Statement of Marlo Lewis  
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On S. 388  
Before the Committee on Energy and Natural Resources  
U.S. Senate  
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Thank you, Mr. Chairman and Members of the Committee, for the opportunity to submit testimony on S. 388, the Climate Change Technology Deployment and Infrastructure Credit Act of 2005.

My name is Marlo Lewis. I am a senior fellow in environmental policy at the Competitive Enterprise Institute in Washington, D.C. CEI is a nonprofit, nonpartisan research and advocacy institute dedicated to advancing the principles of free enterprise and limited government. I am also representing the views of several other conservative and free-market organizations including the American Conservative Union, Americans for Tax Reform, Freedom Works, and the National Taxpayers Union.

We have strong concerns about S. 388’s “transferable credit” provisions, particularly Section 1612(a)(6-7), which direct the Secretary of Energy:

(6) to provide to persons and entities that enter into … voluntary agreements [with the Department of Energy] and reduce greenhouse gas emissions transferable credits that may be used for any incentive, market-based, or regulatory program determined by Congress to be necessary and feasible to reduce the risk of climate change and effects of climate change; and
(7) to provide for the registration, transfer, and tracking of the ownership or holding of those credits for purposes of facilitating voluntary trading among persons and entities.

My testimony develops the following points:

• Although not part of the sponsoring Senators’ intention, U.S. Government provision or certification of transferable credits would build a corporate clientele for Kyoto-type emissions cap-and-trade policies. Transferable credits derive their economic value solely from the threat or imposition of a carbon cap. Consequently, all credit holders acquire financial motives to lobby for a cap.
• Although participation in a transferable credit program is not mandatory, neither is it truly voluntary. Such programs transfer wealth, in the form of tradable emission allowances, from those who not “volunteer” to those who do. Non-participants are penalized under a future cap—hit with extra burdens they would not face absent a transferable credit program.
• The political result of this coercive, zero-sum dynamic is all-too-predictable: a large mass of companies holding carbon-reduction coupons that mature and attain full market value only under a cap. Transferable credits will expand the ranks of energy-rationing profiteers.
• Since all insiders know that transferable credits are a prelude to future cap-and-trade policies, enacting Section 1612 would trigger fuel switching from coal to natural gas—further driving up natural gas prices.
• The Department of Energy (DOE) is nearing completion of a multi-year rulemaking to improve the voluntary reporting of greenhouse gases program (VRGGP) established under Section 1605(b) of the 1992 Energy Policy Act. DOE commendably resisted pressure to adopt accounting rules that would allow special interests to game the system for PR or competitive advantage. Section 1612 threatens to undo DOE’s careful work and give special interests another bite at the apple.
I. Historical Background

Yogi Berra’s famous quip, “It’s déjà vu all over again,” applies in spades to S. 388’s transferable credit provisions. Proposals to award or certify transferable credits—previously known as “early credits” or “credit for early action”—were hotly debated in the 105th and 106th Congresses.

Selling Kyoto

Proponents claimed their objective was to break the “stalemate” in Congress over U.S. climate policy. Resources for the Future put the point more directly: “Proponents of voluntary early credit approaches also point to the potential political benefits: if a broad cross section of business, environmental groups, and others could come together behind such a program, it would provide some political impetus for more ambitious goals, including eventual ratification of the Kyoto Protocol.” In other words, the objective was to nullify S. Res. 98, the July 1997 Byrd-Hagel resolution, in which the U.S. Senate, by a vote of 95-0, preemptively rejected the Kyoto treaty as too costly and unfair to U.S. industry and labor.

Although the implementing rules of early credit programs can be bewilderingly complex, the basic idea is simple. Under such programs, companies that act “early” to reduce emissions of greenhouse gases—chiefly carbon dioxide (CO₂) from fossil energy use—earn credits (emission allowances) they can use later to comply with Kyoto or a similar compulsory regime. In effect, participants acquire Kyoto stock that appreciates and bears dividends if—but only if—the U.S. Government ratifies Kyoto or adopts a comparable domestic regulatory regime. Credit holders thus acquire incentives to lobby for carbon regulation.

