



October 16, 2013

Rajinder Sahota  
Steven Cliff  
Climate Change Program Evaluation Branch  
California Air Resources Board  
1001 I Street  
Sacramento, CA, 95812

**Re: NRDC and Coalition for Clean Air Comments on ARB's Proposed Amendments to the Cap-and-Trade Program**

Dear Ms. Sahota and Dr. Cliff,

On behalf of the Natural Resources Defense Council and Coalition for Clean Air, and our hundreds of thousands of members and activists in California, we appreciate the opportunity to comment on Air Resources Board staff's proposed amendments to the cap-and-trade program for consideration at the October 25<sup>th</sup> Board hearing.

**INTRODUCTION AND SUMMARY**

We appreciate staff's careful attention to the ongoing design and development of the cap-and-trade program. The success of the cap-and-trade program is integral to the success of AB 32 and California's ability to model strong and effective climate action. AB 32 requires ARB to balance a diverse set of policy objectives in the design of the cap-and-trade program, including rewarding early action, minimizing leakage, maximizing co-benefits, and promoting equity. We commend ARB for its attention to these critical objectives to date, and ask that the Board approach future modifications to the program with the same set of considerations in mind.

Summary:

- Industrial assistance factors: We oppose staff's proposal to extend transition assistance for the industrial sector in the absence of any evidence or analysis to suggest the current assistance levels are insufficient to mitigate leakage risk. Dampening the carbon price signal through additional free allocation raises the cost of achieving greenhouse gas reductions, and raises the specter of windfalls for entities that can pass through

compliance costs. These are concerns that ARB has previously cautioned against,<sup>1</sup> yet are wholly absent in the Initial Statement of Reasons accompanying the proposed amendments. **We ask the Board to reject staff's proposal to extend transition assistance for the industrial sector and leave the existing assistance factors in place.**

- Natural gas allowance allocation: We support staff's proposal to distribute emissions allowances from the natural gas sector to natural gas distribution utilities *on behalf of their customers*. This ensures the value of allowances will accrue to customers through an open and public process. We recommend ARB increase the annual allowance consignment requirement on gas utilities, however, to preserve a strong carbon price signal in gas rates and maintain equity and consistency with other sectors under the cap. We also strongly recommend ARB maintain the prohibition on providing a pure volumetric return of allowance value to customers, which would negate any retail carbon price signal in natural gas rates. As detailed herein, prohibiting a volumetric return of allowance value does not unlawfully infringe on the California Public Utilities Commission's jurisdiction to set customer rates as some assert. **We ask the Board to direct staff to increase the utilities' annual consignment obligation and maintain the prohibition on a volumetric return of allowance value to natural gas customers.**
- Cost containment: We support staff's proposal to backfill the Allowance Price Containment Reserve (Reserve) with future vintage allowances designated for auction should demand for Reserve allowances outstrip existing supply. The proposal comports with the Board's direction in Resolution 12-51 to provide additional certainty that allowances prices do not exceed the highest price-tier of the Reserve while maintaining the environmental integrity of the program. **We ask the Board to support staff's proposal and reject cost-containment proposals that do not safeguard the integrity of the cap.**
- Legacy contracts: We support staff's *original* proposal to end free allowance allocation to legacy contract generators after the first compliance period and reduce free allocations to industrial third parties that purchase steam or electricity under a legacy contract. Establishing a clear cutoff point for transition assistance sends the appropriate incentive for outstanding contract negotiations to conclude and ensure the carbon price is passed through to electricity purchasers to encourage emission reductions. We oppose, however, staff's recent amendment to extend transition assistance through the second compliance period (for the same reasons expressed above). **We ask the Board to limit transition assistance for legacy contract generators, per staff's original proposal.**

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<sup>1</sup> ARB, "Appendix J – Allowance Allocation," p. J-8, 9 (Dec. 2010), available at: <http://www.arb.ca.gov/regact/2010/capandtrade10/capv4appj.pdf>

## DISCUSSION

### I. Industrial Assistance Factors

We strongly oppose staff's proposal to extend transition assistance for the entire industrial sector without any supporting evidence or analysis to justify the change. The proposal would distribute significantly more allowances directly to the state's largest emitters, including petroleum refineries, in lieu of requiring their purchase at auction – providing far less certainty that the value of those allowances will be used for the benefit of consumers and to further the purposes of AB 32.

