

## Greenhouse Gas Reductions under Low Carbon Fuel Standards?<sup>†</sup>

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*A low carbon fuel standard (LCFS) seeks to reduce greenhouse gas emissions by limiting the carbon intensity of fuels. We show this decreases high carbon fuel production but increases low carbon fuel production, possibly increasing net carbon emissions. The LCFS cannot be efficient, and the best LCFS may be nonbinding. We simulate a national LCFS on gasoline and ethanol. For a broad parameter range, emissions decrease, energy prices increase, abatement costs are large (\$80–\$760 billion annually), and average abatement costs are large (\$307–\$2,272 per CO<sub>2</sub> metric ton). A cost effective policy has much lower average abatement costs (\$60–\$868). (JEL Q54, Q58)*

Low carbon fuel standards (LCFSs) are rapidly becoming an integral part of the national debate over how to reduce greenhouse gas emissions. On January 18, 2007, California Governor Arnold Schwarzenegger signed an executive order launching a low carbon fuel standard to reduce the carbon intensity of fuels for light-duty vehicles.<sup>1</sup> The standard, which limits an industry's weighted average carbon emissions rate or, equivalently, the carbon emissions per unit of output, allows fuel producers to achieve a given carbon emissions rate by flexibly altering their production of fuels.<sup>2</sup> Senators John McCain and Barack Obama have both called for

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<sup>1</sup> The executive order S-01-07 states the LCFS shall “reduce the carbon intensity” of fuels. An accompanying white paper states that providers must “ensure that the mix of fuel...meets, on average, a declining standard for GHG emissions.”

<sup>2</sup> There is much ambiguity in the design of an LCFS, including what output is covered (e.g., light-duty versus heavy-duty vehicle fuel), how output is measured (e.g., energy versus miles), and how emissions rates are measured (e.g., upstream versus downstream). These policy design issues are currently being debated for the California LCFS.

a national low carbon fuel standard.<sup>3</sup> Other countries, states, and regions also have proposed low carbon fuel standards.<sup>4</sup> Despite its increasing prominence, this is the first paper to analyze the economics of low carbon fuel standards.

The political appeal of low carbon fuel standards has several components. First, federal resistance to the regulation of greenhouse gas emissions has limited states' options. In particular, the options for addressing carbon emissions from the transportation sector, which accounts for 28 percent of US emissions (US EPA 2006) are severely limited.<sup>5</sup> An LCFS might avoid these federal restrictions. Second, Pigouvian taxes, which can correct negative pollution externalities, have proven politically infeasible.<sup>6</sup> An LCFS is not a tax. Third, cap and trade policies, which are more politically palatable, may be undermined by demand shocks.<sup>7</sup> For example, the Regional Clean Air Incentives Market (RECLAIM) emissions market was almost destroyed by the California electricity crisis since it was argued that the rigid emissions limits contributed to high electricity prices.<sup>8</sup> An LCFS, by regulating emissions rates rather than emissions, allows for higher emissions in years with higher demand. Finally, politicians are quite sensitive to the effects of policies on energy prices in general and on gasoline prices in particular. An LCFS certainly does not have a direct effect on prices, and one can imagine scenarios (and we will illustrate one) in which an LCFS reduces carbon emissions without increasing gasoline prices.<sup>9</sup>

Despite this political appeal, we argue that low carbon fuel standards have a large cost in terms of efficiency and effectiveness. In particular, we show that an LCFS limiting carbon emissions per unit of energy (the energy-based LCFS) can achieve the efficient allocation only under unrealistic assumptions.<sup>10</sup> Moreover, we find that, contrary to the stated purpose, an LCFS can actually raise carbon emissions. Additionally, we show that the best LCFS, from a regulator's perspective, "under-taxes" all fuels and may require a nonbinding standard, i.e., the best standard may be no standard at all.

<sup>3</sup> Similarly, US Senators Dianne Feinstein (D-CA), Susan Collins (R-ME), and Olympia Snowe (R-ME) have introduced a measure (S.1073) designed to reduce carbon emissions, which requires an increase in the percentage of alternative fuels.

