WESTERN CLIMATE ADVOCATES NETWORK

June 19, 2009

Thank you for considering these comments submitted by the Western Climate Advocates Network (WeCAN) Cap Setting and Allowance Distribution Committee* on behalf of WeCAN – a network of environmental and public interest organizations around the Western U.S. and Canada working to advance critical issues related to the Western Climate Initiative (WCI). WeCAN appreciates the opportunity to offer answers in response to the WCI's "Stakeholder Discussion Questions on Competitiveness."

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1. What principles should govern how the WCI Partner jurisdictions evaluate and address potential competitiveness impacts of the WCI regional cap-and-trade program?

No one wins if emissions and jobs are simply shifted from an area under a pollution cap to an uncapped area (i.e., leakage of emissions or leakage of jobs). Therefore, leakage and competitiveness concerns should be taken seriously. Nonetheless, the experience with the European Union's Emissions Trading Scheme (EU ETS) suggests that a critical principle in practical terms for responding to competitiveness concerns is the avoidance of overcompensation of regulated entities. Aggressive lobbying has led to windfall profits for those regulated under the EU ETS. For example, steel manufacturers in the European Union received excess allowances (i.e., allowances left over after submitting allowances to cover their emissions) from the EU worth $1.5 billion.[1] Such excess compensation would unduly benefit capped entities, and, in the instance of large corporations would reward their shareholders from outside of the Western Climate Initiative region. This overcompensation would represent a lost opportunity to direct allowance value to invest in emission reductions that cap-and-trade might otherwise fail to induce, to advance technological innovation to protect economically vulnerable households, and to provide worker transition assistance, amongst other potential uses of allowance value for the public interest. Allowances represent a valuable public asset and should be invested carefully to further the public good. We urge the WCI Partners to ensure that the value of allowances accrue to the public interest.

Experience shows that the costs of environmental compliance have usually proven to be lower than they are predicted to be before a program goes into effect. Recent

[1] Szabo, Michael. 2009. "EU Steelmakers Reap $1.5 Billion Benefit from EU ETS," Reuters. (April 9)

Congressional testimony from Nat Keohane, Environmental Defense Fund,[2] and Richard Morgenstern's award-winning article, "On the Accuracy of Regulatory Cost Estimates,"[3] both provide excellent insights on this topic. This is another reason to be on guard against aggressive lobbying by regulated entities who have an interest in making inflated claims about future costs in an effort to secure a larger free distribution of allowances or other special accommodation. We start with an assumption that almost all stakeholders offer arguments in good faith. Yet the ability to rationalize in a way that is consistent with self interest is also a well known human trait. One does not have to assume bad faith while at the same time arguing for the need to be on guard against overcompensation.

In considering how the WCI cap-and-trade program will affect regulated entities, it is critical to go beyond consideration of energy price effects to consider the potential for efficiency to lower energy and other bills. Energy costs are a function of both price and quantity consumed. Efficiency investments can reduce costs and aggressive efficiency investment could actually improve competitiveness of businesses by reducing bills and exposure to energy price spikes. Indeed, there is a school of thought, often attributed to Harvard Business School Professor Michael Porter, that environmental policies can motivate firms to evaluate their operations, become more efficient and innovative, and thus increase their competitiveness relative to unregulated firms. The idea is that pollution is indicative of "inefficient or incomplete utilization of resources or of resources not used to generate their highest value."[4] From this perspective, pollution is not only harmful to public health and our quality of life; it is also bad for business because pollution represents waste and thus higher production costs.

We note that an increasing number of innovative financing mechanisms are being developed to levelize (i.e., spread out) efficiency investments over time. Sonoma County, California, offers a program that allows energy efficiency and on-site renewable

[2] page 20, figure 6, http://www.edf.org/documents/9605_keohane-carbon-cap-testimony-2009.pdf

[3] Morgenstern, R., Harrington, W. and Nelson, P. 2000. "On the accuracy of regulatory cost estimates," *Journal of Policy Analysis and Management* 19(2): 297-322

[4] Esty, D.C. and M.E. Porter. 1998. "Industrial Ecology and Competitiveness: Strategic Implications for the Firm," *Journal of Industrial Ecology* 2:35-43

Esty, D.C. and M.E. Porter. 2001. "Ranking National Environmental Regulation and Performance: A Leading Indicator of Future Competitiveness?" Chapter 2.1. in *The Global Competitiveness Report 2001-2002*: New York: Oxford University Press.

