

GUEST COMMENTARY - US SHOULD PRICE CARBON, DIRECTLY

By Dean Murphy, Principal, The Brattle Group

An increasing number of US businesses, recognising the threat of climate change and seeing that national greenhouse gas regulation has become a near-term likelihood, have begun to call for meaningful federal climate legislation. One of the business community's primary concerns is that it wants "regulatory certainty" – to reduce the risk surrounding potential carbon regulation so that businesses can move forward confidently with strategies and investment plans.

Proposals based on a cap-and-trade approach dominate policy discussions, and are often advocated by many of these forward-thinking firms. But ironically, cap-and-trade does not offer the kind of certainty that business wants, nor the kind needed to encourage effective climate change solutions.

Cap-and-trade does not offer the kind of certainty that business wants

A cap on overall emissions does not give much certainty about price, and price is what really matters. To plan effectively, business and society in general must know what it will cost to emit greenhouse gases, for many years to come. Capping the emissions quantity does "put a price on carbon" to discourage emissions – but it leaves one to wonder what that price will be.

Of course, given an overall quantity cap, we can guess at which sectors might contribute how much reduction, at what cost, based on which new technologies, and how those costs will change over

time as the cap tightens. Putting all this together, we can forecast allowance prices – except that the forecast will be highly uncertain at best, both in the near term and the long term.

The European Union's emissions trading scheme (ETS) offers a striking example. As of this writing, ETS CO₂ allowances are selling for €0.29/ton – almost exactly 1/100th what they cost about a year ago. Even allowing that changes to ETS rules (e.g. allowing banking) would help reduce price volatility, the fact is that an emissions cap will create and maintain substantial uncertainty about CO₂ price. This makes all types of business planning more difficult, but it particularly interferes with the development and deployment of capital-intensive, long-lived carbon-reducing technologies (low-carbon energy sources, renewables, efficiency) that offer the only real answer to the climate problem.

Rather than capping emissions, price them directly

Fortunately, there is another market-based solution. Rather than capping emissions, price them directly. An increasing, revenue-neutral carbon fee on fossil fuels (don't call it a tax; see below) avoids price uncertainty. The fee should start low to allow a gradual phase-in, but increase on a known long-term trajectory. The policy should make clear from the start that CO₂ price will get high enough, during the planning horizon of our energy infrastructure investments, to encourage deployment of carbon-reducing technologies. An increas-

ing carbon fee allows sufficient time to adapt, combined with the foreseeable incentives needed to get the necessary adaptations started immediately. The recent House Bill by Representative Stark provides an example.

Don't call it a tax

Many dismiss a carbon fee as politically untenable because it resembles a "tax," and people hate taxes. But make it revenue-neutral, returning proceeds directly to consumers to offset increased energy costs, and it is much less onerous. Besides, cap-and-trade also amounts to a tax, except that the tax rate is unknown and variable and, if allowances are allocated for free, the "proceeds" may become windfalls to producers that are then unavailable for consumer refunds or program funding.

Some environmentalists worry that a carbon fee would not guarantee emission reductions. But with greenhouse gases, it is long-term atmospheric concentrations that matter; short-term targets are less relevant. In the long run, a fee is likely to lead to greater and more economical reductions than a cap, because it more effectively encourages the development and deployment of low-carbon technologies.

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