



## California Council for Environmental and Economic Balance

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November 4, 2016

Clerk of the Board  
California Air Resources Board  
1001 I Street  
Sacramento, CA 95814

### **RE: October 21, 2016 MRR and Cap-and-Trade Regulation Workshop**

Dear Ms. Sahota:

On behalf of the members of the California Council for Environmental and Economic Balance (CCEEB), we thank the California Air Resources Board (ARB) for this opportunity to comment on the proposed regulation for potential amendments to the Cap-and-Trade Program. CCEEB is a non-profit, non-partisan association of business, labor, and public leaders, which advances balanced policies for a strong economy and a healthy environment.

#### **Overview**

With SB 32 (Chapter 249, Statutes of 2016) now law, CCEEB believes that additional emphasis on Cap-and-Trade is necessary to achieve cost-effective emission reductions and to send a clear market signal to facility operations and projects. CCEEB supports a well-designed Cap-and-Trade Program as the most economically efficient, transparent, and environmentally effective policy for California to achieve statewide greenhouse gas emission reductions and meet the 2030 goal.

Compliance flexibility allows California businesses to select reduction strategies that best suit their unique needs and evolving circumstances, while delivering real emission reductions more efficiently and at less cost than direct measures. Cap-and-Trade continues to achieve GHG emission reductions while sending a clear and transparent price signal throughout California's economy. This in turn prompts behavior change that reduces emissions and spurs the investment and commercialization of advanced technologies. Additionally, Cap-and-Trade provides the potential to export the policy to other jurisdictions through linkage or sector-based offsets, providing a real platform for California to realize its goals as a climate leader.

Prescriptive regulatory amendments, such as, release of market data, cost burden allocation approach, reducing offsets, and unused allowance retirement, set California on a limited path with narrow solutions that will ultimately be costlier, limit technological development, and lead to economic and emissions leakage. Our post-2020 policies should support the opportunity for new, emerging technologies and control strategies, and allow California to do what it does best – innovate.

Moreover, climate change cannot be mitigated by California alone. Policies that reduce greenhouse gases in the most economically efficient way serve as valuable examples that encourage other jurisdictions to link to California, or emulate the State's approach. Adding extraneous policies, stringency, or complexity that does not enhance the efficacy of the program will discourage rather than encourage other states, provinces, and countries to join the fight against climate change. Given today's economic realities, pursuing high cost policies that constrain Cap-and-Trade will only serve to further isolate California from potential sub-regional, national, and international partners. Other jurisdictions will not follow costly programs that create additional economic pressures and impede sustainable economic growth. Even worse would be policies that limit or outright bar California from joining in partnerships with other jurisdictions, either through linkage or use of offsets. Insular policies may achieve in-state goals, but they will not solve global climate change.

ARB, with public input, has spent the last decade developing a strong Cap-and-Trade Program. In light of SB 32's even more ambitious carbon reduction targets, now more than ever, a well-designed Cap-and-Trade Program is needed to help California meet its environmental goals while maintaining a strong economy. We appreciate the work that ARB staff has done to launch Cap-and-Trade; however, we are at a crossroads due to competing political priorities and litigation that could upend the program's success. We urge ARB to keep climate change at the forefront of its policy objectives.

#### **AB 197 – Measured Response**

Assembly Member Eduardo Garcia (D-Coachella), the author of AB 197, testified in Assembly Natural Resources Committee on August 24, 2016:

*“I also want to just clearly state that we to are supportive of the Cap-and-Trade program, the leadership of the Senate who moved the bill out this week is in support of the Cap-and-Trade program, the leadership of the Assembly is in support of the Cap-and-Trade program, the governor of the state is in support of the Cap-and-Trade and has asked that 197 be sent to his desk as a package with SB 32. So, I wanted just to state that the intention is by no means to tamper with the Cap-and-Trade program.”*

In an August 31, 2016 letter to the Assembly Journal, Assembly Member Eduardo Garcia stated, *“It is my intent that nothing in Section 38562.5 shall be interpreted to preclude ARB from adopting any market-based compliance mechanism pursuant AB 32.”*

Based on these statements, CCEEB urges ARB staff to be measured in its response to AB 197 and limit proposed amendments to the Mandatory Reporting Rule and Cap-and-Trade Program at this juncture. Now is not the time to propose radical departures from current program design based on inference of intent without explicit statutory guidance. It is clear that Assembly Member Eduardo Garcia, the Legislature, and the governor did not intend for ARB to substantially deviate from the existing Cap-and-Trade design.

