



Cost Containment Discussion Paper¹

The USCAP's *Call for Action* recognizes that a robust, market-based cap-and-trade approach is the best way to contain the cost of reducing GHG emissions over the long term. At the same time, it recognizes additional cost containment measures may be needed to guard against excessively high and volatile allowance prices. The need for explicit cost containment measures will be especially important during the initial years of a cap-and-trade program as low-carbon technologies are developed, become commercially available and deployed; and, as financial tools and strategies for managing volatility and risk are fully developed.

Principles

In addressing this need, USCAP believes that explicit cost containment measures should be based on the following principles:

- Measures should be predictable, effective and easy to administer;
- They should achieve the legislation's overall GHG emission budget and should ensure that needed reductions are achieved in a timely manner;
- They should, to the maximum extent possible, provide objective, clear and predictable information about the factors influencing future allowance prices;
- They should not supplant or interfere with the development of commercially available financial tools and strategies for managing volatility and risk;
- They should not create opportunity for manipulation of market prices by market participants;
- The use and impact of several of the measures should be designed to diminish over time, to allow market forces to spur investment in the most cost efficient, long-term solutions for reducing GHG emissions;² and

¹ This Discussion Paper contains agreed upon principles and a set of ideas that are still under discussion within the USCAP. Not all of these ideas are equally supported by all USCAP members but they are being shared now to help inform congressional deliberations on this critically important topic.

² Some cost containment measures are likely to have ongoing value in a cap and trade program and as such are not considered transitional.

- In the context of the entire program (inclusive of complementary measures), the measures should not encourage near-term investments in significant new high-emitting sources that would "lock in" high carbon emission streams and make future emission reductions even more difficult to achieve.

Key Linkages

USCAP recognizes that effective cost containment is linked to several other key issues. From our perspective, the following issues must also be addressed along with cost containment:

- An allowance value distribution structure³ (between and within sectors) that cushions the costs to both consumers and business during the transition to a full auction system. The cost control measures USCAP is considering favor balancing environmental integrity and protecting the economy over simple price certainty. Thus, they may well result in higher allowance prices than some other approaches. This price risk creates challenges for entities that must buy allowances and for their customers, but these challenges can be mitigated by an allowance value distribution approach that minimizes the financial impact of the cost of allowances. For example, an allowance distribution approach that buffers energy cost increases will benefit energy consumers throughout the country (including households, businesses, and government institutions), without diluting the incentive for regulated firms to reduce GHG emissions.
- Offset policies, because offsets offer significant cost reduction opportunities but require assurance of environmental integrity. Offset policies also raise issues about long-term impacts on overall emission levels from the domestic electricity, transportation, and industrial sectors, depending on the level of the cap;
- Policies and incentives for developing and deploying new low-carbon technology, which could otherwise be delayed by early low allowance prices due to cost containment measures;
- Emission reduction schedules that are stringent enough to achieve reductions within timeframes consistent with those set forth in the *Call for Action* and the USCAP recommended goal of limiting global atmospheric GHG concentrations to a level that minimizes large-scale adverse climate change impacts to human populations and the natural environment; and
- The need for policies and measure for new electric power technologies and/or incentives for replacing or re-powering existing high carbon emitting electric power technology. These measures should work with a cap-and-trade program to accelerate investments in new low and zero GHG-emitting generating equipment and technologies and discourage a significant deployment of high GHG-emitting plants in the first decade of the program when GHG allowance prices may be lower.

³ The term "allowance value distribution structure" refers to the distribution of the full economic value of allowances through both free distribution and recycling of auction revenues.

Priority Concerns and Tools to Address Those Concerns

Cost containment measures should be designed to address a variety of reasonable concerns about the price and cost impacts of a cap-and-trade system. The primary concerns are: 1) short-term extreme price volatility; 2) sustained excessively high allowance prices; 3) an allowance price trajectory that discourages important investments in emissions-reducing technologies; and 4) an illiquid market. In further addressing these concerns, it is important to use tools that work well together and mitigate these concerns in a manner that is consistent with the above principles. USCAP suggests the following cost containment tools, which could be used in various combinations, as likely to be particularly effective to deal with the key concerns:

1. Extreme Price Volatility

Extreme short-term price volatility may result in increased risk and cost to regulated firms, their customers, consumers and investors and could complicate the development of efficient allowance trading markets. One way to reduce this risk is to allow firms greater flexibility to achieve compliance. USCAP believes the following tools are effective means to increase regulated entity compliance flexibility:

- Acceptance of:
 - international allowances from countries with caps on GHG emissions that are consistent with the goal of limiting global atmospheric GHG concentrations to a level that minimizes large-scale adverse climate change impacts to human populations and the natural environment⁴;
 - qualified project-based domestic and international offsets for part of compliance; and
 - international forest carbon tons (as well as possibly other sector-based agreements)⁵;
- Unlimited banking of offsets, allowances, and forest carbon tons;
- Effective multi-year compliance periods; and

⁴ Acceptance of international allowances would also require countries to have reasonably comparable measurement, reporting, and enforcement programs in addition to caps on emissions consistent with the environmental goal articulated above.

⁵ International forest carbon tons are a potential new type of market based program resulting in an offset-like commodity based on emission reductions below an appropriate national sector baseline rather than a project-by-project effort. A forest carbon program would be designed to provide an incentive to reduce carbon emissions by protecting and perhaps also expanding forests. No such international program currently exists, but one is urgently needed as deforestation produces up to 25% of the world's greenhouse gas emissions. USCAP has not completed its discussions on this issue, but has included the concept in this discussion paper because its members believe a mechanism such as forest carbon tons may provide a viable, cost-effective compliance option for regulated entities.

