



The Benefits of a Price Collar

A price collar is a risk management tool used frequently in financial transactions. It combines a price ceiling and a price floor. It is used to:

- minimize the risk associated with an uncertain price going forward
- define the limits of any price volatility -- the risk of the price going to extremes, either too high or too low
- manage prices effectively over near, intermediate, and longer periods of time

Under cap-and-trade climate legislation, the price collar would eliminate the possibility of a recurrence of the volatile spikes that have occurred in the SO₂ allowance market here, in the carbon markets in Europe, and in California.

Over the past several years SO₂ prices have gone from as high as \$1,600 per ton in 2006 to about \$60 today, a 26-fold swing. The highest prices were seen when natural gas prices spiked after Hurricane Katrina and utilities moved to use more coal. This led to an increased demand for SO₂ allowances at the same time that EPA was attempting to tighten the SO₂ allowance market. The recent collapse in prices followed the court's rejection of EPA's plan. Recent prices are only a fraction of the cost to operate, let alone install clean air technologies, leading to cancelled investments and uncertainty about whether the once-heralded Acid Rain Program will cease to achieve reductions in emissions.

Such spikes or collapses in prices:

- are costly to consumers, regulated industries, entrepreneurs, and the economy
- reduce progress toward achieving emissions reduction targets
- create uncertainty for business planning
- undermine investment in energy efficiency, renewables, and alternative sources of energy

The price collar:

- assures that businesses and consumers have a transparent price signal to encourage less consumption of fossil fuels and more energy efficiency
- stimulates entrepreneurs to “get out to their garages” to explore both incremental and breakthrough technologies needed for a U.S. energy security transition
- escalates on a deliberate incline over time, providing regulated industries the certainty and predictability necessary to manage their businesses
- is more reliable than alternative cost management strategies
- can be managed on an upward trajectory that will achieve emission reduction targets

By avoiding unnecessary spikes, a carbon emissions reduction program WITH a price collar is vastly more predictable, durable and creditable than a program without one. Congress could decide to establish the parameters of a gradually escalating price collar that would begin in 2012 and be adjusted periodically, or Congress could request that the Department of the Treasury do so.

A price collar is also a convenient way of accommodating technology optimists who want greater reductions in emissions and technology pessimists who want less aggressive targets.

- Optimists who believe the rate of technological change will enhance low cost emissions reductions should welcome a collar because they believe the price floor will be reached and therefore the collar will produce additional reductions in emissions.
- Pessimists about the rate of technological change who believe prices will be high should welcome a collar because they believe the price ceiling will be reached but economically and politically damaging price spikes will be avoided as emissions reduction targets are flexibly and sustainably achieved.

The Congressional Budget Office:

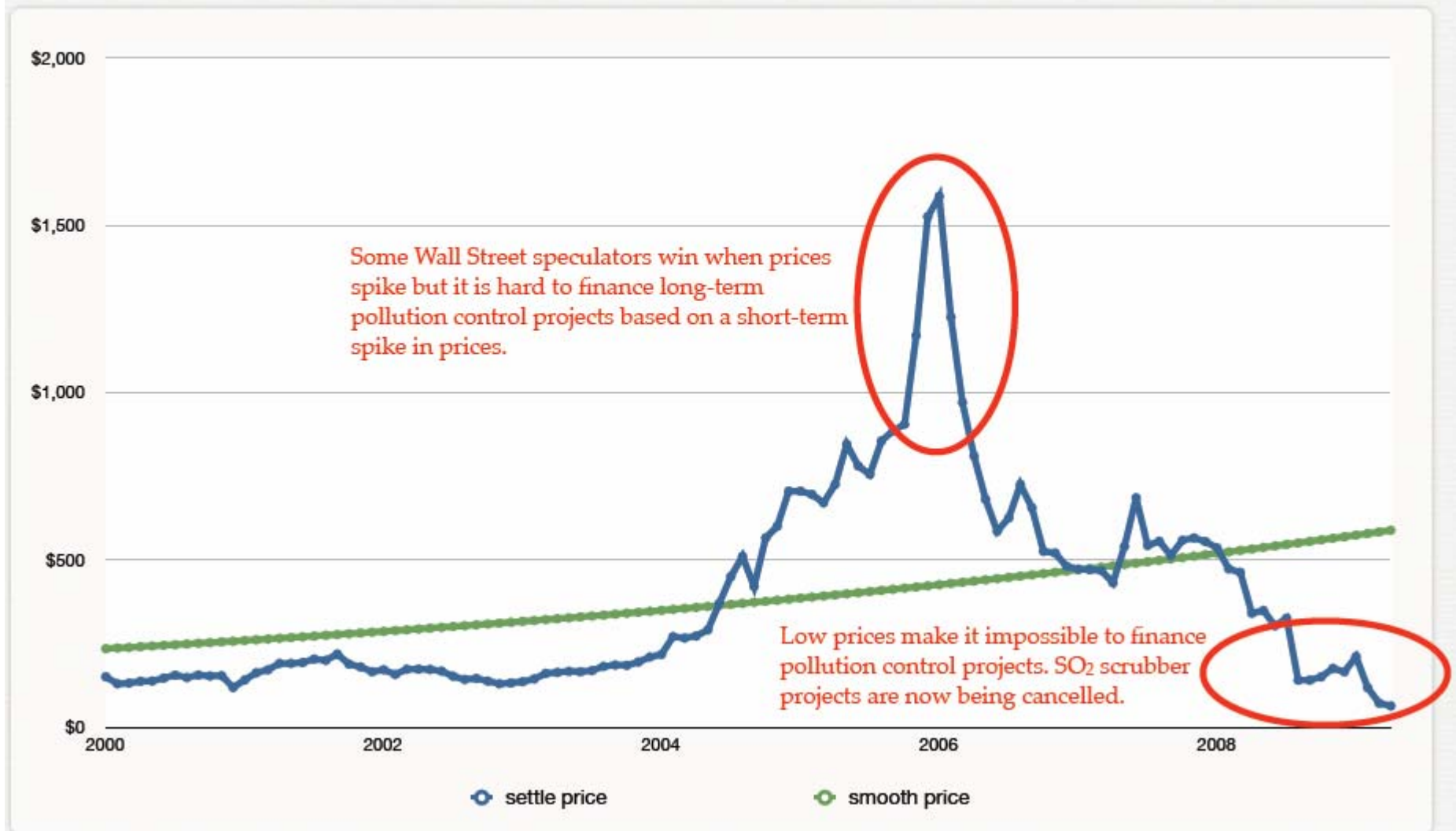
“Allowing flexibility about when emissions (are) reduced would further lower the costs -- and would do so without lowering the benefits -- because climate change depends not on the amount of greenhouse gas released in a given year but on the buildup in the atmosphere over decades.”

