National Commission on Energy Policy

THE CASE FOR ACTION

FORGING THE CLIMATE CONSENSUS

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Seventeen years after Rio and nearly a full decade into a new century the world is out of excuses and ***out of time***:

This Congress, not the next Congress or the one after that, must have the debate, ***make the tough choices***, and cut the deal that will finally begin to ***unleash*** American ***ingenuity and enterprise.***

"WHILE AMERICA CANNOT SOLVE THE CLIMATE PROBLEM ALONE, IT HAS BECOME PAINFULLY EVIDENT THAT THE WORLD WILL NOT ACT ABSENT CREDIBLE U.S. LEADERSHIP ON THIS ISSUE."

THE IMPETUS TO ACT

Seventeen years have passed since President George H.W. Bush traveled to Rio de Janeiro and joined other world leaders in pledging to stabilize greenhouse gas concentrations in the atmosphere "at a level that would prevent dangerous anthropogenic interference with the climate system." In that time, U.S. emissions have increased nearly 14%[1] and global emissions have increased nearly 36%.[2] Developing country emissions, in particular, have shot up more dramatically than anyone could have predicted in the early 1990s—China's emissions alone have more than doubled since 1990 and now exceed total U.S. emissions.[3]

Clearly, the world has fallen far short in living up to the commitments made at Rio in 1992, and just as clearly a new global effort—one that fully engages the United States and major developing countries—is needed. For while everyone recognizes that America cannot solve the climate problem alone, it has also become painfully evident from the lack of progress over the last decade or more that the world will not act absent credible U.S. leadership on this issue. Simply put, international efforts will not succeed unless and until the nation with the greatest economic and technological resources—as well as one of the world's highest levels of per capita emissions—acts to limit its own contribution to global warming.

Continued inaction by the United States not only has global consequences, it is costly because it means that the emission cuts needed over the next few decades to avoid dangerous levels of warming must be that much deeper. In recent testimony before Congress, Dr. R.K. Pachauri, Chairman of the Intergovernmental Panel on Climate Change (IPPC), noted that evidence for warming of the climate system is now "unequivocal" and warned that "[d]elayed emission reductions significantly constrain the opportunities to achieve lower stabilization levels and increase the risk of more severe climate change impacts."[4] Already, experts warn that the more protective stabilization goals often discussed in recent years are moving rapidly out of reach. Moreover, the latest developments in climate science lend greater urgency to the case for action: Effects on natural systems are already being observed and recent findings concerning the potential scope and magnitude of damages from future warming are increasingly worrisome.

ACTION IS NEEDED THIS CONGRESS

In this context, efforts to move climate legislation in Congress—including, notably, the proposal introduced by Chairman Waxman and prior bills sponsored by Senators Warner and Lieberman,

[1] *United States Environmental Protection Agency. 2007 Inventory of U.S. Greenhouse Gas Emissions and Sinks.*

[2] *Energy Information Administration. International Energy Annual 2006. International Carbon Dioxide Emissions from the Consumption of Energy.*