Porter, M.E. and C. van der Linde. 1995. "Toward a New Conception of the Environment-Competitiveness Relationship." *Journal of Economic Perspectives* 9:97-118.

energy investments to be spread out over many years and paid as an increment on property taxes.[5] Business owners that lease their buildings can still qualify by working with their property owners. Utilities are also increasingly offering similar programs in which efficiency investments can be paid over time through an approach called, "on bill financing."[6] Many such programs offer no upfront costs and zero percent financing. The non-partisan business advocacy group Small Business California has become a strong proponent of such programs.[7]

Another principle, reflected in discussion question three, is that that the policy environment is evolving. There is steady global progress in carbon pricing policy, and related clean energy and other areas. Consider the case of China, often cited as a laggard on climate policy. The country has already adopted aggressive vehicle standards that are more ambitious than in the United States, a 10% by 2010 renewable electricity portfolio standard, and a goal to reduce economy-wide energy use per unit of economic output by 20 percent by 2010.[8] Just last month China announced its intentions for future vehicle standards that exceed the new ones announced by the Obama Administration.[9]

As discussed at the WCI CSAD committee meeting, it will be necessary to separate the natural evolution of the economy, the cycle of births and deaths of businesses that are a natural part of a market system, as well as changes that would be reasonably expected in the transition to a low carbon economy. For example, a central task in our effort to manage greenhouse gas emissions is ending our addiction to oil and therefore some diminution of petroleum related activity would reasonably be expected over the years and decades to come. This would not represent emission leakage.

To ascertain legitimate concerns about competitiveness, recent research indicates that it is important to go beyond broad sectoral consideration of leakage to more targeted sub-industry consideration. A more fine grained assessment will help avoid the aforementioned overcompensation to capped entities not really in need. One sectoral note of interest concerns electricity, which is much less subject to foreign competition.

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[5] For more info, go to – http://www.sonomacountyenergy.org/energy-improvements.php
[6] http://ase.org/uploaded_files/5476/On-Bill%20Loans%20-%20Final.pdf
[7] http://www.smallbusinesscalifornia.org/On_Bill_Financing.htm
[8] Renewable Energy Policy Network for the 21st Century. 2007. "Renewables 2007: Global Status Report," http://www.ren21.net/pdf/RE2007_Global_Status_Report.pdf
[9] Bradsher, Keith. "China is said to plan strict gas mileage rules," New York Times. May 27, 2009.

Simply put, electricity cannot be imported from China, India, Denmark or Spain. The generating source must be connected to the Western grid, and furthermore imported electricity is being accounted for.

We agree with our friends in the labor movement that leakage is a serious issue that deserves attention. We recognize that some industries that may face competitiveness challenges are ones with high percentages of union jobs that are relatively well compensated. Going forward, it will be important that the potential of green jobs is realized, that these are not empty promises, so that the transformative effort to transition to a low carbon economy results in better paying jobs that provide greater security. We also agree with labor that windfall profits are a problem as they are a lost source of funding for the public interest uses we've already discussed.

2. What aspects of the WCI cap-and-trade program have the potential to cause intra-WCI competitiveness impacts?

The allowance distribution mechanism is the main aspect of cap-and-trade design that has the potential to cause intra-WCI competitiveness impacts. Intra-WCI competitiveness impacts would be minimized by the harmonization of allowance distribution across jurisdictions.

If allocation relies on auctioning, the prospects for over allocation within an individual jurisdiction are minimized. However, with administrative allocation, even if done uniformly across jurisdictions, the result could be different degrees of allowance scarcity between jurisdictions and, in turn, differences in the extent to which emissions contribute to production costs. In jurisdictions where allowances are over-allocated, and all else is equal, producers in that jurisdiction will have a competitive advantage over producers in jurisdictions where allowances are more scarce.

