January 11, 2010

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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. On behalf of the hundreds of thousands of concerned Californians that the undersigned organizations collectively represent, we respectfully submit comments on the following key issues:

A. Cap Level

The emission reduction potential of a cap and trade program hinges on CARB getting the cap level right. We urge CARB to set a tight, declining cap.

Setting a tight cap from the beginning of the program and mandating meaningful reductions in the initial compliance period will help facilitate price discovery and encourage early, cost-saving investments. If meaningful reductions are not required in the first compliance period, early cost-effective reduction opportunities might be lost. Putting reductions off until later in the program could also lead to delayed reductions and resulting price volatility. Total emissions are measured in terms of the area under the curve, not just the endpoint, so allowing more emissions in the beginning of the program means the program overall is less effective at achieving reductions. To ensure that the cap is set tightly and early reductions occur, we urge CARB to do two things:

(1) *Set the initial cap at BAU levels before the program starts and decline immediately.*

Setting the cap at BAU as of December 31, 2011, and requiring reductions from there will mean that reductions will be required over the course of the first year (2012) and over the course of the first compliance period (2012-2015). The chart on p.32 of the PDR indicates that CARB proposes to set the BAU level at the end of 2012, rather than the beginning. This would mean no reductions would be required over the course of 2012, and the true work of the program would not begin until January1, 2013. To ensure a steady decline and greater overall emission cuts, CARB should require reductions from day 1.

(2) *Use recent and conservative BAU estimates in setting the cap in 2012 and 2015.*

Inadvertently over-budgeting in 2015 due to inaccurate BAU estimates will result in a steeper compliance pathway to meet the 2020 target, which will likely lead to increased pressure for cost containment measures and generally put unnecessary strain on the program. Past programs including RGGI and the EU ETS have used inflated BAU estimates, resulting in a low auction price (in the case of RGGI) and subsequently volatile price swings (in the case of the EU ETS). California should learn from these past mistakes and use a conservative BAU when setting the cap, in order to ensure meaningful reductions from the first period.

B. Compliance Periods

If CARB proceeds with three-year compliance periods there should be some level of annual true-up. A three-year compliance period allows regulated entities to spread their emission reductions over the course of several years, independent of annual fluctuations. A three-year cycle will also put less of an administrative burden on CARB, allowing the agency to direct resources to other critical aspects of the program, and less of a burden on smaller sources.

However, a three-year compliance period must include provisions for a periodic surrender of a significant portion of compliance instruments more often than the full compliance period. Requiring a regulated entity to surrender compliance instruments equal to a significant percentage of its reported emissions after each annual reporting event would ensure that reductions are made from the start of the program, help establish a reality-based price signal, reduce the potential for shortfall at the end of the compliance period, and protect against regulated entities that may go bankrupt or leave the state during a compliance period,.

We believe there is an additional way of hedging against the risk of regulated entities declaring bankruptcy. At the beginning of each compliance period, CARB could set aside a portion of the allowances for that period into an emergency reserve that would be tapped in the case of a potential breach of the cap, such as an emitting entity declaring bankruptcy and failing to provide the remaining number of allowances due.

C. Penalties and Enforcement

We commend CARB in recognizing that cap-and-trade is only effective as an emission reduction policy if the enforcement mechanisms are sufficient to deter non-compliance. To ensure this is the case, we encourage CARB to utilize two types of penalties for non-compliance: 1) a monetary fee that is several times higher than the price of allowances; and 2) an obligation to surrender allowances in the next compliance period to make up for the shortfall and ensure the cap is not violated.

The monetary fee should be due upon non-compliance and set at a level several times than allowance prices. One option would be to set the fee as a multiple of the current market price for allowances. For example, using a multiplier of 5, if allowances are trading at $10, than penalties are set at $50 per allowance shortfall. In addition, during the next year the entity should have to surrender a multiple of the allowances they failed to submit in the previous period. For example, using a multiplier of 5, an entity would have to surrender 5 allowances in the subsequent period for every one they failed to surrender in the current period. This will safeguard the integrity of the cap and will account for the added warming resulting from the delay in emission reductions.

In line with the enforcement objectives identified by CARB at the March 23, 2009 workshop, a price multiplier provides a simple, clear, and transparent mechanism to ensure capped entities will not realize any economic benefit by willfully non-complying. It should always be the better economic decision to comply than to fail to comply. A price multiplier also compliments current staff thinking that the surrender of each compliance instrument constitutes a separate transaction, subject to penalty.