#### a. Additional transition assistance is unjustified and unwarranted

ARB has not provided any analysis or data to support extending transition assistance for covered entities in *all* industrial sectors. The ISOR notes that the proposal is designed “in order to provide additional certainty and time to industry to successfully transition to lower-carbon production methods.”<sup>2</sup> We do not oppose providing limited transition assistance for covered entities under the cap, which ARB has embraced as a core tenet of its overall allowance allocation methodology. But the industrial sector has been on notice for at least seven years since the passage of AB 32 to prepare and plan for carbon reductions, and will receive an additional two years of 100 percent assistance under the current rule out to 2015. ARB has not identified any compelling justification for why the industrial sector requires more than a decade of lead time to plan and invest in carbon abatement strategies.

We are also concerned about the precedent this proposal sets when ARB is confronted with the same set of arguments in two years' time – when assistance factors are now proposed to decline. Staff acknowledges the proposal could lead some entities to delay making additional improvements in the near-term, but argues “it is unlikely that an industry would completely forego implementing future planned improvements since assistance factors for the medium and low leakage risk categories would be reduced again in the third compliance period.”<sup>3</sup> Yet staff has also signaled assistance factors in the third compliance period “may be adjusted,”<sup>4</sup> which industry has already seized upon to continue lobbying for further changes and delay.

As long as those efforts earn reward, ARB is dampening industry's incentive to plan and invest in the carbon reduction strategies needed to facilitate a successful transition and improve public health and air quality. California's major emitters have had ample time and opportunity to prepare for carbon pricing. We can ill afford further delay.

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<sup>2</sup> ARB, “Proposed Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms, Staff Report: Initial Statement of Reasons,” p. 56, available at: <http://www.arb.ca.gov/regact/2013/capandtrade13/capandtrade13isor.pdf>.

<sup>3</sup> Id. at 55.

<sup>4</sup> Id. at 26.

**b. Extending transition assistance to the industrial sector in the absence of any supporting research or analysis risks providing windfalls to the state’s largest emitters**

Staff also defends its proposal to extend transition assistance on the grounds that the supplemental leakage analysis ARB is conducting is not yet complete.<sup>5</sup> We fully agree ARB should take the necessary steps to minimize leakage, as required by AB 32. Leakage undermines environmental and economic objectives alike, and it is vital that California prevent leakage to establish a strong foundation on climate policy for others to follow.

But nowhere does staff acknowledge the risks of over-compensating for leakage risk, which are just as cautionary. As ARB recognized in 2010:

“Windfalls can occur when industries are given free allowances and are able to profitably pass through the cost of surrendering allowance value to consumers. Economic research suggests that this type of windfall occurred during the first phase of the European Union Emissions Trading Scheme (EU ETS)... Researchers emphasize that windfalls occurred because facilities were awarded free allowances and yet still passed opportunity costs through to consumers.”<sup>6</sup>

Accordingly, staff concluded that “*the potential exists for windfalls to any sector that is given free emissions allowances if the firms in the sector are able to profitably pass some or all of the cost associated with the value of the allowances through to customers*” (emphasis added).<sup>7</sup> Staff went on to note that the incidence of carbon pricing in the industrial sector – i.e., the ability of producers to pass through carbon costs to consumers – is uncertain due to the heterogeneity and complexity of the markets for various industrial products.<sup>8</sup>

In light of this uncertainty, ARB conducted an industry-by-industry assessment of leakage risk to support the development of the current assistance factors and leakage risk classifications (which ARB is presently updating). We fully support providing assistance to covered entities commensurate with their identified leakage risk and ARB’s commitment to update and refine its leakage analysis. But ARB’s proposal is not predicated on any new economic research or empirical findings suggesting current assistance levels are inadequate to guard against leakage – in fact, it is predicated on the opposite.

Given the risks of over-compensating for leakage through excessive free allocation, which have plagued cap-and-trade programs in the past and were underscored by the expert panel of economists ARB convened to advise on allowance allocation,<sup>9</sup> ARB should not consider

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<sup>5</sup> Id. at 26.

<sup>6</sup> ARB, “Appendix J – Allowance Allocation,” at J-8, *supra* note 1.

<sup>7</sup> Id. at J-9.

<sup>8</sup> Id.