Unfortunately, the proposal presented by staff at the October 21 workshop, does just that. Moreover it conflicts with AB 32's mandate to ensure cost effectiveness. Issues of concern

include a reduction of offsets, shifting the cost burden through reduction of industry assistance, and retiring allowances from the pre-2020 allowance price containment reserve (APCR). Nothing in AB 197 directs ARB to take such drastic actions. It is premature to make these changes prior to completion of at least two more compliance periods, when the full scope of the program will have been in effect and back-loaded elements of the Scoping Plan implemented. We note that at the workshop, staff acknowledged that the Cap-and-Trade Program already achieved direct emissions reductions.

The Cap-and-Trade proposal appears to be designed with a “cost burden” assumption that higher compliance costs will result in increased direct emissions reductions. CCEEB disagrees with this premise. Rather, CCEEB believes that the post-2020 program needs to be designed to *increase* cost effectiveness, both as a means to maximize GHG emissions reductions (i.e., “biggest bang for the buck”) and as a way to prevent emissions and economic leakage in the post-2020 program as the declining cap drives up the cost of carbon.

Nancy McFadden, executive secretary for the governor, stated on August 4, 2016, “*Let this be clear: We are going to extend our climate goals and **Cap-and-Trade program** – one way or another. The governor will continue working with the Legislature to get this done this year, next year, or on the ballot in 2018.*” This statement stands, and while SB 32 sets a new 2030 climate goal, there is still need to explicitly adopt Cap-and-Trade. Legislation will likely be introduced in the 2017-18 Legislative Session that will explicitly address this; it is prudent to hold off on speculating legislative intent until there is legislation dictating how Cap-and-Trade should be designed post-2020.

### **The Visible Hand - Release of Additional Market Data, Retirement of Unused Allowances, and Reduction of Offsets**

CCEEB opposes the release of market sensitive information on holding and compliance accounts. The release of this information may make entities vulnerable to market manipulation and serves no purpose that cannot be met by compliance reporting already available to ARB. This data includes:

- Quarterly CITSS Registrant Reports
- Quarterly Auction Summary Results Reports
- Annual Compliance Reports
- Annual summary of transfer reports
- Quarterly Compliance Instrument Reports
- Other data related to Cap-and-trade including GHG emissions reporting and California Climate Investment fund proceeds and investments

CCEEB is willing to discuss what additional aggregated data could be included, but rejects the informal proposal presented at the workshop, as we believe that it would substantially damage the market.

The retirement of unused allowances further constricts the market. While this proposal might be in reaction to the limited participation in recent auctions, CCEEB flatly rejects the proposal as it would have substantial unintended consequences. As previously stated, litigation and lack of

post-2020 certainty are impacting participation in recent auctions. However, these issues will likely be addressed in the near future. Restrictive amendments made in response to these problems may hurt California's leadership position and the economic efficiency of the program over the long term.

Additionally, the proposal to reduce the offset limit to 4% will hurt California's leadership position, disregards the importance of carbon sinks, and constrains the reach of Cap-and-Trade to a very few facilities and fuels. Offsets extend the influence of Cap-and-Trade to sectors and jurisdictions not covered by California's climate policy. If the ultimate goal is to mitigate and reduce greenhouse gases, this policy change will reduce California's impact, yet increases costs to Californians.

### **Need for Open Data and Reproducible Study Results**

CCEEB is concerned by the difficulty in analyzing the economic impacts of the proposed amendments due to the lack of information on trade exposure status, holding limits, and other cost containment policies (besides the Allowance Price Containment Reserve). ARB is being guided by leakage studies conducted by Resources for the Future and the University of California, Berkeley. However, the raw data and assumptions used for these highly caveated reports are not available. Furthermore, authors of both studies have cautioned against an over reliance on results. We fear that ARB has taken the conclusions from these studies as facts and are proceeding forward without due caution. Examples of the researchers concerns on use of the data:

In the UC Berkeley Paper, Meredith Fowlie explained that the results do not “estimate leakage potential for any particular industry with any degree of precision.” (Fowlie, et al, p. 41) The authors go on to state, “However, the general patterns that emerge are insightful.” (ibid, p. 42) These general patterns include conclusions such as the greater the level of competition, the higher the demand elasticity and greater the potential for economic and emission leakage. This intuitive result does not appropriately provide a foundation for a leakage analysis that can provide results “with any degree of precision.”

