IETA

Input to Inform CARB's Potential Amendments to the Cap-and-Trade Program

15 December

The **International Emissions Trading Association** (IETA) welcomes this opportunity to provide input on potential amendments to the California cap-and-trade program presented by California's Air Resources Board (CARB) at the 16 November workshop. For over 20 years, IETA has been the leading global business voice on robust market solutions to tackle climate change while driving clean finance at scale. Our global non-profit organization represents over 300 companies, including many with operations, clean investments, and workforces across California.

IETA's comments are structured around the following topics:

- **Cap-and-Trade as a Workhorse**
- **Allowance Removals to Achieve 2030 Target**
- **Automatic Supply Adjustments Based on Auction Settlement**
- **Importance of Maintaining Program Flexibility**
- **Cap-and-Trade Beyond 2030**

Cap-and-Trade as a Workhorse:

As IETA has communicated previously to CARB, our strong view is that cap-and-trade should play a workhorse role, meaning the instrument *should* do most "heavy-lifting" on driving measurable, cost-effective greenhouse gas (GHG) reductions. A "workhorse" program offers cost-effective and flexible compliance by preserving cost containment mechanisms (detailed in the "Allowance Removals to Achieve 2030 Target" section), current holding limits, banking and trading rules (detailed in the "Importance of Maintaining Program Flexibility" section), and the compliance offsets program. Through CARB's cap-and-trade rulemaking process, IETA will continue stressing the importance of program improvements to achieve an increasing share of California's reductions to meet its 2030 climate target and 2045 carbon neutrality target.

We support CARB's ongoing modelling efforts that include lower cap levels. **At present – and at a minimum – IETA encourages CARB to implement the proposed 48% reduction below 1990 levels by 2030 scenario**. In particular, we support the modeled "alternative scenario 3(a)", which would see all allowances removed from the auction and allocation budget.

Allowance Removals to Achieve 2030 Target:

IETA believes that a large majority, if not all, allowance removals required to achieve the state's 2030 climate target should **come directly from the auction/allocation accounts rather than the Allowance Price Containment Reserve (APCR) and ceiling cost-containment accounts**.

Scenarios where allowances are primarily removed from price containment accounts are problematic and could have severely negative consequences for both California consumers and industries. More specifically, removing allowances from cost-containment accounts would expose regulated facilities and California households to significant risk if the thresholds were met.. Further, removing allowances from these accounts (instead of the auction/allocation accounts) would run counter to positioning the cap-and-trade program as the state's workhorse policy, as the impact of the removals would only materialize if the cost-containment thresholds are reached. Opting to remove allowances from the cost-containment accounts would likely result in fewer reductions driven by the program, requiring other, most costly supplementary policies to drive mitigation across the state.

Automatic Supply Adjustments Based on Auction Settlement:

CARB and Quebec are jointly considering a mechanism to enable auction supply to automatically reflect recent auction settlement prices. As presented in November, this automatic supply-based mechanism would likely materialize in a similar way to the Regional Greenhouse Gas Initiative (RGGI)'s Emissions Containment Reserve (ECR) and Cost Containment Reserve (CCR)or, a similar approach to the EU's existing Market Stability Reserve (MSR).

Provided there is future detailed consultation and transparent analyses on its appropriate design, we believe CARB may consider an automatic supply-based mechanism as a reasonable option to address supply concerns. However, this must be in conjunction with other potential changes to the future cap-and-trade program. Several reasons for supporting this effort are summarized below.

- An automatic supply-based mechanism could complement existing cost containment provisions in the cap-and-trade program, respectively balancing climate ambition and economic growth.[1]
- An automatic supply-based mechanism could be a predictable rules-based adjustment to allowance supply that ensures the cap-and-trade program will remain a "workhorse" measure over time as macroeconomic conditions and policy mixes inevitably change.
- Supply-based mechanisms are automatically implemented, such that changes to allowance supply can occur without the need for re-opening regulation. This provides enhanced confidence, clarity and certainty in the market over the longer-term.
- Rules-based automatic adjustments to supply are arguably considered best practice design elements across majority of existing cap-and-trade programs worldwide. As mentioned previously, this includes RGGI and the MSR in the EU ETS, today's largest and most longest-running greenhouse gas cap-and-trade program.

As it is important to be aware of potential merits to using an automatic supply-based adjustment mechanism in California, there are also possible challenges or drawbacks its implementation that CARB will have to consider in order to avoid unintentional negative outcomes. Some of these potential challenges and drawbacks are listed below.

