Marketable Permits

Committee on Regulation

Proposed Recommendation for Committee | April 13, 2017

Marketable permits are government-created licenses[1] or obligations for a specific level of a particular activity.[2] While many kinds of permits can be transferred together with the sale of a business or underlying assets, marketable permits are distinguishable because they can be bought or sold independently of any real property or other interest. Two main categories of marketable permits are cap-and-trade programs and credit trading programs.

In cap-and-trade programs, regulators set an absolute limit on the total amount of activity that can take place (e.g. tons of pollutant, allowable fish catch, or number of airport landing slots). Caps often set absolute limits on the total amount of regulated activity across all regulated entities. Alternatively, a cap can limit the amount of activity in which any given individual can engage (referred to as limiting the "rate" of the activity). The agency then distributes permits; common practices include auctioning the permits or allocating permits based on past levels of activity (a form of "grandfathering"). After the initial allocation, interested parties may be allowed to further trade permits.

In credit trading systems, regulators instead set a relative goal (e.g. no net emissions increase or no net loss of wetlands) and then any new entrants seeking, for example, to increase emissions or develop over wetlands must purchase offsetting credits that are sold by third parties and verified by regulators. Cap-and-trade and credit systems can be combined. For example, in a

[1] In 2015, the Administrative Conference conducted a survey and issued recommendations on the design and tailoring of permits. This recommendation, by contrast, focuses on the use of marketable permits, which primarily concern the alienability of permits and their allocation between parties. Administrative Conference of the United States, Recommendation 2015-4, Designing Federal Permitting Programs, 80 Fed. Reg. 78164 (Dec. 16, 2015), *available at* https://www.acus.gov/report/licensing-and-permitting-final-report.

[2] As there is no consistent definition of "marketable permits" across the literature, this recommendation adopts the definition as set forth by Jason Schwartz, Marketable Permits: Recommendations on Application and Management (March 15, 2017), *available at* https://www.acus.gov/sites/default/files/documents/marketable-permits-draft-report.pdf.

greenhouse gas cap-and-trade program, unregulated sources may be allowed to voluntarily reduce their emissions and sell verified credits into the market.

Evidence confirms that, in many regulatory applications, marketable permits allocate privileges and obligations more efficiently than traditional regulation by allowing the market to identify and prioritize the lowest-cost abatement opportunities or the highest value use of scarce resources. For example, the acid rain market reduced costs by as much as 90% versus alternatives without tradable permits, with savings estimated between $250 million and $1 billion annually.[3] Marketable permit programs also likely incentivize innovation better than traditional regulation by allowing parties to come up with innovative solutions.[4] For example, the trading and leasing of electromagnetic spectrum licenses has helped users develop novel arrangements, such as sharing channels and voluntarily accepting more interference than the Federal Communications Commission typically allowed in its direct licensing. Finally, marketable permits may reduce long-term administrative costs compared to traditional regulation. For example, the acid rain market famously achieved nearly 100% compliance with only about 100 EPA staff.

Many existing marketable permit programs have explicit statutory authority. Others have formed under implicit authority, which has sometimes been codified after the fact.[5] Agencies have been directed in Executive Order 12,866 to assess the advantages of regulating through

[3] H. RON CHAN ET AL., THE NET BENEFITS OF THE ACID RAIN PROGRAM 23 (2015); ROBERT STAVINS, MARKET-BASED ENVIRONMENTAL POLICIES, 7 (1998).

[4] For example, because an air pollution cap-and-trade market puts a price on emissions but does not otherwise constrain compliance strategies, sources are free to experiment continually and develop new, unanticipated methods of low-cost abatement. And because unused permits can be sold for profit, sources can benefit the more reductions they make. By contrast, prescriptive standards frequently—and inefficiently—pick "winners" from among existing technologies: for example, regulating vehicle emissions by mandating use of certain biofuel technologies reduces the incentive to explore other, potentially better reduction opportunities, like new mass transit options. Jack Lienke & Jason Schwartz, Shifting Gears: A New Approach to Reducing Greenhouse Gas Emissions from the Transportation Section 5 (Policy Integrity Brief, 2014).

[5] For an in depth look at a wide range of marketable permit programs and their authorizations, see Schwartz, *supra* note 2, at 7–13.

"economic incentives to encourage the desired behavior, such as user fees or marketable permits,"[6] indicating that agencies have authority to institute marketable permit programs.

Marketable permits are a useful tool for agencies regulating a wide range of industries, but are not suitable for all applications.[7] However, their usefulness in certain scenarios has prompted bipartisan support, with implementations of marketable permit programs during the administrations of Presidents Reagan, Bush (41), Clinton, Bush (43), and Obama. The recommendations that follow provide several considerations for when marketable permits are likely to be useful, features that can be included in the design of such programs to increase their efficacy, and guidelines for establishing and monitoring the market for permits to limit fraud and manipulation.

RECOMMENDATION

Establishment of Marketable Permitting Programs

1. Agencies should consider adopting a marketable permitting program when:
    a. Agencies have sufficient resources to design and administer the program and are capable of reevaluating the appropriate target level of activity over time.
    b. Agencies can clearly define the privileges or obligations to be assigned by the program and have the necessary information to set the level of regulated activity at carefully considered, deliberate levels.

[6] Executive Order 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993). Other examples of regulatory tools drawing on economic incentives include fees, penalties, subsidies, changes in liability rules or property rights, and required bonds, insurance, or warranties. Office of Mgmt. & Budget, OMB Circular A-4 (Sept. 17, 2003).