Further, authors explained that it is difficult to accurately identify the point of origin of U.S. trade exports. “This makes it difficult to separately identify California trade flows.” (ibid, p. 16) Authors go on to explain how they use a proxy for purposes of this exercise.

These are but two examples of the difficulty of accurately evaluating the impact of California-only policy on Energy-Intensive Trade-Exposed industries. Given this uncertainty, policy makers must remain focused on the primary goal, reduced GHG emissions.

We ask ARB to work with stakeholders and make the missing information publicly available so that others can reproduce results from the leakage studies. Peer review is essential. This is important since the proposed amendments seek to substantially reduce industry assistance to all sectors, in many cases by half or more compared to today. Public engagement has been further stymied by a lack of detail about post-2020 program design, which limits stakeholders' ability to assess potential economic and operational impacts between 2020 and 2030. Regulated entities

need access to this information in order to verify findings and determine how proposed program changes will affect California's businesses and economy.

CCEEB is also concerned by the method by which ARB is calculating the 2030 "cap" for the Cap-and-Trade Program. Staff assumes that 77 percent of statewide emissions will be under the cap by 2020. When applied to 2030, this would set the cap at 200.5 MMT per year, which we believe could be overly stringent. The mix of covered entities and amount of associated emissions will change over time. ARB should apply a more robust analysis to the 2030 cap, rather than simply accepting assumptions made during the 2010 rulemaking.

Based on the limited information we currently have available, CCEEB makes the following observations:

- ARB appears to be focused on only preventing emissions leakage, to the exclusion of other program goals, including prevention of economic leakage.<sup>[1]</sup> Although it might be expected that California facilities are so efficient that emissions leakage and economic leakage are the same, this is not always the case. As applied to manufacturing, which must operate at a relatively efficient capacity, economic leakage could result in reduced investment and manufacturing loss. For example, in both cases below, the manufacturer loses market share to out-of-state competitors even as emissions remain the same or even potentially increase if production is replaced by less efficient sources, i.e., economic leakage occurs without emissions leakage:
  - Demand destruction: If California's demand for products decreases, then the amount of emissions associated with California's carbon footprint also decreases. California would consider emissions leakage for products for which there is California demand. If demand drops, however, and industry increases exports but faces out-of-state competition, this results in economic leakage. For example, if demand goes from 100 units to 90, in-state supplied 50 but now 30 and out-of-state supplied 50 but now 40, ARB would only address 10 units, not the full 20.
  - Increases made by out-of-state producers that have the same emissions as in-state producers may not be considered emissions leakage, but it is economic leakage.
- Emissions Leakage may not be one for one. If emissions leakage occurs because production shifts to a less efficient out-of-state facility, with products transported to California to meet in-state demand, then emissions leakage is greater than 1:1. If actual emissions leakage is not 1:1, then ARB is under estimating the potential for leakage by basing their assumptions on a 1:1 exchange.

***CCEEB proposes the following Cap-and-Trade Program Amendments:***

**1.) Remove Unnecessary Constraints on the Market that Increase Cost**

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<sup>[1]</sup> Page 3, Section 38501 (h) It is the intent of the Legislature that the State Air Resources Board design emissions reduction measures to meet the statewide emissions limits for greenhouse gases established pursuant to this division in a manner that minimizes costs and maximizes benefits for California's economy, improves and modernizes California's energy infrastructure and maintains electric system reliability, maximizes additional environmental and economic co-benefits for California, and complements the state's efforts to improve air quality.

