



NATURAL RESOURCES DEFENSE COUNCIL
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December 6, 2010

Chairman Mary Nichols and Members of the Board
California Air Resources Board
1001 "I" Street
Sacramento, CA 95812

Re: Comments on the Proposed Regulation to Implement the California Cap-and-Trade Program

Dear Chairman Nichols and Members of the Board:

Thank you for the opportunity to comment on the proposed California cap-and-trade regulation. On behalf of NRDC's more than 250,000 California members and online activists, we commend CARB for their diligent work in drafting regulations to put in place a first-of-its-kind, economy-wide cap on global warming pollution. Overall, we believe this is a strong program that improves upon other regional programs and federal proposals and will enable California to achieve its AB 32 emission reduction goal of returning to 1990 emission levels by 2020. We write to highlight the positive design elements incorporated in the current regulations and to offer suggestions on how CARB can improve certain aspects of the program within the contours of the proposed framework. In particular, we ask CARB to incorporate the following recommendations:

1. Provide clearer guidance to utilities on the use of allowance value in the electricity sector.
2. Streamline and make more specific reporting requirements for utilities receiving free allowances.
3. Set the industrial benchmark at industry best practices, not industry average.
4. Tighten the assistance factor in the industrial sector to ensure the benefit of the doubt with respect to allowance value goes to consumers, not industry profitability.
5. Close the biofuels loophole by holding fuel providers accountable under the cap for the GHG emissions of transportation biofuels.
6. Close the biomass loophole by accounting for emissions associated with biomass production and combustion.
7. Clarify CARB's authority as the final arbiter of offset credit and verification disputes.

Strong Design Features That Will Spur Emission Reductions and Drive Innovation in Low- and Zero-Carbon Alternatives

We are pleased to see the following strong design features included in the proposed regulations.

Sufficiently Tight, Declining Cap

The most important design element of a cap-and-trade program, from an environmental perspective, is the cap. The cap is what determines how many reductions will be achieved, at what pace, and what the carbon price will be. We are encouraged that CARB has set the cap at levels – starting in 2012 below 2008 actual emissions and declining at 2-3% per year, for a total decline of 15% from 2012 through 2020 – that will enable

the program to achieve significant reductions, foster innovations in emission abatement strategies, and avoid the problems we have seen in other programs from over-allocation.

Tough Penalty Provisions

Clear and effective penalty provisions are essential for the program to achieve emission reductions and deter non-compliance. We commend CARB for the robust and transparent penalty structure proposed in the regulations. Requiring noncompliant entities to surrender a multiple of four compliance instruments within 30 days for every one missed (and only one may be an offset) sends a clear signal that noncompliance will neither be tolerated nor financially advantageous. Tacking on monetary fines that accumulate up to \$25,000/day will further deter would-be violators.

Meaningful Floor Price

We are pleased to see CARB propose a floor price of \$10/tonne, escalating at 5% per year to reach \$15/tonne by 2020. This is considerably higher than RGGI's floor price of less than \$2/tonne. At these levels, the floor price will send a steady signal to the market to find innovative ways of decreasing carbon emissions.

Auctioning in the Electricity and Transportation Sectors

We are encouraged that CARB is proposing to auction 100% of allowances in the transportation fuels sector and will require the investor-owned electric utilities to sell 100% of their allowances into a consignment auction. This means over half of all allowances issued in the program will be auctioned from the start and will increase to roughly three-quarters of all allowances by 2020.

Annual Review

Finally, we commend CARB for establishing an annual review of the program to undertake continuous improvements. As a first-of-its-kind program, it is imperative that CARB built in sufficient flexibility to review and make corrections as needed. This will also afford stakeholders and the public an opportunity to remain engaged with the program and offer insight on how to improve elements of the program moving forward.

Design Elements That Should Be Improved to Advance the Goals of the Program

We recommend the following changes to the regulations to improve the performance of the cap-and-trade program. Many of these suggestions are further elaborated on in a coalition letter to be submitted on December 7, 2010.

Provide Clearer Guidance to Utilities on Use of Allowance Value in the Electricity Sector

The current regulations simply guide electric utilities to use their auction revenue for the benefit of ratepayers, consistent with the goals of AB 32. We urge CARB to be more explicit and require that utilities first use auction revenue for energy efficiency programs that are cost-effective under AB 32's framework. California is a leader in energy efficiency, but there is still more that can and should be done to achieve additional energy savings and utility bill savings for customers. Energy efficiency provides one of our least-cost options for achieving emissions reductions and we must continue to take advantage of these options in order to minimize the overall cost of complying with AB 32. This will ensure that allowance value is funding low-cost reductions while helping Californians lower their energy bills. In addition, we encourage CARB to direct the utilities to devote auction revenue towards new renewable energy projects and to provide rebates to low-income customers.

