

How Incentives to Cheat Undermine Cap-and-Trade

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Imagine buying a car only to find it was a lemon. You would probably go back to the seller in an effort to get your money back. Contract and consumer protection laws are set up to mediate this relationship between buyer and seller. In most cases the power of one balances the other creating fair transactions that are mutually beneficial.

Now Washington and a number of other states are setting up a system that creates an incentive for both the buyer *and* seller to keep quiet when the buyer doesn't get what he paid for.

The cap-and-trade system Washington is helping develop as part of a regional effort would require companies that emit greenhouse gases to purchase carbon allocations from the government, or "offsets" offered by others, to bring them into compliance with the law, or pay a fine. The problem is that if the projects that create these offsets don't protect the environment as promised, both buyer and seller are better off if nobody realizes it. Both have an incentive to collude, keeping the failure of the program a secret.

Such incentives to cheat demonstrate why a regional cap-and-trade system that allows carbon offsets is more likely to have increased enforcement costs, while failing to effectively reduce greenhouse gas emissions. It is another reason that a simpler system of creating a carbon price is a better way to reduce CO₂ emissions.

Cap-and-Trade Accounting

Washington and six other states and three Canadian provinces have joined together in the

Western Climate Initiative, an effort to create a regional "cap-and-trade" system that is supposed to dramatically reduce the amount of greenhouse gas emissions in the region. Companies that emit greenhouse gases¹ would be required to purchase carbon allocations from the government or "offsets" to account for their emissions.

Offsets and carbon credits can be created in a variety of ways. In the case of free allocations, a company that emits less than their allocation can sell that remaining allowance to companies that exceed their cap. Companies can also buy from a limited pool of allocations provided by the government.

Offsets can be created by programs that sequester carbon or reduce emissions in another way, taking carbon from the atmosphere and storing it in a variety of forms. In order to offer an offset, the seller must demonstrate that the carbon being offset would have remained in the atmosphere without the program. This concept is known as "additionality."

A tangible example is the CarpoolMatchNW.org program started by the Oregon Climate Trust, an organization that sells carbon offsets. The program used the money paid by energy companies that want to offset their carbon emissions and created a program designed to promote carpooling, thereby removing cars, and

¹ It may be that companies are given a free allocation equal to some percentage of historic emissions. In this case, companies would need to buy offsets for emissions over that allocation.

their emissions, from the road. In the case of CarpoolMatchNW.org, the goal was to reduce CO₂ emissions by 70,000 tons over the ten year life of the contract.

What happens, however, if the carpool program doesn't perform as promised?

Who Blows the Whistle?

A recent study by the Cascade Policy Institute² in Portland found that the carpool program had not only fallen short of its promised goal, it had missed the goal by a wide mark. During the first five years, the program had reduced CO₂ emissions by an estimated, not measured, 3,075 tons, less than five percent of the way to the target.

The Oregon Climate Trust then substituted credits from another program, credits that were neither "additional" nor measured, to make up most of the difference and then cancelled the program.

Had the Cascade Policy Institute not reported the failure, who would have blown the whistle?

The Oregon Climate Trust had no incentive to highlight the flaws, and did not. Officials there had already spent the money on a program that had failed to achieve the goal. If they were held to their promises, it might mean spending more money than was available, risking bankruptcy. In such a situation, who is liable for those un-offset carbon emissions? Even if the provider of the carbon offset could afford to replace the offsets, such an admission of failure would certainly hurt their credibility and rating as an offset provider.

The buyer, in this case the Klamath Cogeneration Project, has no incentive to highlight

² John Charles, "Money for Nothing: Carbon cartels and the rise of a phantom industry," Brainstorm NW, April 2008, http://www.brainstormnw.com/archive/apr08_feature.html (Accessed May 7, 2008)

the failure. As long as the offsets, real or not, are counted against their mandatory emissions caps, they are satisfied. The value to them is the accounting value of the credits offsetting the emissions cap, not the actual reduction of greenhouse gases. Highlighting the failure of the program would only undermine the value of those credits, both in real terms and for accounting purposes. If they complained that they did not get what they paid for, they might still be liable for achieving the carbon emission reductions, and may end up throwing good money after bad to meet their regulatory obligations.

