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American companies know well that they will eventually be subject to carbon limits of some kind, because it is widely understood that emissions must be restrained. But they have no price signal to guide their investment strategies, and no mechanism for recouping benefits from reduction projects at home or abroad. Without the additional incentives provided by a national or a global carbon market, U.S. investments are lagging in the new, job-creating technologies that would have the double-barreled benefit of addressing the serious threat posed by climate change and improving national security.

Limiting carbon emissions will not be cost-free for some companies and some sectors of the economy. Moreover, there have certainly been hiccups in the development of the international carbon market — and, in the case of the European trading system, some design flaws that teach us important lessons about how to construct an effective system. Nonetheless, the take-away from the emergence of a burgeoning global market for carbon is undeniable: When carbon constraints are coupled with trading mechanisms that provide a broad array of options to reduce emissions, the economy will respond, unleashing huge investments in carbon-reducing projects of all types, including more efficient and alternative sources of energy. Apologists for the Bush administration's empty rhetoric on the subject of climate change have ignored the remarkable ramp-up in the international carbon marketplace, preferring to blithely treat all aspects of the Kyoto Protocol as one giant failure. But the truth is the administration's obstinacy is imposing substantial opportunity costs on the U.S. economy.

Limiting carbon will not be cost-free for some, and the early development of the international market has met with problems.

Congress should take three steps to right this wrong and bring U.S. businesses and investors into the carbon marketplace:

Create a national carbon cap. The United States needs to put a cap on carbon and adopt a national trading system that will allow companies to address emissions limits on a flexible, cost-effective basis. A number of states in the Northeast and California are moving into the policy vacuum, enacting their own market-based schemes. Although these initiatives are well-intentioned, it makes little sense to proceed with a fragmented, state-by-state or region-by-region approach. For example, there will be no incentive provided for investments in alternative fuels in America's breadbasket because Midwestern states are not participating in the market. Simply put, a national market for carbon is far more robust and attractive for investors and it provides more opportunities for low-cost emissions reductions — gained through a much wider array of investments — than any state-specific or region-specific plan.

Create reliable and transparent emission reduction rules and tools. The next step is to provide certainty and confidence for investors by establishing transparent, reliable rules — rather than allowing a hodge-podge of inconsistent, confusing, and sometimes questionable practices to develop haphazardly in a voluntary market. The current U.S. system of so-called carbon emissions "offsets" illustrates both the problem with the dysfunctional status quo and the opportunity for a truly robust market to thrive. Carbon offsets involve reductions in emissions that would not have occurred but for the impetus provided by a buyer's willingness to purchase the offset. Even in today's unregulated market, there is a notable demand for offsets by businesses that want to decrease their carbon footprint. But because there are no rules, hucksters are selling offsets of dubious quality. Moreover, some of the best opportunities to generate offsets — in the developing world — are being mined by the Kyoto signatories, whose investments are guided by strict rules. By creating tough, transparent rules for offsets, the United States would enable carbon reduction projects — ranging from sound farming to methane capture — to be credited appropriately, and allow U.S. companies to begin taking advantage of offshore investment opportunities like their European and Japanese competitors.

But the growing global market shows that when carbon constraints are coupled with flexible trading, the economy will respond.

Re-Engage with the international community. If America moves quickly to develop its own cap-and-trade program in parallel with the Kyoto scheme, it will be in a far better position to lead the international community toward a sound, long-lasting international compact that corrects the protocol's shortcomings. Foremost among these is the imperative that all of the world's rapidly expanding, major economies — including China and India — join in agreeing to limit their emissions.

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The Emergence of a Vital International Carbon Market

The Bush administration made a gross miscalculation when it assumed that by walking away from Kyoto, international efforts to create a carbon marketplace would crumble. By taking its marbles and going home, the United States lost the opportunity to help shape the international economic boom that is now moving forward without meaningful U.S. participation. The European Union and other Kyoto signatories have proceeded impressively down the dual track of phasing in emissions limits and introducing market-based tools to facilitate investments in low-cost reduction opportunities in both domestic markets and the developing world.

The Kyoto Protocol requires developed countries — so-called Annex I Nations — to reduce their carbon emissions from 1990 levels by 5.2 percent during the 2008–2012 timeframe. Additional reductions are likely to be required after 2012, but no agreement has been reached yet.

Each Annex I nation receives a quantity of allowances representing the total emissions that the country is allowed to emit during 2008-2012, with each unit representing one metric ton of carbon dioxide or equivalent. The primary way that Annex I countries meet their reductions is through the direct reduction of in-country emissions, by replacing inefficient equipment or switching to alternative energy sources, for example. When reduction projects yield more than required, firms can sell excess allowances to other companies or countries that need them to meet their requirements.

