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January 11, 2010

***Via: web submission***

California Air Resources Board
1001 I Street
Sacramento, California

Re: Comments on Preliminary Draft Regulation for a California Cap and Trade Program

Dear CARB Staff:

Thank you for the opportunity to comment on the Preliminary Draft Regulation (PDR) for the cap and trade program.[1]

**Compliance Periods**

CARB should adopt one-year compliance periods rather than the proposed three-year compliance periods for the cap and trade program. Many of the problems in other cap and trade systems have shown themselves early on, but if CARB has an initial three-year compliance period, it will be hard to analyze the effectiveness of the program until after information about compliance is available sometime in 2015. The transparency of the system may also be compromised because the participants will have incomplete information about compliance by other actors. The three-year compliance period also discourages early actions because it allows implicit borrowing of credits during the period. A three-year compliance period is contrary to the intent of AB 32 which requires declining annual aggregate reductions from the capped sources. (*See* Health and Safety Code § 38562(c).)

Although three-year compliance periods may provide added flexibility for industry, they are not necessary. By definition the cap and trade system provides compliance flexibility and other flexibility mechanisms such as banking and the multi-sector nature of the capped entities are already built into the system. However, the three-year compliance periods will only provide three opportunities for CARB enforcement in a nine-year program. From an enforcement perspective this is problematic, because any issues regarding compliance will most likely not be addressed until halfway through the program. Moreover, reductions that result will occur later in the program.

Adopting a one-year compliance period will promote better transparency in the system and may give a better indication of demand. It will surface problems with the system at an earlier time and better allow tweaking of the problematic components. Enforcement of a cap and trade system will be complicated and will require learning on the job. One-year compliance

[1] These comments focus on a limited number of issues, but Earthjustice may file more extensive comments on more issues in future rounds of the rule-making.

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periods will provide more opportunities for CARB enforcement. With a shorter compliance period, enforcement would occur earlier. The sooner CARB starts enforcing the better, because the public will have a better sense of whether the program is working at an earlier stage. One-year compliance periods will encourage more emissions reductions at the start of the system and may even encourage more banking. After the system is in place, the public should not have to wait more than three years to see if there is actual compliance with the system. Finally, annual compliance periods better address the bankruptcy issue raised by CARB.

**Offsets**

The proposed offset limit in the PDR fails to comply with AB 32 and undermines one of the fundamental purposes of a cap and trade program. It would allow opportunities for job creation and co-pollutant reductions in the state's most heavily-polluted areas to be missed.

CARB's authorization of offsets is not grounded in AB 32's statutory authority. The Health and Safety Code section 38562(c) requires the cap and trade system to "achieve the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions" from the capped sources. There has been no demonstration that the offset program will comply with this mandate.

The statute also requires that AB 32 emission reductions occur in the state, as exemplified in the AB 32 emissions limit itself, which is defined as the maximum allowable level of emissions *in the state*. (Health and Safety Code § 38505(n).) AB 32 stresses the importance of designing the emission reduction measures to achieve environmental and health related co-benefits in the state, referencing air quality and other local co-benefits in different sections of the law.[2]

[2] **HSC § 38501**: AB 32 declares that "it is the intent of the legislature that the State Air Resources Board design reduction measures…in a manner that minimizes costs and maximizes benefits for California's economy, improves and modernizes California's energy infrastructure…, maximizes environmental and economic co-benefits for California, and compliments the state's efforts to improve air quality."

**HSC § 38562**: To the extent feasible, the board shall design regulations…in a manner that:

- is equitable, seeks to minimize costs and maximize total benefits to California…
- does not disproportionately impact low income communities
- compliments and does not interfere with efforts to achieve and maintain federal and state ambient air quality standards and to reduce toxic air contaminants
- considers the overall social benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health.

**HSC § 38565:** To the extent feasible, regulations should direct public and private investment toward the most disadvantaged communities in California.

