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May 4, 2009

Senator Fran Pavley
State Capitol, Room 4035
Sacramento, CA 95814

Dear Senator Pavley,

We are grateful for your leadership and expertise on the overriding issue of climate change. We write to request your assistance in ensuring that the central purposes of AB 32 (2006) are given effect, as the process to implement the measure proceeds.

In particular, we request that your Select Committee on Climate Change and AB 32 Implementation examine several important issues relating to the consistency of ARB's implementation plan with the statutory requirements and intent of AB 32. Starting on page three, we provide more detail on these, which we briefly summarize here:

- (1) **Passenger Vehicle Regulation:** Under ARB's cap-and-trade plan, any additional emission reductions from mobile sources would be nullified by increased emissions in other sectors.
- (2) **Offsets:** Reliance on out-of-state offsets for up to 49% of the capped sectors' emission reductions does not comport with the statutory limit on emissions "in the state".
- (3) **Maximum Emission Reductions under AB 32:** ARB's current AB-32 implementation plan does not provide incentives for maximum greenhouse gas emission reductions as required by Sec. 38560. It would only motivate the minimum reductions sufficient to achieve the cap even if further reductions could be achieved at zero cost.
- (4) **Cost-Effectiveness Criterion for AB 32 Implementation:** ARB has not established a cost-effectiveness threshold that is at least compatible with the planned cap-and-trade system, and the current cap-and-trade design would not deter a price collapse below any defined cost-effectiveness threshold.

Thank you for your consideration. We look forward to discussing this with you and with your staff at your earliest opportunity.



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1. Emission Trading and Passenger Vehicle Regulation under AB 32

According to ARB's Scoping Plan for AB 32 implementation, passenger vehicles could achieve emission reductions beyond the existing Pavley standards at an incremental net savings of \$262/MT. (This is the balance between \$149/MT costs and \$411/MT benefits, for achieving an additional 4 MMT reduction in 2020.¹) This estimate may even be overly cost-conservative, considering that hybrid costs could fall by a factor of three over the next decade² and fuel prices may be higher than ARB's assumed \$3.673/gallon (2007 dollars) in 2020³. The combined benefits of greenhouse gas reductions, cost savings, and energy security make a compelling rationale for incentivizing expedient commercialization of low-carbon vehicle technologies such as hybrids and alternative fuels (including grid-connected electricity).

Passenger vehicle emission reductions significantly beyond the Scoping Plan projections may be achievable at zero or negative net cost. But under the planned cap-and-trade system such reductions would not result in any reduction in statewide emissions; they would only result in a transfer of emission allowances to other sectors. Absent a reasonable price floor for auctioned allowances in the trading system or similar design feature, there would be no environmental benefit; the only benefit would be reduced emission trading prices, even if the market price is well below the projected \$10/MT.

The following question relates to emission trading under AB 32:

- If significant further emission reductions from passenger vehicles (beyond the Scoping Plan projections) can be achieved within limitations of feasibility and cost-effectiveness, should such reductions result in decreased statewide emissions (rather than just allowing a transfer of emission allowances to other sectors without affecting statewide emissions)?

¹ based on the Draft Scoping Plan, Economic Analysis Supplement, Appendix 1, Table I-2 (Pavley 1 and 2) and Table I-3 (feebates) [www.arb.ca.gov/cc/scopingplan/document/economic_appendix1.pdf]

² "Hybrid Production Cost May Drop by Two-Thirds Over Next Decade," Bloomberg, Oct. 17, 2008, [www.bloomberg.com/apps/news?pid=20601207&sid=aUj9rsy0Q878]

³ Draft Scoping Plan, Economic Analysis Supplement, Appendix 1, Table I-1 [www.arb.ca.gov/cc/scopingplan/document/economic_appendix1.pdf]

2. Offsets to Statewide Greenhouse Gas Emissions under AB 32

ARB's current cap-and-trade plan for AB 32 implementation would allow up to 49 percent of the capped sectors' emission reduction requirement to be achieved through offsets from other uncapped jurisdictions. The rationale for offsets is that California could achieve its near-term compliance obligations at lower cost, while also providing near-term economic benefits to other jurisdictions. But long-term costs may be greatly increased if offsets deter sufficient near-term investment in the fundamental technology and domestic infrastructure changes that will be needed to achieve post-2020 emission reduction goals.

Offsets could also make California economically dependent on low-cost emission reductions that may no longer be available if other jurisdictions adopt greenhouse gas regulations similar to California's, even as California is increasing the stringency of its own regulations. In this case, California would have a perverse economic interest in not having its regulations adopted by others. Alternatively, if California and the WCI were to secure long-term access to low-cost offsets through binding contracts and commercial acquisitions, then other jurisdictions may be deterred from adopting comparable regulations because low-cost compliance options will have been monopolized by the WCI.⁴ To the extent that such monopolization does deter or weaken climate regulations outside of the WCI, the offsets would not satisfy the "additionality" requirement of AB 32, Sec. 38562(d)(2).

Sec. 38505(m) defines "Statewide greenhouse gas emissions" to mean "the total annual emissions of greenhouse gases in the state . . .," but ARB's current AB-32 implementation plan is not limited by the stipulation "in the state". The following question relates to the use of compliance offsets under AB 32:

- Is the stipulation "in the state" in Sec. 38505(m) intended to limit ARB's implementation of AB 32 in any way?

