June 11, 2010

Mr. Kevin Kennedy
Office of Climate Change
California Air Resources Board
1001 "I" Street
Sacramento, CA 95812

**RE: Methods for allowance allocation and uses of allowance value**

Dear Mr. Kennedy,

We would like to thank you and your staff for your hard work and public service. We write to offer our views on how allowance value should be utilized and the best method for distributing allowances to attain those objectives. In particular, these comments are in response to CARB proposals contained in materials presented at the allocation workshop on May 17, 2010.

As you know, the primary purpose of AB 32 is to reduce greenhouse gas emissions,[1] but the law also requires CARB to pursue other goals, including maximizing environmental, economic and public health co-benefits,[2] complementing efforts to reduce air pollution and toxic contaminants,[3] transforming the state's energy infrastructure,[4] protecting low-income communities,[5] and maximizing overall societal benefits.[6] While we commend many aspects of CARB's proposal, the proposal for 100% free allocation to industrial sources would divert allowance value from the uses that are identified and required by law, and lead to unacceptable windfall profits for those industries.

The following comments address our views on appropriate methods for distributing allowances and uses for allowance value.

## CARB should require compelling evidence of leakage risk before awarding free allowances to industrial sources.

We are concerned that CARB is overestimating the likelihood of leakage risk and that this concern, while important, is overriding other key design elements of the program. We urge CARB to consider that freely

[1] Health and Safety Code § 38501 (h)
[2] Id. at § 38501(h), § 38562(b)(6)
[3] Id. at § 38562(b)(4)
[4] Id. at § 38501(h)
[5] Id. at § 38562(b)(2)
[6] Id. at § 38562 (b)(6)

allocating allowances to industrial sources presents its own set of risks, as well as imposing significant opportunity costs in the form of foregone investments in other emission reduction and adaptation strategies. To avoid these pitfalls, we ask that CARB realign the proposed allowance distribution mechanism for industrial sources to require compelling evidence of leakage risk ***before*** awarding free allowances.

1. *CARB does not have the data or technical capacity to implement its current proposal*

We appreciate the technical challenge and staffing and other resource constraints that CARB faces and the good faith efforts put forward by CARB staff to address this issue. The technical approach CARB has proposed to assess the likelihood of leakage, however, is simply inadequate[7] as the sole basis for awarding billions of dollars worth of permits that represent access to pollute the public commons.

The available data does not support CARB's judgment that if a sector is "at risk of leakage," then sources within that sector automatically deserve 100% free allocation. CARB proposes to make this determination as a function of trade exposure and emission intensity, which are relevant variables but are not sufficient to show that leakage would occur. Slide 48 of the staff presentation states that staff plan to "research how much cost pass-through ability covered sectors may have." This is important research for CARB to conduct; unfortunately, CARB has made no attempt to do so. Should CARB choose to continue with its current proposal, we strongly encourage CARB to find a way to conduct this analysis and provide a strong public justification before finalizing plans for allocation.

There is also some indication that CARB plans to use allowance value to compensate industrial sources for competitiveness concerns not directly resulting from AB 32. Determining how much allowance value to use to protect against leakage should focus only the impact of AB 32 and not on other unrelated economic forces. In many cases, a smaller percentage of allowance allocation, such as 10% rather than 100%, could be the appropriate amount to avoid AB 32-caused leakage. We ask CARB to clarify that any allowance value allocated freely to address competitiveness concerns will only be allocated to guard against compelling evidence of leakage risk.

Finally, we encourage CARB to examine relevant evidence from the European Union's Emission Trading Scheme (EU ETS) on the risks of free allocation to address leakage. Recent economic research on the EU ETS has concluded, "[T]here is ample evidence that energy intensive industry has passed through the prices of their freely obtained allowances during Phase 1 and Phase 2 of the EU ETS. This has generated windfall profits in these sectors."[8]

2. *Other factors will mitigate leakage concerns*

We ask CARB to recognize that there are additional factors that will limit leakage. For example, operations involve sunk costs (expensive investments that you can't pick up and move) that will continue to make it more profitable to operate in California than to move operations. In addition, there could be added costs to serving the California market from elsewhere, and it could be possible that that California producers are able to set the price with others following. We do not know the impact of these factors, but the EU ETS experience implies that they could be significant in many cases. In addition, by encouraging

[7] See EAAC, Appendix: Comments on the ARB's Updated Economic Impacts Analysis by the Economic Impacts Subcommittee of the Economic and Allocation Advisory Committee (revised 18 April 2010), pg. 10, "The ARB study did not attempt to measure leakage. The models utilized are not equipped to capture how California policies might cause firms to alter behavior in ways that lead to leakage or reshuffling."

