Cap and Auction Design Position Paper

Supporters as of April 1, 2008

A package of policies is needed to meet AB 32's 2020 emissions limit and the state's 2050 goal. Meeting the Global Warming Solutions Act's 2020 pollution limit, and the Governor's deeper reduction target by 2050, will require many different policy tools to reduce emissions in many parts of the economy. We firmly believe that continuing and expanding the state's regulatory policies that reduce global warming pollution and provide air pollution reduction co-benefits should be the foundation of the AB 32 implementation plan. This includes multiple regulatory and market-based policy tools, including the energy efficiency standards and programs, renewables portfolio standard, emissions performance standard for generation investments, clean car standards and incentives, and low-carbon fuel standard. We urge CARB to deploy tools to assess the potential cumulative impacts of this package of policies.

We support CARB's consideration of several types of market mechanisms, as discussed at the January 16th workshop, including a cap and trade program, incentives, fees, and rebates. We recognize that every policy tool has strengths and weaknesses, and we urge CARB to adopt a package of multiple policy tools that takes advantage of the relative strengths of each of the different policies to meet the multiple requirements of AB 32. This document focuses on only one of these tools - a cap and trade program - without pre-judging whether any of our organizations will ultimately support any particular cap and trade program.

Process and requirements in AB 32 must be met. We support CARB's plan to hold workgroup meetings to hear perspectives from all interested stakeholders on cap and trade as a policy tool and how to best design a program. This process must include, at a minimum, meeting the requirements of Health and Safety Code Section 38570 to consider the impact on criteria and toxic air pollutants,[1] and providing opportunities for the Environmental Justice and Economic and Technology Advancement Advisory Committees and all stakeholders to provide input.

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1. Health and Safety Code Section 38570(b) 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."

Any cap and trade program must meet the objectives of AB 32. A cap and trade program is a regulatory and market-based policy tool in which a limited number of allowances to emit greenhouse gases would be created and regulated entities would be required to hold enough allowances to match their emissions. AB 32 makes clear that CARB must seek to achieve at least the following objectives when adopting any cap and trade program:

- Distribute allowances in an equitable manner
- Seek to minimize costs and maximize total benefits to California
- Encourage early action to reduce GHG emissions
- Not disproportionately impact low-income communities
- Provide appropriate credit for voluntary early action
- Design the program to prevent any increase in emissions of toxic or criteria air pollutants
- Minimize administrative burden and leakage

Elements of a Well-Designed Cap and Trade Program

Any cap and trade program is comprised of many inter-dependent design elements that ultimately must be evaluated as a package. We offer our general views on each individual design element below.

- **Tight Declining Cap.** A tight cap that declines over time and provides real emission reductions is the most important design element, as it determines the program's environmental impact and contribution to AB 32's 2020 limit and the state's 2050 reduction goal. The cap should eventually cover, at a minimum, the main sectors that burn fossil fuels, including the electricity, large industrial, natural gas, and transportation sectors; other sectors should also be considered for inclusion where capable of being effectively monitored and verified. A tight cap is essential in order to ensure real emission reductions are achieved. In addition, a tight cap will ensure that the cap and trade program drives innovation and thereby contributes to the transition to a low carbon economy and in particular supports California's rapidly growing clean tech industries.
- **Auctions and Using Allowances in Public Interest.** 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. Auctioning allowances and using the auction revenue to provide consumer and emission reduction benefits is the preferred method of distributing the value of allowances. Allowances should not be grandfathered (i.e. freely distributed to covered emitters based on historical emissions). Objectives for distributing the value of allowances should include the following, and we urge CARB to provide a detailed description (and take further public input on) how the value of allowances would be distributed.
    - Prevent the creation of large profits (or "windfall profits") for businesses that are unrelated to actions to reduce GHG emissions;
    - Reduce the cost and maximize the benefits of the program to consumers, especially in low-income communities, primarily through programs to help permanently reduce energy costs, such as energy efficiency and weatherization programs, as well as through direct payments such as per capita rebates, and through job skills training

programs that can help transform the state's economy into a low-carbon economy and help transition affected workers;
    - Support additional investments in, and deployment of, technologies and strategies to reduce GHG emissions, such as energy efficiency, renewable energy and transit, as well as research, development and demonstration of innovative technologies to reduce emissions;
    - Encourage action that will reduce emissions prior to the start of the overall AB32 program in 2012 and ensure fair treatment for "early actors" that have proactively reduced GHG emissions;
    - Direct investments to disadvantaged communities to support air pollution reduction efforts and enforcement programs, enhance their adaptive capacity, green community development, energy efficiency improvements and renewable energy technologies;[2] and
    - Protect natural resources that can help sequester carbon dioxide and enhance the adaptive capacity of those resources to climate change.

