



January 11, 2010

Ms. Lucille Van Ommering
Climate Change Cap-and-Trade Section
California Air Resources Board
PO Box 2815
Sacramento, CA 95812

RE: CLFP Comments Regarding ARB's Preliminary Draft Regulation for a California Greenhouse Gas Emissions Cap-and-Trade Program

Dear Ms. Van Ommering:

The California League of Food Processors (CLFP) recognizes the significant amount of effort that Air Resources Board (ARB) staff has devoted to developing the Preliminary Draft Regulation (PDR) and appreciates the opportunity to comment on the proposal. The PDR provides a starting point for discussing a wide range of specific market structure, operations, and oversight issues. However, it is clear that there are many issues that require further clarification, discussion, and refinement. The economic stakes are high, and the cap-and-trade program must function properly from the first day of trading or risk a loss of confidence by participants and other stakeholders.

The Economic Impact of the Cap-And-Trade Program on Food Processors

As you are aware, the business community is very concerned about the costs, regulations, and risks inherent in implementing an emissions trading program that will affect virtually every sector of California economy. Most of the direct costs would be borne by about 600 facilities, including 38 food processors.

Food processors and other manufacturers will have to adapt quickly to the low-carbon business landscape, and many will need substantial financial resources to develop and implement new technologies and practices. Some firms may not survive this transition, as they do not have the financial resources or are unable to make large reductions in GHG emissions due to technical or production considerations. The risk to the state's economy is potentially enormous, especially if a similar regional or national program is not implemented in the near future.

CLFP looks forward to the final report of the Economic and Allocation Advisory Committee (EAAC), and their recommendations regarding allocating emissions allowances, and distributing the billions of dollars in revenue that will be generated by the cap-and-trade auctions. CLFP opposes a market design that includes 100 percent auction of allocations as it would be too costly to businesses. CLFP also opposes using auction revenue to fund an array of programs that do not

directly relate to reducing long-term greenhouse gas emissions. The auction revenue should be devoted to helping to create a path forward by developing, testing, and implementing new technologies to increase energy efficiency and reduce GHG emissions.

CLFP also awaits the next round of ARB's macroeconomic modeling results, as that information will be critical to evaluating a number of key cap-and-trade market design parameters. This analysis should be completed and reviewed by stakeholders prior to completion of the final draft cap-and-trade program regulations.

CLFP believes that the market design is critical because the potential economic impact of the greenhouse gas (GHG) cap-and-trade program on the food processing sector will likely be quite significant.

- Potential High Cost of Purchasing Emissions Allocations and Offsets For the firms participating in the GHG cap-and-trade program the cost of purchasing emissions allocations and offsets to meet compliance obligations will be substantial. Even at relatively low auction prices, most participants will likely incur several hundred thousand dollars per year or much more in costs. Food processors are price-takers, it will be difficult for most firms to absorb these costs or pass them on to buyers in the highly competitive food processing industry.
- The High Cost of Facility Retrofits Most facilities will incur large costs if they modify their operations or purchase new equipment to reduce onsite GHG emissions. Most of the emissions generated at food processing plants are due to the large boilers necessary to cook products and sterilize equipment. Many facilities will not be able to greatly reduce their combustion emissions without compromising food safety or quality, or curtailing production.

Food processing tends to be very energy intensive and so significant increases in energy costs due to the California climate change program will affect the ability of firms to compete. It is important to note that most large food processors have already made major investments in energy efficiency and conservation in recent years, so further reductions may require using technologies or practices that do not meet cost-effectiveness thresholds or do not currently exist. Quite simply, major reductions in fossil fuel combustion may not be feasible at many facilities as most of the "low hanging fruit" with respect to energy efficiency has already been harvested.

- The Cumulative Cost of Environmental Regulation It is important to note that most food processors have purchased, or will soon be purchasing, equipment to comply with other air quality regulations (e.g. SCR units to reduce boiler NOx emissions, forklifts, and off-road equipment). The cumulative cost of environmental regulation is high for most California manufacturers because profits are low and capital is scarce and this situation may not change significantly for some time.
- Higher Input Costs Most of the production inputs used by food processors (packaging, raw farm products, trucking) are relatively energy intensive. Higher energy prices and other embedded cap-and-trade costs will likely increase the cost of production for most

food processors. If transportation fuels are included in the cap-and-trade program in 2012 it will likely have a substantial impact on fuel costs and trucking rates. Again, passing on these costs will be difficult for most firms as food processors compete with numerous other suppliers in the global market.

- Program Compliance Costs Food processors will incur substantial administrative costs to comply with GHG emissions monitoring, reporting, registration, verification, planning, and trading requirements. Many firms have indicated that they do not have this type of expertise available and will have to hire staff to devote to these tasks and/or hire consultants. A recent study commissioned by the Office of Planning and Research¹ documented that California businesses incur very high regulatory compliance costs. The cap-and-trade program and AB 32 regulations will add to that burden.
- Uncertainty and the Cost of Capital Cap-and-trade market and regulatory uncertainty will complicate business planning efforts, increase risk, and may increase capital borrowing costs. Most CLFP members have no experience in trading GHG emissions instruments, and this may generate uncertainty that will likely be reflected in the financial returns expected by lenders or investors to compensate for increased risk.
- Indirect Economic Impact of Emissions Leakage Increased operating costs will affect the ability of California food processors to compete with rivals in other states or nations. Food processing is a highly competitive business that tends to be characterized by relatively low financial margins. Hundreds of farmers, thousands of production workers, numerous suppliers, and a number of rural communities located across the state depend on the food processing industry. CLFP believes that if the compliance costs become too high a number of food processors will cease operating in California, and this outcome would have a major impact on the economy of the Central Valley.

