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Cap-and-Trade in the US

Did you know that September 29 saw the largest carbon auction the world has ever seen? OK, it was pretty small on an absolute level -- it raised just **\$39 million**, and the price per ton of carbon emitted was very low, at \$3.07. But it's a good start, especially because of where the auction took place: right here in the US.

The auction was part of the **RGGI** initiative, whereby ten states in the Northeast agreed to cap the carbon emissions from power plants, bringing them down 10% by 2018. It's a fully-fledged cap-and-trade system, and although it has weaknesses -- foremost among them the fear that emissions will simply "leak" over into Pennsylvania, which isn't taking part -- it's already raising money for the states concerned.

Was leakage the reason why the price of the offsets was so low? It's hard to tell for sure. But there are three other reasons which I think are at least as compelling. The first is the economy: it's going to slow down in 2009, and that means fewer emissions anyway. The second is the fact that the RGGI cap is not very stringent: electricity generators will be able to stay within it quite easily, even if the economy were to grow next year. And the third is high oil prices.

Richard Domaleski, the CEO of World Energy, which administered the auction, explained to me that the Northeast is a unique market in that many energy customers have dual fuel switching capability. When oil gets too expensive, they switch to natural gas, which has a lot less carbon emissions. So maybe the bidders at the auction simply reckoned that emissions would never reach the cap anyway, just because so many of their customers had switched.

I also talked to Wiley Barbour, the co-founder of the American Carbon Registry, about the auction. "We now have a mandatory cap-and-trade in the US, and that's a good thing," he said. "It's coordinated across 10 different state legislatures, and it went off without a hitch."

We got into a conversation about where the best place to measure carbon emissions is, from a cap-and-trade perspective. I've long been a proponent of measuring as far upstream as possible: it makes measuring them much easier, and makes it less likely that important sources of carbon emissions will end up being excluded.

But Barbour explained that although there are good reasons to measure the emissions upstream, there's also a decent argument on the other side. If you measure emissions upstream, the *only* mechanism you have to reduce them is the price mechanism. It's admittedly a very powerful mechanism, but if you measure emissions further downstream, you get something else as well: companies actually need to go out and buy carbon emissions permits for all the carbon they emit.

The difference is quite large, from a behavioral perspective. If you're buying the emissions rights yourself, that makes you very conscious of how much carbon you're emitting, and it focuses the mind on how you can reduce those emissions. If that money is buried in things like electricity bills, you're more likely not to notice, even if it's the same total amount. Said Barbour:

The further upstream you go, the more it looks like a tax. The further downstream you go, you're sending a clearer signal. When you put the burden of compliance on the operator of the fossil-fuel power plant, that's the person who can decide. You're putting the burden on one of the key decision-makers. It's a different signal that you're sending.

It's an interesting argument -- and I'd love to see some empirical research on how much of a difference such things make. Until then, it's all theoretical, and no one knows how important such factors are.

And the good thing about the introduction of RGGI is that we can now start getting real empirical data on a lot of things which have hereunto been theoretical, like leakage. A lot of people are going to be paying close attention to Pennsylvania's power production over the next few quarters, and comparing it to power production in the RGGI states. If the former goes up while the latter goes down, that should give a pretty good idea of how much leakage there has been. And the more leakage, of course, the more important it is to implement national-level or even global-level cap-and-trade schemes.