



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 18, 2009

RE: FOIA No. 2009-04-090

Mr. Christopher C. Horner, Esq.
Competitive Enterprise Institute
1899 L Street, N.W. – Suite 1200
Washington, DC 20036

Dear Mr. Horner:

By letter dated September 11, 2009, we provided a response to your Freedom of Information Act request dated April 30, 2009. Certain portions of the documents provided to you contained information that is privileged, deliberative, and pre-decisional, including financial estimates available in the public domain that were collected and summarized by Treasury staff, along with preliminary assessments and recommendations. This information was provided to new and incoming senior Treasury officials during the presidential transition to assist in their decision-making. Because those portions of the documents do not reflect the official views of the Treasury Department and are exempt from disclosure under FOIA's Exemption Five, Treasury officials opted to redact these portions.

In the interest of promoting transparency, however, Treasury has now decided, in its discretion, to release the exempted portions of these documents. Attached are the un-redacted versions of the released documents.

All numerical estimates contained in these documents were based on Treasury staff review of prior publicly available analyses; no independent Treasury analysis underlies these estimates.

This is a final response to your request. Should you decide to appeal this response, you must do so within 35 days of the date of this letter. Your appeal must be in writing, signed by you, and should reason(s) why you believe an adequate search was not conducted. Your appeal should be addressed to:

Department of Treasury
Freedom of Information Act Appeal
Disclosure Services, DO
Room 6200 Annex
Washington, DC 20220

No fees were incurred in processing your request.

Sincerely,

Jennifer Beasley
Senior Director, International Affairs Business Office

Attachments

Topic: Domestic Climate Policy

Overview: In his February 24, 2009 Joint Session address, President Obama called for a greenhouse gas cap-and-trade program, underscoring his commitment to domestic climate policy. While such a program can yield environmental benefits that justify its costs, it will raise energy prices and impose annual costs on the order of tens (and potentially hundreds) of billions of dollars. At the same time, given the Administration's proposal to auction all emission allowances, a cap-and-trade program could generate federal receipts on the order of \$100 to \$200 billion annually. Finally, by encouraging investments in clean energy sources, climate policy could increase the fiscal cost of existing energy tax provisions, such as renewable electricity and biofuel tax credits. All of this argues for strong Treasury involvement.

Treasury's Role in Policy Development: Treasury is currently involved in the development of domestic energy and climate policy through two channels. First, in early February, the White House Office of Energy and Climate Change established an interagency domestic policy working group. The group initially focused on developing policy principles that were reflected in the President's Joint Session address and budget. The group will turn next to developing more detailed positions on policy design. Second, Treasury has worked directly with the National Economic Council (NEC), the Council of Economic Advisers (CEA), and other agencies on analyses relevant to policy deliberations. For example, together with NEC and CEA, Treasury produced a memo informing deliberations over a national renewable electricity standard.

Policy Priorities: Treasury is focused on those elements of domestic climate and energy policy that have significant implications for the economy, the financial system, and the federal budget. Treasury will be primarily, but not exclusively, focused on key issues relating to the design of a cap-and-trade program, including: the use of auction revenue, measures to contain the program's potential costs, the design of environmentally sound offset provisions, the design and oversight of markets for allowance trading, and measures to address international competitiveness concerns arising from impacts on energy prices. Examples of other economically significant policies that Treasury will be concerned with include renewable electricity and fuel standards.

Outlook: With White House staff increasingly turning their attention to domestic climate policy and the accelerating pace of activity in Congress, Treasury's involvement in domestic policy deliberations will increase considerably in the coming months.

Key Challenges: One key challenge in developing domestic climate policy involves balancing the desire to minimize climate policy's nationwide cost with concerns about mitigating disproportionate impacts on particular populations and industries. Substantial thought will also be required to address concerns about cost uncertainty and international competitiveness in ways that are economically effective and sensitive to sometimes-competing stakeholder concerns. In addition, it will be important to evaluate climate and energy policies holistically to avoid conflicting, distortionary, or redundant overlaps among policies. Finally, domestic policy development must always be informed by and consistent with our international policy objectives.

