Cost Containment Workshop
California Air Resources Board

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Resources for the Future
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Existing Regulatory Framework

- Purpose of cost management
  - Symmetric design for a two edged problem
  - Short run usefulness
  - Long run usefulness
- Several features in place
  - Price floor in auction
  - Trading, banking, offsets, the compliance reserve and others

Focus today on the possibility that prices may rise to exceed the top tier in the compliance reserve

- Safety valve remedy
  - 2007 MAC recommended against an unlimited supply
- Limited compliance reserve
  - Can capture most of the expected cost savings without the prospect of great increases in emissions
- Program review would be triggered in either case

Bailey et al. solve dynamic stochastic model

- Steep supply curve for additional emissions reductions
- Small but positive probability of price rising above the top tier in the compliance reserve
- In an economic model the solution is achieved instantly and inter-annual behavior is captured in a single outcome... as though investors would purchase the entire reserve in anticipatory behavior
  - May violate holding limits
  - Does not anticipate possible regulatory response, chance of federal action, etc.
  - Puts significant capital at risk

Key feature: the drawdown of the reserve would not be instantaneous

- If reserve was ultimately exhausted, regulators would see signals of the possibility years in advance
- ARB Resolution 12-51 asks us to consider policy responses
- I suggest four courses of action…

1. Planning: Guidelines for Governor's Discretion

- Part 7 of AB 32 provides discretion to adjust applicable deadlines for individual regulations in extraordinary circumstances
- Without usurping discretion, ARB could develop plan of decision criteria
- ARB could develop a blueprint for how measures might be implemented at that time (for example, executing measures identified in the staff document)

2. Remedial action: Expand the compliance reserve drawing on allowances from other programs

- There are strong reasons to prefer emissions reductions from inside the state…
- However, if price reaches ceiling, balancing considerations would be different
- Varying stringency of programs provides an opportunity to enhance emissions outcome by aggregating other allowances
- Implementation might involve an independent institution, as might be supported by the World Bank

3. Possible Design: Overlapping Compliance Periods

- Would be especially useful if a confluence of events led to market disruption at end of compliance period
- Staggering the settlement dates would provide additional buoyancy in the short run
- Enables limited borrowing
- To implement, entities could be given voluntary option to settle account early and restart their three-year compliance clock
- May assist in transitioning beyond 2020

4. Policy: Planning for Beyond 2020

- The determination of plans beyond 2020 provides a signal to regulated entities about future obligations
- Increasing stringency could encourage more banking, which might drive up short-term prices
- More likely, in my view, signals about 2020 encourage innovators and investment that should moderate long-term price path