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Cap-&-trade failing the emissions test; calls for carbon tax

Patrick Brown and Christa Grace-Warrick

Carbon cap-&-trade, a government-initiated system devised to let 'free market economics' take care of greenhouse gas reduction, is failing. The scheme to prevent climate change has fallen prey to the 'market's' insatiable need to 'game' any entity put up for trade.

Prices of 'carbon credits,' the trading entity, are so low and volatile that there is no incentive for greenhouse gas emitters to reduce, or to create the technology to reduce, the production of the deadly climate change accelerants.

Fragmented schemes in various parts of the world have only added instability—and spice to traders efforts to 'game' climate change for profit (see BOX 'Gaming...', page 2). How did all this come about?

How Low Are The Prices?

Cap-&-trade has a four year history in the European Union (EU) (see BOX 'How It Works...', page 2). Recent the European Union Allowance (EUA) prices per tonne of CO₂ equivalent have ranged as low as 18 Euros, or about \$22.

Compare this with the expected cost of carbon capture and storage (CCS) for a coal-fired electricity plant, about \$40–\$60 per tonne (and CCS technology is currently far from practical implementation). This makes it quite clear why the EU's cap-and-trade scheme has so far failed to produce demonstrable GHG reductions.

These low, and more importantly, unpredictable prices do not provide assurance to industrial enterprises, their investors, or their lenders, that capital investment in emissions reduction technologies will pay out in a reasonable time period. (A similar

phenomenon is illustrated by the current cutback in oil sands investment in the face of unpredictable crude prices, despite the probability of a crude shortage within the next few years.)

Most emissions reduction technologies require years to design, build, and implement, and cost a lot of money. Many of them encompass significant technological uncertainty and risk.

Cap-&-trade Shenanigans

Prices have been volatile ever since start-up in the European Union, where only about half of European industry is currently covered by the Emission Trading Scheme (ETS).

Initially, each country in the EU was responsible for setting caps and issuing permits for its industries. Industries favoured in particular countries were given emission caps that far exceeded their current emissions, or were granted credits at no cost. Other politically well-connected industries managed to elude the scheme altogether. In fact, some early participants were reported to have reaped a

windfall of many billions of dollars by charging customers for carbon credits that they received from governments for free.

Eastern european nations, building new, modern plants to replace dirty Soviet-era ones, are a large source of oversupply of EUAs, since their caps were set on the basis of 1990 emissions levels.

'Developing' Countries Part of the Muddle

A further destabilizing complication was that the EU scheme also recognized credits issued by the United Nations' 'Clean

How It Works - Or Doesn't

Cap-&-trade systems require governments to set a limit, or the 'cap', on the number of tonnes of GHG each 'major emitter'—a manufacturing, energy generation, or industrial plant—is allowed to discharge into the atmosphere. Each major emitter is then required by law to purchase emissions 'credits' to cover the quantity of its GHG emissions that exceed the cap or it may sell 'credits' totaling the number of tonnes by which it is under the cap.

Or, of course, the emitter which is over its cap may take action to reduce its emissions (which it is unlikely to do unless the cost of doing this is less than the price of credits). In theory, the cap-&-trade scheme's intention is that emissions reductions are effected at minimum cost to the total economy.

However, and not surprisingly, the private sector has dismissed emission reduction as an 'externality' of no economic significance to the scheme! Trading is the name of the game and this has been a chaotic in this sector as in any other. Leaving emission control to the market appears to give one more 'gamers' playground, rather than an incentive to curb

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Island Tides, Box 55, Pender Island, BC, Canada. Phone: 250-629-3660. Fax: 250-629-3838.
Email: islandtides@islandtides.com. Website: <http://www.islandtides.com>

Development Mechanism (CDM)'. These Certified Emission Reduction (CER) certificates have been issued by developing countries to projects, such as biomass electricity generators and forestry projects which either avoided emitting the GHGs which might have been emitted by some other means of achieving the same economic purpose (eg. the generation of electricity), or claimed to absorb GHGs.

