AB 32 Implementation Group

Working Toward Greenhouse Gas Emission Reductions
And Enhancing California's Competitiveness

June 27, 2012

To: The Honorable Mary Nichols
Chair, California Air Resources Board

Fr: AB 32 Implementation Group

Re: AB 32 IMPLEMENTATION GROUP COMMENTS
California's AB 32 Linking With Quebec In A Cap-and-Trade Market

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INTRODUCTION

The AB 32 Implementation Group (AB 32 IG) supports the concept of a market mechanism such as well-designed cap-and-trade program that would minimize the costs of greenhouse gas emission reductions under AB 32. We have encouraged the California Air Resources Board (CARB) to develop a cap-and-trade program that includes broader market features designed to lower compliance costs for California entities subject to the regulation.

At the June 28 board meeting, CARB proposes to link with Quebec, making Quebec-issued allowances acceptable for compliance in California, and vice versa, when California begins to regulate emissions in 2013 and beyond.

The AB 32 IG would like to highlight that over the past five years, and in particular in the last year, business and industry have submitted numerous public comments on the overall policy aspects of linking with other jurisdictions and on the details of the program to link Quebec in particular, yet we do not see any movement to make linking more cost-effective and more administratively effective (see industry comments on holding limits for example). It is imperative that CARB come down from its "full speed ahead" vision and move to make the reasonable, rational changes to make the linking regulation more cost-effective and more administratively workable.

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AB 32 IG opposes the linkage proposal with Quebec at this time. Briefly, we are opposed because:

1.) There has not been sufficient opportunity to review and comment on the Quebec regulation;

2.) There are no significant benefits to the linkage;

3.) There remain a myriad of unanswered questions and potential problems with California's yet to be started market;

4.) Quebec's Auditor General has found serious flaws with the integrity of the systems to measure carbon emissions to the point of calling the measurements "arbitrary;" and,

5.) Linkage with Quebec without first assuring that the market functions properly and that market manipulation protections actually work poses new and unnecessary risks and complications.

REVIEW AND COMMENT OPPORTUNITY

- CARB's regulations preclude California from linking with Quebec until CARB – and the public – have had the opportunity to review proposed linkage regulations from Quebec. Quebec only just issued draft linkage amendments within the last two-and-a-half weeks, and the 60-day comment period on those proposed amendments has only just begun. A preliminary review of these proposed amendments, moreover, suggests that they are even less developed than CARB's proposed amendments.

- Approving linkage under these circumstances would not only be imprudent, it would violate CARB's own regulations, *see* C/T Reg. § 95941, requiring opportunity for full public notice of and comment on linkage with an external jurisdiction. CARB cannot fulfill this obligation if the full picture of the linkage relationship is not available to the public. Linkage would also violate the WCI's Program Design, which requires that each partner jurisdiction have full opportunity to review a linking jurisdiction's program prior to linkage. *See* WCI Program Design at 22. Recognizing these crucial transparency problems, the

California Legislature has proposed legislation requiring independent review of any linkage regulations by the Attorney General and Governor (AB 1478). This underscores the need for CARB to proceed cautiously before any finalization takes place.

- In addition, California's proposed linkage regulations have key gaps – enforcement mechanisms, specification of which precise Quebec compliance instruments California will accept, whether allowance reserves will be pooled or separate – which can only be assessed with full documentation of the proposed linkage from both California and Quebec.

- CARB should not deny the public the notice and comment provided for in the regulation and otherwise should make sure that CARB and the public are fully aware and understanding of the full nature of the linkage relationship before committing to link with Quebec.

INSUFFICIENT BENEFITS FOR LINKING WITH QUEBEC

- The additional liquidity and market power mitigation that could come from partnering with western states is a strong rationale for the Western Climate Initiative. But only Quebec is ready to join and is very small compared to California. The small size of Quebec would not significantly enhance liquidity or reduce concerns about market power.

- In the proposed linkage regulation, [II Summary of Proposed Action] CARB states that, "California will only consider linking our cap-and-trade program with other programs of similar scope and stringency – that is programs of equal rigor in their environmental integrity." It is clear that this test has not been met. California will be regulating more than 300 industries while Quebec only has 80 regulated industries. Quebec does not compete with, nor does Quebec engage in a significant amount of trading with California. As of 2011, the population of Quebec is 7,903,001 and the major industries of Quebec are farming, lumbering, mining, and fur trapping. California has a population of 37,691,912 and, prior to the recession, used to be the nation's leading industrial state, claiming the number one position in almost every general manufacturing category: number of establishments, number of employees, total payroll, value added by manufacture, value of shipments, and new capital spending.

- Imposing a cap-and-trade compliance obligation on Quebec does not protect any California industry from competitive pressures. The leakage prevention value of linking with Quebec is nil.

