July 13, 2010

Mr. Kevin Kennedy
Office of Climate Change
California Air Resources Board
1001 "I" Street
Sacramento, CA 95812

RE: Cost containment in California's cap-and-trade program

Dear Mr. Kennedy,

We would like to express our appreciation for CARB's continued commitment to developing California's cap-and-trade program in an open and transparent manner and for providing this opportunity for public comment. We write to reaffirm our commitment to designing a program that furthers the goals of AB 32 and achieves our emission reduction goals efficiently and equitably. To achieve that end, we propose that CARB employ cost containment mechanisms that use both a price floor and a soft price ceiling, consisting of the following elements:

a. An auction reserve price of $10/ton;
b. A quantitative offset limit that fluctuates according to the allowance price; and
c. An allowance reserve.

We also urge CARB to prohibit borrowing.

I. Cost containment mechanisms should complement the goals of AB 32.

We commend CARB for recognizing that cost containment mechanisms must not compromise the environmental integrity of the cap-and-trade program. We encourage CARB to go one step further, however, and only employ cost containment mechanisms that fit within our long-term blueprint for a low-carbon economy laid out in AB 32. Specifically, mechanisms must ensure a stable, long-term price signal to promote sustained investment in development and deployment of clean technology and infrastructure to enable California to meet both its 2020 and 2050 emission reduction targets.

We also ask that CARB keep in mind that while this particular workshop is entitled "cost containment," the reality is that cost containment concerns have heavily influenced other program design decisions. Most notably, the decision to include a cap-and-trade program as part of the AB 32 suite of policies is itself a cost-containment mechanism allowing capped entities to find the most cost-effective emission reductions available. Design decisions within the cap-and-trade program – including banking, three year compliance periods, administrative allocation of allowances, and offsets – are also designed to contain costs. We submit our cost containment proposal with these principles in mind.

II. CARB should use both a price floor and a soft price ceiling.

We support CARB's preference for a soft price collar rather than a hard price collar, and concur with CARB's assessment that soft collar mechanisms provide an opportunity to control costs without jeopardizing either the integrity of the cap or the importance of a steady price signal. We recommend CARB employ both a soft price floor through a reserve auction price and a soft price ceiling through a flexible offset limit, backstopped by an allowance reserve.

a. CARB should set a reserve price at $10/ton.

We strongly support CARB's proposal to set a minimum auction price below which allowances would not be sold at auction. As set out above, a key feature of designing a cap-and-trade program is setting a stable, long-term price signal to incentivize investment and innovation in low-carbon technologies. Integral to that equation is ensuring that the price signal is high enough to ensure early, sustained, and aggressive investment, which will also reduce price spikes in years with higher allowance demand by ensuring continued progress in years with lower demand. A moderately set price floor will provide that assurance without needlessly distorting the market. We believe $10/ton, adjusted annually for inflation, strikes that balance appropriately.

b. CARB should set the quantitative use limit for offsets according to allowance price.

We support CARB's recognition of offset supply as a cost containment mechanism. With appropriate safeguards in place to ensure that offsets are providing real emission reductions (see separate letter on offsets supply), offsets provide a price mitigation tool that avoids compromising other program design elements. However, we are very concerned at CARB's proposal to allow in more offsets at high prices without a concomitant reduction in the offsets limits at low prices. Because offsets have the potential to reduce direct reductions in California, limiting co-benefit opportunities and allowing covered entities to delay making the investments necessary to achieve long-term reductions, it is important to limit their use to ensure sufficient investments in reductions in California's capped entities.

i. The Offsets limit should follow a smooth curve with the following points:

We encourage CARB to allow the quantitative offset limit to fluctuate with allowance prices in a smooth curve along the following trajectory:

- At $10/ton (the price floor), no offsets are allowed;
- At $X/ton, offsets may be used to satisfy 4% of a covered entity's compliance obligations (i.e., 49% of cumulative emission reductions); and
- At $Y/ton (the soft price ceiling), offsets may be used to satisfy 8% of a covered entity's compliance obligation (i.e., 100% of cumulative emission reductions).

Some stakeholders have expressed concern that not allowing offsets at very low prices will not provide offset project developers with the certainty they need to ensure sufficient offsets are available. We find this concern misguided. CARB's sole focus should be on designing mechanisms that achieve the goals of the program, not guaranteeing market access to offset project developers. Offsets have value to the program as a cost containment device, but are not by themselves in need of special protection. The benefit of a market-based mechanism to private entities such as offset developers is that there is

potentially a profit to be made, but that potential necessarily comes with some market risk. Moreover, in the event not enough offsets are available to meet demand (albeit unlikely given CARB's recent supply forecast)[1], other mechanisms can step in to control costs, as described below.

ii. CARB should construct a marginal abatement cost curve in order to determine appropriate trigger prices.

