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Comments of the Green Power Institute on Allocation Options at Issue in the Design of the Cap-and-Trade Program

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Respectfully Submitted to the ARB by:

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The Green Power Institute (GPI), the renewable energy program of the Pacific Institute for Studies in Environment, Development, and Security,[1] respectfully submits these comments on allocation issues related to the Air Resources Board's (ARB) *Preliminary Draft Regulation* for a cap-and-trade program. Most discussions about the design of a cap-and-trade system for reducing greenhouse-gas emissions fail to distinguish between the separate and distinct steps of allocating emissions allowances, and distributing the allowances to the allocation-rights holders. There is a common misperception that administratively allocating emissions allowances necessarily means that the allowances must be distributed to the allocation-rights holders free of charge. In fact, the GPI believes that combining the administrative allocation of purchasing rights to emissions allowances with distribution of the allowances to the purchasing-rights holders for an administratively-determined fee represents a superior option that can be employed in developing an effective cap-and-trade program.

[1] The Pacific Institute is a public-purpose environmental-research institution located in Oakland, CA. The Pacific Institute is known for its work on water resources, climate change, and renewable energy.

In the existing energy marketplace in the US, in which greenhouse gases are not yet regulated, it is generally acknowledged that the marginal energy source for most of the hours of the year is fossil fuel. As fossil carbon emissions are squeezed out of the system as a result of the implementation of the cap-and-trade program and other measures enacted to implement AB 32, lower and/or zero greenhouse-gas-emitting sources, including efficiency, will have to increase their collective share of the overall energy-supply mix. As this process proceeds, and regardless of the details of the allocation system for emissions allowances that is ultimately adopted, emissions allowances will take on all of the characteristics of a commodity. We suggest that the allowances be treated as the commodities that they are from the beginning. In our opinion, giving emissions allowances away without charge is equivalent to giving away public assets or resources, like timber or minerals, without charge. Rights to public commodities have always been sold, and there is no reason why rights to emit should be treated differently from other publicly-sourced commodities.

The proper approach for distributing greenhouse-gas emissions allowances when administrative allocation is the method of choice is to administratively allocate rights to purchase emissions allowances at a predetermined, administratively-set price. The price should be set a level that is somewhere between zero and the market value of the allowances. The proposal presented at the May 17, 2010, public meeting, to distribute the majority of the greenhouse-gas-emissions allowances administratively during the early years of the cap-and-trade program, is predicated on the need to prevent leakage and soften the economic effects of the program on consumers. These objectives can be better served by charging the recipients of the allowances a fee that is sufficiently below the market price to meet the ARB's objectives (e.g. avoiding leakage), but high enough to ensure that the general public receives a reasonable measure of the value of the commodity that is being distributed, and the entity receiving the subsidy (allowances sold to rights holders at a price below market value are a subsidy to the buyer) receives only the amount of subsidy needed, rather than an unnecessary windfall. We further believe that a secondary market for allowances should be allowed to develop that will serve to arbitrage their value based on constantly changing market conditions.

Selling allowances, rather than distributing them free-of-charge, not only follows the well-established principle that public commodities should not be handed out for free, it also addresses the concern that there might be a need to provide for some amount of price stabilization for emissions allowances, at least in the early stages of the AB 32 program. Selling a significant block of allowances at an administratively-determined price would go a long way towards providing market-price stability for these commodities. Moreover, assuming that the mix of administrative allocation and auction is weighted towards the former in the beginning of the program, and then gradually adjusted towards the auction option over time, the use of allowance sales in conjunction with administrative allocations would also be gradually phased out, as the market matures, and price stabilization becomes less of a concern for regulators.

The administrative allocation to generators of purchasing rights for greenhouse-gas emissions allowances can be done using the same methods as would be used for the administrative allocation of free allowances. The two major competing models are allocation based on historical emissions (emissions based), and allocation based on electricity production (output based). These two approaches will have different effects on the behavior of market participants, regardless of whether the allowances are distributed without charge, or are sold at an administratively-determined price. Selling the allowances at a fair and reasonable price should be the ARB's standard operating practice until all allowances are sold at auction.

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