

December 15, 2010

The Honorable Mary Nichols
Chair, California Air Resources Board
1001 I Street
Sacramento, CA 95814

SUBJECT: CalChamber Comments on the Adoption of a Proposed Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, Including Compliance Offset Protocols

Dear Chairwoman Nichols:

The California Chamber of Commerce (CalChamber) appreciates the opportunity to comment on the California Air Resources Board (CARB) cap-and-trade regulation under AB 32 (Global Warming Solutions Act) as released on October 29, 2010.

The CalChamber is the largest broad-based business advocate in the state, representing the interests of nearly 15,000 California businesses, both large and small. Many of CalChamber's larger members will be directly covered by the cap-and-trade regulation, while many other smaller members will likely experience indirect impacts in the form of new costs passed down from upstream fuel and energy providers.

The CalChamber has also been a constructive voice throughout the process of implementing AB 32. We have long maintained that a market-based mechanism, if designed appropriately, has the ability to garner significant reductions in greenhouse gas (GHG) emissions in a cost-effective manner. Key features of such a program would necessarily include free allowance allocation, a broad use of offsets, and linkage to a regional or federal program.

We are committed to ensuring GHG reductions are achieved while maintaining the competitiveness of California businesses and the health of the economy. In keeping with these priorities, the following comments focus on areas concerns with the proposed regulation which we believe will hinder the State's ability to achieve the required reductions in a cost-effective manner.

Incomplete Regulation

CalChamber has several concerns with moving forward with a regulation that is not yet complete and so urge CARB to address several of the uncertainties and missing design of the program as soon as possible. An incomplete regulation will exacerbate an already difficult economy and will create an uncertain regulatory environment that will discourage economic growth and future investment. It is clear that CARB has a lot of work ahead and with the end of the year fast approaching, it is unlikely that several of these pending issues will be resolved before year's end. With a 2012 implementation date, CARB must fill in the blanks on several of these missing elements.

We urge CARB to implement any changes via an open forum, involving stakeholder input and public comment. If CARB intends to utilize the 15-day notice update process for current placeholder language, it's important they keep stakeholders apprised of any and all changes throughout this process. Stakeholders must have the opportunity to comment on the cumulative impact of all decisions prior to the market opening in 2012. Because businesses need ample time to adjust to the regulation and the policies set forth by CARB, we ask that CARB finalize these missing details sooner rather than later and believe that an April 2011 deadline provides CARB staff ample time to provide this information to CARB at the May Board meeting.

Allowances

The recently released regulation is a significant improvement from last year's preliminary draft regulation (PDR), especially in its approach to allowance allocation. The regulation appears to take into consideration the state's current fiscal crisis as well as the letter Governor Schwarzenegger wrote to CARB in March where he stated that a "full auction of allowances at the beginning of a cap-and-trade program may be too abrupt a transition – posing high short-term costs to capped companies." Unfortunately, much like last year's PDR, this regulation is missing some key design elements that are critical for full implementation of a cap-and-trade program.

The regulation proposes that most allowances be freely allocated at least at the program's onset, primarily to assist the most leakage prone industries. Yet, the regulation lacks critical details for the allowance allocation of various industry sectors in future compliance periods. There remains uncertainty as to how allowances will be allocated to these sectors. CalChamber encourages CARB to make this critical design detail available as soon as possible so that compliance entities have certainty and can make decisions moving forward.

Also, while it's important to aid highly exposed, leakage prone industries through the free allocation of allowances, requiring medium or low leakage prone industries to purchase allowances in an auction in the second and third compliance periods will unnecessarily increase the cost of compliance for businesses. As long as California chooses to "go it alone" on cap-and-trade, the risk of leakage will remain high. CARB should take every step possible to avoid this scenario.

CARB's proposal to raise funds via an auction for reasons outside of administrative fee purposes is beyond CARB's regulatory authority. CARB justifies an auction system as a means of lowering GHG emissions and satisfying requirements under AB 32. CARB proposes that revenues from an auction be appropriated by the legislature for purposes of funding programs such as a community benefits fund, consumer rebates program and a low carbon investment fund. These and other proposed programs are outside the scope of administrative fees, and would likely be challenged as contrary to the legislative intent of AB 32.

Benchmarks

The benchmarks have not yet been determined within the various industries covered by the regulation. Appropriate calculation of benchmarks is essential so that industry sectors know anticipated cost of compliance, and can plan for future operations, projects, expansion, etc. Under the current regulation, a facility that is more efficient than the proposed benchmark will receive more of its allowances freely while those less efficient facilities will have to purchase additional allowances. We agree with this concept so long as the benchmarks are set correctly.

