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 a 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.