

August 11, 2011

TO: The Honorable Mary Nichols, Chair

California Air Resources Board

FR: John Larrea, Governmental Affairs

California League of Food Processors (CLFP)

RE: Comments on Proposed Changes to Cap-and-Trade Regulation

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**Article 5, CALIFORNIA CAP ON GREENHOUSE GAS EMISSIONS AND MARKET-BASED COMPLIANCE MEHANISM 15 DAY RULE AMENDMENTS**

**Unresolved Issues:**

CLFP, in numerous meetings with staff, were given to understand that the regulation would contain a number of provisions that currently are either unclear or missing from the regulation.  The proposed changes to the regulations, either under the MRR or the Cap-and-Trade, to clarify these issues of importance to food processors:

1. Provide that the anomaly years (short season start-ups, etc.) will be excluded in setting the benchmarks for the compliance period in which they occur.
2. The years prior to a facility expansion would also be excluded (i.e. new boiler additions to existing facilities).
3. That a company would be allowed to carry over excess or unused reductions into the next compliance period.
4. That new boilers would be treated as a new process and eligible for separate benchmarking and allowance allocations.
5. That a company would be able to aggregate its compliance instruments among facilities, as opposed to meeting its compliance obligation on a facility by facility basis.

CLFP requests that CARB adopt these provisions pursuant to the understanding with staff within the proposed changes.

**Backpressure Steam Generators**

Under the current proposed modifications to section 95891(c), the Energy-based Allocation Calculation Methodology, facilities utilizing backpressure steam generation maybe be penalized. According to the formula for calculating GHG allowances, steam consumed at the industrial facility for any industrial process shall exclude any steam used to produce electricity.  This rule promotes inefficiency since electricity produced in many industrial processing facilities is simply a byproduct of the process.  A modern more efficient processing facility does not burn additional fuel to produce electricity, but captures energy that would otherwise be lost while supporting facility operations.

According to the Department of Energy (DOE), “In the backpressure turbine configuration, the turbine does not consume steam.  Instead, it simply reduces the pressure and energy content of steam that is subsequently exhausted into the process header.  In essence, the turbo-generator serves the same steam function as a pressure-reducing valve (PRV) – it reduces steam pressure- but uses the pressure drop to produce highly valued electricity in addition to the low-pressure steam.”

With a backpressure turbine configuration, all of the energy produced by the turbine comes from reducing steam pressure, not from the generation of more steam.  In other words, the boilers run at the same load regardless of whether the steam turbine is operating or not.  Further, it is CLFP’s position that the efficiency gained from the utilization of these types devices should be credited to the maximum free allocation, in addition to  the 110% maximum limitation if a facility exceeds that limitation due to the inclusion of this device (as limited in Section 95891. ALLOCATION FOR INDUSTRY ASSISTANCE, Subsection C. (2) Maximum Free Allocation.)

In a recent communication, staff has informed a CLFP member of its position that a backpressure steam turbine generator has no negative impact in regards to 95891(c), the Energy-based Allocation Calculation Methodology. The variable “At”, the amount directly allocated to an operator; will not be negatively adjusted and that  the facility  will receive allocation based on the amount of fuel consumed (“Fconsumed”); and that that no additional fuel or steam energy is consumed in the system as a whole from the backpressure steam.

Therefore, CLFP requests that CARB modify the proposed regulatory changes to Section 95891 to reflect the above.

**Allowance Allocations - Pro rated allowances**

The proposed changes to Section 95870 (e) (3) now provides that if the total amount of allowances available, after all other sectors have received their allotted amounts, should be insufficient to meet the amount allotted for the industrial sector, then such remaining allowances shall be distributed on a prorated basis to the industrial sector.

This is patently unfair as the industrial sector is forced to absorb costs that should be spread equally across all sectors. It is suggests a duplicitous intent by CARB and the utilities to conceal the true costs of the AB 32 scheme from California taxpayers and ratepayers by shifting the cost of insufficient allowances to industrial stakeholders.

Fairness demands that ALL stakeholders should be exposed to the risk of insufficient allowances without favoritism or prejudice against any stakeholder for purposes of political expediency. Food processors, in particular, do not have the financial stamina to absorb both its own legitimate costs of allowances as against well-financed corporations through the auction; nor to cover the costs of CARB’s attempt to shield utility ratepayers from “rate shock” associated with the implementation of AB 32.

CLFP recommends that all sectors carry equal risk as to limited allowances.

**All Sectors Should Receive 100% of Allowances Based on Leakage Risk**

CARB continues to propose less than 100% allowance allocation for various industrial sectors, despite the fact that it has already determined that these sectors, due to their energy intensity and trade exposure, qualify for 100 % free allowance allocation.

CLFP recommends that for those sectors determined to be energy intensive and/or trade exposed, CARB should be providing 100% free allowances, consistent with its own policy and in the interest of achieving the target reductions in the most cost-effective manner possible.