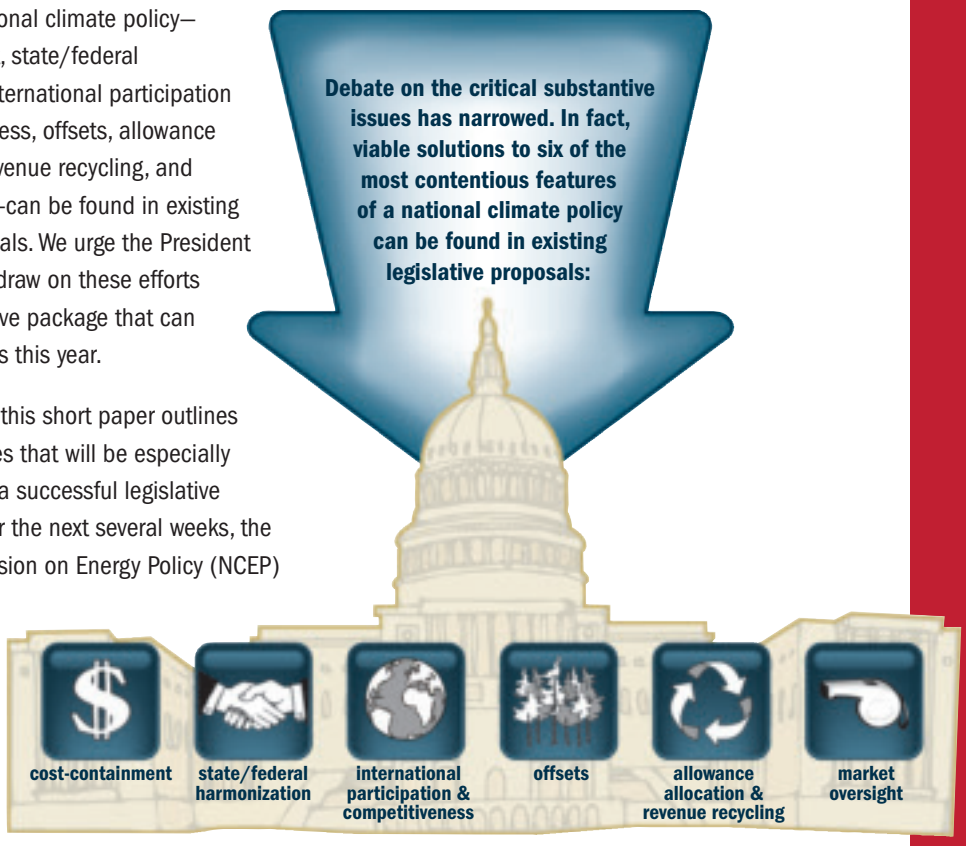
[3] *Energy Information Administration, International Energy Outlook 2008, World Carbon Dioxide Emissions by Region.*

[4] *Testimony before the U.S. Senate Committee on Environment and Public Works, February 25, 2009. Citations from the IPCC Fourth Assessment Report, November 2007.*

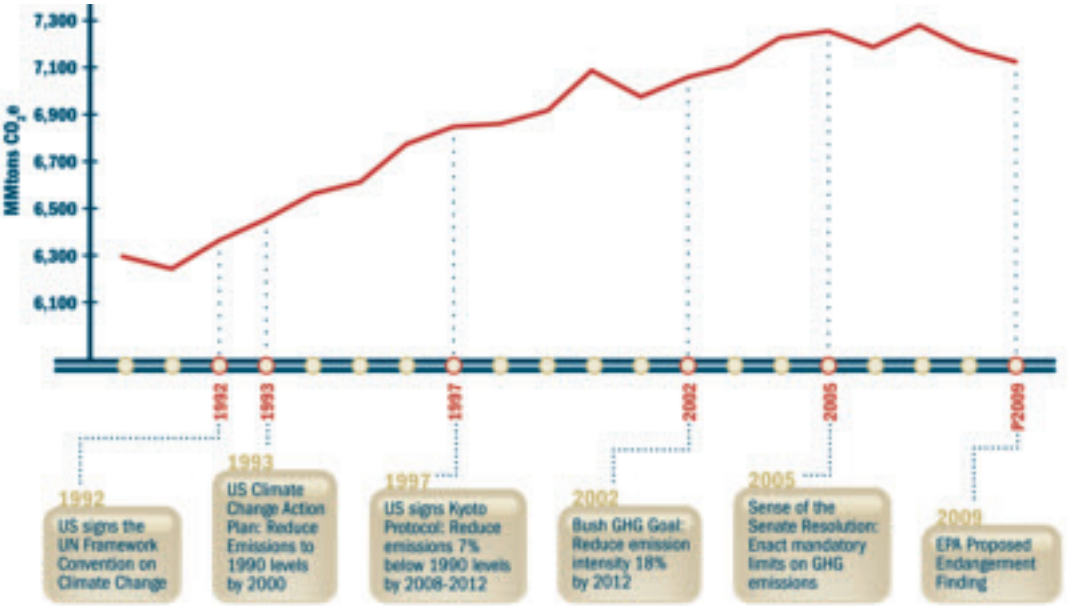
as well as by Senators Bingaman and Specter—are to be applauded. Each of these initiatives reflects a serious and principled effort to find common ground on legislation that will achieve meaningful environmental results while addressing legitimate concerns about costs, regional and sectoral equity, and competitiveness that have blocked prior efforts to put together bipartisan support for action.

