



August 2, 2013

Steven Cliff, PhD
Chief, Climate Change Market Branch
California Air Resources Board
1001 I Street
Sacramento, CA, 95812

Re: NRDC's Comments on the July 18 Workshop on Proposed Amendments to the Cap-and-Trade Program

Dear Dr. Cliff,

We appreciate the opportunity to comment on staff's proposed amendments to the cap-and-trade program presented at the July 18 workshop. The workshop and accompanying discussion draft propose significant changes to several features of the program. We focus our initial comments on a subset of those issues, summarized below. We will provide additional analysis and comment on a broader set of issues as the rulemaking unfolds.

Introduction

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 develop and market effective climate solutions for other jurisdictions to emulate. ARB deserves tremendous credit for its efforts to date in balancing the numerous and diverse set of policy objectives outlined in AB 32 that factor into the design of the cap-and-trade program, including rewarding early action, minimizing leakage, maximizing co-benefits, and promoting equity. We ask that ARB approach future modifications to the program with the same set of holistic considerations in mind.

Summary:

- **Industrial assistance factors:** We strongly 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 achieving greenhouse gas reductions (and therefore the costs of achieving the goals of the program), and raises the specter of windfalls for entities that can pass through

compliance costs – concerns that ARB has previously cautioned against,¹ yet are wholly absent in staff’s current proposal and accompanying rationale.

- Natural gas allowance allocation: We support staff’s overall framework for distributing emissions allowances from the natural gas sector (see also accompanying Joint Statement of Principles). Providing an allocation to natural gas distribution utilities *on behalf of their customers* 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.
- 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. While it is important to address this contingency *ex ante*, we consider the likelihood that allowance prices will reach (and exceed) the highest price tier of the Reserve extremely remote. Per the Board’s direction in Resolution 12-51, we therefore appreciate that ARB’s policy response is narrowly tailored to address this contingency while maintaining the environmental integrity of the program.

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 notice and summary accompanying the discussion draft note only that the proposal is designed “to provide additional certainty and time to industry to successfully transition to lower-carbon production methods.”² 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

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

² ARB, “Notice of Public Availability of Cap-and-Trade Discussion Draft and Workshop,” p. 12, available at: <http://www.arb.ca.gov/cc/capandtrade/meetings/071813/ctnotice0713.pdf>

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. ARB must avoid acquiescing to a self-fulfilling prophecy on industry's need for transition time and assistance to prepare for carbon pricing. As long as delay and obstruction earns reward, ARB is dampening industry's incentive to plan and invest in the very carbon reduction strategies that will facilitate a successful transition into the program and enable California to make good on its long-term climate goals.

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 it is conducting for industrial sectors regulated under the cap is not yet complete. 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 is vital for California to prevent 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). Windfalls accruing to the European electric facilities have been studied most closely. Researchers emphasize that windfalls occurred because facilities were awarded free allowances and yet still passed opportunity costs through to consumers.”³

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).⁴ 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.⁵

³ ARB, “Appendix J – Allowance Allocation,” at J-8, *supra* note 1.

⁴ *Id.* at J-9.

⁵ *Id.*

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 precisely 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 underscored the design recommendations of the expert panel of economists ARB convened to advise on allowance allocation,⁶ ARB should not consider 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.⁷ In the interim, ARB should err on the side of keeping allowance value dedicated for the purposes the Legislature has 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 proposed framework for allocating allowances from the natural gas sector. 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 available to cushion bill impacts, prevent adverse impacts on low-income customers, and help foster engagement and support for the cap-and-trade program and AB 32 broadly by providing a direct benefit to millions of customers.

As outlined in our comments in response to the June 3 workshop on Natural Gas Allowance Allocation,⁸ however, the manner in which allowance value is provided to customers 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

⁶ 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.

⁷ We do not find persuasive arguments that suggest making adjustments to assistance factors mid-program cycle would severely undermine the regulatory certainty industry requires to plan and invest accordingly. If anything, the regulatory course of action that would provide the greatest certainty would be to leave the assistance factors unchanged.

⁸ "Comments of the Natural Resources Defense Council and Environmental Defense Fund on the June 3, 2013 Cap-and-Trade Program Natural Gas Suppliers Workshop," available at: <http://www.arb.ca.gov/lists/com-attach/6-june-3-ng-ws-AmwFcQNmV2cFXANc.pdf>.

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.⁹

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. § 95893(d)(3). 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-effective means of reducing emissions, undermining California’s ability to meet its long-term climate and clean energy goals.

b. 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. Currently, ARB proposes that utilities consign at least 25 percent of their allowances starting in 2015, ramping up 5% each year out to 2020. Table 9-4, “Percentage Consignment Requirements for Natural Gas Utilities by Year”. 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	25 <u>50</u>	30 <u>60</u>	35 <u>70</u>	40 <u>80</u>	45 <u>90</u>	50 <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 preserve incentives for investment decisions and reduction opportunities between and among sectors regulated under the cap.

⁹ 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.

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 has noted, the current programs 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), 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, including the prospect that allowance prices exceed the highest tier of the Reserve. Additional clarity on the front end will provide greater certainty to market participants on what to expect and plan for, while diminishing the potential and incentive for would-be manipulators to attempt to drive allowance prices up purely for financial gain. We appreciate that ARB's current proposal does not provide a fixed upper bound on allowance prices. We are not opposed to ARB exploring additional means of 'protecting' the highest price tier of the Reserve, so long as it remains steadfast in its commitment to safeguarding the environmental integrity of the program. ARB must also ensure that any such mechanism remain focused on providing the benefits associated with emission reductions and investments in California.

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 working closely with ARB in the months to come.

Sincerely,



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