

 ENERGY & ENVIRONMENT

Cap and Trade, or Bait and Switch?

By Don Willenburg

What you think you see in “cap and trade” may not be what you get. The likelihood of this result is large, given the law of unintended consequences, the huge financial stakes involved and the complexity and opacity of the issues.

Cap and trade is currently touted by many as the best way to reduce carbon or all greenhouse gas emissions. There would be a “cap” on emissions from producers, who would be given permits to emit a certain amount. If they produced less than the permitted amount, they could “trade” their permit for the difference to others for profit.

The bait: Here is a way to both limit emissions and generate economic activity. The “switch” or hidden agenda: Create a new market that will encourage and reward speculation, while allowing emitters to continue to emit even more than they would otherwise be permitted, and perhaps even subsidizing greater emissions than would be the case under an alternative system.

Cap and trade is based on a number of propositions that seem almost inarguably true on their own. But how these propositions work in concert, and how they are implemented in practice, may have little to do with reducing environmental harm.

These include: We need to limit and reduce emissions; emissions can be reduced by imposing a legal limit (the “cap”) that declines over time according to a preset formula (this assumes the caps will be enforced and enforceable, but that is a practical problem for its own set of articles); greenhouse gas producers can be induced to emit even less than the cap if they are paid to do so; payment for such beyond-the-required conservation should not come from the taxpayers, but from the private sector; and the sector of the private sector that ought to pay for those who emit less should be those who emit more, in fact who are unable to meet their own limits.

The first and most fundamental question: If caps will reduce the amount of greenhouse gases, then what is the need for trade? Is cap the bait, and trade the switch?

Proponents argue say that a dual carrot and stick method will encourage innovation and conservation better than a single-prong approach. Plus, it will allow political will for more aggressive caps if we build in “flex-

ibility.”

Perhaps, but society does not take that position with regard to other conduct. We set a limit and prohibit transgression, period (e.g. DUI and other criminal laws). We would not accept a “let the market decide” approach to the murder of a single individual. Why allow it for actions that can lead to the death of many?

If a cap works, then use a cap. If you want further reductions, lower the caps. That will be hard enough to calibrate and enforce without the additional problems of creating a new place for speculators to profit without reducing greenhouse gases.

If the trading in permits sounds familiarly like the “derivatives” so much in the news lately, that is because it is. The “products” could get quite divorced from any actual reductions in greenhouse gases. Permit trading could result in the same swings in value and would be susceptible to the same “bubble economy” trends that hit tech a decade ago and housing in the last few years — too much money chasing too little real value. If derivatives are a drag on the economy rather than a positive contribution (which they are in the sense that many financial services are — do credit card fees really add to the economy?), and they are prone both to suck in a lot of capital and then eventually implode, then this trading could wreak further havoc on financial markets. Which, in turn, would result in further economic slowdown, which would be used to justify foot-dragging on emissions reduction (we can’t afford it, we can’t cut jobs).

Trading systems also tend to rely on high demand to keep prices high enough that the trading is worthwhile. What happens when the price of emissions collapses — because the economy collapses — and the factories are shutting down anyway? You can “invest” in rights to pollute with greenhouse gases, but then your investments collapse

Further, what if it turns out that science tells us that the cap needs to be lowered further faster than predicted at the outset? Many scientists are already calling for greater reductions than proposed under some cap and trade scenarios. Opposition will come not only from traditional sources — industry and commercial concerns will claim it is “technologically impossible” or will “cost jobs.” Opposition would also come from those trading in permits, particularly futures trading and other derivatives. They will protest about “market volatility,” “uni-

lateral reduction of asset values” and how “uncertainty” reduces values. The marketization of incentives is not the same as reduction of greenhouse gases, and reliance on markets could (as has historically been the case) lead to greater emissions.

Trading does not reduce overall greenhouse gas emissions below the cap: It simply shifts permitted emissions from parties that conserve to those that pollute. Whether trading creates more incentives to find economical means of reducing emissions than a cap alone depends on the cap. If the cap is low enough, then just as people recognize a zero-tolerance policy for some crimes, people will never go beyond the cap and will find a way to do it. The system produces additional incentives only if the cap is too high — if there are means of controlling emissions that have not been adopted widely enough.

There are additional problems in at least two other areas.

One is the increasingly popular “offsets.” These differ from trading in permits, in that a business offsets funding for an environmental project elsewhere — say, preserving rain forest in Brazil, or building a clean tech refrigerator plant in China. Bait: Here is a way to globalize environmental protections. The problems: First, this does nothing to reduce emissions in this country; it in fact allows greenhouse gas producers in the industrialized world to emit more here. Second, there is no recognized way to verify that the foreign measures would not have been taken anyway. Third, unlike other aspects of cap and trade, use of such offsets provides economic benefits not to green-teching the domestic economy, but instead to projects elsewhere in the world. No green jobs, but more greenhouse gases, here at home.

Another area where the promise of caps may have undesirable consequences of trade is in the initial allocation of permits. There are two competing proposals for initial allocation of permits, and each has problems that do not help reduce emissions.

One proposal is to auction permits to the highest bidder. There are many attractive elements to this, not the least of which the “problem” of what to do with the money generated. A less attractive, all-but-unspoken problem is that many smaller concerns might get squeezed out of business simply because they cannot afford to outbid more cash-rich concerns. This may especially



problematic if the cap and trade system moves to limit greenhouse gas emissions in agriculture, putting a further pressure on small farms to the benefit of large agricultural firms.

The alternative proposal is to give the permits away, based on current emissions levels. That appears to be a fairer way of easing in to the new, declining cap system than auctioning. But this would have the result of giving valuable assets — permit rights — away for free, and giving more of them away to those who are the greatest emitters. The political response will include a fair question: If we are trying to limit emissions, then why is it that we are transferring value to those who emit the most?

Some version of cap and trade all but cer-

tainly will become law and the governing paradigm. Proponents often cite the fact that the European Union recently implemented a cap and trade program. They less often cite the fact that emissions in Europe have risen since the program started. Whether local programs will similarly fail, or engender yet other non-environmental problems, will depend in large part on how these issues are resolved.

Don Willenburg is a partner at Gordon & Rees in San Francisco. He is a member of the firm's appellate, climate change and green technology, and environmental and toxic tort practice groups. He can be reached at dwillenburg@gordonrees.com.