



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 the hundreds of thousands of concerned Californians that the undersigned organizations collectively represent, we commend the agency for taking action to put in place the world's first economy-wide cap on global warming pollution. We submit recommendations for strengthening the proposed regulation and helping the state achieve its global warming emission reduction targets in a more efficient manner, while enhancing public health protections, safeguarding against windfall profits to polluters, and preventing program manipulation. Below are our recommendations, followed by a more detailed explanation of each, including suggested changes to the language of the regulations. We ask that CARB:

1. Require every utility to invest the full value of allowances it receives for free on AB 32-related purposes, which includes cost-effective energy efficiency, renewable electricity, and rebates to low-income customers;
2. Provide guidance on how utilities should spend the allowance value and provide specific, uniform reporting requirements for all utilities receiving free allowances;
3. Require the industrial sector to base product benchmarks on best practices and allow benchmarks to be dynamic over time;
4. Revisit, revise, and phase out free allocation to the industrial sector; and
5. Carve out allowances from the outset of the program for a Community Benefits Fund.

**Require every utility to invest the full value of allowances it receives for free in AB 32-related purposes**

CARB should require all utilities that receive allowances for free to invest the full value of those allowances on AB 32-related purposes, which are described more fully below. Whether a utility sells

into the consignment auction or not, it should be required to account for the full value of the allowances it received, and to report on these expenditures in a timely and transparent manner to its oversight body as well as to CARB. The full value of the allowances received, and thus the full amount to be invested in AB 32-related purposes, should be assessed by multiplying the number of allowances received by the auction price in the quarter the utility received them.<sup>1</sup> In formula form, this means:

$$\text{\$ Invested} = \text{\# Allowances Received} * \text{\$ Auction Price}$$

Requiring utilities to account for the full value of their allowance allocation will ensure that we are investing in the maximum cost-effective emissions reductions in the electricity sector, and not continuing on a business-as-usual path. Utilities engaged in the joint CPUC/CEC proceeding starting in 2006 and the ongoing CARB proceeding have pointed out the difficulty of being required to “pay twice” – once to acquire allowances, and once to invest in emissions reductions. The rationale for initially giving utilities allowances for free is to ensure that they only have to gather the capital necessary to invest in making the reductions. Requiring utilities to spend the equivalent value of their freely received allowances on cost-effective emissions reductions ensures that they invest in additional, cost-effective reductions. Our rough calculations indicate that the minimum total allowance value in the electricity sector will be approximately \$11 billion over the life of the program (2012-2020).<sup>2</sup>

### **Provide guidance on how utilities should spend allowance value**

We support the proposal to restrict the use of allowance value in the electricity sector to purposes related to AB 32. We remain concerned that requiring auction revenues simply be spent for the benefit of ratepayers “consistent with the goals of AB 32,” however, gives utilities insufficient direction and risks allowance value being used to subsidize existing operations or to reduce rates rather than to invest in clean energy. While we appreciate the additional level of oversight that the CPUC and local governing boards of the publicly owned utilities (POUs) can provide, we encourage CARB to provide additional guidance in the regulations to give utilities a better sense of where they should direct allowance value, and to ensure uniformity among the state’s many utilities. We ask CARB to give clear guidance to the utilities, as well as the CPUC and local governing boards, that allowance value should be spent on the following three uses, each of which will help offset customer bill impacts and further the goals of AB 32.

#### **1. Cost-Effective Energy Efficiency**

Utilities should be required to first use allowance value to invest in cost-effective energy efficiency. California’s loading order establishes all cost-effective energy efficiency as utilities’ first priority procurement resource. In that context, cost-effective is defined as a ratio of the total system-wide benefits from saving energy through efficiency measures relative to the total system-wide costs of achieving the savings (the Public Utilities Commission employs the Total Resource Cost (TRC) test to

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<sup>1</sup> Thus, if a publicly-owned utility received 15 million allowances but only put 10 million allowances up for sale at auction, the utility should be required to account for the full value of allowances received (15 million) not simply the portion put up for auction (10 million).

<sup>2</sup> Using an auction price of \$10/MMT, escalating at 5% plus 2.5% CPI per year, multiplied by projected allowances allocated in the electricity sector results in total sectoral allowance value of \$10.859 billion.

make this calculation).<sup>3</sup> As long as the benefits exceed the costs (TRC >1), an efficiency program is deemed cost-effective.

Under AB 32, however, cost-effective is defined relative to the cost of achieving the emission reductions necessary to meet AB 32's goal of returning to 1990 emissions level by 2020.<sup>4</sup> As long as energy efficiency can provide emission reductions at lower cost than other emission reduction strategies, it should be considered cost-effective. Significant energy efficiency potential remains in utility service territories that may not be considered by the PUC to be cost-effective under a utility procurement framework, but is cost-effective when compared with other abatement measures available to meet the goals of AB 32. To comply with the AB 32 directive to achieve emission reductions at least cost, and to provide additional bill relief to utility customers, CARB should require utilities that receive allowance value to capture additional energy efficiency savings.