- By default, introducing an automatic supply-based mechanism increases the complexity of the program.
- If the thresholds for the automatic supply-based mechanism are set incorrectly, the mechanism would not work as intended and could result in perverse market impacts.
- If the automatic supply-based mechanism requires allowances to be removed from the auction/allocation allowance pools, it would likely result in reduced program revenue and, by extension, fewer proceeds being channeled into the Greenhouse Gas Reduction Fund.

At this stage, we do not take a firm position on the inclusion/exclusion of an automatic supply-based mechanism within the joint WCI program. However, IETA is extremely well-versed in both the design and operationalization of these mechanisms across other existing markets. Should CARB decide to move forward in implementing the new mechanism, the agency must clearly outline and communicate the expected benefits and outcomes to the public and allow ample time for consultation and feedback.

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[1] Burtraw, D., Holt, C., Palmer, K. and W. Shobe. 2022. "Price-Responsive Allowance Supply in Emissions Markets". Journal of the Association of Environmental and Resource Economists 9(5).

<u>Importance of Maintaining Program Flexibility:</u>

Given that the post-2030 program would be materially different from the 2013-2030 program as the cap is tightened towards the State's ambitious 2045 climate target, IETA acknowledges that a careful review of all program aspects is necessary to ensure a "Well-Designed Program" that remains effective post-2030. Throughout this review, IETA cautions against considerations that would unnecessarily reduce compliance flexibility awarded to regulated facilities. In the context of tightening program stringency, compliance flexibility will prove critical to reducing the burden on regulated entities to protect against competitiveness and leakage concerns.

Banking Rules Including Duration Limits and Trade Requirements: IETA does not support tightening banking rules. Banking is a much-needed cost-containment measure that protects against price spikes and is crucial to supporting the competitiveness of California's regulated facilities. Similarly, imposing minimum trade requirements would reduce the cost-containment benefits of banking, further jeopardizing the competitiveness of regulated entities. Unless absolutely necessary to ensure the program can continue to function as intended post-2030, IETA does not support CARB to consider limiting banking or imposing trade requirements.

Holding Limits: IETA strongly suggests that CARB avoid unnecessary reductions to the program's holding limits. Excessive downward adjustments to holding limits could achieve the opposite of cost containment, increasing the burden imposed on regulated facilities. IETA understands CARB's caution towards allowing non-compliance entities to hold significant volumes of allowances, but many non-compliance entities that hold inventory have already sold their allowances to other participants for forward delivery. This is because the market price to delay delivery is often lower than the cost of capital for compliance entities but higher than the cost of capital of financial institutions. It is therefore economically efficient for compliance entities to sell their inventory and buy allowances back for delivery in the future (when they need them for compliance submissions). Reducing the ability of non-compliance entities to hold allowances for this purpose will make it harder for entities to provide this storage "service"[2]. This, in turn, will push up the price of California Carbon Allowances (CCAs) for later delivery compared with immediate delivery, which will raise the costs of acquiring allowances by compliance entities. **Put another way: reducing holding limits, imposing transactional requirements, or limiting the bankability of CCAs could achieve the opposite of cost containment**.

Offsets: Beyond 2030, IETA holds that the program must be designed to continue allowing high quality offsets to serve as an important flexibility mechanism for covered entities. Compliance offsets are important cost-containment measures that support the overall goals of the program while delivering financial signals to reduction sectors/opportunities that are not covered by compliance requirements. IETA supports CARB's recognition that approved offset projects provide direct environmental benefits, including improvements in air and water quality, as well as conservation, biodiversity and local economic benefits that come with technological innovation and bring new jobs and skills.

<u>Cap-and-Trade Beyond 2030:</u>

With caps declining to net zero emissions, the cap-and-trade program should be extended through at least 2045. Over the last year, IETA has provided both legal rationale and evidence

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[2] for example, by reducing holding limits, imposing transactional requirements, or reducing the ability of California Carbon Allowances (CCAs) to be banked

in support of program extension. Extension would eliminate post-2030 uncertainties, unlock additional climate investments for the state, create ideal conditions for investors to confidently reduce in-state emissions, and alleviate concerns around banked allowances – a point which was clearly highlighted and underscored in the UC Davis modelling presentation, featured during the November 2023 workshop. Legal analysis, published by IETA in late 2022,[3] not only suggests a strong case for CARB's authority to extend the program through regulation, but also that a simple majority is all that's required for post-2030 extension. '

Conclusion:

IETA appreciates this opportunity to record insights and recommendations to CARB on potential amendments to the California cap-and-trade program. If you have any questions or follow-up requests, contact Joey Hoekstra at hoekstra@ieta.org.

[3] **IETA Legal Memorandum on California Cap-and-Trade Program Beyond 2030. Submitted to the Independent Emissions Market Advisory Committee. (Link)**