

***** BEGINNING OF MESSAGE *****

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COMMENTS: July 28, 2008

TO:

MGA GHG Accord Advisory Group

From:

Clean Wisconsin; Environment Illinois; Environment Ohio; Environmental Law and Policy Center; Iowa Environmental Council; Izaak Walton League of America; Minnesota Center for Environmental Advocacy; Natural Resources Defense Council; Plains Justice; Respiratory Health Association of Metropolitan Chicago; Union of Concerned Scientist

RE:

Environmental advocates position paper on design principles for a Midwestern cap and trade system

CAP AND TRADE IN THE MIDWEST
DESIGN PRINCIPLES

A. GENERAL GOALS

A well-designed Midwestern cap and trade system holds great promise as part of a suite of complementary policies to reduce greenhouse gas emissions. Essential elements of a cap and trade system are set forth more specifically below. In general terms, a cap and trade system should be designed to meet the following goals:

**ensure the reduction of greenhouse gases, beginning as soon as possible, from covered sources to levels consistent with the levels scientists believe are required to avoid dangerous global warming;

**maximize public benefits, administrative efficiency, and transparency while minimizing the potential for manipulation by private interests;

**speed innovation in, and implementation of, energy efficiency and sustainable energy technologies with the greatest potential to cost-effectively reduce greenhouse gases;

**avoid inequitable impacts on low-income communities and communities of color;

**prevent shifting of emissions to non-participating states or regions; and

**position the region to capture maximum economic and environmental benefits under a strong national cap-and-trade program.

B. CAP STRINGENCY / EMISSION REDUCTION GOALS

The region's cap must put the region on a reduction path that starts reductions promptly and reduces emissions steadily to achieve the deep mid century reductions in line with levels science shows are necessary to prevent the worst impacts of climate change.

The cap should initially be set at current emission levels and gradually reduced along a pathway that achieves interim reductions of at least 15% below 2005 levels by 2015, 30% by 2025, and 80% by 2050.

These caps should be reviewed periodically, such as every three to five years, to determine if they need to be tightened in light of scientific developments. Not all states in the region need to establish an identical cap using identical baseline years, but all state caps should drive comparably aggressive emission reductions.

Implementation of the cap should begin in 2010. Early reductions and a relatively smooth reductions curve are optimal along with frequent opportunities to assess progress. Allowances should be issued/auctioned annually, and compliance periods should be at most three years.

C. SECTORS COVERED

Our objective is an increasingly diverse, economy wide carbon market which can yield the greatest innovation and most rapid reductions at lowest cost.

The regional cap-and-trade should cover as many sectors of the economy as is administratively feasible provided that emissions can be reliably quantified, including the electric power sector, major industrial emitters, the transportation sector, and certain other major point sources not otherwise covered such as, buildings, landfills, and confined animal feeding operations (CAFOs). If particular sectors are not included in an initial program, these sectors should be added when administrative problems can be resolved.

D. SIZE OF MARKET

As with sectors covered, a larger more diverse market will increase reduction opportunities and decrease cost, but markets should not be broadened at the expense of market standards or environmental certainty.

The regional market should include the MGA jurisdictions that have agreed to participate in cap and trade under the Greenhouse Gas Accord (Illinois, Iowa, Kansas, Michigan, Minnesota, Wisconsin and Manitoba), and we should seek to

expand the trading market to include Accord observer states (South Dakota, Indiana, and Ohio). Trading relationships should be sought with other trading schemes, such as the EU ETS, the Regional Greenhouse Gas Initiative (RGGI), and the Western Climate Initiative (WCI), provided that the quality of allowances issued under other trading schemes is assured.

E. POLLUTANTS COVERED

The cap-and-trade should cover all Kyoto-6 gases (CO₂, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride).

F. POINT OF REGULATION AND "LEAKAGE"

The point of regulation - that is, which entities within a sector must hold allowances and submit them to the regulator - should be determined on a sector-by-sector basis. The chart (Fig 1 and 2) below shows the path of fossil fuels through the economy and the upstream and downstream options for potential point of regulation.

In choosing the place to regulate, key objectives should be to maximize reduction certainty and administrative simplicity and minimize overall costs to consumers and the economy. The incentives created by choosing a point of regulation are also important. Where possible, the regulated entity should be an actor with significant direct ability to effect emissions reductions.

We should also seek to minimize "leakage," (the transfer of emissions to non-covered states, such as would occur if the cap could be avoided by purchasing power from a neighboring jurisdiction outside the cap), being mindful of the likely transition to a national trading system, which would eliminate most interstate leakage issues.

