May 15, 2007
Project 10096.001

Mr. Winston Hickox
Chair, California Environmental Protection Agency
Prof. Lawrence H. Goulder
Vice Chair, California Environmental Protection Agency
Market Advisory Committee
California Energy Commission
Climate Change and California
1516 Ninth Street, MS-29
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Ms. Catherine Witherspoon
Executive Director
California Air Resources Board
1001 "I" Street
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Subject: Initial Comments & Recommendations for the Market Advisory Committee

Dear Messrs. Hickox and Goulder and Ms. Witherspoon:

As representatives of the California cement industry, we appreciate the opportunity to share our initial thoughts and concerns on the design and implementation of a California greenhouse gas (GHG) emissions reduction program. We applaud California's aspirations to be an international leader on addressing global warming and support the Market Advisory Committee's (MAC's) mission to recommend market-based compliance measures that have the real potential to achieve reduction targets, while mitigating the economic impact on critical domestic industries and vulnerable communities. We look forward to working closely with the MAC towards the goal of designing an effective, efficient, and equitable market-based system.

The California cement industry is the largest state cement industry in the U.S. and has some of the most efficient facilities in the world. It is a cornerstone of economic growth and development both within the state and the nation. Given increasingly tighter international cement markets and the state's need to repair its aging infrastructure, the cement industry is of high strategic value to the state as well. Thus, any new regulations that significantly impact domestic cement manufacturers are likely to have far reaching consequences for the state's future growth and its ability to cost-effectively satisfy its considerable infrastructure and construction needs.

Furthermore, any new regulations that might significantly increase costs for California's cement manufacturers and place them at a competitive disadvantage in the marketplace is of high concern to the cement industry, our employees, our customers, and the California economy as a whole. We hope that the MAC will make an effort to understand these concerns, develop an appreciation for the cement industry's unique challenges, and recognize the alignment between cement manufacturers' interests and California's economic and environmental objectives.

This comment letter represents what we hope will be the beginning of a productive, transparent, and responsive dialogue between the MAC, state officials, cement manufacturers, and consumers. Considering that the MAC has released limited information to date on its specific intentions and recognizing that you have been carefully deliberating, we are reluctant to anticipate the committee's thinking by commenting on specific features of a market-based mechanism. Rather, we would like to take the current opportunity to share some general thoughts and concerns. We look forward to reviewing and commenting on the MAC's preliminary recommendations in detail upon release.

GOALS OF ASSEMBLY BILL 32

Assembly Bill 32 (AB 32) identified several goals to be considered when designing a comprehensive emissions reduction program, including:

- achieving significant emissions reductions,
- minimizing costs,
- minimizing leakage,
- considering each source's contribution to statewide emissions of GHGs, and
- considering overall societal benefits and larger strategic goals.

We strongly support these basic goals but recognize that any effective program will necessarily entail making tradeoffs among them. The MAC has been charged with the challenging task of

recommending market-based mechanisms that can judiciously and fairly balance these important but often competing objectives.

GUIDING PRINCIPLES

The development of sound policy not only requires clarity of purpose, but also a set of guiding principles. We believe the following guiding principles are consistent with the vision embodied by AB 32 and should form the foundation of a successful market-based mechanism:

1. ***Effectiveness:*** It is of paramount importance that any new regulations or mechanisms to reduce GHGs be effective in meeting targets, and that the trajectory chosen to achieve a given target be realistic and achievable.

2. ***Experience:*** Policymakers should learn from the valuable experience of other programs and always seek to balance practice and theory. Policy should be innovative, not experimental – untested ideas should be gradually implemented as regulators gain experience, markets mature, and the system establishes credibility.

3. ***Efficiency:*** Policy should achieve its objectives at the lowest possible cost. This includes design features that are simple and lower control costs, administration costs, compliance costs, transaction costs, and market volatility. However, policymakers must also recognize the inherent tradeoffs between the efficiency of a GHG reduction program and larger strategic goals, such as equity and economic competitiveness.

4. ***Equity:*** Public policy should encourage all actors to positively contribute in a manner that is fair and equitable. The system should adequately compensate "losers" for the additional costs of regulation and encourage investment decisions that are consistent with the state's long-term economic, environmental, and security objectives.

5. ***Economic Competitiveness:*** Public policy should be designed with an understanding of the economic competitiveness of various industries. Failure to appreciate the competitive dynamics of an industry and overestimating an industry's true capacity to

reduce emissions in a financially sustainable manner will only encourage critical industries to relocate to more favorable regulatory regimes.

PRELIMINARY RECOMMENDATIONS

- ***Primary Mechanism***: We strongly support the implementation of a cap-and-trade system as the primary mechanism for reducing GHG emissions and achieving targets.

As you know, established economic theory and the balance of empirical evidence suggest that a cap-and-trade system has the greatest potential to achieve emissions reduction targets in the most efficient and least onerous manner. A well-designed cap-and-trade system will be essential to decreasing the overall economic costs of the program, mitigate the financial burden imposed on California businesses, and lower costs to consumers.

- ***Scope***: We believe that a truly efficient and effective system will be as inclusive as practically possible. All non-trivial emission sources should contribute their fair share of reductions, assuming it does not place them at a significant competitive disadvantage.

A more inclusive program with all significant GHG emitting sectors will insure that GHG reductions are undertaken at the lowest cost source and mitigate the program's negative economic impact on the state. In addition, to maximize effectiveness and efficiency, all major emission sources should be included in the regulatory framework as soon as practically possible. For example, the cap-and-trade system should include from the start more industries than the sectors currently included in the first tier of the mandatory reporting regulations. As stated by Prof. Goulder, "the broader the market, the greater the potential for cost savings."1

- ***Allocating Allowances***: We strongly support a balanced hybrid approach to allowance allocation, with appreciation for the practical experience gained in previous cap-and-trade programs, the limitations of economic theory, and the value of measured policies.