[8] Sander de Bryun, Agnieszka Markowska, Femke de Jon, Marta Bles, "Does the energy intensive industry obtain windfall profits through the EU ETS?" Research Commissioned by the European Climate Foundation.

energy efficiency and renewable energy, California may also help business by reducing their exposure to future price shocks in the volatile world markets for oil and gas.

3. *CARB should place the burden of demonstrating leakage risk on industry*

In light of the limitations on resources and available data, and significant risks involved in over-allocation, we propose that CARB require compelling evidence of leakage risks before granting free allowances to industry. Industrial sources have much better access to the kinds of information that can make this showing and the resources to complete the undertaking. CARB's current approach appears to require compelling evidence that there is ***not*** a risk of leakage in order to deny free allocation. Given the degree of uncertainty involved in the analysis, it is unlikely CARB could ever come to this conclusion. Instead, we believe that CARB should place burden of proof on the industry in question to show that there ***is*** a risk of leakage, and how much allowance value is required to mitigate that risk. This will better ensure that industries are not reaping windfall profits and diverting allowance value from advancing the goals of AB 32.

## Benchmark for output-based free allocation should be based on industry best practices.

We urge ARB to set the benchmark for output-based free allocation at a GHG-intensity that matches each industry's best practices. This would ensure that only the cleanest and most efficient entities within a sector would receive allowances that completely fulfill their compliance obligation. By benchmarking to the most efficient actors in the sector, for example, entities that have made investments in Best Available Control Technology, all other operators have an incentive to achieve the same high level of efficiency.

In contrast, if the benchmark is set lower, many facilities may be less inclined to reduce their emissions intensity. Furthermore, entities that have emissions less than the benchmark could reap a windfall profit since their allocation of free allowances could be more than their actual emissions.

We strongly urge ARB to set the benchmark for output-based free allocations at a level that provides an incentive for the majority of a given industry to improve efficiency to at least the level of the current best practices. Further, we suggest that the appropriate pool of facilities against which to measure performance would be those that operate in California rather than the entire country.

## CARB should outline pathway to phasing out free allocation (except to address compelling leakage risks).

The Scoping Plan stated that CARB "expects… to transition to 100 percent auction," (page 36) yet this objective disappeared completely at the May 17 workshop. We align ourselves with the EAAC, which states that CARB should, "rely principally, and perhaps exclusively, on auctioning," (pg. 63). CARB should make clear that free allocations, to the extent these occur, are not entitlements in perpetuity and should outline a clear pathway to ending free allocation to industrial sources absent compelling evidence that it is necessary to prevent leakage.

As noted by the UK Carbon Trust, "If [firms] get all the allowances they need, they may just continue with 'business as usual' behaviour, rather than trying to optimise – particularly if they believe that investments in lower-emitting technologies may just result in them receiving fewer allowances in

subsequent phases."[9] Benchmarking can reduce some types of distortions and potentially reduce windfall profits, but can also create production subsidies for GHG intensive products and create barriers to efficiency and lower/zero GHG alternatives.

We support CARB staff's preliminary assessment that free allocation will not be used for the transportation fuel sector when those entities come under the cap in 2015. Like electricity deliverers, CARB's proposed treatment of fuel deliverers will eliminate any leakage concern by assigning a carbon price to both in state producers and importers. And, as CARB correctly notes, fuel deliverers can internalize carbon prices in their fuel prices, thereby passing on those costs to end users. Thus, fuel deliverers do not need free allowances to account for leakage or for transition assistance and should be required to purchase allowances at auction. We strongly support CARB's proposal, presented at the May 17 workshop, that allowance value from the transportation sector be used to benefit Californians and to advance the goals of AB 32.