We should also seek to minimize windfall profits accruing along the supply chain in a way that increases overall costs to consumers and the economy without resulting in any additional emission reductions.

Coal/ Power sector : The MGA should carefully consider whether the point of regulation for the power sector should be on the load-side (i.e. the utilities providing retail power to the consumer, known as the "load-serving entity" or LSE) or on the supply-side (the generators combined with the first sellers of imported power within the jurisdiction of the cap). (Note that power plants that burn natural gas or fuel oil may not need to be regulated at either the generator or the LSE level if they purchase fuel from a fuel supplier already regulated upstream.)

In deciding whether to set the point of regulation on the load or supply side, the MGA should thoroughly analyze the pros and cons of both approaches and model each approach to determine its impact on consumer energy costs.

The advantages of setting the point of regulation on the generator side are:

**power plants are large, easily-monitored and already-regulated point sources, and placing the point of regulation at this level provides greater emissions certainty and fewer opportunities for gaming. However, in order to capture imported power, a supply-side approach would also have to regulate the first entity within the jurisdiction of the cap and trade program that sells power generated by sources outside the cap (“first jurisdictional sellers”), which would be less simple and certain. In contrast to regulating generators, a load-based approach would require each LSE to track and report on the source of its power and its emission attributes (though LSE’s must do this anyway in order to pay for their power purchases).

**such an approach would be more consistent with the RGGI regulatory model (which caps generators) and the one that the WCI has proposed using (generators and possibly first jurisdictional sellers), making it easier to ultimately integrate these markets.

**A generator-side cap would capture emissions associated with power that is generated within the MGA states but exported to other states.

The advantages of setting the point of regulation on the load-side are:

**a load-based cap may be far less expensive to consumers because it does not result in windfall profits to energy suppliers. Placing the point of regulation on generators and importers could raise the marginal price of power on the wholesale electric markets, prompting all competing wholesale energy providers to raise their prices too, whether they face allowance costs or not. This could significantly amplify the cost of a cap and trade program to energy consumers. The MGA should carefully investigate this risk, including through computer modeling of load- and supply-based caps, before establishing a point of regulation for the power sector.

**LSEs have far more options for cost-effectively reducing their carbon emissions than do generators. LSE’s can reduce emissions through energy efficiency programs and by shifting toward lower-carbon energy sources, and placing the cap on them more directly incentivizes these cost-effective actions. The fact that LSEs are already subject to regulatory oversight and planning requirements in some states can help ensure these options are pursued.

The comparison of this option should also factor in which approach will work better under a future federal cap and trade law, at which point leakage issues will not be a major concern.

Coal/Industrial sector: the point of regulation for large combustion or process emissions should be at the point of emissions (unless that fuel stream is regulated upstream).

Petroleum/ Transportation sector: the point of regulation should be upstream, such as at refineries or petroleum pipelines entering the region.

Natural gas/ Residential, commercial, power, industrial:
The point of regulation for natural gas should be upstream, such as natural gas processing plants or pipelines entering the region. (Natural gas distributing

utilities should be treated like LSE's regarding incentives or obligations to increase energy efficiency and protect consumers)

Major methane emitters: The point of regulation should be at the point of emissions (such as the CAFO or landfill)

High GWP gases: the point of regulation should generally be the distributors of these gases.

G. OFFSETS

Offsets are tradeable credits from reductions made outside of capped sectors.

We view offsets with great caution because of their potential to undermine the environmental integrity of a cap and trade program and to greatly multiply a program's administrative complexity and monitoring requirements. Even a well-financed regulatory system may be unable to fully ensure that diverse offset types are real, surplus, verifiable, permanent and enforceable (the traditional criteria for offsets, discussed more below). Screening offsets for quality could require many behind-the-scenes, project-specific, and largely subjective administrative judgments - potentially violating the principles of regulatory transparency and simplicity and creating a system that invites abuse.

Generally speaking, if a sector can provide a significant amount of low-cost emission reductions that can be reliably quantified, it is preferable to include that sector in the cap and trade. If it cannot, then it is not a suitable candidate for providing offsets.

Offsets associated with changing agricultural or forestry practices have many important co-benefits related to land, water, and wildlife conservation. However, it is especially difficult to quantify their carbon impact and ensure their permanence, making them generally unsuitable as offsets (which is why the EU ETS does not accept any such carbon "sinks" as offsets). While it is important to pursue these carbon-reducing agricultural and forestry changes, they should be pursued using other policies that do not have the effect of allowing additional greenhouse gas emissions under the cap. This is particularly true given that some states, like Minnesota, are already counting heavily on reductions associated with their forestry and agricultural sectors in order to meet their greenhouse gas reduction targets. Allowing such reductions to also be used as offsets under the cap would result in double-counting.

