

MARKET CERTAINTY IN A CARBON-CONSTRAINED WORLD

In this decade, a large number of multi-national corporations have incorporated voluntary environmental performance goals, including greenhouse gas reductions, into their business planning. These companies have seen first-hand that business and environmental performance are not mutually exclusive goals. In the absence of mandatory regulatory controls, most notable in the United States (U.S.), many businesses have found that energy efficiency improvements, investments in cleaner energy technologies, improved waste management, and recycling can help their bottom line *and* lower their greenhouse gas emissions.

One of the most successful tools for reducing greenhouse gas emissions is to create a market in which carbon has a monetary value. Cap-and-trade is a proven market-based policy tool that rewards innovation and allows the flexibility to reduce emissions at the lowest cost. For example, the [US Acid Rain cap-and-trade program](#):

- Was expected to have high compliance costs, in the range of \$579-1935 per ton of SO₂; the actual market price as of January 2004 was slightly over \$200 per ton.
- In the 1990s, this program achieved 100% compliance in reducing sulfur dioxide emissions.
- In fact, power plants participating in the program reduced SO₂ emissions 22% - 7.3 million tons - below mandated levels.
- Prior to the launch of the program, cost estimates had ranged from \$3-\$25 billion per year; after the first 2 years of Phase I, the costs were around \$0.8 billion per year. The long-term costs of the program are expected to be around \$1.0-\$1.4 billion per year, far below early projections.

Although many companies have made major strides by voluntarily reducing their emissions, mandatory emission controls are now a part of the global business landscape. As recently as last week, several Canadian companies sent Prime Minister Martin a letter supporting cap-and-trade and an extension of the carbon market beyond 2012. Multinational corporations now have to adapt to a carbon-constrained world even without U.S. participation in either system. The [European Union's Emissions Trading Scheme](#) (EU ETS), based on the US EPA Acid Rain program, started on January 1st of this year, shortly followed by entrance into force of the [Kyoto Protocol](#) (KP) on February 16th.

The aim of the EU ETS is to help EU Member States achieve compliance with their commitments under the Kyoto Protocol. The EU ETS is currently the largest multi-country, multi-sector greenhouse gas emission trading scheme in the world. It covers some 12,000 installations representing close to half of Europe's emissions of CO₂. As a result of the Kyoto Protocol, the European market in carbon dioxide will reach \$5 billion in 2005, and is projected to have a total value of 50 billion euros by 2008.

A global carbon market is the optimal method for large-scale reductions in greenhouse gas emissions. Cap-and-trade is a proven market-based policy tool that rewards innovation and allows the flexibility to reduce emissions at the lowest cost. The private sector needs market certainty and a post-2012 agreement must build on the cap-and-trade market approach.

CAP AND TRADE: HOW DOES IT WORK?

“Cap and trade” harnesses the forces of markets to achieve cost-effective environmental protection. Properly designed cap and trade programs achieve superior environmental protection by giving businesses the flexibility to find the lowest-cost reductions, and direct financial incentives to find newer, better, faster, cheaper and more innovative ways to reduce pollution. The key elements are:

A mandatory emissions “cap.” This is a limit on the *total* tons of emissions that can be emitted.

A fixed number of allowances for each polluting entity. Each allowance authorizes the holder to emit one ton of pollution at any time.

Fungibility. A single unit of emissions “currency” denominated in one ton of CO₂-equivalent is essential to maximize incentives to reduce emissions while keeping transaction costs low. So-called “intensity targets” cannot serve as a basis for trading because they provide no assurance that any actual reduction in total emissions have occurred.

Banking and trading. A source that reduces its emissions below its allowance level may sell the extra allowances to another source. A source that finds it more expensive to reduce emissions below allowable levels may purchase allowances from another source. Buyers and sellers may “bank” or save any unused allowances for future use.

Transparent reporting and accountability. At the end of the compliance period (e.g., one year, five years, etc.), each source must hold a number of allowances equal to its tons of emissions for that period, and must have measured its emissions accurately and reported them transparently. Sources must be held accountable for any emissions over allowable levels.

Flexibility. Sources have flexibility to decide when, where and how to reduce emissions.

THE “COST CAP” OR “SAFETY VALVE”: A BAD IDEA

Some have suggested that to control the costs of fighting global warming pollution, policymakers adopt a “cost cap,” so that if the price of emissions allowances rose above a fixed threshold, government would make more allowances available at the threshold price. This policy *does not* provide a “safety valve”. It simply lets polluters pollute as much as they want at the fixed price. The “safety valve” is a tax and does not solve the pollution problem. Instead, it fouls the market mechanism.

Why? Firms will refrain from investing in pollution control today if they know that at some future date, they can pay their way out of their pollution reduction obligations. Countries around the world have tried pollution taxes; in Europe, China, Russia, and elsewhere, the result has been the same in each place: pollution goes up, and the added tax burden suppresses economic growth.

A better way to manage cost uncertainties is to let companies spend money now to create a savings bank of low-cost emissions reductions as a hedge against future costs. Building up a bank of low-cost emissions reductions now is what will keep the costs of the program low, and it was one of the things that made the U.S. Acid Rain program so affordable. The cost cap policy sends a message to companies that it is acceptable to pollute as long as they pay the fee. That is bad for the environment and bad for the economy – it will drive costs up in the future.