



May 5, 2008

Mr. Sam Wade  
California Air Resources Board  
1001 I Street  
Sacramento, CA 95818

**RE: DESIGN CONSIDERATIONS FOR A POTENTIAL CALIFORNIA  
GREENHOUSE GAS CAP AND TRADE PROGRAM**

Dear Mr. Wade:

The California League of Food Processors (CLFP) is a statewide trade association that represents food processing companies with manufacturing operations in California. Several CLFP members emit more than 25,000 metric tons of CO<sub>2</sub> per year due to combustion of natural gas in boilers and these companies may be directly affected by some of the regulations being formulated for inclusion in ARB's AB 32 Scoping Plan. CLFP has been closely monitoring the development of the Scoping Plan and the design of a potential cap and trade program and has several specific recommendations for ARB.

CLF appreciates that ARB staff is working diligently to meet the mandated deadlines for implementing AB 32. However, CLFP is very concerned that the various elements of the Scoping Plan, including the cap and trade program, are being formulated in a very compressed time frame that is not conducive to a complete consideration of all of the policy options and the possible ramifications of implementing those options. The hurried pace of the rulemaking is causing great anxiety in the business community which fears that, despite the best efforts of ARB and stakeholders, the plan that is ultimately forwarded to the Board may contain fundamental flaws that could cause significant economic disruption in future years. As a result, it would seem entirely prudent that ARB keep all potential cost containment options for a cap and trade system on the table for review and discussion. CLFP believes that ARB should design the most flexible market system possible to minimize the potential for runaway carbon prices that could harm the state's economy and undermine public confidence in the entire climate change initiative.

During the April 25, 2008 stakeholder working group meeting regarding AB 32 program design, ARB staff requested that interested parties provide comments about three specific questions pertaining to the cap and trade program. CLFP's responses to the questions are as follows:

**1. What type of cost containment mechanism should California consider for a cap and trade system?**

Although some types of manufacturers may have relatively consistent production and CO<sub>2</sub> emissions patterns, some other operations may have emissions levels that vary significantly between years. For example, due to fluctuations in crop size and quality, fruit and vegetable processors may experience considerable swings the scale of their operations and CO<sub>2</sub> emissions from season to season. This will complicate their ability to comply with mandated annual CO<sub>2</sub> emissions reduction schedules. In addition, the level of production at any given facility may change greatly from year to year due to a host of factors, including shifts in production costs, competition from foreign suppliers, value of the U.S. dollar, and the general health of the California and U.S. economy. The design of the cap and trade system should account for variations in production and allow firms to best plan for and manage their compliance costs.

A cap and trade system will impose significant new costs on firms that may, or may not, be in a position to absorb those costs in a given year. Cost containment measures will be necessary for firms to cope with the changing needs of their operations or fluctuations in the business cycle. CLFP recommend that the following cost containment mechanisms be included by ARB in the cap and trade program:

The Slope of the Emissions Reduction Curve Should be Relatively Flat in the First Few Years of the Cap and Trade Market:

CLFP recommends that the 2012 – 2020 emissions reduction path prescribed in the Scoping Plan be designed to achieve only limited emissions reductions in the first few years to allow firms sufficient time to learn the nuances of trading emissions allowances and to develop cost-effective strategies to meet their long-term emissions reduction goals. The transition to a low carbon economy will not be simple or easy and the economic stakes are too high for ARB to focus on a headlong rush to achieve early greenhouse gas emissions reductions. A measured initial approach to emissions reductions would seem prudent for the stability of the program.

The Banking and Borrowing of Allowances Should be Permitted:

CLFP believes that allowing cap and trade program participants to bank and borrow allowances will be necessary for firms to comply with emissions reduction targets, manage their risks, and meet the changing needs of their business operations. Banking will encourage firms to take aggressive early action where feasible. Borrowing may be a necessity for firms to be able to grow their business during periods when the market price for carbon is very high. Banking and borrowing will provide the flexibility that businesses will require and will not compromise the integrity of the carbon market. As long as the ultimate 2020 emissions reductions goal is clear, consistent, and enforced by ARB then firms will not be able to effectively use banking and borrowing to avoid compliance.

A Three-Year Compliance Time Frame Should be Implemented:

As previously noted, business conditions and operations are rarely predictable. Also, the time frame to plan and implement capital improvement projects designed to reduce any type of emissions can be lengthy. As a result, a one-year compliance period will greatly complicate business planning and lead to unnecessary volatility in the marketplace. This dilemma can be easily remedied. CLFP believes that, especially in the early years of a cap and trade system, the compliance period should be at least three years.

The Carbon Market Design Should Include a Price Safety Valve:

AB 32 clearly provides the administration with the authority to intervene if short term conditions or poor market design yield unreasonably high prices. Judicious use of carbon price caps would provide a safety valve for any unforeseen flaws in market structure and reduce the potential for market manipulation and speculation. A suggestion was made at the April 25 workshop that the price cap be based on greenhouse gas reduction cost effectiveness calculations. This option would provide a quantitative basis for the price cap and warrants further consideration by ARB and stakeholders.

