CALIFORNIA MANUFACTURERS & TECHNOLOGY ASSOCIATION

Subject: **Comments on proposed Cap & Trade regulation**
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California Manufacturers & Technology Association (CMTA)

CMTA is a trade association representing over 700 manufacturers in California, including such diverse industries as glass, fuels, chemicals, steel, cement, aerospace, consumer products, food and drink processors and more. Many members will be directly subject to the proposed cap and trade regulation, and/or will be incurring the costs passed through from application of the rule on upstream electric generators, transportation fuel suppliers and natural gas providers.

Large manufacturers are subject to high operating costs in California, particularly for electricity, with rates more than 50% higher than the average of other states. These high energy prices have already forced existing manufacturers to embrace energy efficiency in order to cut costs and stay in business. Since 2000 we have lost about 34% of our manufacturing employment, and the most recent data shows manufacturing either declining less, or growing more rapidly, in other states. We believe more job losses will occur when new costs are imposed on California manufacturers to meet AB 32 targets.

CMTA hopes that market mechanisms such as cap and trade can be employed to provide compliance flexibility and thus reduce the costs of achieving emission reductions under AB 32. However, as CARB staff has described in the final statement of reasons, the risks of unintended outcomes is high, including emissions and economic leakage, and the market design must protect against this to ensure the integrity of the program. In addition, to ensure fairness and encourage the hoped-for behavior, the market rules and parameters must be sufficiently known in advance to provide market participants information upon which to base their important business decisions. Finally, it is crucial for CARB to develop and use reliable monitoring tools to determine that all outcomes are acceptable and to make adjustments as necessary without changing the rules in a way that unfairly impacts market participants who have based important decisions on existing rules.

With these principles in mind, we have the following comments and recommendations for important elements of the proposed rule:

I. Free allocation of allowances for all industrial sectors until 2020

CARB staff proposes free allocation of allowances for all industrial sectors for the first compliance period but not for the second and third periods. We recommend the free allowance distribution up to the output-based benchmark for each sector in all compliance periods up to 2020, for these reasons:

- AB 32 does not authorize CARB to raise revenue for purposes unrelated to administration of the program, and CARB has not shown in the statement of reasons that an auction to raise revenue is necessary for, or limited to, administration of the program. In fact, CARB staff suggests that the legislature appropriate auction revenues for very broad purposes related to technology development, community benefit, workforce training, etc. Unless and until CARB can justify that revenues are required for administration of the program, the revenue is a tax that requires a 2/3 vote of the legislature.

- CARB staff suggests that auctions are required to avoid windfall profits, yet free allowance up to the benchmark automatically protects against such risk by ensuring that no entity receives more allowances than needed to operate their facilities. Because there is no real risk of windfall profits under this proposed allocation scheme, it is clear that the real purpose of the auction is to raise revenues for purposes unrelated to the cap and trade program as outlined above.

- CARB staff presents no justification that an auction is necessary to achieve the emission reduction goals of the AB 32 scoping plan. The declining cap, market monitoring, reporting rules, offset verifications and other design elements ensure that emissions will be reduced and no auction revenues are necessary to achieve that goal.

- The imposition of a broader auction in the second and third periods will only increase leakage by imposing higher costs on industry. So long as California is not joined in the cap and trade program by other jurisdictions and California industry remains subject to competitive forces, this leakage risk is heightened and CARB should take every step possible to avoid it.

- Assessing leakage risk is an inexact science at best and many CMTA members have expressed great concern about how their industries have been categorized. Because cost ramification of the determination is so high, we should be much more certain that the leakage categories and the industry members of each are valid. Moving forward with this scheme with the current level of analysis is fraught with political, legal and economic risk.

Finally, it is noteworthy that CARB staff has failed to determine levels for allocation that we urgently need to know (see comments below regarding benchmarks), yet CARB staff is willing to commit immediately to impose a massively burdensome new charge on manufacturers for unspecified and unjustified purposes in the future. In fact, by indicating now that costs will be significantly higher in future compliance periods due to the proposed auction, CARB could cause immediate economic harm and leakage as entities start preparing to reduce their California footprint to minimize costs.

II. Require benchmarks be finalized no later than June 30, 2011

We are disappointed and very concerned that CARB has not yet proposed the output-based benchmarks that will apply to all the industry sectors covered by the regulation. This is crucial information for companies planning for future operations, capital projects, product pricing, etc. There is no guarantee that the information will be complete in advance of the last quarter of 2011, mere months before the start of the market in 2012.

