

# Capping Global Warming Pollution: Myths and Realities

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Worries about “gaming” or market manipulation often crop up as objections to climate and energy legislation. While these concerns are understandable, they are not warranted – and they can be addressed in a well-designed system.

Let’s look at some of the most common myths.

## **Myth #1: Cap and trade markets have no track record.**

**Reality:** Cap and trade has been tested and proven in the United State. More than a half dozen American cap-and-trade programs are already up and running -- with **no evidence of market manipulation.**<sup>1</sup>

- The US Acid Rain Program, administrated by the EPA, has a track record dating to 1995. The program exceeded the SO<sub>2</sub> emissions cap years ahead of schedule and for only one-fourth of what was expected.<sup>2</sup> After more than a decade of operation, analysts have concluded that the SO<sub>2</sub> cap-and-trade program has been free of gaming.<sup>3</sup>
- The EPA also runs the NO<sub>x</sub> Budget Trading Program – designed to reduce smog-contributors – which has been similarly successful, and free of market shenanigans too.<sup>4</sup>
- The Regional Greenhouse Gas Initiative (RGGI), the nation’s first climate cap-and-trade program, has been fully operational for more than year – with great success.<sup>5</sup> Close inspection has revealed no evidence of anticompetitive conduct or market gaming.<sup>6</sup> In fact, **the program has met its early goals so easily and so cheaply that some advocates are calling for the carbon cap to be tightened ahead of schedule.**<sup>7</sup>

## **Myth #2: Europe’s cap-and-trade program has failed.**

**Reality:** The European Union’s Emissions Trading Scheme (ETS), begun in 2005, has created a Europe-wide carbon market that is a remarkable success story – both environmentally and economically.<sup>8</sup>

- Thanks to the ETS, Europe is on track to meet its emissions reduction obligations under the Kyoto Protocol.<sup>9</sup>

- Independent analyses have repeatedly confirmed that the carbon markets have been effective at reducing emissions while remaining largely free of interference.<sup>10</sup>
- In fairness, there were some hiccups in the rollout of the ETS -- including an initial overallocation of allowances to polluters, insufficiently stringent offset provisions, and some price volatility. Yet these problems resulted from European efforts to create a system on “training wheels” without complete information. And in fact, the problems are fixable and are already being addressed as the program evolves. US policymakers can learn from Europe’s early design mistakes, but they should recognize that **there are *not* fundamental flaws in the policy or the carbon markets.**

### **Myth #3: Carbon markets are at risk of Enron tricks or wild derivatives speculation.**

**Reality:** Common-sense regulation makes carbon markets no riskier than the markets for pork bellies or soybean futures. As US cap-and-trade programs have demonstrated, well-regulated markets can reduce pollution cost-effectively.

- Restricting trading to registered exchanges is a smart idea, at least at the outset of the program.<sup>11</sup> One good example is the “Carbon Market Oversight Act of 2009,” sponsored by Senators Dianne Feinstein (D-Calif.) and Olympia Snowe (R-Maine), which puts the Commodity Futures Trading Commission in charge of the carbon market, and creates other restrictions on market behavior.<sup>12</sup>
- Other particulars of market design also help. To minimize price volatility, authorities can ensure transparency about prices and the number of permits available. Opening auctions to all bidders with adequate financial reserves, conducting auctions frequently and early, and limiting the number of permits any one actor may hold—all these things will help keep prices stable and prevent market manipulation.<sup>13</sup>
- Carbon markets have built-in disincentives to manipulation: neither the public wants it (because it could raise power bills), nor do the market participants that buy permits (because they don’t want to pay more to pollute).

Of course, as with any policy, cap and trade’s success will ultimately depend on strong oversight, transparency, and vigorous enforcement. But there is every reason to believe that a well-crafted and -regulated system can function smoothly and cost-effectively.

*For more details, please see Sightline Institute's “Cap and Trade 101: A Federal Climate Policy Primer,”* [http://www.sightline.org/research/energy/res\\_pubs/cap-and-trade-101](http://www.sightline.org/research/energy/res_pubs/cap-and-trade-101).

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<sup>1</sup> Eric de Place, “How Cap-and-Trade Markets Work for Acid Rain and Smog,” Sightline Institute’s Daily Score blog, November 24, 2009, [http://daily.sightline.org/daily\\_score/archive/2009/11/24/how-cap-and-trade-markets-work-for-acid-rain-and-smog](http://daily.sightline.org/daily_score/archive/2009/11/24/how-cap-and-trade-markets-work-for-acid-rain-and-smog); and US Environmental Protection Agency, “Cap and Trade Programs,” <http://www.epa.gov/captrade/programs.html>

<sup>2</sup> US Environmental Protection Agency, “Acid Rain Program 2007 Progress Report,” January 2009, <http://www.epa.gov/airmarkt/progress/arp07.html>; Zachary Coile, “‘Cap-and-trade’ model eyed for cutting greenhouse gases,” San Francisco Chronicle, December 3, 2007, <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/12/03/MNMMTJUS1.DTL&hw=Cap+trade+Acid+Rain&sn=001&sc=1000>

