

Communities for a Better Environment  
1904 Franklin Street, Suite 600  
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September 27, 2011

California Air Resources Board  
Mary Nichols, Chair  
Members of the Board  
California Air Resources Board

Re: **CBE Comments on CARB's Second Notice of Public Availability of Modified Text and Additional Documents and Information to the Proposed California's Cap & Trade Regulation**

Dear Chair Nichols and Members of the Board of Directors,

Communities for a Better Environment (CBE) respectfully provides the following comments in response to the California Air Resources Board's (CARB's) "Second Notice of Public Availability of Modified Text and Additional Documents and Information."

Regardless of CARB's political position regarding cap and trade, it still must fulfill AB 32's statutory mandates (i.e. its mandates under Cal. Health & Safety Code §38500 et seq.). However, in viewing the proposed changes, we can only conclude that sustained pressure from the most polluting industries, as well as the heavy influence of bankers and traders wishing to establish a massive new market worth many billions, is having an undue influence on CARB's decision. Otherwise, it is impossible to explain the choices made in the draft regulation. This program will also cost the public billions that could be spent on a transition to a real green economy if not squandered on free allocations, offsets, and a pollution market where traders get to take their own cut. The pollution traders and industries will profit from this market, but health, the environment, California jobs, and the public will not.

The changes in this latest draft regulation encourage increased emissions from the biggest polluters & replicates EU failures. Specifically, the changes increase subsidies to the biggest polluters—which will likely lock us into a high-carbon infrastructure for decades to come—eliminate transparency by allowing CARB to rely on secret industry data—that the public will never see—to develop and implement oil refinery "benchmarks," increase cumulative impacts in low-income communities and communities of color, threaten public health in these same communities both by providing perverse incentives to add high-carbon intensity projects and by expanding definitional terms, and fail to reduce co-pollutants when it can and should. The changes also both exacerbate the risk of oppression and reduce environmental protections through excessive and risky offsets.

Cap and trade accounts for nearly 100% of the industrial and agricultural sector reductions. Hence, if it is undertaken, the program's success is absolutely critical. We urge the Board to reject these changes and put the public and the environment first.

### Summary of findings:

- **Oil refining (the largest sector in the cap and trade program) has been given many sweetheart deals, including new provisions that allow *increased* emissions:**

Previously, CARB gave industry a windfall at the public's expense when it offered refineries free allocations, exempted their fugitive, storage tank and certain other emissions, allowed them to exclude major parts of their high carbon processing in calculating emissions—such as emissions from hydrogen plants on refinery property linked to other refinery equipment but owned by third parties. Now, CARB proposes to set new refinery benchmarks that allow refineries even more free allocations perversely based on processing intensity. These benchmarks are based on secret industry data, which is unscientific and illegal, and the benchmarks will actually cause an increase in GHG emissions. CBE has addressed this major change in detail in a separate letter (Karras, 9/27/2011)

- **Benchmarks and other provisions for oil drilling are more lax**
- **Definition changes expand exemptions and increase the leniency of the program:**
  - The definition of “Permanent” is shortened from “the lifetime of CO2 emissions” (centuries) to 100 years. In the life of forest offsets this would allow wholesale clearcutting of forests at a point in time when climate change is expected to be far worse. The change also illustrates the difficulty in enforcing “permanent” offsets instead of directly replacing fossil fuel industries with a clean alternatives infrastructure.
  - The definition of “tribes” is broadened from federally recognized tribes to include any “entity” created by the tribe. This change expands benefits intended for tribes to include virtually anything or anyone—a nuclear power company, a derivatives clearing house.
- **Offsets continue to drastically undermine the intent of the program** – Offsets are allowed to cover up to 8% of emissions, which translates to about 80% of emissions reductions. CARB has acknowledged this.<sup>1</sup> Allowing this high percentage of offset usage ensures that big polluters can avoid almost all local California reductions by paying for out-of-state programs that are dubious in their ability to provide verifiable reductions. Californian's would pay the price of fewer jobs and loss of air quality improvements even

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<sup>1</sup> This article discusses 8% offsets equaling 85% of emissions reductions. This number was calculated by the Union of Concerned Scientists before the change by CARB, removing 2012 from the cap and trade enforcement. This number is now re-calculated to about 80% when 2012 is left out, calculations shown later in this comment. CARB acknowledges the possibility that offsets could comprise about 85% of emissions reductions in this NY Times article, 8/8/2011, <http://www.nytimes.com/gwire/2011/08/08/08greenwire-offsets-could-make-up-85-of-califs-cap-and-tra-29081.html?pagewanted=all>

if the dubious offsets could provide an out of state benefit. This major flaw has been repeatedly brought to CARB's attention (by the Union of Concerned Scientists and many others), but is still unaddressed. The proposed offsets also present the following problems, among others:

