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Rajinder Sahota
Branch Chief California Cap-and-Trade Program
California Air Resources Board (CARB)
1001 I Street Sacramento, CA 95814

Dear Ms. Sahota,

Thanks to you and all CARB staff for your hard work and excellence at the forefront of climate policy development and implementation. This letter offers comment on the proposals discussed at the cap-and-trade workshop that took place on October 21, 2016.

We support the proposal to retire unsold allowances at the end of 2020. This is an essential step for adjusting to the oversupply of allowances that has become clear, for example in recent auctions results, with some allowances going unsold at the auction reserve price. CARB's own analysis has demonstrated that an oversupply of allowances in excess of covered emissions is likely to continue through 2020. This is evident in slide eight of the staff presentation to the March cap-setting workshop, which shows approximately 300 MMT (million metric tons of carbon dioxide equivalent) of emissions under the cap in 2020 as compared to the cap level of over 330 MMT in that same year.

ADJUST POST-2020 CAPS TO ACCOUNT FOR BANKED ALLOWANCES ACCUMLATED BY THE END THE THIRD COMPLIANCE PERIOD IN 2020

Our principal recommendation is to adjust post-2020 cap levels to account for the number of banked allowances at the end of the 3rd compliance period. Specifically, a number of allowances equal to the size of the bank should be removed from the allowance levels proposed for the fifth and sixth compliance periods and added to the Allowance Price Containment Reserve.

The quantity of banked allowances could be very large by the end of 2020. In the first compliance period, about 17 percent of allowances issued under the combined California-Quebec program were banked, totaling over 62 MMT. This first compliance period bank is directly estimable from CARB's quarterly compliance instrument reports.

The auction reserve price (informally, the price floor) provides a crucial automatic adjustment mechanism. The program's price floor of $12.73 per ton is higher than any other major cap-and-trade program, yet it is arguably still fairly low, less than one-third of the current midpoint of the range of U.S. EPA's Social Cost of Carbon. Factoring in the annual five percent price increase, the

floor price will be approximately $15.50 in 2020 (in real terms—that is, not including a forecast of future annual inflation, which is also added to the floor under the annual adjustment formula).

We are working to develop a quantitative estimate of the expected range of oversupply through the end of 2020, and will soon circulate it for review among stakeholders. Please contact us at the above email address if you wish to review the work. We continue to refine our methodology. Currently, we are estimating that oversupply will amount to between 100–250 MMT by the end of 2020 (across the two jurisdictions, California and Quebec). Of course, Ontario offers another wrinkle.

Once the regulated community becomes more convinced of the credibility of the program's longevity, there will be an incentive to purchase and bank significant amounts of allowances. This will be especially true if CARB goes forward with the plan to retire unsold allowances. For this reason, we urge this further step of lowering of the post-2020 cap levels to account for the large bank of allowances likely to exist by the end of 2020.

OFFSETS

CARB is considering lowering the offset limit due to AB 197 guidance prioritizing direct, local reductions. That may be the most legally robust approach. It would be preferable to have a policy that automatically adjusts to cost feedback from the market. For example, a design that would limit out-of-state offsets, unless allowance prices rise to some threshold level at which compliance costs would exceed in-state benefits from continued prioritization of local/in-state reductions. We understand this would introduce a new avenue for legal challenge, which would argue in favor of the route you have announced you are considering.

Another design feature that might fulfill the requirements of AB 197 would be to forbid the use of offsets by capped emitters in areas that are in noncompliance with federal air quality standards unless a rigorous, independent audit indicates the emitter has taken advantage of all emission reduction opportunities under some cost-effectiveness threshold.

CITIZEN PERMITS OPTION

We are confident that policymakers will solidify the legal basis for auctioning in the near future. That is the best approach. Nonetheless, as a backup plan, and to put more pressure on regulated entities, we wish to sketch the citizen permits option as a viable option under current law.

How citizen permits would work

It would be relatively straightforward to distribute allowances directly to the people of California. Equal per-capita shares, recognizing equal and shared ownership of the atmosphere, is a natural approach to direct allocation. A method of distribution could be through certificates that are mailed to all residents. Another task would be providing ready means for people to monetize these and get them into circulation. An existing or new nonprofit or quasi government institution could be developed as a mechanism to make this easy. This entity would serve as a

middleman, in effect, between the people that will hold allowances and the emitters that will need to acquire them.

The consumer protection imperative

Free allocation to the emitters covered under the program would be another way to distribute allowances if auctioning is disallowed. The problem with this approach is that it would be regressive and create windfall profits for emitters. It would represent a missed opportunity to protect consumers from price effects as the costs of carbon pollution are factored into our economic system.

Monetizing access to the public resource of the atmosphere creates a huge amount of monetary value. The value far exceeds the cost of investments polluters will have to make to comply. Put differently, the value of allowances far exceeds compliance costs. So it is important to make sure this value lands in the pockets of consumers, not as a windfall to carbon-emitting businesses.

Theory and real world experience show that giving away allowances to polluters does not protect consumers. Consider this situation: If a scalper selling tickets to a sporting event or concert finds a ticket on the ground, that scalper is not going to give it away for free. The fundamentals of supply and demand, not the method of distribution, determine the value of a freely allocated good. For businesses receiving carbon allowances for free, there is an opportunity cost to using them. They forgo the opportunity to sell them. Thus, they seek to pass along this "cost" of doing business to consumers, even if they have not paid for their allowances. Free distribution does not affect the price of allowances, and businesses will seek to have the price of carbon emissions reflected in the price of their product, regardless of how allowances are handed out.

Past experience with free distribution of allowances has shown doing this will produce windfall profits in most instances. Many businesses—including small, local businesses as well as major fuel suppliers such as electricity and gasoline sellers/oil companies—are able to pass "costs" of freely allocated allowances through to consumers. There are a select handful of industries—energy intensive, easily traded—that can be legitimately considered for free allocation in the public interest. In these few cases where businesses will not be able to pass through the carbon price, free allocation does make sense and could still be part of the overall allocation mix as it is currently for energy intensive, trade exposed industries.

A credible threat to encourage support for auctioning in the regulated community

The citizen permits' approach provides a viable alternative to allow for the continuation of the state's cap-and-trade program in the way that maximizes public benefits, avoiding the windfall profits that would follow from large-scale free distribution. Explicit recognition that this is a possibility might even encourage greater support in the regulated community for legislation to enable auctioning. Capped emitters would have to be concerned about the possibility that some citizens would choose to keep their allowances in order to lower the cap. Some would also

inadvertently fail to cash them in, which would put further downward pressure on the cap. While auctioning would be simpler and preferable, at the least, recognition of the citizen permits option might reduce opposition to a legislative solution to auctioning authority post-2020.

Thank you for your consideration of these comments.

We stand ready to assist in whatever way we can be most helpful.

Sincerely,

Chris Busch

Research Director, Energy Innovation

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