<sup>3</sup> Sam Napolitano et al., US Environmental Protection Agency, “The US Acid Rain Program: Key Insights from the Design, Operation, and Assessment of a Cap-and-Trade Program,” *The Electricity Journal*, August/September 2007, [http://www.epa.gov/airmarkets/resource/docs/US%20Acid%20Rain%20Program\\_Elec%20Journal%20Aug%202007.pdf](http://www.epa.gov/airmarkets/resource/docs/US%20Acid%20Rain%20Program_Elec%20Journal%20Aug%202007.pdf); and US Environmental Protection Agency, “Allowance Markets Assessment: A Closer Look at the Two Biggest Price Changes in the Federal SO<sub>2</sub> and NO<sub>x</sub> Allowance Markets: White Paper,” April 23, 2009, <http://www.epa.gov/airmarkets/resource/docs/marketassessmnt.pdf>

<sup>4</sup> World Resources Institute, “Greenhouse Gas Emissions Trading in U.S. States: Observations and Lessons from the OTC NO<sub>x</sub> Budget Program,” January 2005, <http://www.wri.org/publication/greenhouse-gas-emissions-trading-us-lessons-from-otc-nox>

<sup>5</sup> Eric de Place, “How Carbon Markets Work in RGGI,” Sightline Institute’s Daily Score blog, November 12, 2009, [http://daily.sightline.org/daily\\_score/archive/2009/11/12/how-carbon-markets-work-in-rggi](http://daily.sightline.org/daily_score/archive/2009/11/12/how-carbon-markets-work-in-rggi)

<sup>6</sup> Potomac Economics, “Report on the Secondary Market for RGGI CO<sub>2</sub> Allowances,” May 2009, [http://www.potomaceconomics.com/uploads/documents/Secondary\\_Market\\_Report\\_2009\\_05.pdf](http://www.potomaceconomics.com/uploads/documents/Secondary_Market_Report_2009_05.pdf)

<sup>7</sup> Environment Northwest, “RGGI At One Year: An Evaluation of the Design and Implementation of the Regional Greenhouse Gas Initiative,” February 2010, [http://www.enw-ne.org/public/resources/pdf/ENE\\_2009\\_RGGI\\_Evaluation\\_20100223\\_FINAL.pdf](http://www.enw-ne.org/public/resources/pdf/ENE_2009_RGGI_Evaluation_20100223_FINAL.pdf)

<sup>8</sup> Eric de Place, “How Carbon Markets Work in Europe,” Sightline Institute’s Daily Score blog, November 18, 2009, [http://daily.sightline.org/daily\\_score/archive/2009/11/18/how-carbon-markets-work-in-europe](http://daily.sightline.org/daily_score/archive/2009/11/18/how-carbon-markets-work-in-europe).

<sup>9</sup> European Environment Agency, “Annual European Community greenhouse gas inventory 1990–2007 and inventory report 2009,” May 29, 2009, <http://www.eea.europa.eu/pressroom/newsreleases/2009-greenhouse-inventory-report>

<sup>10</sup> A. Denny Ellerman and Paul L. Joskow, “The European Union’s Emissions Trading System in Perspective,” Massachusetts Institute of Technology, prepared for the Pew Center on Global Climate Change, May 2008, <http://www.pewclimate.org/eu-ets>; Michael Grubb et al., “Climate Policy and Industrial Competitiveness: Ten Insights From Europe on the EU Emissions Trading System,” The German Marshall Fund of the United States, July 2009, <http://www.gmfus.org/doc/GMF%20Grubb%2035.pdf>; Jill Duggan, “The Truth About Cap-and-Trade in Europe,” World Resources Institute, November 19, 2009, <http://www.wri.org/stories/2009/11/truth-about-cap-and-trade-europe>; and New Carbon Finance, “Press Release: Emissions from EU ETS Down 3% in 2008,” February 16, 2009 available at James Kanter, “Group Says European Cap-and-Trade System Reduced Emissions,” *New York Times*, February 16, 2009, <http://www.wri.org/stories/2009/11/truth-about-cap-and-trade-europe>

<sup>11</sup> Natural Resources Defense Council, “DOs and DON’Ts For Creating Carbon Price Safeguards,” [http://www.usclimatenetwork.org/resource-database/FINAL\\_Carbon%20Price%20Safeguards\\_Aug13.pdf](http://www.usclimatenetwork.org/resource-database/FINAL_Carbon%20Price%20Safeguards_Aug13.pdf); and Environmental Defense Fund, “Ensuring the Integrity of the Carbon Market,” [http://www.edf.org/documents/10408\\_Market%20Regulation%20one%20pager%20v2.pdf](http://www.edf.org/documents/10408_Market%20Regulation%20one%20pager%20v2.pdf)

<sup>12</sup> Govtrack.us, “Text of S. 1399: Carbon Market Oversight Act of 2009,” <http://www.govtrack.us/congress/billtext.xpd?bill=s111-1399>

<sup>13</sup> Alan Durning et al., “Cap and Trade 101: A Federal Climate Policy Primer,” Sightline Institute, July 2009 edition, [http://www.sightline.org/research/energy/res\\_pubs/cap-and-trade-101/Cap-Trade\\_online.pdf](http://www.sightline.org/research/energy/res_pubs/cap-and-trade-101/Cap-Trade_online.pdf); and Western Climate Initiative, “Market Oversight White Paper,” November 18, 2009, <http://www.westernclimateinitiative.org/component/remository/Markets-Committee-Documents/Market-Oversight-White-Paper>