## **2. Renewable Electricity**

If utilities are allowed to use allowance value to invest in renewable energy resources, CARB should establish general principles for such investments in accordance with the goals laid out in AB 32.<sup>5</sup> New renewable projects that provide health and job benefits to Californians should be prioritized. For instance, local distributed generation, which typically does not require new transmission capacity and may provide jobs closer to load centers, should be prioritized. All investments using allowance value to procure renewable energy should be limited to projects that service the customers covered by the cap-and-trade program, in order to maximize the environmental and health co-benefits for those customers. Renewable energy investments using allowance value should not count towards any cost cap that is established to limit the costs of achieving renewable energy procurement requirements that exist in law.

## **3. Rebates to Low-Income Customers**

We support the proposed language on using allowance value to provide rebates to customers as long as the rebate is not on a per kWh basis (so as not to provide perverse incentive for increased usage).<sup>6</sup> We encourage CARB to go one step further and specifically require the utilities to consider providing rebates, subject to the same restrictions currently in the regulations, to low-income customers.

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

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.

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<sup>3</sup>See CPUC's "Energy Efficiency Policy Manual, v.4," p.7-8, available at:

<http://www.cpuc.ca.gov/NR/rdonlyres/F17E8579-3409-4089-8DE4-799832CF682E/0/PolicyRulesV4Final.doc>.

<sup>4</sup> See Coalition Comments submitted to CARB re: AB 32 Cost-Effectiveness: General Framework (June 2, 2008).

<sup>5</sup> AB 32 identifies many goals, including "not disproportionately impact low-income communities," complement "air quality standards and reduce toxic air contaminant emissions," and consider "overall societal benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health." Health & Safety Code § 38562(b).

<sup>6</sup> Sec. 95892(d)(3)(B)-(C).

- 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.

### **Reporting requirements for utilities receiving free allowances**

CARB should require each utility to report to its regulator, to CARB and in the case of POUs, to 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.

The reporting requirements should be modeled after the federal ARRA reporting requirements, which allow regulators and individuals to track all expenditures on-line at [www.Recovery.gov](http://www.Recovery.gov). Using the ARRA reporting software would save money and avoid recreating the wheel. Setting a uniform reporting requirement for all utilities would allow CARB and the public to see how the allowance value is being spent and help build public trust in the program.

**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.

### **Require the industrial sector to base product benchmarks on best practices and allow benchmarks to be dynamic over time**

The product benchmarks should be based on known best practices in the sector, and not on sector average performance, as is currently proposed. If the average sector performance is below what known best practices could achieve, then industries that received allowances based on average performance will not be incentivized to adopt best practices. In order to achieve emissions reductions and transform our economy, every sector must be incentivized to adopt current and evolving knowledge of best practices, and not simply continue with average performance.

In addition, the current proposal leaves these benchmarks unchanged for the life of the program. This may result in industries receiving excessive allowances that provide windfall profits. The benchmark should be set at current best practices and be revisited regularly to determine whether best practices have evolved. If so, the benchmark should be revised accordingly. The electric power industry, for example, is subject to Best Available Control Technology requirements for criteria pollutants, which has resulted in a 99% reduction in power plant NOx emissions from new power plants since the Clean Air Act was adopted. Benchmarks should be technology forcing in recognition of goals far beyond 2020.

### **Revisit, revise, and phase out free allocation to the industrial sector**

#### **The proposed level of free allocation to the industrial sector is likely much higher than is needed to combat leakage and should be revisited and revised**

All stakeholders agree that we must prevent leakage of industrial jobs out of California. However, excessive allocation beyond what is needed to avoid leakage is akin to subsidizing GHG-intensive products and services, a consequence counter to our need to transition to cleaner and efficient alternatives.

The proposed allowance allocation in the industrial sector will concentrate resources primarily among large oil, cement, and chemical companies instead of providing transition assistance to a broad range of small and large businesses.<sup>7</sup>

We believe that CARB has been overly generous in giving more allowances than are actually needed to prevent leakage. The proposed free allocation to the industrial sector is worth billions of dollars. Any portion of that amount that is not necessary to maintain competitiveness and prevent leakage will be pocketed by the industry while the price of carbon is passed on to their customers, resulting in a windfall profit to the industry. CARB must strive to ensure that any free allocation is absolutely necessary to maintain competitiveness, prevent leakage, and does not result in any windfall profit.

Although there is little information available specifically on the competitiveness concerns of California industries, there is research to suggest that a much smaller portion of allowances would sufficiently protect against leakage.<sup>8</sup> For example, a newly available report from UCLA Professor Matthew Kahn and Erin Mansur of Dartmouth College, *How Do Energy Prices, and Labor and Environmental Regulations Affect Local Manufacturing Employment Dynamics?*,<sup>9</sup> finds that leakage claims of industrial sector firms are overblown: “[E]nergy prices are only a significant determinant of locational choice for a handful of manufacturing industries such as primary metals” (p. 24). Empirical evidence from the EU ETS also suggests that leakage will not be a significant problem large enough to warrant long-term giveaways that eventually act more as crutches than investments.<sup>10</sup>

ETAAC also recognized that subsidizing GHG-intensive processes and products through free allowance allocation creates barriers to transitioning to a cleaner, more efficient economy.<sup>11</sup>

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<sup>7</sup> See ETAAC Report, pp. 1-10, available at

<http://www.arb.ca.gov/cc/etaac/meetings/ETAACAdvancedTechnologyFinalReport12-14-09.pdf>.