**HSC § 38570:**

- Market mechanisms may be included after consideration of the potential for direct, indirect, and cumulative emission impacts, including localized impacts in communities that are already adversely impacted by pollution.
- Design any market compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants.

The proposed use of offsets appears to be based on an arbitrary limit that does not maximize reductions of global warming pollutants and co-pollutants in the capped sectors, nor does it ensure that AB 32 emission reductions occur within the state.

In fact, under the offset limit proposed in the PDR, in the first two compliance periods the cap and trade program may not achieve any additional emission reductions in the capped sectors beyond those achieved by complementary measures, and it may achieve very few additional emission reductions in the third compliance period.

The amount of offsets proposed in the PDR nearly exceeds the emission reductions expected from cap and trade. The Union of Concerned Scientists estimates that the cap and trade program is expected to achieve roughly 145 MMT of reductions from 2012-2020 (calculating reductions as cumulative annual reductions below emission levels in 2012 and assuming that transportation is included under the cap from the start of the program).[3] CARB proposes allowing 122 MMT of offsets into the system, making the capped sectors responsible for a mere 23MMT of additional cuts over the life of the program. In other words, only 16% of the cap and trade reductions will be required to occur in the state's most heavily-polluting sectors.

The very nature of using offsets from non-California jurisdictions and linking to other regional trade programs or international programs, where credits are generated in other states or jurisdictions and then traded into California, raises enforceability issues. Proposed Memorandums of Understanding (MOUs), where CARB allows other jurisdictions to enforce the validity of credits generated in other jurisdictions, do not comply with Health and Safety Code section 38580 which requires CARB to enforce the rules adopted pursuant to AB 32. The MOUs could improperly create surrogates for CARB's enforcement responsibility, unduly limiting CARB's enforcement powers.

Compliance and enforcement issues are particularly problematic with respect to international offsets. For example, the PDR requires that in order for international sector-based credits to be eligible, the foreign country, state, province or program issuing the sector-based credit must "implement substantive and procedural requirements for the relevant sector that provide equal or greater assurance of the integrity of such sector-wide GHG reductions." (PDR section 96430(b)(3).) However, should a foreign government or entity fail to meet these requirements, how will CARB guarantee that compliance is enforced? The foreign government/entity cannot be held legally accountable in California or the United States for its actions. Moreover, it is not clear what is meant by "equal or greater assurance of integrity." For example, will it include the right of the public to participate in the process, or to challenge the issuance of sector-based credits in court? How will this be achieved given the limited jurisdiction/oversight that CARB will have over foreign governments and entities?

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- Market mechanisms should maximize additional environmental and economic benefits for California, as appropriate.

[3] See "Proposed Scoping Plan offset policy analysis," UCS, November 17, 2008. Note that other regulations will result in reductions in the capped sectors. The focus here is on the reductions to be achieved as a result of the cap and trade regulation itself.

The PRD also provides that California must have entered into an MOU with the foreign country, state, or province that includes "the obligation to perform audits of offset project sites, and to report and enforce against violations of this subarticle." (PDR section 96420(e).) However, the capacity (in terms of personnel, technology, and financial resources) in most developing countries is extremely weak. Therefore, the ability of developing country governments to accurately establish baselines and monitor/verify emissions reductions is also likely to be weak, and corruption and a lack of transparency/public participation/access to information prevalent. In addition, some countries (e.g., China) have been reluctant to "open their books" to outside parties. The PDR does not indicate who will have the obligation to perform audits – but it is possible that certain developing countries will not agree to allow third-party audits of sector-based offsets.[4]

**Sector-Based Offsets Raise a Host of Issues.**

In addition to the compliance and enforcement issues discussed above, there are numerous other problems, challenges, and risks involved in sector-based crediting that CARB must address before including these types of international offsets in California's cap and trade program. Establishing accurate baselines is extremely difficult. Future GHG emissions are driven by a wide range of factors such as fuel prices, economic growth, and technological advancements. Any projected emissions baseline will therefore have inherent uncertainties.

