



March 16, 2018

Dear ARB Board Members and staff,

Thank you for the opportunity to comment on the materials provided for ARB's March 2018 workshop on the implementation of AB 398's cap-and-trade program reforms. Our comments today focus on two issues: ARB's overall market design proposal and staff's proposed interpretation of AB 398 offsets limits. We will keep our comments brief and refer staff to more extensive analysis contained in two attached Near Zero Research Notes.¹

1. Pursuant to AB 398, ARB still needs to evaluate market oversupply conditions and allowance banking regulations.

AB 398 requires ARB to "[e]valuate and address concerns related to overallocation"² in the cap-and-trade program and "[e]stablish allowance banking rules that discourage speculation, avoid financial windfalls, and consider the impact on complying entities and volatility in the market."³ The Board's March 2018 workshop materials include some discussion of these requirements, but do not evaluate either issue. Staff has requested further stakeholder input on these topics.

¹ Danny Cullenward, Mason Inman, and Michael Mastrandrea (2018a), Implementing AB 398: ARB's initial post-2020 market design and "allowance pool" concepts. Near Zero Research Note (Mar. 16, 2018) (attached here as Attachment 1); Danny Cullenward, Mason Inman, and Michael Mastrandrea (2018b), Interpreting AB 398's offset limits. Near Zero Research Note (Mar. 15, 2018) (Attachment 2 here).

² Cal. Health & Safety Code § 38562(c)(2)(C).

³ *Id.* at § 38562(c)(2)(H).

Troublingly, ARB staff have indicated that they view the current oversupply of allowances in the market as a sign of its success, not a result of relative program laxity.⁴ Staff present no evidence to support this view.

Without mentioning any of the various independent studies and reports that have concluded the market is experiencing a significant oversupply condition—including analysis from the Legislative Analyst’s Office,⁵ the Environmental Commissioner of Ontario,⁶ Energy Innovation,⁷ Near Zero,⁸ and the Carbon Market Compliance Association,⁹ to name only a few—Board staff suggest that the “relationship between GHG reductions and carbon price requires a more thoughtful and in-depth evaluation – not simply [an analysis of] supply vs. demand.”¹⁰ If the Board believes that there are methodological deficiencies with these existing conclusions, it should make more specific criticisms and identify a better approach. We identify the elements of an oversupply calculation the Board should

-
- ⁴ ARB, Amendments to the Cap-and-Trade Regulation Workshop (March 2, 2018), slides 22-24.
- ⁵ Legislative Analyst’s Office (2017), Cap-and-Trade Extension: Issues for Legislative Oversight (Dec. 12, 2017), <http://lao.ca.gov/Publications/Report/3719>.
- ⁶ Environmental Commissioner of Ontario (2018), Ontario’s Climate Act: From Plan to Progress, Appendix G: Technical Aspects of Oversupply in the WCI Market, <https://eco.on.ca/reports/2017-from-plan-to-progress/>.
- ⁷ Chris Busch (2017), Oversupply grows in the Western Climate Initiative carbon market: An adjustment for current oversupply is needed to ensure the program will achieve its 2030 target. Energy Innovation LLC Report.
- ⁸ Danny Cullenward, Mason Inman, and Michael Mastrandrea (2017), California’s climate emissions are falling, but cap-and-trade is not the cause. Near Zero Research Note, <http://www.nearzero.org/wp/reports/>.
- ⁹ Comment letter from Andre Templeman (CMCA) to Richard Corey (ARB) (Sept. 15, 2016) (estimating oversupply at up to 300M allowances), available in ARB, Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanism: Final Statement of Reasons (Aug. 2017), 499-500, <https://www.arb.ca.gov/regact/2016/capandtrade16/ctfinsor.pdf>.
- ¹⁰ ARB workshop presentation, supra note 4, slide 23.

consider and would be glad to provide additional information to assist ARB staff.¹¹

Although ARB staff officially dispute the view that today's oversupply condition puts the program's environmental performance at risk, we note that the Board's proposed allowance pool concept would transfer some of the excess allowances in the post-2020 program budgets to the new price containment points and/or the price ceiling.¹² The total number of allowances that would be transferred under ARB's proposal is 75.1 million allowances. While removing this quantity of allowances from the auction supply curve could help address market oversupply conditions, the total transfers represent only 28% of Chris Busch's central estimate of market oversupply in 2020 (270 ±70 million allowances).¹³ They are therefore insufficient to address the extent of market oversupply documented by credible, independent studies.

