

## **There's a better way to cap carbon emissions**

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***The Globe and Mail***  
**Tue 27 Feb 2007**  
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**Section: Comment**

Look not to Kyoto but, instead, south to the United States to find where the real carbon pressures on the Canadian economy will come from. This country's meaningless Kyoto commitment may be hotly debated during the next federal election, but it would take something in the neighbourhood of a 30 per cent reduction in the GDP to wrestle emissions down to Kyoto's targets. I doubt there is a very large political constituency for that option. But, at the same time, there is a growing political constituency in Canada for the type of action now being taken by an ever-increasing number of U.S. state legislators.

California's newly passed Global Warming Solutions Act sets the bar the highest with a comprehensive plan to reduce the state's carbon emissions. Meanwhile, New York, New Jersey, Connecticut, Maine, Delaware and Vermont have joined together to create the Regional Greenhouse Gas Initiative that will cap emissions from the largest utilities in the region by 2009, and seek a 10 per cent reduction in emissions thereafter. Other states such as Massachusetts, Rhode Island and Pennsylvania either have joined or are considering joining the initiative. What is sweeping across state legislatures will soon find a home in Washington as well. Already there is a bi-partisan bill before Congress sponsored by Senators John McCain and Barack Obama, as well as Joseph Lieberman, that would establish a federal carbon emissions program centred around a cap-and-trade system.

A cap-and-trade system is where CO<sub>2</sub> emitters would receive emission permits and then be allowed to trade them. Over time, the government would gradually reduce the permits until the desired reduction in emissions is achieved. U.S. systems have been in place for well over a decade for both sulphur dioxide (SO<sub>2</sub>) and nitrogen oxide, two gases commonly associated with acid rain.

A company always has the choice between using an emission credit or introducing abatement measures that reduce emissions directly. If the cost of the emission credit is greater than the cost of abatement, the firm will be encouraged to make the required emission-reducing changes in its production process. Alternatively, if the cost of abatement is higher than the cost of an emission credit, the firm has incentive to buy the emission credit. The more expensive the credit, the greater the incentives for abatement. Such systems have been extremely successful. Sulphur dioxide emissions have fallen 40 per cent below 1980 levels as the cost of emission credits rose from \$100 a ton to around \$500 a ton.

Note the U.S. has achieved significant reductions in actual emissions and not simply reductions in emission intensity (emissions per unit of output or GDP) as suggested by some people.

Indeed, emission intensity targets, as currently contemplated in Ottawa, have proven to be effectively meaningless as a measure of carbon containment, let alone carbon reduction in a growing economy. Canada's abysmal emission performance is a case in point. Instead of reducing emissions to 6 per cent below 1990 levels as required by Kyoto, Canada will end the decade with emissions that are some 40 per cent higher. Yet emissions per unit of GDP will have fallen by 20 per cent. (Improvement in emissions per unit of GDP was overtaken by the growth of GDP itself.)

The key to a successful carbon program is to put a high enough price on emissions that, in the short-run, there are sufficient economic incentives for carbon abatement and, in the long run, sufficient incentives for emission-reducing technological change.

That doesn't always happen, even in systems that target actual emission reductions. Take Europe's 2005 effort to set up a fully functioning CO<sub>2</sub> emissions market. Carbon emission credits began trading at around \$30 (U.S.) per ton, a level sufficiently high to have an impact on carbon practices. But, within six months of the market opening, credits plunged to less than \$1 a ton, a token fee that wouldn't prevent even a single ton of emissions from going into the atmosphere. How does the price of carbon emissions on the European Climate Exchange suddenly plunge so far? Simple. Just give out way more emission allowances than there are emissions and let the market do the rest. That way, you get all the PR benefits without actually doing anything to limit emissions.

While the U.S. has not ratified Kyoto, and may never do so, Canadians shouldn't believe U.S. legislators don't care about climate change. By the decade's end, the vast majority of states will have carbon cap-and-trade systems and, chances are, there will be a federal regime, as well, after the 2008 elections. And unlike the outlandishly rigged EU effort, the Americans are likely to get the price right.

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