



BIG VISION, BOLD ACTION

The mission of the Climate Protection Campaign is to create a positive future for our children and all life by inspiring action in response to the climate crisis. We advance practical, science-based solutions for significant greenhouse gas reductions.

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Dear Chairman Goulder and Members of the Economic and Allocation Advisory Committee,

On behalf of the Climate Protection Campaign, we offer the following comments. Market design has the potential to be either the best or worst part of the state's AB32 implementation. Well-designed market measures can produce the right incentives to reduce GHGs throughout the economy, accomplish reduction goals efficiently, and distribute revenues to assist consumers through the transition. However, if designed improperly, market mechanisms can exacerbate inequities, delay real reductions, subsidize or enrich the largest emitters, and do more harm than good.

We submitted comments previously to the Market Advisory Committee (MAC) and the ARB's AB32 Draft Scoping Plan. In those comments we advocated for:

- **An upstream system**
- **100% auction of permits**
- **Compensating consumers with Cap and Dividend**
- **Carbon fees to fund important programs and a price floor on allowances**

These comments will also address issues with the CPUC's analysis of auctions and dividends, why allocation to utilities differs from dividends to consumers, and how dividends can address concerns expressed by high-emitting utilities.

An upstream system

An upstream system refers to a point of regulation closer to where fossil fuels enter the economy. An upstream system provides greater coverage and is simpler to administer. Since greenhouse gases (GHGs) are ubiquitous in the economy, an upstream system is more appropriate. Facility-based (downstream) models such as the SO₂ market, RECLAIM, and the European Emissions Trading Scheme (ETS) often lead to sector-by-sector allocations, which can cause distortions in allocation for example between the electricity sector and the transportation sector.

The downstream point of regulation is one cause of the ETS' difficulties in incorporating transportation fuels. An upstream, auctioned system is more flexible for an economy-wide system. We commend ARB for choosing an upstream system for its proposed AB32 administrative fee.

Auction 100%

Since the MAC meetings in 2007, auctioning has become recognized as the preferable allocation method for cap and trade systems. The most vocal opponents to auctioning are almost always lobbyists for organizations that have high emissions and want free allowances. A current giveaway transitioning to 100% auction is sometimes offered as a political compromise. This only delays the emergence of a carbon price signal, leads to market uncertainty and volatility, and encourages gaming behavior from lobbyists.

In his EconomicPrincipals.com newsletter, David Warsh notes the growing recognition of auctions by the National Bureau of Economic Research's Market Design Working Group, and that although politicians try to avoid auctions, they are inevitable:

"President Obama campaigned on a promise to auction the permits. But a coalition of Midwestern and Southern Democrats teamed up to alter the (Waxman-Markey) bill, and when its language was released last week it turned out that fully 80 percent of the permits would be given away at first to electricity utilities and their big industrial customers, with the portion of permits to be sold at auction slowly rising to 100 percent by 2030..

But the historical momentum in this case is clearly on the side of equality. Auctions, especially auctions of government property, are not a tool of the rich, especially when coupled with egalitarian principles of distribution (for instance, the proposition that every citizen should benefit equally when the radio spectrum is sold). As principles of market design become more thoroughly articulated and widely understood, the sphere of governmental discretion will shrink. More and more, politicians will be forced to play by the rules."¹

Every allowance that is given to large emitters for free reduces the amount of potential auction revenue available for public trust investment or consumer rebates. A *phased-in* auction system takes auction revenues away from consumers and gives them, presumably, to large emitters in order to prevent them from feeling the full impact of the carbon price signal. But allowing large emitters to avoid a price signal defeats the purpose of cap and trade. Phasing-in auctioning could also complicate linkages between state and regional systems. Large companies or emitters could play each state's market against the other to try to achieve special favors and free allowances, resulting in a "race to the bottom." For these reasons, going directly to 100% auction is preferable to phasing-in auctioning.

Compensating consumers

As mentioned in our comments previously submitted on the draft MAC report and the AB32 Draft Scoping Plan, consumer compensation may provide popular political support for further emission reductions, and if done on a per capita basis, would address disproportionate impacts and environmental justice concerns.

