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This paper details the International Emissions Trading Association's (IETA's) concerns regarding the Carbon Limits and Energy for America's Renewal (CLEAR) Act, S.2877.

IETA has been the leading voice of the business community on the subject of emissions trading since 2000. IETA supports efforts to address the pressing environmental challenge of climate change, and is dedicated to the establishment of environmentally effective market-based emissions trading systems that generate reductions at least cost to the economy. In working to establish a nation-wide program, Congress should not lose sight of the economic benefits these emission markets can generate.

The CLEAR Act would set a greenhouse gas emission reduction target of 20% below 2005 levels by 2020, where reductions would be achieved by "upstream" entities that import or produce fossil carbon and through the operation of a new government fund, the Clean Energy Reinvestment Trust Fund (CERT). Regulated entities would be required to purchase 100% of their needed allowances through an auction process where 75 percent of the resulting revenue would be returned to citizens while the remaining 25 percent would go to the CERT Fund, to be invested in opportunities to mitigate the costs of climate change and reduce emissions outside the capped sector.

IETA has numerous concerns about the ability of the CLEAR Act to reduce emissions in a cost-effective manner. These concerns include:

1. The bill's ability to achieve its stated environmental targets;
2. The bill's ability to capture the economic benefits of markets;
3. The bill's prohibition on offsets to meet compliance requirements;
4. The bill's failure to facilitate the development of offset projects;
5. The bill's high percentage of allocations subject to initial auction.

As the Senate debates this bill, IETA would like to address these concerns and offer the following recommendations:

1. Environmental Assurance

Climate legislation must contain a robust and mandatory cap on greenhouse gas emissions consistent with today's best available science. Despite the fact that the



CLEAR Act appears to have a solid emissions reduction target, IETA is concerned that specific provisions in the bill compromise the cap's integrity.

The CLEAR Act sets forth an emissions reduction goal of 20 percent below 2005 levels by 2020. However, this cap is aspirational, not real, for the following two reasons:

- 1) There is no legally binding limit on emissions: The number of carbon shares available for auction can be modified, and the "safety valve" allows for the unlimited purchasing of allowances by covered entities if auction prices hit the ceiling price. At \$21 in 2012, this cap will likely be lower than the market price for carbon and could result in a flood of credits into the market. Limiting the cost of allowances and allowing emitters to exceed the emissions cap simply acts as a high transaction-cost carbon tax, and will not achieve the environmental objective of reducing emissions to the desired level.
- 2) The emissions reduction target is disconnected from the emission reductions to be achieved by the market component of the bill: Estimates suggest the auctioning of emission allocations will only reduce emissions by 4 to 7 percent by 2020, falling well short of the 20% by 2020 reduction goal. As a result, more than two thirds of CLEAR's reductions will be reliant on unspecified federal investment in emission reduction opportunities funded through the CERT Fund. Subject to Congressional appropriation, there is no mechanism to ensure that CERT distributions will achieve the desired quantity of emission reductions. In fact, the CERT has over a dozen statutory purposes, of which only a handful are related to investment in actual reduction projects.

Given these two problems, it is unclear how the CLEAR Act would accomplish its environmental goals. The Breakthrough Institute estimates the CLEAR bill would initially direct just \$2.5-8 billion annually to support U.S. clean energy technologies and industries, far less than \$30-80 billion that may be required to meet reduction goals in a cost-effective manner.

It is well known that industry acts most efficiently when the regulated targets are defined and the options for compliance are clear. **IETA recommends setting quantifiable and enforceable limits on greenhouse gas emissions to help transition the US to a clean energy economy and ensure that the country meets future international climate commitments.**



2. Use of Markets to Keep Down Costs to Consumers

In working to establish a federal program to reduce greenhouse gas emissions, Congress should not lose sight of the economic benefits of emissions markets, nor devise restrictions that unnecessarily limit those benefits. IETA believes that the restrictive provisions included in the CLEAR Act will hamper its ability to achieve the greatest possible reductions at the lowest possible cost.

CLEAR restricts the carbon market in five ways:

- 1) Who can buy: Only upstream, regulated entities may participate in the auction and post-auction trading of allowances; Financial intermediaries, which offer investment capital for clean energy projects, are excluded;
- 2) How much can be bought: The number of allowances each entity can purchase is subject to government control;
- 3) The price: A narrow floor and ceiling price is established for allowances up for auction;
- 4) The type of transactions: The financial products essential for regulated entities to manage risk, such as derivatives, are prohibited;
- 5) Where sales can occur: An over-the-counter marketplace providing risk management and trading efficiency is banned in favor of exchange trading.

In combination, these restrictions almost entirely eliminate any semblance of a real market, as well as the economic efficiencies and price savings that a market achieves.