- Forestry offsets are notoriously unverifiable, and inherently provide no reduction in toxic and smog-forming co-pollutants
- The Urban Forestry Protocols appears to encourage planting non-native species, which can cause environmental harms, by introducing invasive species or species with high water needs, among others. For example since the protocol bases offset credits on tree size and speed of growth without prohibiting non-natives, it could encourage planting inappropriate, invasive species such as eucalyptus in California<sup>2</sup>, or other inappropriate species outside California.<sup>3</sup> Moreover, while urban tree planting in general is a good thing, it cannot be considered remotely equivalent to reducing emissions from an oil refinery, and so does not offset that pollution.
- ODC offsets assume that the state will not adopt any additional controls of ODCs, which is an obvious alternative. California could set standards requiring that instead of being used as offsets, ODCs in foam and refrigerators be destroyed—rather than recycled.
- **Design aspects of EU carbon trading, which caused bad results in Europe are being replicated in the current California cap and trade proposal**, including allowing banking credits, resulting in less progress in later years; free allocations, overallocation, and offsets, allowing industries to escape reductions; failure to account for swamping of reductions through high-carbon imports (a different kind of leakage of emissions *into* instead of *out* of the system); and taking credit for reductions caused only by economy crashes.
- **The Cumulative Impacts of the proposed changes haven't been analyzed, especially in low-income communities of color.** For example, Wilmington, California hosts many heavy polluting sectors. Consequently, the regulation's specific provisions that loosen standards for these polluters, and effectively subsidize these highly concentrated industries through free allocations and loose benchmarks, have a major potential to encourage further expansion and increase cumulative impacts. About a third of the entire state's oil refinery capacity is located in or next to Wilmington; the Wilmington oil field (about the third largest in the country) is also located here, as well as the most extreme goods movement and transportation sources in the state. The proposed changes actually encourage the worst polluters through subsidizing credits for the most intensive types of oil drilling. We urge CARB to evaluate the cumulative impacts of the specific provisions in the regulation.<sup>4</sup>

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<sup>2</sup> [http://www.cal-ipc.org/ip/management/plant\\_profiles/Eucalyptus\\_globulus.php](http://www.cal-ipc.org/ip/management/plant_profiles/Eucalyptus_globulus.php).

<sup>3</sup> <http://edis.ifas.ufl.edu/pdf/files/fr/fr07300.pdf> florida.

<sup>4</sup> See Cal. H&S Code §38570. (b)(1),(2) (requiring CARB to consider the potential for localized direct, indirect, and cumulative emission impacts from market mechanisms “in communities that are already adversely impacted by air pollution,” and to design any market-based mechanism to prevent “any increase in the emissions of toxic air contaminants or criteria air pollutants.”)

- **Based on the proposed changes, cap and trade may result in the selling of the same kind of derivatives and futures which in other circumstances caused the major crash of the last few years.** In 2009 when the U.S. considered a national cap and trade system, numerous financial and government experts highlighted that cap and trade could mean a massive futures commodity market.<sup>5</sup> Due to the vast size of this new market, it could endanger our precarious economy.

The outcomes of the previous regulatory provisions are made even worse by the new changes discussed below. This includes the failure to reduce greenhouse gases and co-pollutants of California's highest polluting industrial sources, especially oil refineries, as well as failure to reduce greenhouse gases globally. This is disastrous for the planet, for California's environment, for public health—particularly in low-income communities of color where most of the oil refineries and other heavy polluters in California are located, and for California's economy.

### **I. Breaks for the Oil Industry Including Refineries and Drilling Operations Allow Increased Emissions, and Undermine the Regulation**

CBE has submitted a separate letter evaluating in detail the severe impact of the major change to oil refinery benchmarks in the latest cap and trade regulation modifications.<sup>6</sup> This change allows increased emissions from oil refineries—the largest industrial source of greenhouse gases in California and in the cap and trade program. This sector is also a major emitter of toxic emissions and smog precursors, and located mostly in low income communities of color. Cap and trade is squandering the opportunity of AB32 to clean up this industry. Moreover, because the credits would be mostly given away for free, the regulation would both increase the current massive, record-breaking profits for this sectors and also fails to force or even encourage emission reductions. (See also *infra* p. 11.)

Oil drilling benchmarks also provide more allowances for higher polluting drilling, subsidizing pollution expansion in heavily industrialized areas such as the Wilmington Oil Basin in L.A.

The latest regulation modification has further loosened requirements for another sector of the oil industry – oil drilling (extraction). It provides more lax requirements for the most intensive oil drilling operations, which effectively subsidizes and encourages these practices. Wilmington California, already the location of severely concentrated pollution sources, is also the third biggest oil field in the U.S.. Neighbors have called the increased drilling that has occurred there “a living hell.” (See *infra* p. 5.) The cap and trade regulation provides such practices as 100% free allocations throughout the entire cap and trade program through 2020. It also provides more credits to higher polluting practices compared to other types of drilling (for example, Table 9-1 now allows thermal drilling 10 times the allowances/barrel compared to non-thermal drilling)

<sup>5</sup> See <http://motherjones.com/politics/2009/06/could-cap-and-trade-cause-another-market-meltdown>.

