



NATURAL RESOURCES DEFENSE COUNCIL

June 11, 2007

Via e-mail to climatechange@calepa.gov

Winston Hickox
Chair, Market Advisory Committee

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Re: Comments on the Market Advisory Committee's Draft Report

Dear Chairman Hickox and Committee members:

On behalf of the Natural Resources Defense Council (NRDC), thank you for your hard work in putting together draft recommendations to help inform the California Air Resources Board's (CARB) policymaking process. As the draft Market Advisory Committee (MAC) report notes, CARB has been charged with determining whether AB 32 implementation will include market mechanisms, and if so, how they can best be designed to meet the law's goals. We appreciate you offering your expert advice to help assist CARB in making these decisions with regard to a cap and trade program.

The discussion among stakeholders about the pros and cons of cap and trade as a policy tool to reduce greenhouse gas (GHG) emissions in California, and the proper design of any such program, is only just beginning. NRDC is engaged in discussions with other stakeholders to explore these issues and to understand their varying perspectives in greater detail. As such, the following comments on the draft MAC report represent our preliminary views, and we expect that our views may continue to evolve as these discussions continue. NRDC supports many of the draft report's recommendations, and we focus our comments on suggestions for aspects of the draft report that we believe could be improved upon to design a program that is in the best interest of California and meets the requirements of AB 32. This includes achieving real emission reductions, providing net economic benefits, not disproportionately impacting low-income communities, and complementing state efforts to improve air quality and reduce toxic emissions. Attachment A to this letter provides more detailed comments on specific parts of the draft report. In addition, NRDC and a group of other environmental organizations are submitting another letter today with further comments on the draft report.

In summary, we urge you to revise the draft report to:

- 1) Emphasize that the stringency of the cap is of paramount importance.
- 2) Further explore both the strengths and weaknesses of cap and trade as a policy tool.
- 3) Recommend that offsets should be limited.
- 4) Recommend that allowances should not be grandfathered.

- 5) Urge that both the “load-based” and “first seller” approaches in the electricity sector should be analyzed.
- 6) Recommend that environmental integrity must be maintained if linkage is allowed.
- 7) Provide more specific recommendations on how the program can complement the state’s air quality and toxic reduction goals.
- 8) Set out guidelines for effective enforcement, including independent verification, transparency, and strong penalties.

Stringency of the Cap is of Paramount Importance

The benefits of a cap and trade program can only be realized if the cap is set tightly enough to achieve real reductions in emissions, beyond the level that could be achieved through regulatory programs alone. We agree with the draft report’s recommendation that the cap decline over time, and urge you to also emphasize (in section 4.1 and throughout the report) the importance of a sufficiently stringent cap to make the program effective.

The importance of a tight cap was a crucial “lesson learned” from both the RECLAIM program and the European Union’s “pilot” phase of the Emissions Trading Scheme. As the draft report mentions, a cap and trade program would work in concert with California’s other regulatory efforts, so the only way for it to be effective is to set the cap below what could otherwise be achieved. Therefore, we urge you to make clear that the level of the cap is perhaps the most critical element in the program’s overall effectiveness.

Further Explore Both the Strengths and Weaknesses of Cap and Trade as a Policy Tool

A cap and trade program is just one type of policy tool that CARB may consider in implementing AB 32. By clearly explaining both the strengths and weaknesses of cap and trade as a policy tool, the MAC report will better assist CARB in determining whether it should adopt a cap and trade program, and how such a program could complement the state’s other policies. The draft report mentions some concerns with a cap and trade program (section 2.5), but does not discuss specific weaknesses of cap and trade as a policy tool, such as its inability to overcome specific market barriers (e.g. for energy efficiency), or to spur innovation for a particular technology or in a specific sector.

In addition, the report should further explain that one of the most important strengths of a cap and trade program is that it creates an absolute limit on emissions that is enforceable against individual emitters. It would also be helpful to further explain the difference between the “cap” created by a cap and trade program (that is enforceable against individual emitters) and the “cap” created by AB 32 (which the state itself commits to achieve through a combination of policies). We urge the MAC to more fully explore these strengths and weaknesses in order to give CARB a complete understanding of the potential role of a cap and trade program in a package of policies to reduce emissions.

Offsets Should Be Limited

One of the benefits of a cap and trade program is that it incentivizes investment and innovation in the capped sectors. This is important to achieve the long-term changes within the capped sectors needed to secure the deep emission reductions necessary to curb global warming. Offsets allow emission reductions in uncapped sectors instead of in capped sectors, reducing the incentive for long-term changes and resulting in, at best, no overall change in emissions. While we recognize that there are many pros and cons to consider in determining whether offsets should be included in a program, we believe that there are better policy tools to achieve emission reductions in uncapped sectors.