Fortunately, debate on the critical substantive issues has narrowed. In fact, viable solutions to six of the most contentious features of a national climate policy—cost-containment, state/federal harmonization, international participation and competitiveness, offsets, allowance allocation and revenue recycling, and market oversight—can be found in existing legislative proposals. We urge the President and Congress to draw on these efforts to craft a legislative package that can pass the Congress this year.

The remainder of this short paper outlines some of the issues that will be especially critical in forging a successful legislative compromise. Over the next several weeks, the National Commission on Energy Policy (NCEP) will release more detailed proposals that we believe can form the backbone of a robust and durable domestic climate policy. Many will surely disagree with some of the trade-offs we propose. Some will argue that it is not worth passing legislation if the resulting bill compromises short-term stringency or certainty about emission reductions; others will argue that whatever the long-term climate risks, further delay is appropriate in light of current economic conditions. ***We strongly disagree.***



U.S. GREENHOUSE GAS EMISSIONS



Since 1990, net U.S. greenhouse gas emissions have increased 14%.[5] In the years since the U.S. signed the UN Framework Convention on Climate Change, there have been numerous voluntary initiatives to limit U.S. emissions. While these initiatives have likely contributed to slowed emissions growth, none have succeeded in achieving the necessary leveling and reduction of U.S. emissions.

Under a well-designed climate bill, emissions limits would be initially modest and ramp up in a gradual and predictable way over multiple years, with effective mechanisms in place from the outset to (a) guard against high or excessively volatile allowance prices and (b) protect low-income households and trade-sensitive, energy-intensive businesses. This approach will provide time and a favorable investment environment for robust low-carbon technology alternatives to become available, thereby reducing climate-related costs to the economy in the long run. It will also help ensure that the transition to a low-carbon economy provides a steady impetus for the creation of durable new industries and employment opportunities.

Most importantly, a successful bill will deliver clarity about U.S. climate policy and certainty about carbon costs going forward. This is *the* critical issue for businesses attempting to make strategic investments in new energy technology and long-lived infrastructure. It is also the central priority from the standpoint of engaging major developing countries in a re-invigorated international process. A clear signal concerning our nation's commitment to future greenhouse gas reduction efforts would greatly strengthen U.S. influence and leverage in international climate negotiations starting at the next United Nations conference in Copenhagen and beyond.

In sum, it has been the Commission's considered view for some time that the benefits of prudent but imperfect action profoundly outweigh the arguments for further delay. Increasingly, we are joined in that view by a diverse group of stakeholders that includes military experts, CEOs of major oil companies and electric utilities, labor leaders, state governments, religious leaders, sportsmen, and environmental advocates. All of these groups

[5] *The United States Department of Energy. Energy Information Administration (EIA). Emissions of Greenhouse Gases Report. 2008. Note that data for 2007-2009 is an estimate as projected by the EIA.*

> *CLARITY ABOUT U.S. CLIMATE POLICY IS* THE *CRITICAL ISSUE FOR BUSINESSES ATTEMPTING TO MAKE STRATEGIC INVESTMENTS IN NEW ENERGY TECHNOLOGY AND LONG-LIVED INFRASTRUCTURE.*

recognize they will not get everything they want in national climate legislation. All of them also recognize that the intolerable (and probably far more costly) alternative to a clear federal policy is continued uncertainty, international paralysis, and reliance on highly imperfect regulatory mechanisms such as those triggered by EPA's recent finding that greenhouse gases endanger human health and welfare under the Clean Air Act. Seventeen years after Rio and nearly a full decade into a new century we are out of excuses and out of time. *This* Congress, not the next Congress or the one after that, must have the debate, make the tough choices, and cut the deal that will finally begin to unleash American ingenuity and enterprise on what is, by wide agreement, among the most difficult and consequential challenges we confront in our time.

KEY ISSUES FOR U.S. CLIMATE LEGISLATION

As noted above, we believe there are several key issues that must be resolved to reach agreement on national climate legislation in this Congress. The Commission will be releasing more detailed papers with specific recommendations and proposals for compromise on each of these issues in the coming weeks.

