Ruben Lubowski

Chair Lauren Sanchez
California Air Resource Board
1001 I Street
Sacramento, CA 95814

May 4, 2026

RE: Comments on Proposed Modifications (15-Day Amendments) to the Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms

Dear Chair Sanchez:

I greatly appreciate the opportunity to provide feedback on the proposed modifications (15-Day Amendments) to California's cap-and-invest program posted on April 14. California's cap-and-invest program is not only critical to achieve the state's climate and affordability goals but is important as an example of well-designed market-based climate policy across the US and globally.

Lombard Odier Investment Mangers (LOIM) is the asset management arm of the Lombard Odier Swiss banking group, founded in 1796, with a core investment conviction in the net zero transition. I am part of the carbon team at LOIM, which manages an investment strategy trading across carbon markets globally, including the California/Quebec cap-and-invest market. I am also an Adjunct Professor teaching Carbon Pricing at Columbia's University School of International and Public Affairs. The views expressed here are mine alone and do not necessarily reflect those of others at these organizations.

Thank you very much for your time and consideration.

Sincerely yours,

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COMMENTS:

1) Requiring industrial recipients of free allocation to consign allowances would bolster ability of the auction reserve price to provide predictable price signal for investment

The auction reserve price is an important feature of the program, helping to support program revenues and provide a predictable price signal to drive investment by managing the potential variability of prices. However, the ability of the ARP to provide a "soft" floor on the secondary market is weakened by the proposed increases in the quantities of free industrial allowance allocations, particularly from the Build Up California Reserve Account (BUCRA). In addition, the uncertain timing and quantities of BUCRA allowances to be allocated each year under the Manufacturing Decarbonization Incentive (MDI) Allocation program will contribute to market uncertainty. This at the same time as the added free allocation and MDI allocations stand to reduce demand for the auction, potentially more than one for one if each allowance allocated reduces emissions by at least one ton in addition to expanding the allowance budget by one ton. The combined effect will be to depress the price, potentially below the auction floor price.

Maintaining the ability of the auction reserve price to provide a soft floor on the market is important not only for program revenues but for supporting a stable gradually rising price signal that drives investment, potentially countervailing the purpose of the MDI program.

A logical solution would be to require that all industrial entities that receive free allocation consign their free allocation for sale during the auctions in the same way as investor-owned utilities. In particular, all entities receiving MDI allowances should be required to monetize these via consignment auctions, rather than selling them on the secondary market or using them directly for compliance. This would bolster the ability of the price floor to stabilize the market.

As we have noted in prior comments, in the context of declining auction volumes, this would bolster the ability of the auction reserve price to assure a predictable price signal to drive investment in line with California's climate goals. These consignment requirements would also increase liquidity and price transparency and correspondingly reduce potential for market manipulation in the context of smaller overall allowance budgets.

2) Building Up California Reserve Account (BUCRA) should be within the allowance budget

The creation of the BUCRA account separate from the program allowance budgets sets a dangerous precedent for the integrity and predictability of the program, paving the way for new special purpose reserves in the future.

The proposal reduces 118.3 million from the allowance budgets through 2030 but then proposes to essentially shift or "backload" these volumes to later years through the MDI program. Limits on annual MDI allocations should ensure that emissions cannot exceed California's statutory climate goals.

Even if this requires a follow-up rulemaking process, it would strengthen program credibility and be more consistent with prior practice for CARB to set the allowance budget to account for the BUCRA "under" rather than "outside" of the cap, just as the APCR and all other free allocation is accounted for. This would also be consistent with the policy direction to account for offsets under the cap to help assure the environmental integrity. This could be implemented together with stricter requirements on MDI as discussed below.

3) Potential unintended consequences of the Manufacturing Decarbonization Incentive (MDI) program

The proposed design of the MDI program risks creating unintended incentives to delay investments and gain windfall profits. As currently laid out, recipients of MDI allowances do not have to show any investment until two compliance periods have passed and then have the option to return allowances (at the average value of the quarterly auctions in the initial allocation year) for any unspent funds. This flexibility creates a strong incentive for all entities to apply for allowances and then to delay investments to provide time for potential allowance price increases. For example, if an entity receives one million allowances at a value of $30, the entity can wait two compliance periods to see if the price increases, which one would expect to be at least at 5% plus inflation assuming the price floor holds. If the price eventually increases to $60, for example, the entity can sell allowances, invest the $30 million as originally proposed and reap $30 million in windfall profits. If the price falls, the entity has no price risk and can return the allowances at the original year's price as recognized by CARB.