<sup>6</sup> Karras, Cap and Trade regulation comments 9/27/2011

CBE and neighbors have documented the severe environmental, health, and quality of life impacts from urban oil drilling in Wilmington residential areas.<sup>7</sup> Others have documented the impacts of rural drilling.<sup>8</sup>

An excerpt below from a State of Texas document (Chapter 4, Crude Oil, Window on State Government<sup>9</sup>) finds that the Wilmington oil field in Los Angeles uses this type of intensive extraction that will receive added credits (hot steam - enhanced oil recovery), turning a largely depleted field into a heavy producer:

#### **Federal/Private Partnership for Enhanced Oil Recovery [EOR]**

**The Wilmington field, running roughly southeast to northwest through the Los Angeles Basin, is the third-largest oilfield in the contiguous U.S.** and has been in operation for 73 years.<sup>78</sup> This oilfield had seen a steady decline in oil production over the years, and many considered it to be depleted.

In 1995, DOE and a private company began a partnership to employ new EOR methods to revitalize the field. Specifically, the project has developed:

- new three-dimensional computer modeling to find better ways to inject steam, hot water and other treated water into the production zone, thus heating its thick crude and driving it toward production wells without causing surface subsidence, a common problem in the area; . . .
- The project formally ended on March 31, 2007. **The new technologies developed in the project ultimately could add 525 million barrels of additional oil production at Wilmington field.** The private company that implemented the DOE-supported technologies has experienced its most successful drilling in 25 years at the Wilmington oil field. In fact, its best wells were drilled in an area that had been abandoned as depleted.<sup>79</sup>

This type of thermal extraction that is being encouraged and subsidized by the cap and trade regulation, provides extra, and free allocations.

Co-pollutants of oil drilling include emissions of deadly hydrogen sulfide gas—which is also extremely irritating at very low levels—and many emissions that exacerbate asthma. Impacts of drilling include major health and quality of life impacts such as pounding noises all night, trucking impacts, fugitive emissions of oily residue on residences, damage to house foundations, increased fire risks during earthquakes, and many others. CARB should absolutely remove the free, and increased allocations that are present at 100% throughout the entire cap and trade program to 2020.

In a survey of neighbors by CBE, Wilmington residents describe the oil drilling operations as “a living hell.” CBE organizers carried out this survey of neighbors after bitter complaints about Warren drilling operations. Neighbors gave the following descriptions of their experience of the drilling operations:

- “It’s been different since the Warren site came to the neighborhood;”

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<sup>7</sup> CBE Warren ND comment Sept 2010 to AQMD, Re: Warren neighbors concerns about Warren E&P Inc. WTU and additional impacts left out of the Negative Declaration, 9/6/2010, attached as Exhibit A CBE Warren ND comment Sept 2010 to AQMD

<sup>8</sup> Drilling Down, NRDC, Protecting Western Communities from the Health and Environmental Effects of Oil and Gas Production <http://www.nrdc.org/land/use/down/fdown.pdf>

<sup>9</sup> <http://www.window.state.tx.us/specialrpt/energy/nonrenewable/crude.php>

- “A lot of allergies, breathing problem, headaches, chronic problems, lack of sleep;”
- “Get a weird taste in my mouth, difficulty in bad traffic, breathing, there’s a breeze of dust, the house is full of dust, must close the windows in the house 24/7;”
- “Mainly health problems—sleeping. House always has dust and oily residue, vibrations;”
- “I know my blood pressure is just on edge, I just have to leave. This can’t go on much longer;”
- “Smell, noise, illness. Extreme breathing difficulties, Dr. visits;”
- “Evening noise—more dust, smells, extensive lung illness, constant coughing—less sleep;”
- “Lots of dust. Every morning lots of black film all over the cars;”
- “Problems breathing. More dust in my home, Headache;”
- “Affected my health by asthma, community is dirt;”
- “Headache, nausea, and difficulty breathing.”

The most intensive practices, located in the most polluted communities—which are low-income communities and communities of color—will receive the greatest subsidies to pollute; this is environmental racism and violates California law.<sup>10</sup> Oil drilling in Wilmington is a perfect example of operations that cause CO2 emissions where CARB has the ability to reduce co-pollutant emissions, especially those not addressed by local regulators. Instead CARB is allowing these operations *extra* and *free* credits for these polluting operations. CARB must evaluate the impacts of the ten times higher allocations for the most polluting practices.

## II. Definition Changes Have Major Impacts That CARB Has not Evaluated or Supported With Evidence

In addition to changing the definition of oil refinery benchmarks, the new draft also changes the definitions for “permanent” and “tribes” to the detriment of the public, and to the environment.