We urge the MAC to revise its draft report to better explain both the pros and cons of offsets, and to recommend that offsets should only be considered if the cap is set tightly. Further we urge the MAC to recommend that if offsets are allowed, they should be limited to a small portion of the compliance obligation and to project types that will provide environmental and economic co-benefits to California.

Allowances Should Not Be Grandfathered

The draft report proposes several principles for how allowances should be distributed. We urge the MAC to highlight these principles as a key recommendation, particularly that allowance distribution should be designed to reduce costs to consumers, avoid windfall profits, promote investment in low-emission strategies, avoid perverse incentives, and advance the state's broader environmental goals. (Section 6.1.1) We further agree with the draft report's recommendation that "there should be no free allocation to firms under the cap that are able to pass most of their costs on to consumers." (p. 53) These principles and guidelines are important to highlight in the final report, because the allowance distribution methods that comport with them may vary depending on the point of regulation.

Under many program designs, including the one recommended by the MAC, auctioning allowances and using the proceeds to advance the goals of the law is the best means to meet the principles discussed above. Grandfathering allowances – that is, allocating them for free based on historical emissions – cannot meet these principles under any program design. We urge the MAC to explicitly recommend that allowances not be grandfathered. This is important both to meet the allowance distribution principles, and to encourage early action (discussed in Section 6.2 of the draft report).

Both the "Load-Based" and "First Seller" Approaches in the Electricity Sector Should be Analyzed

The draft report provides a useful initial analysis of how the state might make the "first sellers" of electricity into California's power market the point of regulation. However, the draft report leaves many questions unanswered that must be addressed before the state determines whether a "load-based" approach or a "first seller" approach to the point of regulation will best meet California's goals.

Perhaps most importantly, the draft report makes the questionable assumption that load-serving entities (LSE) will make identical investments in low-cost emission reduction strategies under both approaches because the price signal would be consistent. However, this ignores the fact that long-term investments in the electricity sector in

California today only occur with a long-term commitment from a LSE, and price is only one of many factors that an LSE considers. Under the first seller approach, individual generators and marketers would face penalties if sufficient allowances are not available to cover their emissions. Under the load-based approach, LSEs would face the potential penalties. Since LSEs will need to make the long-term investment decisions that determine what resources will be available in a future compliance period (when potential penalties might be assessed) many years in advance of that compliance period, they will be much more focused on investments in no- and low-carbon resources and ensuring that the cap will be met if they face potential penalties (under a load-based approach), than under a first seller approach where the generator or marketer faces potential penalties and the LSE can simply pass procurement costs through to customers. We agree with those on the committee who believe that the load-based approach “will produce stronger direct incentives for LSEs to pursue low-cost emission reduction strategies” (Table 5-3), and believe this should be a primary criteria in determining which approach to pursue.

In addition, the draft report does not provide a sufficient level of detail on how a first seller approach would work to support its claim that it would create an easier system to track emissions and administer. The draft report assumes that CARB could track and enforce against entities that are the first sellers of electricity into the state. However, the draft report simply assumes that this would be accomplished through “E-tags or through some other reporting mechanism,” (p. 40) but does not explain how CARB would gain access to this information and ensure that it is complete, or estimate how many entities this might include. These and other tracking issues are important issues that must be addressed before California determines which approach would be administratively simpler. The draft report’s recommendation of a first seller approach appears to rest on the assumption that it would be relatively simple and easy to track emissions (p. 49). However, we believe these issues merit further exploration. Given the significant unanswered questions, and the technical nature of these issues, we urge the MAC to revise the draft report to recommend that the CPUC, CEC, and CARB explore the first seller approach alongside the load-based approach in their ongoing proceeding.

Environmental Integrity Must be Maintained if Linkage is Allowed

NRDC believes that linkage should only be considered with other jurisdictions if stringent criteria are met. We agree with the draft report’s statement that CARB would need to negotiate terms with specific jurisdictions individually, and monitor any linked systems to ensure that they continue to meet its requirements. While we agree with many of the design considerations the draft report presents in this section, we offer two suggestions for the final report. First, we disagree that “stringency of targets” does not pose compatibility problems between systems (p. 66). To maintain the environmental integrity of California’s system, it would require that any linked systems have stringent caps. In addition, we urge the MAC to recommend that a condition of linking should be to further tighten the combined cap. Second, we suggest that the Committee include concerns about “leakage” in its discussion of environmental integrity in this section. CARB would need to consider whether another jurisdiction’s system is prone to leakage before determining whether a link would be appropriate.