We recommend the following edits to §95892(d)(3) in the rule (additions underlined; deletions in ~~strikethrough~~):

Auction proceeds obtained by an electrical distribution utility shall be used exclusively for the benefit of retail ratepayers of each electrical distribution utility, consistent with the goals of AB 32, and may not be used for the benefit of entities or persons other than such ratepayers.

- A. All electrical distribution utilities shall use allowance value first to invest in energy efficiency programs that are not already required by California law and that achieve cost-effective GHG emissions reductions, according to the requirements of AB 32. The PUC, CEC, and POU Boards shall work together to determine the minimum amount of allowance value that should be spent on energy efficiency and develop a methodology to determine which energy efficiency programs are additional to existing programs and cost-effective under AB 32. If an electrical distribution utility does not use this minimum amount towards such programs, it risks forfeiting receipt of future allowance value.
- B. To the extent that an electrical distribution provider uses allowance value to invest in new renewable energy, it shall prioritize projects that achieve environmental and health co-benefits for Californians.
- C. Investor owned utilities shall ensure equal treatment of their own customers and customers of electricity service providers and community choice aggregators.
- D. All electrical distribution utilities shall consider the impacts of this program on low-income customers and devote allowance value, in accordance with section 95892(d)(3)(E) below, to offset the impacts of this program, if any, on low-income customers.
- E. To the extent that an electrical distribution utility uses allowance value ~~auction revenue~~ to provide ratepayer rebates, it shall provide such rebates with regard to the fixed portion of ratepayers' bills or as a separate fixed credit or rebate.
- F. To the extent that an electrical distribution utility uses allowance value ~~auction revenue~~ to provide ratepayer rebates, these rebates shall not be based solely on the quantity of electricity delivered to ratepayers from any period after January 1, 2012.

Streamline and Make More Specific the Reporting Requirements for Utilities Receiving Free Allowances

We encourage CARB to require that each utility to report to its regulator, CARB and in the case of POU's, the CEC, in a transparent, timely, and uniform fashion. POU reporting should be coordinated with current reporting on energy efficiency achievements and targets, as required by SB 1037 and AB 2021, and the reports should indicate how the value from allowances under this program have brought **additional** energy efficiency and renewable energy investments. As part of the adaptive management plan, CARB, the CEC, and the PUC should hold a joint hearing every year to analyze these reports and consider the need for further regulatory oversight of allowance value distribution.

We recommend the following edits to § 95892(e) in the rule (additions underlined; deletions in ~~strikethrough~~):

(e) Reporting on the Use of Auction Proceeds. No later than June 30, 2013, and each calendar year thereafter, each electrical distribution utility shall submit a report to the Executive Officer, and the appropriate designee at the CEC and PUC, describing the

disposition of any auction proceeds received in the prior calendar year. In July of each year, the ARB, CEC, and PUC shall hold a joint hearing to consider further action regulating the use of these proceeds based on the information included in these reports. This report shall include:

- (1) The monetary value of allowance value ~~auction proceeds~~ received by the electrical distribution utility and how these resources compare to other resources used for clean energy investment as required by California law.
- (2) How the electrical distribution utility's disposition of such auction proceeds complies with the requirements of this section and the requirements of California Health and Safety Code sections 38500 et seq.

Set Industrial Sector Benchmarking at Industry Best Practices, Not at Industry Average

Currently, benchmarking for the industrial sector starts at about 90% of the average performance level for the industry. A facility that is performing only slightly better than average could therefore receive all of its allowances for free. Rather than setting the benchmark according to average performance, we encourage CARB to peg the benchmark to industry "best practices" to ensure that only the most efficient facilities have all their allowances covered, and poorer performing facilities will have to purchase allowances. This will incentivize all facilities to adopt industry best practices.

Lower Industrial Sector "Assistance Factors"

We recognize the significant concerns posed by leakage and the difficulty CARB faces in designing a state program that does not put California businesses at a disadvantage in an increasingly global economy. To that end, we commend CARB in their efforts to prevent leakage by identifying industries that are at high, medium, and low risk and providing free allowances to offset any competitive gains to be had from moving out of state. This is a sound policy in principle but in practice we are concerned that the assistance factors in the proposed regulation are overly generous and will devote allowance value to industry profits at the expense of consumer welfare. Studies at the U.S. and EU level indicate that only about 10-20% of free allowances are needed to prevent leakage. While California-specific data is required to determine the competitiveness concerns of the program, CARB should ratchet down free allowances in the industrial sector should the data show that the allocation formula is overcompensating for leakage risk.