<sup>8</sup> EAAC report, p. 43 states, “relatively little allowance value would be needed under this mechanism to address leakage”; Aldy et al., May 2009, RFF Discussion paper DP08-16, *Designing Climate Mitigation Policy*, p.22 finds that, “...only about 15-20 percent of allowances are needed to compensate energy-intensive industries, for their loss of producer surplus, so the huge bulk of allowances could still be auctioned.”; Goulder, Hafstead, and Dworsky, “Impact of alternative Emissions Allowance Allocation Methods Under a Federal Cap-and-Trade Program,” August 2009, states that, “Under a wide range of cap-and-trade designs, freely allocating less than 15 percent of the total allowances prevent profit losses to these most vulnerable industries. Allocating 100 percent of the allowances substantially overcompensates these industries, in many cases causing more than a doubling of profits.”

<sup>9</sup> Available online at: [http://ei.haas.berkeley.edu/pdf/working\\_papers/WP209.pdf](http://ei.haas.berkeley.edu/pdf/working_papers/WP209.pdf).

<sup>10</sup> See coalition comment letters submitted in the CARB and WCI policymaking processes:

<http://westernclimateinitiative.org/public-comments/comment/418>;

<http://www.arb.ca.gov/cc/capandtrade/meetings/041309/apr13pcgwac.pdf>;

<http://westernclimateinitiative.org/public-comments/comment/550>

<sup>11</sup> ETAAC Advanced Technology Subgroup, *Advanced Technology to Meet California's Climate Goals: Opportunities, Barriers & Policy Solutions*, December, 2009, p 1-10. Online at <http://www.arb.ca.gov/cc/etaac/meetings/ETAACAdvancedTechnologyFinalReport12-14-09.pdf>.

**CARB should build in an explicit adaptive management process to adjust the free allocation to the industrial sector based on specified evaluation metrics**

As a condition of free allocation, CARB should require industrial sector emitters to provide detailed information on production input costs and revenue to enable a more rigorous, analytical understanding of the extent to which free allocation protects consumers and prevents leakage, or to what extent allocation needs adjustment to avoid windfall profits. This information would be kept confidential at the individual firm level, though it could be released at the sector level so that proprietary information would not be compromised. After two years of data are collected, the ability to pass through costs would be assessed during the last year of the first compliance period. With this better understanding of the real importance of trade exposure and the risk of leakage, adjustments can be made for the second compliance period and going forward.

CARB has identified the industrial sector as especially challenging. In its summary of “expected incidence of carbon costs by sector assuming no return of allowance value,” (p. J-10), the industrial sector is the only part of the economy where there is considerable uncertainty. This means that CARB is unsure whether capped industries or consumers will bear the cost of pricing carbon. As the table notes, “Disagreements about cost pass-through ability require sector-by-sector analysis.” In light of this, rather than laying out a specific schedule through 2020 without an explicit process for adaptation as greater certainty is achieved, CARB should build in a specific assessment process that is both adaptive and robust.

The CARB staff report also notes uncertainty over whether domestic captive producers such as oil producers face potential leakage risk. We agree with CARB staff that further analysis is warranted and recommend completing this analysis prior to establishing a 100% free allocation factor for these producers.

**Carve out allowances from the outset of the program for a Community Benefits Fund.**

We urge CARB to carve out allowances from the outset of the program to be used for a Community Benefits Fund (CBF). Inclusion of a community investment program has been broadly supported by community-based, environmental justice, health, and environmental organizations throughout the development of the cap-and-trade program. AB 32 requires CARB to “direct public and private investment toward the most disadvantaged communities in California.”<sup>12</sup> While the CBF is noted in the staff report as a possible use of allowance value, there is not a specific recommendation to create and operate a fund by a certain date. We urge CARB to include provisions in the regulation to set aside a minimum of 4% of allowances from the industrial and electricity sector from the outset of the program, and from the transportation and natural gas sectors when they are included in the program in 2015, and dedicate the revenue to the CBF.

We recognize that the Legislature has ultimate authority over the use of funds collected under the program, but we believe that CARB should include a carve out in the regulations for the creation of a

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<sup>12</sup> Health & Safety Code § 38565.

CBF, and a recommendation to the legislature that these funds be used to protect and benefit our most vulnerable communities.

CARB should recommend that funds be used for programs or projects in the most impacted and disadvantaged communities CARB has identified to:

- Reduce GHG emissions (i.e., home energy efficiency investments)
- Mitigate public health impacts of air pollution and climate change (i.e., pollution reduction strategies, public health programs)
- Promote green collar employment opportunities within these communities (i.e., investment in worker transition programs)

Thank you for the opportunity to offer these comments and for considering our recommendations.

Sincerely,

Kristin Eberhard  
Natural Resources Defense Council

Erin Rogers  
Union of Concerned Scientists

James Fine  
Environmental Defense Fund

Bill Magavern  
Sierra Club California