Compliance & Enforcement

With so much uncertainty in the regulation there is concern about the enforcement and penalties that covered entities will be subject to going forward with the program, especially in light of so many crucial key elements still missing. To ensure fairness, the market rules and parameters must be known sufficiently in advance to provide all market participants information upon which to base their important business decisions. Missing elements such as reporting requirements and monitoring tools will make compliance with the program both difficult and confusing to

participants. CalChamber urges CARB to develop a time schedule for the development of the compliance tools, policies and infrastructure necessary for entities to comply with this regulation.

The regulation proposes that entities that miss the deadline for retiring compliance instruments retire four allowances for every ton of emissions. Not only is this requirement unfair but it penalizes market participants by limiting the number of allowances in the market every time an entity misses its retirement obligation. Furthermore, this creates a double burden by taking allowances out of the market and placing them in the allowance reserve where the price for allowances are likely to be higher (see *Allowance Reserve*). Taking away from the market limits allowance supplies, creates market uncertainty, and ultimately raises costs for market participants. CARB must develop a better way to enforce compliance without compromising the cost-effective goals of the program and without unfairly disadvantaging market participants because of one bad actor.

Linkage

CalChamber has long maintained that a successful cap-and-trade program cannot be a California-only unilateral program and must allow for seamless linkage with other regional and international programs. At this point it appears the only imminent linkage is at the regional level with the WCI, which can only happen if other participants can agree to the program's implementation and will be ready for the 2012 start date. Without linkage to other programs, a California-only cap-and-trade program ignores the opportunity for economic growth and puts California at significant economic risk. Furthermore, a cap-and-trade program must not be duplicative or conflict with existing air emission requirements at the state, local and federal levels, especially if those requirements create a double burden for California businesses and increase costs beyond what is reasonable to achieve policy objectives. The cap-and-trade program must be a system that meets the overall goals set forth by AB 32. It must allow for economic recovery and provide regulatory certainty for our businesses. It is important that CARB create a program that California can seamlessly interface with the WCI partners with ultimate linkage to a national and international platform.

Offsets

CalChamber appreciates that the limit on offsets has been extended from the previously recommended 4% limit proposed under the PDR up to 8% of the compliance obligation in the latest draft. While we believe the extension of offset limitation is a step in the right direction, we believe that to reduce the costs of a California-only program, a robust supply of offsets is required. Therefore, we encourage CARB to consider the inclusion of other offset protocols outside of the four protocols currently under consideration. We believe that a broad qualitative use of offsets is an important cost-containment mechanism to the cap-and-trade program. Geographic restrictions will result in unnecessarily high compliance costs. As noted in Governor Schwarzenegger's March letter, "CARB should carefully consider how to assure an ample supply of high-quality offsets to help companies comply with carbon reduction strategies in a cost-effective manner." CalChamber urges CARB to consider the inclusion of other offset protocols with linkage to existing offset programs, near term linkage to regional programs such as the Western Climate Initiative (WCI), and future linkage to a possible EU offset programs as well.

Offset Buyer Liability

The regulation proposes to hold buyer's liable in the event of offset reversals. The burden to rectify an offset reversal falls on the buyer regardless of whether the reversal is intentional or unintentional, but enforcement and penalties are far more egregious in the case of an intentional reversal. According to the regulation, CARB will give a buyer 30 days to correct an intentional offset reversal. Failure to do so will constitute a violation resulting in CARB assessing penalties. CalChamber opposes buyer liability amongst regulated entities and believes that enforcement of such liability ignores the purpose of approved offsets and a certification process supported by a

third party verifier. Imposition of liability upon the buyer creates uncertainty that could suppress the market.

Allowance Reserve

CalChamber agrees that an allowance reserve is necessary, especially if intended as a cost-containment mechanism to moderate allowance prices. However, as proposed, the reserve price is set too high. CARB is proposing to sell allowances at \$40/metric ton beginning in 2012 rising to \$75/metric ton in 2020. The escalating cost of the reserve over time negates the overall purpose of the reserve to serve as a cost-containment mechanism. We are concerned about the potentially high cost of allowances under this reserve system.

We are also concerned that CARB has determined allowance prices before finalizing key elements of the program that could in fact influence the overall pricing outcome and will be useful in setting appropriate levels for the price reserve. Before setting price levels, CARB must first resolve important issues including benchmarking, allowances, leakage assessment, compliance & enforcement and monitoring tools.

Monitoring and Review Process

To ensure GHG reductions are achieved while maintaining the competitiveness of California businesses and the health of the economy, it is critical for CARB to monitor key indicators of not only the GHG reductions that are occurring but also indicators of the health of California's economy. We urge CARB to identify and monitor these key indicators, so that any inadvertent problems that may occur can be corrected before significant damage is done to California economy or environment.

Also, we urge CARB to include a periodic review process for the cap-and-trade regulation.

Again, we appreciate your consideration and the opportunity to comment on the cap-and-trade regulation. We look forward to further communication as CARB continues to work on the important design elements of the program.

Should you have any questions, please feel free to contact me at (916) 444-6670.

Sincerely,



Brenda Coleman
Policy Advocate