ALLOWANCE ALLOCATION AND REVENUE RECYCLING: Exactly who gets what share of the allocation pie is likely to remain very contentious, as the stakes are high—the potential allowance value created by an economy-wide program to limit U.S. greenhouse gas emissions is on the order of tens or even hundreds of billions of dollars per year. We continue to stress that while allocation affects the distribution of benefits and burdens among firms, industry sectors, and consumers (and thus can be used to address equity concerns) it does not affect the environmental results of a cap-and-trade program. With this in mind, NCEP believes that allocation must serve three essential purposes. First, allowance allocation should be used to protect households, especially low- and moderate-income households, from adverse economic impacts as a result of higher energy prices under a climate program.[6] Second, it must support energy-intensive industries in making a viable transition to a lower carbon footprint without resulting in the significant export of jobs and emissions to our trade competitors. Third, allowance value should be used to create incentives for increased investment in the research, development, and deployment efforts needed to advance critical no-and low-carbon technologies and for investment in needed adaptation measures.

[6] *Note that protection for consumers should be de-linked from energy consumption, so that appropriate price signals for reducing demand and avoiding emissions are preserved. Mechanisms that achieve this objective include recycling allowance revenues through other programs, such as income tax credits.*

> *A PRICE FLOOR ALONG WITH A PRICE CEILING SHOULD BE CONSIDERED BECAUSE ALLOWANCE PRICES IN PAST MARKET-BASED REGULATORY PROGRAMS HAVE MORE OFTEN PROVED TO BE LOWER THAN EXPECTED, RATHER THAN HIGHER THAN EXPECTED.*

In pursuing these goals, we believe that Congress should strive for allocation designs that stress simplicity, clarity, and transparency and that avoid producing undesirable outcomes, such as windfall profits to certain firms or industry sectors, or perverse incentives. The approach we recommended in 2007 provides a reasonable basis for compromise and transition: One would start by allocating roughly half of the allowances for free to affected industry and consumers while the remaining half of the allowances would be auctioned. Over time, the quantity of allowances allocated for free would decline to allow for a gradual transition to a full auction. It is also possible to design an efficient and equitable approach that begins with a somewhat larger free allocation at the outset and transitions to a 100% auction more quickly. Recognizing that the revenue streams generated as an allowance auction expands over time will be significant, it is appropriate to begin exploring the fiscal implications and possible uses of these revenues. Many economists argue, for example, that the use of some auction revenues to reduce or offset other taxes could significantly improve the overall economic efficiency of the policy.

Allocation issues within the electric sector are particularly complex and have been the focus of recent discussions concerning this aspect of program design. Here the Commission generally supports an approach that has been endorsed by the U.S. Climate Action Partnership (US CAP),[7] a coalition of industry and environmental stakeholders. Under this proposal, the initial allocation to the power sector is close to the full level of allowances required to avoid disruptive price impacts during the early phases of program implementation. Within the electricity sector, competitive power generators not affiliated with a utility would receive a small portion of allowances that reflect their net incremental costs. The remaining allowances would be allocated to local distribution companies (LDCs) for the benefit of their customers. The Commission recommends completely phasing out free allocation to the electricity sector in roughly 10 years.

COST CONTAINMENT AND PRICE VOLATILITY: Concerns about adverse impacts on the larger economy have always been central to the debate over whether and how to limit greenhouse gas emissions. Adverse impacts could occur if the costs of achieving

[7] *The proposal is available at www.us-cap.org.*

greenhouse gas reduction are much higher than expected; they could also occur if program costs on average are in line with expectations, but allowance prices are excessively volatile—that is, prone to sharp upward spikes as a result of unpredictable short-term factors such as weather. With respect to the first issue, disagreements about overall program cost have been difficult to reconcile because they are driven by different opinions about the anticipated rate of technological progress. Small differences in assumptions can lead to dramatic differences in predicted impacts and neither technology optimists nor technology pessimists can guarantee that their assumptions are right. The volatility concern is likewise important since excessive price fluctuations in carbon markets can erode confidence in the policy, prevent firms from planning effectively (potentially resulting in inefficient, subsequently stranded investment), and produce large, short-term impacts on consumers and businesses.