<sup>4</sup> A current count includes British Columbia, Washington, Oregon, Arizona, New Mexico, Minnesota, Illinois, the United Kingdom, and the European Union.

<sup>5</sup> The Clean Air Act of 1970 stipulates only the Environmental Protection Agency (EPA) is allowed to regulate fuel economy. California AB 1493, which caps greenhouse gas emissions from vehicles, is currently being challenged in the courts.

<sup>6</sup> While some governments in other parts of the world have successfully passed carbon tax legislation, most recently British Columbia, carbon taxes in the United States have been unpopular. For example, two separate proposals in the US House of Representatives put forward by Representative John D. Dingell of Michigan and Representative Pete Stark of California in 2007 have been all but abandoned.

<sup>7</sup> Permits that are fully tradeable intertemporally can increase the flexibility of tradeable permits. In practice, permits are "bankable" but not "borrowable." Hybrid instruments can also increase the flexibility of tradeable permits. A carbon intensity policy (based, for example, on gross domestic product) can also adjust for demand shocks, see William A. Pizer (2005).

<sup>8</sup> See Paul L. Joskow and Edward Kahn (2002) or Severin Borenstein, James Bushnell, and Frank A. Wolak (2002) for an analysis of this claim.

<sup>9</sup> In initial policy discussions for implementing an LCFS in California, no mention was made of any effects on prices.

<sup>10</sup> We use efficient allocation to describe the levels of emissions and energy production that maximize producer plus consumer surplus less carbon damages. Because of additional noncarbon market failures, this allocation may not be first best. We discuss the implications of noncarbon market failures in Section VII.

The intuition behind these effects is that the LCFS acts as an implicit tax on any fuel with a carbon intensity above the standard, but acts as a subsidy for any fuel with a carbon intensity below the standard. The efficient allocation cannot be attained since it requires that any fuel emitting carbon should be taxed (not subsidized) in equilibrium. Carbon emissions can increase because compliance with the LCFS can be achieved by reducing the production of high-carbon fuels or increasing production of low carbon fuels. In equilibrium, it is optimal for firms to do both. We show that it is possible that increases in carbon from ramping up production of the low carbon fuel can outweigh the reduction in carbon associated with decreasing output of the high-carbon fuel.

We extend the theoretical analysis in a number of ways. First, we argue that the results under perfect competition also hold for firms with market power. In Section III, we discuss meeting the LCFS by trading carbon, energy, or weighted emissions rates and show that trading can reduce compliance costs by allowing firms to equate the marginal production cost of each fuel across firms. Section IV illustrates the surplus gains and losses to producers and consumers. Depending on the relative elasticities, producers and/or consumers can bear the burden of the LCFS. Incorporating gains from carbon trading shows that producers of low carbon fuels are better off under an LCFS, while producers of high-carbon fuels are harmed.

Section V analyzes variants of the energy-based LCFS. First, we show that an LCFS, which measures output as miles driven, has similar inefficiencies as the energy-based LCFS. We argue that feasible variants, which use different baselines for output, can have better incentives than the energy-based LCFS by increasing the implicit tax and reducing the implicit subsidy of the LCFS. In particular, a historical baseline LCFS, which regulates carbon emissions relative to historic energy production, can attain the efficient allocation of emissions and fuel production. Analysis of these variants makes explicit the difficulties of finding a suitable baseline for the LCFS or for any other trading program. Section VI analyzes the incentives under the different policies for technological innovation in carbon emissions rates and fuel economy.

