

CLIMATE: CRA's David Montgomery talks economics of Calif. policy, says safety valve positive tool (Tuesday, June 19, 2007)

As California leads the way in the creation of emissions reduction policies, the economic effects of these standards still remain uncertain. During today's OnPoint, David Montgomery, vice president of CRA International and co-head of CRA's Energy and Environment Practice, discusses a new report focusing on the economic implications of California's climate policies. Montgomery compares his report to the findings of other major economic reports including the IPCC, Stern and MIT reports. He says a safety valve approach will be positive to managing costs and says it is important that the rest of the United States learn from California.

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Monica Trauzzi: Welcome to OnPoint. I'm Monica Trauzzi. Joining me today is David Montgomery, vice president of CRA International and co-head of CRA's energy and environment practice. David is also a former deputy assistant secretary for policy at the Department of Energy. David thanks coming back on the show.

David Montgomery: You're quite welcome, delighted to be here.

Monica Trauzzi: David, you're the lead author of a new report that focuses on the economic implications of California's climate initiatives. And it basically analyzes the economy-wide impacts of specific climate policies. We'll get into the specifics in a moment, but I first wanted to start off with a basic headline of the report. Can California successfully implement climate policies without suffering economically?

David Montgomery: No. That's one of the main conclusions of the report. Contrary to some comments when these goals were first announced, it will cost California something to meet the targets. How much it costs is going to depend very much on how California designs its policies. Some policies could substantially increase the cost and produce really serious harm. Other policies could considerably reduce those costs to the economy.

Monica Trauzzi: So what are the six different scenarios that you analyzed in the report?

David Montgomery: What we looked at in the report were a range of scenarios that started with what we called a pure trade case, which was a comprehensive

market-based cap and trade system used by itself to meet the caps in California. And then from that, we worked through several different possibilities to try to explore such questions as what happens if costs are higher than anticipated by California? What would be the benefits of a safety valve approach like we see in the Bingaman proposals to limit costs? How would efforts to layer on regulatory programs, which has been proposed by numerous parts of the California Legislature, as ways to implement the program, how much more would it cost and what would be the potential unintended consequences of adding these kinds of regulatory programs? And then we tried to look at the biggest issues in California, which is how can they can achieve their ambition of managing the emissions associated with imports of electricity into California? Even the sovereign State of California cannot control directly what happens outside its borders and some very strange consequences could come about from the ways they're thinking about trying to manage those emissions.

Monica Trauzzi: And let's talk about that more specifically. It's called leakage from other states surrounding California. How could this interfere with their overall goals more specifically?

David Montgomery: Specifically the biggest problem is one that's become called contract shuffling, that there is right now a great deal of hydropower and nuclear power that's being generated in the West. California, at this point, imports a substantial share of its electricity. A good bit of it comes from coal-fired power plants that are either owned, for example by the LA DWP, or that supply the electricity under contract to California. The simplest thing to do, if you are under the kind of regulation that California is developing, is to get rid of all your contracts at the coal-fired power plants. Let them supply electricity to other parts of the West and buy up all the existing contracts for hydro and nuclear power. Thereby, it will look like the importer has reduced emissions to zero, hasn't actually changed anything that's being generated in the West, but it's gotten credit for a substantial reduction in emissions that means that is not going to occur inside California.

Monica Trauzzi: So, if California's plan spreads to other states in the West how do they handle that then?

David Montgomery: A uniform cap and trade system that covered everything west of the Rockies, which is a pretty ambitious aspiration, would take care of the problem, because the problem is that California cannot control emissions at the source the way a cap and trade program normally does. California can only try to tell its electric utilities how they should buy electricity. So it's much like the problem the United States has with leakage to China. We can't control what China does if we try to limit our emissions. California can't control what Arizona and New Mexico and Wyoming do. But if there were a comprehensive cap and trade program that measured the emissions at each of the power plants then you wouldn't have this kind of a problem.

Monica Trauzzi: The report shows that as time goes on it gets more costly to maintain emission reductions. Why does that happen?

David Montgomery: It's because the pace of economic growth and the way that drives the need for energy is outpacing even pretty optimistic assumptions about how technology can progress in order to make it cheaper to reduce emissions in the future. And California's goal is to reduce emissions to 80 percent below 1990 levels by 2050. That's very close to zero. And you just run out of technology options with anything that's available today for electricity generation or transportation long before you get down that far. So it's necessary to basically drive prices up high enough to force enough energy conservation to get emissions down there. Because the technology solutions just don't exist yet.

Monica Trauzzi: So how do the findings in this report compare to some of the other major reports we've seen, the Stern Report, MIT, IPCC? They've all gotten a lot of attention. How does your report compare?

