



INTERNATIONAL

November 27, 2007

Steve Church  
California Air Resources Board  
1001 I Street, PO Box 2815  
Sacramento, CA 95812

Dear Mr. Church:

I am writing to comment on two statements in the "Results of Oct 3 ETAAC subcommittee meeting on response to Market Advisory Committee Report." They are claims that putting a price on carbon emissions will lead to innovation and that an auction is necessary to establish a clear price signal. Neither is correct.

It is not possible to provide a sufficiently large and credible incentive for innovation by merely announcing a policy that will put a price on carbon emissions. This is the clear conclusion of virtually every economic analysis that has addressed this issue, including the Stern Report and my own research. The well-known problems of capturing the rewards of innovation are not solved by promising to put a future price on carbon, because policies directed at carbon emissions do nothing to address the underlying R&D market failures. Moreover, the inability of current policymakers to commit their successors to a course of action destroys the credibility of any announcement of a future price high enough to provide an adequate reward to large scale R&D. Once a discovery is made, governments have every incentive to keep the carbon price no higher than needed to bring the innovation into use, which leaves nothing left over as a return to the R&D investment. Carbon pricing can get technology off the shelf, but it is not able to create new technology.

An auction is neither necessary nor sufficient to establish a clear price signal to reduce emissions—even with 100% grandfathering, trading of allowances will reveal prices just as transparently. The price signal is provided to regulated parties by the requirement that they surrender allowances to cover their emissions, and is clearly apparent when they buy or sell allowances. All that is required for a clear price signal is a well-functioning market for those allowances, and brokers, traders, and operators of exchanges are clamoring to create that market. As long as such a market exists, the price signal will be clear and easy to look up in multiple publications—as are carbon prices today for the CCX and the EU ETS (which operate with little or use of auctions). Moreover, if auctions are not designed properly, allowance prices set in those occasional events may not be representative of underlying fundamentals, and again a secondary market will be necessary for efficient trading and a clear price signal. What is required for a clear price signal is the broadest possible market, undistorted by regulatory programs, technology standards or other command and control approaches that remove decisions from the influence of carbon prices.

Sincerely yours,

W. David Montgomery  
Vice President  
CRA INTERNATIONAL, INC.