[7] Current applications of marketable permits span a broad swath of the regulatory landscape, from air pollution markets, 42 U.S.C. § 7503(c), to fishery catch share programs, National Oceanic and Atmospheric Administration Catch Share Policy, 75 Fed. Reg. 55305 (Sept. 10, 2010), to the licensing of the electromagnetic spectrum, Federal Communications Commission, Secondary Markets First Report and Order, 68 Fed. Reg. 66252 (Nov. 25, 2003). There are also marketable permit programs at the state and local level, including transferable development rights, liquor license markets, and taxi medallion auctions. This recommendation deals solely with marketable permits at the federal level.

c. Regulated entities have more information about compliance costs, or the value of the resources to be allocated, than regulators. This often occurs when the activity to be regulated is conducted by heterogeneous or small sources.

d. The overall level of an activity matters more to regulators than the identity of the actors, and the risk of unintended consequences from trading, such as the potential for highly localized problems, can be efficiently managed. -and-

e. Regulators are reasonably confident that a robust market is feasible. This requires interest and participation by regulated entities and requires them to have sufficient knowledge to make efficient decisions in the market. In addition, variation across different permittees' compliance costs or their individual valuation of the resources traded is needed to encourage trading of permits.

2. When an agency designs a marketable permitting program, the agency should be cognizant of the present and future resources that are required to develop and operate the program. In the case of marketable permits, the agency should consider that designing and implementing a marketable permitting program may require significant upfront costs but require fewer resources to administer once the program has been established.
3. Before establishing such a program, regulators should make sure they have sufficient legal authority to monitor permit markets for fraud, manipulation, and other abuses.

Desired Features of Marketable Permitting Programs

4. Agencies should establish clear expectations as to the longevity of marketable permits and the precise rights that they convey.
5. Agencies should consider using notice-and-comment when establishing a new permitting program or when providing guidance on an existing marketable permitting program, especially when explicit statutory authorization for creating the program is absent.
6. When designing a marketable permitting program, agencies should consider whether their policy objective would be better served by capping the total level of activity (e.g. when a pollutant's total emissions levels is what drives the environmental effects) or by capping the rate of the activity (e.g. for a short-lived pollutant with highly localized

effects, so that the rate of pollution from individual plants is what drives the environmental effects). During the design phase, agencies should create a mechanism for monitoring the level of activity and for subsequently adjusting the cap.

7. Agencies should consider allowing open access to the market so parties besides the regulated entities can buy credits to remove them from the market based on social preferences.
8. Agencies should consider instituting mechanisms for issuing additional permits or releasing reserved permits in case of emergencies that dramatically increase demand.
9. When making the initial allocation of permits, agencies should consider using auctions over grandfathering to prevent windfalls and barriers to entry for regulated parties. If auctions are not feasible, agencies should consider alternate allocation techniques, like setting aside permits for new entrants or using output-based allocations.[8]
10. If an auction is used, agencies should emphasize the market management and distributional reasons for choosing auctions, to limit the chances that the permit auction is perceived by a court as an impermissible tax designed by agencies to raise revenue.
11. In designing a marketable permitting program, agencies should include clear sanctions for noncompliance and create plans for bringing parties into compliance.
12. When possible, agencies should pursue economies of scale in managing marketable permitting programs. Federal agencies should provide clear guidance on trading policy to regional and state offices, where applicable. This may include providing training sessions to regional and state officials.

[8] Often proposed in marketable permit programs that regulate electricity generators, output-based allocation allocates permits for pollution based on the amount of electricity produced by a given party, as opposed to the historical amount of pollution that party generated. This results in awarding permits to some of the cleanest producers of electricity, like renewable energy, rather than disproportionately to the most heavily polluting producers. Project on Alternative Regulation, Marketable Rights: A Practical Guide to the Use of Marketable Rights as a Regulatory Alternative 14 (1981).

Oversight of Marketable Permitting Programs

13. When designing a marketable permitting program, an agency should include a mechanism for oversight and establish clear criteria for verification to ensure that credits are not double-counted and constitute real offsets of the regulated activity. Depending on feasibility and efficiency, agencies should consider overseeing the program directly, making use of self-verification, or engaging third parties to verify compliance. If an agency chooses to use third-party credit verifiers, it should set standards to ensure that they are qualified, insured, and free from conflicts of interest.
14. Agencies should use available tools to limit fraud and abuse in permit markets. Regulators should adopt limits on purchasing and holding marketable permits (including a maximum number that can be held by a single party) or employ other tools to prevent monopolies, excessive speculation, and other manipulations of the market for permits.

Information Management

15. Agencies should collect data on the operation of marketable permitting programs, and should consider periodically assessing both the policy effectiveness and economic efficiency of existing marketable permitting programs. Agencies should be cognizant that some of the data collected will likely be confidential and should implement procedures for handling this data appropriately.
16. To the extent feasible, agencies should release non-confidential data on permit transactions, prices, and holdings to help the public gauge a market's policy effectiveness and to help parties make efficient decisions in the market.
17. Agencies that manage marketable permitting programs should coordinate with each other to improve existing marketable permitting programs and design more efficient systems in the future. Agencies should explore memoranda of understanding or other mechanisms for formalizing their relationships with other agencies as well as state and local governments.

18. Marketable permit regulators should develop communication policies for announcing policy changes or enforcement actions that could influence the market to prevent pre-publication leaks and information asymmetries.