Although AB 32 authorizes CARB to assess penalties under existing statutory provisions,[1] relying exclusively on this framework may prove inadequate to advance CARB's enforcement objectives. The statutory caps on penalties may prove insufficient to deter non-compliance (or, if interpreted liberally, will complicate the process) and the lengthy list of factors CARB must consider in assessing penalties will add uncertainty and remove transparency from the system.

D. Including Transportation Fuels in 2012

Transportation fuels should be included in the cap and trade program from its start in 2012. The transportation sector is the single largest source of global warming pollution in California, producing 40% of the state's total emissions. Consequently, it is important for transportation fuels to be included so that the scope of the cap and trade program covers all major sources of emissions. As noted in the Market Advisory Committee report:

> "including the transportation sector is critical to providing a consistent price signal across all sectors to promote economy-wide reductions in GHG emissions. Failing to provide this consistent signal would lead to distortions in automobile supply and purchase decisions. In addition, if cap-and-trade were applied to the transportation sector, it would help reduce distortions relating to decisions as to how much to drive. Specifically, by incorporating the carbon price in the price of gasoline, it

[1] H&SC § 38580(a); directing CARB to apply H&SC § 42400 et. seq. and H&SC § 43025 et. seq.

would encourage owners of conventional fuel cars to make more socially efficient decisions as to how much to drive." (pg. 36)

An economy wide market will lower emission reduction costs, resulting in a lower carbon price, and will provide greater market liquidity. In addition, the Market Advisory Committee also notes that including the transportation sector from the start of the cap-and-trade market "would reduce uncertainties about whether this sector will ever be included, and establish an efficient architecture for the cap-and-trade program to grow in stringency over time." Finally, the revenue from the auctioning of carbon allowances in the transportation sector can be used to expand and enhance consumer transportation choices, such as mass transit, smart growth, and other strategies that could increase the long-run elasticity of demand for transportation fuels.

E. Set-Asides for Voluntary Investment in Renewable Energy Generation

We support the set aside and retirement of allowances as outlined to account for voluntary investment in renewable sources of electricity generation. Many organizations, households, farms, other businesses, universities and houses of worship have chosen to voluntarily install on-site solar generation or purchase renewable electricity or renewable energy certificates as part of their commitment to help reverse global warming. As a result, the voluntary market has been an important driver of clean energy development in California. Millions of additional tons of carbon dioxide would have been emitted if fossil fuel-based plants had replaced the electricity generation that has been supported through voluntary renewable energy purchases (for details see the nonprofit and clean energy coalition comment letter to CARB dated June12, 2009[2]). Though the 33% Renewable Electricity Standard and other policies will play a crucial role going forward, a vibrant voluntary market can provide meaningful supplemental clean energy development.

Absent the proposed adjustment mechanism, the number of emission allowances—and hence the level of emissions produced—will be unaffected, and emission reduction claims from these voluntary investments will become problematic. In other words, absent corrective action such as that proposed, voluntary renewable energy purchases would simply free up allowances, allowing increased pollution from other sources. Since a key driver of purchases of voluntary renewable power is customer confidence that these actions help reduce the pollution that causes global warming, casting doubt on their environmental effectiveness will undercut this thriving market. On the other hand, if CARB implements the proposed adjustment mechanism described in section 95910 (b) of the PDR, California's voluntary renewable power market will grow, thereby delivering supplementary low cost emission reductions, related reductions in co-pollutants, job creation in California, and enhanced energy security.

F. Protecting Disadvantaged Communities

[2] Accessible at http://www.arb.ca.gov/cc/capandtrade/meetings/051809/may18pcnonprofcleane.pdf

It is well documented that low-income and minority segments of the population (disadvantaged communities) bear a higher burden of health and economic impacts from both air pollution and climate change. For these reasons, AB 32 contains explicit statutory language requiring CARB to consider the potential for direct, indirect, and cumulative emission impacts from market-based mechanisms, including localized impacts in communities that are already adversely impacted by air pollution, ***prior*** to the inclusion of any such mechanism.[3]

Thus, we urge staff to evaluate the health impacts of a cap and trade program under different design scenarios, including various offset and allowance allocation scenarios, prior to finalizing the cap and trade regulation. The law requires that CARB conduct such an evaluation "to the extent feasible." We believe that it is feasible to work with the Public Health Working Group on a Health Impacts Assessment on a series of scenarios that examine impacts on co-pollutant emissions and associated health outcomes and inequities. The evaluation scenarios and resulting health impact assessments are critical to this rulemaking and must be included in the ISOR to fulfill AB 32's requirements.

We urge CARB to complete these evaluations and include the findings in the next version of the draft cap and trade regulation. In addition, CARB should include a discussion of how the findings influenced the choice of cap and trade design elements—in particular, allowance distribution and offset limits. CARB must also explain the policies it will adopt to prevent any increase in air pollution in disadvantaged communities.

