July 13, 2010

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California Air Resources Board
1001 "I" Street
Sacramento, CA 95812
Submitted electronically

Re: Comments on AB32 Cap-and-trade Provisions to Manage Allowance Prices

Thank you for providing the opportunity to comment on allowance price management mechanisms for the cap-and-trade program that Environmental Defense Fund considers to be a cornerstone strategy for cost effectively meeting the requirements of the Global Warming Solutions Act of 2006 (Assembly Bill 32).

While appreciating the need to efficiently and equitably steer California's economy toward a clean and sustainable horizon, we recognize that a credible long-term price signal on greenhouse gas emissions will serve as the guiding compass. The cap and trade program is itself a cost containment strategy for AB 32, so Environmental Defense Fund urges CARB to continue to trust in the ingenuity and efficiency gains to be delivered by California's entrepreneurs, rather than to shackle the marketplace in the name of "protection". While containing allowance prices may be attractive for entities with a compliance obligation, low prices have an unwanted effect of dampening the innovative spirit that, ultimately, may be key to minimizing abatement costs.

Prior EDF Comments on Cost Containment

Strategies posed by CARB deserve highlighting because they will tend to moderate allowance price volatility and reduce the market equilibrium price (i.e., auction clearing price):

Plan to incorporate transportation fuels, natural gas use, and high global warming potential gases (HGWPs) to create a broad and deep market
Allow for floating, three-year compliance periods
Allow banked allowances to be used across compliance periods
Limit offsets by quality, and facilitate adequate offsets supply by crediting projects from outside California that meet rigorous quality standards established by CARB, and by accepting high quality credits from other programs, including international sector-based credits
Rule out "hard" price collars and valves in favor of a "firm" price ceiling backed up by a reserve of allowances – holding account - taken from under the cap.

The above design features will contain allowance prices and control volatility by expanding the program, with commensurate benefits of more stable, lower prices, a larger pool of potential reductions, and less potential for influential non-competitive behavior.

There are several additional reasons to expect that the probability of "unacceptably high" allowance prices will be very low. CARB staff have indicated that the cap in the early years of the program will likely be set at or above anticipated emissions, which means that allowances will not be scarce. Reductions achieved through complementary measures, such as vehicle, building, appliance and industrial process efficiencies and reduced

VMTs, will also help reduce allowance prices — even as many of them save consumers and society much more than they cost to implement.[1] Furthermore, while costs associated with investments in emission abatement will be felt by regulated entities, so too will the savings from efficiency gains. These gains will deliver real benefit to producers and consumers alike as avoided utility bills and reduced costs of inputs to production. These opportunities are in addition to the value of the avoided health impacts from reduced co-pollutant emissions, the worst effects of global warming, and the benefits of inspiring innovators to lead California into a clean energy future. This bodes well for the cap and trade program with low and stable allowance prices, and for an even more robust and productive California economy.

It is important that cap and trade provisions provide flexibility for regulated entities in terms of how to manage allowances (e.g., banking, borrowing), to acquire more allowances (trading, purchase of offsets or allowances from a holding account), or to avoid emissions with on-site investments. To the extent that firms are allocated allowances administratively, there will need to be commensurate protections for consumers, an equity dimension that must be considered in concert with allowance price management. Administrative allocation is also a key strategy to avoid the pass through of abatement costs to consumers, and will require thoughtful requirements and careful, determined regulatory oversight to ensure.

Responses to Questions Posed by CARB

In the remainder of this letter, EDF responds directly to topics posed by CARB staff during public workshops. In particular, CARB staff have asked for feedback on:

Choice of mechanisms to avoid "unacceptably high" allowance prices
Preference for a trigger price mechanism versus a "window" sales approach
How much to expand the supply of instruments in each mechanism
Tradeoffs between each cost containment mechanism and the goals of AB 32

Environmental Defense Fund supports several program elements posed by CARB, including a "firm" price ceiling backed by an allowance reserve (rather than hard collars), a trigger price to relax quantitative limits on offsets, and a price floor as part of an overall strategy to inspire earliest possible abatement actions so as to avoid facing steeper costs in the future.

A firm price ceiling can provide greater assurance to emitters that they will not face "unacceptably high" prices, while ensuring the integrity of the emissions cap. Of the options presented by CARB, Environmental Defense Fund supports the maintenance of a reservation price (i.e., price ceiling) by releasing allowances from the reserve holding account.

Environmental Defense Fund supports carving allowances from within the cap to fill the pool with allowances (i.e., direct allocation to the holding account from the annual emissions budget). EDF supported a 1 to 2 percent annual carve out in federal legislative proposals. We support the CARB proposal to use an allowance reserve holding account to help to manage allowance prices with at least three items of caution.

First, the size of the reserve as well as the quantity of allowances that may be withdrawn from the reserve in any given year must be limited to be consistent with the overall environmental integrity and other goals of AB 32. Environmental Defense Fund supports the federal approach embodied in the Kerry-Lieberman proposal that allows each covered entity to purchase up to a fixed percentage of their allowance obligation each year. In the case of the Kerry-Lieberman proposal, that limit was 15% of an entities compliance obligation. This entity-level limit effectively imposes a similar percentage limit on the total number of allowances that may be drawn from the reserve in any given year.

The determination of the percentage limit on holding account purchase should take into account the extent of free allocation to covered entities as well as the implied total permissible emissions. In particular, EDF supports

[1] See CARB Updated Economic Impact Analysis of Climate Change Scoping Plan, Page 37, Table 13.

a percentage that (in combination with administrative allocations) gives covered entities a clear picture of the likely cost of compliance obligations, while ensuring that the overall cap must decline over time to meet the 2020 (and beyond) goal(s), even if the reserve is drawn down.