The Commission has recommended one option that effectively addresses both cost and price volatility concerns: a cap on the price of emissions allowances to ensure that the per-ton cost of emissions reductions required under the program cannot rise above a known level. We have argued that such a price cap should be phased out when actual mitigation costs are established through experience and significant progress has occurred at the international level. During the initial years of a climate program, when carbon markets and associated regulatory mechanisms are still developing, however, such a mechanism provides multiple benefits. Not only would a price cap protect consumers, businesses, and the economy as a whole in the event that abatement costs prove significantly higher than expected, it would also provide an effective safeguard against excessive speculation and price volatility in carbon markets.

Along with a cap on allowance prices at the high end, the Commission supports the concept of a floor or lower limit on allowance prices in case abatement costs prove significantly *lower* than expected. A price floor along with a price ceiling should be considered because allowance prices in past market-based regulatory programs have more often proved to be *lower* than expected, rather than higher than expected— in some cases because emissions budgets were inflated, in some cases because other factors (such as slower-than-expected economic growth) temporarily reduced demand for allowances. Some price stability at the low end, as well as at the high end, would assure that there are sufficient—and sufficiently consistent—incentives for investment in low-carbon technologies over time (along with sufficient *dis*incentives to

> *OVER-RELIANCE ON INTERNATIONAL OFFSETS—GIVEN THE PRACTICAL DIFFICULTY OF ASSURING THAT EMISSIONS REDUCTIONS CLAIMED IN OTHER COUNTRIES ARE REAL, PERMANENT, ADDITIONAL, AND VERIFIABLE—COULD UNDERMINE PROGRAM GOALS AND POLITICAL SUPPORT.*

new investment in long-lived carbon-intensive infrastructure). Combining a price floor with a price ceiling could thus be quite important to the successful development of new climate-friendly industries and could help ensure that artificially low prices in the short term don't lead to significantly higher costs in the long run, when deeper emission reductions are needed to achieve program goals.

While the Commission sees strong arguments in favor of an explicit, legislatively determined price ceiling and floor (sometimes referred to as a price "collar") during the initial phases of a cap-and-trade policy, we are aware that some find this approach unacceptable because it risks foregoing emission reductions if costs prove higher than expected—that is, it allows for the possibility that actual emissions will exceed the cap. Given these objections and recognizing the importance of resolving cost concerns in forging a legislative consensus, other cost-containment options and compromises should be explored. The key here, in the Commission's view, is to provide for a transparent and legislatively pre-determined "worst case" that does not rely on economic models, projections, or good intentions.

For example, we believe that an "allowance auction reserve" mechanism, if designed carefully, could provide an adequate response to cost and volatility concerns. Under this approach—which has also been endorsed by US CAP—an additional, fixed quantity of allowances would be available for purchase from a 'reserve' that is deducted (or borrowed) from future year allowance budgets. Reserve allowances would be auctioned subject to a pre-determined starting price. The quantity of allowances available through this mechanism would need to be large enough to provide reasonable assurance that the target price maximum would not be surpassed for the first several years of program implementation.

The starting price for reserve allowances should be set at a level that is above the expected allowance price at the beginning of the program but that is still designed to protect the economy if technology does not advance at the anticipated pace. (As a point of reference in this regard, we note that a recent EPA analysis of the Waxman-Markey proposal estimates that allowance costs will fall in the range of $13–$17 per ton of carbon dioxide equivalent in 2015, the first year for which EPA provides an estimate.)[8] The reserve allowance starting price should escalate at a known rate each year.[9] If true costs are much higher than projected, the reserve would provide a "cushion" while Congress considers whether further program adjustments are needed.