<sup>9</sup> Economic and Allocation Advisory Committee (EAAC), “Allocating Emissions Allowances Under a California Cap-and-Trade Program,” p.3, March 2010, available at: [http://www.climatechange.ca.gov/eaac/documents/eaac\\_reports/2010-03-22\\_EAAC\\_Allocation\\_Report\\_Final.pdf](http://www.climatechange.ca.gov/eaac/documents/eaac_reports/2010-03-22_EAAC_Allocation_Report_Final.pdf).

lingering uncertainty an appropriate or sufficient consideration to extend transition assistance. ARB should instead commit to reexamining assistance factors once the supplemental leakage analysis is complete, and make any necessary adjustments (up or down) based on the results of the objective analysis.<sup>10</sup> In the interim, ARB should err on the side of keeping allowance value dedicated for the purposes the Legislature established for the use of auction proceeds: to fund GHG reductions that create jobs, target benefits in the state's most disadvantaged communities, and further the regulatory purposes of AB 32.

## **II. Natural Gas Allowance Allocation**

We support ARB's proposal to allocate allowances from the natural gas sector for the benefit of natural gas customers. Like ARB's approach for allocating allowances from the electric sector, allocating allowances to the gas utilities *on behalf of their customers* ensures allowance value is used to benefit consumers and further the goals of AB 32. For example, the allowance value would be available to help customers reduce emissions through improved energy efficiency, cushion bill impacts, prevent adverse impacts on low-income customers, and help foster engagement and support for AB 32 broadly by providing a direct benefit to millions of customers.

The manner in which allowance value is provided to customers, however, is critical to achieve these objectives. The criteria identified by staff to guide the treatment of natural gas allowance allocation – encouraging GHG reductions, maintaining equity and consistency among sectors, advancing California's long-term climate and clean energy goals – all hinge on how allowance value is ultimately provided back to natural gas end users.<sup>11</sup>

### **a. ARB should retain the requirement that allowance revenue be returned to gas utility customers in a non-volumetric manner**

We strongly support ARB's requirement that allowance revenue be returned to customers non-volumetrically – i.e., the more you consume does not equal the more you get.<sup>12</sup> A pure volumetric return of allowance value would undermine each of staff's objectives highlighted above, by: (1) blunting the incentive to reduce end use consumption (and associated GHG emissions) by tying usage directly to allowance value; (2) muting the carbon price signal in natural gas rates, which would raise equity issues relative to other sectors under the cap; and (3) dampening the incentive for businesses and consumers to find the most efficient and cost-

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<sup>10</sup> We do not find persuasive industry arguments that adjusting assistance factors during a compliance period would severely undermine the regulatory certainty needed to plan and invest accordingly. If anything, the regulatory course of action that provides the greatest certainty would be to leave the assistance factors unchanged, as we propose.

<sup>11</sup> ARB, "Suppliers of Natural Gas: Background and Options," slide 12 (June 3, 2013), available at: [http://www.arb.ca.gov/cc/capandtrade/meetings/060313/natural\\_gas\\_suppliers\\_workshop\\_presentation.pdf](http://www.arb.ca.gov/cc/capandtrade/meetings/060313/natural_gas_suppliers_workshop_presentation.pdf).

<sup>12</sup> ARB, "Appendix E: Proposed Regulation Order," § 95893(d)(3), available at: <http://www.arb.ca.gov/regact/2013/capandtrade13/capandtrade13isorappe.pdf>.

effective means of reducing emissions, undermining California’s ability to meet its long-term climate and clean energy goals.

**b. Prohibiting a volumetric return of allowance value does not unlawfully infringe on the California Public Utilities Commission’s authority to set customer rates**

The utilities argue that prohibiting a volumetric return of allowance value to natural gas customers, as staff proposes, unlawfully infringes on the California Public Utilities Commission’s authority under the California Constitution to conduct ratemaking. We disagree.

First, it is not clear that setting broad policy parameters around the distribution of allowance value constitutes ratemaking. The California Constitution provides only that the “Commission *i* fix rates.”<sup>13</sup> The notion of exclusivity comes from caselaw, first elucidated by the court of appeal in *City of Vernon*.<sup>14</sup> Yet there, the court held that the Commission’s exclusive authority covers rates the public utility earns for *services furnished by the utility*.<sup>15</sup> In contrast, the distribution of allowance revenue is not a service furnished by the utility; it is the creation of ARB’s cap-and-trade program. Indeed, ARB could have elected to bypass the utilities altogether through other allocation methodologies.

Yet even if the distribution of auction revenues were considered ratemaking, prohibiting a volumetric return does not unlawfully infringe upon the Commission’s authority. The Commission does not have “exclusive jurisdictional control over any and all matters having any reference to the regulation and supervision of public utilities.”<sup>16</sup> While the Commission’s ratemaking authority may be exclusive over local governing entities, this has not been established where *state-level* statutory schemes are at issue.<sup>17</sup> Rather, courts have frequently found that the Commission does not have exclusive authority when its jurisdiction is concurrent with another comprehensive statutory scheme (such as AB 32) and where the Commission has yet to issue relevant competing regulations (as here).