At this point the cumulative long-term costs that will borne by businesses due to implementation of AB 32 have not been fully quantified. This should be of great concern to policy makers. CLFP suggests that ARB develop some company-specific case studies to better understand and quantify the potential regulatory financial burden and how it will affect the ability of the enterprises to continue and compete. This type of study could be a very useful complement to the macroeconomic analysis conducted by ARB.

CLFP Comments Regarding ARB's November 24, 2009 PDR

CLFP has reviewed the PDR and has several comments for consideration by ARB:

- Offsets should be a very important cost containment option for many firms. CLFP continues to strongly advocate that ARB not take a restrictive approach to the use of emission offsets by cap-and-trade program participants. ARB should not impose any arbitrary restrictions on the cap-and-trade program participants regarding the number/percentage of offsets that can be used, the geographic location of offsets, or the types of offsets that would be eligible. ARB should instead focus on the *quality* of offsets; that they meet the requirements of being real, additional, quantifiable, verifiable,

¹ Cost of Regulations on California Small Business, Varshney and Associates, September, 2009.

and permanent. As long as offsets meet that rigorous standard then their use by regulated entities should not be limited for compliance purposes.

- Emissions borrowing and banking should be allowed to provide more compliance flexibility. As long as firms have to meet the mandated long-term emissions reduction targets then ARB should provide them with the tools to best manage their own internal planning and investment paths to satisfy those requirements.
- A key cap-and-trade cost containment and risk management provision will be to institute a carbon price safety valve. This can be accomplished by either releasing allowances when market prices approach an established maximum level, or to set a price ceiling. A safety valve is necessary to help market participants to plan their financial outlays and to minimize the potential for short-term market manipulation by non-regulated entities that may be purchasing allowances.
- CLFP supports having three-year compliance periods to provide firms with a sufficient planning horizon and to cope with annual fluctuations in production and sales. However, CLFP opposes ARB's proposal to have an annual compliance true-up to ensure that firms will not go bankrupt and not meet their compliance obligations. The annual true-up will negate much of the advantages of having a three-year compliance period, as firms will be forced to make investments on an arbitrary annual basis rather than based on the most cost effective path.
- CLFP recommends the formation of a permanent advisory committee for the cap and trade program. The purpose of the advisory committee would be to review how the cap and trade program is functioning in terms of a market efficiency and fairness. The advisory committee should include economists with specific expertise in emissions markets and representatives from the regulated sectors. In addition, CLFP recommend that an independent dispute resolution process be developed to address some of the issues that may arise from the cap-and-trade market.
- Both ARB and the program participants will be on a steep learning curve during the initial years of emissions trading. ARB should avoid imposing automatic penalties for non-compliance, especially for clerical or administrative errors. Enforcement will be important to the integrity of the program, but efforts should focus on the activities of opt-in participants who do not have compliance obligations and may have an incentive to manipulate the market.
- On page 27 of the PDR, ARB suggests that firms with emissions that drop below 25,000 metric tons will continue to have surrender obligations for six consecutive years. This provision seems to require clarification and/or modification. If the compliance periods are three years in length and the firm only exceeded 25,000 metric tons of emissions for one of those years, why would they continue to have to surrender obligations in the next compliance period if their emissions in that period did not exceed 25,000 metric tons? CFLP believes that they should not have to surrender emissions allowances or pay ARB administrative fees unless their emissions again exceed the minimum threshold.

- The cap-and-trade program should focus on GHG emissions, and use other regulatory options to address specific local criteria pollutant problems.
- ARB should ensure that its cap-and-trade program will link directly to a U.S. federal program and to regional programs such as the Western Climate Initiative. Although California has been a leader with respect to climate change, California businesses will suffer and environmental goals will not be met if regulators do not closely coordinate and link market programs. CLFP believes that a “go-it-alone” approach is not a viable option.

CLFP Recommendations to ARB

Food processors collectively account for less than one percent of the 2008 emissions reported to ARB. However, CLFP is very concerned that the direct compliance costs and cumulative secondary economic costs generated by the cap-and-trade program will be excessive and have a very detrimental impact on the ability of many California food processors to remain financially solvent and continue operations. This type of economic disaster could be averted. Regulators in the European Union (EU) have faced a similar issue and concluded that food processing is a vital sector to Europe’s economy and is subject to strong international competition. To prevent the loss of this industry and avoid significant emissions leakage, the EU Emissions Trading System has proposed providing food processors with additional free GHG emissions allowances during the 2013-2020 time period.

CLFP recommends that ARB take a similar approach. Food processing is a very energy intensive and trade sensitive sector that has an important role in the California economy. California processors provide consumers with abundant, affordable, and high quality food that is produced locally and generates income and employment in communities across the state. California food processors are subject to a range of rigorous environmental and labor regulations that many of their foreign competitors do not face. For a host of reasons, California and U.S. consumers should not rely on foreign producers for their food supplies.

CLFP looks forward to continuing the dialogue with ARB regarding the structure of the cap-and-trade program and how it can be best shaped to minimize compliance costs and preserve the viability food processing industry in California.

Sincerely,



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