What’s the concern?

• First question to ask: What are we worried about?
  – Allowance prices too high?
  – Volatility?
  – Overall economic impact?
  – Economic impact on specific sectors, e.g. electric power?

• Environmental perspective
  – Very high prices could threaten the program (RECLAIM).
  – But busting the cap ahead of time is not a solution.
Problems with the leading solutions

• Price ceiling ("safety valve")
  – Busts the cap
  – Changes behavior
  – Dampens incentive for investment and innovation

• Carbon market efficiency board
  – Much better than the safety valve, but …
  – Devil is in the details
  – Rules vs. discretion
  – Institutional authority must be earned
The overlooked means of cost containment

- Allocation: Contain costs, not prices
- Financial instruments: Markets can manage volatility
- Borrowing: Government “discount window”
- Offsets: Expand the scope of the market
- Forest carbon tons: Reservoir of low-cost emissions reduction opportunities
What’s the concern? (Refrain)

• Temporary shocks or long-run fundamentals?

• Long-run solution is simple: Adjust the target.
  – Note that we are also deeply uncertain about the long-run fundamentals of the climate system
  – Argues for an approach that keeps options open

• Built-in flexibility mechanisms should focus on accommodating short-run shocks.
What might a “starter kit” look like?

- Early years of the program are critical
- Would like to have a cushion in place against short-run shocks
- How do we get the market working well?
  1. Early tons are essential
     - Early action credits, offsets, etc. underway right away
     - Need forest carbon sooner rather than later
  2. Credibility is crucial
     - This is the heart of the matter, since in theory banking and borrowing are sufficient to smooth out SR shocks
     - Single allowance reserve? Long-run horizon for forward auctions?