
Climate Change Legislation: A Price Collar Is Critical

As Congress considers climate change legislation to reduce the nation's carbon dioxide (CO₂) and other greenhouse gas (GHG) emissions, it is essential to include effective consumer protections—such as a price collar—that will reduce price increases for consumers and help avoid harm to U.S. industry and our economy. A price collar—which sets an upper limit (ceiling) and a lower limit (floor) on the price of CO₂ emission allowances—is designed to minimize the economic disruption of a national carbon policy. A price collar will help to protect consumers from the possibility of dramatic price increases and the nation's economy from volatile carbon prices and possible market manipulation, while supporting emissions reductions.

How A Price Collar Works

Under a cap-and-trade program for reducing CO₂ emissions, a national limit on GHG emissions is established and, over time, that “cap” is lowered, thus requiring additional emissions reductions. To implement the program, the federal government would create credits or “allowances” for regulated entities, adding up to the total emissions allowed under the cap.

A price collar would set an upper limit (ceiling) on the price that a regulated entity would have to pay for the emissions allowances needed to help meet its reduction target. Setting a ceiling ensures that prices do not rise so high that jobs and the economy are harmed. The use of a lower limit (floor) would assure the price of carbon does not fall below a certain level and assure investment in energy efficiency. This type of economic safeguard is “triggered” when the market price of existing allowances under a cap-and-trade program either exceeds the maximum price level or falls below the minimum price level. For example, if the price ceiling is triggered, regulated entities could purchase the number of allowances they need for compliance at the ceiling price; and if the floor is triggered, the government could withhold allowances from the market in order to increase the price to the floor level.

Benefits Of A Price Collar

A price collar has important benefits over other legislative cost-relief options, including:

- **Cost Certainty:** A price collar establishes cost certainty, and it minimizes price volatility and the possibility of market manipulation or excessive speculation. A price collar ensures that a regulated entity (*e.g.*, power plant, manufacturer, etc.) can comply with a carbon policy within a price range for allowances. Without a price collar, the price of allowances could fluctuate significantly. For example, prices under Phase 2 of the European Union emissions trading scheme (E.U. ETS) have ranged from a high of about 32 Euros per metric ton of CO₂ to a low of about 8 Euros per metric ton (approximately \$45 to \$11 U.S. dollars at current exchange rates) for vintages usable in the first two years.¹ Such volatility would complicate the effective functioning of CO₂ emissions trading markets significantly and would undermine public support for the cap-and-trade program.
- **Financial Protection:** A price collar helps to protect against harm to the economy and U.S. international competitiveness. A price collar protects electricity consumers, workers, and industries from unexpected price increases for emissions controls and from potential market manipulation.

¹ Price volatility under the E.U. ETS prompted Poland to propose the use of a price ceiling and floor for the post-2012 period.

- **Transitional Design:** A price collar could be transitional in design (*e.g.*, start narrow and gradually widen over time) and eventually could be phased out. A price collar would provide the necessary protection against volatile energy prices for consumers and industries until advanced climate technologies are widely available and commercially deployable, and other major economies and trade competitors of the United States have established comparable GHG mandates. At that point, the price collar could be phased out.
- **Straightforward Approach:** The most appealing feature of a price collar is its simplicity. Other cost-relief mechanisms—such as banking or borrowing—fail to establish a clear price signal, may not respond proactively enough to changing market conditions, and may only postpone economic disruptions. A price collar is a straightforward approach that allows companies to develop more effective compliance plans.

To be most effective, the price collar initially should be set at a narrow range and gradually expand over time as cleaner technologies become available. This will enable it to send a price signal, while minimizing price volatility.

Support For A Price Collar

The Congressional Budget Office (CBO) issued a report in October 2008, which concluded that “price floors and ceilings could provide timing flexibility and more certainty about allowance prices” under a future U.S. GHG cap-and-trade system.² CBO noted that the “floor would tighten [the] cap in low-cost years, [the] ceiling would loosen the cap in high-cost years,” and the “floor and ceiling could be adjusted periodically to ensure that emissions are on track to achieve long-term targets.”

Similarly, the National Commission on Energy Policy (NCEP) released a report in July 2009 that supports inclusion of a price collar in climate change legislation. NCEP concludes:

“A simple price cap that is paired with a minimum price floor and that escalates in a pre-determined manner over time still offers, in our view, the most straightforward and effective response to the cost concerns expressed by many stakeholders, both with respect to long-term mitigation costs and with respect to mitigating the potential for short-term price volatility.”³

As lawmakers consider climate change legislation, it is essential that a price collar be included in the legislation. A price collar will help to protect consumers from the possibility of dramatic price increases and the economy from price volatility, while accomplishing significant emissions reductions.

² U.S. Congressional Budget Office (CBO), *Preparing for Our Common Future: Policy Choices and the Economics of Climate Change*, presentation by then CBO Director Peter Orszag to Wellesley College, October 2008.

³ National Commission on Energy Policy, *Forging the Climate Consensus*, July 2009.

September 18, 2009