We are preparing our own estimate of the number of compliance instruments banked at the end of 2017, beyond entities' expected compliance obligations. We believe our analysis will show strong evidence that substantial banking has already occurred. As soon as this analysis is complete, we will send it to ARB and also release it publicly. Because ARB has made several public statements arguing that market participants are not banking significant amounts of allowances beyond their need for emissions already incurred,¹⁴ we strongly encourage ARB to perform its own analysis and publish the results, methods, and underlying data.

¹¹ Cullenward et al. (2018a), supra note 1 at Appendix 2 (see Attachment 1 to this letter).

¹² ARB, Preliminary Concepts: Price Containment Points, Price Ceiling, and Allowance Pools (Feb. 2018).

¹³ Busch (2017), supra note 7.

¹⁴ See, e.g., ARB, Responses to Questions, for Joint Oversight Hearing of the Senate Environmental Quality Committee and Senate Budget and Fiscal Review Subcommittee No. 2 on Resources, Environmental Protection, Energy and Transportation (Jan. 17, 2018).
http://senv.senate.ca.gov/sites/senv.senate.ca.gov/files/arb_responses.pdf.

- 2. Rather than dispute the cause of market oversupply, ARB should consider how to develop a post-2020 market design that manages a transition from today's low prices to the higher prices that are likely needed to achieve California's 2030 target.**

Today's market prices are low because the supply of compliance instruments significantly exceeds near-term demand. Eventually, oversupply conditions will diminish and, absent a recession or major technological breakthroughs, carbon prices will likely rise—potentially to significantly higher levels. However, ARB staff have proposed a market design that does not include mechanisms to actively manage a gradual transition. By relying on market oversupply conditions to keep near-term prices low, the Board's proposal defers serious action, risks rendering the program ineffective at reducing emissions in the short term, and creates a political liability for the next administration to manage.

We urge the Board to consider an alternative approach wherein oversupply conditions are carefully managed via program cap adjustments, banking rules that discount the value of banked allowances, and/or other creative approaches developed collaboratively with stakeholders. Instead of relying on oversupply to manage prices—a strategy that will eventually stop working as caps decline in the years to come—the Board might consider setting price containment points at lower levels and implementing a graduated price ceiling that starts at a lower initial price and increases more rapidly over time. We note that these alternative cost containment strategies are warranted only if ARB simultaneously resolves market oversupply conditions; if combined with no action on oversupply, they would only weaken the status quo market design.

- 3. ARB needs to indicate how its proposed post-2020 offset limits are consistent with the legislative intent in AB 398.**

ARB has proposed interpreting AB 398's post-2020 offset limits in a way that substantially increases the number of allowable offset credits

in the years 2024 and 2025. Rather than apply the AB 398 offset limits on a calendar year basis—in which case 2024 and 2025 emissions would be subject to the lower 4% limit—ARB has proposed applying the higher 2026 calendar year limits (6%) to the bulk of compliance obligations associated with emissions in calendar years in 2024 and 2025.¹⁵

We calculate that this interpretation would increase the number of permissible offset credits by approximately 8.5 million, relative to a scenario in which the AB 398 limits applied on a literal calendar year basis and assuming covered entities' emissions are equal to program year allowance budgets plus maximum allowable offsets in each scenario.¹⁶

ARB has not justified its interpretation as being consistent with the statutory text in AB 398, which appears to apply to calendar year limits. ARB should explain how its proposed interpretation is consistent with the legislative intent behind AB 398.

4. ARB should exclude consideration of greenhouse gas emissions from its proposed bottom-up determination of an offset project's "direct environmental benefits."