Our second note of caution is a corollary to the first. The holding account should be "stocked" with new allowances only once, at the start of each compliance period. We understand that CARB has rejected the idea of replenishing the holding account by purchasing offsets. EDF supports the approach proposed by CARB to relax quantitative offset limits at amounts equal to any additional within cap allocation to replenish the holding account. EDF agrees this interplay between the holding account and offsets limit can manage allowance price pressure without compromising the environmental integrity of the program (so long as offsets used continue to be of high quality).

Environmental Defense Fund agrees that the holding account could be replenished with unsold allowances from regular auctions.

In no event should the reserve be replenished repeatedly with newly generated allowances taken from "on top of" or above the cap. An unlimited allowance reserve, or one that can be replenished again and again with new allowances or by trading for poor quality offsets, shares the same crucial drawbacks as a price valve, notably that the environmental integrity of the program will be compromised.

In addition to holding account restocking limits, and ensuring the environmental integrity of the program, our third note of caution pertains to the conditions under which the reserve allowances become available. Conditions for making reserve allowances available should be clearly specified in advance and kept constant in order to provide transparency and predictability to market participants. One approach is to define a "price trigger" at which allowances become available, with a trajectory that is specified in advance. Over time, the price trigger should rise in real terms (i.e., at a rate of 5% to 7% per year above the rate of inflation). This price trigger can play one of several roles:

In a "reserve window" approach (such as in the Kerry-Lieberman proposal), the price trigger represents the *purchase price* that entities must pay to purchase allowances from the reserve. At that price, entities can buy up to a specified number of reserve allowances during a specified time period during each compliance period. Alternatively, the price trigger can be used as a *threshold* for releasing allowances from the reserve — i.e., if allowance prices exceed the trigger for a defined period of time, the allowance reserve would become available. As a third possibility, the price trigger could be defined as a *minimum bid* (reserve price) in a periodic auction of reserve allowances. In this case, the actual price that entities must pay for the reserve allowances will be determined at auction.

In general terms, the "threshold" approach has the advantage of being the most resistant to market manipulation and strategic gaming, with a reserve window approach also helping to reduce that risk.[2] On the other hand, the reserve window approach has the virtues of simplicity, transparency, and predictability for covered entities. Moreover, having reserve allowances available only once at the end of each compliance period will increase the likelihood that the reserve is drawn down only when needed to meet compliance obligations, rather than inviting speculative purchases based on expectations about future prices. As a result, Environmental Defense Fund recommends a reserve window approach with a pre-specified trajectory for the price trigger.

[2] For example, some analysts have cautioned that making allowances available to anyone willing to pay the reserve price, regardless of the market price, will invite manipulation and gaming: firms with short positions in the allowance market (who would benefit from a fall in price) could purchase reserve allowances at the minimum reserve price, even when the market price of allowances is below the reserve price, in order to increase supply and depress the market price further. The risk of such strategic behavior is greater when the opportunity to purchase allowances is more frequent, e.g., at quarterly auctions versus an annual "open reserve window." If a reserve window approach is used, regulators should be given authority to scrutinize purchases made from the reserve when the current market price is significantly below the price trigger.

Environmental Defense Fund also supports using the trigger price approach to relax quantitative offset limits, which provides a second lever to collar allowance prices.

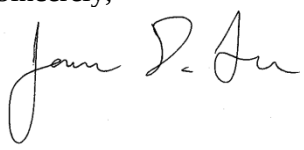
In establishing these levers and triggers, we caution policymakers to remain focused on inspiring speedy action. CARB should avoid setting an unnecessarily high emissions cap in early years that results in significant banking, or otherwise delays cost-effective investments in abatement strategies due to lack of a strong price signal. A price signal that is responsive to changes in demand, yet reliably strong over the long term, will be good for the economy, and deliver benefits for all segments of our society. Furthermore, and ultimately most important, a strong price signal will position California to achieve emissions reductions goals beyond those specified for year 2020.

When we consider the equity implications of cap and trade program design choices, the choice of price trigger has direct implications for the magnitude of funds available for a community benefits fund or for funding low-carbon research and development. So too does the size of an allowance holding account, and how revenues from sale of reserves from that account are used. Here again there is need for thoughtful calibration between administrative allocation of allowances to regulated entities with requirements for consumer benefits and protections, and firm-level limits on the use of allowance holding accounts to meet compliance obligations. Allowance reserve revenues ought to be spent for the benefit of Californians, and specifically directed to cover gaps in consumer and disadvantaged community protections that will remain after the value of free allowance allocations has be invested.

In closing, we pose a general question to CARB staff. What does the best available research, including CARB's own modeling, indicate about allowance prices and their sensitivity to various design features? For example, what does CARB's modeling indicate about possible price ceilings and trigger prices for limits to offsets? While CARB's updated economic impact analysis concurs with many other studies indicating that offsets can contain allowance prices, other features are as yet unexamined analytically. Does CARB have a plan to do this analysis, perhaps in collaboration with scholars at the Duke University Nicholas Institute? We would be relieved to know that such analysis is under way or planned. **Environmental Defense Fund stands ready to provide CARB staff assistance in doing quantitative analysis of the design and performance of an allowance reserve mechanism**.

Thank you for considering our feedback. We look forward to working with the board and staff as the cap-and-trade regulation is drafted and refined.

Sincerely,



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