Environmental Defense (then known as Environmental Defense Fund, or EDF) was the strategy’s chief architect. The Clinton Administration began promoting the idea in October 1997 as part of its climate change policy initiative. The Pew Center on Global Climate Change, headed by former Clinton Administration Kyoto negotiator Eileen Clusssen, took the lead in marketing early action crediting to corporate America. In October 1998, these efforts coalesced in a coordinated political campaign. The Clinton Administration, via the President’s Council on Sustainable Development, formulated and promoted “principles” of early action crediting. The Pew Center published a major report advocating a credit for early action program. Most importantly, Senators Joe Lieberman (D-CT), John Chafee (R-RI), and Connie Mack (R-FL) introduced S. 2617, the “Credit for Voluntary Early Action Act.”

With ten internal references identifying the end of the “early action” period as the day before the start of the Kyoto Protocol compliance period (January 1, 2008), the bill was a fairly obvious attempt to jumpstart compliance with a non-ratified treaty. Senator Chafee was upfront about the Kyoto connection in his floor statement on the bill: “The credits would be usable beginning in the

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2 At a July 15, 1999 hearing of the House Government Reform Subcommittee on Economic Growth, Natural Resources, and Regulatory Affairs, EDF Executive Director Fred Krupp stated that EDF “developed” early action crediting “in early 1997.”
3 President Clinton, Remarks to the National Geographic Society, October 22, 1997: “Second, we must urge companies to take early actions to reduce emissions by ensuring that they receive appropriate credit for showing the way.”
first five-year budget period (2008-2012) under the Kyoto Protocol, if the Kyoto Protocol is ratified.\(^6\)

Enron was a prominent member of the Pew Center’s Business and Environmental Leadership Council, and lobbied aggressively for the Kyoto Protocol. Enron was a natural gas distributor, and Kyoto would suppress coal as a fuel source for electric power generation, boosting demand for natural gas. Enron’s energy traders also might make a killing as brokers in a Kyoto-created emissions trading market. In a December 12, 1997 internal memorandum, John Palmisano, Enron’s senior director for environmental policy and compliance, described Kyoto as “exactly what I have been lobbying for,” adding: “This agreement will be good for Enron stock!!”\(^7\)

However, in an email dated October 14, 1998—four days after the bill’s introduction—Palmisano criticized S. 2617. First, he worried that early credits would relieve the “pressure” Kyoto would put on other companies to purchase Enron’s natural gas, solar, wind, and energy management services. But he also worried that the bill was too “blatant”:

> This proposal, if adopted, would start implementing Kyoto. And while I support this (personally), I question the likelihood of this initiative having political traction and the wisdom of being blatant vis-à-vis implementing Kyoto. The bill is not incremental. They are going for almost the “whole enchilada.”\(^8\)

Alluding to the debate in Congress over appropriations language to prohibit EPA from implementing Kyoto through the regulatory “backdoor,” Palmisano characterized S. 2617 as Kyoto through the legislative “front door.”

Whether due to Palmisano’s behind-the-scenes criticism or to free market groups’ public criticism of S. 2617 as “Kyoto Lite,”\(^9\) the sponsors performed cosmetic surgery before re-launching their bill in the 106\(^{th}\) Congress. They stripped out all internal references to the Kyoto compliance period, and deleted the word “early” from the title, which in the original version visibly meant earlier-than-Kyoto. On March 4, 1999, the sponsors offered S. 547, the “Credit for Voluntary Reductions Act.” On the House side, Rep. Rick Lazio (R-NY) introduced a companion bill, H.R. 2520.

House Government Reform Regulatory Affairs Subcommittee Chairman David McIntosh (R-IN) led the opposition to transferable credits in the 106\(^{th}\) Congress. McIntosh queried EPA about the lobbying incentives an early credit program would create,\(^{10}\) held a hearing at which Environmental Defense Executive Director Fred Krupp was a key witness,\(^{11}\) and introduced legislation to counter Lazio’s bill. Due to these actions, early credits became radioactive among Kyoto opponents in the House,\(^{12}\) and Senator Lieberman’s bill lost steam without a viable House companion. Senator Lieberman did not reintroduce the bill in the 107\(^{th}\) Congress. To all appearances, credit for early action was politically defunct.