- a. **The definition of “Permanent”** has been greatly shortened from “a period comparable to the long atmospheric lifetime of CO2,” to “at least 100 years:”

~~(143)(186192)~~ “Permanent” means, in the context of offset credits, either that GHG reductions ~~or~~ and GHG removal enhancements are not reversible, or when GHG reductions ~~or~~ and GHG removal enhancements may be reversible, that mechanisms are in place to replace any reversed GHG emission reductions ~~or~~ and GHG removal enhancements to ensure that all credited reductions endure for a period that is comparable to the atmospheric lifetime of an anthropogenic CO<sub>2</sub> emission at least 100 years.

(A-34)

<sup>10</sup> See Cal. H&S Code §§38562 (b)(2),(4),(6); §§38570. (b)(1),(2),(3).

The lifetime of CO<sub>2</sub> is actually hundreds of years (clearly much longer than 100 years) for the bulk of CO<sub>2</sub> emissions, and essentially forever for about 25%.<sup>11</sup>

Redefining “permanent” to mean 100 years may seem *effectively* permanent compared to most regulatory contexts, but in this context, the opposite is true. CARB is fully aware that Climate Change is projected to be far worse in 100 years, even if California’s Cap and Trade were to be effective (an assumption we challenge). And with respect to the establishment of forests or to the impacts of CO<sub>2</sub> emissions, one hundred years is not long at all, and is definitely not permanent. The regulation change would essentially allow forests to be liquidated completely in 100 years, and any other offset would be allowed to be reversed at that time.

It is understandable that CARB and offsets industry lobbyists would want to limit their responsibilities to a finite period of time, but the real need for actual permanent reductions illustrates the difficulty in enforcement of “permanent” offsets. If instead we directly replace polluting industries with a clean alternatives infrastructure, we don’t have to worry about overseeing out-of-state offsets programs forever or even for 100 years.

CARB did not provide an analysis of the environmental impacts of clearcutting the forests providing offsets after 100 years. CARB should calculate the maximum emissions increase that could occur, and other environmental impacts that could occur with such clearcutting at the time of expiration at 100 years. CARB should also evaluate the enforceability of offsets. Can CARB oversee these offsets even for 100 years? What about CARB’s intention to link to the Western Climate Initiative and to other countries? Will CARB be able to enforce out of state and international offsets for even 50 years, if at all? Will CARB have any the ability to enforce offsets if our relations with another country turn sour? In decades, conditions can change drastically, rendering the offsets unenforceable.

It is patently obvious that instead of providing this major offsets program—that allows polluters to avoid 80% of the reduction aims of this program—CARB would have a vastly more enforceable program if it performed its normal function of regulating the polluters right in California.

**b. The Definition of Tribe** has been broadly expanded to include “any entity” created by a tribe.

This definition could mean virtually anything according to the definitions, and affects offsets protocols:

277) “Tribe” means a federally-recognized Indian tribe **and any entity created by a federally-recognized Indian Tribe**. ~~“Tribal Nation” means those Native American tribes in the United States and listed in the Federal Register. . . .~~

96) “Entity” means a person, firm, association, organization, partnership, business trust, corporation, limited liability company, company, or government agency.

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<sup>11</sup> Carbon is forever, Nature Reports Climate Change, published online: 20 November 2008, doi:10.1038/climate.2008.122, <http://www.nature.com/climate/2008/0812/full/climate.2008.122.html>, attached as Exhibit B Carbon is Forever climate.2008.122

This change is so broad that we can only imagine the potential effects, which are quite negative. We didn't see any evaluation supporting such a change. This is very troubling since there is a trend toward siting harmful entities on tribal lands, which are frequently contested by tribal members, but approved by tribal governments.<sup>12</sup> CARB should not be in a position of encouraging use of tribal lands for potentially harmful activities.

Many tribal members are fighting new and major pollution sources on tribal lands in the U.S. and are fighting their own tribal governments, which, like other local governments in the U.S., sometimes rubber-stamp heavy development projects without full review. (Examples include fracking, building new refineries without full permitting processes, new coal-fired power plants, extremely heavy diesel traffic, and more).<sup>13</sup>

The effect of CARB setting such broad definition changes listed above might even allow a nuclear power company to be considered a "tribe" under this provision or allow "clean" coal projects. The added language on "any entity" should be struck entirely.

### **III. Approving a Very Large Offsets Program Continues to Significantly Undermine the Intent of the Program**

While 8% offsets might sound relatively small, the 8% refers to the total emissions, not the total reductions. Table 9.2 of the regulation shows the nominal cap emission reduction over time is 7.5% for some sectors and about 15% for others (think of an average for discussion purposes of about 10% emissions reductions) This means that 8% offsets equals about 80% of emission reductions. This issue has been brought up repeatedly by the Union of Concerned Scientists, but has not been addressed by CARB. (The calculations are shown in the footnote below.)<sup>14</sup> Given the highly speculative benefit of offsets, counting on 80% of them to fulfill the cap and trade aim is unconscionably high.