## CARB should focus transition assistance on helping businesses, especially small businesses, reduce their GHG footprint.

CARB is proposing to give free allowances to industrial polluters as transitional assistance "to smooth market start-up" and shield industrial sources from a carbon price. Defraying the cost of carbon runs counter to the purpose of the cap and trade program and the long-term interests of industrial sources because it blunts incentives for them to invest in low-carbon technologies. In addition, this approach appears to shut-out California small businesses. It is difficult to see any small businesses among the electricity producers, petroleum companies, and cement plants that are the 100 largest GHG sources in California (CARB, http://www.arb.ca.gov/cc/reporting/ghg-rep/ghg-reports.htm, accessed 6-1-2010). Instead of subsidizing large GHG emitters, CARB can instead focus on true transition assistance that helps make California businesses including small businesses more efficient and reduces their GHG footprint.

We agree with the ETAAC Advanced Technology sub-group, which supported following transitional assistance methods that included low and zero cost loans as well as accelerated depreciation to reduce capital barriers for equipment that helped companies move to low and zero carbon operations. This is especially important for small businesses, which typically have the least access to capital. As the ETAAC stated, "AB32 cap & trade allowances paid for by California businesses could be similarly used in part to help California businesses transition to most efficient 'best in class' operations while also helping create markets for advance zero and low GHG technologies."[10]

However, any assistance should be provided with careful oversight and legally enforceable requirements for investments in low-carbon technologies or practices. If regulatory overseers determine that allowance value is 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.

## CARB's proposal on allocating allowances to utility sector needs additional clarification to ensure that it advances AB 32's goals.

[9] EU ETS Phase II allocation: implications and lessons", p. 12, May 2007, UK Carbon Trust
[10] Advance Technologies to Meet California's Climate Goals: Opportunities, Barriers & Policy Solutions" December 2010 p. 2-6 and 2-7

In concept, many of our organizations are comfortable with CARB's proposal to allocate allowance value to California citizens through their regulated electric utilities, while others believe that utilities are not the preferred vehicle to return the proceeds back to California citizens. If designed correctly, the proposal to auction allowances to retail providers via a double-sided auction, with the requirement that providers invest the proceeds in low GHG energy resources on behalf of their customers, can accelerate investment in clean technologies and key emission reduction strategies, and guarantee a means of support for low-income customers.

We are concerned that if designed poorly this approach could fail to spur investments in our lowest cost reduction strategy (energy efficiency) and could divert vital resources away from achieving the complimentary objectives of AB 32. It is therefore imperative that CARB get the details right and direct allowance value to investments that will benefit Californians.

1. *Auction revenue should go toward more than offsetting the cost of the RES.*

The slides CARB presented at the May 17th workshop suggest that the sole purpose for which electricity deliverers should use auction revenue is to offset the rate impacts of complying with a 33% Renewable Energy Standard (RES).[11] We ask CARB to clarify that the guiding principle of the allocation scheme – that retail providers invest auction revenues on behalf of their customers – encompasses more than mitigating the rate impacts from the RES. As the Joint Utilities highlighted in their March 26 letter to CARB, there are several purposes for which auction revenue can be used to benefit their customers, including energy efficiency and targeted low-income assistance. Unlike offsetting rate increases, these investment opportunities can achieve additional emission reductions while providing bill relief to the customers who need it most.

2. *There are additional, low-cost reduction opportunities available to retail providers that will be lost if auction revenue is restricted to offsetting rate impacts.*

California has successfully implemented many complementary policies to encourage energy efficiency. However, energy efficiency programs run by California investor-owned utilities must meet a cost-effectiveness threshold that compares the cost of energy efficiency to the cost of avoided supply side sources. The cost-effectiveness test under AB 32, in contrast, compares the cost of reduction opportunities relative to each other. As a result, there are many energy efficiency opportunities that may not meet the CPUC cost-effectiveness test, but are still much cheaper than other reduction options identified in the Scoping Plan. Allowance value directed to utilities should therefore be used to achieve these additional, low-cost energy efficiency opportunities which might not otherwise be captured. If not, the whole cost of the AB 32 program will rise. In order to minimize costs, it is imperative that the allocation scheme be designed in a way that encourages utility-sector investments in demand-side, low-cost reduction options and leverages the vital roles of local governments and other community organizations that can be important partners for achieving demand-side reductions in our hardest to reach communities.

