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<u>Electronic Submission</u>

California Air Resources Board
1001 "I" Street
P.O. Box 2815
Sacramento, CA 95812

Subject: **ARB Draft Scoping Plan Issued June 2008**
Comments of Morgan Stanley

Morgan Stanley Capital Group Inc. ("MSCG") has reviewed the Climate Change Draft Scoping Plan (the "Draft Plan") issued in June 2008 pursuant to AB 32.[1] It is clear that the California Air Resources Board ("ARB") has put a lot of work into this document. The Draft Plan comprehensively describes the broad range of policy options available to California to address the issue of climate change. MSCG believes that the decision to attempt an integrated regulatory framework across as broad a range of sectors as possible is a wise one. Specifically, MSCG endorses the implementation of a cap-and-trade program because it will enable ARB to achieve its desired environmental goals at the least cost to society.

Despite MSCG's general support for the approach described above, there are three aspects of the Draft Plan that MSCG finds troubling: (1) the proposal to restrict the use of offsets for compliance purposes to 10% of the obligation; (2) the high level of programmatic mandates contemplated; and (3) in relation to the above issue, the extent to which such mandates can isolate certain sectors from the rest of the economy, an example of which is the proposal to regulate the transportation sector via a low carbon fuels standard, thereby isolating it from the broader program as a whole. All of these recommendations will add costs to consumers without achieving any incremental reduction in greenhouse gas ("GHG") emissions.

With respect to the use of offsets in a cap-and-trade program, the Draft Plan explicitly acknowledges offsets' cost reduction benefits. Given such a substantial benefit and the theme of avoiding economic harm to California clearly underlying the Draft Plan, there can be no justification for limiting offsets to only 10% of any entity's compliance obligation. In addition, in keeping with the climate change mantra that "a ton is a ton," the criteria used for vetting offset

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1 Assembly Bill 32, Global Warming Solutions Act of 2006 (Núñez, Chapter 488, Statutes of 2006) ("AB 32").

eligibility should only consider quality factors. For those offsets that meet the quality requirements, there is no reason to apply any limitations based on quantity or geography. A priori, it is not known what offset opportunities will be available, at what cost, or in what locations. Imposing rigid geographical restrictions (*e.g.*, California/West Coast or WCI) risks making it difficult or impossible to find quality offsets at all, thus preventing offsets from making any contribution to cost mitigation. Therefore, the regulations governing offsets should be developed so that such offsets are thoroughly vetted against quality criteria, but once approved, their use should not be further limited.

MSCG firmly believes that the use of a market mechanism, such as a cap- and-trade approach, is the most efficient and cost-effective method of meeting California's emissions targets. Once implemented, the financial signals generated by a cap-and-trade program will stimulate innovation that may provide solutions not currently envisioned by anyone working to develop the regulations. The fallacy of programmatic mandates is that, inherently, if they truly are the most cost-effective solution they will be achieved without the mandate, or, in the alternative, the mandate will have imposed an extra cost.

Isolating particular sectors of the economy imposes additional incremental costs on the industry and consumers. For example, in the case of transportation fuels, the imposition of sector-specific reductions through a low-carbon fuels standard will leave other, less expensive reductions in other sectors (if such exist) unutilized. This adds costs without achieving any greater reduction of GHG emissions. Worse, excluding a particular sector of the economy from interaction with other sectors actually risks increased GHG emissions in certain situations. This may occur if a program designed for a specific sector has an unexpectedly harsh impact. The resulting political pressures for an abatement will likely be very strong and probably successful, thus leading to a relaxation of the standard in that sector, and therefore an increase in overall GHG emissions. On the other hand, if the sector suffering from the unexpectedly harsh impact is wholly integrated, the targeted reductions would simply be achieved from another, less expensive sector, avoiding both the harsh impact and failure to achieve the environmental objective.

MSCG recognizes that market failures do exist, and does not object to regulatory approaches that remedy true market failures. However, market failures should not be *presumed*. Only after a market failure is identified should measures to remedy the issue be undertaken. Even once a remedy become necessary, the true solution for a market failure is rarely, if ever, a mandate. Market failures generally stem from a lack of information, a conglomeration of market power, or barriers to entry. When these failures are identified, the approach should be to address the cause of the failure itself, for instance by providing more information, mitigating market power, or removing barriers to entry. Even in cases where the costs and benefits accrue to different parties, such as in the landlord – tenant problem, an example of an appropriate approach might be to create a generalized energy efficiency standard for commercial residential properties, rather than mandating a specific action, such as installation of triple glazed windows.[2]

MSCG appreciates the opportunity to comment on the Draft Scoping Plan, and looks forward to participating in the complete development of the regulations over the next two years. If there are follow-up questions on our comments, please contact the undersigned or Steve Huhman, Vice President, at (914) 225-1592 or at Steven.Huhman@morganstanley.com.

Sincerely,

/s/

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[2] While the landlord-tenant "problem" was included due to its common usage in public discussions, it is not clear that it is a viable example of market failure. While it is true that a landlord who installs energy saving equipment will not see the benefit of lower energy bills directly (assuming the tenant pays such bills), touting the energy efficiency of the property could make it more attractive to tenants who will benefit, thus allowing the landlord to charge relatively higher rents.