⁴ This concern was voiced by the late Anil Agarwal and Sunita Narain of India's Centre for Science and Environment, in a 1998 Briefing Paper on the Kyoto Protocol, which stated the following:

If developing countries accept JI [Joint Implementation] then all that they are doing is to let the cheaper carbon dioxide reduction programmes go to industrialised countries. . . . it allows current generations in developing countries to sell off cheaper emissions-control options today leaving their future generations straddled with high cost options.
from "The Atmospheric Rights of All People on Earth,"
[\[www.cseindia.org/html/eyou/climate/atmospher.htm\]](http://www.cseindia.org/html/eyou/climate/atmospher.htm)

3. Maximum Emission Reductions under AB 32

ARB's strategy for AB 32 implementation follows the precedent set by the U.S. acid rain program, which is achieving mandated emission reduction targets at a cost about 40 times lower than monetized benefits (primarily from reduced mortality).⁵ Additional reductions under more stringent regulations would have an estimated benefit-to-cost ratio of 25 to 1.⁶ However, the EPA's cap-and-trade system creates no incentive for long-term emission reductions beyond the cap limit, no matter how low the cost or how great the benefits (e.g., in terms of avoided deaths), and the EPA has encountered legal obstacles in trying to institute new regulations within the framework of the Clean Air Act.

Following the policy precedent set by the acid rain trading system, ARB has established a fixed cap for California's greenhouse gas emissions at 422 MMT in 2020⁷, and ARB's proposed cap-and-trade system, as currently envisaged, would not motivate emission reductions beyond the minimal cap requirement irrespective of whether such further reductions would be "technologically feasible and cost-effective" according to Sec. 38560 of AB 32. The achieved emission reductions would be determined solely by the 422 MMT target and would not be influenced by Sec. 38560; hence, the Sec. 38560 mandate requiring maximum emission reductions (subject to limitations of feasibility and cost effectiveness) would have no operative meaning and would not affect emission reductions under ARB's current plan.

The following question pertains to the maximum-reduction mandate of Sec. 38560:

- Is the qualifier "maximum" in Sec. 38560 ("The state board shall ... achieve the maximum ... emission reductions ...") intended to have any operative meaning and to at least potentially affect emission reductions under AB 32?

⁵ "Acid Rain Program Benefits Exceed Expectations," EPA [www.epa.gov/airmarkt/cap-trade/docs/benefits.pdf]

⁶ "Clean Air Interstate Rule," EPA [<http://www.epa.gov/cair/>]

⁷ The 422 MMT target is based on the state's 1990 emissions of 427 MMT, minus a fixed 5 MMT "margin of safety" to account for regulatory uncertainty.

4. ARB's Cost-Effectiveness Criterion for AB 32 Implementation

The 2020 emission limit imposed by AB 32 is not conditioned on feasibility and cost effectiveness. However, the Governor would have authority to suspend the regulations in the event that compliance costs approach the threshold of “significant economic harm” (Sec. 38599). On the other hand, the type of unrestrained price erosion or collapse that has occurred with prior cap-and-trade systems would not be consistent with the evident legislative intent of Sec. 38560, which requires “the maximum technologically feasible and cost-effective greenhouse gas emission reductions ...”.

A carbon tax or fee, unlike cap-and-trade, would maintain a stable price incentive based on a mandated emission price. Some stakeholders, the AB-32-instituted Environmental Justice Advisory Committee⁸, and members of the Board⁹ have advocated for a carbon tax or fee as a possible alternative to cap-and-trade. ARB rejected a carbon fee in its Scoping Plan on the grounds that “a carbon fee does not provide certainty in terms of the amount of emission reductions that will be achieved.”¹⁰ However, a price floor, applied to auctioned allowances in a cap-and-trade system, could maintain a minimum price incentive while still guaranteeing the cap (subject to the Governor’s intervention authority). For example, if allowance prices are selling at the price floor, then unanticipated emission reductions in transportation emissions would not lead to reduced allowance prices and, thus, diminished emission-reduction incentives in other sectors.

Under the premise that the planned cap-and-trade system is cost-effective, the projected \$10/MT trading price would indicate that a marginal compliance cost of at least \$10/MT would meet the AB 32 cost-effectiveness requirement. But ARB has not yet established a cost-effectiveness threshold or a mechanism for preventing a price collapse below any defined cost-effectiveness threshold. The following question relates to the Sec. 38560 cost-effectiveness requirement:

- Should a cost-effectiveness threshold be established for the cap-and-trade system, in terms of a marginal “cost per unit of reduced emissions of greenhouse gases adjusted for its global warming potential” (Sec. 38505(d)), that is at least compatible with the currently estimated \$10/MT trading price?

⁸ <http://www.arb.ca.gov/cc/ejac/ejac.htm>

⁹ from November 11, 2008 Board meeting [www.arb.ca.gov/board/mt/2008/mt121108.pdf]:
BOARD MEMBER SPERLING (p 150-151): ... I would like to suggest that we keep the carbon tax idea on the table, not push it off yet too quickly. ... I would urge that we not completely disregard the possibility of carbon taxes here.

BOARD MEMBER BALMES (p 157): ... what I would ask is in the economic analysis that we do that we consider how a carbon fee/tax fits into a potential future picture. ... I don't see anything wrong with going ahead with the Cap and Trade Program that's been outlined, but also keeping options open with regard to analyzing a carbon tax.

¹⁰ Scoping Plan Appendices, Volume 3, p. J-87
www.arb.ca.gov/cc/scopingplan/document/appendix3.pdf