While the proposed budget cap for the first year is intended to provide the California economy most of the allowances it needs to operate as usual, there will be winners and losers within each industry sector. For entities operating facilities less efficient than the benchmark, there will be immediate new obligations to purchase allowances to make up the difference between their free allowances and what is needed to operate. At this time they do not know how many allowances they will receive for free, and they don't know when they will get this crucial information. This uncertainty will exacerbate an already difficult economy and will discourage manufacturing investment and new hiring.

The 15 day update process to fill-in these blanks will operate under the radar at a staff level and the full implications of all the decisions will not be knowable until very late in the year. Because total allowances in the system is capped, a too-generous allocation for one sector will operate to the detriment of others, both within and without each sector. Unless we understand all the benchmarks and allocation determinations soon, the public will not have a meaningful opportunity to comment on the total impact of all allocation decisions prior to the market opening in 2012.

For this reason, we recommend that CARB resolve to require staff to provide the Board and the public a report on the progress toward establishing benchmarks by April 30, for review by the CARB Board at the May meeting, with a target to have final determination on benchmark methodologies, procedures needed and documentation requirements no later than June 30, 2011.

III. <u>Impose no limits on use of qualified offsets</u>

Because California has embraced energy efficiency for many decades and costs for energy are very high, the low-hanging energy efficiency fruit has already been picked for many large and sophisticated companies. Lower cost offsets from other sectors of the economy will help keep costs under control. We are disappointed that the cap and trade program will proceed with so few approved protocols for offsets.

We appreciate that CARB staff has increased the ability to use offsets from 4% up to 8% of the compliance obligation. However, this parameter is likely too small to accommodate the needs of a growing California economy. We recommend that CARB impose no quantitative limit on qualified offsets and that CARB not impose geographic limitations.

This recommendation should be easy to accept because the stringent offset qualification rules, the need for CARB approval of any offset protocol, and the potentially costly implications of buyer liability for offset reversals will limit the availability of offsets in any event. We shouldn't impose artificial constraints on the offset market that will be difficult to grow even under the best of circumstances.

IV. Need more information to set price collar levels for the allowance containment reserve account

CARB staff proposes a price containment mechanism with floor and ceiling prices to moderate allowance prices. The level of pricing in the allowance containment reserve is not well justified – more data is needed. CARB staff acknowledges that monitoring tools for leakage have not yet been developed, and all attempts to model the economic impact of AB 32 and the cap and trade program have not included an assessment of the impacts of leakage. Without a better understanding of how prices should be contained to minimize leakage, it is impossible to establish a justifiable range for this account. The $10 floor may be far too high (particularly compared to prevailing carbon prices in other markets) and extremely damaging economic outcomes may be experienced at market prices much less than the proposed ceiling. The proposed levels are not well-justified in the regulation.

We recommend that CARB postpone determination of these thresholds until the regulation is more complete, with all the allocation benchmarks determined and all the monitoring tools established to measure leakage and other potential market failures. The process of developing these tools will likely inform the appropriate levels for price collars in the market.

V. Buyer liability issue for offsets should be determined in the protocols

There is no need to make a one-size-fits-all rule that buyer liability should apply to reversals of offsets. The protocol for each offset type could include analysis of the particular risks of reversal and perhaps identify methods to protect against this outcome, or incorporate insurance within the offset itself, to provide a remedy in the case of destruction. This would provide more certainty for the buyers of offsets and facilitate market trading of offsets.

VI. Penalties for non compliance should be less punitive and not take allowances out of the market

CARB proposes that noncompliance should be penalized with a 4 times multiplier for excess emissions. We believe that the per ton penalty approach proposed by CARB staff is overly punitive. In addition, taking the additional allowances out of the market and putting them in the allowance reserve would make them available for purchase only at the higher reserve price, a bad outcome for remaining innocent market participants. We recommend that a more moderate penalty structure be adopted without taking allowances out of the market.

VII. Resolve to coordinate state and federal climate policy implementation

California industry is faced with state, local and federal requirements for air emissions that threaten to conflict, duplicate, or otherwise increase costs above that necessary to achieve our individual and collective policy goals. The current political and legal situation is confusing, to say the least, and entities are struggling to predict and plan for what may be coming in the next years. A policy statement from CARB that recognizes the situation and puts a high priority on addressing these questions to protect the California economy would be welcome and provide some confidence that CARB will not proceed in a manner that puts California industry at risk. For example, we recommend that CARB resolve to modify the timeline, content, and implementation strategy of the state cap and trade program to avoid these excess costs and burdens.

Thank you for considering these comments and recommendations.