Close the Biofuels Loophole

We strongly recommend that CARB treat emissions from all transportation liquid fuels equally and hold fuel providers accountable under the cap for the GHG emissions of all biofuels. The proposed regulations currently exempt emissions from all "biodiesel" and "fuel ethanol" and do not address any other type of biofuel. It is well understood, however, that GHG emissions resulting from the use of transportation biofuels varies dramatically depending on how the biofuel is produced. According to CARB's own analysis, ethanol made from corn starch and biodiesel derived from soybeans can actually *increase* GHG emissions. As a result, exempting all ethanol and biodiesel from compliance obligations could have the perverse effect of incentivizing the greater use of all ethanol and biodiesel, regardless of whether it can contribute to reduced GHG emissions. We therefore urge CARB to require fuel providers to hold compliance instruments to cover the GHG emissions from transportation biofuels. It is critical to the integrity of the AB 32 program that CARB not create an emissions loophole by treating all transportation biofuels as "zero emissions."

Close the Biomass Loophole

The proposed regulations provide a significant incentive to produce energy from forest materials by exempting biomass facilities from compliance obligations. Exempting these categories from compliance obligations is equivalent to assigning a net carbon impact of zero to the growth, harvest, production, and

combustion of these fuel sources. In effect, the rule assumes, without justification, the “carbon neutrality” of all biomass fuels. Failure to accurately account for the GHG impacts of biomass energy incurs the risk of significant, uncounted increases in GHG emissions. We strongly recommend that CARB commit to both developing reporting requirements for biomass facilities and to addressing the resulting emissions, if any, in a manner consistent with other generation sources in the AB 32 regulatory framework.

Clearly Define CARB’s Role in Offset Verification Disputes

Qualified third-party offset registries can play a valuable role in managing offset programs used for compliance with the cap. Independent private entities (either nonprofit or for-profit), however, cannot be granted ultimate authority over compliance determinations. As the regulatory agency designated by the legislature to implement AB 32, CARB must retain final authority to determine whether an offset credit submitted for compliance conforms with the established requirements under the program. The Executive Officer should be the ultimate arbiter of disputed verification reports and CARB should be given explicit authority to deny issuance of an offset credit when a project does not comply with regulatory requirements.

We recommend the following edits to § 95977(e)(2)(C)(xix)(a.-c.), § 95977(e)(2)(C)(xx) and § 95981(d)(5) in the rule (additions underlined; deletions in ~~strikethrough~~):

§ 95977(e)(2)(C)(xix)

- a. If the Offset Project Operator or Authorized Project Designee and the verification body cannot reach agreement on modifications to the Offset Project Data Report that result in a Positive Offset Verification or Qualified Positive Offset Verification Statement, due to a disagreement on the requirements of this article or Compliance Offset Protocol, the Offset Project Operator or Authorized Project Designee may petition the Executive Officer ~~or Offset Project Registry~~ to make a decision as to the verifiability of the submitted Offset Project Data Report.
- b. If the Executive Officer ~~or Offset Project Registry~~ determines that the Offset Project Data Report does not meet the standards and requirements specified in this article, the Offset Project Operator or Authorized Project Designee shall have the opportunity to submit within 30 calendar days of the date of this decision any Offset Project Data Report revisions that address the Executive Officer’s ~~or Offset Project Registry’s~~ determination, for re-verification of the Offset Project Data Report. In re-verifying a revised Offset Project Data Report, the verification body and offset verification team shall be subject to the requirements in sections 95977(e)(2)(C)(xviii)(a.) through 95977(e)(2)(C)(xviii)(d.), and must submit the revised Offset Verification Statement to ARB ~~or the Offset Project Registry~~ within 15 days.
- ~~e. If the Offset Project Operator or Authorized Project Designee disagrees with a determination made by an Offset Project Registry, they can re-initiate the dispute resolution process in section 95977(e)(2)(C)(xix)(a.) through the Executive Officer.
(i) The process must be reinitiated within 60 days of the applicable verification deadline.
(ii) The Executive Officer, verification body, Offset Project Operator or Authorized Project Designee shall be held to the requirements in section 95977(e)(2)(C)(xix)(b.).~~

§ 95977(e)(2)(C)(xx)

(xx) Upon submission of the Offset Verification Statement to ARB ~~or the Offset Project Registry~~, the Offset Project Data Report must be considered final and no further changes may be made. All verification requirements of this article shall be considered complete.

§ 95981(d)(5)

(5) If ARB determines the information submitted in sections 95981(d)(1) and (d)(4) does not meet the requirements for issuance of ARB offset credits, then ARB may deny issuance of an offset credit. The Offset Project Designee or Authorized Project Operator may appeal ARB's decision by petitioning the Executive Officer, within 10 days of denial, for a review of submitted information in section 95981(d)(1) and (d)(4) and respond to any issues that prevent the issuance of ARB offset credits

Thank you for considering our recommendations.

Sincerely,

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Natural Resources Defense Council