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\(^6\) _Congressional Record_, October 10, 1998, S-12310.


\(^8\) Personal copy of Palmisano memorandum.


\(^10\) In letters dated May 27, 1999 and July 22, 1999.

\(^11\) July 15, 1999, “Early Action Crediting: Win-Win or Kyoto through the Front Door?” I served as staff director on Rep. McIntosh’s subcommittee.

\(^12\) McIntosh introduced H.R. 2221—a measure to prohibit funding of early credit programs—just days before Lazio had planned to introduce H.R. 2520. Lazio postponed introducing his bill until a month later. McIntosh’s bill eventually gained 32 co-sponsors, compared to Lazio’s 15.
Back from the Dead

On February 14, 2002, however, early credits rose from the political graveyard. President Bush directed the Secretary of Energy not only to enhance the “accuracy, reliability, and verifiability” of the VRGGP, but also “to give transferable credits to companies that can show real emission reductions.” It is unclear why the President resurrected the Lieberman-Pew-Environmental Defense strategy to mobilize business lobbying for Kyoto-type policies. Apparently, the President’s advisors were beguiled by the claim that transferable credits are “voluntary,” “market-based,” and, thus, benign.

Indeed, White House staff not only endorsed early credits without thinking through the political ramifications, they also failed to check whether current law allows DOE to set up a credit program in the first place.

This was not a difficult topic to research. The pertinent provision of the 1992 Energy Policy Act, Section 1605(b), is only one and a half pages long. It makes no reference, or even allusion, to tradable credits. Similarly, the Conference Report’s discussion of 1605(b) does not say or imply anything about credits. Equally telling, when House and Senate conferees produced the final version of 1605(b), they considered and rejected language that would have established a credit program.13

To carry out the President’s February 2002 directive, DOE has conducted one of the most extensive rulemakings in its history. DOE has held two national workshops and four regional workshops on its proposed revisions of the 1605(b) reporting program, and it has just opened a fourth public comment period. During this time CEI, through coalition letters, public comment, op-ed columns, and the like, made the case that DOE (a) has no authority to award or certify transferable credits and (b) should not seek such authority. On March 22, 2005, DOE released an interim final rule setting forth the general guidelines of the revised 1605(b) program. The rule specifically states that DOE has no authority to award or certify transferable credits.14

II. The Case against Transferable Credits

CEI is submitting this testimony because Section 1612(a) of S. 388 would give DOE the authority it lacks. The pro-energy bona fides of the key co-sponsors—Senators Chuck Hagel (R-NE) and Larry Craig (R-ID)—are beyond question. CEI is therefore confident that, once Senators Hagel and Craig comprehend the unwholesome effects a transferable credit program would have on the politics of energy policy, they will drop Section 1612 from the bill.

Here are five reasons why transferable credits as a prescription for public policy disaster.

1) Transferable Credits Will Mobilize Pro-Kyoto Lobbying

Credits awarded for “early” reductions become valuable assets only under a legally binding emissions cap. That is because, although many companies would like to sell carbon credits, no company will buy credits unless faced with a cap or the threat of a cap. Without buyers, there are no sellers and, hence, no market.

Consider the low opening bids at the Chicago Climate Exchange (CCE). The Greenwire news service reported that, at the first auction, the exchange’s 22 member companies and


municipalities “paid an average of less than $1 for the right to emit one ton of CO$_2$.”\textsuperscript{15} Why? Former CCE senior vice president for sales and marketing Ethan Hodel explained: “Without regulation and governmentally imposed sanctions, the early evidence … is that the American business community is not very interested in a voluntary greenhouse gas cap-and-trade program.” Were it not for the risk that Congress may cap carbon emissions in the future, the “bid” price for credits today would be zero.