Moreover, to be effective, sectoral crediting mechanisms must employ *appropriate* sector crediting baselines – baselines that recognize what can be achieved through Developing Country (DC) mitigation policies and measures (*i.e.*, Nationally Appropriate Mitigation Actions or NAMAs)[5] on the one hand and carbon markets on the other. In order to stabilize temperatures at safe levels, by 2020 not only must developed countries reduce emissions by 25 - 40%, but DCs must also achieve a substantial deviation from baseline.[6] Unilateral and internationally supported NAMAs are intended to help DCs achieve these absolute emissions reductions below business as usual that the science demands. Sector-based crediting must therefore take into account the amount of emissions reductions that can be achieved in a certain sector through unilateral and supported NAMAs, and then determine an appropriate crediting baseline below that amount. Where sector-based crediting baselines are inaccurate or too weak, issuing offsets that can then be used by domestic entities to increase emissions undermines not only California's cap but also the overall goal of stabilizing climate.

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[4] It is worth noting that both the House and Senate climate change bills call for a discounting of international offsets after 2018. See H.R. 2454, S. 1733 § 722.

[5] The Bali Action Plan calls for enhanced national/international action to mitigate climate change, including consideration of "Nationally appropriate mitigation actions by developing country Parties in the context of sustainable development, supported and enabled by technology, financing and capacity-building, in a measurable, reportable and verifiable manner." Bali Action Plan, Section 1(b)(ii), Decision 1/CP.13, FCCC/CP/2007/6/Add. 1, available at http://unfccc.int/resource/docs/2007/cop13/eng/06a01.pdf#page=3.

[6] Climate Change 2007: Mitigation. Contribution of Working Group III to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change [B. Metz, O.R. Davidson, P.R. Bosch, R. Dave, L.A. Meyer (eds)], Cambridge University Press, Cambridge, United Kingdom and New York, NY, USA, pp. 775-776, *available at* http://www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-chapter13.pdf.

Determining the scope of a sector-based crediting program also presents technical and policy challenges. The PRD provides that CARB may approve a sector "of a specific developing country, or state or province in such country." (PDR Section 96430(c).) However, limiting the number of facilities within a sector, *e.g.*, to a province or region within a developing country, will likely lead to leakage, especially where the cost of mitigation is greater than the price of carbon. On the other hand, including an entire sector on a country-wide level (especially if the sectoral crediting baseline is too weak) may result in the generation of an amount of offset credits that far outstrips demand. For example, a recent report by IEA and OECD indicates that the potential credit supply for the power, cement and forestry sectors alone is much larger than current estimates of possible demand by the European Union and the United States.[7] Before adopting such a program for California, CARB must carefully assess sectoral options for crediting to avoid raising unrealistic expectations on possible finance from the carbon market.[8]

One of the purported advantages of sector-based crediting is that it addresses international competitiveness concerns. (The potential loss of market share to competitors in developing countries has been a major argument for those opposed to federal climate legislation.) However, the overall goal of federal and state climate policy should be to put certain carbon intensive sectors at a disadvantage. Sectoral approaches that seek to level the playing field are therefore counter-productive. As described in a report by the World Resources Institute, "[a]n efficient response to the climate challenge will include displacement of some inherently emission-intensive products and processes by less emission-intensive alternatives (e.g., electricity). Policy design that weakens this competition between products will raise the cost of emission abatement. Sector agreements therefore should not be a means of relieving the pressure on a particular emission-intensive product relative to competing products."[9]

Sincerely,

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Staff Attorneys

[7] *See* IEA and OECD, "Sectoral Approaches and the Carbon Market," (June 2009), Section 2, at p. 9, *available at* http://www.oecd.org/dataoecd/8/7/42875080.pdf.
[8] Id.
[9] WRI Report (2007) "Slicing the Pie: Sector-based Approaches to International Climate Agreements, Executive Summary, p. 4, available at http://pdf.wri.org/slicing-the-pie.pdf.