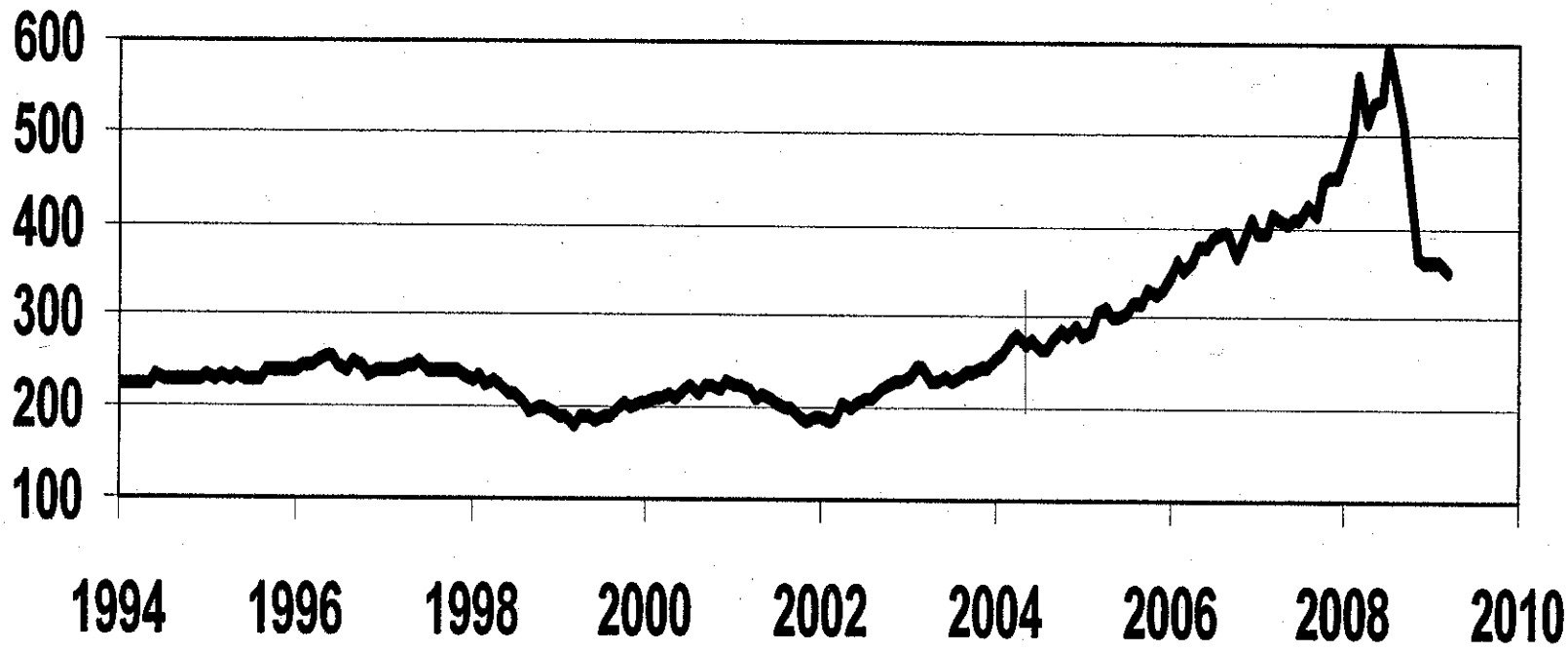