Accordingly, cases involving competing state laws and accompanying agency jurisdictional conflicts have come to very different holdings than cases involving conflicts between local governments (which the utilities rely on).<sup>18</sup> In *Leslie v. Superior Court*, for instance, the Court

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<sup>13</sup> Cal. Const., art. XII, section 6 (emphasis added).

<sup>14</sup> *City of Vernon v. Southern Cal. Edison Co.*, 191 Cal.App.2d 378, 387 (App. 2 Dist. 1961).

<sup>15</sup> *Id.* (emphasis added).

<sup>16</sup> *San Diego Gas & Electric Co. v. Sup. Ct.*, 920 P.2d 669, 700 (Cal. 1996), citing *Vila v. Tahoe Southside Water Utility* 233 Cal.App.2d 469, 477 (Cal. Ct. App. 1965)).

<sup>17</sup> See, e.g., *Leslie v. Superior Court* (1999) 73 C.A.4th 1042, 1049, 87 C.R.2d 313 and *Orange County Air Pollution Control Dist. v. Public Util. Com.*, 4 Cal.3d 945, 954 (Cal. 1971).

<sup>18</sup> Compare *City of Anaheim v. Pac. Bell Tel. Co.*, 119 Cal. App. 4th 838, 842-43 (Cal. Ct. App. 2004) and *City of Vernon v. Southern Cal. Edison Co.* 191 Cal.App.2d 378 (App. 2 Dist. 1961) with *San Diego Gas & Electric Co. v. City of Carlsbad* (1998) 64 Cal.App.4th 785, 797 (noting “the PUC has been held to have paramount jurisdiction in cases where it has exercised its authority, and its authority is pitted against that of a local government involving a matter of statewide concern. Where its jurisdiction conflicts with other than a local agency, commission directives have not been given such controlling effect.”) (emphasis added).

held that state housing law and Commission rules and regulations were of equal dignity, especially where no overt conflicts existed from the Commission generating its own rules.<sup>19</sup> And in *Orange County Air Pollution Control*, the California Supreme Court held the Commission must share its jurisdiction where it is concurrent with another comprehensive, statutory scheme.<sup>20</sup>

The details of the revenue return methodologies for natural gas customers will ultimately be determined by the Commission, which we agree is the appropriate forum to address those issues. But ARB is on firm legal footing to maintain the prohibition of a pure volumetric return, which it has already determined is integral to the design of its overall allowance allocation framework for the natural gas sector. We urge ARB to maintain the current prohibition.

**c. ARB should increase the consignment obligation on gas utilities to preserve a strong carbon price signal and maintain equity with other sectors under the cap**

The ability to submit allowances directly for compliance operates as an implicit volumetric return of allowance value (in that instance, the gas utility is using allowance value to prevent natural gas rates from rising to reflect the carbon price). We therefore recommend ARB increase the percent of emissions allowances that gas utilities must consign to auction, in order to ensure customers receive the benefits in a non-volumetric manner. Currently, staff proposes that utilities consign at least 25 percent of their allowances starting in 2015, ramping up 5% each year out to 2020.<sup>21</sup> We propose ARB increase the consignment obligation to 50% starting in 2015, and ramp up 10% each year out to 2020, such that gas utilities will consign all of their allowances by 2020.

Table 9-4: Percentage Consignment Requirements for Natural Gas Utilities by Year

Compliance Period	2			3		
Year	2015	2016	2017	2018	2019	2020
Percent Consigned	<del>25</del> <u>50</u>	<del>30</del> <u>60</u>	<del>35</del> <u>70</u>	<del>40</del> <u>80</u>	<del>45</del> <u>90</u>	<del>50</del> <u>100</u>

By preserving only part of the carbon price in natural gas rates, ARB’s current proposal raises equity issues relative to the treatment of other fuels and sectors under the cap. Natural gas competes with gasoline, diesel and electricity for various applications, including space and water heating, transportation, and use in various appliances. ARB must be careful to avoid creating perverse incentives for investment decisions and emission reduction opportunities between and among sectors regulated under the cap.

<sup>19</sup> *Leslie v. Superior Court* (1999) 73 C.A.4th 1042.

<sup>20</sup> *Orange County Air Pollution Control Dist. v. Public Util. Com.*, 4 Cal.3d 945 (Cal. 1971).