Portions of the proposed amendments and existing program unnecessarily constrain the market. The advantage of a Cap-and-Trade program is to allow market pressures to create solutions that best fit business models and consumer behaviors. Due to the current market size, some limitations are necessary. However, care must be taken to ensure market liquidity. Of concern are the following:

- The holding limit is too low. As written, the Cap-and-Trade programs holding limits create an uneven playing field that wrongly favors bankers and traders, that do not have a compliance obligation to plan for, over large regulated entities that are constrained in the quantity of their holdings due the size of their compliance obligation relative to a holding limit. Compliance entities must be able to hold and trade a larger portion of their allowances to adequately manage their risk and plan for compliance throughout the Cap-and-Trade program, including any post-2020 Program.

CCEEB recommends that the program allow compliance entities to hold sufficient allowances to cover their obligation for the entire compliance period based on a rolling three-year emissions obligation and enable a much more liquid market where an entity could adequately hedge its forward risk without major complications.

- CCEEB has concerns with an annual surrender as it doesn't allow facilities to freely adjust their holdings over the compliance period, removing the benefit of a 3-year compliance period. While there may be legitimate concerns about default risk, the ARB should not penalize entities that are not true risks. To address this, ARB should establish a financial assurance test that would exempt non-risk compliance entities from an annual surrender. We note that all compliance entities have an interest in preventing others from defaulting, and that any financial assurance test would need to be rigorous to avoid risk from defaults.
- Business fluctuations at the end of a compliance period should be anticipated. These fluctuations could adversely impact the smooth operation of the market. To minimize market impacts, CCEEB recommends that ARB allow vintage allowances (i.e. borrowing from current year) to be used during the true-up period. This will provide a mechanism for the end of compliance true-up and will increase market confidence.

## **2.) Establish a Program to Monitor California's Economic Health and Market**

The Cap-and-Trade regulation impacts a significant portion of California's businesses and consumers. It is imperative that the State monitor leading indicators that reflect the economic health of California. The ARB must be positioned to identify any potential problems that may be inadvertently caused by this regulation, and in time so that any regulatory structural problems can be corrected before they cause significant damage to the economy. CCEEB recommends that the ARB include provisions in the Cap-and-Trade regulation to:

- Monitor specific economic indicators, including Cap-and-Trade market elements, such as, the price in the quarterly auctions, the functioning of secondary markets, adequacy of the Allowance Price Containment Reserve, detection of market manipulation, offset supply, evidence of contract shuffling, progress towards achieving the 2020 target, total cost of the program, jobs in manufacturing, vacancy rates, home sales, volume of trade

through ports, GSP, energy prices, and other indicators used by the Department of Finance to monitor the health of California's economy;

- Establish formal reviews of the regulation, based on market monitoring, at least once each compliance period; and
- Develop and implement a more structured process and approach for evaluating the comparative cost-effectiveness of program measures, as well as the relative cost-effectiveness of those measures vis-à-vis the Cap-and-Trade program, and identify any potential problems.

CCEEB has long recommended the inclusion of transparent economic indicators to evaluate program success. In a letter to the ARB on May 17, 2007, regarding *Proposed Early Actions to Mitigate Climate Change in California*, CCEEB stated, "that it is important to view the market mechanisms as a continuum that continually examines the economic impact of the program and allows for realistic turnover of capital investments." CCEEB suggested that, "the [ARB] consider recommending additional details surrounding the implementation of the Cap-and-Trade program in its report so that any market system failure can be properly mitigated with as minimal impact to the California economy as possible. This detail should include identification of the criteria and data that will be needed to determine that there is a working market and the information that needs to be tracked to identify market system failures before they cause significant harm."

Market monitoring is essential to help ensure reasonable market behavior and results, and to instill confidence among market participants and other stakeholders. For example, the Federal Energy Regulatory Commission requires that all organized electricity markets (including the CAISO) have independent market monitors. Independence helps ensure monitoring is done objectively and is aligned with the best interest of the auction. CCEEB recommends that an Independent Market Monitor be established with authority to: (1) review bids prior to the running of any auction; (2) provide analysis of the competitiveness of any auction, preferably on an ex-ante basis (e.g. prior to running the auction); and, (3) report findings and concerns to the ARB and the California Senate Energy, Utilities and Communications Committee.

