swiss Re — Corporate, Reinsurance, *www.theclimategroup.org/index.php?pid=428*. AIG is also developing an insurance policy that will respond when a project fails to cut emissions sufficiently to generate tradable credits. Marianne Lavelle, *Insurers May Cash In on Climate Change*, U.S. News & World Report (June 6, 2006), *available at www.usnews.com/usnews/news/articles/060605/5warming.b1.htm*.

Insurance Products and Alternatives That Mitigate Global Warming Risks

Insurers are offering products and services designed not only to help companies mitigate the risks of global warming and reduce insured losses, but also to support company efforts to limit emissions and reduce dependence on traditional energy sources. For example, Energy Savings Insurance ("ESI") protects the owner of an energy-efficient project from underachievement of predicted energy savings; it provides policyholders with an incentive to use alternative energy sources, by insuring the risk that those sources will underperform. Evan Mills, *Risk Transfer via Energy-Savings Insurance*, Energy Policy 31, at 274 (2003). More specialized policies also can help ensure the performance of renewable energy systems. Insurance for wind turbines is already available, Marsh Report, at 25-28, and insurance products for other renewable energy sources, including solar, wave, and tidal energy, will most likely follow.

Insurers and brokers are offering risk management services as well as insurance products. Marsh has developed a roadmap and an Environmental Business Consulting service to help businesses evaluate climate change solutions. *Responding to Climate Change Risks and Opportunities* (Marsh, 2004). AIG's affiliate, Solomon Associates, offers project development, benchmarking, and risk management services for companies trying to reduce GHG emissions. *www.solomononline.com/ghg /index.asp*.

Conclusion

The insurance market is likely to evolve quickly as public and private demand for regulatory action increases. Given the magnitude of climate change risks and the scrutiny companies face in responding to those risks, businesses need to evaluate their existing insurance coverage and to consider new insurance options to ensure that they are effectively minimizing the risks of climate change to the company.

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