<sup>21</sup> ARB, “Appendix E: Proposed Regulation Order,” Table 9-4, “Percentage Consignment Requirements for Natural Gas Utilities by Year,” available at:

<http://www.arb.ca.gov/regact/2013/capandtrade13/capandtrade13isorappe.pdf>.

### III. Cost Containment

We support staff's proposal to make future vintage allowances designated for auction available for purchase by covered entities at the highest price tier of the Reserve in the extreme event that the Reserve's supply is exhausted.

In Resolution 12-51, the Board directed staff to adopt an additional cost containment mechanism to achieve two primary objectives: (1) ensure prices do not exceed the highest tier of the Reserve and (2) maintain the environmental integrity of the program. The Board's direction was narrowly tailored to address the contingency that allowance prices reach and exceed the 'soft price ceiling' built into the rule. As staff notes, the current program already contains a bevy of cost-containment mechanisms designed to prevent this very occurrence, including multiyear compliance periods, unlimited banking, limited use of offsets, an allowance reserve, and generous provision of emission allowances at no cost.

Accordingly, we strongly support staff's proposal insofar as it is designed to apply only if allowance prices reach the highest price tier and the Reserve's current supply is depleted. Resolution 12-51 does not require ARB to further reduce the probability of an already unlikely event by modifying other aspects of the rule (e.g., by modifying offset usage limits, crediting periods, or eligible geographic scope, as some stakeholders have proposed), which could end up creating more problems than it solves.

We agree with stakeholders that ARB should, to the extent possible, clarify *ex ante* the procedures it will employ to address future market contingencies. However, as members of the Emissions Market Assessment Committee (EMAC) have noted, in the unlikely event allowance prices reach the highest tier of the Reserve, it will not happen overnight.<sup>22</sup> Early signs of the market conditions required to trigger such a perfect storm would be known years in advance, providing ARB ample opportunity to assess and propose additional safeguards through its existing regulatory process.

### IV. Legacy Contracts

We support staff's *original* proposal to end free allowance allocation to legacy contract generators after the first compliance period. Board Resolution 12-33 directed staff to include appropriate transition assistance for the handful of legacy contract generators that have been unable to renegotiate their contracts following the passage of AB 32 to account for carbon costs.

Under a legacy contract arrangement, compliance costs cannot be reasonably passed through to the purchaser of electricity, which negates the carbon price signal created by the cap-and-trade program to encourage emission reductions. By establishing a clear cutoff point for transition assistance, staff's initial approach was responsive to the Board's direction while sending the appropriate incentive for those outstanding contract negotiations to conclude.

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<sup>22</sup> See, e.g., Presentation of Dallas Burtraw at ARB's June 25, 2013 Cost Containment Workshop, slide 5, available at: <http://www.arb.ca.gov/cc/capandtrade/meetings/062513/dallas-burtraw-presentation.pdf>.



We oppose, however, staff's new proposal to extend transition assistance for legacy contract generators through the second compliance period (consistent with our opposition to staff's proposal to extend transition assistance for the industrial sector, as outlined above).<sup>23</sup> We ask the Board to adopt staff's original proposal and cut-off transition assistance to legacy contract generators after the first compliance period to encourage renegotiation and ensure a carbon price is passed through to electricity purchasers to encourage emission reductions.

Finally, we support staff's proposal to reduce allowance allocations to industrial third parties under contract with a legacy contract generators for the emissions associated with their steam and electricity purchases. As staff notes, since emissions associated with a legacy contract do not have an emissions cost from the perspective of the steam or electricity purchaser, there is no incentive on the part of the industrial third party to reduce those emissions.<sup>24</sup> Allocating the allowances associated with those emissions to the legacy contract generator instead will correct the missing incentive and encourage renegotiation.

## **Conclusion**

We appreciate ARB's ongoing commitment to examine and resolve key design features of the cap-and-trade program through an open and public process. We look forward to continue working closely with ARB as it implements the program in a manner that furthers the goals of AB 32.

Sincerely,

Alex Jackson  
Natural Resources Defense Council

Bill Magavern  
Coalition for Clean Air

Cc: Board members  
Virgil Welch,  
Michael Gibbs  
Elizabeth Scheehle  
Eileen Hlavaka

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<sup>23</sup> ARB, "Revised Staff Proposal for Legacy Contract Treatment in Cap-and-Trade," Oct. 16, 2013, available at: <http://www.arb.ca.gov/cc/capandtrade/legacy-contract-proposal.pdf>.

<sup>24</sup> Id. at 17.