- Provisions to allow capped firms to buy and use allowances in a current compliance period from near-term future compliance periods (e.g. 1-3 years in the future).

2. Sustained High Allowance Prices

Early sustained high allowance prices could significantly burden a broad swath of the US economy including individual capped firms, other businesses, and consumers. Such prices may signal that the emission reduction schedule is outstripping the predicted ability of commercially available technology to achieve the needed GHG emission reductions, which is most likely during the early years of a cap-and-trade program.

As noted above, the availability of effective cost containment measures will be especially important during the initial years of a cap-and-trade program during which the development and deployment of low-carbon technology may lag behind the level needed to achieve mandated emission reductions targets. To deal with this situation, USCAP believes two strategies, in addition to those listed in the section on extreme price volatility, could be helpful:

- Relax quantitative restrictions, if any, on the use of qualified project-based offsets to be used to demonstrate compliance.
- Enable system-wide allowance transfers from future periods. (For a discussion of the extent to which there should be limits on system-wide allowance transfers, see below.) Allowance transfers would increase the supply of available allowances when prices are excessively high and compensating for the increase by a corresponding reduction in emission caps and allowances in a future period.

Expanding the use of qualified offsets which meet the test of additionality and other criteria would be preferable in addressing sustained high allowance prices, rather than transferring allowances from the future.

In determining how to limit the transfer of allowances from future periods into current periods, it is important to balance the need for cost certainty with the need to recognize the risk to the climate posed by postponing excessive amounts of emission reductions to future years. Some limits on the total number of allowance transfers from a future period into a current compliance period are necessary to ensure the environmental integrity of the program over the longer term. Yet, overly restrictive limits on allowance transfers will increase the likelihood of sustained excessively high carbon prices, resulting in an economic and political environment that could threaten the viability of the entire program.

Currently, there are differing views within the USCAP on how to limit transfers from future compliance periods to current compliance periods. Nevertheless, the USCAP believes the nation's climate protection program should be designed to ensure that sufficient reductions are made in a timely manner to ensure the integrity of the emissions cap over a multi-year period in order to minimize large-scale adverse climate change impacts to human populations and the natural environment.

The following principles are important to any use of allowance transfers:

- An appropriate discount rate should be applied to any transferred allowances to account for fewer environmental benefits from future emission reductions; and
- The timing of any future reductions in cap levels must be sufficiently certain and transparent, and far enough in the future, so as not to interfere with normal forward trading.

The following options could be used to increase the near-term supply of allowances created through allowance transfers:

- Future allowances could be transferred into the current period at the discretion of an administrative carbon market board.
- Future allowances transferred into the current period could be made available to covered entities at a fixed price (such allowances may or may not be fully fungible with current period allowances).

Options to increase the near-term supply of allowances could be used alone or in combination as a tiered approach. The USCAP is actively evaluating various combinations and tiered approaches to the use of these tools and plans to contribute further to the discussion of effective cost containment measures as the legislative process evolves. While tiered approaches have certain advantages, these must be carefully weighed against the increased complexity and potential negative interactions between tiers.

3. Sustained Low Allowance Prices

If scientifically necessary emission reductions are being achieved, low market prices demonstrate that innovation has succeeded in achieving environmental objectives at low cost. Low allowance prices may also signal an opportunity for accelerating emission reductions, particularly where science indicates a need to accelerate and deepen the emission reduction pathway.

The use of unlimited banking should effectively prevent short-term reductions in allowance prices as long as firms believe emission reduction costs and allowance prices will be higher in the future. Thus any sustained period of low allowance prices is more likely to be due to program success than to short-term volatility or other price depressing factors.

To the extent that sustained low allowance prices are perceived as a problem, because they may discourage investments in low-carbon technology necessary to move to a globally competitive low carbon economy, USCAP believes two approaches may be useful for dealing with this issue.

- *Reduced future emission caps.* The most environmentally beneficial strategy for raising allowance prices is to accelerate the pace of required emission reductions and steepen the slope of the national emission reduction trajectory in the relatively near future, but outside of the period that may interfere with the forward market. This approach would lead to a near-term increase in prices due

to an increase in banking as covered entities and investors prepare for the tighter market created by the reduced future markets. This approach has the benefit of being fully transparent and market driven.

- *Auction reserve price.* The allowance auction could have a reserve price (i.e., a minimum offer price requirement that must be met if allowances are to be sold by the government) which would effectively reduce the supply of allowances when the market is oversupplied with emission reductions.

4. Market Liquidity and Integrity

The fundamental pre-condition for a liquid market is a large number of buyers and sellers, while market integrity requires a stable and predictable regime that establishes and protects the rights of those buyers and sellers in a fair, commercially reasonable, transparent manner. While such a regime will enhance liquidity and confidence in the market, liquidity cannot exist if the market is poorly designed or if the various cost-containment and structural provisions do not work together effectively as a whole.

Further, any government interventions in the market – which most of the USCAP recommended cost-containment measures admittedly are – must be carried out in a fair, non-discriminatory, objective and transparent manner. USCAP believes the following measures – in addition to those listed above – could promote liquidity and integrity:

- Point of regulation provisions that balance the administrative burden of a large number of regulated entities with the need to ensure a large number of buyers and sellers in the market.
- A fully independent, highly professional Carbon Market Board charged with administering those cost-containment market interventions that must be carried out through the use of well-defined administrative discretion (for example, the determination of how many allowances to make available into the market to relieve excessive prices); and
- Rigorous oversight of market participants' rights, obligations and transactional dynamics modeled after the requirements and practices of the Commodities Future Trading Commission and/or the Securities Exchange Commission.

In addition, all cost containment provisions must be designed and implemented in a manner that does not induce market manipulation.