

## Joint Letter of Economists and Economic Experts to Governor Brown Relating to the Allowance Allocation Design of the California Cap-and-Trade Regulation

August 26, 2012

Governor Jerry Brown  
California State Capitol  
Sacramento, CA 95814

Re: Maintaining the AB32 cap-and-trade auction is important to the success of the trading program

Dear Governor Brown,

We commend your leadership in implementing the world's most comprehensive climate law and strongly support your commitment to auction allowances as part of the crucial launch phase of the cap-and-trade program.

The most important aspect of a cap-and-trade system is the actual cap. In theory, it does not matter to the environmental integrity of the program whether allowances are auctioned or given away for free. In reality though, once real-world conditions are introduced, the difference matters. These conditions include transactional costs, unfair market power, uncertainty, allowance allocation formulas that may be based on output or other changeable conditions (even with the expressed intent to reduce leakage), and other industry market behaviors that can introduce inefficiencies into perfectly functioning markets.<sup>1,2</sup>

The difference between auctioning allowances and giving them away for free is largely one around who gets the rents associated with the carbon price.<sup>3</sup> The more allowances are given away for free, the more rents businesses will receive. Auctioning allowances generates proceeds for government to redistribute to households, reduce other taxes, or achieve further environmental and equity goals that otherwise may not be achieved if allowances are given for free.

Moreover, whether an industry operates in a perfectly competitive market or otherwise, there is always the potential for windfall profits from free allocation. In most situations businesses are able to pass the market value of allowances through to consumers, even though they themselves received allowances for free. This is what happened in the EU's wholesale electricity market.<sup>4</sup> Short of fundamental market reform, the easiest step to reduce the potential for such undue profits is to auction allowances, a step the EU has since taken.

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<sup>1</sup> Hahn, Robert W. and Robert N. Stavins. 2012. "[The Effect of Allowance Allocations on Cap-and-Trade System Performance](#)," *Journal of Law and Economics* 54(4): pp. S267-94.

<sup>2</sup> The impact of real world conditions was also discussed in the 2010 EAAC report titled "[Allocating Emissions Allowances Under a California Cap-and-Trade Program](#)," March 23, 2010.

<sup>3</sup> Rent, or economic rent, is generally referred to as the difference between the raw costs of everything needed to produce a good or service and the price of that good or service.

<sup>4</sup> Sijm, Jos, Karsten Neuhoff, and Yihsu Chen, 2006. "[CO2 cost pass-through and windfall profits in the power sector](#)," *Climate Policy*, and Ellerman, Denny, and Paul L. Joskow. 2008. "[The European Union's Emissions Trading System in perspective](#)," Pew Center on Global Climate Change working paper (now: Center for Climate and Energy Solutions).

Lastly and perhaps most significantly, there is the fundamental question of policy certainty. In December 2011 (and dating even further back when considering the March 2010 EAAC report and adoption of the AB 32 scoping plan in 2008), California businesses were given the clear expectation of participating in an allowance auction when the program started. That auction is much more than a mere “price finding” exercise. It establishes the fact that businesses will pay for some portion of their carbon pollution.

Cancelling or scaling back the auction would simply result in a wealth transfer to covered entities beyond anyone’s expectations and disrupt the current design of the AB 32 cap-and-trade program.

Sincerely,

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