In order to set the allowance prices at which additional cost containment measures would be necessary to control costs (X and Y in the offset limit trajectory described above), CARB should construct a marginal abatement cost curve of emissions reductions available in California.

- The X in the trajectory above should be set at the place on the curve where the total negative-cost emissions equal 110% of the positive cost emissions. This means that, if we are capturing all low-cost options, the net cost of the program is still negative. It is important to capture low-cost reductions within the capped sectors before allowing excessive offsets.

- The Y in the trajectory above should be set at the place on the curve where the total negative-cost emissions equal 90% of the positive cost emissions. This means that, if we are capturing all low-cost options, the net cost of the program is now positive. All credible economic models have indicated that the net cost of the program is likely to be close to 0, so it is unlikely that the auction price will reach Y.

c. CARB should create an allowance reserve to complement offsets.

We propose that CARB create an allowance reserve to complement the supply of offsets as a secondary soft price collar mechanism. By tying the releases of allowances from the reserve to the same price triggers as the offsets limit, the reserve can alleviate some concerns that the amount of offsets available will be insufficient to mitigate prices adequately. The combination of offsets and reserve allowances will ensure price mitigation at the triggers described above. We urge CARB to be cautious, however, in how it constructs an allowance reserve. The reserve should only be filled and accessed in a manner that complements the overarching objectives of the program.

i. CARB should fill the reserve with unsold allowances.

Many of the proposals on how to fill an allowance reserve present significant problems. Filling the reserve with allowances borrowed from future compliance periods, for example, may create more of a hazard than a safety net, as it is simply a form of borrowing that could delay investments and lead to a dangerously precipitous decline in the cap in later years. Similarly, filling the reserve from allowances outside of the cap would in effect create a safety valve, as any allowances used from the reserve would violate the cap, in conflict with one of CARB's stated cost containment principles. Accordingly, we encourage CARB to construct the reserve conservatively and fill it only with unsold allowances if an auction resolves at the floor price. This approach will provide an additional layer of cost protection without potentially undermining other fundamental aspects of the program. In the early years of the program, if all allowances are purchased, this would likely indicate that entities are banking allowances for future use, which mitigates the need for an allowance reserve. Conversely, if the program is over-allocated initially and allowances go unsold, CARB can 'bank' the allowances in a reserve and make them available for future use should offsets fail to contain prices.

[1] CARB, Update on Offsets and Linkage in a California Cap-and-Trade Program, slide 29 (June 22, 2010).

ii. CARB should make reserve allowances available at auction when allowance prices exceed the first trigger price ($X/ton) described above.

If the auction price reaches $X/ton, as described above, we propose that CARB release reserve allowances into the auction to drive down the price. For example, if an auction was set to clear above the trigger price ($X/ton) because there were only allowances available to satisfy bids above that price, CARB should release allowances from the reserve until it can satisfy bids at $X/ton, thus dropping the clearing price to $X/ton. If the reserve is completely depleted and prices continue to rise, more offsets would be allowed according to the trajectory described above to continue mitigating prices.

Using an auction approach ensures equal access to reserve allowances for all covered entities and eliminates the opportunities for gaming and manipulation that fixed-price mechanisms present. For instance, we caution against using a 'window price' or discount window approach as employed in the Kerry-Liebermann bill. The focus of cost containment mechanisms should remain on safeguarding against the *possibility* of unacceptably high allowance prices. Window price mechanisms, on the other hand, allow purchases at fixed prices regardless of the prevailing market price. Unless the window price is set at the price ceiling, this provides opportunities for rent seeking, which to prevent requires added layers of complexity (e.g., banking and transfer restrictions) and which may yet prove ineffective.

III. CARB should NOT allow borrowing.

We strongly urge CARB to prohibit entities from borrowing allowances from future compliance periods to meet present compliance obligations. Other approaches, like the framework described above, can provide the same cost mitigation benefit of borrowing without incurring the risks that borrowing present. As several stakeholders pointed out at the June 22 workshop, borrowing is problematic for a number of reasons – it encourages entities to put off making the investments needed for long-term reduction solutions, which will discourage the market for low-carbon technologies; it risks swapping lower costs now for even higher costs later as fewer allowances are available in future periods, leading to potential political pressure to change or abandon the program; and it leads to cascading shortages if entities continuously borrow, which could ultimately lead to significant non-compliance and put CARB in a difficult enforcement scenario. In short, borrowing puts the environmental integrity of the program in jeopardy, in conflict with one of CARB's fundamental cost containment objectives. We therefore ask that CARB eliminate borrowing from contention as a cost containment mechanism.

Thank you again for providing this opportunity for comment and for considering our views and proposals.

Sincerely,

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Natural Resources Defense Council

Erin Rogers
Union of Concerned Scientists

Bill Magavern
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