AB 32 Implementation Group

Working Toward Greenhouse Gas Emission Reductions
And Enhancing California's Competitiveness

To: Mr. Steven S. Cliff, Ph.D.
Manager Program Development Section
Office of Climate Change -- California Air Resources Board

Fr: AB 32 Implementation Group

Date: August 30, 2012

Re: Cap-and-Trade Program:
Emissions Leakage Research and Monitoring Workshop

Submitted Electronically

The AB 32 Implementation Group is a coalition of employers and taxpayer groups advocating for policies to achieve greenhouse gas emission reductions in a manner that will protect jobs and the economy. We thank you for the informative 'Emissions Leakage Research and Monitoring Workshop' on July 30, 2012.

We believe that leakage minimization is a crucial element of AB 32 for environmental as well as economic reasons. Leakage results in job loss, reduced in-state investments and lower tax receipts for California while failing to achieve our emission reduction goals.

At the workshop California Air Resources Board (CARB) staff stated that CARB plans to revisit leakage risk classification and allocations for the second and third compliance periods. This plan does not meet the requirements of AB 32 to minimize leakage. It is too late to address the leakage that is already taking place and will continue in the first compliance period. It is also too late to prevent the leakage that will occur in future compliance periods due to investment and business plan decisions that are currently being made for those future years. Serious and thoughtful leakage analysis and development of regulations based on that analysis should have been started at least 3 years ago and completely before the cap-and-trade regulation was adopted.

-- more --

To minimize leakage going forward, CARB should immediately offer free allocations up to a reasonable industry benchmark for all compliance periods.

The AB 32 Implementation Group (AB 32 IG) has the following concerns with the current handling of leakage issues:

1. Cap-and-trade Program Design is expensive: Staff notes that CARB's obligation under AB 32 is to "design measures to minimize leakage to the extent feasible." The focus is appropriately on the design of the measures, to prevent leakage from happening. Yet, CARB failed to satisfy this obligation when the CARB Board adopted a cap-and-trade regulation that withholds allowances from regulated entities and puts them up for auction without having conducted studies to determine the impacts of allowance withholding on California businesses and industry. The high costs of allowance withholding will lead to leakage, yet this feature was not adequately studied to minimize the impacts. Other design elements, including limitations on offsets, buyer liability, and non-obligated purchasers of allowances will also drive up costs and contribute to leakage. We have commented on these and other flawed design features of cap-and-trade program in prior comments.

2. Monitoring of Leakage: CARB proposes to monitor leakage in the early years of the program, but there is little CARB will be able to do to minimize leakage after the program is underway as the damage to businesses and industry will have already taken its toll. No amount of staff "timely monitoring… allow[ing] for refinement or development of policies to minimize leakage" will undo the damage or return lost companies, lost production, or lost jobs to California. The monitoring will be of no value except to record for historical purposes all the jobs and investment the state lost during the period measured, with no ability to change policies to prevent the loss or regain the jobs and investment back.

In addition, the proposed leakage monitoring would address leakage from cap-and-trade for the covered entities only. Staff plans to annually update the Board on "shifts in business activity that may result in emission leakage and changes in market share for covered entities and sectors as a result of the cap-and-trade program." But this limited perspective of the possible sources and causes of leakage fails to take into account many possible leakage scenarios such as could result from higher costs and burdens associated with all elements of the AB 32 Scoping Plan, not just the cap-and-trade program, and not just for the companies directly regulated under the cap. This recommendation is far too narrow and limited to constitute a leakage monitoring program.

Finally, the monitoring approach recommended by CARB relies on company information, much of it confidential, that is not needed to provide a reliable tracking of leakage. Confidentiality and trade secrets aside, the proposal does not capture information relevant to how businesses make investment decisions. For example, CARB assumes that leakage is not happening if monitoring shows little change in behavior in the prior year of data. But companies make plans for investment, product development, hiring, etc, years in advance of such data points revealing themselves. Plans for capital investments and site locations are particularly long term, with three- to ten-year time horizons for major decisions. This means that projected costs of AB 32 have already been included into investment decisions being made in the years since 2006.

A monitoring record showing "no leakage" in 2012 ignores the losses that occurred in 2007 through 2010 before monitoring began but when costs were initially incorporated in decision-making. On the flip side, the same "no leakage" result in 2012 could represent the last year of full production before significant changes are predestined to occur in 2013 and beyond. In the best case scenario, it would likely take two or more years of data to draw any conclusions about the extent or cause of leakage, and each year of delay is another year of losses CARB will not have prevented.

CARB's failure to minimize leakage cannot be remedied by monitoring the exodus of jobs and investment and trying to fix it later. Leakage will happen if entities that operate in regional and global markets suffer higher costs than competitors in other states or countries and CARB should focus on correcting these design elements to prevent this inevitable outcome. The Pew Center on Global Climate Change issued a 2008 study that modeled up to 44% of emissions from a federal cap-and-trade program could leak to other countries. A state-only program is at greater risk of leakage, especially a trade dependent economy like California's.

<u>3. Need for competitiveness analysis:</u> CARB's proposal does not include a plan to measure economic activity by competitors in other states. Business and industry in the U.S. does not operate in a vacuum. States will not remain neutral nor idle once cap-and-trade commences, but will actively seek to lure business away from California. In effect, leakage will occur when California fails to obtain its proportionate share of investment and hiring, while other states get more than their proportionate share. Therefore it is critical that CARB consider not only the short-term impacts but also how proposed regulations are already effecting growth and investment in energy intensive sectors and businesses that provide services to them. The California Manufacturers & Technology Association (CMTA) tracks manufacturing investment trends in California compared to the rest of the country. Between 1977 and 2000, California attracted 5.6% of U.S. manufacturing investment, but the rate has plummeted to 1.9% since 2001. The leakage represented by this lack of growth has been happening for years, right under our noses, and it will likely ramp up in surrounding states in order to take advantage of the competitive burden that CARB is placing on California industry. If a flat yet disproportionately low level of investment occurs in future years, the monitoring proposal will neither recognize nor remedy such leakage.

When evaluating leakage, CARB needs to consider the added costs not only of the cap-and-trade program but also the complementary measures contained in AB 32. All of the programs under AB 32 and additional programs related to other GHG reduction programs (RPS) contribute to these additional regulatory costs. CARB needs to evaluate the combined effects of all regulations, including complementary measures.

Recommendation: By 2015 the entire California economy will be incurring cap-and-trade related costs in natural gas, electricity and transportation fuels, while other states and nations may be actively lowering costs to attract manufacturing and other investments. Rather than burdening regulated parties with a new reporting requirement that seeks confidential information without providing useful information in return, the AB 32 IG recommends that leakage analysis should be based on models and surveys that would estimate the impact of design features that could influence investment decisions and leakage.

If you have any questions or need anything further please contact Shelly Sullivan at (916) 858-8686.

cc: *Mary Nichols, Chair, CARB*
Virgil Welch, Special Assistant, CARB
James Goldstene, Executive Officer, CARB