Focus On: Cap and Trade Terminology

Learning the Lingo

Like any field, cap and trade has its own terminology. The following discussion provides a high level explanation of the most common terms.

Once a limit on emissions (the **cap)** is set, the **emission allowances** must be allocated. Allowances are permits that entitle the holder to emit a specified quantity of carbon dioxide equivalent (one allowance equals one ton). **Allocation** is the process by which emissions allowances are initially distributed. For example, if the cap were set at 100 metric tons, then a total of 100 allowances would be made available to the market (**allocated**) in some fashion, either through free distribution or by an auction.

Allowances can be allocated for free using three methods: 1) based on historical emission levels (**grandfathering**); 2) by setting of the level of permitted emissions per unit of input or output (**benchmarking**), or; 3) in the electrical sector, based on the energy consumption of the customers served (**load-based**).

A **baseline** value, calculated from either past or projected emissions or consumption data, is used to determine the number of allowances available as well the level of reductions achieved.

Allowances may also be **auctioned**; that is, sold to the highest bidder.

The **point of regulation** (also sometimes called **point of compliance**) refers to which entities will be required to hold allowances. The point of regulation does not need to be the emitter, but could be the entities responsible for energy consumption or those that supply or distribute fossil fuel. In a **source-based** or **downstream** system, the point of regulation is generally the same as the point of emission. In an **upstream system,** the point of regulation is the point of entry of fossil fuels into commerce within a jurisdiction covered by the cap and trade program.

MORE INFORMATION

Visit the State's Climate Change web site:
www.ecy.wa.gov/climatechange/index.htm

Focus On: Cap and Trade
www.ecy.wa.gov/pubs/0701036.pdf

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The **compliance period** is the time frame for which entities must submit sufficient allowances equivalent to their emissions during that period. This submission is called a **true-up**. Reporting periods may be shorter than compliance periods. For example, the reporting period may be annual but the compliance period may be three years.

Banking allows entities to hold more allowances than they need to cover their emissions in one compliance period and use these allowances in future compliance periods to cover emissions.

Borrowing allows entities to apply allowances from a future compliance period in the current compliance period. Borrowing may involve a penalty such as a requirement to surrender extra allowances or pay a fee.

After the initial distribution of allowances, entities covered by the cap and trade program that can make reductions may sell (**trade**) their excess allowances to entities that have not been able to make reductions or for whom the cost of those reductions are higher than the market price of the allowances. If allowances are scarce, the market will push the price higher. If allowances are plentiful, the market will push the price down. A **price cap** is a legally enforceable maximum allowance price. A **price floor** is a legally enforceable minimum price.

Linking or **linkage** is when entities covered under a cap and trade program are allowed to buy allowances or offsets from another jurisdiction's cap and trade program. Linking is a way to expand the market and potentially lower costs.

Offsets are an alternative compliance mechanism where emission reductions are made by sources not included in the cap and trade program. An offset must result in an emission reduction outside of the cap. These reductions must be **additional**, meaning over and above those that would otherwise have occurred in the absence of the project. They must also be **permanent**, the definition of which is subject to the rules that govern specific categories of offset projects. When reductions are made by an offset project, the sponsor of the project receives **carbon credits**. These credits can be sold and traded within a cap and trade program and function similar to an emissions allowance.