It is also disappointing CARB continues to propose less than 100% allowance allocation to the industrial sector in future compliance periods. The leakage analysis is insufficient to justify this. It is also premature to make this decision when there is time to do such analysis prior to the 2015 compliance time period. This decision should depend on the level of participation by other states and jurisdictions in the program as a key metric for how much each industry sector is at risk for leakage.

**Extend NAICS Code Designations for Food Processing Sector**

Food manufacturing is the only industry for which the CARB has aggregated up to the 3-digit level per the North American Industry Classification System (NAICS). Every other industry is disaggregated at least to the 4-digit level. Using 3-digit level data obscures important differences among industry segments. For example, sector 3114 food processors are grouped with poultry processors in sector 3116, which have a very different energy use pattern. Food processors appear to be more energy intensive than the rest of the food manufacturing sector. Thus, the energy intensity measure for sector 3114 is diluted unless the NAICS code designations are expanded.

CLFP recommends that the NAICS Code designation be expanded.

**Uncapping the 3114 Sector and Using Alternative Regulation**

Uncapped establishments will not be subject to any form of direct GHG regulation and thus will not incur any costs, either in implementing reductions or buying and selling allowances, or in regulatory compliance, associated with AB 32. This situation is identical to what was foreseen for implementing an EITE adjustment—regulated facilities are likely to face a competitive cost disadvantage to firms that provide a close substitute. The uncapped facilities, smaller emitters in this case, can increase their output and attendant GHG emissions, thus defeating the intent of AB 32 to reduce overall GHG emissions.

Providing free allowances to large food processing emitters only partially mitigates this situation however. In an industry where so much of the competitive in-state production will fall below the regulatory threshold, and so few of the capped facilities have large emissions (only a half dozen of the sector 3114 plants emit more than 50,000 tons), better public policy is to uncap the entire food processing sector and leave the emission reduction strategies to other means.

For food processors, almost all emissions come through either natural gas or electricity use. The load serving entities for both natural gas and electricity will be under the cap and trade program by 2015. The energy utilities will have strong incentives to encourage their customers, including food processors, to reduce their emissions through utility-based programs and measures. Thus, the food processing sectors will be regulated through an alternative means, but in a less costly manner.

CLFP recommends designating food processors (NAICS 3114) as an uncapped sector.

The board should note that discussions with staff are ongoing regarding first point of process being integral to the farm, and as such vegetable and fruit processing operations may be justified as being designated an uncapped sector in conjunction with the Agriculture Sector.

**Provide for Emissions Allowance Borrowing**

CLFP supports emissions borrowing. The current regulation only allows emissions banking in the cap-and-trade. CARB should allow borrowing allowances with some limits and standards. The ability to borrow will aid in reducing costs and allow companies to meet obligations without penalty for short periods of time.

**Multi-Year Allocations**

Without the benefit of multi-year allowance allocations, regulated entities will not be able to properly determine their growth potential and plan accordingly to select new sites or expand current facilities. A multi-year allocation approach allows regulated entities the time necessary for capital planning purposes. It is not very feasible for a facility to responsibly plan an expansion or retrofit that will take multiple years, if it must start the project without knowing how it will obtain allowances to cover facility emissions in future years of the project.

Multi-year allocations will allow businesses to plan ahead.

**Benchmarks**

While CLFP supports the basic policy direction of free allocation of emissions allowances, the purpose of distribution benchmarks is to establish equitable bases for distribution of free allowances within industries. Benchmarks should be developed that are supported by the affected industries and serve to distribute allowances equitably among members of the targeted industry.

CARB should not be using benchmarking and other distribution methods to undercut the free allocation of allowances to energy intensive and trade exposed industries. CARB should not, for secondary reasons, adopt benchmarking methods which penalize the superior energy efficiency of California industries relative to competitors in other states, or methods which distort the distribution of allowances among industry members without regard to energy efficiency.

To be fair to California industries, energy benchmarks should be set based upon a national standard. Setting industry-wide benchmarks, using only California facilities after nearly 30 plus years of energy efficiency efforts and expenditures by California industries, will only further exacerbate the trade exposure of California industrial facilities. Industry in California will be even more susceptible to competitors or startups in states choosing not to enact climate change regulations on their industrial base.

Unfortunately, CARB’s most recent proposals on benchmarking create increasing concern on the part of industry, that the basic principle of free allowance allocation is being subordinated to secondary concerns. This will likely result in large allowance shortages for many facilities and significant adverse impacts for California businesses and their workers.

**Offsets**

Offsets represent an important cost containment tool for many food processors and producers and should the economy ever rebound, offsets will be vital to keeping the cost of allowances from skyrocketing as industries begin to ramp up production to meet demand.  CLFP recommends that CARB not take a restrictive approach to the use of emission offsets by cap-and-trade program participants such as limiting the number or percentage of offsets that can be used; the geographic location of offsets; or the types of offsets that would be eligible.