Enacting a cap would instantly pump up demand, boosting credit prices by orders of magnitude. For example, carbon equivalent credits that sell for less than five dollars per ton today on the Chicago Exchange would, according to the Energy Information Administration, fetch $93-$122 per ton under Sen. James Jeffords’s (I-VT) Clean Power Act, $79-$223 per ton under McCain-Lieberman, and $67-$348 per ton under Kyoto.\textsuperscript{16} Clearly, credit holders must lobby for “regulation and governmentally imposed sanctions” if they want to turn “voluntary” reductions into real money.

(2) A Credit Program Will Coerce Companies to “Volunteer”

Proponents are fond of describing credits as “voluntary” and “win-win” (good for business, good for the environment). In reality, transferable credits would set up a coercive zero-sum game in which one company’s gain is another’s loss.

To repeat, credits have no monetary value apart from an actual or anticipated emissions cap—a legal limit on the quantity of emissions a firm, sector, or nation may release. The cap makes credits valuable by creating an artificial scarcity in the right to produce or use carbon-based energy. Both the market value of the credits and the program’s environmental integrity absolutely depend on restricting the supply of credits that may be traded under the cap.

And there’s the rub. If the cap is not to be broken, then the quantity of credits allocated to companies in the mandatory period must be reduced by the exact number awarded for “early” reductions in the “voluntary” period. For every company that earns a credit for early action, there must be another that loses a credit under the cap. In short, companies that do not “volunteer” will be penalized—forced in the mandatory period to make deeper emission cuts than the cap would otherwise require, or pay higher credit prices than would otherwise prevail.

The coercive, zero-sum dynamic of an early credit program is easily illustrated. Assume for simplicity’s sake that there are only four companies in the United States (A, B, C, and D), each emitting 25 tons of CO$_2$, for a national total of 100 tons. Also assume that Congress enacts a mandatory emissions reduction target of 80 tons, and authorizes DOE to issue 80 tradable allowances or credits (1 credit being an authorization to emit 1 ton). Absent an early credit program, each company would receive 20 allowances during the compliance period, and have to reduce its emissions by 5 tons.

Now assume there is an early action program that sets aside 20 allowances for reductions achieved before the compliance period. That reduces each company’s compliance period allocation from 20 credits to 15 (4 companies X 15 credits each = 60 + 20 early action credits = 80, the total U.S. emissions budget). Finally, assume that Companies A and B each earns 10 credits for early reductions. In the compliance period, A and B will have 25 credits apiece (10 + 15), which is 5 more (25 instead of 20) than an equal share under the cap would give them. In

\textsuperscript{15} Lauren Miura, “Voluntary emissions trading draws mild interest, criticism,” Greenwire, October 3, 2003. On Friday, April 8, 2005, carbon dioxide-equivalent credits sold for $1.32 per metric ton.

contrast, C and D will each have 5 fewer credits (15 instead of 20). C and D must make deeper reductions than the cap would otherwise require—or they must purchase additional credits from A and B. Either way, the early reducers gain at the expense of non-participants.

That credit for “voluntary” reductions is a wealth-transfer scheme is widely recognized by proponents and critics alike. The Center for Clean Air Policy writes: “Credits earned should be subtracted from the pool of allowances given out in the binding program, rather than added to it. This means that early reducers will be rewarded at the expense of those who do not participate.”\(^\text{17}\) As one CCAP scholar put it, "This is the essence of an early reductions program—it reallocates first budget period allowances from those who don’t take early action to those who do."\(^\text{18}\) The Pew Center’s monograph also acknowledges that early credits must be “drawn down” from the compliance period budget.\(^\text{19}\) Similarly, Resources for the Future cautions: "If the United States were to implement an emissions control program during that [2008-2012 Kyoto compliance] period with tradable carbon allowances, holders of early reduction credits would be allocated a share of the allowances, implying fewer allowances for others."\(^\text{20}\) Enron’s Palmisano opined that S. 2167 would “transfer substantial wealth to so-called early actors while imposing substantial penalties upon those companies that are neither good nor bad but merely choose, for whatever reasons, to wait to control emissions until a regulatory control program goes into effect.” Consequently, as more companies participate, “more and more pain will be imposed on fewer and fewer non-participating companies.”\(^\text{21}\)

Programs that penalize non-participants are coercive, not “voluntary.” Programs that enrich participants at the expense of non-participants are zero-sum, not “win-win.”