ARB Should Not Place Undue Restrictions on the Use of Offsets by Cap and Trade Program Participants:

Emissions offsets should be an important cost containment mechanism included in the cap and trade program. CLFP believes that there should be no geographic or other restrictions on the purchase of offsets as long as the offsets are real, additional, verifiable, permanent, and enforceable.

**2. Is there a need to establish an independent market oversight body?**

It is CLFP's view that an independent market oversight organization should be formed to monitor the cap and trade system. The objective of a "California Carbon Trust" would be to ensure that the market is fair, transparent, and sufficiently liquid to provide an adequate trading forum for emissions buyers and sellers. CLFP agrees with the recommendation made by some other groups that the Carbon Trust would function similar to the U.S. Federal Reserve Bank by actively monitoring transactions and intervening in the market when necessary to induce trading activity or stabilize prices. CLFP believes that the Carbon Trust should be comprised of representatives from the business sectors participating in the cap and trade program.

**3. Which systems should be considered for linkage with a potential cap and trade system?**

To the greatest extent possible a California cap and trade system should be designed so that ultimately it could be directly linked on a multilateral basis with other accredited regional, national, or international carbon trading markets. Developing a system that can accept allowances or credits issued by other trading programs will increase the liquidity of the California market, provide the opportunity to further lower the cost of reducing emissions, and mitigate the potential for one or several firms in California exercising market power to manipulate pricing.

**Other Issues:**

There are two other issues of concern to food processors regarding a greenhouse gas emissions cap and trade system:

**Credit for early action and prior action.**

A key issue for ARB will be to set thresholds to determine which firms will, or will not, be included in the initial cap and trade market based on their greenhouse gas emissions profile. Establishing a baseline will be critical for individual companies. CLFP believes that, in addition to credit for “early action” (measures undertaken between 2007 and 2012), it is very important that ARB allow firms to obtain direct credit for all of the “prior actions” taken to reduce their greenhouse gas emissions from 1990 to 2007. Since the target for the entire AB 32 effort is to reduce emissions back to 1990 levels, it would seem entirely consistent with the legislative intent to allow firms the option to use 1990 as the starting point for their accounting and proceed forward until the Scoping Plan regulations are enacted in 2012.

In response to rising and uncertain energy prices, and to maintain competitiveness in the marketplace, many food processors have been very aggressive over the last decade in their efforts to become more energy efficient. These firms have made major reductions in greenhouse gas emissions and are concerned that they will effectively be penalized relative to other firms that have taken little or no action. The option to document and obtain tangible credit for past actions should be available to all regulated entities. Failure to reward prior actions will result in an uneven playing field once the regulatory program commences in 2012.

Accounting for prior actions will not place an unreasonable administrative burden on ARB if simple energy intensity measures are employed. ARB staff has expressed reservations about accounting for historical emissions reductions due to a perceived issue with collecting and auditing records and the level of administrative oversight necessary. CLFP contends that, properly structured, accounting for prior actions will not place an undue burden on the agency. CLFP suggests that a simple energy intensity metric could be employed. For example, firms seeking credits could report the amount of Btu’s of natural gas used to produce a pound of product in 1990 or some prior year compared to the amount used in 2007. In this case, firms could report their natural gas consumption (the same way that some will be required to starting in 2009) along with production volume figures. Simple division would provide the final energy intensity measure, which can be translated into a CO2 equivalent. CLFP believes that a fair, accurate, and consistent metric can be used that will require little oversight by ARB.

To provide industry with sufficient regulatory certainty ARB must decide soon if, and how, firms will receive credit for prior or early action. CLFP has been working with the California Energy Commission and several utilities to aggressively promote energy efficiency programs in the food processing sector. However, some firms may choose to delay undertaking major improvements until they are sure that they will benefit, or at least not be disadvantaged, if they take aggressive early action.

Auctioning of Allowances:

CLFP opposes the auctioning of a large portion of the emissions allowances in the first five years of the program. The transition to a low carbon economy will be expensive and fraught with potential risks for businesses. The auctioning of emissions credits will add costs to firms that already have incurred substantial expenses to comply with criteria pollutant regulations and other environmental mandates. The extra costs associated with emissions auctions will essentially be an arbitrary tax that will directly affect the ability of California businesses to compete in the global marketplace. CLFP believes that in the first five years that most, or all, of the allowances be granted to the market participants to ease the transition into the cap and trade market.

**Summary:**

In the course of implementing AB 32 California must not repeat the calamity associated with the 2000 – 2001 meltdown of the electricity market. ARB should move slowly and cautiously into the uncharted territory of large-scale carbon emissions trading. If the carbon market falters or fails in the early stages of implementation some firms may flee California for other locations with a more predictable and hospitable regulatory environment. To avoid this possibility ARB should ensure that a wide range of cost containment measures are included in the plan, that the carbon market has sufficient oversight, that the California emissions trading market be designed to mesh with other regional or national markets, that firms receive sufficient credit for all prior emissions reductions, and that in the initial years only a limited portion of allowances be distributed via auction. These elements will be critical to the stability and integrity of the system and will not undermine ARB's ability to meet 2020 emissions reduction targets.

If you have any questions about CLFP's views on this topic please contact me. CLFP looks forward to further discussions with ARB with respect to these issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Rob Neenan". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Rob Neenan  
Director of Regulatory Affairs