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[8] *The United States Environmental Protection Agency's Preliminary Analysis of the Waxman-Markey Discussion Draft in the 111th Congress, The American Clean Energy and Security Act of 2009. Note that the analysis is based on a 20 percent reduction target by 2020. Allowance costs would be lower with a 17 percent reduction target by 2020, the target in the bill as reported by the House Energy and Commerce Committee.*

[9] *Note that we would support a similar approach to setting the level of an absolute price cap—the difference between that approach and an allowance auction reserve being that in the price cap case there is no limit on the additional quantity of allowances that could be purchased.*

INTERNATIONAL PARTICIPATION AND U.S. COMPETITIVENESS:

Domestic efforts to limit greenhouse gas emissions are necessary but not sufficient. Action by other nations is essential—not only because the problem of climate change will inevitably require a global response, but because concern about adverse impacts on U.S. competitiveness will continue to arise as long as our major trading partners (including especially major developing countries) are not undertaking similar action to reduce emissions. Absent mitigating measures, a cap on domestic greenhouse gas emissions will not only increase costs to energy-intensive sectors, but could lead to the offshoring of domestic industry and jobs to nations with lax or non-existent climate policies, thereby worsening the effect of global warming. Successful climate legislation must address this concern. Fortunately, analysis of the potential competitiveness impacts of a greenhouse gas cap-and-trade program indicates that the additional costs of such a policy to energy-intensive sectors can be mitigated to a large extent - but not solely - through allocation measures and investment policies worth around 10%–15% of the overall allowance value generated by the program.[10]

Regarding the engagement of our major trade partners, the Commission strongly believes that a combination of carrots and sticks offers the most effective approach. Current legislative proposals provide positive inducements for participation by other nations (such as technology assistance). In addition, the United States must work with other countries to develop forceful and coordinated responses to international trade and competitiveness concerns if major emitting nations fail to adopt comparable climate policies over some reasonable timeframe.

OFFSETS: Emission offsets present another aspect of program design with implications for the cost of a cap-and-trade program. Depending on the offset provisions adopted as part of such a program, American companies could take advantage of low-cost emission reductions or carbon sequestration opportunities in the United States, and potentially in other countries. As an alternative compliance mechanism, domestic and international offsets would enhance regulatory flexibility and reduce program costs. The question is how large a role offsets can play without undermining the administrative feasibility and environmental integrity of the underlying program.

In particular, the Commission is concerned that over-reliance on international offsets— given the practical difficulty of assuring that emissions reductions claimed in other countries are real, permanent, additional, and verifiable—could

[10] *Note that Representatives Inslee and Doyle have introduced legislation that would allocate 15% of total allowances to energy-intensive industries such as iron and steel, pulp and paper, cement, rubber, basic chemicals, glass, industrial ceramics, and aluminum.*

> *THE BEST RESPONSE TO THIS CONCERN IS TO ENCOURAGE STATE ACTIONS THAT ARE CONSISTENT WITH A NATIONAL PROGRAM BUT THAT AVOID CREATING OVERLAPPING CAP-AND-TRADE PROGRAMS.*