¹ Warsh, David. May 24, 2009 EconomicPrincipals.com Newsletter
<http://www.economicprincipals.com/issues/2009.05.24/412.html>

As you know, Governor Schwarzenegger's May 22, 2009 letter of invitation to EAAC members recognized the importance of a market design that gives the value of allowances to the people of California, saying,

*"Among other tasks, you must carefully consider various options for freely distributing or auctioning allowances potentially worth billions of dollars and, if auctioned, for distributing or deploying auction revenues. In that regard, there is one idea in particular I would like you to explore among other options: **the concept of returning the value of allowances back to the people, including through an auction of allowances and distribution of auction proceeds in the form of a rebate or dividend, in order to minimize the cost to California consumers and maximize the benefits to the state's economy.**"*

The MAC Final Report supported consumer compensation:

"The Committee believes that it is appropriate to devote a portion of allowance value to the general public. In doing so it reduces the impact of the cap-and-trade system on consumers. If allowances are auctioned, some of the revenue from the auction can be used to finance reductions in State tax rates, or can be returned to taxpayers directly through rebate checks, perhaps on a per-capita basis." (pg. 57)

"CARB may wish to convene an advisory group involving persons with budgetary experience and wide knowledge of energy, environmental, tax and budgetary policy, and including representatives of both the Department of Finance and the Legislature, to prepare a study outlining several sensible options for recycling revenues to businesses or individuals." (pg. 57)

"Some observers have suggested that CARB may not have the authority to auction and that auctioning might require further legislative action. If this is the case the agency could consider a number of alternatives to implement a design that would resemble an auction, including allocation to a public trustee, LSEs, or local distribution companies who could auction allowances on behalf of the state's citizens, or direct allocation to households." (Pg. 59)

A Cap and Dividend program functions by auctioning permits to companies and then returning auction revenues to consumers as a per capita dividend. The Dividend can be designed to bypass the State General Fund and be revenue-neutral for the government. Cap and Dividend removes political pressure from CARB, because there would be no free allocation of permits (choosing winners and losers) or choosing between competing programs to spend the revenues (also choosing winners and losers). Instead, with the Dividend, all Californians are winners. Another approach with a similar outcome is called Carbon Share, where permits are first allocated directly to consumers as a "Share" and then sold to upstream companies via brokers, eBay, or other methods.

We encourage the EAAC to examine approaches such as Cap and Dividend and Carbon Share. More information on consumer compensation may be found at the following websites: www.capanddividend.org, www.carbonshare.org, or www.climateprotectioncampaign.org.

If revenues raised in an auction are returned to consumers on a per capita basis, this is scalable and can facilitate linkages if adopted by other states in the Western Climate Initiative (WCI), and a national or eventually international system. If, instead, ARB chooses to provide certain communities with set-asides (for example, setting aside 30% of revenues from an auction for specific environmental justice communities), this may lead to a politicized and contentious process in each WCI state resulting in

different outcomes depending on the demographics and political clout of each state's disadvantaged communities. Nationally, there will be a patchwork of different policies and set-asides. When different groups achieve more political power, they may seek to change or dismantle the system, similar to the gaming and lobbying problem with giving away allowances instead of auctioning them. A per capita dividend, rebate, or share is a simpler, more transferable, and more inclusive approach.

Lest the EAAC be tempted to divide auction revenues into hundreds of tiny pieces (as the House's version of HR.2454 American Clean Energy And Security Act of 2009 (ACES) did), and only provide a small fraction back to consumers, here are several "showstopping reasons to not spend the revenue" on anything other than dividends, adapted from a presentation by Dr. Holmes Hummel of UC Berkeley:²