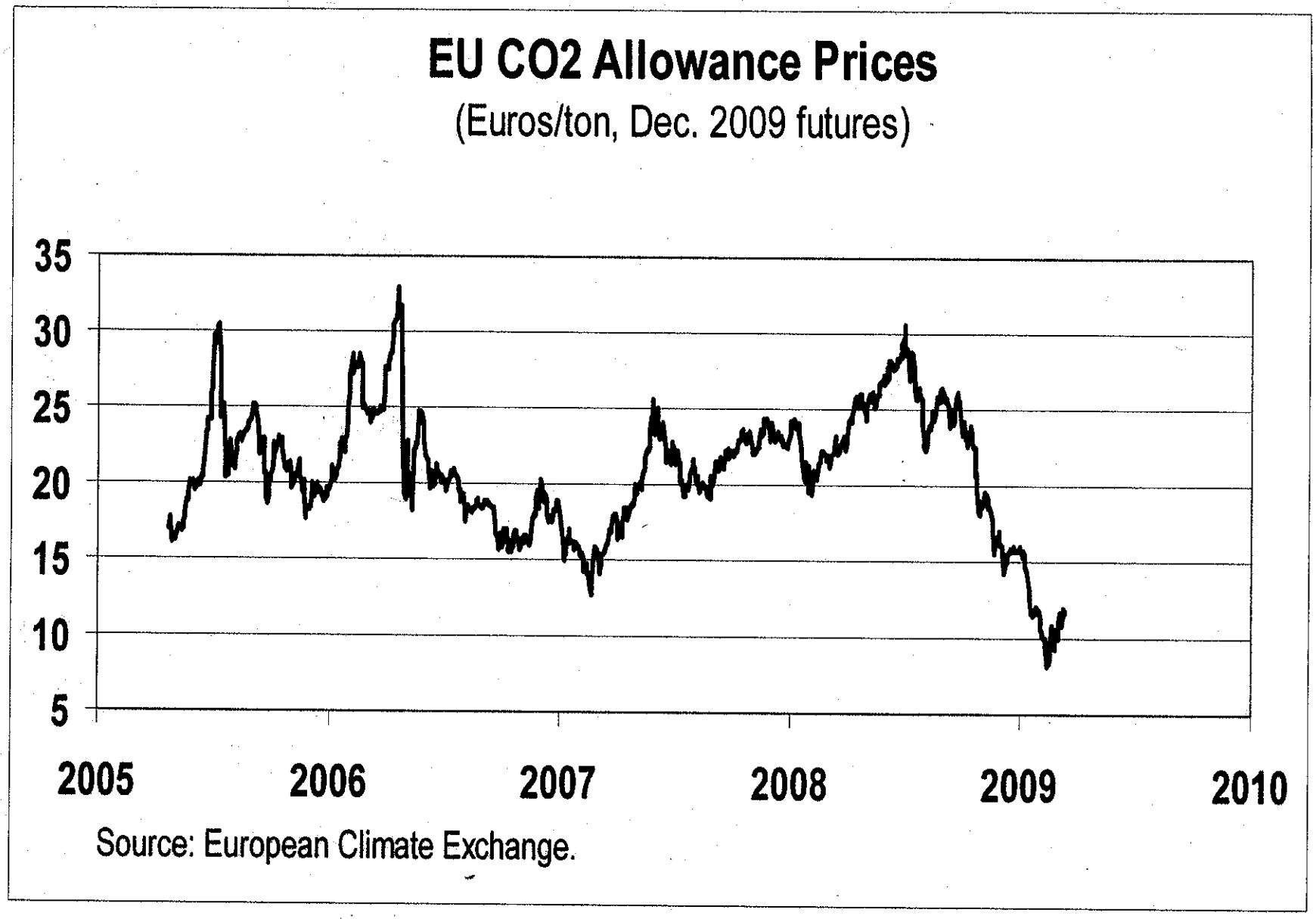
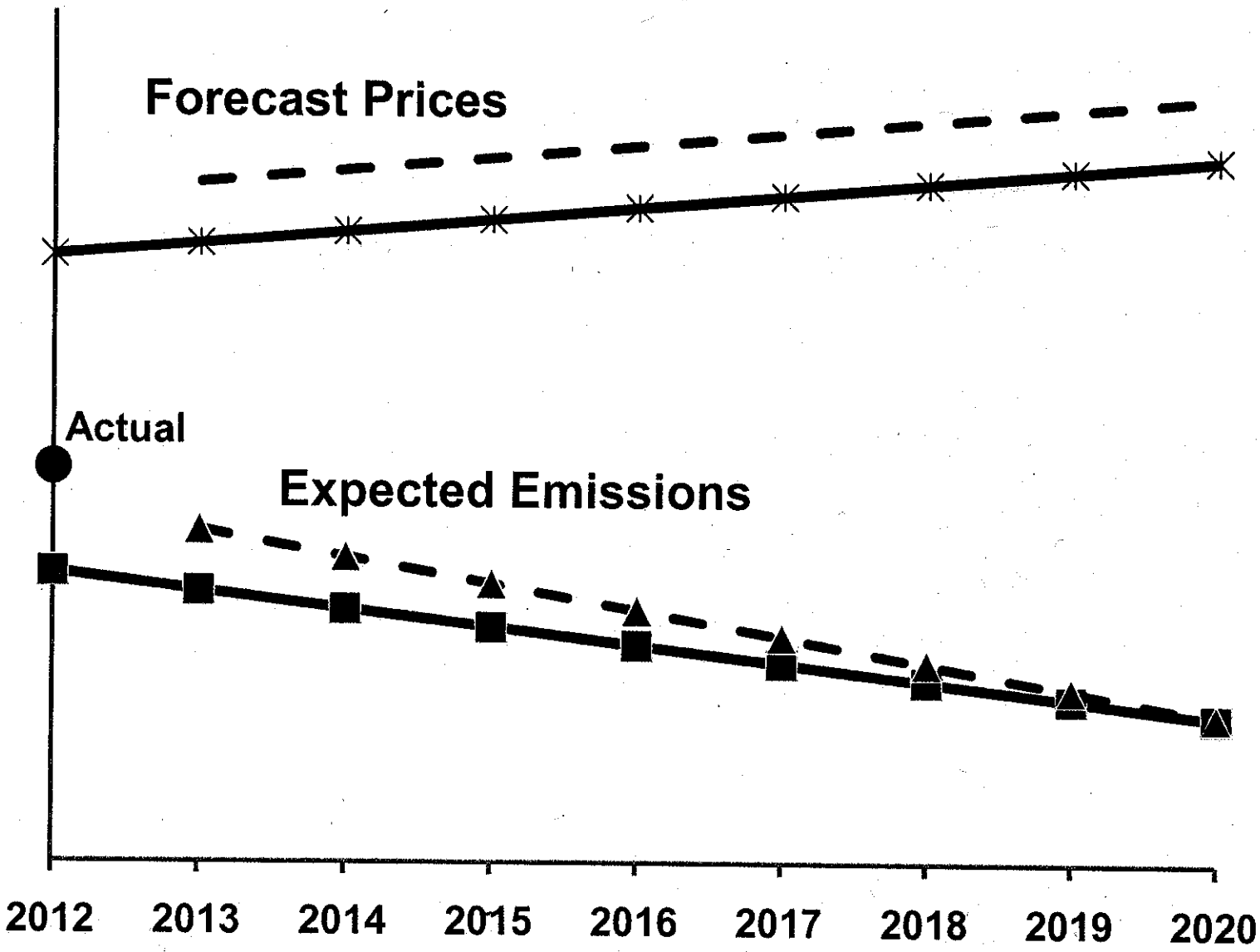
A Broad Index of Commodity Prices