3. *Retail providers should receive allowances based on retail sales, adjusted for verified energy efficiency savings.*

We support CARB's preliminary thinking to allocate allowances to retail providers on the basis of retail sales.[12] Compared to historical emissions, a sales-based distribution will provide long-term incentives for retail providers to reduce the carbon intensity of their resource mix. While we appreciate CARB's

[11] See slides 33-34, 39.
[12] Slide 34

concern to provide transition assistance to regulated entities, we are not persuaded that retail providers with high historical emissions have not had sufficient time to begin this transition.[13] More importantly, allocating allowances on the basis of historical emissions will punish, not reward, those providers that have already made investments in low-carbon resources – in direct opposition to one of the key objectives identified by CARB for the design of the cap-and-trade program.[14]

While preferable to a historical emissions scheme, a sales-based scheme still faces the challenge of potentially discouraging investments in energy efficiency. This would be in direct conflict with California's loading order, which prioritizes energy efficiency as our cheapest, fastest, and cleanest energy resource. Accordingly, should CARB pursue a sales-based distribution, as recommended, it is vital that verified efficiency savings be included as a component of retail sales (i.e., distributing allowances to utilities not only for each kilowatt hour sold, but also for each kilowatt hour saved).[15]

*4. CARB must hold retail providers accountable.*

A critical component is ensuring that retail providers are accountable for the auction revenues they hold in trust for their customers. We assume that the CPUC and local governing boards of publicly owned utilities will oversee how auction revenues are used by retail electricity providers. While this provides an important oversight layer, CARB should maintain ultimate authority to ensure the utilities are investing allowance value on behalf of their customers and in accordance with the goals of AB 32. Key to that effort will be developing clear criteria for how allowance value may be used and building transparency into the process.

## CARB should elevate the priority given to the Community Benefits Fund and California Carbon Trust, which further the goals of AB 32.

CARB's proposal for distributing allowance value risks leaving the critical uses included under the Community Benefits Fund (CBF) and California Carbon Trust (CCT) largely unfunded. We urge CARB to recognize the vital importance these uses will play in enabling California to meet AB 32's reduction target at least cost and elevate their priority in subsequent proposals.

We recognize, as CARB has noted, that the EAAC proposed a tiered approach to distributing allowance value that first accounted for addressing leakage risk (if any). We do not agree, however, that CARB's current approach adequately respects the EAAC's thoughtful recommendations in this regard. Unlike CARB, EAAC anticipated the allowance value necessary to account for leakage would constitute "a very small share."[16] The Committee also expressed time and again the importance of investing allowance value in the types of investments that can be made through the CBF and CCT. Even if leakage risk proved greater than the Committee had anticipated, we find it hard to believe EAAC would have

[13] E.g., the program will launch a full six years after AB 32's passage (and long after regulated entities have been on notice of pending carbon regulation), will set the cap at projected business-as-usual-emission levels, and will gradually decline over time.

[14] Most recently, CARB stressed at the May 17th workshop that one of the principles guiding program design is to "reward those who have invested in energy efficiency and greenhouse gas reductions." Slide 3. Should CARB choose to allocate based on historical emissions at the outset, however, we recommend CARB transition to 100% sales-based distribution as soon as possible.

[15] This approach received broad support during the joint CEC/CPUC proceeding on GHG regulatory strategies, including from PG&E, SMUD, and SDG&E/SoCalGas.

[16] EAAC Final Report, p.63

recommended devoting almost no allowance value to the uses that constituted the lion's share of their recommendation.[17]

We appreciate CARB's recognition that the CBF and CCT are deserving of allowance value. Implicit in the tiered structure CARB has proposed, however, is that the concerns of imposing costs on industrial sources trump the equally important concerns addressed by the CBF and CCT (currently designated as 'subordinate'). We ask that CARB ensure a minimum amount of allowance value go toward funding these vital efforts.