### **3.) Establish a Process to Refill the Allowance Reserve**

In addition to the primary cost containment mechanism of using offsets, CCEEB supports an allowance reserve as an insurance policy against events, such as unexpected market dynamics or difficulties obtaining ARB-approved offsets. An Allowance Reserve provides market certainty and helps contain costs. We understand that it is the ARB's intent to fix any problems through the regulatory process, or initiate the emergency provision of the Health and Safety Code, Section 38599, if the reserve is depleted. We believe that the regulatory process may be too time consuming to respond, and that relying on the emergency trigger creates undue disruptions and is unwarranted. Instead, CCEEB recommends that the ARB preplan for contingencies and adopt a process to backfill the reserve before it is completely depleted. The refill mechanism should trigger once the reserve is 50% depleted to bring more supply into the market, recognizing that use of the reserve indicates scarcity and potential liquidity problems. To preserve environmental integrity, we note that the Legislature and the ARB could utilize a portion of the revenue from the sale of "refilled" allowances to purchase and retire an equivalent quantity of high-quality GHG instruments (such as offsets) from another program.

#### **4.) Adopt Offset Protocols as Quickly as Possible and Avoid Unnecessary Limitations**

CCEEB supports the idea of unlimited, high-quality offsets to contain costs. Essentially all the studies on the economics of Cap-and-Trade show that offsets are critical to minimize costs. In some models (most notably those by USEPA, Congressional Research Service, and CRA International), Cap-and-Trade cost reductions range from 40% to 80%, depending on the model and the any restrictions on the use of offsets. Limiting offsets increases costs to California businesses, which leads to leakage of both jobs and emissions out of state. Within California and the nation, economic modeling has demonstrated that offsets provide near-term opportunities for cost-effective, verifiable GHG reductions that deliver long-term, sustained emissions reductions. Offset credits should be allowed without any geographical or quantitative restrictions. Unfortunately, ARB staff's informal proposal is to further limit offsets; this would be counter-productive, costly, and parochial at a time when California is striving to provide international climate leadership.

Previous adverse local impact arguments for offset limitations have been challenged by the ARB Co-Pollutant Emission Assessment, which found *de minimis* co-pollutant co-benefits from quantitative restrictions on offsets. Quantitative restrictions on offsets do not provide meaningful co-benefits. As such there, is little reason to limit the use of offsets as a compliance instrument. Abundant offsets will ultimately provide environmental benefits, demonstrate state leadership, spur deployment of advanced technologies, while effectively contain costs. yet this regulation unreasonably restricts their use.

Developing economies are using more energy to fuel their economic growth, thereby increasing global GHG emissions, and rejecting binding caps on emissions. Constraints on offsets, in the belief that local co-benefits can be realized, inhibits the adoption of GHG policies in other nations. For example, deforestation causes 15% of our global GHG emissions- representing a higher global percentage than transportation. Offsets present a huge shovel-ready solution, implementable today at scale, with a high impact on a dollar-per-dollar basis, meaning the dollars go further towards averting climate change than many complementary measures adopted pursuant AB 32. Imposing limits on the use of offsets, on the other hand, simply raises the cost of the emission reduction program, and comes at the risk of undermining political support for without providing real environmental benefits.

Instead, the ARB should move rapidly to (1) *raise* the offset limitation above 8%, (2) adopt additional offset protocols for projects viable in California, (3) recognize national and international offset programs, and (4) remove restriction on carrying over unused portions of an entity's offset limit into subsequent compliance periods. This will ensure that local benefits are captured while still leading the developing world towards a low-carbon future. Additional supply options should include:

- Use of additional Climate Action Reserve Protocols;
- Use of offsets from Western Climate Initiative Partners;
- Support the development of REDD+ Projects;
- Approve protocols developed by California air districts, as appropriate.
- Allow unused offset allocations to be carried over



## **5.) Expedite Linking with Other GHG Cap-and-Trade Programs**

California businesses continue to need access to a pool of verifiable offsets and allowances. The EU carbon markets produce robust offsets and allowances. Linking to the EU would ensure a supply of high-quality and tradable market instruments for California's carbon market.

If and when, a Clean Power Plan (CPP) mass-based trading program emerges, California's program should be positioned to link with it. This provides more opportunities to reduce emissions as well as larger markets for California's clean energy technologies and products.