Prepared by: Judson Jaffe, 622-7751

Deputate: IL/ILE (Environment & Energy)

Domestic Climate Change Policy transition memo
Draft 2, 11/6/08

Growing political momentum around the issue of climate change raises the likelihood that the U.S. will enact a policy in the near term. Economic costs will likely be on the order of 1% of GDP, making them equal in scale to all existing environmental regulation. Treasury plans to engage in the policy discussion to ensure these resources are spent wisely through good design. This memo briefly discusses five aspects of a climate policy with potentially significant economic implications. They include market-based instruments, policy stringency, coverage, allocation and revenue, and competitiveness. Each area includes plausible options that influence environmental outcomes, administrative burdens, and costs.

Market-based instruments

The U.S. intends to center its policy around a market-based mechanism that minimizes costs to the economy. Two such mechanisms are a *carbon tax* and a *cap and trade* system. Both can generate least-cost abatement of greenhouse gas emissions by pricing carbon – either at a fixed tax rate or a variable market price of emission allowances. Firms and consumers consider this price signal when they choose to reduce emissions, pursuing only those reductions that cost less than the price and thereby reducing emissions in an efficient manner.

Key differences between the two approaches have blurred, as cap and trade programs now tend to auction allowances and include mechanisms to manage prices, neutralizing the historic differences in revenue and focus on price (under a tax) versus emissions (under a cap). Nonetheless, the history of conventional pollution regulation in the U.S., as well as more recent greenhouse gas regulation abroad, have leaned heavily towards cap and trade, creating a strong predisposition to this approach. Meanwhile, the (at least apparent) simplicity of a tax approach remains attractive.

Policy stringency

Stringency is the degree to which a policy constrains carbon emissions (i.e., the size of the cap in a cap and trade system). Addressing climate change effectively requires that stringency discussions be informed by climate science. Science provides our best understanding of the quantity of greenhouse gas emissions consistent with avoiding dangerous climate change impacts. If domestic policy is to support the goals of the UNFCCC, its stringency should be aligned with the emissions guideposts put forth by the scientific community.

Generally, stricter emissions constraints generate greater environmental benefits and impose higher costs. These tradeoffs are well-known; however, cost estimates are imprecise, as models provide a wide range of results, e.g., GDP loss estimates in 2050 from implementation of the Lieberman-Warner bill vary by a factor of nearly four depending on the model. The central point is that the cost of climate policy is highly sensitive to its design. Policy should pursue efficient design and appropriate stringency and coverage to minimize costs to the economy.

Climate policy coverage

The breadth of coverage refers to which economic sectors are included within a policy. Generally, broader coverage includes more mitigation opportunities and lower marginal abatement costs. When coverage is narrow, exempted sectors of the economy have no incentive to reduce emissions and therefore remain inefficient, while covered sectors face deeper reductions and higher costs than would have been the case had coverage been broader. A phased-in approach to coverage could smooth the transition to an economy-wide climate policy, beginning with sector(s) with greater capacity and readiness, e.g., electricity generation.

Allocation and revenue

Emissions allowances under a cap and trade system are valuable assets regardless of their allocation method (analogous to revenue under an equivalent tax policy). Firms favor receiving free allowances based on historic emissions as this will reduce their costs – possibly creating net profits, as witnessed in the European Trading Scheme. Environmentalists tend to prefer auctioning of allowances to provide revenue for energy efficiency, renewables, adaptation to climate impacts, or even refunds to consumers. However, either method results in efficient abatement. One advantage of auctioning allowances is the potential for generating large revenues (perhaps \$300 billion annually) that could be used to offset distortionary taxes on labor or capital, improving the economic efficiency of the tax system and reducing overall compliance costs to the economy.

Competitiveness

Some stakeholders are concerned that a climate policy will raise costs for domestic industries, putting them at a disadvantage to foreign competitors who do not face carbon regulation. This may result in loss of domestic and international market shares for U.S. companies, and relocation of U.S. firms abroad, representing both a political problem and an environmental problem. The latter, referred to as *leakage*, diminishes the effectiveness of climate policies by offsetting economic activity in emissions-constrained areas with increased activity in countries lacking such constraints.

