

CAP AND TRADE

WHAT IS CAP AND TRADE? Under cap and trade schemes, governments or intergovernmental bodies set an overall legal limit on emissions in a certain time period (“a cap”) and then grant industries a certain number of licenses to pollute (“carbon permits” or “emissions allowances”). Companies that do not meet their cap can buy permits from others that have a surplus (“a trade”). The cap is supposed to reduce emissions over time. However, setting a limit on pollution can be highly susceptible to corporate lobbying and favoritism, to such an extent that companies can frequently continue to increase pollution while remaining within the cap.

SO WHAT'S WRONG WITH CAP AND TRADE? The goal of the system is to help polluters meet “reduction” targets in the cheapest way possible. But what is cheap in the short-term does not translate to an environmentally effective or socially just outcome over the long-term, and the system is wide open to gaming by industry and traders.

MAIN DRAWBACKS: Some of the key problems with cap and trade are:

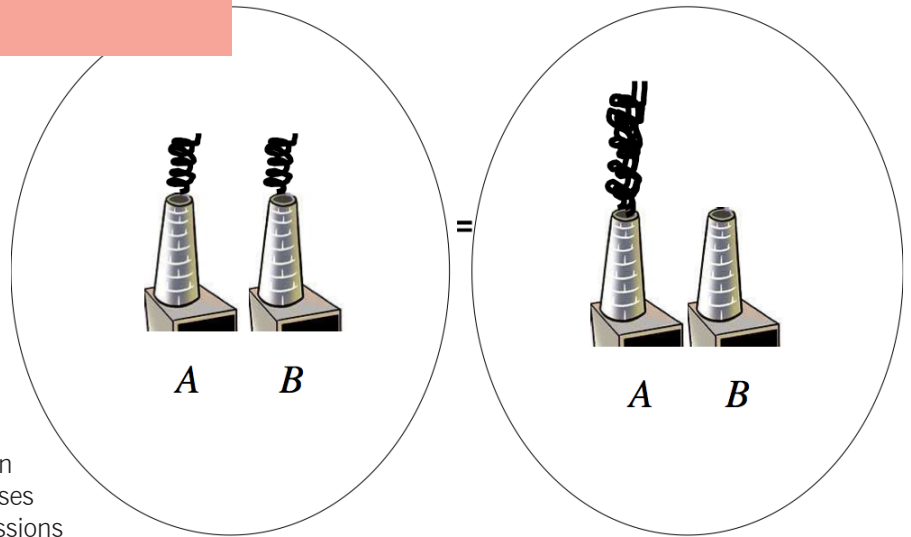
The “trade” component does not require any emissions reductions. It simply allows companies to buy cheaper “emissions allowances” or “carbon offsets” which are supposed to represent emissions reductions elsewhere.

The “cap” has too many holes and sometimes caps nothing. The cap is only as tight as the least stringent part of the system. This is because permits are sold by those with a surplus, and the cheapest way to produce a surplus is to be given too many permits in the first place.

Offsets burst the cap. While cap and trade in theory limits the availability of pollution permits to trading between polluters, offset projects are a license to print new, even cheaper and less regulated ones. Virtually all current and proposed cap and trade schemes allow offset credits to be traded inside them through “linking mechanisms” – including the EU Emissions Trading Scheme (EU ETS) and the cap and trade scheme currently passing through the US Congress.

Locking in pollution. In chasing after the cheapest short-term cuts, cap and trade tends to encourage quick fixes to patch up outmoded power stations and factories – delaying more fundamental changes.

The price will never be right. Carbon markets claim to set a “price signal” that encourages polluters to



switch to cleaner technologies. But carbon prices are incredibly volatile and prone to major crashes – in large part because “carbon” is a commodity that does not exist as a single entity outside of the numbers displayed on trading screens. The result is that these markets emit, at best, a very weak signal. The practice of “hedging” carbon permit prices against shifts in energy prices and currency exchanges then cancels out this signal altogether.

CAN CAP AND TRADE MARKETS BE REFORMED?

In theory, a “robust carbon price” would make dirty industry uneconomic. In practice, such a price is of a different order of magnitude to current prices – mainstream economists estimate ten times or more the €13/tonne at which it currently trades. The record of corporate lobbying to date suggests that a price ceiling would be imposed before the price came anywhere near this level.

There are more fundamental problems, too. A high and stable price would at best encourage companies to invest in changes that push the problem off their books. In the power sector, for example, this could make nuclear and biomass more competitive, since the associated greenhouse gas emissions are made elsewhere (uranium mines, plantations, and transport) – typically, outside the capped area. Nor could such a price solve the problem of “locking in” pollution.

WILL MARKETS CONCERNED WITH GROWTH BE ABLE TO DELIVER REDUCTIONS OF CARBON?

Markets are growth-oriented, so new sources of accumulation are imperative for market survival. In carbon markets, this is achieved by increasing geographical scope and the number of industrial sectors and gases covered by the scheme. Yet this contradicts the essence of tackling climate change, which should be about reducing the causes of climate change rather than building up a tradable commodity.