G. Implementing the Offset Limit

(1) *At least half of the emission reductions (as defined below) from the cap and trade program should occur in the capped sectors each compliance period.*

The proposed offset limit in the PDR would permit a large share of emission reductions from the cap and trade program to occur outside of capped sectors. This would undermine the effectiveness of the program by diminishing opportunities for job creation and co-pollutant reductions in the state's most heavily-polluted areas, and transfer what should be public wealth in the form of allowance value to private, and potentially out-of-state, offset developers.

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.)[4] CARB proposes allowing 122 MMT of offsets into the system, leaving a mere 23MMT of reductions in capped sectors due to the cap and trade program over the ten year life of the program.[5] In other words, only 16% of the cap and trade reductions will be required to

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[3] H&SC § 38570 (b)

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

[5] Other regulatory programs are expected to achieve 113MMT of reductions in the capped secots.

occur in the state's most heavily-polluting sectors. We believe it is important that CARB ensure that at the very least, half of the emission reductions in each compliance period occur in the capped sectors.

(2) *Reductions should be calculated relative to the cap level at the end of the prior compliance period, not relative to the cap level in 2012.*

CARB is not using the appropriate method for calculating emission "reductions" (upon which the offset limit is based). CARB estimates that in 2012, the capped sectors in California will emit roughly 433 million metric tons of global warming pollution. Each year, the cap is lowered slightly, resulting in emission reductions. Each year, the emission reduction relative to 2012 gets larger and larger, even though year-to-year it's the same. For instance, each year from 2016-2020 the annual reduction relative to the emission level from the year before is 11 MMT. However, in 2020, the emission reduction relative to 2012 is a whopping 68 MMT. CARB has chosen to calculate the offset limit based on the cumulative annual reductions relative to 2012 (249 MMT), instead of the cumulative total of actual reductions occurring from year to year, or from compliance period to compliance period (64 MMT). This is problematic because reductions that have already occurred are counted as additional reductions every year thereafter. In essence, CARB is double and triple counting the same reduction. Because of this, the offset limit, which is based on the double and triple-counted reductions, ends up being too large. Instead, we encourage CARB to calculate emission reductions by counting the actual reductions that occur each compliance period, relative to where the cap was at the end of the previous compliance period.

(3) *Offsets that reduce emissions and co-pollutants in California should be prioritized.*

AB 32 requires CARB to maximize emission reductions in capped sectors and in the state. Furthermore, using offsets from non-California jurisdictions raises enforceability issues. Proposed Memorandums of Understanding ("MOUs") where CARB allows other jurisdictions to enforce the validity of credits generated in another jurisdictions do not comply with Health and Safety Code § 38562 (d)(1) and § 38580 which require CARB to enforce the rules adopted pursuant to AB 32.

H. Distribution of Allowance Value

We commend CARB for waiting for the recommendations of the Economic and Allocation Advisory Committee (EAAC) before addressing the issues of how to distribute allowances and allowance value. While we are encouraged by the direction EAAC is headed, we would like to briefly address the following three points:

(1) *100 percent of allowances should be auctioned from the start of the cap and trade program.*

Compared to the other alternatives discussed in the EAAC Draft Report, 100 percent auctioning emerges as the clear winner under the four criteria – cost-effectiveness, fairness, environmental effectiveness, and simplicity – EAAC has identified to guide its recommendations for allowance allocation. Indeed, in their 2007 report, the Market

Advisory Committee concluded that "the fundamental objectives of cost-effectiveness, fairness, and simplicity... favor a system in which California ultimately auctions *all* of its emission allowances." (emphasis added). Auctioning provides an economically efficient, simple, fair and transparent way to allocate allowances and it inherently incentivizes early actions. Furthermore, the revenue generated from auctioning will prove vital in transitioning California businesses and communities towards a low-carbon future.

(2) *CARB should focus on transition, not compensation.*

If CARB does not auction 100 percent of allowances from the start of the proram, we believe the cap and trade program should avoid free allowance allocation to firms with a potential to realize windfall profits. This rule should hold even if free allowances are intended to combat leakage for energy-intensive, trade-exposed industries. As EAAC acknowledges in its Draft Report, free allowance allocation in the European Union Emissions Trading System resulted in billions of dollars of windfall profits and thus lead to a transition to a full auction. We agree with the EAAC that the competitiveness and emission leakage concerns are a very small problem, significant in only a very few instances (see, e.g. page 58, Draft EAAC Report, December 14, 2009), and that the preferable way for addressing these concerns is through border adjustments. If CARB does provide free allowances to trade exposed, energy intensive industries, it should be for near-term transition assistance rather than persistent compensation. The assistance should be provided with careful oversight and legally enforceable requirements for investments in low-carbon technologies or practices. If regulatory overseers determine that administrative allowance allocation is resulting in windfall profits, failing to prevent leakage, or not being utilized to hasten transition to a low-carbon business model, then free allocation should cease and the value of allowances intended to aid transition should be returned to the people of California. Also, in considering the issues documented in EAAC draft reports, we recommend that any allowance allocation should be output based with performance benchmarking, and should have clear, near-term termination timelines as the AB32 cap and trade program moves quickly to auctioning 100% of allowances.