Source: Reuters-Jefferies (month end CCI index)


EU CO2 Allowance Prices
(Euros/ton, Dec. 2009 futures)
35
30
25
20
15
10
5
2005
2006
2007
2008
2009
2010
Source: European Climate Exchange.

An Example of the Safe Markets Development Approach



Statement of

Gilbert E. Metcalf
Professor of Economics
Tufts University

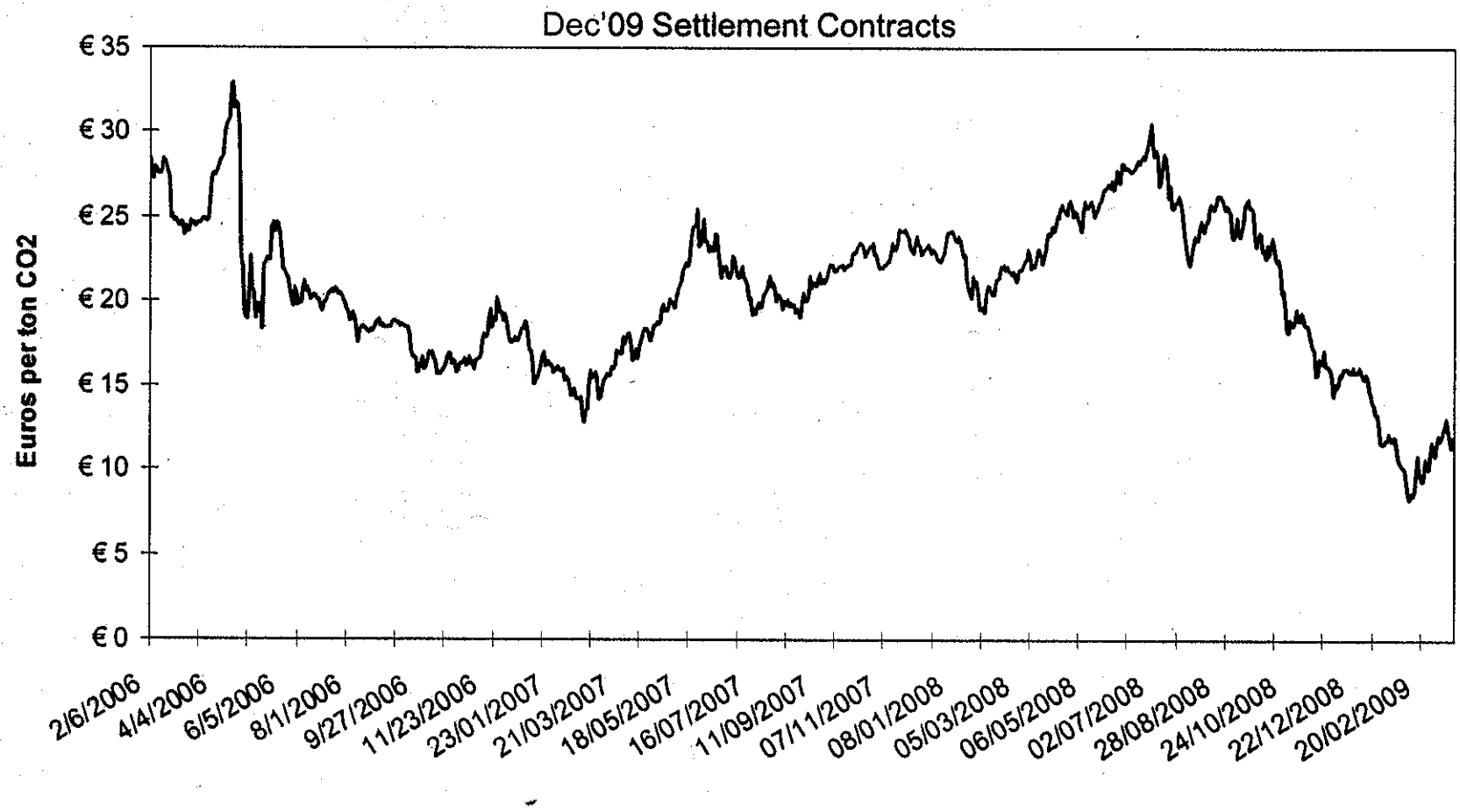
Price Volatility in Climate Change Legislation

before the
Committee on Ways and Means
U.S. House of Representatives
March 26, 2009

Key Points

- Policy should distinguish between short run and long run price uncertainty
- Carbon tax provides the greatest certainty over future price path
- Hybrid policies can bridge the difference between tax and cap-and-trade systems
- Cost containment mechanisms in cap-and-trade may have unintended consequences