A few U.S. energy-intensive sectors, such as the steel, aluminum, paper, chemicals, and cement industries, where imports are ready substitutes and lower carbon technologies are not widely available, are clearly vulnerable. Potential measures to address competitiveness concerns include:

- Loosening stringency of the overall climate policy
- International harmonization of climate policies
- Targeted exemptions of vulnerable subsectors from policy
- Free allocation of allowances (or carbon tax rebates) to vulnerable subsectors
- Border carbon adjustments such as requiring importers to purchase allowances

Workplan

Treasury staff are refining its views of these and other economically salient issues regarding domestic climate policy. The intended outcome of the process is to provide

informed recommendations within the interagency policy development process. Ongoing steps:

- Meetings with Congressional staff, key stakeholders, and other agency staff to gain perspective
- Reviewing policy proposals of informed stakeholders
- Developing briefs on potential elements of domestic climate policy

Topic: Treasury's New Office of Environment and Energy

Overview:

Secretary Hank Paulson created the office of Environment and Energy in August 2008 to develop, coordinate, and execute the Treasury Department's role in the domestic and international environment and energy agenda of the United States. The office has consolidated the Department's domestic and international environmental work and begun expanding its analytical capabilities to address broader economic issues related to climate and energy.

Responsibilities:

The office oversees international financial mechanisms that support global environmental goals, including the multi-billion dollar Clean Technology Fund (CTF) established at the World Bank in July, the Tropical Forest Conservation Act, and the Global Environmental Facility. It is also analyzing domestic and international policy options that a new Administration may want to consider. These include the financial architecture for an international climate policy, market design and regulation for a domestic climate policy, revenue and allocation issues, mechanisms to address competitiveness concerns, and efforts to reduce emissions from deforestation.

Justification:

Domestic policies to address climate change and the related issues of energy security and affordability will involve significant costs and potential revenues, possibly up to several percentage points of annual GDP (i.e. equal in size to the corporate income tax). Creation of a domestic cap and trade system would require management and oversight consistent with, if not stronger, than existing markets for commodities and government securities. A global deal between developed and developing countries would require international financing mechanisms capable of effectively delivering billions of dollars in support of low-carbon technology deployment, climate resilience, and avoided deforestation in exchange for developing country commitments. As the lead U.S. agency supporting economic prosperity and financial security, Treasury is uniquely positioned to provide the executive branch with informed and credible policy options to address these issues, to implement chosen options in its areas of operational responsibility, and to communicate those choices to Congress, foreign governments, international institutions, as well as stakeholders in the business community and civil society.

Coordination:

Given the broad economic impact of energy and environmental policies, the office has both domestic and international responsibilities. Within Treasury, it reports directly to the Undersecretary for International Affairs, but works closely with the Assistant Secretary for Economic Policy and, where appropriate, the Assistant Secretary for Tax Policy. Externally, it coordinates closely with the State Department (OES), Environmental Protection Agency (OAR), Department of Energy, as well as other key agencies in the executive branch.

Staff:

The office is led by Dr. William A. (Billy) Pizer, a career senior executive and the Deputy Assistant Secretary for Environment and Energy. He previously spent 12 years at the nonpartisan research organization Resources for the Future as Research Director and Senior Fellow. He has also served as Senior Economist at both the National Commission on Energy Policy and the White House Council of Economic Advisers. Pizer oversees six full-time policy and technical staff and will have a total of eight staff members by January 2009.

Prepared by: Jim Kapsis, ext. 2-0766
Deputate: IA/Environment and Energy

Topic: Treasury's Office of Environment and Energy

Overview:

Former Secretary Hank Paulson created the office of Environment and Energy in August 2008 to develop, coordinate, and execute the Treasury Department's role in the domestic and international environment and energy agenda of the United States. The office has consolidated the Department's domestic and international environmental work and begun expanding its analytical capabilities to address broader economic issues related to climate and energy.

Responsibilities:

The office oversees international financial mechanisms that support global environmental goals, including the Global Environment Facility (the financial mechanism for several multilateral environmental agreements), the multi-billion dollar Climate Investment Funds (CIF) established at the World Bank in July, and the Tropical Forest Conservation Act. It is also analyzing domestic and international policy options under consideration. These include the financial architecture for an international climate policy, market design and regulation for a domestic climate policy, revenue and allocation issues, mechanisms to address competitiveness concerns, and efforts to reduce emissions from deforestation. Treasury also engages on financing issues regarding international environmental issues, including with regard to a new mercury agreement, international discussions on chemicals issues (such as SAICAM), and forestry issues, including the issue of Reducing Emissions through Deforestation and Degradation (REDD)>

Justification:

Domestic policies to address climate change and the related issues of energy security and affordability will involve significant costs and potential revenues, possibly up to several percentage points of annual GDP (i.e. equal in size to the corporate income tax). Creation of a domestic cap and trade system would require management and oversight consistent with, if not stronger, than existing markets for commodities and government securities. A global deal between developed and developing countries would require international financing mechanisms capable of effectively delivering billions of dollars in support of low-carbon technology deployment, climate resilience, and avoided deforestation in exchange for developing country commitments. As the lead U.S. agency supporting economic prosperity and financial security, Treasury is uniquely positioned to provide the executive branch with informed and credible policy options to address these issues, to implement chosen options in its areas of operational responsibility, and to communicate those choices to Congress, foreign governments, international institutions, as well as stakeholders in the business community and civil society.

