ETAAC and Market Mechanisms for AB 32 Implementation

Achieving the State's emissions reduction targets and related objectives is a significant challenge that will require the participation of all sectors of the economy. The state must create clear and simple rules to encourage broad participation in the fight against climate change. Technological innovation in all sectors will be necessary to meet reduction goals, reduce long term costs, and achieve economic co-benefits.[i]

The ETAAC members had a healthy debate on several issues but were united in the effort to develop recommendations that will meet AB32's emission reduction targets while also yielding the co-benefits of cleaner air, health benefits, new industries, and job growth here in California. There was agreement that AB32 must be achieved in a way that stimulates technological change and puts California on a path to a near-zero carbon future by 2050. To get there, we'll need innovative policies and innovative financial mechanisms.

Balanced Policy Portfolio

To reach AB 32's targets and timelines, the state will have to use all the tools in the policy tool box. ETAAC believes that AB 32's goals call for a balanced portfolio of policies, including regulations, market mechanisms, performance standards, efficiency standards and support for RD&D. ***It is important to create a clear set of rules and incentives to encourage emissions reductions and investment by all sectors of the economy.***

- Placing a price on carbon and other GHG emissions is a critical step towards responding to the climate change threat as it allows private markets to incorporate the value of reducing these emissions into their everyday business decisions. A flexible cap-and-trade system with clear rules could drive emissions and innovation while bringing down compliance costs for capped entities.
- Additional market barriers and co-benefits would not be addressed if a cap-and-trade system were the only state policy employed to implement AB 32. Complementary policies will be needed to spur innovation, overcome traditional market barriers and address distributional impacts. Additional market-based policies such as revenue-neutral fee shifting can help address some of these issues. Performance standards and support for RD&D will also be needed.

Why are market mechanism needed?

- The State has imperfect knowledge about emissions. Because the state can't know everything in advance about emissions, it is important to provide regulated entities with some flexibility. Auctioning and trading will provide this flexibility.
- Auctioning will establish a price for carbon which will, in turn, enable businesses to make smarter (and cleaner) investments.

- Market mechanisms reduce the cost of compliance by encouraging the lowest cost emissions reductions.

ETAAC Comments on the MAC's Cap and Trade Recommendations[ii]

ETAAC provided comments on the Market Advisory Committee's cap and trade design recommendations. The ETAAC was asked to comment on the recommendations with respect to ***three crucial policy goals: encouraging early action; stimulating innovation; and creating a real price for carbon.*** The most important observations are below.

- Scope of Carbon Cap: The cap should include as many sectors of the economy as possible, as a broader cap is preferable for all three policy goals.
- Allowance Allocation Method: ETAAC members agreed that grandfathering is bad for all three criteria. There was general agreement that some level of auctioning will be necessary. Auctioning provides the strongest incentives for early action and for innovation within capped sectors. Auctioning is also necessary to provide a clear and early price signal.
- Offsets: With regard to ***offsets for compliance***, ETAAC notes that offsets are useful for short term cost containment and for driving reductions in sectors outside the cap-and-trade system, but the increased flexibility and lower compliance costs reduce the incentives for innovation within capped sectors. Limits may therefore be necessary. With regard to the ***voluntary offset markets***, larger markets can drive reductions and innovation outside of capped sectors without negative consequences. CARB should therefore encourage the growth of the voluntary market.
- Banking, Borrowing, and Cost Containment: Allowance banking is necessary to encourage early action and innovation. Some limits may be needed to force allowance sales and prevent the buildup of large banks. The flexibility provided by banking should help address price fluctuations and stabilize the market. Borrowing delays innovation and discourages early action and should be allowed only in extreme circumstances as a cost containment mechanism. For cost containment, ETAAC recommends the creation of an active market maker, such as the proposed California Carbon Trust, rather than a static safety valve.

ETAAC Recommendations Related to Other Market Mechanisms

Many of ETAAC's policy recommendations relate to market mechanisms for achieving policy goals.

- Create a California Carbon Trust: use revenues from an auction of emissions allowances to encourage carbon reductions outside of capped sectors, while also supporting environmental justice goals, actively managing the carbon market, and encouraging RD&D efforts. Activities could start prior to 2012, helping to set an early price signal for GHG emissions.[iii]
- Fee and Tax Shifting (Feebates): Use existing tax and fee structures to encourage consumers to purchase lower carbon products. The goal this kind of fee and tax shifting is to encourage the distribution and purchase of products that either generate less GHG emissions during their manufacturing lifecycle or during their actual use. Examples include the State excise tax on transportation fuels and car registration fees assessed with new vehicle purchases.[iv]

- Pay-as-You-Drive Insurance: Assesses individualized premiums based upon miles driven instead of the calendar year, providing motorists a new option to save money by driving less and therefore minimizing insurance risk. This would provide a financial incentive for drivers to reduce vehicle miles traveled emissions from transportation.[v]
- Vehicle Feebates, Registration Fees and Indexed Fuel Taxes: Create a market pull for more efficient and therefore cleaner vehicles through higher fuel taxes and registration fees levied on GHG emissions directly or on surrogate factors such as vehicle weight. For example, purchase taxes could be reduced for low carbon vehicles and increased for high carbon vehicles.[vi]

Important Overarching Considerations for AB 32 Implementation[vii]

- Create Clear Rules to Encourage Broad Participation: The market is a very powerful force, but private actors will maximize financial returns regardless of the state's policy goals. A clear, consistent set of rules and incentives can direct the power of the private sector toward the climate challenge, while the absence of these signals will direct private investment and ingenuity elsewhere. ARB should therefore create clear and simple rules to encourage participation in climate change mitigation by all entrepreneurs and sectors of the economy, not just capped entities.
- Use Auction Revenues Wisely to Further AB 32 Goals: ETAAC believes allowance auction revenues represent an important opportunity for achieving policy goals. Appropriate uses of auction revenues include: investment in GHG emissions reductions outside of capped sectors, funding for University RD&D, public financing mechanisms to encourage and accelerate technology deployment, and funding for emissions reduction projects in disadvantaged communities. Auction revenues could be used to address distributional issues related to the costs of climate change mitigation.[viii]
- Invest in Reductions Outside of Capped Sectors: The public sector has an important role to play in encouraging reductions outside of capped sectors. The State could directly support voluntary markets for additional reductions through the creation of a California Carbon Trust.[ix]

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[i] ETAAC, Chapter 1
[ii] ETAAC, 9 – ETAAC Review of the Market Advisory Committee Report (p. 9-1)
[iii] ETAAC, II.2.A (p. 2-3)
[iv] ETAAC, II.3.E (p. 2-19)
[v] ETAAC, III.3.A (p. 3-15)
[vi] ETAAC, III.4.G (p. 3-27)
[vii] ETAAC Chapters 1 (Introduction), 2 (Financial Sector) and 9 (Review of the Market Advisory Committee Report) are the most relevant to market mechanisms and overarching issues.
[viii] ETAAC, 9.D (p. 9-4)
[ix] ETAAC, II.2.A (p. 2-3)

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You can find the ETAAC Report at www.ETAAC.org