Allowing the use and availability of a large quantity of offsets from the very beginning of the program will be crucial to the program’s success. Policies that increase the likelihood of an inadequate supply of offsets and the inability to link to other cap and trade program will greatly decrease the potential for a cost effective California program.

CLFP recommends that CARB instead focus on the quality of offsets; that they meet the requirements of being real, additional, quantifiable, verifiable, and permanent.  As long as offsets meet that rigorous standard then their use by regulated entities should not be limited for compliance purposes.  CLFP also recommends that the proposed 8% level be established as a floor, and that additional offsets be allowed as necessary to maintain costs of the program within acceptable limits. For the same reason, we also recommend that the regulation not impose geographic limitations at this time.

Further, CLFP encourages CARB to address offset supply options by accepting energy efficiency projects as an approved offset.

**Buyer Liability:**

CLFP believes the buyer offset liability language is problematic because buyers suffer sanctions or must replace credits that, though approved by the CARB, later turn out to be invalid.

The net effect:

1. Offset transaction costs will be higher than need be.
2. Programmatic compliance costs will be higher.
3. Not the norm: Standard seller liability is used in all other cap and trade programs in the US and EU.
4. Offsets are likely to be considered to be second class compliance instruments by the market.
5. Faced with higher costs, sources on the margin will be that much more inclined to expand their operations and/or export jobs outside the jurisdiction of AB32.

CARB has suggested that a “buyer beware” approach will suffice, one utilizing exhaustive due diligence, the deployment of trained verifiers, or even the use of cleverly written conveyance contracts and sophisticated derivative products.

It will not work, especially in situations where a credit may be created and then sold a number of times before it is used and applied. Instead, buyer liability will more than likely raise transaction costs. For instance, prior to each purchase, buyers will need to re-verify the credits and reexamine prior evaluations of the initial verifier. Even if a buyer excels in due diligence, nothing will prevent CARB or some third party (perhaps several years after their creation) from challenging the credits after they are purchased and applied to a project.

Nor should CARB conclude that the problem of offset reversals can be managed through the use of insurance or financial derivative products. While such products may initially reduce the risk of purchasing offsets the instruments, if priced based on risk, will sell at prices that dramatically increase transaction costs.

It does not have to be this way. Other offset/cap-and-trade programs (e.g., New Source Review, RECLAIM, Houston MECT, etc.) have effectively dealt with and eliminated this problem.

CLFP recommends that CARB amend the language to give buyers an opportunity to avoid liability by:

1. Allowing a source to secure CARB/air district review and approval of credits. This is how it has been done for decades in California with offsets that have been useable for new source review compliance purposes.
2. CARB/air district issuance of permits to offset creating sources. Again, consider the NSR example.
3. Creating an insurance pool that is either privately funded with credits or through a CARB administered shave that is applied to each credit issued and/or traded

**Forward Carry Of Unused Offset Capacity:**

In an effort to provide flexibility and reduce compliance costs to regulated entities, companies should be allowed the flexibility of banking unused offsets on a year-to-year basis. Another mechanism that should be available to regulated entities is the ability to trade the balance of their remaining offsets to another company.

**Dispute Resolution Program**

Currently the cap-and-trade and mandatory reporting regulations give CARB’s Executive Officer sole authority on program implementation, including determining whether regulated parties have complied with regulations and to determine penalties. Absent costly and time consuming litigation, there is currently no independent administrative option for stationary source facilities to challenge the Executive Officer’s decisions that could not be resolved.

CLFP believes the Executive Officer should not have the final decision on such a comprehensive program as AB 32, and instead it would be in both CARB’s and the regulated industry’s best interest that a formal, autonomous dispute resolution process should be established in order to provide independent decision making with equity for all parties involved in any dispute.

This program should use an unbiased mechanism to resolve disputes, variances and penalty disagreements with the Executive Officer. Without such a program issues that could be resolved relatively quickly could become time-consuming litigation which could hinder the goals of AB 32.

**Industry Stakeholder Advisory**

CLFP supports and encourages a stakeholder advisory committee to provide continual and thoughtful feedback to CARB as the program rolls out during the next few years.

**CPUC Should Control Dispensation of Auction Funds**

CARB should defer to CPUC as to the dispensation of the funds that the IOU’s receive from monetizing their emissions allocations. CPUC is the agency charged with protecting ratepayers, not CARB. All of the funds should be refunded back to all classes of ratepayers and not diverted to fund solar, wind, or environmental justice community projects. The same concept should apply when natural gas is brought into the cap-and-trade system. Despite assurances from CARB, there exists real concern that non-regulated entities will game the system. Perhaps, as suggested in the recent workshop, CARB should initiate at least one dry run before the first auction. With a system as complex as this, the stakes for entities required to participate, are high.

**Reduce Records keeping from ten to seven years**

CLFP supports the CARB recommendation to reduce the record keeping requirement from 10 to 7 years.

Thank you for considering our comments. Should you have any questions or need anything further, please feel free to contact John Larrea at (916) 640-8150.