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Prepared by: Jim Kapsis, ext. 2-0766
Deputate: IA/Environment and Energy

Transition Memo

Subject: Carbon Market Oversight Issues

Overview:

Experience with carbon markets abroad (European Union Emissions Trading System – EU ETS) and environmental markets here in the U.S. (Acid Rain - SO₂ & NO_x) suggest that there will be several oversight issues that will require thoughtful planning before a carbon market is established in the U.S. The key role of oversight should be to ensure liquid, transparent markets that function with minimal intervention. Oversight should also focus on preventing manipulation or abuse of the market. Keeping that in mind the following topics should be considered:

- Role of existing institutions
- Market transparency
- Cost containment and liquidity measures
- Backstop authority

Issues:

Role of existing institutions: In the U.S. commodities and futures markets are largely regulated by the Commodity Futures Trading Commission (CFTC). The CFTC's chief focus is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets. The CFTC uses a rules based approach to ensure the health of markets. The CFTC is already involved in the SO₂ and NO_x environmental markets as well as the new regional RGGI carbon market.

To the extent that carbon securities will be traded on the securities exchanges, the SEC will have some role as well. The SEC, unlike the CFTC, uses a legal interpretation approach to ensure sound markets and protect investors. The SEC's function in a potential carbon market at a minimum would focus on ensuring the soundness of the exchanges trading carbon market products.

There may be no immediate need to create a new regulatory authority just for carbon markets in the U.S. The CFTC and SEC already have the authority needed to regulate this market. This is consistent with the experience in the EU ETS where each member government oversees the carbon markets in their own countries using their existing systems and institutions.

Market Transparency: As in all markets, transparency and information will be key elements of a successful carbon market. The regular, timely and wide release of data and information by the USG on rules, regulations, cap levels, allocation of allowances and other pertinent information under the control of the government will be a crucial element

to ensure a functioning market. Regular release of emissions data will also be critical for an efficient and transparent market.

Cost Containment and Liquidity Measures

One of the key elements to creating a successful carbon market, particularly in the initial phase, will be ensuring liquidity in the market in order to get good price discovery. In some cases this may require some market oversight or intervention.

Containing the cost that a carbon market imposes may be important for garnering public support for any climate regime in the U.S. This may also require some market oversight or intervention. Measures that have been floated in recent legislation to contain the cost of carbon include:

- Safety valve price at which the government could inject more credits into the market;
- Carbon price floor or ceiling that could be set to ensure a price that is deemed “reasonable”;
- Allowance reserve that could be withheld and later tapped into should prices go beyond a specified level;
- Offset credits, either the purchase of domestic or international offsets outside of the cap; and
- Borrowing and banking of carbon credits from future allowance periods.

Clear rules about how these measures would operate would be necessary to ensure market stability. It should also be noted that while these options might lower the price of carbon, some of them could effectively loosen the cap on emissions.

Backstop Authority

There are a variety of proposals for an institutional body that would oversee the carbon markets. They range from the idea of a “Carbon Fed” that would manage carbon allowances in a manner similar to how the Federal reserve manages the money supply-- to a more modest carbon market oversight committee that would intervene when necessary and through a wider variety of mechanisms (as in Lieberman-Warner Bill). On one hand a backstop authority might be appealing to ensure market stability in this time of financial market uncertainty, however on the other hand, the presence of a new and untested carbon market authority could actually risk destabilizing these very markets.

Workplan:

Treasury staff are refining views of the options for carbon market oversight and regulation. The intended outcome of the process is to provide informed recommendations within the interagency policy development process. Ongoing steps:

- Meetings with Congressional staff, key stakeholders, and other federal staff to gain perspective

- Meetings with potential market participants, existing market regulators, and exchanges
- Reviewing policy proposals of informed stakeholders