

Economic and Allocation Advisory Committee

January 11, 2010 Meeting

Agenda

Allocation Report

- Legal Context (Rick Frank)
- Public Comments
- Discussion of Report, Last Checks
- Presentation of Finalized Report

Economic Impacts Work

- Update (Jim Bushnell)
- Public Comments
- Discussion

EAAC Subcommittees

Allowance Distribution Methods

Allowance Value Provision

Legal Issues

Economic Impacts

Criteria for Evaluating the Options

- Cost Effectiveness
- Fairness
- Environmental Effectiveness
- Simplicity

Criteria for Evaluating the Options

- Cost Effectiveness
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- Simplicity

These connect closely with stated objectives of AB 32. The Act stipulates that regulations should be designed in a way that ...

- Seeks to minimize costs; minimizes the administrative burden
- Designs the regulations in a manner that is equitable; ensures that compliance with the regulations does not disproportionately impact low-income communities; directs public and private investment toward the most disadvantaged communities in California
- Minimizes leakage; ensures overall social benefits, including reductions in other air pollutants

Recommendations

1. The EAAC recommends that the ARB rely principally, and perhaps exclusively, on auctioning as the method for distributing allowances.
2. The EAAC recommends that the ARB employ free allocation only for the purpose of addressing emissions leakage associated with energy-intensive trade-exposed industries, and only in circumstances where the alternative of some form of border adjustment is not practical.

3. The EAAC advises the ARB to adopt policy instruments that can be substantially modified or eliminated as leakage problems change with the emergence of regional or federal policies. The ARB should avoid policies that create property rights or other entitlements that cannot be changed should regional or federal policies be adopted. The ARB's commitments to border adjustments or other leakage-oriented measures should be of short duration (though renewable), thereby allowing more adaptability.

4. A uniform price, sealed bid (single round), double auction is a strong candidate for the choice of auction design, and it is a good default choice in the absence of compelling reasons for choosing an alternative. Resolution of ancillary design features that EAAC identifies, including more detailed rules governing the auction, should be considered through subsequent analysis sponsored by the ARB. Laboratory experiments are recommended to test the auction design and guide decisions about subordinate auction rules. The state may want to conduct a bidding procedure to select a third-party vendor to run the auction.

5. The State of California should devote allowance value to several different purposes, including: preventing adverse impacts of AB 32 to certain individuals, communities, or businesses; financing various investments or other public expenditures; and directing the value to citizens in the form of financial transfers (“dividends”) or reductions in California income or sales taxes.

6. The EAAC recommends that sufficient allowance value be conferred to low-income households to avoid disproportionate adverse economic impact of AB 32 on such households. Such conferral should be accomplished through financial transfers rather than through subsidized energy prices. The EAAC recommends that households with income below 150% of the poverty line be regarded as low-income households. It is important to consider the impact of AB 32 as a whole, not just the impact of the cap-and-trade component.

7. While the EAAC supports using allowance value to protect incomes of low-income households, it recommends against the additional conferral of allowance value to electricity consumers (whether directly or indirectly through provision to local distribution companies).

8. The EAAC recommends against supporting industry profits with allowance value, except when this is a byproduct of efforts to prevent potential leakage.

9. To meet the objectives of AB 32, the EAAC recommends that the ARB devote a significant share of allowance value toward financing of public and private investments. The investments to consider include those oriented toward achieving low-cost emissions reductions (both directly and through investments in cleantech RD&D), adaptation to climate impacts, environmental remediation, improvements to disadvantaged communities, and job training.

10. Committee recommends that the ARB's selection among alternative investments to be financed through allowance value be based on an expanded measure of cost effectiveness (one that accounts for environmental co-benefits) as well as fairness, accountability and transparency. The EAAC recommends that the ARB work with other relevant agencies to arrive at a process for applying these criteria in determining the investments to which allowance value shall be devoted. The EAAC also recommends the establishment of an independent Investment Advisory Board to assist in screening potential investments and investment vehicles that meet the recommended criteria. The ARB should also respond to AB 32's directive that public and private investments be devoted "where applicable and when feasible ... toward the most disadvantaged communities in California..." (section 38565).

11. The EAAC recommends that a fraction of allowance value be allocated to a contingency fund to be devoted to any communities experiencing increased exposure to co-pollutants as a result of any possible fossil-fuel burning stemming from AB 32 implementation. The funds would be for the purpose of environmental remediation.

12. The EAAC supports the return of a significant fraction of allowance value to households either through lump-sum rebates (as under the “cap and dividend” proposal) or through cuts or avoided increases in the state’s individual income or sales tax rates.

13. The EAAC recommends that the total allowance value over the interval 2012-2020 be apportioned across the various uses in the following manner:

- a. Some allowance value should be earmarked for the following purposes or contingencies. First, as discussed in Recommendation 2 above, to the extent that addressing **leakage** requires the use of output-based free allocation, allowance value should be devoted to this purpose. Second, as indicated in Recommendation 11 above, a sufficient amount in allowance value should be placed in a **contingency fund to finance environmental remediation** in any communities found to experience increased exposure to co-pollutants as a result of any possible fossil-fuel burning stemming from AB 32 implementation. Third, if (as indicated under b below) allowance value is returned to households through tax rate cuts, a small fraction of the allowance value should first be reserved to **finance income transfers to low-income households** so as to avoid disproportionate economic impacts on such households, as discussed under Recommendation 6. As discussed earlier in this report, a relatively small share of the total allowance value over the interval 2012-2020 is likely to be needed to serve these three objectives.

b. The remaining allowance value is expected to represent the bulk of this value. This value should be allocated to two major uses: (1) **financing investments** to reduce emissions and other public expenditures as described in Section 5 and in recommendations 9 through 11, and (2) **returning allowance value to households** as described in recommendation 12. **Roughly 75% of this value should be returned to households** either through lump-sum payments or through cuts in individual income or sales tax rates. **Roughly 25% of this value should be devoted to financing investments** and other public expenditure, along the lines indicated in recommendations 9 through 11. Because the amount of allowance value is expected to be lower in early years than in later years, it would be **appropriate to allow these ratios to change over time**. In particular, it would be appropriate to apply a larger share to investment in earlier years, when total allowance value is lower, so that high-priority investment needs can be financed. Among the investment alternatives, investments to achieve greenhouse gas reductions or adapt to the effects of climate change should be treated as senior obligations; that is, as objectives that must be addressed before allowance value can be allocated to other investment uses.