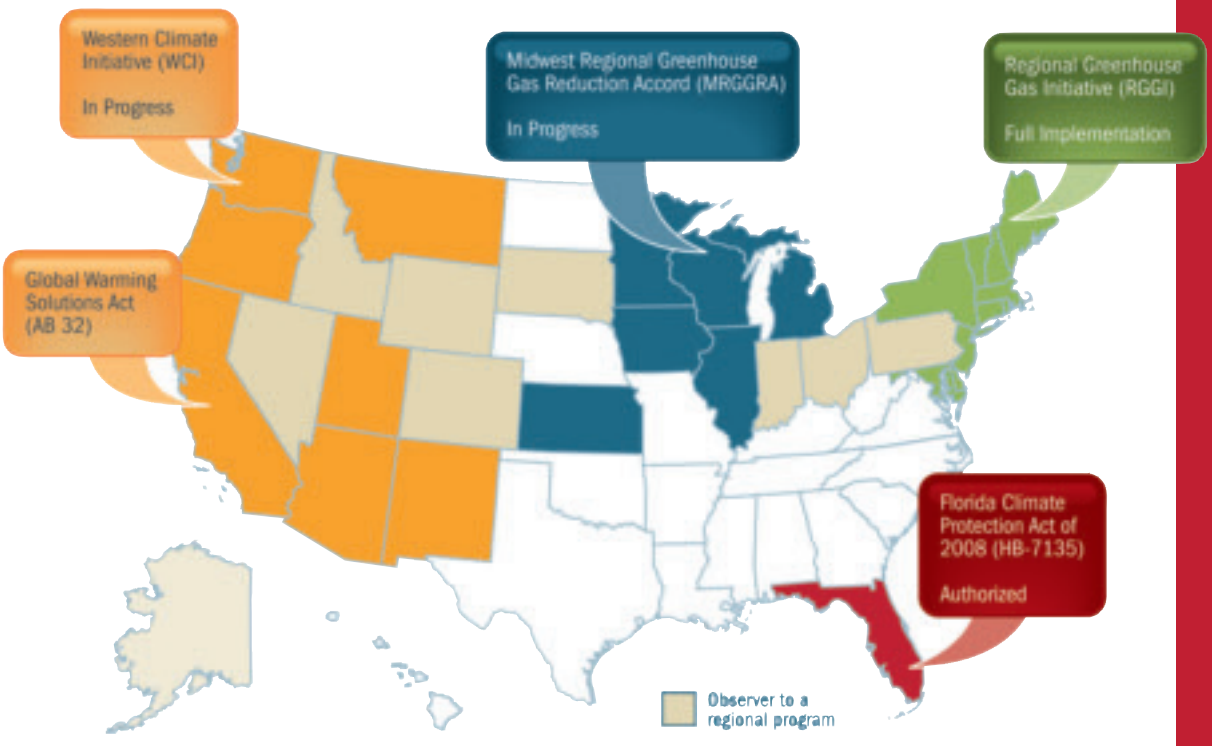
undermine program goals and political support, especially if substantial U.S. funds are leaving the country to support abatement efforts abroad rather than at home. Moreover, we believe that the assumptions in some current proposals regarding the scope and timing of an international offsets program are unrealistic, particularly to the extent that such a program would require rigorous government review of numerous individual projects. For example, EPA's analysis of the Waxman-Markey proposal assumes that compliance would be achieved, in part, through the maximum use of international offsets. Based on provisions in the Waxman-Markey proposal, this implies the use of roughly 1 billion tons of offsets (in carbon-dioxide-equivalent terms) for regulated sources in the United States on an annual basis. Assuming that an average overseas project would generate 100,000 offset tons per year, this would require the approval of 10,000 projects within three years of the start of the program. To put the administrative burden in perspective, this is more than seven times the total number of projects registered under the Clean Development Mechanism (CDM) established by the United Nations as part of the Kyoto Protocol.[11]

In part because of concern about these administrative and practical challenges, there is growing interest in moving away from a project-by-project approach to emissions offsets in favor of an increased emphasis on sector-wide and standards-based reductions. Under this type of approach, offsets could be measured against a national-level commitment to, for example, reduce rates of deforestation or emissions in a specific sector. Even taking into account, however, that a sector- or standards-based approach could substantially expand the potential scope and scale of a manageable offsets program (while simultaneously reducing the need for project-by-project review), it will take some time to resolve the myriad methodological, measurement, and political issues that must be settled before these types of international offsets can play a significant role in providing additional compliance options under a domestic cap-and-trade program.

In sum, given the large administrative and environmental uncertainties that apply to international offsets, NCEP does not believe that an offsets program, by itself, can provide an adequate cost-containment mechanism. Long-term U.S. policy with respect to international offsets should be designed strategically to induce more significant developing-country commitments on greenhouse gases, rather

[11] *The United Nations Framework Convention on Climate Change. Clean Development Mechanism. CDM Statistics. A total of 1,329 projects were registered as of January 1, 2009.*

SELECTED STATE AND REGIONAL GREENHOUSE GAS INITIATIVES



than being solely viewed as a means to reduce compliance costs in the United States.

STATE/FEDERAL HARMONIZATION:

A number of states and regions have moved ahead of the federal government to adopt their own greenhouse gas reduction goals and regulatory requirements and some of them are concerned that a federal program could undermine their ability to pursue more ambitious targets. The Commission believes that it is critical to preserve states' ability to innovate and iterate in pursuing cost-effective climate solutions—indeed, as laboratories for democracy, state efforts in this arena may be critical to the long-term success of federal efforts. At the same time, there is a concern that state programs could undermine the efficiency of an eventual federal program by burdening industry with redundant and conflicting state requirements.