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<sup>12</sup> <http://www.ienearth.org/>

<sup>13</sup> For example, see MHA Nation refinery EIS process including public comments, available at EPA website, <http://www.epa.gov/region8/compliance/nepa/mharefinery.html> others

<sup>14</sup> The Union of Concerned Scientists (UCS) got the result of 85% (which included year 2012, before CARB removed that year from enforcement). UCS and others submitted comments to CARB on this issue, <http://www.arb.ca.gov/lispub/comm/bccommlog.php?listname=capandtrade10>, August 11, 2011, Later UCS modified their calculation to about 80%, after removing the year 2012. (phone conversation, 9/23/2011) Although there is a maximum amount of offsets that can be used each year (8% of emissions), offset credits and allowances can be banked, so they are basically interchangeable. In its October 2010 Initial Statement of Reasons for the cap and trade regulation, Table II-2 and Table V-1 CARB identified the annual allowances (pollution credits) for each year through 2020, and the levels projected for BAU (Business As Usual levels (Forecast for the sources). CARB also states: "Cumulative projected emissions over 2012 through 2020 total 2,948 MMTCO<sub>2</sub>e. The number of allowances that would be made available over those years is 2,674 million. The difference between these two numbers, 273 million, represents the required program reductions, some of which may be achieved through projects that generate offset credits." p. VIII-7, <http://www.arb.ca.gov/regact/2010/capandtrade10/capisor.pdf> The cumulative BAU emissions add up to 2974 million tons over 2012 to 2020, and the cumulative allowances add up to 2674 million (each representing a ton of emissions). 2947 million - 2674 million = 273 million tons of reductions expected, 8% offsets are allowed for compliance obligations (total allowable emissions). Thus 8% x 2674 million = 213 million, 213 million / 273 million tons of reductions projected = 78% (close to 80%). UCS also took into account a few other complications that only slightly changes these numbers. (For example, in the first few years of the program fewer sectors are under the cap, total allowances are less, covering only some of the sectors,)



#### **IV. California's Draft Regulation Replicates the Failed Design Elements of European Carbon Trading**

CARB's assumption that the EU-ETS is working is wrong, and this fact challenges CARB's basis for replicating that program's features.

##### **1. The European program did not make good progress over time.**

- EU Phase I carbon trading started out at high emissions, and overallocated in 2005
- 2007 - baselines were lax but emissions still increased
- EU Phase II 2008 & 2009 emissions decreased, but this was only due to severe recession
- 2010 emissions increased<sup>15</sup> (even during the recession) but were reportedly under the cap. These reductions included widely discredited international offsets, and failed to account for major imports of high-carbon goods (*EU carbon trading emissions rise 3.5%*)<sup>16</sup>
- 2011 have continued to increase
- Phase III: 2016 emissions are projected to increase 34%

International Energy Agency report found emissions and energy use started high in 2005<sup>17</sup>

This report found that energy use and emissions started out high in 2005 compared to 1990 levels.

##### *Recent Trends in Energy Use and Efficiency*

- ***Between 1990 and 2005 global final energy use increased by 23% while the associated CO2 emissions rose by 25%. . . .***
- ***Oil products remained the most important final energy commodity with a global share of 37% in 2005, driven by their use in transport. Electricity consumption is growing rapidly in many countries; its global use increased by 54% between 1990 and 2005. pp. 12***

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<sup>15</sup> *EU carbon trading emissions rise 3.5%*, **BusinessGreen**: European ETS figures for 2010 are in line with expectations and leave carbon markets flat, analysts say, <http://www.guardian.co.uk/environment/2011/apr/01/eu-carbon-trading-emissions-ets/print>

<sup>16</sup> **BusinessGreen**: European ETS figures for 2010 are in line with expectations and leave carbon markets flat, analysts say, <http://www.guardian.co.uk/environment/2011/apr/01/eu-carbon-trading-emissions-ets/print>

<sup>17</sup> Report Worldwide Trends in Energy Use and Efficiency, Key Insights from IEA Indicator Analysis, International Energy Agency, 2008, [http://www.iea.org/Papers/2008/Indicators\\_2008.pdf](http://www.iea.org/Papers/2008/Indicators_2008.pdf)

### European CO2 emissions increased in 2007 and carbon credits were effectively free

The following excerpts summarize that emissions increased in 2007 even after emissions increased under cap and trade, and the market collapsed.<sup>18</sup>

EU industrial installations publicised CO2 emission data in 2007, indicated a 1.1% overall increase, according to carbon market consultancy Point Carbon. . . .

On today's 'spot' market, one tonne CO2 is effectively free, hovering at slightly above €0. . . .

