Friends of the Earth

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California Air Resources Board
1001 I Street
Sacramento, California
Via: California ARB website

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

Dear CARB Staff:

Friends of the Earth (FOE) welcomes the opportunity to comment on the Preliminary Draft Regulation (PDR) for California's cap and trade program.

The role and design of a cap-and-trade system

First, we applaud the fact that, in recognition of carbon trading's inherent limitations, AB 32 and the Scoping Plan wisely employ a suite of strategies to mitigate GHG emissions, rather than rely predominantly on a carbon trading market. FOE urges ARB to ensure that California's cap-and-trade program does not end up playing an outsized role in the state's overall climate strategy by directly or indirectly undercutting other GHG mitigation efforts or other aspects of AB 32.

One lesson learned from the development of other cap-and-trade systems is that the process of designing carbon markets tends to be strongly influenced by those who have a financial interest in the design of the system. Aggressive lobbying has resulted in cap-and-trade systems that are relatively complicated, prone to gaming, difficult to manage and regulate, and ultimately vulnerable to environmental failure.

For example, in the US House of Representatives-passed American Clean Energy Security Act, policymakers responded to cost containment concerns by allowing a significant proportion of offsets into the system. This created a host of other concerns. For example, a large offset market has significant project finance requirements, which "necessitates" the creation of larger and more liquid carbon markets. This exacerbated concerns about price volatility, which was solved though adopting a price collar. But the price ceiling led to concerns about cap busting, so that led to the creation of an allowance reserve, which in turn altered the allocation process. A large offsets market also "required" banks to have the ability to broker in over-the-counter derivatives, raising a new set of problems related to market regulation.

Far from simple "Econ 101" emissions trading systems, carbon markets are becoming complex inventions, often incorporating offsets, free allowance give-aways, unlimited participation of financial speculators, links to other trading systems, price collars and allowance reserves, etc. Although ARB has attempted to avoid some mistakes of other programs, the PDR still includes design elements that complicate and undermine the environmental effectiveness of the program.

Recommendation 1: Complete Localized Impact Analysis

AB 32 requires ARB to analyze the "potential for direct, indirect, and cumulative emission impacts from [market] mechanisms, including localized impacts in communities that are already adversely impacted by air pollution." Only after such analysis is completed should ARB "design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants."

It is disconcerting that ARB has issued its first draft regulations for a carbon trading program without having completed this analysis. For example, it appears as if there has been more consideration given to how the market can be linked to the Western Climate Initiative and other trading systems than to ensuring that the program protects communities which are already exposed to high levels of pollution. A localized health analysis could have huge implications on the size, role, scope and design of a state-wide cap and trade system.

Friends of the Earth urges ARB to complete the localized impact analysis before proceeding with the further development of the carbon trading program.

Recommendation 2: Prohibit Offsets

The concept of offsets emerged as a small-scale experimental idea agreed to by embattled negotiators in the last hours of the Kyoto Protocol talks in 1997. Since then, offsets have become a significant component of many carbon trading programs, and a way for governments to commit to more ambitious-sounding levels of emissions reductions while requiring covered entities to do less. For example, according to the Union of Concerned Scientists, California's cap-and-trade system is projected to reduce emissions by 145 MMT from 2012-2020.[1] But since the PDR proposes allowing 122 MMT of offsets to be included in the program, covered entities may only need to cut emissions by 23 MMT, or a mere 16%.

In addition, the staff is aware of the how difficult it is to ensure offset integrity. Studies have shown that the Clean Development Mechanism (CDM, the largest offset market in the world) is prone to corruption, has produced perverse incentives to pollute, and causes major delays to urgently-needed low-carbon economic transformations in developed countries. Many of the so-called reductions from CDM offsets are blatantly false or at best next to impossible to verify for additionality, leading to increases in net emissions.[2] ARB has attempted to avoid these problems, but offsets are fundamentally flawed and cannot be reformed; they create entrenched interests (from offset providers and covered entities) that will continually advocate for lower

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[1] "Proposed Scoping Plan offset policy analysis," UCS, November 17, 2008.
[2] *A Dangerous Distraction: Why Offsets are a Mistake that the US Cannot Afford to Make*, Friends of the Earth, September 10, 2009.

standards. We point to concerns raised about the proposed Forest Protocols as an example of the problems associated with creating offsets.

