Ms. Rajinder Sahota
California Air Resources Board
1001 I Street
Sacramento, CA 95814

June 3, 2016

Submitted electronically via: www.arb.ca.gov/cc/capandtrade/meetings/meetings.htm

RE: Public Workshop on Potential Updates to California's Cap-and-trade Program on Cost Containment

Dear Ms. Sahota,

Thank you for this opportunity to comment on the cost-containment workshop held April 5, 2016. We commend ARB for engaging stakeholders on the important topic of cap-and-trade design post-2020 and want to thank ARB for their informative workshops.

In over three years of implementation, California's cap-and-trade program has proven to be a success. Capped emissions are declining, California is adding jobs and growing the economy faster than the national average, the state is able to create more wealth with fewer emissions, Quebec and California are linked and holding quarterly joint auctions, almost all businesses have successfully complied with cap-and-trade requirements, and California communities - especially low-income, pollution-burdened communities - are seeing real benefits from cap-and-trade investments.

Because of this success we strongly support ARB moving forward with amendments to extend the cap-and-trade program beyond 2020 and believe this is the right time to do so. The cap-and-trade program needs certainty about future emissions reductions in order to continue providing robust incentives for reducing emissions. Similarly, because of the cap-and-trade program's success to date, we believe that there should be as much consistency as possible between the pre-2020 and post-2020 cap-and-trade program with updates to meet post-2020 needs and to best address the policy objectives of the cap-and-trade program. We believe that ARB has successfully balanced the need for consistency and flexibility to date and we look forward to seeing this continue.

Offsets Limit and Allowance Price Containment Reserve (APCR)

Consider further alignment between the offsets limit and the APCR

EDF considers both offsets and the APCR important components of the California cap-and-trade program especially with regard to cost containment. The APCR is an innovative component of California's cap and trade program that provides an effective price cap without compromising environmental integrity since allowance come from under the cap. Offsets allow compliance entities valuable flexibility in meeting their compliance obligations. In addition, offsets allow

for the direct involvement of the uncapped sectors, particularly the agricultural and forestry sector – the largest uncapped sectors in the state – and generate a multitude of other social and environmental benefits. Similarly, per comments EDF has submitted separately, international forestry sectoral offsets could provide a valuable source of compliance instruments while amplifying the impacts of California's climate program globally.

However, we want to recognize the concerns raised by the April 2014 EJAC recommendation to limit offset use because offsets "can diminish direct industrial emissions reduction at fenceline communities and compromise GHG reductions in the state". This is the reason that California has implemented an offsets limit. EDF believes that a quantitative limit on offsets strikes an important balance between the benefits of allowing offset use in the system and stimulating in-state emissions reductions. EDF would further like to suggest that one way to retain the benefits of offsets but to effectively counterbalance the potential impact of offsets on direct emissions reductions within the capped sectors would be to consider further alignment between offsets limit and the APCR post-2020.

The offsets limit and the APCR effectively have opposite impacts on the cap with respect to the obligation the cap places on capped entities to reduce emissions within the capped sectors. Since offsets include crediting of emissions reductions coming from out-of-state, using offsets from outside California can reduce the level of in-state emissions reductions required by cap-and-trade. Conversely, since the APCR draws allowances from under the cap, the APCR effectively increases the number of in-state emissions reductions required by cap-and-trade unless prices reach high enough levels such that it becomes economical for regulated entities to purchase allowances from the reserve. We also note that using offsets as a cost containment tool reduces the likelihood that prices will rise to the point that the APCR allowances are used and, in the event that the APCR is used, reduces the number of APCR allowances that will likely be demanded. If the number of offsets allowed for compliance equaled the number of allowances in the APCR, capped entities would be required to make emissions reductions in the capped sectors as if neither policy tool existed, unless prices rise dramatically. If an offset is used in lieu of an allowance from the reserve, moreover, an additional emission reduction is provided, with net benefits to the atmosphere.

Pre-2020, four percent of capped emissions were set aside in the APCR (and have not been used so far) and the offsets limit was set at eight percent of entities' compliance obligation. EDF is not taking a position now on adjustments that should be made create further alignment between these levels. Rather we want to emphasize in these comments the relationship between the two policy tools. Specific decisions about the level of the APCR and offsets limit should be informed by economic modeling and stakeholder input, especially from the EJAC and other equity groups and from linked and potentialy linked partners like Quebec and Ontario.