(3) *CARB should invest allowance value according to the key objectives in AB32.*

When determining how to invest allowance value, we encourage CARB to weigh heavily the multiple, reinforcing objectives of AB 32. In addition to investments in GHG emission reductions, AB 32 call includes the following objectives:

- <u>Improve Air quality and Reduce Toxic Air Contaminant Emissions:</u>
  AB 32 states that CARB should "prevent any increase in the emissions of toxic air contaminants or criteria air pollutants."[6] AB 32 recognizes the potential double win of reducing GHG and co-pollutant emissions simultaneously. Any investment of allowance value that yields double benefits for public health ought to receive priority over investments that only address GHG emissions.
- <u>Maximize other environmental benefits:</u>
  AB 32 states several times that implementation should maximize the air quality,

[6] H&SC § 38570 (b)(2)

environmental, public health and other co-benefits.[7] CARB should seek investment opportunities that maximize environmental benefits beyond those listed above, including ecosystem restoration and protection for water quality and quantity, air quality, public health preparedness, climate regulation, fish and wildlife habitat, and resource-dependent economies, among other strategies to help California's natural systems, working lands, and human communities adapt to climate change. Investments should incorporate both a short-term and long-term carbon mitigation strategy that lays the groundwork for greater emission reductions needed by 2050, particularly in supporting compact growth, open space conservation, and mass transit.

- Disadvantaged Communities:
  AB 32 is clear that implementation should "ensure that activities undertaken to comply with the regulations do not disproportionately impact low-income communities."[8] Pertaining to market based systems, AB 32 requires consideration of "… the potential for direct, indirect, and cumulative emission impacts from these mechanisms, including localized impacts in communities that are already adversely impacted by air pollution."[9] Further, AB 32 seeks to "direct public and private investment toward the most disadvantaged communities in California."[10] With these goals in mind, allowance value investment opportunities that generate new, high-quality employment, initiate or expand energy efficiency and pollution control technology programs, provide for energy efficiency and mass transit oriented improvements without compromising environmental quality, in our historically disadvantaged communities ought to be top priorities.
- Adaptation:
  While we must reduce GHG emissions to prevent the most serious effects of global warming, a certain amount of warming is now unavoidable. As a consequence, AB 32's goals to protect our air quality, public health, environmental co-benefits and disadvantaged communities will be undermined without significant investment in strategies for communities and ecosystems to adapt to global warming. Such strategies should include, but are not limited to: 1) public health preparedness for communities that are vulnerable and exposed to increased extreme heat days and diminished air quality; 2) conservation and restoration of natural systems and working lands (i.e. agriculture) to protect water quality, climate regulation and habitat, and reduce vulnerability to catastrophic fire; and 3) improved land use and transportation planning to improve air quality, reduce chronic illnesses, and protect natural systems and communities. California's 2009 Climate Adaptation Strategy calls for such activities, for example citing the need for "public health research, adaptation and climate resiliency education that addresses Environmental Justice."[11]

I. Establishing an Auction Reserve Price

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[7] H&SC § 38501 (h), 38562 (b), and 38570 (b)(2)
[8] H&SC § 38562 (b)(2)
[9] H&SC § 38570 (b)(1)
[10] H&SC § 38565
[11] California Natural Resources Agency. 2009 Climate Adaptation Strategy. December 2. 2009. p. 44.

We support an auction reserve price (i.e. price floor) in order to guard against the price volatility and uncertainty resulting from initial over-allocation, which has been a significant problem for past cap and trade programs. A price floor will also serve to bolster California's crucial clean tech sector by providing greater certainty that the marketplace will reward clean tech innovation and avoid prices that are too low to encourage long-term capital investments in low- and no-carbon technologies. Allowances held back due to insufficient demand at auction (i.e. bid prices that are too low) should be permanently retired.

Thank you again for the opportunity to comment on the cap and trade PDR. We look forward to discussing these issues with you in greater detail in the near future.

Sincerely,

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