**But 'carbon scarcity' needed to push the CO2 price to a level that can spur large-scale investments in low-carbon technologies is not expected until the third phase of the EU ETS (after 2013), casting doubts on the bloc's ability to honour CO2 reduction commitments on time.**

As the carbon market becomes tighter, **the bloc's energy intensive industries insist they need free emissions allowances** . . . The Commission has given its assurances that the concerns of key sectors will be addressed . . .

### EU emissions won't decrease until after 2016, and leakage justifications undermine reductions

The study *Cap or Trap* by Sandbag funded by the European Climate Foundation found, among other things that the EU ETS program risks locking in carbon emissions.<sup>19</sup>

It also found that offsets could allow EU emissions to grow 34%!

*It is more probable that European emitters will purchase cheap offsets to give them a carbon space to grow domestic emissions. In fact, despite the promise of much more aggressive Phase III caps we find that on-going availability of cheap offsets could allow Europe's domestic emissions to grow a staggering 34% from current levels by 2016 (see Figure E2). . . .*

The study also found that, as in California's cap and trade, the concept of leakage was used to justify subsidizing credits for high energy industrial sectors. Additionally, the study suggested that the EU might need to revert to direct emissions regulation. (*Ibid.*)

## **2. The EU-ETS has created perverse incentives and resulted in dubious projects**

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<sup>18</sup> April 03, 2008, on EurActiv, <http://www.euractiv.com/climate-change/european-co2-emissions-2007/article-171327>

<sup>19</sup> Sandbag, September 2010, funded by the European Climate Foundation, [http://www.sandbag.org.uk/site\\_media/pdfs/reports/caportrap.pdf](http://www.sandbag.org.uk/site_media/pdfs/reports/caportrap.pdf)

Der Spiegel found that EU offsets were massively abused, caused perverse incentives, and could cause increased emissions

This article illustrates the problem of too many offsets, and the unenforceability of “additionality” of offsets, since it is almost impossible to verify that the emission reductions wouldn’t have been carried out anyway, or that they provide reductions compared to BAU. Offset profits provide perverse incentives to keep environmental problems continuing, so that markets can use them:

*Will Trading System Encourage Emissions? The Lucrative Business of Polluting,*<sup>20</sup>

*If critics are right, the system is massively abused and discourages reductions that might otherwise be made. Nearly all European industries can buy their way out of reductions. . . . Nicola Jaeger, a Berlin earth scientist, believes this could lead "to an increase in global emissions." Jaeger analyzed dozens of German projects and found many already completed before registered as CDM projects.*

Example projects include Indian and Chinese factories getting paid for exhaust gas disposal of HFC-23 at their factories, but manufacturing these coolants would probably have been banned in China long ago. Now it pays to keep harmful plants running. Equipment manufacturers, coolant companies (earn around five times as much for exhaust-gas disposal as for their main product), the Chinese government, (65% tax on certificates), financial institutions, such as Deutsche Bank (which sells pollution rights as green investments to polluters) all profit.

*. . . UN environmental expert Lambert Schneider documented the manipulation involved in these projects. After analyzing all 19 HFC projects, Schneider concluded that many of them were extremely suspicious, and found the sideline business of disposing of exhaust gases had become the core business. Many facilities were still only in operation to earn HFC-23 emission certificates.*

The article also showed many dubious projects:

- *The latest example is using coal to save the planet - one in China involves improving the efficiency of a coal mine.*
- *German inspectors also gave the green light to a dam project on China's Bala River that entailed a massive population resettlement. This March, even the UN Climate Change Secretariat finally had enough of TÜV Süd's willingness to approve suspicious projects. Its executive council temporarily suspended the Germans from all further certification processes.*

More perverse incentives: Free carbon credits and lax benchmarks for higher-polluting activities caused construction of many new coal plants in Germany

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<sup>20</sup> Nils Klawitter, Spiegel Online, 12/30/2010, <http://www.spiegel.de/international/business/0,1518,736801,00.html>

An academic evaluation provided detailed modeling showing that German's free allocation of carbon credits to power companies gave them even more economic incentives to build new coal powered plants. Because coal started out cheaper, adding free allocations just provided the power companies with windfall profits that financed their new coal plants and didn't turn investors toward clean energy.

### ***How emission certificate allocations distort fossil investments: the German example<sup>21</sup>***

*We find that technology specific new entrant provisions have substantially increased incentives to invest in hard coal plants compared to natural gas at the time of the ETS onset. **Expected windfall profits compensated more than half the total capital costs of a hard coal plant.** Moreover, a shorter period of free allocations would not have turned investors' favours towards the cleaner natural gas technology because of preexisting economic advantages for coal. **In contrast, full auctioning of permits or a single best available technology benchmark would have made natural gas the predominant technology of choice.***

Both these conditions are present in the proposed California cap and trade regulation. For example, CARB provides 100% free allocation for oil drilling operations through 2020, and gives 10 times more allocations for higher-pollution types of drilling. Oil refineries receive mostly free allocations (about 72% total over the 8 years from 2013-2020)<sup>22</sup> and are proposed to use the distorted Solomon index which favors more energy-intensive refinery processes, described in detail in CBE's separate comment letter on this subject (Karras).

