December 9, 2009

Dr. Lawrence Goulder
Chair, Economic and Allocation Advisory Committee
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Comments on "Allocating Emission Allowances Under California's Cap and Trade Program: November 16 Draft

Dear Dr. Goulder and Committee Members:

Thank you for considering these comments on your draft report. The AB 32 Implementation Group represents large and small businesses, taxpayers and consumers. Your report covers issues of great importance to members of the group and the broader California economy. We have the following suggestions for inclusion in your report:

<u>Establish firm foundation of credible economic analysis to support cap-and-trade design.</u>

The absence of a valid and credible analysis of the economic impact of AB 32 is hampering the work of EAAC and is slowing down the process of creating a cap-and-trade program that will work for California. As a result, the alternative design elements, allocation strategies, and revenue distribution options are being debated in a vacuum. Policymakers do not understand the cost and benefit trade-offs of the options under consideration.

For example, the economy-wide impact of the AB 32 measures, over the early years of the program, is completely unknown. We don't know the initial costs and capital investment requirements of the AB 32 measures, nor how the measures will impact the various sectors of the economy and consumers. We need that information to understand job impacts and the potential displacement of workers. We need a valid analysis to make good decisions about the glide path for cap-and-trade, the need for offsets to reduce costs, and the appropriate use of revenues.

For these reasons, we recommend that the final EAAC report be delayed until the committee has time to review the updated economic analysis promised by the California Air Resources Board (CARB).

<u>Recommend that CARB investigate and disclose leakage risks and provide for solutions prior to adopting other design elements for the program.</u>

The success of a "cap" in a cap-and-trade program depends on keeping manufacturing and other large energy users within California to avoid leaking jobs and emissions. Since leakage would undermine the environmental and economic purpose of the program, it should be the first issue fully understood and resolved prior to making other design element decisions. The solutions to minimize leakage should lead directly to the right answers for some other design choices, and clarify where the real options remain for the balance of the program design.

Certain parts of the draft report are counter to this principle. For example, the draft report measures the allocation options against four criteria including fairness, cost-effectiveness, environmental effectiveness, and simplicity. We believe that "cost-effectiveness" and "environmental effectiveness" are the first-order criteria, and that "fairness" and "simplicity" are secondary goals that should be considered only after the first order criteria are satisfied. Raising the importance of achieving the environmental goals in a cost-effective manner will go a long way toward minimizing leakage as a high priority goal.

CARB should immediately establish the criteria for determining at-risk industries, describe how the magnitude of the risk will be measured, and propose options for minimizing the risks. More guidance from EAAC on the best tools and approaches for this work would be helpful. And while the draft provides options for CARB to mitigate or prevent leakage, such as issuing free allowances or recycling revenues back to impacted industries, there is little analysis of how a choice will impact other design elements of the program.

<u>Recommend that collection and use of revenues associated with the cap-and-trade program fully comply with existing law.</u>

The revenue raising authority for CARB under the terms of AB 32 itself is limited to the amount needed to administer the program and mitigate the specific burden created by the fee payor. In *Sinclair Paint Company v. State Board of Equalization,* 15 Cal. 4th 866, 874 (1997), the California Supreme Court ruled that there are key distinctions between taxes and fees. The ruling stated that to avoid being considered a tax, a regulatory fee cannot be used to generate revenue beyond what is needed to mitigate a problem created by the entity that pays the fee. Proposition 13 requires that new taxes and tax increases be approved by a two-thirds vote of the Legislature. This vote threshold applies to taxes, but not fees. If an exaction is used to raise revenues beyond what is required to mitigate the specific burden created by the fee payor's activities, then it is a tax, not a fee. When taxes are mislabeled as fees and approved without a two-thirds vote, they are illegal, unconstitutional taxes.

As EAAC moves forward, we urge the committee to recommend cap-and-trade allocations that strictly adhere to the criteria of *Sinclair*. As discussed in EAAC's draft report, possible recommendations to CARB on how to allocate auction revenues include: 1) compensation to disadvantaged communities, industry or others, 2) dividends to the public, 3) a reduction in the sales or income tax rates, or 4) investments and other public expenditures. All of the revenue expenditure proposals must be scrutinized. The EAAC should strongly recommend to CARB that it first address the significant legal issues related to Sinclair before it makes policy design choices while incorrectly assuming that the consequences of those design choices can be "compensated" with revenue that CARB may not be able to collect.

<u>Maximize Offsets:</u>

The preliminary draft cap-and-trade regulation, developed by CARB staff, recommends severely restricting the use of offsets to 4%. This limitation will significantly increase the cost of the cap-and-trade program. Moreover, it does not appear that CARB staff will be measuring the impact of this limitation because its economic analysis will model only offsets at zero and 4%. We strongly suggest that EAAC recommend a far more robust analysis of the impact of offsets. Prior research has shown that maximizing the use of offsets would be one of the most effective tools for reducing program costs. In addition, limiting offsets would likely retard the development of innovative greenhouse gas reduction programs that small businesses, local school districts and others in California are considering which would cost us jobs in our state.

Again, we appreciate all the dedication EAAC has demonstrated in crafting its recommendations to CARB. We hope you will take our comments under advisement as you continue your efforts. We would be happy to further discuss these issues with you.

Sincerely,

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