Complementing the State's Air Quality and Toxic Reduction Goals

AB 32 requires that CARB do all of the following before including a market-based compliance mechanism in its regulations: "(1) Consider 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. (2) Design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants. (3) Maximize additional environmental and economic benefits for California, as appropriate." As described in more detail in a letter submitted by a group of environmental organizations today, we urge the MAC to provide more specific recommendations on how the program can complement the state's air quality and toxic reduction goals and meet the requirements of the law. We agree with the draft report's recommendations to use a portion of the allowance value to help meet these goals, and to monitor the impact of the program over time. We urge the MAC to consult with the Environmental Justice Advisory Committee, and to explore additional ideas, such as:

- Evaluate potential strategies covered entities in each sector might use to comply, identify problematic strategies that could increase air or toxic pollution, and either prohibit these strategies or do not include a sector that might use problematic strategies in the program.
- Monitor the program's impact on air quality and toxic emissions by incorporating these considerations in mandatory reporting systems, make the data publicly available by source and sector over time, and promptly act to address any problems that are identified, for example, through complementary regulations or by requiring a higher "allowance ratio" (e.g. 1.5-to-1) for all allowances purchased in those areas.
- Identify specific technical strategies for covered sectors that will reduce both greenhouse gas emissions and other co-pollutants; promote investments in these strategies as means to comply with the program through more targeted complementary programs.

Effective Enforcement Requires Independent Verification, Transparency, and Strong Penalties

As the draft report notes, a rigorous system for collecting data is the foundation of a successful cap and trade program (section 7.1), and public confidence in a regulatory system is an important element in its success (section 7.5). We urge you to recommend that emissions reporting be independently verified in order to ensure its accuracy, and that CARB should strive for maximum transparency to facilitate public understanding of the system. We further agree with the draft report's recommendation that penalties "should be automatic and non-negotiable," with civil and criminal penalties for intentional violations (section 7.3). We urge the MAC to also recommend that these automatic, non-negotiable penalties include a monetary fine and a requirement to surrender a multiple of the shortfall of allowances. In addition, we urge you to include a summary of these recommendations at the end of section 7 and section 8.

Thank you for considering these suggestions as you finalize your recommendations to CARB.

Sincerely,

Kristin Grenfell
Project Attorney

Devra Wang
Director, California Energy Program

Attachment A

We also offer the following more detailed comments on specific parts of the draft report.

p. 7 – It would be useful to clearly explain in this initial description of a cap and trade program the difference between “trading” and “offsets.” These mechanisms have important distinctions, but the terms are often used interchangeably.

p. 31, Table 4-1 – This table significantly overstates the contribution of any potential cap and trade program’s emission reductions towards the AB 32 limit, because it does not account for the emission reductions achieved by the complementary regulatory programs and standards in the capped sectors. The cap and trade program would achieve the additional increment of emission reductions beyond those achieved by the regulatory programs (and help provide a backstop to ensure the savings from those programs are achieved). We suggest that the table subtract out the reductions expected from the complementary programs, or explicitly note that this has not been accounted for.

p. 39, Box 5-1 – This box is missing a significant number of recent PUC policies that reduce greenhouse gas emissions, including adoption of ten-year electricity and natural gas saving targets, implementation of the renewable portfolio standard, and implementation of SB 1368’s greenhouse gas emission performance standard for long-term financial commitments to baseload generation. In addition, the CEC has adopted several policies that reduce emissions from the utility sectors.

p. 40 – This section could discuss the use of a high default value, or using data that “intentionally overestimate emissions in order to create incentives for complete monitoring” that you mention on page 70. We agree that using a high default value is more likely to incentivize reporting.

p. 48 – This section on the Western Regional Climate Action Initiative should note that Oregon, the only other state in the Initiative that has looked at cap and trade designs in detail, had a stakeholder process that recommended a load-based cap.

p. 53 – While we generally support the draft report’s recommendations for what allowance auction revenues should be invested in, we emphasize the need for this funding to supplement and not replace existing funding sources. In particular, the state’s existing energy efficiency programs are funded through a public goods charge and utility procurement funding that provide a stable source of funding critical to the success of the energy efficiency industry, and these cost recovery mechanisms should be maintained.

pp. 63-64 – We agree with your conclusion that a safety valve should not be included, and believe you could state this conclusion even more strongly in section 6.4.2, in addition to your recommendation in the summary that a safety valve not be included.

p. 84, 86 – We urge the MAC to clarify the definition of “credits”, “carbon credits”, “emissions trading”, and “offset.” These are key terms in understanding a cap and trade program design and are often used in multiple ways, so it is essential that the final report be clear about how it is using these terms. “Credits” are often used to mean “allowance” or “offset,” often causing confusion since these are two very different instruments. The current vague definition of “credit” leads to further confusion in the definition of both “emissions trading” and “offset.” In addition, “emissions” are not traded; rather, “allowances” are traded. We suggest a more precise definition of “trading” such as “A mechanism authorized by the regulator allowing entities to buy and sell allowances, and authorizing covered entities to use allowances purchased from other entities for compliance.”