California is in the process of defining the next chapter of its world-renowned climate leadership. Having pioneered a set of policies over the past decade that have put the state on course to meet its greenhouse gas emissions limit in 2020, lawmakers now face the question of what role the state's cap-and-trade program should play in achieving the much more ambitious 2030 target passed in SB 32 last year. As previous posts in this series have touched on, several factors bear on that calculus:

- Cap-and-trade's legal footing is uncertain beyond 2020 absent explicit statutory authorization that would insulate the program from charges that it constitutes an illegal tax.
- With the 2030 emissions limit already in law, the appetite of industry groups and some elected officials for preserving a market-based means of achieving it has grown considerably.
- Nearly a decade of implementation has produced a host of lessons learned, but different constituencies have sharply different views on what those lessons are and what they mean for the program going forward.
- Members of the Legislature want more say over how the Air Resources Board (ARB) designs and implements the state's climate plan, including the cap-and-trade program.
- And most recently, a close legislative vote on SB 1 to raise California's gas tax for the first time since 1994 has raised questions about the political viability of another supermajority vote that could have an impact at the pump.

A balancing act

Against that backdrop, SB 775 offers one approach to navigating the market and political dynamics that its backers argue will stymie any attempt at a simple extension. Driving that calculus are two key assumptions: that allowance prices will spike once the market prices in legal certainty beyond 2020, and remain high in the post-2020 period given the significantly increased stringency of the 2030 target. To prepare for the fallout, SB 775 proposes to:

1. Decouple the pre- and post-2020 programs to defer any impact on gas prices until 2021;
2. Install a hard price collar to contain prices in 2021 that would start (at $30) well below the current entry point of the allowance reserve ($51);
3. Prohibit banking in the post-2020 program to prevent market players from buying an unlimited supply of allowances at the low ceiling price;
4. Attempt to impose border adjustments as leakage protection as relying on output-based allocation has its limits at high carbon prices; and
5. Issue per capita dividends to cushion the impact of high prices on Californians.

As Ann Carlson and Dallas Burtraw have noted, there is much to like in the proposal but it comes at a significant price. By resetting the program in 2021, California would need to reestablish its current linkage with Quebec and planned linkage with Ontario (should it proceed), which may not be possible under the program parameters that SB 775 would establish. That would send a troubling signal of California going it alone in the face of a global problem. By splitting the program into pre- and post-2020 periods, the incentive for reductions and investments through 2020 would be curtailed while the current program dies on the vine. And by imposing a legally perilous and administratively staggering approach to prevent leakage, the proposal may simply trade a state constitutional challenge for a federal one (with potentially significant collateral damage to other state level climate policies, such as California's Low Carbon Fuel Standard, which narrowly survived review in the Ninth Circuit but only after seven judges dissented to the denial of the petition for rehearing en banc).

Let's get political

While SB 775 attempts to solve for certain political challenges, it raises a host of others. All the compliance entities seem likely to oppose leakage prevention shifting from free allocation to a speculative promise of border adjustments. Many legislators are not keen on orphaning the current program for three years with a corresponding hit on auction proceeds. Governor Brown, whose legacy is cloaked in subnational climate leadership, is not likely to look favorably at severing linkages, resetting the program in 2021, or taking on new legal risk. And the moderate Democrats and handful of Republicans who may warm to a price ceiling and dividend may balk at the proposed price trajectory, upon which the emissions reductions delivered by the reconstituted program would depend (eliminating the artificial escalation in the floor price is one of the Republican working group's core principles). Each of these factors alone would be difficult to overcome on the path to securing a two-thirds vote; together they are at least as daunting as the "blank check"/simple extension path that the SB 775 backers rightly criticize as deficient.

Build and refine

So what's to be done? Let's start by testing the core assumptions underlying SB 775. First, there is scant evidence of which I am aware to conclude allowance prices will spike upon enactment (the results of the modelling exercise I've heard cited to produces only a range of average prices over a study period that extends into the 2030s, based on multiple scenarios, and which all suffer from the same conservative assumptions on technology costs and innovation that have consistently led to exaggerated cost estimates for virtually every environmental regulation). To be sure, we'd expect to see allowance prices track upward once the legal clouds are parted, much as they did following the appellate court decision upholding the auctions. But the program contains many features to dampen escalating costs, and there is a sizeable buildup of unsold allowances from previous auctions over the past year that would become available to meet higher demand.

