An alternative to Cap and Trade

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Cap and Trade systems are complicated, difficult to administer and hence expensive to operate. The objective is to encourage investment by putting a price on not doing things. If you do not do something - like make your building more energy efficient - then you can buy credits from someone who has made their building more energy efficient. The idea is that if the cost is high enough then it is worth your while to make the building more energy efficient or to pay someone else to do another building to make up for your failure to act. The price gets high enough by establishing a cap on energy use for buildings so requiring builders either make the buildings efficient or pay extra. While this may work it is not guaranteed to work and is a very expensive system to operate and administer.

In effect the cost of a building will increase. This will mean that the builder will have to obtain more finance to build the building. Let us assume that the building costs an extra $1M dollars. Let us assume the finance cost is 10% and the repayments are to be made over 10 years even though the expected life is 20 years. This means the building will have to generate enough income to pay back $200K each year to cover the finance costs. In practise money for new asset creation comes as equity rather than loans and the return on investment demanded by equity investors is of the order of 20% return on investiment not 10% interest. This means that instead of interest costs being $100K a year the costs required to get investments is of the order of $300K a year.

The alternative way to finance energy savings is to reduce the finance costs. Finance costs can be reduced by giving zero interest loans that are repayable over the life of the building. If this is done then the extra cost to be recovered is $50K each year as the only finance costs are repayments over 20 years.

Such loans can be introduced and can be issued by commercial banks - if the government guarantees the money created for the loan. That is, the government does not guarantee the loan but guarantees that any money created for the loan and that does not get repaid is still valid currency. With regular loans the banks guarantee the money created and if the loan is not repaid the bank has to make up the money. This requires them to pay interest to ensure the money gets repaid and if it doesn't then they have been able to cover their losses. The banks also cover their losses by not giving out loans unless they have lien on an existing asset. However, if the government guarantees the money then banks can give zero interest loans and only require repayments over the life of the asset constructed.

Zero interest loans with repayments over the life of the asset are of considerable value and there would be a demand for such loans. There is also the problem of how to ensure the loans are repaid and ensuring that the loan money is spent on what was intended.

The following system will solve the compliance problem and will solve the equity problem of distribution of the right to a zero interest loan - and can be achieved for little cost to the government.

The government calculates the approximate amount of money it is thought will be needed to invest to address the problem and the number of years over which to do the investments. Let us assume it is $100billion and it is to be done over the next 10 years. That is $10 billion each year. Each year let the government create the rights to take out $10 billion dollars worth of zero interest loans for the purposes of increasing energy efficiency and let the government distribute these rights to all residents of Australia - or about $500 per person. People have to apply for the rights. The rights are tradeable. That is they can be sold to anyone who has a need to make their buildings more efficient.

To get a loan the borrower has to deposit say 10% that is refundable when the loan is repaid. The borrower and the lender together work out how the loan is to be repaid. This will be on the basis of the value of energy saved and as well as deciding the amount to be made the borrower and lender will determine the mechanism to measure and pay the amount and this will be part of the loan agreement. There can be incentives for early repayment to both the lender and the borrower.

If either a borrower or a lender do not comply with the rules of the loan then they will be banned from further participation in the loans scheme.

The government's task is to decide how much money is to be invested, how the money is to be distributed, to set the general framework of the rules, and to ensure compliance of the rules of the loans. The cost of compliance and the cost of making the loans by the banks are covered by transaction costs.

Compliance is almost certain to be near universal because the penalty of not being able to participate in future issue of rights to loans is a great deterrent.

The banks will like the system as there is no risk associated with loan money not being repaid and they will be able to make profits from the transaction fees. The government has a relatively simple system to monitor as the whole system can be built by the banks. The community will contribute to the system through their selling of the rights to loans. Industry will like the scheme as it reduces their costs.

The market place in both rights to loans and in ways to save energy will ensure that the money will be spent in the most advantageous way.

An early version of the system could be in place within six months.