The best response to this concern is to encourage state actions that are consistent with a national program but that avoid creating overlapping cap-and-trade programs with different currencies. The Commission believes a temporary moratorium on state and regional caps, as required in the Waxman-Markey bill, is a sensible way to proceed and will provide greater certainty to industry during the early years of a climate program. States should retain the authority to impose more stringent caps after the moratorium is over, but there should be restrictions on the quantities of federal allowances that states would be able to retire.[12]

[12] *The rationale for such restrictions would be to address a concern that individual states, by pulling federal allowances out of circulation, could—in effect—impose more stringent emissions limits and higher costs on the citizens of other states. This concern is less applicable to the extent that allowances are retired on the basis of successful state efforts to reduce energy consumption or demand.*

Moreover, states should retain explicit authority to adopt more stringent building codes, auto efficiency standards, low-carbon fuel standards, and other programs.

MARKET OVERSIGHT: Doubts about the transparency, integrity, and fairness of financial markets are at an all-time high. These concerns have led to proposals for oversight of greenhouse gas allowance markets to protect against market manipulation and excessive speculation. The Commission agrees that there should be vigorous oversight of emerging allowance markets and that this will require new rules to govern reporting, disclosure, and other areas. Some of these concerns are specific to carbon markets and should be addressed in climate legislation. Other oversight issues should be addressed by Congress in the context of broader planned reforms of financial markets. We are concerned that legislative solutions that focus only on greenhouse gas markets may ignore important linkages to related energy markets. More generally, it is critical that the major features of any oversight program are consistent with an emerging consensus on the need to identify and reduce systemic risks. We recognize that it may take some time for Congress to revamp financial market reforms more generally and we would support interim measures to increase transparency in greenhouse gas markets. In addition, we strongly believe that a robust cost-containment mechanism for the initial years of a climate program can serve as an insurance policy to limit manipulation or excessive speculation while Congress develops a more comprehensive approach to market reform and oversight.

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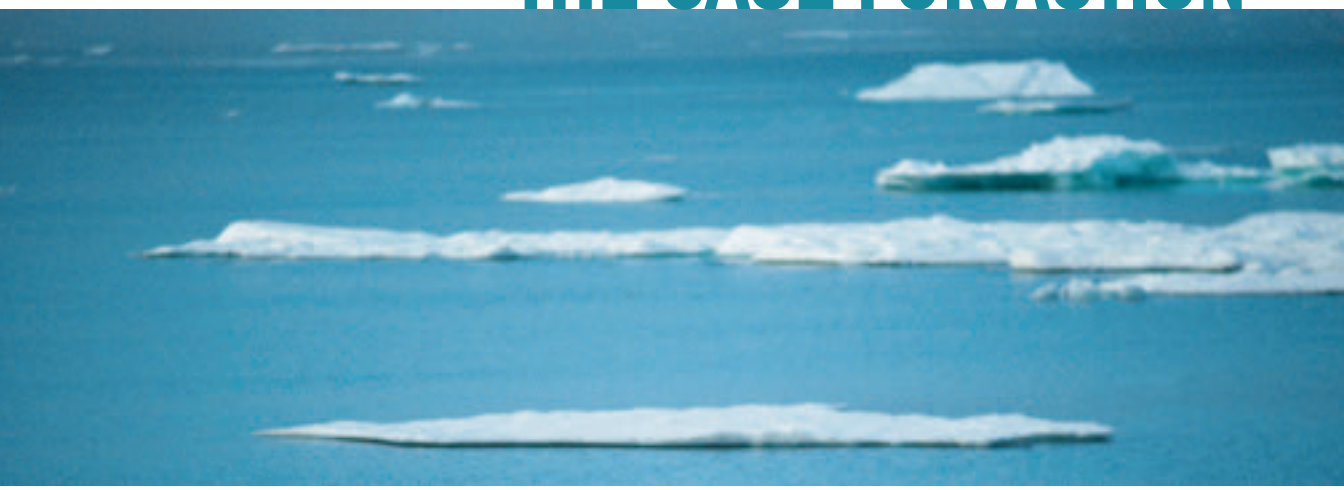
THE CASE FOR ACTION



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