

DOs and DON'Ts for Creating Carbon Price Safeguards

As the Senate takes up energy and climate legislation, many are considering the best approach to meet a strong cap on carbon emissions while assuring that carbon allowance prices remain reasonable and that market abuses are prevented. The core tools we need are a means to provide additional allowances to the market *without breaking the law's emissions cap*, and a robust set of market regulation safeguards against market abuse. With these tools, Congress can deter price manipulation and place effective limits on prices without compromising the law's vital climate protection objectives.

A declining cap on carbon emissions—a limit on the total amount of carbon pollution over time—is the heart of effective climate legislation. A firm limit is essential to avoid the worst impacts of climate change and to promote the broadest rewards for clean technology investments.

Three separate government analyses have shown we can meet proposed carbon caps at modest and affordable cost. The Energy Information Administration (EIA), the Congressional Budget Office (CBO), and the Environmental Protection Agency (EPA) have each pegged the cost of carbon allowances at \$18 per ton or less in 2020, with overall costs averaging less than a postage stamp a day for each household.¹ Recent studies by McKinsey & Co. show how these costs could be driven even lower through investment in cost-effective energy efficiency measures.²

Congress has a variety of tools for keeping allowance prices from straying substantially above the range predicted by these analyses while still assuring that we meet the proposed carbon caps. We offer the following **DOs** and **DON'Ts** on carbon price safeguards as the Senate moves forward:

DON'T Bust the Cap

The investor-owned utilities' trade association and some others have proposed a "safety valve" or "price collar" where if carbon prices rise above a set level, the government just prints and sells more allowances, letting carbon pollution increase well above the cap. That approach just throws carbon pollution limits out the window, leaving us with only two bad choices:

- Give up on limiting total carbon pollution and suffer worse climate impacts or
- Decide later to make steeper, more expensive emission cuts to catch up.

We can safeguard carbon prices without busting the cap.

DON'T Encourage Risky Investments

Hard-wiring a maximum price through a price collar would only encourage risky high-carbon investments and discourage investment in the low-carbon technologies we need. Building another generation of long-lived, high-emitting facilities would lock us in to a high-carbon emissions pathway, making it prohibitively difficult and costly to cut emissions later on the scale needed to avoid the most dangerous climate impacts.

Prudent investors and lenders are increasingly aware of the financial risks associated with building capital-intensive high-carbon facilities. They know that carbon emissions need to be reduced, and they are quite reasonably insisting that high-carbon project proponents show that their projects make financial sense in a carbon-constrained future. A fixed-price collar would create a counterproductive subsidy for high-carbon investments by arbitrarily capping the financial risk for these private investors. But this risk does not disappear.

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It is merely shifted to the public and other covered entities. By encouraging high-carbon projects, the price collar would drive up demand for allowances years into the future, making allowance prices higher than they would be without the collar's distorting impact on investments.

Similarly, a fixed-price collar will deter investors from financing low-emitting products and projects unless they are certain their concepts will be profitable at carbon prices well below that hard-wired amount. This would deter investments critical to reducing emissions and lowering carbon prices in the future.

DO Prevent Market Manipulation

Poorly regulated markets have caused deep economic pain over the last year. The Commodity Futures Trading Commission (CFTC) recently identified a set of bad trading practices as the cause of last year's \$140 per barrel oil price spikes. Many fear that these practices could also cause high price spikes in a carbon market.

The solution is not to abandon markets, but to build the regulatory safeguards that will prevent these abuses into both energy markets and the climate protection program. The House bill and the Feinstein-Snowe Carbon Markets Oversight Act (S. 1399) both include important safeguards. See the box for more detail.

DO Build in Price Protections That Safeguard the Cap

The Senate can create an effective price protection mechanism that prevents high allowance prices and maintains the integrity of the long-term carbon cap.

This can be done by creating a *strategic allowance reserve*—a stand-by reserve of allowances and offsets that can be released into the market to avoid price spikes or end them quickly. According to the National Commission on Energy Policy (NCEP), compared to a price collar, this approach “has the not insignificant advantage of providing greater certainty about cumulative emissions reductions over the time horizon of the program.”³

The House bill creates a stand-by reserve of 2.7 billion tons by bringing forward a small percentage of the allowances from each future year out to 2050. If prices run up over a trigger level, government would pour reserve allowances into the market through auctions. The bill requires the government to refill the reserve, if it is used, by using these auction proceeds to buy offsets created by reducing tropical forest losses. Offset providers also can offer more tons for sale through the reserve.

Key Measures to Prevent Manipulation in Energy and Carbon Markets

SET STRONG “POSITION LIMITS.” The authority to set and enforce position limits—restrictions on the size of any trader's holdings—is fundamental to establishing a well-regulated commodities market.

- Strict position limits deny any trader—even the biggest investors or banks—the power to corner the market or push prices up or down.
- Strict position limits (roughly 2% of the market) are already standard features in CFTC-regulated markets for wheat, corn, and other agricultural commodities.
- The CFTC is now proposing strong position limits to curb oil traders' power to run up prices in futures markets for oil and other energy commodities.
- The House bill establishes position limits for the new carbon market like those in the agricultural markets, and Feinstein-Snowe beefs up the regulators' enforcement powers.

BAN “DARK TRADING.” “Over-the-counter” trading allows traders to buy and sell a commodity out of view of regulators and other market participants, increasing price volatility and credit risk in the energy and financial markets. Congress should ban “dark trading” by requiring trading to take place on registered exchanges, or with transparent reporting.

- When trading takes place on regulated, open exchanges, everyone knows the real prices and regulators can do their job more effectively. Exchange trading is also safer—participants put up collateral to ensure they'll perform; the exchange guarantees against one side's default; and credit risks are effectively eliminated.
- The House bill proposes that “dark trading” be banned for the energy markets as well as for the carbon markets. Feinstein-Snowe pushes carbon markets towards exchange trading, but provides limited exemptions for emitters hedging their carbon risk.

¹ Energy Information Administration, Energy Market and Economic Impacts of H.R. 2454, the American Clean Energy and Security Act of 2009 (Aug. 4, 2009), <http://www.eia.doe.gov/oiaf/servicert/hr2454/index.html>; Congressional Budget Office, The Estimated Costs to Households From the Cap-and-Trade Provisions of H.R. 2454 (June 19, 2009), <http://www.cbo.gov/ftpdocs/103xx/doc10327/06-19-CapAndTradeCosts.pdf>; Environmental Protection Agency, Analysis of the American Clean Energy and Security Act of 2009 H.R. 2454 in the 111th Congress (June 23, 2009), http://www.epa.gov/climatechange/economics/pdfs/HR2454_Analysis.pdf.

² McKinsey & Co., Reducing U.S. Greenhouse Gas Emissions: How Much at What Cost? (Dec. 2007), <http://www.mckinsey.com/client-service/ccsi/greenhousegas.asp>; McKinsey & Co., Unlocking Energy Efficiency in the U.S. Economy (July 2009), http://www.mckinsey.com/client-service/electricpowernaturalgas/US_energy_efficiency/.

³ National Commission on Energy Policy, Managing Economic Risk in a Greenhouse Gas Cap-and-Trade Program (July 2009), <http://www.energycommission.org/ht/a/GetDocumentAction/i/10972>.

