



www.cleanair-coolplanet.org

Cap-and-Trade Primer

EMISSIONS REGULATION BACKGROUND

The basic ideas behind a cap-and-trade system are very straightforward:

- A mandatory economy-wide cap on greenhouse gas (GHG) emissions, subject to a price collar¹, is set for the nation.
- Each emissions allowance permit enables the holder to emit one ton of carbon dioxide.
- Fossil fuel producers and refiners must submit allowances equal to the carbon content of the fuels.
- The cap creates a price for carbon which acts as a financial incentive to reduce emissions.

CAP-AND-TRADE LEGISLATION DETAILS

Market regulation:

The inclusion of a **price collar** within any cap-and-trade system is critical for establishing market stability and imposing flexible emission reduction levels. The price collar provides a vital element of **certainty** regarding future allowance costs and would ensure against unintended spikes in energy prices that could adversely affect the economy.

If the maximum market allowance price were reached, the government would then step in and sell additional allowances at the collar price, thus preventing the price from rising any further. The price collar would escalate **over time**, preventing permit price spikes, creating more certainty in the market, and **allowing businesses to plan** for future increases. Through such a price collar, the government assures a minimum price certainty to entrepreneurs, innovators, and investors.

Economic Impact of Revenue Recycling

The imposition of a **price on carbon can have a deadweight effect** on the economy and can disproportionately affect those at the low end of the income scale. The Congressional Budget Office has concluded that **the most efficient way to reduce this deadweight effect** and lessen the impact on those of lesser means is to recycle revenues through the existing tax code and subsequently **reduce other taxes**. This solution will not only **put money back** into the pockets of consumers, but will also **increase the productivity** of the economy while addressing the distributional consequences of a climate change proposal that affects those who spend a disproportionately higher amount of their income on energy.

Auctioning the allowances, rather than giving them away, or grandfathering them, is the most efficient way to allocate these scarce resources. The **lion's share of the revenue** from the allowance auctioning should be **recycled back into the economy** through the existing tax code. Furthermore, **a portion** of this revenue could be **used for technology research** and development which would serve to lower these costs in the long run.

¹ A price collar, which escalates over time, establishes an emissions cap goal and a tradeable allowance system for which there is a maximum (or minimum) allowance price at all times. The price collar protects consumers, businesses, and the economy at large from price spikes and promotes entrepreneurship by maintaining a minimum allowance price.

ADDRESSING COMMON CONCERNS

There are several common business concerns surrounding emission reduction proposals:

Higher Energy Costs

Businesses and residents alike have expressed concerns regarding higher energy costs under a cap-and-trade system. The **failure to include a price collar** in the proposed cap-and-trade legislation **has led to a battle of cost estimates**, all of which make certain assumptions. The price inclusion of a price collar, however, does away with that uncertainty. In addition, the recently enacted economic stimulus plan includes provisions which could create incentives for additional energy efficiency developments and partially offset some of the increase in energy costs.

From a residential standpoint, for many consumers, increases in energy costs can be offset by the proposed revenue recycling.² Though greater consumers of energy than households, most businesses can also offset most of the energy cost increases by investing in efficient technologies. For example, Timberland, one of CA-CP's partners, has recently indicated that it has achieved a 27% decrease in GHG emissions in part through efficiency improvement and renewable energy development.³ By decreasing emissions and improving energy efficiency, Timberland has protected itself against even marginal energy cost increases and laid the foundation to be a corporate leader in energy legislation.

The European Union's Experience:

Businesses in the United States have expressed concerns regarding the recent hiccups in the European Union Emissions Trading Scheme (EU ETS). It is important to note **three crucial differences** between the EU ETS and the plan for the United States' system. First, the EU ETS system does not provide for a price collar, thus giving rise to greater market price volatility. Second, the EU ETS grandfathered too many allowances and thereby diminished incentives to reduce emissions. Third, the EU ETS only covers roughly half of the emissions in the EU.⁴ Therefore, when assessing whether a cap and trade system will be effective in the United States, it is important to assess whether any US proposal with the bulk of the allowance revenue recycled to taxpayers will avoid the pitfalls of the EU ETS.

Competitiveness Issues:

There is concern around the lack of emission reduction commitment by high-emitting countries, especially China and India. To preserve the United States' industrial and employment bases and prevent "leakage" of emission producers to China and India, we propose that the **escalation of the price collar be linked** to the actions of these developing countries. This will not only prevent "leakage" from energy intensive industries, but also **will avert any unnecessary economic damage** to US manufacturers. In the absence of this measure, as well as other measures addressing the competitiveness issue, there is no assurance of environmental benefits. Furthermore, the possibility of migration of American industry and jobs to countries which do not have emission reduction programs would still be very real without this linkage.

HOW CLEAN AIR – COOL PLANET CAN HELP

As a non-partisan, not-for-profit organization, Clean Air-Cool Planet (CA-CP) has a decade-long track record of providing practical advice to corporations seeking to reduce their greenhouse gas emissions or establish themselves as leaders on climate and energy solutions, particularly in the Northeast. Our Washington, D.C. policy office has been instrumental in advocating **and helping design elements of a cap-and-trade system that will be economically efficient and environmentally effective**. We believe that corporate support for such a system is essential to both its political and economic success. For more information and success stories from our partners, check out our website at www.cleanair-coolplanet.org/for-business.php or contact Teal Tigner at ttigner@cleanair-coolplanet.org.

² Letter to Rep. John Boehner from Professor Reilly of MIT's *Joint Project on the Science and Policy of Global Warming*, April 1, 2009.

³ Timberland 2009 Climate Strategy Report, p. 4.

⁴ Ellerman, Danny and Paul Joskow of MIT, *The European Union's Emissions Trading System in Perspective*, prepared for the Pew Center on Global Climate Change, May 2008.