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Carbon trading won't work

Experiments with the market scheme favored by Schwarzenegger shows trading favors big polluters without curbing global warming gases.

By Michael K. Dorsey
MICHAEL K. DORSEY, assistant professor on Dartmouth College's faculty of science, teaches in the environmental studies program.

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Economists, some environmentalists and a growing gaggle of politicians are pushing a grand strategy that a market mechanism — known as "carbon cap and trade" — can rescue us fastest from a climate catastrophe. But early evidence suggests that such a

scheme may be a Faustian bargain.

Gov. Arnold Schwarzenegger is one of the chief proponents of the market view. He has joined the governors of Washington, Oregon, New Mexico and Arizona to create the Western Regional Climate Action Initiative, which "sets the stage for a regional cap-and-trade program" that he hopes will serve as a model for a national program. The Kyoto Protocol, which went into effect in early 2005 (but which the United States has not signed), also endorses this approach.

Carbon cap and trade works this way: A group of nations (signatories to the Kyoto Protocol) or a group of states (the five Western states in Schwarzenegger's plan) cap their carbon emissions at a certain level. Then a government agency, such as the European Union or the California Environmental Protection Agency, issues permits to polluting industries that tell them how much carbon dioxide they are allowed to emit over a certain time.

Companies unable to stay under their cap can either buy permits, or "emission credits," on a trading exchange, which allows them to pollute more, or they will face heavy fines for exceeding their carbon dioxide targets. Firms that are able to come in under their caps can sell their excess credits on the exchange. Thus the right to pollute is a commodity bought and sold in a market.

The idea of trading pollution rights was part of the reauthorized 1990 Clean Air Act. The program successfully reduced the amount of sulfur dioxide emissions, which cause acid rain, largely because the sources were few enough (about 2,000 smokestacks in the Midwest) that they could be monitored effectively and because there was a national system, administered by the federal Environmental Protection Agency, to enforce the legally required limits, or caps.

Carbon trading on a global scale, however, amounts to an untested economic experiment. The most ambitious carbon-trading experiment to date began in the European Union in 2003. About 9,400 large factories and power stations in 21 member states were targeted, and the EU Greenhouse Gas Emissions Trading Scheme was established to trade pollution rights.

In January 2005, the EU governments distributed carbon credits — permits to pollute — to the companies and power plants. The credits were based in large part on what the firms estimated their annual carbon dioxide emissions would be. Because these credits were given out, not auctioned off, the firms did not pay for their pollution. Yet they stood to make money by selling them.

The EU's official accounting of the companies' emissions, released in April 2006, revealed that the companies' and power plants' actual emissions came in below estimates. Some said the firms had inflated their earlier emissions estimates, and thus all had credits to sell. This situation produced a surplus.

Once it was known that the number of available permits exceeded demand, prices slumped. Indeed, fear that there are too many permits for sale (combined with concerns about the EU's regulatory shortcomings) have effectively collapsed the market. A March 2007 report from Deutsche Bank Research noted that "many EU nations are still a long way from delivering on their Kyoto Protocol commitments to reduce carbon dioxide emissions."

Researchers at Open Europe, an economics think tank in Britain, recently issued a report on the experiment. They concluded that the EU Greenhouse Gas Emissions Trading Scheme represents "botched central planning rather than a real market." As a result, the report said, carbon trading has not resulted in an overall decline of the EU's carbon dioxide emissions.

Worse, the early evidence suggested that the trading scheme financially rewarded companies — mainly petroleum, natural gas and electricity generators — that disproportionately emit carbon dioxide. The pollution credits given to the companies by their respective governments were booked as assets to be valued at market prices. After the EU carbon market collapsed, accusations of profiteering were widespread. In fall 2006, a Citigroup report concluded that the continent's biggest polluters had been the winners, with consumers the losers.

Larry Lohmann, who works with the Corner House, a research organization in Britain, argues that carbon trading is little more than a license for big polluters to carry on business as usual. For instance, the Greenhouse Gas Emissions Trading Scheme was further weakened by provisions that allowed big polluters to buy cheap "offset" credits from abroad. A British cement firm or oil company that lacked enough EU permits to keep on polluting could make up the shortfall by buying credits from, say, a wind farm in India or a project to burn landfill gas to generate electricity in Brazil. "Such projects," Lohmann said, "are merely supplementing fossil fuel … not replacing it."

These problems may soon infect the cap-and-trade system of the five Western U.S. states. In July 2006, Schwarzenegger and British Prime Minister Tony Blair announced their intention to join together to address global warming, possibly by linking emerging markets for pollution credits in the U.S. with established ones in Europe.

U.S. industry and environmental leaders recently joined together under the catchy name USCAP, for U.S. Climate Action Partnership. Among the participants are Alcoa, Caterpillar, Duke Energy, DuPont, General Electric, Pacific Gas & Electric, the Natural Resources Defense Council and the Pew Center on Global Climate Change. The group called for some form of carbon cap and trade, but its reduction targets, in effect, would keep atmospheric carbon dioxide at roughly current levels over the next five years.

The EU experience doesn't augur well for the effectiveness of a global carbon-cap-and-trade scheme in a world characterized by growing economic inequality and enormous differences in governmental capacity to provide oversight, let alone regulation. The risk is that by the time it's apparent such a scheme is not working, extreme climate change will already be wreaking havoc.

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