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To: California Air Resources Board Staff (ccplan@arb.ca.gov)
Re: NRDC Comments on Allowance Allocation Issues
Date: March 28, 2008

Below are NRDC's comments on the four "Key Questions for Discussion" presented at the stakeholder workshop on allowance allocation on March 17, 2008. To provide further detail on NRDC's position, particularly regarding the electricity sector, we have also attached comments that NRDC and UCS submitted to the CPUC/CEC in October 2007 on allowance allocation issues.

As a preliminary matter, NRDC emphasizes that any potential cap and trade program would be only one tool in a package of policies to achieve the reductions required by AB 32. Any cap and trade program must be well-designed to be a valuable part of that package, and it must meet the requirements laid out in AB 32. We understand that CARB must be able to explicate the design of the key elements of a cap and trade program, including allowance distribution methods, in order to undertake the steps required in Health and Safety Code Section 38570(b) and decide whether the potential program could be included in the regulations. Within that context, we offer the following comments on how allowances should be distributed and how their value should be used.

1. What method should we use to distribute the allowances?

Allowances are valuable permits to pollute the public atmosphere, and their value should be distributed in the public interest and to further the goals of AB 32. AB 32 requires that the distribution of allowances must: (all references below are to sections of the Health and Safety Code)

- Be equitable; (38562(b)(1))
- Reduce the cost of the program to consumers, especially in low-income communities; (38562(b)(2))
- Encourage early action; (38562(b)(1))
- Promote investment in technologies to achieve the maximum technologically feasible and cost-effective greenhouse gas emission reductions; (38562(a))
- Contribute to the state's efforts to improve air quality and reduce toxic air contaminant emissions; (38501(h), 38562(b)(4) and 38570 (b)(2))
- Promote investment in innovative and pioneering technologies; (38501(e))
- Minimize costs and maximize the total benefits to California; (38562(b)(1))
- Help improve and modernize California's energy infrastructure and maintain electric system reliability; (38501(h))
- Maximize additional environmental and economic co-benefits for California; (38501(h) and 38570 (b)(3))
- Direct investment toward the most disadvantaged communities in California and provide an opportunity for small businesses, schools, affordable housing

associations, and other community institutions to participate in and benefit from statewide efforts to reduce greenhouse gas emissions. (38565)

In order to comply with these requirements, allowances should be auctioned, or allocated with a specific requirement that the allowance value be used for the public good. NRDC prefers auctions because they are transparent, provide equitable access to allowances, reward early actors, require polluters to pay for the right to pollute, and avoid windfall profits.

NRDC believes policymakers should design an auction to:

- Be as simple, easy to understand, and straightforward to participate in as possible;
- Minimize administrative costs;
- Be stable and predictable, and provide certainty for regulated entities and investors;
- Provide transparent information about the market (e.g., the price of allowances, which entities acquired how many allowances, etc.);
- Ensure that the revenues raised will go to the intended purposes; and
- Protect against market manipulation.

Allowances should *not* be grandfathered (i.e., distributed for free to emitters based on historical emissions). Grandfathering does not comply with the requirements of AB 32 because it rewards historical polluters, penalizes early actors, could lead to windfall profits, and asks the biggest polluters to reduce their emissions the least. Grandfathering would also create a very poor precedent for a federal program; a federal program that grandfathers allowances would severely disadvantage California because California's economy is relatively less carbon-intensive than the national average. (See pp. 11-12 of the attached comments).

2. How should allowance value be used? And, if the allowance value should be used to ease the costs of regulation for entities, who should receive them and how many allowances should each entity receive?

Allowance value should be used in the public interest and to further to goals of AB 32. In order to meet the clear requirements set out in AB 32 (see list above), allowance value should be used to:

- Reduce costs to consumers, particularly low-income consumers, for example through investments in end-use efficiency beyond the state's existing programs.
- Support investments in, and deployment of, technologies to reduce GHG emissions;
- Support investment in RD&D of technologies to reduce GHG emissions;
- Provide economic opportunities to low-income and disadvantaged communities, as well as small businesses, schools, affordable housing association, and other community institutions;
- Support air and toxic pollution reduction efforts and enforcement programs, particularly in environmental justice communities;

- Supporting development of “green collar” jobs.