To prevent such incentives, CARB should require entities to sell all MDI allowances on consignment, providing transparency to CARB on the amount received. Further, they should be required to invest the full amount received in either decarbonization or compliance. If entities do not make the proposed investments within the allowed period, in addition to returning allowances, entities should also be required to pay back the monetary amount received with interest.

4) Manufacturing Decarbonization Incentive (MDI) program treatment of exempt biomass fuels

Special care should be taken to ensure that the MDI program does not inadvertently increase emissions through its proposed support for 50% of the costs of "exempt biomass-derived fuels" 95891(g)(2)(A). This stands to exacerbate the leakage problem and perverse interaction with the LCFS created by the fact that biomass-derived fuels are treated as zero emissions under the cap and invest program, rather than aligning with the emissions accounting under the LCFS. If the MDI program promotes substitution of biomass-derived fuels in the place of fossil fuels, the associated emissions will completely drop out of the coverage, lowering demand in the program which will depress prices. In addition, this will allow other entities to increase emissions by a corresponding amount even though the actual emissions reductions might be much less. This stands to erode rather than support California's climate goals unless the greenhouse gas accounting is corrected.

The most straightforward solution would be to align the accounting for granting allocations under the MDI with the emissions accounting under the LCFS. Furthermore, entities should not be able to claim LCFS credits for the same quantities of fuel supported by the MDI, given that this can distort incentives for cost-effective reductions under the LCFS. Finally, allowances should be canceled in the subsequent year to make up for any emissions that drop out due to the substitution of fossil for exempt biomass-derived fuels to ensure California stays on track for its climate goals.

5) MDI should be targeted to promote cost-effective emissions reductions, avoid leakage risk, and provide systemic demonstration benefits

Output-based free allocation for EITE sectors directly targets leakage risk by virtue of being proportional to output levels. As noted in our previous comments, approaches to support industrial decarbonization projects have potential to protect against leakage but also could reduce emissions intensity for industrial emitters, reducing their compliance burdens while not providing any incentives to preserve output. Also, to the extent these projects are all reducing emissions from covered entities already covered under the cap, the "waterbed" effect within the cap (which could be considered a different form of leakage) means that this would in most situations not reduce overall emissions (unless the result was to avoid releases of units from the APCR or price ceiling). This contrasts with other potential state investments to reduce emissions from natural and working lands or other emissions sources outside the cap. The MDI could even increase emissions on net due to the inconsistent accounting for biogenic emissions, as noted above.

A minimum safeguard should be to require consignment of all industrial free allocations to bolster the ability of the auction reserve price to provide a predictable price signal for investors. Ideally, to ensure additional emissions benefits, California would also retire a number of allowances equal to the number of emissions reductions estimated to have been directly paid for using state resources.

In addition, we recommend that any investments in industrial decarbonization projects be 1) well targeted at avoiding leakage risk and 2) cases where there is a demonstrable case that the project will avoid reductions in output. Care should also be taken not to award so many MDI allowances relative to the emissions of any particular entity that this becomes a subsidy to increase output and associated emissions beyond what would have occurred without any carbon price. A cautionary example of this is discussed in Box 5-7 (Technical note: Impacts of output-based allocation) in PMR-ICAP (2021).

Given a limited number of allowances, California should also seek to prioritize projects that have the most systemic and catalytic benefits beyond the individual project, including through the demonstration of new technologies and required publication and sharing of lessons. Furthermore, use of state resources should also be structured so as to 1) entail a competitive bidding and application process (e.g. through a reverse auction) targeting cost-effective and "additional" emissions reductions, which require the added financial support; 2) maximize leverage from the private sector given the limited budgets relative to the potential need; and 3) work in a complementary manner with the carbon price by promoting cost-effectiveness and technology neutrality.

In this respect, California could consider contracts-for-difference as a potential approach. Governments are using these contracts with companies to backstop the functioning of carbon markets by guaranteeing a minimal carbon price signal to derisk large-scale private investments in the face of carbon market uncertainties. Recent examples of such contracts to spur industrial decarbonization include the Canada Growth Fund (https://cdev.gc.ca/canada-growth-fund-inc/) and Germany's Federal Ministry for Economic Affairs and Energy (https://www.klimaschutzvertraege.info/en/home). There are several important design features, as described by Look et al (2025).

References:
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