There are dozens of other reports, papers, and articles available showing the failure of the design elements of carbon trading. CBE provided other evidence about this in our July comments on the Scoping Plan. Many others have documented these problems. The continued march toward this program in California is at this point disgraceful.

### **3. At the same time as the EU-ETS provided windfall profits for companies, it increased costs for the public**

BTI Europe found that the EU emissions went up, and still cost the public 100 billion Euros<sup>23</sup>

This article found that EU emissions did not reduce emissions, but cost the public billions:

***But if Europe did not reduce its emissions, then what happened to the €100 billion it spent on its much-touted Emissions Trading Scheme? The answer, we show in this second article, is fraud, rent-seeking, price volatility, abuse, and inefficiency. . . .***

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<sup>21</sup> Michael Pahlea, Lin Fanb, Wolf-Peter Schillc, Potsdam Institute for Climate Impact Research, Department of Geography of Environmental Engineering, The Johns Hopkins University, DIW Berlin, Department of Energy, Transportation, Environment, [http://www.diw.de/documents/publikationen/73/diw\\_01.c.366720.de/dp1097.pdf](http://www.diw.de/documents/publikationen/73/diw_01.c.366720.de/dp1097.pdf)

<sup>22</sup> 100% the first two years, 75% the next three years, and 50% the last three years

<sup>23</sup> *Part II, Twilight of European Climate Leadership*, Jerome Roos, December 10, 2010 4:49 PM, BTI Europe, [http://breakthrougheurope.org/blog/2010/12/game\\_over\\_the\\_twilight\\_of\\_euro.shtml](http://breakthrougheurope.org/blog/2010/12/game_over_the_twilight_of_euro.shtml)

*Today, the Scheme stands no longer as a model for the rest of the world, **but as a warning of what happens when we attempt to make fossil fuels more expensive through complicated regulatory schemes, rather than making clean energy cheap** through limited but direct government support for innovation.*

The article found that carbon-intensive industries made windfall profits after lobbying successfully for over-allocation of permits. It found:

- “Criminals and bankers” reaped the financial gains paid for by European taxpayers and consumers
- The German power company RWE, Europe's largest emitter, received a [\\$6.4 billion windfall](#).
- The steel and cement sectors are estimated to gain €2.3 billion and €1.8 billion, respectively, during Phase II.
- The 10 most over-allocated companies in 2008 stand to gain €3.4 billion in emission permits. These firms have accrued so many surplus allowances that they could afford to grow their emissions 50 percent by 2020.

This report stated that by the time volume peaked, it was discovered that up to 90 percent of the trade in some European countries were completely invalid.

This article found that the EU ETS (carbon trading) seems to have subsidized the polluters during the recession. It found that “Rapidly, a consensus is emerging among experts that the ETS has been a dramatic failure.”

*In his foreword to an [influential report](#) by Open Europe, Max Andersson - who is a Member of Swedish Parliament for the Green Party - warns that "real environmentalists should be very skeptical indeed of the EU's record on this area ... It will do practically nothing to fight climate change."*

It also quotes U.S. media:

*The [Washington Post](#) stresses that carbon trading schemes are "complex and vulnerable to lobbying and special pleading." According to the [Wall Street Journal](#): Not only does the taxpayer carry the cost of any cap and trade scheme, but their money also provides profit for a whole new industry: the carbon trading sector, the middlemen who make the system work.*

The article sums it up: “The idea that the 'invisible hand' of the carbon market will automatically guide private investors to clean energy alternatives remains wishful thinking at best and misguided idolatry of market magic at worst.” But CARB is doggedly counting on the same regulatory structure to get different results. There is no reason to believe that California’s market will perform any better, especially since the same traders and bankers will be involved.

## V. Could the cap and trade regulation cause another and more severe market meltdown?

Apparently so. In this case “follow the money” is good advice for understanding why this regulation is being politically pushed. For example, the regulation identifies the following entities that are allowed to enter the program:

### §95814. Voluntarily Associated Entities and Other Registered Participants

*(3) An entity providing clearing services in which it takes only temporary possession of compliance instruments for the purpose of clearing transactions between two entities registered with the Cap-and-Trade Program. A **qualified entity must be a derivatives clearing organization**<sup>24,25</sup> as defined in the Commodities Exchange Act (7 U.S.C. § 1a(9)) that is registered with the U.S. Commodity Futures Trading Commission pursuant to the Commodities Exchange Act (7 U.S.C. § 7a-1(a)).*