Second, there is little reason to presume allowance prices will reach as high as $100/ton. At that level, abatement strategies like carbon capture and sequestration become cost-effective *today*, let alone several years from now. And California is showing no interest in taking its foot off the gas, nor should it, in ratcheting down sector-based policies like the Renewable Portfolio Standard that leave the cap with less work to do. Even in the face of steeper targets, that has many market observers forecasting the market will remain long through the mid-2020s (and even longer if the linkage to Ontario falls apart).

More importantly, should expectations or reality prove otherwise, ARB has the latitude to respond without having to prejudge the outcome.

Reforms ahead

But ARB does not have authority in other areas (such as to issue dividends), and legislators understandably are looking for more assurances. While SB 775 outlines one pathway, the Legislature has other options to address political sensitivities but retain continuity in the program, preserve the backstop, avoid taking on new legal risk, and sustain linkage. For example, the Legislature could direct ARB to make changes to allowance banking rules between the pre- and post-2020 periods to comport with certain policy guideposts (such as mitigating price volatility and preventing windfalls). That signal alone would likely create enough uncertainty to mitigate any near-term price spikes. Similarly, the Legislature could direct ARB to reevaluate the viability of border adjustments as a preferred leakage prevention tool, while leaving room for the agency to assess its practical and legal implications.

We likewise encourage Legislative consideration of the following ideas teed up by SB 775 and AB 378.

Dividends

A two-thirds vote opens the door to using auction proceeds to fund dividends, tax credits or other means of returning revenue directly back to Californians. NRDC labored alongside many allies at the California Public Utilities Commission for years to help lay the foundation for California's Climate Credits, a biannual household dividend that already appears on utility bills for electricity customers of the state's investor-owned utilities. We support the Legislature expanding on this concept to afford protection where the incidence of carbon pricing will fall and to counteract any regressive impacts.

Price collar

While a price collar would allow the cap to be breached, that is not cause enough (for me) to fall on my environmental integrity sword. In the end, California's contribution to climate change will be measured by its leadership, not by constraining emissions at all costs. But the 2030 emissions limit in SB 32 should not be conflated with the regulatory cap that backstops it. As currently designed, the carbon price from cap-and-trade adjusts automatically based on the success of other policies and exogenous factors – such as the economy, natural gas prices, technology innovation, etc. – that dictate progress toward California's statutory emissions limits. If the state does not need to rely more on the cap and the price signal it provides, and other policies and market trends continue to overperform in delivering reductions, that's a result to cheer, not bemoan. But that is not the case if the cap is lifted and prices are set too low, which is always a risk in a political process. Developing new measures to course correct would take time for ARB to plan, implement and roll out, and would make achievement of the SB 32 limit less assured.

Any price ceiling should accordingly be set high enough – above the highest tier of the Allowance Price Containment Reserve in 2021 – and coupled with a trigger mechanism to make up for excess emissions authorized by allowance sales at the ceiling. One option would be to use a portion of the proceeds to purchase a commensurate number of offsets, particularly if offsets are curtailed as a compliance option. Offsets provide a financial tool to value climate mitigation and sequestration in sectors like forestry and agriculture, but are challenging to verify as truly additional reductions. While ARB's program is far more rigorous than the Clean Development Mechanism that earned offsets their bad rap, financing mitigation in uncapped sectors through allowances sales would afford more latitude to tailor projects in-state and based on a more holistic set of factors than what market pressures dictate.

Air quality

The absence of meaningful direct measures on industrial sources in the original Scoping Plan has led to very little abatement coming from those sources. For the predominately low-income and minority communities living near those facilities, that justifiably feels like a missed opportunity to capture the co-benefits that tend to follow. That's why we've been working to help develop AB 378, which recognizes the opportunity to more closely align

California's climate and air quality goals. While areas of the bill still need refinement, at its heart is a simple proposition: should California subsidize the production of industrial facilities that are behind the curve on controlling toxic and criteria emissions? We think the answer is no.

Getting to yes

California has a proven program that is the product of more than a decade of rulemaking and ongoing refinement. While the Legislature has an essential role to play in shaping its next phase, it should think twice before letting assumptions about allowance prices dictate program changes that may create more problems than they solve. We instead encourage lawmakers and the Governor to knit together components of SB 775 and AB 378 to build on the current foundation by elevating air quality, providing more protections for consumers, and attracting more partners. More than ever, the world is watching California to get it right.

Alex Jackson serves as Legal Director, California Climate Project and Energy & Transportation Program for the Natural Resources Defense Council.

This is part of a series, with links compiled at The Future of California's Greenhouse Gas Cap and Trade Program After 2020.