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The Complexities of California's Cap and Trade Program

CGA President Ron Fong continues his review of key State legislative and regulatory issues and the impact – in “plain English” – that they have on your business. This month: the Global Warming Solutions Act.

In 2006 the California legislature enacted Assembly Bill (AB) 32 the Global Warming Solutions Act, a comprehensive state mandate to reduce greenhouse gas emissions (GHG). Under AB 32, the California Air Resources Board (CARB) was required to develop various regulations and market mechanisms to reduce GHG emissions to 1990 levels by the year 2020.

The main funding mechanism for AB 32 is the market-based cap and trade emission auction. Under this program the state sets a limit on the amount of greenhouse gases a business can emit, and reduces that amount each year. While this may be a laudable environmental goal, the business community by and large is directly on the hook for funding AB 32 reforms.

The program covers primarily energy and petroleum producers in California, but will roll out to include suppliers of natural gas, pulp and paper manufacturing, glass production facilities and others—all the while generating billions of dollars in revenue for the state.

The actual cap and trade auction is not what you might imagine. There is not an auction house jammed with traders nor are there phones ringing incessantly. Rather, the auction is held on-line, lasting three hours. Using what's known as a sealed bid technique, bids are placed from companies across the country while state officials monitor the auction. Regulators acknowledge that there is a shroud of secrecy surrounding the auction and that secrecy is needed to maintain the auction's integrity.

There are various ways companies can stay under the cap. Companies are able to purchase permits to emit GHG's through the auction, modify operations to use energy more efficiently or pay for what are called “offsets” which allows

companies to go over the cap as long as they are investing in an environmentally beneficial project somewhere—even out of state. The offset system was put in place to allow companies sufficient time to modify their operations to adhere to the increasingly strict goals outlined in AB 32.

Cap and trade is hailed by some as the most advance eco-economic policies in the nation yet this “unique” way of attacking climate change has not caught on in other states as the proponents claimed it would. Proponents of a cap and trade program envisioned that this market-based system would quickly be adopted in other states but thus far not a single one has enacted legislation on par with these California specific mandates.

Moreover, there is some ambiguity about the legality of the program. Although the auction is public, revenues raised from the auction are (in part) placed in a newly established state fund used for state projects such as the controversial high-speed rail project—among other renewable projects. The California Chamber of Commerce contends that AB 32 violates Proposition 26 which states that all new taxes must be passed by a 2/3 majority of the legislature. AB 32 was passed by the legislature with a simple majority vote. Thus far, the state has survived its first legal challenge. Cal Chamber's legal appeal is currently pending.

Capital investment costs for manufacturers will continue to rise as the state continues to require lower and lower GHG emissions levels. So what does this mean for the grocery industry? In short, the price of goods will continue to rise. Grocery companies will have to make their own independent business decisions on how to combat price increases, but it stands to reason that increased costs will have to be passed on to the consumer in order to remain profitable. ■