Even the government agencies responsible for certifying carbon offset programs may have conflicting incentives. On the one hand, they are supposed to ensure that such programs perform as promised. However, enforcement agencies will also feel a range of political pressures to overlook any failure of the offset system.

First, under a regional cap-and-trade system, it will become increasingly difficult to judge the effectiveness of a growing number of carbon offset programs. The cost of verifying actual emissions reductions for all of these projects could be significant. As time has gone on, Europe has grown increasingly skeptical of carbon offsets for this very reason.

Second, if a significant number of carbon offset programs fail, the public news of such failures would undermine the political viability of the cap-and-trade system. Administrators of an agency reliant on the integrity of cap-and-trade will feel pressure to minimize the failings of the system. In the case of CarpoolMatchNW.org, the agency in charge of overseeing the offsets denied knowing the program didn't work. The Cascade Policy Institute report notes that, "When contacted in March 2008, Energy Facility Site Evaluation Council (EFSEC) Manager Tom Stoops professed to know little about the carpooling program and its waste of Climate Trust funds, even though EFSEC holds three of the seven positions on the Climate Trust's board."³

³ Ibid.

Third, politicians whose political capital is tied up in their support for cap-and-trade will also want these problems overlooked. The more difficulties experienced by cap-and-trade, the worse those who promoted and voted for it will look to the public.

These problems are already playing out under the Kyoto Protocol. Offsets are provided under the Clean Development Mechanism (CDM), in which companies pay to help organizations reducing their CO₂ emissions, usually in developing countries, use more efficient technology. Recently, the *UK Guardian* reported that “A working paper from two senior Stanford University academics examined more than 3,000 projects applying for or already granted up to \$10bn of credits from the UN's CDM funds over the next four years, and concluded that the majority should not be considered for assistance.”⁴ The reason is that the carbon reductions from many of the offsets would have been achieved anyway, so the reductions were not additional.

Predictably, the government defended the program and the credits. The UK government told the *Guardian* that “We completely reject any assertions that [it] is fundamentally flawed. We've worked consistently for and seen improvement in CDM processes over the past few years of its operation. We believe the CDM is essentially transparent and robust, though we will continue to press for the environmental integrity of projects.”⁵ Of course, the government has an incentive to defend the program because an admission that offsets are failing to create actual reductions would call into question an important part of the cap-and-trade system.

Simple is Better

There are ways to reduce the accounting difficulties associated with carbon offsets. Some

⁴ John Vidal, “Billions wasted on UN climate programme,” May 26, 2008, <http://www.guardian.co.uk/environment/2008/may/26/climatechange.greenpolitics> (Accessed May 28, 2008)

⁵ Ibid.

argue that simple accounting systems can be created to judge the worth of particular carbon offset programs. Every system, however, is a tradeoff and narrowing the allowable types of credits also reduces the ability of such offsets to limit costs.

All solutions that limit the use of offsets increase the rigidity, and therefore the costs, of the cap-and-trade system. Carbon offsets are used specifically to increase flexibility for emitters and put downward pressure on the cost of carbon by introducing competition and encouraging innovative ways to sequester carbon or reduce emissions. Eliminating offsets gives firms fewer options, potentially increasing the cost of energy, which impacts consumers and the overall economy.

The choice for those who support cap-and-trade, then, is between a system that includes carbon offsets and the incentives to cheat that come with them, and a system that is inflexible and, therefore, more subject to wide price fluctuations, uncertainty and higher costs.

If Washington decides to take steps to reduce CO₂ emissions, the simplest way is to avoid the problems associated with cap-and-trade accounting and adopt a system that uses a more straightforward and flexible system like one that increases the price of carbon offset by tax reductions. As long as Washington continues down the cap-and-trade path that includes offsets, however, it will find increasing difficulties with a system that provides numerous incentives to overlook projects that fail to make real reductions in greenhouse gas emissions. In such a system the incentives to cheat are large and the rewards for blowing the whistle are low.

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