First and foremost, the CLEAR Act fundamentally misunderstands the nature of an emissions market. Functioning markets have both buyers and sellers that have differing appetites and views of market fundamentals. Functioning markets vest market participants with the discretion to decide how much or little to buy of a particular commodity. The CLEAR Act does none of these things. Markets must have participants who are willing to “make” a market; participants who will buy and sell readily (i.e. provide liquidity) in order to give the compliance entities in an emissions market the ability to monetize allowances to raise capital for emissions reductions projects and/or the ability to protect themselves from volatility. If only upstream, regulated entities are eligible to participate in the carbon market, their ability to raise capital and hedge their risk is severely limited because other regulated entities are unwilling or unable to play the role of buyer and seller. Entities required to reduce emissions are primarily in the power generation or manufacturing business—not finance.

By confining the allowance market to upstream parties, the CLEAR Act also misses the opportunity to utilize the innovative potential of U.S. industry in developing ways



to control and sequester carbon emissions. For example, the markets envisioned in the Waxman-Markey and Kerry-Boxer bills would provide incentives for power plants and other large emitters to develop and implement carbon capture and storage projects. The CLEAR bill removes the incentive for privately financed carbon capture and storage projects by limiting the incentives to just the receipt of federal funds. If companies can't leverage those funds to tangibly benefit their companies' profits or operations, they will have little or no incentive to undertake them.

The CLEAR Act's ban on the use of derivatives and over-the-counter trading will further raise compliance costs by forcing regulated entities to raise capital and manage their risk in ways that are much less efficient. Bilateral, over-the-counter derivatives allow parties to manage interest rate and commodity price risks in a customizable, flexible manner. These risk management contracts are an essential element of a functioning emissions market given the long-lived assets that must be deployed to transition the economy and the long-term nature of the risks that must be undertaken. The scale and duration of investment required to transition to a low-carbon economy is simply too great to limit carbon price and risk management to standardized, exchange-traded products.

For example, regulated entities seeking to build new low carbon infrastructure will only be able to secure financing for next-generation power plants or offset projects if they can demonstrate that they have managed carbon price-risk over the term of the financing, which is likely to be of 7-10 years duration. Carbon-risk management products of this extent, while absolutely essential to successful functioning of the market and deployment of capital, will not be available through exchanges because they cannot be standardized. They are only offered on a privately negotiated, bilateral basis, often by financial intermediaries. This is nothing new; project developers must manage fuel price risk to secure financing for today's conventional power projects, and they do so through long-term bilateral contracts—not exchange traded products—because there are no exchange traded fuel products of sufficient duration. The benefits of a market-based approach to achieving GHG reductions cannot be fully realized without similar recourse to long-term contracts for carbon.

The financing needed for the transformation of our national energy infrastructure will be unavailable or vastly more expensive if carbon and fuel risk cannot be effectively controlled through bi-lateral hedge contracts. In addition to the impracticality of looking to exchanges for long-term, large-scale commodity contracts, collateralizing the contract through a second lien, as is currently commonly done, is impossible on an exchange because the clearinghouses that support exchanges, rightly, require cash or cash equivalent (e.g., US Treasuries) as collateral.



A related concern is the practicality of so-called “clearing” of OTC carbon derivatives through a “clearinghouse” or “Designated Clearing Organization” in the parlance of the Commodities Exchange Act. In practice, this presents significant obstacles since the carbon derivatives needed to effectively hedge the emissions risk of new power plants will vary substantially from project to project, making the virtually instantaneous risk assessment that clearinghouses require to calculate their risk nearly impossible to perform. In addition, the inherent illiquidity (i.e. the inability to instantaneously sell something) of second lien collateral further complicates clearing for carbon derivatives. Clearinghouses must require cash or cash-equivalent collateral to effectively manage the risk of default of one of the parties to a transaction. To effectively manage its systemic risk, a clearinghouse must be able to immediately judge the risk inherent in the transaction it is attempting to clear and to hold extremely liquid collateral (i.e. cash or cash-equivalent) to manage that risk.

Carbon market participants will likely use exchanges for a large portion of spot trades, forwards, futures and options as well as secondary or issued offsets if permitted. However, many carbon offset transactions and structured allowance trades are non-standard and cannot be listed as contracts on a commodity futures exchange.

For these reasons, IETA strongly supports keeping standardized contracts on formal exchanges while allowing non-standardized contracts to be traded off-exchange. Mandating all carbon offset and allowance trades to be cleared and/or transacted on a designated exchange platform would result in significantly fewer clean energy and carbon reducing projects being developed, and impair the ability of companies to customize contracts to suit their compliance needs. An appropriate confidential disclosure process for all carbon trading activity should be implemented to ensure that the benefits of OTC derivatives that cannot currently be exchange-traded or cleared can be realized without impeding broader market transparency or creating undue risk.

IETA recommends establishing transparent and enforceable market oversight policies, such as the full disclosure of all transactions to regulators, that do not eliminate the tools necessary for carbon markets to achieve the greatest possible emissions reductions at the lowest possible cost.