Testimony of Douglas W. Elmendorf, Director, Congressional Budget Office, entitled *Flexibility in the Timing of Emissions Reductions Under a Cap-and-Trade Program*, before the Committee on Ways and Means, U.S. House of Representatives, March 26, 2009.

“When combined, some design features could allow a cap-and-trade program to achieve many of the advantages in efficiency associated with a tax on emissions... Minimizing price fluctuations requires measures to limit both unintended price increases and unintended price declines.”

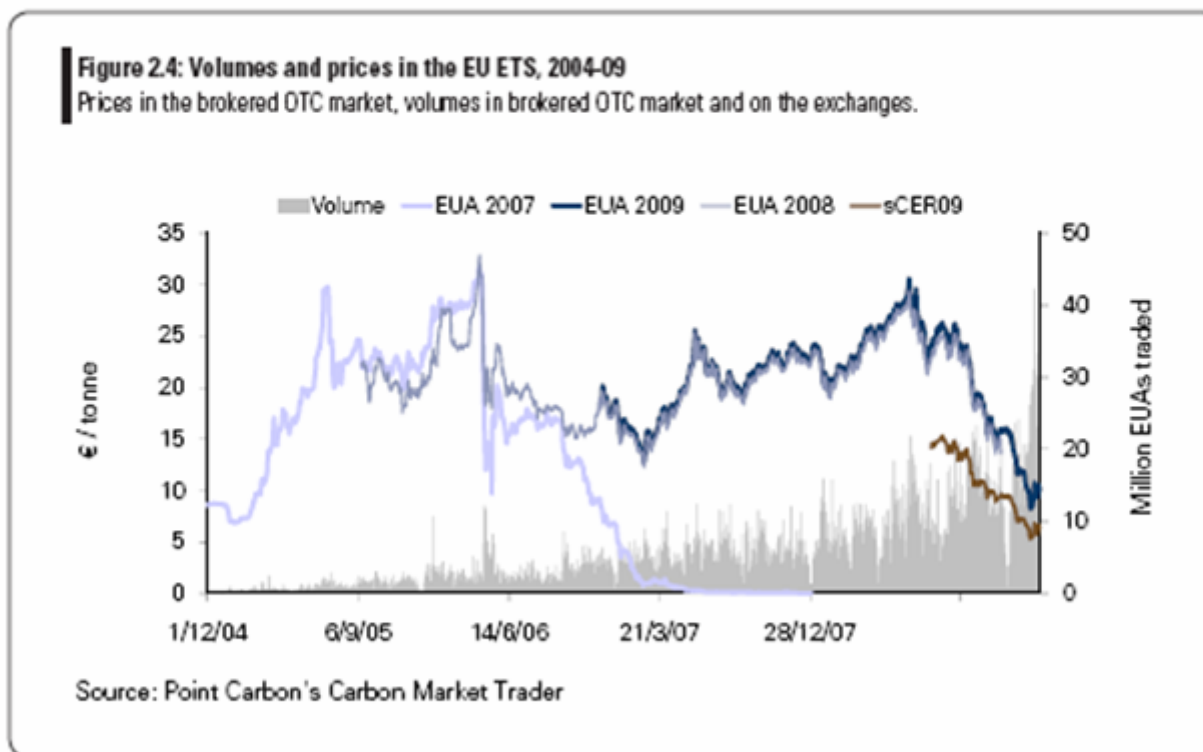
Testimony of Peter R. Orszag, Director, Congressional Budget Office, entitled *Implications of a Cap-and-Trade Program for Carbon Dioxide Emissions*, before the Committee on Finance, U.S. Senate, April 24, 2008.

ACTUAL SO₂ ALLOWANCE PRICE VOLATILITY VERSUS DESIRED PREDICTABILITY



Settle prices in dollars per ton from Evolution Markets (<http://new.evomarkets.com/>). Smooth prices have same average since 2000 and increase at five percent in real terms.

EU ETS volumes and prices 2004-2009



Graphic from *Carbon 2009*, Point Carbon, March 2009