We note in particular that programs that help consumers use energy more efficiently are a preferable use of allowance value, as these programs can both permanently lower costs for consumers and reduce emissions, thus providing a durable benefit which is preferable to the temporary benefit derived from a single cash payment to consumers.

The presentation on March 17 discussed the potential to use allowance value to compensate regulated entities for the costs of regulation, including the anticipated losses of profits. We urge CARB to approach this option with extreme care and to take into account:

- 1) Many privately-owned entities will be able to pass through costs to consumers, therefore any compensation would result in windfall profits;
- 2) All entities have known that investments in carbon-emitting resources were risky since at least 1990 when the IPCC First Assessment Report was completed. California should not shield those entities who took on the risk of investing in high GHG-emitting resources at the expense of those who managed the risk well. Those who accepted the risk should bear the risk.

We note that the point of allocation of allowances (or auction revenues) need not be the same as the point of regulation. For example, in the electricity sector, if a deliverer point of regulation is adopted, as recommended by the CEC/CPUC in their joint decision issued March 12 and 13, 2008, CARB could allocate allowances, or distribute the revenues from an auction, to utilities as trustees on behalf of their customers (subject to oversight and verification).

The electricity sector presents some unique issues with respect to allowance allocation and use. The distributional impact across utility service territories has been, and will continue to be, the subject of intense discussions in the joint CPUC/CEC proceeding. We recognize the concerns that many stakeholders have raised, and we believe a well-designed auction can address them. One possible solution that we encourage CARB and other parties to explore is an auction design wherein electricity utilities who bid into an auction could retain, at least initially, a majority of the funds they spend in an auction with a requirement to invest those funds in ways that benefit their customers and to make long-term investments to reduce their GHG emissions (subject to oversight and verification and a “use it or lose it” restriction). (See pp.4-5, 10, 18 of attached comments for more information on this proposed revenue retention model.)

Another possible solution to distributional concerns could be to distribute, at least initially, some auction revenue to electricity utilities based on historical emissions. As explained above, we oppose allocating allowances based on historical emissions (ie: grandfathering) because it rewards historical polluters, penalizes early actors, could lead to windfall profits for private generators, and asks the biggest polluters to reduce their emissions the least. However, initially distributing some auction *revenues* to electricity retail providers based on historical emissions with a requirement to invest the funds in

ways that benefit their customers and to make long-term investments to reduce their GHG emissions, results in the same distributional impact as grandfathering, but avoids the downside of grandfathering because it essentially requires the biggest polluters to invest the most to clean themselves up.

We continue to believe there are multiple ways to distribute and use the value of allowances to meet the requirements of AB 32 and the policy principles described above, and we look forward to continuing discussions with other stakeholders and CARB on this important issue.

3. How should allowances be distributed to new entities and how should entities that cease operating in California be treated?

New entrants should be treated on an equal footing with incumbent entities. Auctioning allowances frequently (multiple times during each compliance period – at least annually and possible quarterly) is the best way to enable new entrants into the market, because they will be able to participate in an auction soon after beginning operations in California. (See Holt, C. et al. *Auction Design for Selling CO2 Emission Allowances Under the Regional Greenhouse Gas Initiative*. October 26, 2007; See also pp.7-8 of attached comments).

Auctions will not create any perverse incentives for entities to cease operating in California because those entities will not have been freely allocated any allowances whose value they could pocket if they ceased operating and sold the allowances. Entities that cease operating in California should still be required to surrender allowances at the end of the compliance period for their emissions during that compliance period.

4. How should the methods of distributing allowances in a cap-and-trade program change in future years?

The method for allocating allowances for the entire AB 32 compliance timeline should be determined up front, before enforcement begins in 2012, so that all parties know what to expect and can plan ahead to reduce emissions and acquire allowances.

As explained above, NRDC prefers auctioning and opposes grandfathering. If CARB initially does not auction all allowances, it should move towards full auctioning of allowances through annual or quarterly auctions as quickly as possible, on a pre-determined schedule.