1. Goulder, Lawrence. Market Advisory Public Meeting. February 27, 2007.

As stated by MAC members Burtraw and Prof. Goulder, "the combination of auctioning and free allocation offers a reasonable balance of the competing goals of efficiency and equity."[2] Research has shown that 100 percent free allocation systems can generate gains for allowance recipients. On the other hand, the benefits of primarily allocating permits in a large, multi-sector program through an auction mechanism remain largely untested. Although the theoretical benefits of auction should be a consideration, the regulation of emissions in the world's fifth largest economy should not be based on purely theoretical grounds. As demonstrated by the failure of market liberalization in California's electric power sector, theoretical benefits may not materialize in less-than-ideal conditions of the marketplace.

For these reasons, we believe that a prudent and responsible approach would be to adopt a well-balanced hybrid allocation scheme that leverages the practical knowledge gained through previous programs. This system should initially favor free allowances, with the proportion of auctioned allowances rising over time as regulators gain more experience with the system and as more accurate data on the "optimal mix" becomes available.

- ***Sector-Specific Considerations***: We strongly recommend that allowance allocations be based on a firm understanding of the unique constraints, challenges, and conditions faced by a given sector.

An industry's ability to realize super-normal profits from free allocation is a function of that industry's cost of emission control and its ability to pass cost increases through to consumers, both of which can vary significantly across industries. In a multi-sector program such as that proposed in California, a "one size fits all" approach that fails to appreciate the critical differences between industries may create significant hardships for certain industries with relatively high control costs and an inability to pass costs through to consumers. Consequently, the appropriate mix between free allocation and auction should be determined on an industry-by-industry basis – again, with initial allocations favoring free allowances and the proportion of auctioned allowances rising over time as more accurate data on the "optimal mix" for that sector becomes available.

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2. Burtraw, Dallas, Alexander E. Farrell, Lawrence H. Goulder, and Carla Peterman. 2006, Managing Greenhouse Gas Emissions in California. Chapter 5: Lessons for a Cap-and-Trade Program, January.

Furthermore, a sector-specific approach to allocation will help minimize the potential of leakage. Failure to recognize the unique constraints and challenges of a particular industry will increase the likelihood that businesses are not made whole by free allocations and encourage shutdowns and relocations. Although this would decrease California's GHG emissions, it could easily increase global GHG emissions as production relocates to states and nations with less stringent or non-existent GHG emission standards. From a public policy perspective, California should not just minimize leakage, but should encourage carbon intensive industries to invest within the state and operate under more strict and progressive environmental policies.

- ***Price Safety Valve***: We believe that a price safety valve will be a critical component of any market-based mechanism.

A limit on allowance prices will significantly mitigate price uncertainty, foster efficient long-term capital budgeting decisions, curb market speculation, and generally serve as a hedge against market imperfections and unintended consequences. As demonstrated by the sharp spike in California electricity prices in the early stages of deregulating trading markets, short-term volatility and unanticipated events can lead to significant economic hardship for business and customers. A price safety value will allow California to reap the powerful benefits of markets, while also recognizing their limitations and vulnerabilities.

- ***Offsets Programs***: We strongly recommend that a well-designed cap-and-trade system should include a robust offsets program without geographic restrictions.

Economic theory and efficiency criteria strongly argue that regulated entities should have the ability to purchase emission offsets to insure that reductions are occurring at the lowest cost source. A geographically unrestricted and credible program that is based on real, additional, permanent, verifiable, and enforceable offsets is critical to achieving environmental objectives in a cost-effective manner. Offsets validation should be streamlined to the maximum extent possible.

CONCLUDING REMARKS

It is our understanding that the California Air Resources Board has identified cement manufacturers as one of five sectors to be initially regulated under a new program. It remains

unclear if and when regulatory development will proceed on other major emission sources. The cement industry recognizes that it has an important role to play and we are willing to do our fair share in helping the state achieve its larger environmental goals. Nevertheless, we strongly believe that a truly effective emissions reduction program will require *all* non-trivial emitters to make contributions that are consistent with their share of GHG emissions, their strategic value to the state, and their ability to reduce those emissions without being placed at a significant competitive disadvantage to non-California companies. Although we realize that such decisions are not within the MAC's jurisdiction, we hope that the committee shares this perspective and will advise policymakers on the benefits of a fully inclusive program and importance of a sector-specific approach.

Although we understand that the MAC is an advisory committee, we recommend that ARB's design of the AB32 market system be done under a process that includes substantive public participation and is subject to the full provisions of the Administrative Procedures Act (APA), including identification of supporting studies, description of reasonable alternatives, and factual support for adverse economic impact on business. Specifically, we request that ARB undertake a formal technical collaborative process for the cap-and-trade market program that includes economic modeling of multi-sector issues that are specific to the California economy.

We reiterate our support of California's larger strategic objectives and intend to play a constructive role in helping the MAC meet its challenge of designing an effective and equitable system that can balance competing economic and environmental objectives. We hope that the MAC will make a concerted effort to understand the unique conditions faced by California's cement manufacturers as an industry that is operating in an intensely competitive marketplace and a sector of high strategic importance to the state's economic future. We look forward to the MAC's preliminary recommendations and welcome the opportunity to submit more detailed comments.

Sincerely yours,

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