- Major programs are better funded through annual appropriations, government purchasing priorities, changes in subsidies and expenditures, and fees rather than auction revenues. Carbon fees are more predictable than allowance prices, and allow for easier planning of project budgets. Fees and caps can co-exist.
- Other funds are available for spending on emissions reducing programs. In California, money is being continually invested in the parking structures, new highway lanes and widening roads, resulting in higher GHGs.
- Anything you could fund with auction revenue wouldn't start until 2013.
- The price signal needs to endure while spending priorities will change. The two decisions should be kept separate, not combined.
- Lobbyists will take as much as they can get away with, leaving those without a strong voice in Sacramento with nothing. Some questionable projects have strong lobbyists (ethanol, clean coal, nuclear, etc.) and could overwhelm better projects that have weaker lobbyists.
- A carbon price will affect household budgets, and if the money is not returned, it will be labeled "raising taxes," and spur a "taxpayer revolt."
- Competing claims are strong: National debt, education, and liability to elders and veterans. Once politicians see revenues being spent, it will be tempting to "borrow" from those funds.
- But when you try to protect auction revenues from the appropriations process, you create "the mother and father of all earmarks."
- No matter how much money you spend on compensation, it will never be enough for the fossil fuel companies being driven into new product lines. They will still complain they need to be made whole, but that money would be coming from the poor people into the pockets of the wealthier people (shareholders).
- If you spend a large proportion of the money (rather than return it), fossil interests will exploit distributive claims and prevailing distrust of government to destroy the policy within a matter of a few election cycles. **The best defense for the policy is to engage those households directly (i.e. provide a dividend).**

Regarding utilities

The California Public Utilities Commission (PUC) has made some conflicting rulings regarding auctioning and the use of auction revenues. On the one hand, they have expressed support for the idea of using auction revenues for consumer benefit.³

² Dr. Holmes Hummel's presentation [Committing a Carbon Trust: The Trillion Dollar Bargain](http://www.holmeshummel.net/ClimatePolicyDesign/) is available at <http://www.holmeshummel.net/ClimatePolicyDesign/>

³ CPUC. [Proposed Revised Interim Decision on Basic Greenhouse Gas Regulatory Framework for Electricity and Natural Gas Sectors, Draft Joint Agency Decision, publication # CEC-100-2008-002-D.](#) March 11, 2008.

"We have determined that the next portion of this proceeding can be most focused and productive if a few major design principles are adopted in this decision. As a starting principle, it is important that any policy for distribution of allowances provide that revenues from the sale of allowances be used primarily to benefit consumers in the energy sectors directly." (Pg 7)

"An integral part of this auction recommendation is that the majority of the proceeds from the auctioning of allowances for the electricity sector should be used in ways that benefit electricity consumers in California, such as to augment investments in energy efficiency and renewable energy or to provide customer bill relief. There are multiple ways to accomplish allocation of benefits to consumers." (Pg 8)

Unfortunately, the PUC did not model dividends as one of its scenarios, even though dividends are the most direct way of returning revenues to consumers. Instead, the CPUC proposed returning auction revenues (or allocating allowances for free) to utilities to administer on behalf of consumers (their ratepayers) perhaps through rebates on their utility bills.⁴ Providing a rebate through utilities (showing up only as a line item on electricity bills) shields consumers from the price signal and discourages changed behavior. This mirrors the American Clean Energy Security Act (ACES) approach that refers to utility bill rebates as allocation for "consumer" benefit. However, **separating the return of money from the utility bill is critical for sending any price signal at all to residential customers. There is NO environmental benefit from keeping people's utility bills low.** This same flaw in the CPUC recommendation also occurs in ACES.

A more direct way to compensate consumers is to send dividends to them. There is no need to allocate to utilities to act as a middleman. A high bill coupled with a cash dividend encourages conservation and efficiency, even though the financial impact on the consumer is the same. A study by Dallas Burtraw and others at Resources for the Future explains:

"Returning allowance value to customers through their local distribution companies would raise electricity prices little or not at all, thereby greatly reducing the burden of climate policy. However, the small price rise also means that consumers receive a weak signal to reduce consumption or invest in improving end-use efficiency. In effect, allocation to consumers is a subsidy to electricity consumption that raises the overall cost of the cap-and-trade program. As a consequence of the fact that consumers do not see higher prices, the amount of reduction necessary elsewhere in the economy goes up."⁵

The CPUC's proposed phase-in from 80% giveaway to 100% auction between 2012-2016 begs the question, how much will really change in four years? Since these discussions about rule making began in 2006, companies will already have had over four years to make changes. Why not just start at 100% auction in 2012?