David Montgomery: I think if you look at those reports we're coming to very similar conclusions. There are differences in estimates of economic costs, but there's no question, the Stern report, all of MIT's work, and, really, I think the main message that comes out of the IPCC is that it's going to cost something to limit emissions. There are differences in conclusions about how much it's going to cost based on assumptions about mainly how rapidly technology is going to develop. But they all agree that there's going to be a cost.

Monica Trauzzi: You mentioned Senator Bingaman and his safety valve earlier. And in the report you say that establishing a safety valve reduces the economic uncertainty associated with a market-based cap and trade system. Explain why it would be a positive, because this is something that's very controversial on Capitol Hill.

David Montgomery: Yes. I think to really think about a safety valve you need to get back to what the climate problem really is. The climate problem is global average temperatures, global temperatures which are affected by the concentrations of greenhouse gases in the atmosphere which accumulate over not just decades, but hundreds of years. It really doesn't matter for climate policy whether we hit a specific cap this year or 10 percent above it or 20 percent below it. What matters is the average over a long period of time. You can aim for that average pretty accurately if you send a price signal. You don't need to force emissions to stay below some hard cap every year and never deviate. If you try to do that you're going to get immense and unnecessary instability and variability in the price of carbon permits and that translates into potentially large economic losses. The idea of a safety valve is you cut that off by saying that there is a price that we think it's appropriate to pay at different points in the future for reducing emissions. And we're going to manage the carbon price to stay below that level. You may have to adjust that level over time in order to aim for the amount of

emission reductions you want, but there's absolutely no need to have a hard cap every year to deal with this very long-term problem.

Monica Trauzzi: Why is the use of models beneficial in comparing the effects of varying climate policies?

David Montgomery: The use of models is beneficial because sometimes the effects of the policies are very complicated and just hard to work out. For this particular study we felt we needed to take a very detailed model of the electric power sector in the West because some of the most important issues about designing California's policies had to do with this question of how you're going to deal with imports. You can't answer that from first principles. You need to look at how behavior is going to change, what the possible unintended consequences of the policies are, you have to add up how much existing hydro and wind and nuclear power is out there to see to what extent that can cause leakage and frustrate the goals. So it's just complicated and the models are a way to think through the complications.

Monica Trauzzi: What does this all mean for our national climate policy? Can we sort of extrapolate your findings in this report on the national level?

David Montgomery: I think there are a couple of findings that apply generally. One of them is the ability of a safety valve to reduce and manage the costs of climate policies. The second one certainly is that a broad-based, market-based approach is going to be very much less expensive than an attempt to use command and control regulations and directives to achieve climate policies. But I think the other thing it suggests is that California sees itself as an experiment that the rest of the United States can learn from. And I think the other thing our report suggests is that there's a potential that we will learn from some rather big mistakes that California might make if it pursues some of the directions it seems to be going in, as well as learning what can work well.

Monica Trauzzi: So should the rest of the U.S. be waiting to see what happens in California?

David Montgomery: I think what happens in California's going to be really important and the direction that California takes is really going to matter. That if California embarks on one of the approaches that does have unintended consequences, produces perverse results in Western energy markets, it could find itself, for example, recreating the California energy crisis of 2000. That could really set back policymaking at every level, so it's really important I think for everyone that California gets it right. But there are also definitely going to be lessons to be learned if California takes a different approach.

Monica Trauzzi: So, taking a look at all the climate policies that we've seen proposed on the Hill thus far, which do you think falls in line best with the

findings of your report?

David Montgomery: Well, the findings of our report have really been trying to look at how you can design policies in order to avoid unnecessary costs. There's a choice there, and we've tried to describe it in sort of a curve, which shows what's the policy that gets you the emission reductions you want at least cost? Well, a policy that has a broad-based economic incentive, either a cap and trade system or a uniform carbon tax that covers all sources of emissions and is relied on exclusively, without layering on other regulations like a renewable portfolio standard, gets you those emission reductions at least cost. And then you have to choose how much you want to do. For example, California needs ultimately to choose whether it wants to stick with the target of holding emissions to 1990 levels or go to 50 percent below or go to 80 percent below? We look at those, if you decide on a more ambitious target it's going to cost you more, but it buys you more. So that's kind of the choice between a Bingaman type approach and a Sanders-Boxer approach. One is going to buy more. It's going to cost a lot more. But as far as design goes, I think the study clearly shows that uniform market-based policies and safety valves can significantly reduce the cost compared to any other way of doing things.

Monica Trauzzi: All right. This is a very interesting topic and we'll be watching it. Thanks for coming on the show.

David Montgomery: Thank you. You're welcome.

Monica Trauzzi: This is OnPoint. I'm Monica Trauzzi. Thanks for watching.

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