Relying on a limited market Cap-and-Trade program to reduce emissions in California without linkage to a broad, liquid market diminishes the economic efficiency of Cap-and-Trade and undermines the policy goals.

CCEEB recommends expediting linkage and making it a priority. If linkage to sizable multi-jurisdictional markets and economies that equal or exceed California's is not possible, then CCEEB believes that other cost-containment measures must be adopted to soften the economic impact of this regulation and limit leakage of jobs and emissions.

### **Natural Gas Suppliers**

In recognition of the challenges facing natural gas suppliers to source alternative supplies of natural gas, current regulations provide a gradually decreasing cap adjustment factor and a gradually increasing minimum consignment percentage to avoid sudden and significant ratepayer impacts. ARB's proposal to nearly double the annual rate of decline from the current cap adjustment factors, and increase the consignment percentage to 100% in 2021, will result in significant costs to Californians and reduce the amount of consignment revenue available for cost mitigation. Accelerated cap adjustment factors and consignment percentages will have a severe impact on Californians. CCEEB requests that ARB not increase the consignment factor to 100% in 2021 and maintain the current plan is 5% per year reaching 100% in 2030.

### **Municipal Solid Waste**

Municipal solid waste (MSW) combustion facilities (waste-to-energy) are currently included in the Cap-and-Trade program by virtue of the fossil-derived waste components of the incoming waste stream. The three-impacted waste-to-energy facilities, all serving state municipalities, receive post-recycled waste that can either be managed at these facilities or at a local landfill. Directing post-recycled MSW to a landfill instead of a waste-to-energy facility results in a greater amount of greenhouse gas emissions due to release of fugitive landfill methane emissions. In fact, if an avoided methane component is added to lifecycle calculations of overall emissions of the waste-to-energy facilities—using a methodology approved and reviewed by ARB staff—then the GHG CO<sub>2</sub>e emissions would actually be negative.

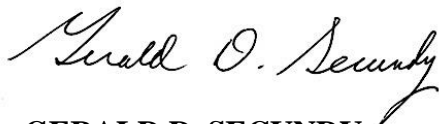
The waste-to-energy facilities have no ability to control the incoming MSW, so there could be no opportunity to reduce fossil-based CO<sub>2</sub> emissions, leaving the purchase of allowances, or CARB compliance obligations, as the only option. These facilities cannot pass allowance costs through to their customers since the customers would instead choose the cheaper option of landfilling, resulting in a greater amount of greenhouse gas emissions, as described previously, an "internal to California leakage."

CCEEB believes that these waste-to-energy facilities should receive a full exclusion from compliance obligations rather than the partial exclusion outlined in Health and Safety Code Section 95852.2 (d). This is consistent with other widely recognized international Cap-and-Trade frameworks, proposed Federal climate legislation, and the regional program RGGI, and should be an important consideration for future linkage. Existing State law, H&S Code Section 41516, recognizes the important nature of these facilities, and “that such projects should therefore be encouraged as a matter of State policy.” A huge financial burden placed on local governments to purchase allowances, with a strong potential to increase greenhouse gases if these facilities were forced to close, is not consistent with State policy. Considering SB 1383, these facilities should receive their exclusion until 2020 when the SLCP strategies are implemented.

### **Conclusion**

CCEEB thanks the ARB for considering our comments on the proposed amendments to the Cap-and-Trade regulation. CCEEB represents a broad cross-section of the covered entities in California. As such, CCEEB is able to represent diverse industry sectors and offer our assistance to the ARB in developing these ideas further. CCEEB looks forward to playing an integral role in the future development and operability of California’s Cap-and-Trade Program. Should you wish to discuss our comments in more detail, please contact me or Jackson R. Gualco, Kendra Daijogo or Mikhael Skvarla, CCEEB’s governmental relations representatives at The Gualco Group, Inc. at (916) 441-1392.

Sincerely,



**GERALD D. SECUNDY**  
President

cc: Honorable Chair & Members of the Air Resources Board  
Mr. Richard Corey, the Air Resources Board  
Mr. William J. Quinn, CCEEB  
Ms. Janet Whittick, CCEEB  
The Gualco Group, Inc.