



By Robert N. Stavins

AB 32: The Whole World Is Watching

Why should sub-national climate policies exist? In the case of California's Global Warming Solutions Act (AB 32), the answer flows directly from the very nature of the problem — global climate change, the ultimate commons problem.

Greenhouse gases uniformly mix in the atmosphere. Therefore, any jurisdiction taking action — whether a nation, a state, or a city — will incur the costs of its actions, but the benefits of its actions (reduced risk of climate change damages) will be distributed globally. Hence, for virtually any jurisdiction, the benefits it reaps from its actions will be less than the costs it incurs, despite the fact that the global benefits of action may well be greater than global costs.

This presents a classic free-rider problem, in which it is in the interest of each jurisdiction to wait for others to take action, and benefit from their actions. This is the fundamental reason why the highest levels of effective government should be involved, that is, nations. And this is why international, if not global, cooperation is essential.

Despite this fundamental reality, there can still be a valuable role for sub-national climate policies, particularly when national policies fail to materialize. Furthermore, a special argument for the importance of California's climate policy is its potential precedent and lessons for other juris-

dictions around the world, including other states, provinces, countries, and regions.

Therefore, getting the design right of AB 32's cap-and-trade system is important, because the performance of the system will receive great attention from other jurisdictions around the world considering their own climate policies. The outcome of California's program will affect the likelihood of future commitments being made by other jurisdictions beyond the state's borders, as well as the ambition of those commitments. And the system's design and performance will have significant effects on design decisions in other states, provinces, countries, and regions.

Current allowance prices, which are near the auction reserve (floor) price, should not diminish attention to getting the design details right. Market conditions could change, leading to price increases, in which case the details of design will affect environmental performance and have economic consequences. Considering potential market rule changes to refine the program is prudent. It would be a mistake to wait until it is necessary to make ad hoc decisions in a time of crisis. Several pending design issues are crucial. In this column, I examine one of these: the GHG allowance reserve.

A recent study by University of California economist Severin Borenstein and his colleagues suggests that allowance prices in the AB 32 cap-and-trade system are likely to remain relatively low over the remainder of this decade, and that the probability is small of triggering and exhausting the system's allowance reserve, which is intended to moderate prices. Nevertheless, the possibility remains that as a result of unanticipated changes in the market (such as higher than anticipated economic growth in California, slower diffusion than anticipated of low-cost abatement tech-

nologies, etc.), the current reserve structure could lead to excessively high allowance prices if the reserve is exhausted. Establishing a mechanism now to avoid this potential future outcome is important to avoid ad hoc policy responses that might be developed in a crisis atmosphere.

A variety of mechanisms could be made available for providing incremental allowances to the reserve. For example, specific criteria could be established up front to grant the governor discretion (allowed under AB 32) to relax compliance obligations. Or provision could be made to replenish the reserve with allowances from other cap-and-trade systems or from the post-2020 AB 32 system. Another possibility would be overlapping compliance periods, which in effect provide for limited borrowing, as well as banking, thereby providing an additional cushion on price changes.

The most effective device would be a simple safety valve, whereby the government would offer to sell an unlimited number of allowances at a given price, thereby capping allowance prices and abatement costs. However, the authorities at the California Air Resources Board believe that this would not be allowed under AB 32, since a safety valve could result in the statute's specific emissions targets not being met.

Overall, CARB has done an excellent job in its initial design, but there will inevitably be unanticipated challenges that will arise, whether from complying firms, from the broader economy, from litigation, or from other legislation. It is important to design a system that is robust to such unanticipated shocks.

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