The Kyoto Protocol created two additional compliance mechanisms through which nations or individual companies may acquire emissions credits. First, credits may be acquired through projects under the Clean Development Mechanism, a brilliant innovation that allows private investors to find and fund low-cost carbon reduction projects in developing countries, thereby advancing their own economic interests while attracting much-needed investment dollars into emerging economies. Second, under Kyoto's Joint Implementation program, Annex I countries with binding targets can invest in specific projects in other developed countries and thereby acquire credits. These credits are primarily associated with projects in countries that are former members of the Soviet bloc. In addition, "removal units" are generated for land use and carbon sequestration activities.

The carbon market in Europe has developed more rapidly than expected. To prepare for the reductions that kick in during 2008–2012, the EU required member companies to identify emissions baselines, calculated largely on a business-as-usual scenario — with the expectation that countries and companies would experiment with trading and other market mechanisms during a 2006–2007 shakedown period. Instead, members have leapt straight in. A year into the shake down, it is apparent that the current, status-quo-oriented limitations on carbon — when combined with the prospect of additional reductions in 2008–2012 — have created significant market forces that are driving carbon reduction efforts in Europe and throughout the world. In the EU market, $6.5 billion in credits traded in the first quarter of 2006 alone.

The new international carbon market has triggered significant investments in CDM projects in developing nations. The result is a flow of investment dollars into economies that need it, and direct dividends in the form of carbon credits to the investing countries or companies. As of June 2006, more than 1,000 projects were in the CDM pipeline, including a large number of renewable energy projects. The CDM market is expected to continue to grow in strength as the need for further reductions under Kyoto kicks in. Some experts have estimated that more than $20 billion in credits from CDM projects will need to be purchased to meet limits set for 2008–2012 timeframe. Uncertainty regarding Kyoto's post-2012 requirements may slow this strong push for new investments at some point, but the smart money suggests that Kyoto signatories will extend carbon reduction requirements past 2012.

The carbon market has triggered a flow of investment dollars from industrial nations to economies that need it.

Although the track record of the international carbon marketplace is remarkable, the Kyoto Protocol anticipated that there would be challenges in creating an international market from scratch. As expected, there have been growing pains as various jurisdictions developed their approaches for creating a carbon market. Most notably, it now is apparent that national plans approved by the European Union for 2006–2007 included too many emissions allocations, which led to a drop in the carbon market price once actual emissions levels were reported. Even more importantly, however, EU members' de-

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cisions to give away all initial allocations without charge, instead of holding back some and auctioning them off, provided a windfall to some major carbon emitters, while missing an opportunity to raise funds for investments in new technology and to help set the market price for carbon.

There also have been some difficulties in administering the CDM program's project-based credit system. The program is thick with red tape, and sign-offs by the CDM Executive Board and other parties (including the host nations) have been maddeningly slow in many cases. Questions relating to the methodologies for proving real reductions from new projects have been more complex than expected, testing the patience of investors and host countries alike. In addition to red tape, a handful of CDM projects are generating such enormous profits for investors that critics fear such windfalls will encourage companies to look for cheap and easy opportunities to clean up egregiously dirty facilities rather than make more costly improvements to the vast majority of facilities whose emissions could be reduced, but without such huge profit margins.

American firms are facing major investment decisions, but without a price signal they are flying blind.

The Kyoto signatories are taking steps to address these shortcomings. With new national plans due for the 2008–2012 period, the EU has something of a fresh start ahead. New emissions estimates are being adjusted to reflect actual emissions; the EU is encouraging member nations to auction off some percentage of their allocations for 2008–2012; and more money and attention is going into reducing the CDM program's red tape.

Adopting a National Cap-and-Trade System

American companies are facing major investment decisions that impact carbon emissions, but without a price signal, they are flying blind. As a result, many firms that recognize the inevitability of carbon constraints are delaying needed and environmentally preferable capital investments until the U.S. regulatory picture becomes clearer. Others are making investments in older technologies that ignore carbon risks in the hope that emissions limits will continue to be delayed, or that they will be grandfathered into any new system. Also, without the architecture to create a vibrant carbon market in place in the United States, the Chicago Climate Exchange, which is trying to emulate the European and international model, is a mere shadow of its counterparts. Adding insult to injury, the exchange is now under fire for crediting certain carbon offset projects that critics complain are not market-tested — another predictable outcome of a voluntary system that is undisciplined by financial transactions that have real economic consequences.

Actions by states around the country are pressing Washington to create a national cap-and-trade system.