UNANSWERED QUESTIONS AND POTENTIAL PROBLEMS

- As noted by CARB at a July 27, 2009 workshop, a purpose to link is to reduce overall greenhouse gas emission abatement costs by allowing emitters to choose lower cost reductions in one program instead of higher cost reductions in the other program. But a recent study by the WCI suggests that Quebec's greenhouse gas reductions are much more expensive than California's partly due to the large amount of hydroelectric power in the Province. Assuming that three-fourths of allowable offsets are available for the market, the study finds that in 2013 a Quebec-only program will see prices of $37/mt and that a California-only program would yield $17/mt. The analysis projected prices of $19/metric tonne (mt) in 2013 in a joint Quebec/California program scenario. It appears that overall lower abatement costs for the linked California/Quebec program would be achieved by the decision to link with Quebec. However it also means a higher cost for California facilities when compared to a California-only program. In CARB's initial statement of reasons (ISOR) for the linking regulation, CARB even goes as far as saying that increasing the price of allowances is good for California business, because it allows them to invest in more expensive (but now "cost-effective") emission reductions that they can sell to Quebec. This logic has two huge flaws:

  1) In California, it takes years to get emission reduction projects from concept to permit to construction to operation. Facilities in California would have to have projects well underway right now in order to have excess emissions to sell to Quebec within the 2020 timeframe. Does CARB know of such a scheduled project?

  2) California's cap-and-trade program is 6 times as large as Quebec (ISOR – page 85) making California's need for reductions and offsets much greater than Quebec's. However, according to the WCI study, since Quebec's price of carbon is over twice as large as California, linking with Quebec will only make the cost of offsets higher as Quebec industry will have twice

the incentive to go after the limited number of offsets, thereby increasing the cost of offsets. Thus from a California facility standpoint, linking with Quebec with a small cap-and-trade program and a higher carbon price is a lose/lose proposition – higher cost for offsets and higher cost for emission reductions.

QUEBEC PROGRAM IS POTENTIALLY FLAWED

- Quebec may not be ready to link with California. Recently, 'in an annual report, Michael Samson, the Canadian province's acting Auditor General, said Quebec's greenhouse gas reporting data has been erratic to the point where it won't be clear whether it has achieved the reduction target set out in its 2006-2012 Climate Action Plan. Samson said the Province too often relies on reporting that is "anecdotal" and cannot be verified, and said new policies are needed." While California's program has gone to extremes and at a high cost to the state and industry to get a very accurate verified emissions inventory, yet Canada's own Auditor General is placing doubt on the program in Quebec. Wouldn't it be more prudent and in the best interests of California employers and consumers for California's regulatory agency (CARB) and elected officials to delay linking to a program that has not yet been verified? How can a ton of carbon in California be equal to a ton in Quebec, when Quebec does not even know how many tons are really there? Further, how can the price for that ton be legitimate, when the market will not know how many emissions there are and how many emission reductions are needed? Again, beyond the question of prudence, finalizing linkage with Quebec under these circumstances would violate CARB's own public notice requirements and the WCI's pre-linkage review protocols. *See* C/T Reg. § 95941; WCI Program Design at 22.

CALIFORNIA'S PROGRAM IS NOT TESTED AND READY

- The California program has not begun, is untested, and systems are still being put in place for an auction in November and compliance obligations in 2013. California should not link with Quebec until California's own cap-and-trade system has had opportunity to function independently. Given the magnitude and complexity of California's own program, adding an unnecessary additional layer of complexity by coordinating with a foreign jurisdiction at the outset would be imprudent.

- Other cap-and-trade systems, such as the European Union's ETS, have encountered implementation problems in their initial period. California also is likely to experience unforeseen difficulties in implementing its program, and thus should proceed incrementally. Linking with foreign jurisdictions only will make the system more complicated for the State and for stakeholders.

- Stakeholders and regulated parties are expressing serious concerns about holding and purchase limits, allowance allocation and the availability of offsets to minimize the costs of allowances. CARB may wish to amend the regulation in the future to adjust to market problems, yet not have freedom to act unilaterally if the program is linked with Quebec.

- Current and future litigation about important elements of the program could also upset timing and execution, and resolution will be complicated if California must include foreign governments in negotiations. Involving another jurisdiction in our program could seriously limit flexibility to make needed adjustments in the program.

CONCLUSION

Implementation of AB 32 is a massive undertaking that poses enormous risks to the California economy. CARB should take every opportunity to simplify, streamline, and preserve options to make mid-course corrections if needed to respond to market and economic consequences of AB 32 regulations. Linkage with Quebec at this time is counter to that purpose and should not be adopted at the June 28, 2012 CARB meeting.

cc: ARB Board Members
Virgil Welch
James Goldstene
Richard Corey
Edie Chang
Steven Cliff