<u>Consider a volumetric rather than percentage level post-2020 for offsets limit and APCR</u>

Pre-2020 the number of allowances in represented by the offsets limit and contained in the APCR has been identified as a percent of the compliance obligation. As the cap declines out to 2020 a set percent of the compliance obligation will be a declining amount as well. Since the level of the cap is decreasing and the need for cost containment is likely to increase, especially

with more ambitious post-2020 targets, it may be most appropriate to identify the offsets limit and the APCR as a volumetric number based on anticipated cost containment needs. In the case of offsets, this could be implemented as a percentage of the compliance obligation that rises, rather than remains fixed, over time.

Continue to consider ways to ensure the integrity of the APCR without undermining the cap

The MSG has determined that, while unlikely, there is a risk that the APCR could be exhausted. However, all evidence seems to suggest if this is a risk at all that risk will not arise for quite some time. The limited borrowing measures that ARB has adopted and is considering provide sufficient protection in the short-term. However, as ARB does economic analysis and continues to consider the post-2020 market, staff should continue to consider whether there are other options for refilling the APCR should it become exhausted. All options considered should preserve the environmental integrity of the cap. As one example, staff could consider whether there are ways to refill the APCR with offsets if necessary. This option may become more feasible if California does link with a jurisdiction like Acre that can provide sectoral offsets and as the increasing price signal from the cap-and-trade program further incentivizes domestic offsets creation. Because current cost containment measure do seem sufficient, we do not believe this is an issue that needs to be addressed in this current rulemaking.

Narrowing the spread between the floor price and APCR trigger price

EDF believes it is important to have the floor price continue to rise steadily and predictably. A rising floor price will make an increasing number of direct emissions reductions cost effective and provides lead time for industry to implement reduction strategies. Similarly, the rising floor price predictably increases the incentive and ability of offset providers to deliver high quality reductions. Finally, the rising floor price can improve the market function by providing a consistent return on investment when regulated entities or traders bank allowances or purchase allowances in the advanced auction.

Therefore, if ARB decides that it is important to narrow the spread between the floor price and the APCR trigger price, we believe this should be accomplished by allowing the floor price to rise while making adjustments to the APCR trigger price. The most significant current issue is that the spread between the floor price and the APCR trigger price continues to grow as both increase at 5% plus inflation. The most important adjustment would be to ensure that the price differential between the floor price and the APCR trigger price stays constant over time.

Other Cost Containment Design Features

EDF supports:

- Continuing to allow banking post-2020 and to allow banked pre-2020 allowances to be used post-2020. The European Union Emissions Trading System example where

allowances from the first compliance period were not bankable saw a dramatic collapse of the market price approaching the end of the first compliance period[1].

- Continuation of cost containment design features adopted in 2014 such as limited borrowing at top tier APCR prices from future vintages.
- Placing at least a fraction of allowances that go unsold pre-2020 into the post-2020 APCR seems appropriate. Full retirement seems too extreme at this time given the uncertainty about the APCR and need for cost-containment post-2020. However, ARB has been given the charge of *maximizing* cost-effective emissions reductions. Thus, if emissions are so far below the cap that auctions are not selling out, it seems appropriate to further tighten supply at floor prices by shifting allowances to the reserve. If price tiers remain post-2020, unsold pre-2020 APCR allowances should move into the highest post-2020 APCR price tier.
- Allowing limited borrowing at a premium in accordance with the MSG proposal. The general concern with borrowing is that regulated entities could use it as a way to procrastinate on their compliance obligations, jeopardizing the future effectiveness of the future cap. The premium charged for a borrowed allowance seems sufficient to dissuade this strategy. Ideally this will mean that borrowing will only be used in limited and unlikely scenarios where the market has short-term and unexpected tight supply or when a firm is facing a special internal situation that creates a temporary shortfall of abatement. If this proposal is implemented, the market monitor should watch for sign that this tool is being abused or being used too broadly in a way that could endanger the cap or cost-containment long-term.

Sincerely,

Erica Morehouse
Senior Attorney, Global Climate

[1] Lucas Merrill Brown, Alex Hanafi, and Annie Petsonk, The EU Emissions Trading System: Results and Lessons Learned, Environmental Defense Fund (2012) https://www.edf.org/sites/default/files/EU_ETS_Lessons_Learned_Report_EDF.pdf