10 Reasons to Engage with Emissions Trading

Introduction

The key goal for all those concerned about climate change is to see global emissions peak and decline in the near future. There are many theories about how best this can be achieved but in the words of Friedrich Engels: “an ounce of action is worth a tonne of theory” and, with an emissions trading schemes already up and running in Europe as well as the development of emissions trading systems in a number of countries, action on the ground is already occurring as a result.

These systems are far from perfect. They must be monitored and scrutinised by stakeholders to ensure they are achieving the task for which they have been invented. But experience shows that these trading systems are potentially powerful tools for change, as long as it is born in mind in setting up systems, that it is necessary to allow for some early learning. Below we set out some of the reasons why we are committed to engaging with the emissions trading or 'cap and trade' policy. These 10 points come from some of the early lessons that have been learned by designing and implementing these systems, in particular from the EU Emissions Trading System (EU ETS).

About Sandbag

Sandbag is a UK based not-for-profit campaigning organisation dedicated to achieving real action to tackle climate change and focused on the issue of emissions trading. Our view is that if emissions trading can be implemented correctly, it has the potential to deliver the deep cuts in carbon emissions the world so badly needs to prevent the worst impacts of climate change.

10 reasons

1. Emissions trading systems create a legal cap or limit on emissions and implement the "polluter pays" principle.

Governments are often nervous of setting a cap on emissions that introduces a carbon price. They are concerned that this may put their industry at a significant disadvantage relative to those who do not face a carbon constraint. Experience to date has shown that abatement tends to be a lot cheaper and easier than analysts estimate and that these fears are largely unfounded. For this reason it is important to allow early adjustment to a trading system to allow refocusing of the targets after the initial concerns are allayed. The first learning phase of the EU ETS saw the price of allowances drop to zero. This was caused by a combination of poor installation level data, excessive lobbying, political concern and very cheap abatement and efficiency savings.

A common criticism of the EU ETS is that, so far, schemes have involved weak caps and giveaways of free permits. A well-functioning emissions trading scheme, however, delivers an ambitious cap and requires that permits are auctioned. The EU is in the process of transitioning to such a market. Caps with auctions ensure that the most emissions-intensive companies have to pay the most to pollute and encourages them to seek low carbon solutions. The key feature which determines the environmental effectiveness of an emissions trading system is the level at which the cap is set. The barriers to setting tight caps are higher if industry perceives targets cannot be met without being burdened with additional high costs. Attaching trading to the cap counters this fear by reducing costs and enables all participants to achieve compliance irrespective of their particular circumstances. This increases the potential for tighter caps to be set.

2. Trading is an ancient form of economic activity that predates capitalism.

Whatever your opinion of capitalism, the trade of carbon does not necessarily rely on a capitalistic system. Trading has gone on in every societal structure since the dawn of civilisation. The concept of paying someone to undertake tasks you lack the skills or resources to complete yourself is an age old principle and no-one

would sensibly advocate its demise. The ability to trade carbon permits makes sense since the atmosphere does not care where emissions are made or saved – the warming effect is global not local. It encourages technological innovation in low-, or no-carbon solutions and incentivises companies to reduce their emissions. Trading does not 'put corporate profits before the environment' but rather harnesses efficient market forces to uncover least cost solutions. The creators of emissions trading were regulators and policy makers who recognised that there was a value in enabling industry to work out its own route to reaching a low carbon economy.

3. Emissions trading may be the worst way of reducing carbon emissions - except for all others!

Taxation is often presented as the alternative to emissions trading, however, taxation is seen negatively by industry who will apply their energies to creating and exploiting tax avoidance loopholes or exemptions rather than attempting to reduce pollution levels. By applying a simple change of terminology, from 'tax' to 'trade' and allowing companies to profit from innovating and implementing green solutions, they apply their creative talents towards reducing their emissions, increasing the speed and decreasing the cost of emissions reductions.
The US Clean Air Act is a case in point. It produced reductions in emissions of acid rain causing gases far faster, and far cheaper than previous command and control – achieving the required emissions reduction at 18% of the expected cost and 3 years before schedule. Emissions trading systems for carbon encourage the development of a low carbon economy which bring a huge range of benefits including improved air quality and increased energy security.

Caps ensure a much more predictable environmental outcome than taxes. When taxes are set, companies can merely absolve themselves of their environmental responsibilities by paying the tax. As an overall cap on emissions is not set, it is impossible to predict with any certainty the CO2 reduction. In addition, taxes remove money from companies that could be used to invest in green technology, instead giving it to the government where it could be spent on other unrelated projects. A cap also provides automatic stabilisers when the economy is in recession, if economic output declines demand for permits decreases, the price drops and therefore so does that costs to industry. Unlike taxes, this allows for automatic responses to economic troubles.

4. Mandatory trading systems are a form of regulation and once set, caps are enforced with fines and subtraction of permits.