The following article identified a Duke study and found among other things that a cap and trade market in the U.S. could become very large (dwarfing other commodities markets), and that derivatives trading will probably exceed the market for credits themselves:<sup>26</sup>

*In fact, a study (PDF) by Duke University's Nicholas Institute for Environmental Policy Solutions<sup>27</sup> anticipates that if the United States passes a cap-and-trade law, the derivatives trade will probably exceed the market for the allowances themselves. **"We are on the verge of creating a new trillion-dollar market in financial assets that will be securitized, derivatized, and speculated by Wall Street like the mortgage-backed securities market,"** says Robert Shapiro, a former undersecretary of commerce in the Clinton administration and a cofounder of the US Climate Task Force.*

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<sup>24</sup> According to 7 USCS § 1a (9), the derivatives clearing organization is defined as: "(A) In general. The term "derivatives clearing organization" means a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, with respect to an agreement, contract, or transaction-- (i) enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties; (ii) arranges or provides, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions executed by participants in the derivatives clearing organization; or (iii) otherwise provides clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such agreements, contracts, or transactions executed by the participants. (B) Exclusions. The term "derivatives clearing organization" does not include an entity, facility, system, or organization solely because it arranges or provides for-- (i) settlement, netting, or novation of obligations resulting from agreements, contracts, or transactions, on a bilateral basis and without a central counterparty; (ii) settlement or netting of cash payments through an interbank payment system; or (iii) settlement, netting, or novation of obligations resulting from a sale of a commodity in a transaction in the spot market for the commodity." <http://definitions.uslegal.com/d/derivatives-clearing-organization/>

<sup>25</sup> Novation: The substitution of a new contract for an old one. The new agreement extinguishes the rights and obligations that were in effect under the old agreement. A novation ordinarily arises when a new individual assumes an obligation to pay that was incurred by the original party to the contract. It is distinguishable from the situation that occurs when another individual makes a guarantee that a debtor will pay what he or she owes to a creditor. In the case of a novation, the original debtor is totally released from the obligation, which is transferred to someone else. The nature of the transaction is dependent upon the agreement between the parties. A novation also takes place when the original parties continue their obligation to one another, but a new agreement is substituted for the old one.

<sup>26</sup> 2009, <http://motherjones.com/politics/2009/06/could-cap-and-trade-cause-another-market-meltdown>

<sup>27</sup> [http://www.nicholas.duke.edu/ccpp/ccpp\\_pdfs/carbon\\_market\\_primer.pdf](http://www.nicholas.duke.edu/ccpp/ccpp_pdfs/carbon_market_primer.pdf)

Banks like JPMorgan Chase, Morgan Stanley, and Goldman Sachs already have active carbon trading desks that deal in instruments connected to Europe's cap-and-trade system and voluntary markets in the U.S. Business is expected to explode with expansion of cap-and-trade in the U.S. This is not something that has been focused on by most environmentalists:

*Among environmental groups, there is, understandably, less focus on the finer points of financial regulation. "The derivatives side is not something that a person who comes to the table worried about carbon emissions has on their agenda," says Michael Greenberger, a derivatives expert at the University of Maryland who has also served in the CFTC and the Justice Department. "Those people—and they're fighting a good battle—opened the door."*

Another article found:

***Carbon Capitalists Warming to Climate Market Using Derivatives***<sup>28</sup>

***Banks Moving In***

*Banks intend to become the intermediaries in this fledgling market. Although U.S. carbon legislation may not pass for a year or more, Wall Street has already spent hundreds of millions of dollars hiring lobbyists and making deals with companies that can supply them with "carbon offsets" to sell to clients.*

***The banks are preparing to do with carbon what they've done before: design and market derivatives contracts that will help client companies hedge their price risk over the long term. They're also ready to sell carbon-related financial products to outside investors.***

***"This requires a massive redirection of capital," Masters says. "You can't have a successful climate policy without the heavy, heavy involvement of financial institutions."***

In response to concerns about this, the International Emission Trading Association acknowledges the concerns and states that they are fixed by the Dodd-Frank Act.<sup>29</sup> But many sources find that the mentioned regulatory fixes to prevent a recurrence of market manipulations and collapse were extremely weak and ineffective, leaving us open to even worse collapses in the future with such continued practices.

We urge the Board to address these severe problems.

Sincerely,

Julia May

*Senior Scientist*

Bill Gallegos

*Executive Director*

Adrienne Bloch

*Senior Staff Attorney*

<sup>28</sup> December 4, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aXRBOxU5KT5M>

<sup>29</sup> International Emissions Trading Association, December 06, 2010, [http://www.ieta.org/index.php?option=com\\_content&view=article&id=218:ieta-response-on-carb-cap-and-trade-program-rules&catid=24:position-papers&Itemid=91](http://www.ieta.org/index.php?option=com_content&view=article&id=218:ieta-response-on-carb-cap-and-trade-program-rules&catid=24:position-papers&Itemid=91)