3. Reduce Costs to Consumers through Offsets

The CLEAR Act would dramatically increase costs to both covered entities and the nation as a whole by failing to recognize the benefits of offsets in reducing emissions in a cost-effective manner. The CLEAR Act does this in two ways. First, it directly prohibits regulated entities from relying on offsets to meet their compliance requirements. Second, while the Act would allow the government to purchase offsets using CERT funds



or auction revenues, it does so in a way that would fail to develop an adequate offsets supply (see section 4).

Directly prohibiting the use of offsets in the regulated market eliminates a major cost containment mechanism. Offsets provide critical assistance containing costs and stabilizing prices by providing low-cost emission reductions that are available in the near-term (unlike many low-carbon technologies,) giving covered entities the flexibility they need to efficiently reduce emissions. CLEAR removes this flexibility, forcing regulated entities (and consumers) to swallow the additional costs of compliance. EPA's analysis of the Waxman-Markey bill found that allowance prices can be as much as 2 ½ times higher without offsets, and excluding international project-based credits like Certified Emission Reductions would make climate legislation 34% more expensive. Indeed, by excluding the cost containment benefits of offsets from the system, the CLEAR Act makes it more likely the safety valve will be reached and the emissions cap exceeded, allowing regulated entities to increase their emissions. Thus, the exclusion of offsets has not only economic but also very significant environmental consequences.

IETA recommends integrating a robust offset market, including international project-based credits, into a cap-and-trade framework to best ensure that needed reductions in greenhouse gas emissions are met at the lowest possible cost.

4. Encourage Emissions Reductions in Non-Covered Sectors

While the CLEAR Act prohibits private-sector entities from using offsets to meet emissions requirements, it does allow the government to purchase offsets. These offsets would be purchased from federal funds generated from either 1) the CERT fund, or 2) revenue from the purchase of allocations at the safety valve price. Since the bill does not create an effective compliance market for covered entities, a large proportion of emissions reductions will instead come from the government. In fact, according to some estimates, nearly two-thirds of emissions reductions projected for 2020 would need to come directly from government purchases to meet the bill's targets. While the source of these reductions is not specified, government purchases of offsets will likely be the cheapest, most straightforward means to meet emissions targets in this short timeframe. Yet, IETA is concerned that CLEAR lacks the necessary incentives to create an adequate offset supply. By relying on vaguely defined public funds to invest in offset projects, it will be difficult to meet the demand for offsets under this bill.

While the route to financing emission reductions outside the cap (i.e. offsets) is established, the Fund has over a dozen different purposes, and is subject to the vagaries of the annual appropriations process. The Act does not guarantee the amount of



funding that will be invested in offset projects or the quantity of emission reductions that will be achieved. Without more certainty about year-to-year demand for offset emission reductions, project developers will be reluctant to invest in offset projects which may take several years to design and implement. This threatens the development of offset projects and the US offset supply. Even more concerning, the appropriations process assumes that government is more efficient at allocating resources to support offset projects than the market. IETA believes there is ample evidence to support the contrary and encourages establishing a market-based approach to improve confidence in the offsets market, increasing participation and boosting supply.

Furthermore, an international offsets program is a major source of private sector investment in developing countries as well as the source of the lowest cost reductions. Because the CLEAR Act would not create a steady, predictable demand for international offset credits, the private sector will not likely invest in international emission reductions. This will inhibit the ability of the US to meet international commitments and funding obligations like those in the 2009 Copenhagen Accord.

IETA recommends integrating a robust federal offset program, with offset quality standards and early-action incentives, into any comprehensive climate bill. Establishing a federally-regulated, market-based offsets program improves confidence in the offset market, increasing participation, boosting supply and dramatically lowering compliance costs.

5. Increase Allocation in order to Lower Costs to Consumers

IETA opposes high levels of initial auctions in a cap-and-trade program, and has serious concerns about the implications of the immediate 100 percent auctioning of permits under the CLEAR Act. A key implication of the CLEAR Act auction approach is the necessity of regulated entities to finance their allowance purchases.

In addition, given the lack of a global system, an unnecessarily high level of initial auctioning would have negative repercussions for several reasons:

- 1) From an industrial perspective, regulated firms will have increased difficulty meeting compliance costs, inhibiting their ability to compete in both domestic and international markets.
- 2) From a consumer's perspective, the cost of purchasing allowances at auction will be passed down in the form of higher energy prices. While a government dividend is intended to compensate for these additional costs, this payback is determined on a per capita basis, irrespective of one's residence or income. Thus, regional discrepancies among residents will not be accounted for, leaving



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citizens in many states, especially those dependent on coal, agriculture or heavy industry, disproportionately disadvantaged.

IETA recommends allocating allowances to covered entities at the onset of a program so that compliance costs, which will ultimately be borne by consumers, can be most effectively minimized.

IETA believes the CLEAR Act is fundamentally flawed as it is currently written. As the Senate debates legislation to limit greenhouse gas emissions in the US, IETA urges that the CLEAR Act be rejected as a costly and ultimately unworkable proposal.