How significant are these intra-WCI competitiveness impacts compared to potential impacts arising from competition with businesses located outside the WCI Partner jurisdictions?

Since intra-WCI competitiveness impacts should not cause emission leakage (i.e., the shifting of emissions elsewhere, frustrating efforts to induce reductions), external competitiveness questions are of somewhat greater importance. That said, worker

dislocations are no less disruptive if they are due to economic shifts within the WCI region.

3. How can the WCI Partner jurisdictions best anticipate potential U.S. and Canadian federal efforts?

The logical course of action is to expect that federal climate policies are imminent, and may be in place as soon as 2012. Obviously, federal policies by both the U.S. and Canada will help to ensure a level playing field.

What competitiveness issues should the WCI Partner jurisdictions emphasize in communication with the two federal governments?

The WCI Partner jurisdictions contain or are close to many of the most abundant clean energy zones in North America and are ahead of the game in clean technology development. We should emphasize the need to keep in mind the opportunities offered by leading the way in development of 21st century energy systems that run on safe, abundant domestic sources like the sun and the win.

4. What opportunities and/or challenges, in terms of the competitiveness of covered sectors, might the WCI program present?

For the first time, in 2008, the majority of world investment in electricity generation went to renewable technologies.[10] By moving forward with the WCI, we will provide the policy framework for clean energy firms within the WCI to flourish, putting them in a better position to compete in this huge and ever expanding global market.

[10] Kanter, James. "Clean Energy Funding Trumps Fossil Fuels," New York Times, June 3, 2009.

"Global investors spent about $250 billion building new power capacity in 2008, and for the first time the lion's share of that money went to renewable sources, according to the United Nations Environment Program. Renewable sources accounted for 56 percent of investment dollars, worth $140 billion, while investment in fossil fuel technologies was $110 billion, the U.N. program said in a report, Global Trends in Sustainable Energy Investment 2009, released on Wednesday and produced in collaboration with New Energy Finance, a research company based in London.

The WCI Partners should be on guard against tried-and-proved-untrue arguments that economic growth and environmental protection are a zero-sum tradeoff. We can both grow the economy and enjoy cleaner air and water. Energy efficiency measures enable businesses and consumers to reduce emissions, save money, and increase economic growth. Climate policy can contribute to the growth of the industry domestically, putting indigenous clean energy firms in a better position to compete globally. One challenge is the difficulty that economic models have in modeling these potential upside opportunities.

What other factors might interact with the cap-and-trade program to enhance or hinder the competitiveness of covered sectors within a jurisdiction?

A strong set of complementary policies across all sectors, harmonized across WCI jurisdictions, will boost the cost effectiveness of the overall program, thereby reducing competitiveness concerns.

Cap-and-trade (or a carbon tax) corrects an important market failure, the lack of a price on carbon emissions. But we know there are other market failures and imperfections, including many that would inhibit the achievement of otherwise low cost measures (or even cost negative measures, e.g., ones that create net benefits due to energy savings). Therefore, complementary policies can capture low cost reductions that cap-and-trade might not be able to produce because other market failures would interfere with their realization. The California Market Advisory Committee, created to advise the Air Resources Board on cap-and-trade, endorsed this view as well.[11]

Think of the McKinsey and Co. assessment of the costs of various measures. All the negative cost measures, the ones that save money (mostly energy efficiency), are indicative of market failures that a simple price correction won't fix. This is because the energy savings already outweigh the additional incremental capital costs at current prices, and these rational investments aren't being made.

[11] See page 28:
http://www.energy.ca.gov/2007publications/ARB-1000-2007-007/ARB-1000-2007-007.PDF

The following NRDC fact sheet on polices to achieve near-term deployment of renewable energy, provides insight into four other relevant market failures.
http://www.nrdc.org/globalWarming/cap2.0/files/poweringup.pdf

***WeCAN Cap Setting and Allowance Distribution Committee**

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