Friends of the Earth urges ARB to wholly eschew the use of offsets, particularly international offsets, in a California carbon trading system.

Recommendation 3: Limit Participation of Certain Opt-In participants

ARB should limit carbon trading to covered entities only. Market fundamentalists argue that financial investors should have virtually unlimited access to carbon markets in order to ensure liquidity, price discovery, and risk transfer; and help prevent cornering (commodity hoarding to manipulate prices). But doing so makes the system much harder to regulate, and subjects it to problems such as excessive speculation. Cap-and-trade systems do not have to embrace large secondary markets and ample speculation in order to function.

For example, in a "textbook" emissions market, liquidity is actually designed to decrease as the emissions cap tightens in the long term. In the short term, it is supposed to be more difficult to find a seller when many buyers are short; this dynamic provides an incentive to make extra reduction efforts. Policymakers can use limited banking and borrowing and longer compliance periods, rather than financial speculation, to help alleviate liquidity problems.

Similarly, concerns about price discovery may be overstated. Unlike other markets, the "accurate price" for carbon markets is not what best reflects "what the market will bear" -- a figure that could be greatly influenced by who is trading -- but rather whether the price is high, clear, and consistent enough to generate the intended environmental results. An accurate price for carbon, for example, could be the marginal cost for electric utilities to switch from high- to low-carbon fuel; arguably, masses of speculators are not needed to help determine that figure. In fact, in other commodities markets, where financial speculators own some 70% of open interest positions, excessive speculation has not only undermined price discovery, but has undermined the functionality of those markets for bona fide physical hedgers.

Finally, the need for risk transfer has been so exalted that it has been used as an argument against proposed derivatives regulations, such as position limits, exchange-based futures trading, and higher margin requirements. Having a large pool of risk-tolerant financial speculators may be more logical in a trading system with offsets and volatile carbon prices. However, carbon markets do not have to be designed this way at all; by eschewing offsets and adopting price smoothing mechanisms such as collars, the trading program can achieve its environmental objectives without creating additional financial risks.

In December 2009, US Senators Maria Cantwell and Susan Collins introduced the Carbon Limits and Energy for America's Renewal (CLEAR) Act, which is a cap-and-dividend/ cap-and-invest system that does not include offsets and limits trading to covered entities only. Friends of the Earth commends this bill to ARB's attention for the legislation's proposed market structure.

Friends of the Earth urges ARB to limit carbon trading to covered entities only.

4. Other recommendations

With respect to the other questions on which ARB solicited comments, Friends of the Earth offers the following input:

- Threshold for inclusion of covered entities
  By excluding biomass combustion at stationary sources, the PDR adopts the same "biomass loophole" which undermines the effectiveness of other cap-and-trade programs. As the staff is aware, according to the Energy Information Administration, actual carbon emissions from biomass energy can be similar to that of coal.[3] The biomass loophole could also have significant adverse impacts on biodiversity and result in increased deforestation.

  FOE urges ARB to close the biomass loophole by including biomass in the cap.

- What other compliance instruments could be included?
  The notion that trading systems should be linked, in order to allow capital to be allocated to the cheapest reductions, sounds good in theory. But in reality, capital will simply flow where environmental standards are lowest, undermining the integrity of California's program.

  FOE urges ARB to limit compliance instruments to California allowances only.

Conclusion

In sum, the ARB should design a cap-and-trade system to resemble, to the greatest extent possible, a simple "textbook" emissions trading system. This means setting an ambitious cap that covers all relevant sectors (including bioenergy), limiting compliance instruments to allowances, fully auctioning all allowances, and limiting trading to covered entities only. Finally, in order to address the inherent weaknesses of carbon trading as a climate strategy, the ARB should ensure that all necessary precautions are taken to protect vulnerable communities and the effectiveness of other GHG mitigation strategies.

Sincerely,

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[3] Voluntary Reporting of Greenhouse Gases Program: Fuel and Energy Source Codes and Emission Coefficients," Department of Energy, Energy Information Administration, http://www.eia.doe.gov/oiaf/1605/coefficients.html#note2, page viewed July 29, 2009