

# **Electricity Crisis Short-Circuits Promising Environmental Program**

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California's policymakers just can't seem to stop giving markets a bad name. First they smeared the term "deregulation" by applying it to California's unsuccessfully restructured electricity market. Now RECLAIM, southern California's pollution trading market for nitrogen oxide (NOx) emissions, is drawing fire from all sides as well. And just as with electricity, policymakers have charted a return to old-style "command-and-control" regulation. But rather than pointing up the failures of markets, RECLAIM is a lesson in how market-wary regulators and environmentalists, combined with industry lobbyists seeking political advantage, can ruin otherwise promising innovations in environmental protection.

NOx emissions contribute to the formation of ozone, a component of smog. Southern California needs to reduce emissions of nitrogen oxides and other pollutants to meet the federal ozone health standard. The market principle behind RECLAIM is a proven one: Emission reduction programs that set a declining annual cap on pollution for an area, and allow companies to trade pollution credits with one another produce cost-effective emission reductions. In the case of RECLAIM, the declining cap would reduce NOx pollution from industry by 50 percent between 1994 and 2003.

But in setting up RECLAIM, regulators made several errors. First, they let businesses start off with many more pollution credits than they needed to operate at full capacity. In attempting to be business-friendly, the South Coast Air Quality Management District (AQMD) gave out about 30 percent more pollution credits than necessary. The result was several years of paper credit reductions, a false expectation of cheap credit prices, and no real pollution cleanup. RECLAIM thus earned the ire of the Environmental Protection Agency, the California Air Resources Board, and environmentalists.

AQMD's second error was to leave itself in the position of "escape valve." Just as RECLAIM was starting to work, and credit prices were rising, another mangled program – electricity deregulation – drove permit prices through the roof and put regulators in the hot seat. With power generators buying up every pollution credit in sight to run at peak capacity, businesses accustomed to cheap pollution credits saw prices skyrocket in 2000 from a few thousand dollars per ton of NOx to tens of thousands of dollars per ton in just a few months.

But instead of rushing to install pollution controls to cash in on the power generators' voracious demand for credits – exactly the point of market-based pollution control – businesses instead petitioned AQMD for relief from the volatile trading system. And the regulators, under pressure to appear cooperative in the midst of a crisis, have now

approved a plan to remove power generators from the market and eliminate most of the flexibility and resulting savings that the market was intended to create.

RECLAIM provides hard lessons for would-be environmental innovators. RECLAIM had the appearance of a market-based approach, but the rules were written to leave the door open for regulators to step back in if credit prices got too high. This potential for a regulatory bailout probably discouraged industry from making pollution control investments to generate new credits. Issuing excess credits at the start also undermined program effectiveness. At the same time industry clamored for innovative market-based replacements of heavy-handed traditional environmental rules, industry also facilitated the demise of the very program it wanted by lobbying for excessive starting allocations and ensuring that no real reductions would occur for years.

The only bright spot in all this is that RECLAIM was never an ambitious program in the first place, so its failure won't cause much harm. RECLAIM applies only to industrial sources, which contribute only about six percent of total NOx pollution. Thus, full implementation of RECLAIM would have reduced nitrogen oxide emissions in southern California by only about three percent during the program's entire 10-year life. But due to technology and durability improvements in the cars and other mobile sources that make up 90 percent of NOx pollution, overall nitrogen oxide emissions have been dropping by about five percent *every year*. As a result of this, as well as even larger reductions in volatile organic compounds from mobile sources, southern California went from 120 ozone violations in 1994 down to 40 last year.

The troubles with RECLAIM have little to do with market failure, and much to do with regulatory failure. Distrust of markets, and gaming by interested parties leads regulators to create faux-market programs with built-in seeds of their own destruction.

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