It is often forgotten that underpinning the carbon market are a set of strict rules and regulations that are designed to ensure environmental outcomes are delivered. That is not to say that certain loopholes have not been found – but regulators are usually swift to close these to preserve the integrity of the market.
If a capped entity is not in compliance at the end of the period it faces stiff fines and also a reduction in the number of permits it receives in the future – there is no 'buy out option' that would undermine the environmental purpose of the system.

Critics of emissions trading will often suggest that 'straight regulation' is a better alternative, meaning entities are simply regulated to achieve a certain performance standard with no flexibilities. However, there are many complexities involved in identifying who should do what to reduce emissions most effectively, and processes which try to determine this often become very lengthy and drawn out. In addition policy makers often do not possess the correct information to make these judgements and are reliant on industry to give them the appropriate information but they will have their own vested interests and may not be objective.
Emissions trading is a form of regulation which dictates an outcome – it does not, however, dictate the means by which that outcome will be met and this is one of its greatest strengths.

5. The European Emissions Trading Scheme is working.

In Europe power stations have already been capped at levels significantly below their emissions. This has advantaged companies with low CO2 profiles and created a disadvantage for those who are heavily dependent on coal.

So far in Europe power stations have been allocated roughly 1 billion permits fewer than were needed to cover their emissions. This created an incentive to reduce their emissions through improving efficiency and switching to cleaner fuels. In 2010, the EU has a working market in carbon, with an average market price of €15 and increasing prices projected for the future. The cost of carbon is already having a major impact of the behaviour of polluting industries. For example, Drax, a large power station in the UK saw its credit rating devalued because of its exposure to coal. It is investing €110 million in efficiency savings as well as introducing biomass co-firing in order to reduce its carbon emissions and buying carbon offsets.

Overall the caps need to be tighter but the mechanism to deliver more ambition is now in place providing politicians with a guaranteed way of meeting the targets they sign up to.

6. Markets spur innovation.

Emissions trading creates a clear set of parameters within which market participants can work, guaranteeing rewards for those who can bring cost effective solutions to market. There is no need to wait for Governments to decide on which technologies they will support and by how much – innovation is swiftly rewarded and the list of potential technologies and solutions is not proscribed.

Cap and trade gives pollution reductions a value in the marketplace, the system prompts competition in technology and processes that reduce pollution. This point is not theoretical; experience has shown these results particularly in the Clean Development Mechanism where numerous methodologies for reducing emissions are presented for approval.

If government subsidies pick winners they also risk creating losers. A subsidy may make one technology overly competitive in comparison to newer technologies and by doing so, quash innovation. Emissions trading is technologically blind, the most cost efficient innovation is invested in and brought to market.

7. Emissions trading schemes are relatively easy to oversee.

The EU trading system generates large volumes of publicly available data which is one of the strengths of the policy. Data is often available down to the individual point source of emissions, so stakeholders can see where the largest amounts of pollution are being emitted. In addition, those seeking to use political power to gain economic advantage that might succeed in securing more permits than they need can be quickly exposed as emissions data is revealed.

The data generated is an important tool which can be used to inform and improve the future implementation of the scheme. Ensuring the data is up-to-date and available to stakeholders means that they can also helping to ensure a system is operating successfully.

8. Trading policy is flexible and can be designed to achieve a range of objectives.

As well as having a direct effect on the polluters included in any emissions trading system it is also possible to create broader incentives for a wider range of economic actors. This can be achieved by making it possible for permits to be created outside the scheme and traded in to it - often referred to as 'offsetting'. This can direct finance towards projects in un-capped countries or in uncapped sectors in the same country. The advantages of this are that it broadens the range of participants and the range of solutions that can be found by the market. It can also help to create a price safety valve – if emissions are proving costly to achieve in the sectors directly covered by the caps, then solutions can be found elsewhere.

Where auctioning is used as the way to allocate permits this also creates a revenue stream which can be spent on achieving additional policy objectives. This is a feature of the Regional Green House Gas Initiative (RGGI) in place on the East coast of America where auction revenues are used to subsidise energy savings programmes for consumers which help to offset the impact of increases to energy bills.

9. Emissions trading is here to stay and is expanding to cap more emissions.

Emissions trading policy is already in operation, the EU, Switzerland and New Zealand all have functioning national emissions trading schemes. In the US there is a state level scheme in operation on the East Coast. There are also sub-national schemes in Japan and Australia. Japan, South Korea and Taiwan are all moving towards implement their own systems and Australia looks set to restart the debate. A state level system on the West Coast of the US and Canada is also proposed and there has been talk of regional pilot schemes in China. It seems inevitable that higher and higher proportions of global emissions will be regulated by legally binding cap and trade systems. If caps are set in the right way they will create powerful incentives for change.

10. It is political will not the choice of policy that will determine if we take action in time to avert dangerous climate change.

Whether or not we act in time to tackle climate change will be determined by the ambition demonstrated by our political leaders not by the choice of policy instrument. However, we do not have time to try lots of options until arriving at one that works. Emissions trading is already up and running and successfully seeking out least cost solutions. It can also be relatively easily improved once up and running. Its popularity amongst many businesses helps to mitigate shorter term political considerations about costs that make ambitious policy decisions difficult.

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