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• Comments:



COMPETITIVE ENTERPRISE INSTITUTE

December 20, 2002

Fred L. Smith, Jr.
President

Mr. James Connaughton
Chairman
Council on Environmental Quality
722 Jackson Place, N.W.
Washington, DC 20503

Dear Jim:

Thank you and your staff for providing us at CEI the opportunity to exchange views on environmental policy. We do seem to agree on several important matters:

- *Environmental Federalism:* States should have more power to set environmental policy within their borders (although not to restrict consumer choice in other states, as California's CO₂ law would do);
- *Agricultural Biotech:* This most promising technology is good for both people and the planet;
- *Egalitarian Focus:* All environmental policy initiatives should in part be supported or opposed based upon their effects on the poor (at home and abroad). Wealthier is *cleaner* as well as healthier!
- *Risk/Risk Tradeoffs rather than the Precautionary Principle:* Current environmental policy presumes that new products and technologies are inherently more risky than the status quo. However, risk taking and innovation are essential to social, economic, and environmental progress. The "inherently safer" chemicals legislation would further entrench the precautionary approach.
- *Senator Inhofe's Chairmanship of the Senate Environment and Public Works Committee:* Senator Inhofe's chairmanship offers the best hope in decades for reforming the EPA, for asking basic questions about the direction and nature of current environmental policy.

On the other hand, our views seem to differ on several other critical issues:

- *Awarding "transferable credits" for "voluntary" greenhouse gas (GHG) reductions (see below).*

- *Failing to renounce the U.S. signature on Kyoto:* We are dismayed that the Administration has so far failed to "un-sign" Kyoto, as it did the Rome Treaty that created the International Criminal Court. Remaining a Kyoto signatory, coupled with publication of an alarmist Climate Action Report, increases the likelihood that: (1) the United States will face eco-dumping charges under WTO rules; (2) agencies will have to consider "climate impact" under NEPA; and (3) U.S. companies will be liable for damages under the Alien Tort Claims Act.
- *Proposing sweeping Clean Air Act reforms before educating the public:* The Administration seems determined to promote some variant of Clear Skies as a *replacement* for current regulatory policies. This may or may not be a good idea, but the Administration has made little effort so far to popularize the case for Clean Air Act reform. Green groups typically condemn any regulatory modernization as "gutting" and "rollback"; they shape public opinion on environmental issues; and they will use votes on the floors of the Senate and House to portray the Administration as anti-environmental. If we're to change that reality, we must spend the time needed to inform the debate. It is an uncomfortable truth that, unless some crisis forces quick action, enacting major controversial legislation almost always requires sustained effort through several Congresses.

Further discussion might broaden the areas of agreement, but let me touch now upon a few problems we see with the direction CEQ is taking.

I think you acknowledge the legitimacy of our concern that GHG credits will foster the growth of a powerful rent-seeking lobby for Kyoto-style energy rationing schemes. Such credits will have value, after all, only to the extent that policymakers establish a binding carbon cap. Coupon holders will thus lobby fiercely to make "voluntary" programs "mandatory." Yet you assure us (time did not permit a fuller explanation) that safeguards will be adopted to minimize the value such credits would have under a cap. We find this difficult to believe.

Capping carbon will create another iron triangle of government bureaucrats, members of Congress, and industry clients. The interest-group beneficiaries will lobby to capture the program and exploit it for competitive advantage. This happened with peanut quotas, old/new gas production, and oil import quotas. Can you name a single counter example?

The idea that you can build in safeguards against profiteering under a cap is not credible for an even more basic reason. If the credits the Administration plans to award will not be valuable as regulatory offsets under a future Kyoto-type regime, then what is the point of the whole exercise? Why should American Electric Power, Cinergy, Dupont, BP, NEI and other early credit advocates help CEQ build a crediting system, if there is no money to be made under a cap? Why should other companies sign on if the credits won't be valuable enough to provide significant "baseline protection"?

To allay our concern that the Administration is inadvertently mobilizing pro-Kyoto lobbying, you also suggest that environmentalists may decide to buy up and retire the credits, reducing Kyoto's profit potential for early reducers. First, CEI does not view large-scale credit retirement as a realistic scenario. Carbon credits are cheap now, because there is no cap. Conceivably, environmental groups could afford to buy large quantities of credits at current prices. But why would corporate credit holders want to sell credits at today's low prices? They are more likely to wait until there is a cap, and then sell the credits at much higher prices.

Second, if environmental groups do somehow buy up and retire lots of credits, that means fewer emission allowances will be available to U.S. firms under Kyoto or a similar domestic regime. Thus, once a cap is imposed, the costs of compliance will be greater. What then happens to U.S. Government assurances of "baseline protection"? Do we really want an America in which businesses seeking to grow must purchase expansion rights from a cartel of anti-growth advocacy groups?

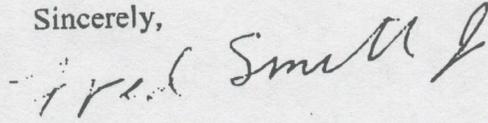
Finally, I want to reiterate our conviction that the Administration has no authority under section 1605(b) of the 1992 Energy Policy Act to transform the Voluntary Reporting of Greenhouse Gases Program into a crediting scheme. We think the Administration should forthrightly address the issue of its legal authority before taking further steps to implement credits. This is a simple requirement of good (transparent and accountable) governance.

If I am not mistaken, you think the Administration is wise to defer discussion of the legal issue, because raising it now would only encourage some members of Congress to reintroduce credit for early reduction legislation. We are confused by this argument. Why would you not want Congress to grant specific statutory authority for what you want to do? Perhaps I misunderstood your point, but in any event, CEI is prepared to run the risk that some legislators may try to supply the authority the Administration now lacks. As you may recall, Senators Chafee (R-RI) and Lieberman (D-CT) introduced early credit legislation in the 105th and 106th Congresses. Chafee-Lieberman mustered only 12 co-sponsors on its second go-round. Rick Lazio's (R-NY) House companion bill attracted just 15 co-sponsors. Neither bill ever came to a vote in committee, much less on the House or Senate floor. We've beaten it in the past, and we can beat it again.

In conclusion, we have several questions about the Administration's transferable credit initiative. First, does the Administration intend to take steps to minimize the value transferable credits would have under a future Kyoto-type policy? If so, has the Administration made that objective clear to the multitude of companies participating in ongoing discussions about how to "enhance" the 1605(b) program? Second, does the Administration intend to encourage environmental groups to buy up and retire credits awarded under the "enhanced" 1605(b) program? If so, how will large-scale credit retirement affect the U.S. Government's ability to provide "baseline protection"? Last, does the Administration believe it has statutory authority to award GHG credits? If so, what are the relevant provisions in current law?

I would very much appreciate your thoughts on the foregoing questions. I do appreciate your taking the time to meet with us. I would be even happier if we were more in agreement.

Sincerely,

A handwritten signature in cursive script that reads "Fred L. Smith, Jr." The signature is written in dark ink and is positioned to the right of the word "Sincerely,".

Fred L. Smith, Jr.
President

FLS/ml