- **Limited Offsets.** AB 32 sets an economy-wide limit on global warming pollution, so reductions will be needed from every major sector of the state's economy. Offsets do not provide additional reductions towards the 2020 limit, but rather provide emission reductions in a sector outside the cap and trade program *instead of* emission reductions in a capped sector. Therefore, CARB should use regulatory programs and other policies to achieve emission reductions in sectors outside the scope of the cap and trade program, so that they can contribute to meeting the statewide 2020 limit, and the further reductions necessary to meet the state's 2050 reduction goal. A necessary precondition to including offsets in a cap-and-trade program is a tight cap; *if* offsets are allowed, they should be subject to at least the following conditions:
    - Represent a limited portion of covered entities' compliance obligation, to ensure that offsets are a limited fraction of the reductions the overall program would achieve;
    - Discounted where appropriate to compensate for loss of local or in-state environmental benefits and for the uncertainty of the emission reductions;
    - Limited to specific project types that have stringent protocols to ensure the emission reductions are real, quantifiable, additional (beyond business as usual), permanent, subject to independent third-party verification and enforceable by CARB; and
    - Priority should be given to projects that will provide environmental co-benefits to California, especially in communities suffering from excessive levels of pollution.
- **Complementing Air Quality and Toxic Reduction Goals.** Any program should be designed to explicitly consider the impact on air quality and toxic emissions, both in local communities and statewide, and to complement state efforts to reduce these emissions, as AB 32 requires. CARB must design any cap and trade program to prevent any increase in toxic and criteria air pollutant emissions. In addition, CARB should strive to achieve additional air quality co-benefits from greenhouse gas emission reductions measures to provide near-term public health benefits, especially in communities that have traditionally been impacted by multiple sources of air pollution.

2 Health and Safety Code Section 38565.

- **Strong Monitoring and Enforcement.** Vigorous monitoring and enforcement of emissions, trades, and regulatory compliance is of paramount importance. The program will only limit emissions and provide an environmental benefit if enforcement is strong, consistent, and prompt. Every regulated entity within the cap and trade system must be subject to mandatory annual reporting. Enforcement against an entity whose emissions exceed its allowances should include fines, a requirement to surrender a multiple of the allowances not surrendered, and the other legal remedies (including civil and criminal penalties) contained in AB 32. In particular, there should be a clear penalty up-front for any excess emissions that is large enough that that no rational covered entity would choose to pollute and accept the penalty.
- **Benefit environmental justice communities.** CARB should ensure that any cap and trade program carefully follows all the guidelines in AB 32 for evaluation and prevention of environmental justice impacts. CARB should also design the program to provide benefits to the communities that suffer the greatest cumulative impacts from air pollution. Potential approaches that should be considered include: (i) directing auction revenues to benefit these communities, (ii) limiting the geographical or sectoral scope of the program; (iii) requiring entities purchasing allowances contribute to a community benefits fund.
- **Flexibility and Cost-Containment.** Trading of allowances, banking, and a multi-year compliance period are preferred methods to provide flexibility and lower the costs of the program. (This document does not make specific recommendations about whether trading should be allowed among capped sectors, or be limited to specific geographical areas based on cumulative impact assessments.) *A price cap on allowances (a "safety valve") should not be included, because it would break the program's cap and allow emissions to increase.*
- **Transparency.** The program should make data on emissions, allowances, trades, prices, and evaluations of compatibility with air quality and toxic reduction efforts transparent and publicly available by source and sector in a timely manner to establish a well-functioning program.
- **Linkage with Comparable Programs.** Linkage (i.e. allowing covered entities to surrender allowances issued by another jurisdiction) can provide benefits such as reducing leakage and lowering costs, but should only be considered if the other jurisdictions' programs meet stringent criteria (e.g., comparably stringent caps, comparable mandatory reporting, strong enforcement, limited offsets, etc.) in order to maintain the integrity of the program.