## Appropriate investments for the Community Benefits Fund

The CBF should direct funds to the most impacted and disadvantaged communities in California to accelerate GHG emission reductions or mitigate direct health impacts of climate change in those communities. Funds appropriated should be used to provide competitive grants for projects including, but not limited to, the following:

a) Reduce greenhouse gas emissions, while achieving co-benefits such as reductions in air pollution;
b) Increase water and energy efficiency and conservation through retrofitting, replacing, or weatherizing activities;
c) Install clean distributed generation systems that utilize locally available renewable energy sources such as solar, wind, and geothermal energy;
d) Initiate or enhance public mass transit, and transit-oriented housing development.
e) Minimize the direct health impacts of climate change and prepare for emergencies from extreme weather events by taking actions such as the operation of air-conditioned cooling centers that are open to the public.
f) Provide community-based greening, forestry, or water-related projects, such as stormwater capture, tree planting, and water conservation and efficiency measures that have been recognized to reduce GHG emissions and produce co-benefits.

## Appropriate investments for the California Carbon Trust

We recognize that research, development and demonstration projects in zero and low GHG technologies are important. However, we also believe that it is important that the CCT direct funds to investments in other areas outlined below.

*1. Improvements to mass transit, land use planning and clean transportation*

Transportation is the largest sector of GHG emissions in California and the following are examples of appropriate investments in transit, planning and clean transportation will help achieve the goals of AB32 while benefiting California's businesses and residents:

a. Funding for Smart Growth planning;
b. Mass transit enhancements;
c. Incentives to improve commercial and passenger vehicles through early compliance and/or reductions beyond regulatory requirements;
d. RD&D for cleaner and more efficient energy supplies, including both improvements to conventional producers and alternatives.

[17] E.g., EAAC noted that the allowance value used to finance investments and returned to California households "is expected to represent the bulk of [allowance] value." p.68.

*2. Natural resource protection, including natural and working lands*

Allowance value should be directed toward the protection, improved management, and restoration of our natural resources, including natural and working landscapes to maintain and increase the suite of public and environmental benefits they provide, including GHG mitigation, the protection of air and water quality, recreation, food, fish and wildlife habitat, and employment. In a warming climate the protection of these resources will only become more critical. Specific investments should include, but not be limited to:

a) Research and demonstration to examine the farming practices and systems that reduce GHGs and sequester atmospheric carbon while providing environmental co-benefits;
b) Technical assistance to communicate and translate research findings into real opportunities for California agriculture to provide GHG reductions;
c) Incentives for agricultural and forestry practices to overcome barriers to practices that mitigate climate change and offer environmental co-benefits, including improved air and water quality, enhanced wildlife habitat and water conservation;
d) Land and easement acquisition to create and maintain habitat corridors and refuges for wildlife species, as well as pollinators to protect food supply;
e) Green infrastructure, restoration and improved management to reduce impacts of natural disasters, such as floods and fires (i.e. wetlands and forest restoration and management, invasive species control);
f) Biodiversity conservation to promote ecosystem resilience in a warming climate;
g) Watershed and stream protection, improved management and restoration for water quality and supply and habitat protection;
h) Urban forestry for air and water quality protection.
i) Land use practices that optimize natural resource protection and other environmental co-benefits.

*3. Workforce transition and job training.*

Funds should be directed to education, training and placement of workers in jobs and industries that are growing as a result of AB 32. Training programs should prepare workers for career pathways that provide prosperity for themselves and their families. Green job training programs should provide graduates with opportunities to be hired into green jobs, enter into union apprenticeship programs, receive education through adult schools, community colleges and four-year educational institutions, or other further job training.

## Returning allowance value to the public

Allowances should be seen as a public asset, since they represent permission to use the atmosphere, which belongs to all of us, to dispose of pollution. Therefore, the value of allowances should accrue to, and be used in, the public interest and to further the goals of AB32. In addition to the specific uses for allowance value outlined above, we support CARB's proposal to initiate a public rebate program to return the value of allowances to the people of California.

Thank you for reviewing our comments and considering our suggestions for strengthening CARB's proposal for allocating allowances and allowance value in California's cap and trade program.

Sincerely,

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