(3) Credits Will Corrupt the Politics of Energy Policy

Once companies figure out that the program will transfer wealth—in the form of tradable emission allowances—from those who do not “act early” to those who do, many will “volunteer” just to avoid getting stuck in the shallow end of the credit pool later on. The predictable outcome is a surge in the number of companies holding Kyoto stock—assets worth little or nothing under current law but worth millions or billions of dollars under Kyoto, McCain-Lieberman, or the Clean Power Act. Credits will swell the ranks of energy-rationing profiteers.

(4) Credits Will Further Drive Up Natural Gas Prices

Coal is the most carbon-intensive fuel (CO\(_2\) emissions per unit of energy obtained from coal are nearly 80 percent higher than those from natural gas and about 35 percent higher than those from gasoline).\(^\text{22}\) Consequently, Kyoto-type policies can easily decimate coal as a fuel source for electric power generation. For example, according to EIA’s analysis, the McCain-Lieberman bill would reduce U.S. coal-fired electric generation in 2025 by 80 percent—from 2,803 billion kilowatt hours to 560 billion kilowatt hours.\(^\text{23}\)

A transferable credit program will send a political signal that mandatory reductions are in the offing and, hence, that coal’s days are numbered. As environmental lawyer William Pedersen observed of President Bush’s February 2002 directive, developing “company-by-company

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\(^\text{17}\) Center for Clean Air Policy, Key Elements of Domestic Program to Reward Early GHG Emissions Reductions, January 1999 (emphasis added), \url{http://www.ccap.org/pdf/erc.pdf}.

\(^\text{18}\) Tim Hargrave, personal communication, February 2, 1999.

\(^\text{19}\) Nordhaus and Fotis, \textit{Analysis of early reduction crediting proposals}, p. 21.


\(^\text{22}\) EIA, \textit{Analysis of S. 139}, p. 173.

\(^\text{23}\) EIA, \textit{Analysis of S. 139}, p. 176.
greenhouse emissions accounts” makes little sense “except as a step towards legally binding controls.” Indeed, he asked, why would firms go to the trouble and expense of earning credits applicable to a future regulatory program “unless they believed such a program was coming?”

The U.S. Government cannot issue or certify transferable credits without confirming the opinion, tirelessly asserted by Kyoto supporters, that some form of carbon regulation is “inevitable.” Anticipating such constraints, many companies will make plans to switch from coal to natural gas. That, in turn, will put additional pressure on already tight natural gas supplies, further driving up natural gas prices.

(5) Transferable Credits Are Incompatible with the Emissions Intensity Focus of S. 388 and the President’s Climate Policy

History amply demonstrates that economies can grow while reducing emissions intensity (emissions per unit of GDP). Accordingly, both President Bush and S. 388 seek to replace Kyoto’s emission tonnage reduction targets, which are inimical to growth, with emissions intensity reduction goals, which can accommodate growth.

However, to be applicable to a future cap-and-trade program, credits would have to be awarded for tonnage reductions. Consequently, the scheme would ratify rather than replace the Kyoto framework. More critically, an emissions intensity goal provides no alternative to cap-and-trade policies if it is coupled with a crediting plan that fuels pro-Kyoto lobbying.