Sale of these CERs yielded funds which could be invested in the developing country projects. India and China are currently major issuers. However, emission reductions promised by CERs are difficult to confirm, and often not credible. So, CERs have always sold for less than EUAs on the open market, and have effectively pulled down the price of EUAs.

North America Now In On The Game?

A new, and greater source of uncertainty right now is the forecast adoption by the US under President Obama of its own cap-&-trade system. Canada, with its significant oil sands GHG emissions, and its apparent preference for an 'intensity-based' system of setting caps, also introduces a new variation on both the quality and the potential effectiveness of emission credits.

Combining the US and Canada, the North American market would be at least as significant as the EU in price-setting, and would potentially change the dynamics of the international market. But its startup would introduce the questions of cap-setting, favours to politically connected industries, and initial pricing all over again.

In addition, emissions trading in the US, which so far has a doubtful record of securities market regulation, could well introduce a whole new group of derivatives and market players. So an extensive regulatory bureaucracy would be essential, both for setting and enforcing caps, and tracking and supervising trading.

Calls For A Carbon Tax In The States

In contrast, the other scheme for green house gas reduction, a carbon tax, would be far easier to manage, and much more

transparent.

Connecticut Democratic Representative John Larson, recently elected Chairman of the US House of Representatives Democratic Caucus, has cited the current economic crisis and 'fallible investment banks' in arguing for his carbon tax proposal. In a recent letter, James Hansen, director of the NASA Goddard Institute of Space Studies, has urged President Obama to levy a rising tax on fossil fuels and redistribute 100% of the proceeds to taxpayers. 'Politically, [cap-and-trade] will be convenient, but it will not solve the problem,' he says. (Twenty years ago, Hansen was the first climate scientist to publicly state that GHG emissions were causing climate change.)

More recently, Exxon Mobil CEO Rex Tillerson came out in support of a carbon tax, in preference to a 'cap-&-trade' system.

Commentary: A Worldwide Concern—A Worldwide Approach

Can we trust the worldwide problem of GHG emissions reduction to such an unpredictable and volatile market, given its susceptibility to both financial and government manipulation, economic fluctuations (as at present), and its lack of accountability?

The answer is clearly and conclusively no. Such a market would only be, as in Macbeth, 'a tale told by an idiot, full of sound and fury, signifying nothing'—nothing for climate change, that is.

The public interest in climate change is, of course, worldwide, encompassing all peoples in all nations. The responsibility for mitigating climate change, including GHG emissions, clearly falls to governments. Any fiscal incentives must be long-term, internationally coordinated, and protected.

What is required is a worldwide carbon tax system, with high enough rates to achieve clear incentives, and sufficiently financed to pay for regulation and enforcement, GHG and climate monitoring, and technological research.

Today, as we actively and critically re-examine the role of markets, is the right time to assign the responsibility for climate change action to an international community of governments. ☞

Gaming The Carbon Market

According to the UN, the world-wide carbon credit market cycled \$64 billion in 2007. The actual investment in emission reduction was clearly nowhere near this amount.

From the beginning, cap-&-trade has been seen as a new gaming playground for investors, brokers, aggregators, and speculators. Many new players have contributed to the volatility of the market.

Derivatives were quickly developed, including futures; China has been accused of announcing projects, selling CER futures, and then not carrying out the projects. In the absence of a renewal of the Kyoto protocol beyond 2103, futures for dates beyond that time are still available, but sell at a steep discount. Options and swaps are also traded.

New countries starting new carbon credit markets are not consistent in their approach; whether they will have a 'soft' startup (easy caps: cheap or free credits or a 'hard' startup: caps difficult to meet, credits auctioned). Some forestry companies sell emissions reductions for a hundred years into the future!

In fact, the real market, for organizations that need credits to comply with government-set caps, is small and inflexible. It seems possible that, like crude oil futures, the market has been dominated by speculators.

However, as in the crude oil market, speculators would have recently been hobbled by the world-wide financial upheaval; the carbon credit market has behaved much like the oil market in recent months, a factor that may have contributed to today's low prices.

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