The CPUC proposals may have tried to answer some utilities' arguments against auctioning, including what we have called the "RPS-first" and "wealth transfer" arguments. However, we feel that the dividend can answer both concerns.

⁴ CPUC News Release. GHG Reductions Recommendations Adopted, October 17, 2008.

http://docs.cpuc.ca.gov/PUBLISHED/NEWS_RELEASE/92385.htm

⁵ Burtraw, Dallas and Rich Sweeney and Margaret Walls. "The Incidence of U.S. Climate Policy: Where You Stand Depends on Where You Sit," Resources for the Future Discussion Paper RFF DP 08-28, September 2008, Pg. 43.

First, the RPS is different from a carbon price. Utilities can pass along a carbon price to their customers, which will make the investments in low-carbon energy as mandated in the RPS more cost-effective. Generators may raise wholesale energy prices under either a giveaway or auction. This is not a threat to utilities because they can pass along rate increases to their customers as well. There should be a line item showing "GHG allowance auction." As long as consumers receive a per capita cash dividend, they will want that line item to decrease, and the best way is to decrease the amount of carbon in the utility grid. Without the dividend, consumers might prefer to elect a politician who would do away with the cap. Rates might decrease, but then climate change would remain unabated. The dividend can help consumers to understand and support higher rates for higher carbon electricity.

Second, some Southern California utilities have expressed concern that auction funds would flow to Sacramento and not return to their jurisdiction resulting in a wealth transfer from high-carbon utility customers to low-carbon utilities customers. However, if the State provides a per capita dividend that is equal to all Californians, no business or organization could claim they were treated any differently than anyone else. A per capita cash dividend returns auction revenues to all customers, facilitating the transition to higher electricity rates. The dividend encourages customers to implement conservation and efficiency measures so that even though they see higher rates, their reduced consumption leads to lower bills. We caution against diverting auction revenues for pet projects including filling State budget deficits instead of returning them to consumers.

Utilities with high coal have benefited from lower rates, but the carbon price will change that. Free allocation only delays this, and climate change worsens each year of delay. West Virginia's electricity mix is 98% coal. The electricity mix of the Los Angeles Department of Water and Power (LADWP) is about 45% coal, so they have only half the liability of West Virginia (and arguably at least twice the renewable energy potential). Rather than opposing a carbon price, LADWP and others should promote market designs that allow for the market to treat all market players fairly, incentivize emission reductions, and compensate consumers.

Funding other worthy programs (clean tech, green jobs, etc.) with fees and other revenue sources

Of course, we also support the many other worthy programs advocated by the environmental and renewable energy community. However, we feel those projects should be funded through fees, feebates, subsidies, and the normal budgetary appropriations process rather than by auction revenues. We feel that consumers must be compensated first, and other programs can be funded, as they have been, through public goods charges and other fees and subsidies.

Price floor for permits

We have encouraged a price floor reserve price for allowances as a design element for a Cap and Auction system. It can be implemented through a carbon fee that rises over time. This reduces low-end price volatility, and can help companies justify long term capital investments in low-carbon technologies.

Market Advisory Committee report discusses the need for a price floor:

"While a price ceiling could jeopardize environmental integrity and reduce the return on investments in clean technologies, a price floor would reinforce environmental integrity and the value of clean investments. The Committee encourages CARB to consider enforcing a price floor."
(pg 68)

Offsets and Economic Analysis

Limiting offsets will strengthen the demand for clean energy innovation, which in turn provides more good jobs for Californians. Any offsets allowed should at most represent only a small portion of a polluter's required emission reductions. They should have stringent protocols ensuring that the reductions are geographically limited, quantifiable, additional, and permanent. Offsets from sinks, such as planting trees or avoiding tree cut-downs, are problematic, because what happens if there is a wildfire or a drought?

Finally, the economy is in a recession. The EAAC's report should include a section on the regressive impacts of potential fuel and electricity price increases. We encourage EAAC to maintain an academic, analytical approach, and focus on the most effective means to achieve emissions reductions while protecting consumers from higher energy prices. In this way, the EAAC can follow the Governor's advice and highlight policies to assist consumers with short term costs such as returning revenues through a per capita dividend.

Thank you for your consideration.

Sincerely,

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