Price Volatility in the EU-ETS



Source: European Climate Exchange

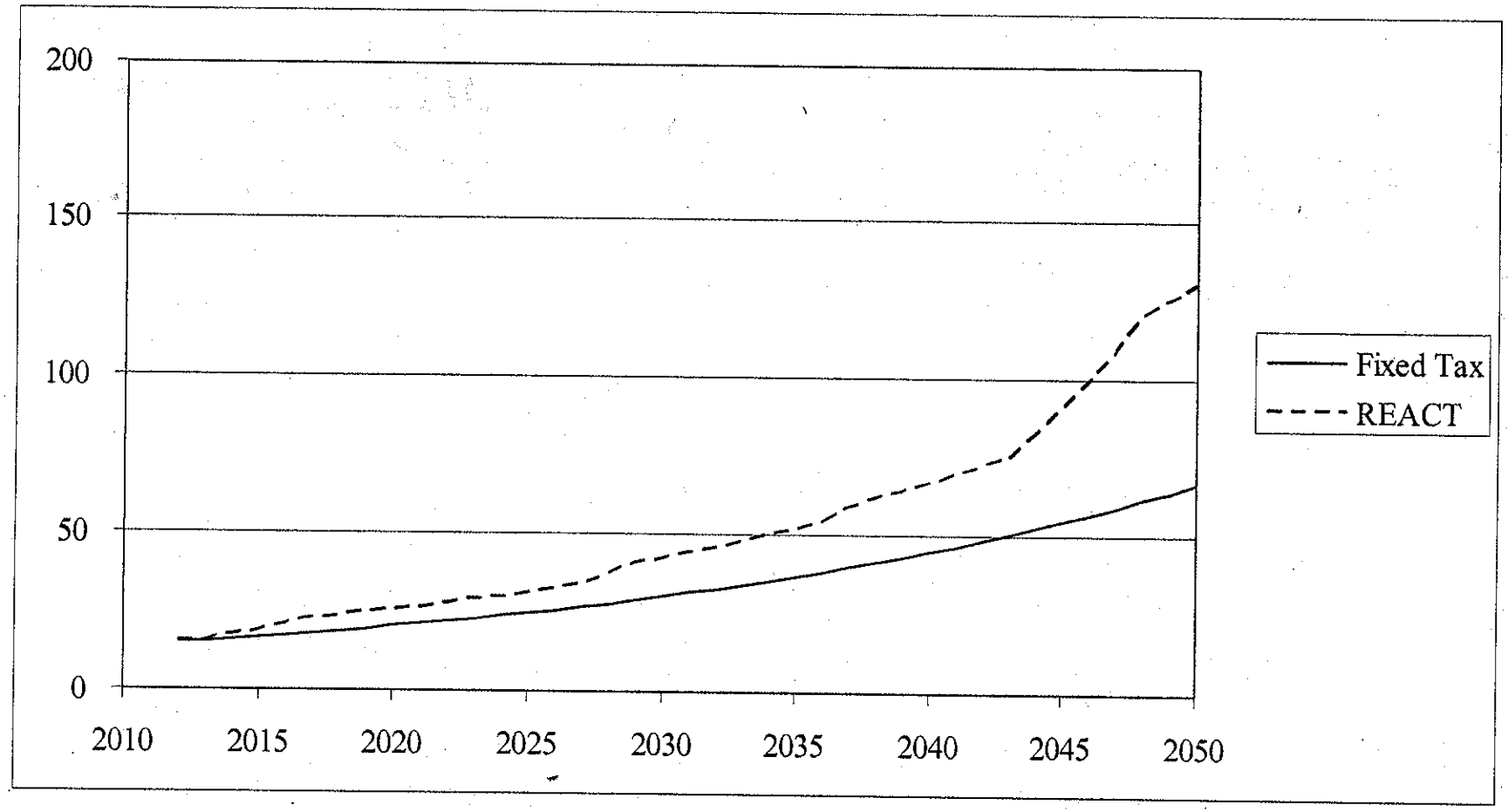
Cost Containment

- Safety valve approach is transparent
  - Potential arbitrage opportunity in anticipation of future tightening of policy
- Allowance reserve is a restricted safety valve
  - Less transparent
  - Effectiveness may be undermined by strong demand for banking

Responsive Emissions Autonomous Carbon Tax (REACT)

- An initial tax and standard growth rate for the tax
- Benchmark targets at set intervals for cumulative emissions over the control period
- Exceeding the target in benchmark years triggers an increase in the growth rate of the tax to a higher catch-up rate until cumulative emissions fall below the target again.

Sample Price Path



Benefits of REACT

- Short run price volatility eliminated
- Uncertainty over long run price path reduced
- Transparent mechanism for price changes
- Emission targets over the control period are maintained

Summary

- Policy should focus on eliminating short run price volatility
- A carbon tax provides the greatest certainty over future carbon prices
- REACT: a tax based approach that ensures long run emission targets are met