The status quo is unacceptable — for U.S. businesses and for the environment. A national cap on carbon emissions should be set now, in parallel with the establishment of trading mechanisms that promote the same type of positive dynamics that are emerging in the Kyoto-driven international carbon market. This is the consensus view of the bipartisan National Energy Commission and the Pew Center on Global Climate Change, among many others. Actions that are being taken by states, in the absence of leadership by the Bush administration, have increased the imperative that a national cap-and-trade system be put in place. California's plan to create a single-state carbon market will provide limited opportunities for companies to find low-cost carbon reduction opportunities. Also, California's plans to regulate carbon emissions from energy sources in other states that do not have carbon constraints will breed confusion at best and, more likely, paralyzing litigation.

Establishing Rules for Carbon Reduction Offsets

Parallel to establishing a cap-and-trade program, America should immediately establish rules that inform and discipline the helter-skelter development of carbon offsets. As the European experience is demonstrating, the carbon market is powered primarily by investments in direct reductions in carbon emissions, but the market benefits from — and some participants need — access to offset credits generated from free-standing carbon reduction projects. These are credits that are obtained, for example, from CDM projects in the developing world that may involve the capture and destruction of carbon emissions ranging from landfills and feed lots to sophisticated manufacturing facilities. Credits also

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can be generated through certain land use-related projects that take advantage of carbon sequestration opportunities, such as reforestation projects and carbon-sequestering farming practices.

A number of players in the U.S. economy that are not willing to wait for a cap-and-trade system are interested in matching up carbon reduction offsets that they purchase from third parties against their own carbon footprints. Participants range from large cities, to financial service businesses and law firms looking to offset the carbon impacts associated with recruiting trips, to utilities that want to provide customers with options to offset the carbon impact of their power purchases. All of these entities are beginning to purchase carbon offsets from third parties that are, in turn, purporting to reduce carbon emissions or increase carbon sequestration opportunities through projects that may — or may not — generate legitimate, measurable, and verifiable carbon benefits.

Critics are understandably leery of some of these third-party offsets. As more and more questionable or unverifiable offsets emerge, there is the very real danger that this important supplemental tool for controlling carbon will become irretrievably discredited. In addition, the outsized profits that some companies in the developing world have earned from relatively small investments in controlling greenhouse gas emissions are leading some emissions trading skeptics to question whether more accountability needs to be built into the system. The United States should acknowledge the emerging demand for carbon offsets and move quickly to bring credibility and discipline to this arena. If transparent and verifiable rules are developed for various types of reduction projects, the offset business can become a respected part of the carbon market, rather than a pariah. If the United States begins to tackle the tough work of developing rules that govern carbon investments, it will be in a better position to later join the international effort and credibly recommend improvements.

Re-Engaging Internationally

The Bush administration's in-your-face rejection of the international community's carbon initiative has left the United States on the outside looking in, as the large community of nations involved in implementing the Kyoto Protocol has created a dynamic, vibrant international carbon market. The administration has attempted to put a fig leaf over its embarrassing lack of involvement in this burgeoning market by emphasizing cooperative, technology-related agreements that it has entered into with some trading partners. But the fact that British Prime Minister Tony Blair chose to enter into a climate change agreement with California Governor Arnold Schwarzenegger regarding potential mutually beneficial carbon market opportunities speaks volumes about the near-irrelevance of the United States when it comes to involvement in the international carbon market.

This situation is unacceptable. The United States should re-engage in serious discussions with the world community regarding potential U.S. participation in the global international marketplace. Initially, those discussions could facilitate a better global understanding regarding the cap-and-trade program, and the offsets initiative that I recommend domestically.

As it begins to implement its own program, America will be writing rules that make sense for itself, but it also should study the approaches that the world community has taken under Kyoto. Ideally, this will enable the United States to incorporate the best of the lessons learned by the international community into its own carbon market. And it will do so while in an open dialogue with the other nations that share the planet, setting the stage for the potential integration of the U.S. effort into the global marketplace — on terms that are acceptable to the United States and that take full advantage of the U.S. experience.

The U.S. can take advantage of the lessons learned under the Kyoto Protocol, and open a dialogue with other countries.

Needless to say, this approach will not be successful unless America does, in fact, move forward with its own trading and offset programs and related initiatives. But if it moves quickly in this direction, the United States will put itself in a much stronger position to negotiate conditions of its participation in a global trading system that may replace the Kyoto scheme. A new arrangement would borrow features of Kyoto and the new U.S. carbon market that have worked well, while addressing the shortcomings of the protocol, particularly with regard to obtaining agreements by China, India, and other expanding economies to limit their carbon emissions. •

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