In addition to setting overall limits on offsets usage, AB 398 also requires that no more than half of total post-2020 offsets limits come from projects that do not provide a "direct environmental benefit" ("DEB") to California air or water quality.¹⁷ ARB has proposed a bifurcated approach to determining a DEB wherein certain bright-line conditions would automatically qualify an offset project as providing a

¹⁵ ARB workshop presentation, *supra* note 4, slide 25.

¹⁶ Cullenward et al. (2018b), *supra* note 1 (see Attachment 2 to this letter).

¹⁷ Cal. Health & Safety Code § 38562(c)(2)(E).

DEB while allowing all other projects the opportunity to make an individualized case as to whether or not they provide a DEB.¹⁸

We agree that a bifurcated approach to determining a DEB could, if executed carefully and consistently, fairly balance the need for program flexibility with AB 398's statutory requirements. However, if the Board elects this approach, it is critically important that ARB identify arguments that cannot be used to demonstrate a DEB.

Specifically, ARB should clarify that offset projects may not argue that their gross avoided or reduced GHGs generate a DEB. Offset projects produce no net GHG reductions because for every avoided or reduced GHG emissions, ARB awards an equal number of offset credits that will eventually be used by covered entities to increase their own GHG emissions by the same amount the offset project reduces or avoids. Thus, there is no basis whatsoever for an offsets project to claim a DEB on the basis of its gross GHG reductions.¹⁹ Accordingly, ARB should explicitly foreclose this argument in whatever process the Board ultimately adopts for determining whether or not an offsets project provides a direct environmental benefit to state air or water quality.

5. ARB needs to show how its proposed market design is consistent with the role the Board identified for cap-and-trade in the final 2017 Scoping Plan.

Finally, we reiterate the need for ARB to show how the market design it selects in the AB 398 implementation process is consistent with the large role the Board identified for the cap-and-trade program in its final 2017 Scoping Plan. The cap-and-trade program was identified as the single largest contributor to California's climate goals, representing 38% of the required cumulative emission reductions over

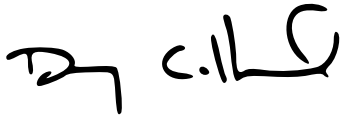
¹⁸ ARB, Preliminary Discussion Draft of Potential Changes to the Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (Feb. 2018), at 17-19.

¹⁹ Cullenward et al. (2018b), supra note 1 (see Attachment 2 to this letter).

the period 2021-2030²⁰ and almost 47% of the annual reductions projected for the year 2030.²¹ Whatever choices ARB makes in implementing its discretionary authority under AB 398 should be consistent with the role ARB identified for the cap-and-trade program.²²

We appreciate that the design choices facing ARB require difficult policy judgments and complicated technical analysis. Nevertheless, we urge ARB to be transparent in its process and to address the fundamental challenges present in the current market. If we can provide analytical support to the ARB in the future, please feel free to contact us.

Sincerely,



Danny Cullenward JD, PHD



Mason Inman



Michael D. Mastrandrea PHD

Disclaimer: Dr. Cullenward is a member of the California Independent Emissions Market Advisory Committee; however, this letter does not represent the official views of the IEMAC.

²⁰ ARB, 28.

²¹ *Id.* at 26.

²² We expressed this view in the Scoping Plan process. See Comment letter from Michael Mastrandrea and Mason Inman (Near Zero) to Rajinder Sahota (ARB) (Oct. 27, 2017), <http://www.nearzero.org/wp/2017/10/27/cap-and-trade-2030/>.

Attachment 1:

Danny Cullenward, Mason Inman, and Michael Mastrandrea (2018a),
Implementing AB 398: ARB’s initial post-2020 market design and
“allowance pool” concepts. Near Zero Research Note (Mar. 16, 2018).

Attachment 2:

Danny Cullenward, Mason Inman, and Michael Mastrandrea (2018b),
Interpreting AB 398’s offset limits. Near Zero Research Note (Mar. 15,
2018).