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Congressional staff; business leaders; environmental lobbyists

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Time for a price collar on carbon

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Lede

Senate leaders intend to take up the narrowly passed House climate and energy measure soon, with the hope of having a bill signed into law before December's international climate negotiations in Copenhagen. The goal is to make Americans face the societal costs of carbon emissions and oil use. But might the costs of limiting carbon emissions — especially during a recession — sink this legislation?

Problem

As proposed, the House cap-and-trade system would set a quantity target on emissions and allow the market to determine the price of carbon — but with a price floor. Given that a key political vulnerability of the program is its economic effect on American households, sponsors of a Senate cap-and-trade bill could strengthen its prospects by imposing a price ceiling, in effect establishing a price collar.

Thesis

By preventing the policy from being either unexpectedly lax or unexpectedly stringent, a price collar protects both investors in green technologies and households and preserves strong incentives to abate. The price floor proposed in the House bill would start in 2012 at $10 per ton of carbon dioxide equivalent and rise by 5 percent annually. Our research suggests that adding a ceiling starting at $35 per ton and increasing both the floor and the ceiling by 4 percent per year would increase cumulative emissions over the period from 2010 to 2050 by about 6 billion metric tons, or about 4 percent relative to a policy without a price ceiling.

Support 1

In exchange, adding the ceiling would allow the Senate to jettison the reserve auction, rein in offsets and possibly raise more federal revenue, both by selling allowances if the ceiling is triggered and by setting a higher reserve price for auctioned allowances if the floor price is triggered.

Support 2

With these changes, the resulting bill would be simpler and more transparent and would provide clear evidence that worst-case economic costs would be limited.

Support 3

The price ceiling could work like the "safety valve" included in a 2007 bill introduced by Sens. Jeff Bingaman (D-N.M.) and Arlen Specter (D-Pa.), which would have allowed the government to sell additional emissions allowances if permit prices rose above a preset ceiling. A safety valve limits the worst-case costs of a cap-and-trade policy, so it would improve the bill's prospects with moderate senators by guaranteeing that compliance costs would not be excessive.

Other views

Environmental groups may be reluctant to support a price collar, but they should remember that the stakes are very high: A bill that fails in the Senate or promptly collapses after enactment will do nothing at all to control emissions. If a price collar helps build a 60-vote majority in the Senate, the expected effect on emissions is well worthwhile.

Support 4

Any climate bill will have to include cost containment provisions of some kind in order to have a realistic chance of passing. The House bill, for example, includes an allowance reserve, which operates a bit like a limited safety valve by holding back 1 percent to 3 percent of each year's allowances for auction during periods of high allowance prices. However, the approach merely moves stringency from one year to another without actually limiting the overall cost.

Support 5

The bill also includes billions of tons of potential offset credits for emissions reductions in U.S. sectors not covered by the cap-and-trade system and for certain reductions in other countries. Offsets allow U.S. emitters to exceed the cap cheaply while obscuring the actual effect on the environment.

Ask

As the cap-and-trade effort heads to the Senate for Round Two, there are mechanisms that could take this over the finish line. Ideally, cost containment should be transparent: It should be clear how it would affect domestic costs and what the consequences would be for U.S. and global emissions. It should also be credible: It must operate in a way that households and firms will perceive as economically and politically sustainable over the long run.

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