III. Giving Special Interests another Bite at the Apple

Some 80 organizations and individuals submitted comments to DOE during the first comment period (May 6-June 5, 2002) on the President’s directive to “enhance” the VRGGP. Many companies and trade associations pushed for accounting rules that would allow them to game reporting requirements for PR or competitive advantage. CEI’s review of these comments revealed a pervasive pattern: Companies sought windfall profits for “anyway” tons: credits for doing (or not doing) what they would do (or not do) anyway for purely economic reasons. Some also wanted credits for emission reductions due to business decisions taken before global warming became a public concern. A few examples:

- Aluminum companies wanted credits because they recycle aluminum for a living (recycling “avoids” emissions because it is less energy intensive—and also cheaper—than using virgin metal). They also wanted the government to credit them (not automakers or auto buyers) for the emissions “avoided” when cars built with aluminum rather than heavier steel components get more miles to the gallon and, thus, emit fewer grams of CO₂ per mile.
- Waste-to-energy (WTE) companies wanted credits because they burn trash for a living (trash combustion “avoids” methane emissions from decomposing landfills). One such company, Covanta, argued that WTE companies should get credits for burning trash as far back as

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1974, i.e., when some scientists were worried about global cooling and the onset of a new Ice Age.

- ISG Resources, Inc. wanted credits because it sells coal combustion products for a living (when fly ash is used to make concrete, it can substitute for cement and, thus, “displaces” CO₂ emissions that might otherwise be produced by cement makers).
- Forest and paper companies wanted credits because they grow trees and burn wood for a living (trees “sequester” carbon and using wood as bio-fuel reduces the company’s demand for electricity generated from more carbon-intensive fuels like coal).
- Utilities producing electricity from nuclear power wanted credits because they split atoms for a living.
- American Electric Power, Cinergy, and Detroit Edison wanted a “default rule” that awards credits to them when a manufacturer causes a reduction in their emissions by investing in a combined heat and power plant.

Commendably, DOE not only abandoned its initial plan to transform the VRGGP into a credit program, it also set rigorous standards for companies seeking to register emissions reductions.

DOE’s rule: (a) does not allow large emitters to register reductions unless they undertake an entity-wide inventory and demonstrate net emission reductions; (b) does not allow large emitters to register project-level reductions; (c) does not allow companies to register reductions made prior to 2002; (d) does not allow utilities to register reductions caused by a manufacturer’s investment in combined heat and power; and (e) requires U.S. multilaterals to identify whether any reported reductions outside the U.S. were “credited or required under the greenhouse gas programs of other countries.”

The significance of these requirements is as follows: (a) and (b) will discourage “cherry-picking” (reporting project-level reductions while overall emissions increase); (c) will prevent baseline manipulation for competitive or PR advantage; (d) puts the kibosh on AEP and Cinergy’s attempt to cash in on manufacturers’ investments; and (e) will prevent U.S. firms from counting as voluntary reductions cuts made pursuant to foreign legal or regulatory requirements.

Section 1612’s provisions directing DOE to establish an emissions registry and issue guidelines are at best unnecessary and disruptive. Over the past three years, DOE and scores of stakeholders have spent thousands of hours revising the 1605(b) emissions registry and its guidelines. DOE’s revisions are now part of the Code of Federal Regulations, so there is no need for Congress to add anything legislatively. Redoing DOE’s careful work would delay a process that has already run much longer than anyone originally anticipated, and put the results of that process in doubt.

Worse, Section 1612’s registry provisions would give special interests another bite at the apple. The same organizations that tried and failed to bend the process to their advantage would be able to lobby Congress to undo DOE’s good work.

**IV. Conclusion**

Transferable credits may seem benign at first glance—a “market-based” program to reward “voluntary” efforts to “save the planet.” In reality, transferable credits are a strategy to build the accounting framework and corporate clientele for Kyoto-style cap-and-trade programs. Although touted as “voluntary” and “win-win,” transferable credits would create a coercive zero-sum game in which one company’s gain is another’s loss. By expanding the ranks of energy-rationing profiteers, transferable credits would thoroughly corrupt the politics of energy policy.

Senator Chuck Hagel and Senator Larry Craig, the two principal sponsors of S. 388, cannot possibly want to shift the political balance of power in favor of Kyoto-type policies. Indeed, a
transferable credit program would directly imperil Senator Hagel’s great legislative achievement, the Byrd-Hagel resolution. CEI is therefore hopeful that, once those Senators understand the perilous repercussions of a transferable credit program, they will drop Section 1612 from S. 388.

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