If any offsets are allowed under a cap and trade program, in order to maintain the integrity of the cap, they must truly represent real, verifiable, permanent, and enforceable carbon reductions that would not have otherwise occurred (and thus are "additional" or "surplus"). The additionality requirement must ensure such reductions would not have happened under other policies or under existing or likely economic conditions.

Even where these conditions are met, however offsets must be quantitatively limited. They should make up only a small portion of the total allowances traded or they can undermine the effectiveness of the market in driving transition in regulated sectors.

More specifically, we support:

****Quantitative limit:** a quantitative limit should be set forth that ensures that the overwhelming majority of annual emission reductions come from capped sectors.

****Project limits:** standards should be adopted ensuring that offsets are real, surplus, verifiable, permanent and enforceable. Allowable project types should be specifically identified.

****Geographic limits:** offset projects should be located only in the states that are trading allowances to ensure adequate oversight of the offset projects and to maximize the environmental and economic co-benefits trading states would receive.

****Cap adjustment:** to the extent that capped sectors are allowed to use offsets to claim the benefit of reductions made in uncapped sectors where those uncapped sectors are already expected to contribute emission reductions to help a state meet its reduction targets, the overall cap should be adjusted downward so as to ensure that economy-wide reduction targets are met. Another option for sectors where there is a concern that offsets may not truly be additional, is to require a greater than one to one trade with known emissions (i.e. to count 'questionable' offset tons as only a fraction of a ton).

H. ALLOCATION VERSUS AUCTION

An auction mechanism holds great promise for speeding up the transition to a clean energy economy. Auctioning emission allowances creates a pool of publicly-controlled resources that can be used to help finance the transition away from polluting technologies at the lowest cost, jump start the Midwest's struggling manufacturing sector, and address any inequities that such a transition may cause.

100% of emission allowances should be auctioned, for several reasons:

****Giving allowances away for free to emitters amounts to a subsidy of polluting technology;**

****Charging emitters nothing can inhibit technological innovation and result in windfall profits for industry;**

****Auctioning allowances sends a true price signal through the market, and reduces emissions more efficiently and equitably.**

While we prefer auctioning 100% of emission allowances because of the many benefits of so doing, if a jurisdiction decides to allocate allowances to emitting sources to meet compliance requirements, it should limit the percentage of total allowances allocated and tailor the rules of that policy to encourage cleaner, more-carbon free behavior. For example:

****Any allowance distribution outside of an auction (during a transition period) should still have a price associated with each allowance to make sure that pollution subsidies are minimized and that early reductions are given an incentive.**

**As the revenues from the allowance auctions are distributed, new players and technologies will emerge in the clean energy sector. A portion of any allowances being distributed outside the auction should be set aside to assist these start-up companies in their critical early period of operation

**Full-scale carbon capture and storage must be a requirement of any new coal plant seeking to obtain allowances outside of an auction.

**To ensure that the clean energy economy transition continues smoothly, a time limit of no more than a few years should be established for any direct allowance distribution.

**To achieve the goal of making the transition as equitable as possible, rules must be put in place—such as rate regulation or other regulatory oversight—to ensure that those receiving allowances outside the auction (in fact placing a fee on them is one way of preventing the windfall) are prevented from making windfall profits from them.

I. COST CONTAINMENT/ SAFETY VALVES

It is very important to prevent speculation, extreme price volatility, and extreme impacts on particular industries or actors (like low income consumers) under a market based cap and trade system. Fortunately there are many mechanisms available to regulate and provide flexibility within the market to moderate and control cost. In choosing a cost control mechanism, it is critical that mechanisms do not undermine the environmental integrity of the cap, or obscure overall price signals, or undermine the certainty of the reduction path necessary to motivate short and long term investment.

We oppose “safety valves” or similar measures that would allow the release of unlimited additional allowances if prices reach a certain level. Safety valves structured in this manner would gravely undermine the environmental integrity of a cap and trade and gut investment in next generation technologies.

By contrast, banking or multi-year compliance mechanisms allow compliance flexibility while maintaining overall reductions in the system and provide far better options for cost containment.

J. ENERGY EQUITY

A cap-and-trade system should protect against discriminatory effects of pollution. Low-income communities and already-polluted communities should not bear the cost of an increase in localized pollution, and any benefits of system implementation should be broadly and equitably shared. All communities affected should have an opportunity to participate in the development of plans and alternatives.

***** END OF MESSAGE *****