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U.S. Left Out of Emissions Trading

By OTTO POHL

LONDON — During negotiations over the Kyoto Protocol, the United States preached the importance of market solutions to reduce greenhouse gas emissions. Few countries listened.

Now, with the Americans no longer at the table, the former free-market opposition has taken over the pulpit. Canada ratified the treaty in December, meaning the plan to reduce greenhouse gases is just one nation shy of becoming law in more than 100 countries. And the heart of the treaty is an emissions-trading plan that closely resembles what the United States originally proposed.

"When Bush pulled out in the cavalier way he did, he galvanized everyone around the world to make it work," said David Doniger, a former Kyoto treaty negotiator under President Bill Clinton and now policy director of the Climate Center at the Natural Resources Defense Council. "The system is made in America, and the Americans aren't part of it."

Other countries see opportunity in America's retreat.

"Now that the Americans are out, Europe can dominate the emissions trading market," says Steve Drummond, managing director of a greenhouse gas brokerage in London called CO2e.com. "It entitles the Europeans to write the rules for global trading."

And Europe has indeed been busy writing. Britain introduced the world's first organized trading system two years ago. Denmark has begun a smaller plan, and in December the European Union issued plans to begin full-scale trading in 2005. With Kyoto shaping a multibillion-dollar commodities exchange, companies are already trading emissions reductions, which are expected to become increasingly valuable as other companies enter the market.

The idea behind what are called cap-and-trade arrangements is to issue a limited number of pollution permits and then allow companies to buy and sell them. Whoever can reduce emissions cheaply can sell unused permits to others, making creative ideas for pollution reduction a profit opportunity. As overall reductions are realized, governments can slowly reduce the number of outstanding permits to keep both the price of permits and interest in further reductions high.

It is hard to quantify the benefit or loss to American businesses for not being part of the global market. Certainly, heavy polluters are better off because they do not have to buy pollution permits or invest in new technology. Companies that could achieve low-cost reductions, however, cannot realize the profits by making those reductions, and the market infrastructure of brokers and trading experience is developing abroad.

American multinational corporations are also forced to put in place two ways of accounting for carbon dioxide emissions, one for emissions inside the United States and one for emissions in nations that signed on to Kyoto. And with various proposals before Congress to regulate greenhouse gas emissions, companies contemplating equipment upgradings in their American plants are unsure what kind of regulatory environment they face.

So far, regulation is strictly self-imposed. Trading at the Chicago Climate Exchange, a market based on voluntary compliance, is set to begin in June. The chairman and chief executive of the exchange, Richard Sandor, says that even voluntary markets can allow the United States to be competitive internationally. "This will squarely put the

U.S. in a very good position to lead efforts in developing market-based solutions to environmental problems," he said. "Carbon is only the beginning."

Outside experts are not as hopeful for voluntary measures. "Mandatory programs can force behavior from inefficient firms," says Thomas P. Lyon, a visiting fellow at Resources for the Future, a Washington research center. "A voluntary program simply can't touch those."

One reason companies are involved with the climate exchange is to prepare for mandatory requirements they foresee. "It's an insurance policy," said Bruce Braine, vice president for strategic planning and analysis at American Electric Power, the nation's largest power generator and biggest emitter of carbon dioxide. "If you ultimately have mandatory requirements, then this gives us first-mover advantages."

So far, the right to emit an estimated 200 million tons of greenhouse gases has changed hands, and trading volumes are growing rapidly. According to Natsource, a large environmental gas brokerage firm, volumes last year matched the volume for the previous five years. Most of the volume is driven by the desire to get low prices on emissions reductions that companies expect will be valid under the Kyoto agreement.

The right to emit the equivalent of one metric ton of carbon dioxide now sells for $3 to $8, said Jack D. Cogen, chief executive of Natsource. When Kyoto takes effect in those countries that have ratified it — Russia, for one, is still to act — that price is expected to rise sharply. Estimates for the size of the greenhouse gas market vary widely, but everyone agrees it will be a major commodities market. "Every time you burn fossil fuels you create carbon," Mr. Sandor of the climate exchange said. "This market could be as big as the energy market."

The Dutch government is now one of the largest buyers on the market. Canadian corporations, which had been buying large volumes of American emissions reductions in recent years, have scaled back since it became clear the American reductions would not be compliant with Kyoto.

Brokers are still waiting for precise Kyoto rules to be published, which will allow trading to develop similar to that for stocks and bonds. For now, each deal is based on an estimate about whether the reductions will comply. "It's like selling real estate," said Frank Joshua, managing director of Natsource Tullett (Europe) Ltd.

Today at CO2e.com, a subsidiary of Cantor Fitzgerald, just a few employees sit in offices next to Cantor's trading floor, where billions of dollars of bonds change hands daily. Mr. Drummond of CO2e.com looks forward to the day when his brokers join the brokers working the bond market a few feet from his desk. "The emissions market closely resembles the bond market," he said. "This is a serious business opportunity."

The idea of trading pollution credits first came up in a significant way in the Clean Air Act of 1990. It was intended to reduce pollutants responsible for acid rain and was signed into law by President George H. W. Bush.

The Clean Air Act reduced dangerous pollutants like sulphur dioxide for a fraction of what it had cost before. The Environmental Protection Agency estimates that for a cost of $1 billion, the legislation has saved the United States at least $50 billion in health costs alone.

By not putting in place similar legislation for greenhouse gases, critics fear, the United States allows other countries to gain experience and win business in the field. "All we're doing now is giving other countries a chance for remedial education," said Mr. Doniger of the Natural Resources Defense Council, "and it will cost us in the end."