The carbon market is developing in ways that increase the scope for profit and speculation. This includes the use of complex financial instruments (futures trading and derivatives) which risk creating a “carbon bubble.” This is not a surprise, as it was created by many of the same people at the Chicago Climate Exchange who created the derivatives markets that led to the recent financial crash.

WHAT EXAMPLES HAVE THERE BEEN OF CAP AND TRADE SCHEMES?

There have been a number of Cap and Trade markets – the EU ETS, the United States Acid Rain Program, the Los Angeles Region Clean Air Markets (RECLAIM), the Chicago Emissions Reduction Market System (ERMS) and the Regional Greenhouse Gas Initiative. The EU ETS, established in January 2005, is the largest cap and trade scheme in operation worldwide and is a clear example illustrating how carbon trading has failed in practice.

HOW HAS THE EU ETS PERFORMED SO FAR?

Most cap and trade markets use projections of historical emissions provided by industry itself to calculate the initial caps. Industry has a clear incentive to overstate its past emissions in order to gain more credits. As a result, all of the cap and trade markets listed above started out with too many permits. This includes the EU ETS, which awarded major polluters with more free pollution permits (called EUAs, European Union Allowances) than their actual level of carbon emissions. Therefore, this gave no incentive to reduce emissions, or even to buy permits. As a result the price of the permits collapsed – ending 2007 at €0.01. In phase I (2005-2007) as a whole, according to the EU's own data, major polluters had permits worth 2.1 per cent more than their actual level of emissions.

WILL THE SECOND PHASE OF THE EU ETS (2008-2012) RESOLVE THIS FAILURE?

The EU claims that it has learned from its mistakes and that the second phase of its scheme is working. While it is true that for the first time in 2008, polluters were awarded fewer permits than their actual level of emissions in total, the vast majority of factories and industries still have a surplus of permits. In 2009, they will receive the same amount again, even though many industries have reduced production because of the EU-wide recession. Corporations receive the same number of credits even if they temporarily close or scale down operations for short-term economic reasons.

The picture is even worse once “offsets” are taken into account. Although the EU claims emissions reductions of 3 per cent, or 50 million tons from sectors included in the EU ETS in 2008, at least 80 million tons of carbon offsets in the developing world were bought as part of the scheme. As well as outsourcing the problem, there is evidence that a lot of the supposed “cuts” are not reductions at all (see “carbon offsets” factsheet).

SO WHO PROFITS FROM CARBON TRADING?

Free emissions permits are equivalent to a subsidy – and with allocations made on the basis of historical emissions, the largest subsidies goes to the dirtiest industries, especially coal-fired power plants. Windfall profits also arise from an accounting trick around “opportunity costs.” Power companies choose to do the cheapest thing to meet their ETS target which is usually through buying Clean Development Mechanism (CDM) credits (called CERs, Certified Emissions Reduc-

tions). But the companies will pass on costs to consumers as if they were making the most expensive change, which would be actually reducing emissions on site. Power companies receiving free credits from the EU ETS have passed on the non-existent “cost” of these credits to consumers. Research suggests that the likely windfall profits made by power companies in phase II could be between €23 and €71 billion, and that these profits would be concentrated in the countries with the highest level of emissions.

ArcelorMittal, the world's largest steel company, is another example of a corporation that has profited immensely from carbon markets while making few or no changes. ArcelorMittal routinely receives an increase of a quarter to a third more credits than it would have needed to even begin reducing emissions. The company is likely to have made over €2 billion in profits from the EU ETS between 2005 and 2008, with over €500 million of this achieved in 2008 alone – yet it has made minimal proactive changes to reduce emissions, and none that were stimulated by the carbon market.

WILL NEW RULES FROM 2013 ONWARDS IMPROVE THE SCHEME?

The third phase of the EU ETS, which runs from 2013 to 2020, claims to tighten the cap and change the basis of the scheme from a free allocation of permits to a system based on auctioning. But it is in significant trouble before it has even begun. The ability to bank permits left unused in phase II for use in phase III means that it could start with a significant surplus. Based on current figures, there could be as many as 700 million surplus permits by the end of phase II – equivalent to 14 times the “reduction” claimed by the EU in 2008. If companies decide to purchase offset credits and “bank” this surplus too – which would currently be the cheapest option for them – this could result in a surplus of 1.6 billion tonnes, enough to ensure that the ETS would require no domestic emissions reductions at all for the next seven years.

One of the key debates over phase III of the scheme concerns “carbon leakage.” This relates to industry claims that strict regulations on factory emissions in one part of the world will encourage the migration of industries to locations with fewer regulations. Trade liberalisation, unequal labour standards, and low shipping and aviation costs remain the main drivers of industrial relocation however “leakage” is being used to water down the promise that pollution permits will be auctioned rather than handed out for free. From cement producers to weapons makers, and nuclear fuel processors to underwear manufacturers, European industry have lined up to claim that the EU ETS puts their business at risk. The result of this lobbying is that over three-quarters of manufacturers covered by the scheme stand to be given free permits.