To understand the likely impacts of an LCFS, Section VII calibrates the theoretical model using a range of parameters representative of US supply and demand conditions for ethanol and gasoline. We find that an energy-based LCFS is unlikely to increase CO<sub>2</sub> equivalent (CO<sub>2</sub>e) emissions.<sup>11</sup> In fact, we find that the CO<sub>2</sub>e reductions can be surprisingly large. For example, an LCFS that reduces the carbon intensity by 10 percent reduces emissions by 45 percent for one set of parameters.<sup>12</sup>

While the CO<sub>2</sub>e reductions can be significant, the energy-based LCFS is an expensive way to achieve these reductions. For the 10 percent reduction in carbon intensity, we find that the average abatement cost per ton of CO<sub>2</sub>e, the private surplus

<sup>11</sup> Although termed low *carbon* fuel standards, the California proposal aims to reduce emissions of CO<sub>2</sub> and other greenhouse gases. Throughout the paper we use the terms *carbon* and CO<sub>2</sub>e interchangeably to include all greenhouse gas emissions. We use *tons* to describe metric tons of CO<sub>2</sub>e, abbreviated as MTCO<sub>2</sub>e and MMTCO<sub>2</sub>e for one million metric tons.

<sup>12</sup> The proposed LCFS in California calls for a 10 percent reduction in carbon intensities.

loss per ton of CO<sub>2</sub>e reduction, ranges from \$307 to \$2,272 per ton.<sup>13, 14</sup> This implies that if the damage per ton of CO<sub>2</sub>e is less than \$307, the LCFS reduces welfare. Since most damage estimates are less than this, our calculations imply that society would be better off without an LCFS compared to a standard that reduces the carbon intensity by 10 percent. In fact, if carbon damages are less than \$140, even a modest LCFS reducing carbon intensities by only 1 percent would not increase welfare in our simulations.

We compare these costs to the historical baseline LCFS, which is equivalent to carbon trading and can attain the efficient allocation. The abatement costs under the historical baseline LCFS, which attains the same CO<sub>2</sub>e emissions reduction, are much lower ranging from \$60 to \$868 per ton of CO<sub>2</sub>e.<sup>15</sup> This historical baseline LCFS corrects the perverse incentive for firms to internally subsidize ethanol production, taxing all fuels commensurate with their carbon content.

The main advantage of the energy-based LCFS is that it corrects the relative prices of high- and low carbon fuels and gives an incentive to reduce carbon emissions rates. However, the main shortcoming of the energy-based LCFS is that it fails to correct the price of driving, and may even exacerbate the low price, because of the implicit subsidy to energy. In particular, the surest ways to reduce carbon emissions (carpooling, driving less, taking mass transit, etc.) do nothing to help satisfy the LCFS. Other policies may have similar advantages and/or shortcomings. Table 1 summarizes a variety of policies across four dimensions for reducing carbon emissions. In particular, the table asks whether each policy corrects the relative prices of fuels, the price of driving, and the incentives to improve carbon emissions rates and fuel efficiency. For example, the first policy research and development support for reducing carbon emissions from fuels only addresses one of the four ways to reduce carbon emissions. Similarly, Corporate Average Fuel Economy (CAFE) standards only provide an incentive to improve fuel economy and do nothing about carbon emissions rates or the incentive to drive. The LCFS is arguably superior to either of the policies alone since it can correct the relative prices of high- and low carbon fuels and give an incentive to reduce carbon emissions rates. However, the energy-based LCFS is clearly inferior to either a carbon tax or a historical baseline LCFS, both of which reduce carbon emissions through all four dimensions.

Table 1 provides an interesting perspective on two other carbon policies. First, the fuel economy LCFS can provide an incentive to improve fuel efficiency of cars. The energy-based LCFS does not provide this incentive. However, given the existence of a national CAFE standard and bills in California to improve fuel economy, most

<sup>13</sup> Equivalent calculations that consider an energy-based LCFS operating only in California result in an average abatement cost that ranges from \$263 to \$903 per ton of CO<sub>2</sub>e. This analysis holds ethanol consumption for the remainder of the United States fixed, while allowing California consumption to vary. Therefore, these estimates represent a lower bound on energy prices and average abatement cost. For intensity reductions less than 10 percent, energy prices are lower under the California LCFS than under the unregulated equilibrium. This results in increased consumer surplus and is reflected in the relatively lower average abatement cost compared to the US system.

<sup>14</sup> Throughout the paper, private surplus is the sum of producer and consumer surplus; welfare is the private surplus less carbon damages; and abatement costs are the lost private surplus from a policy. Thus, a policy increases welfare if avoided damages are greater than the abatement costs. As defined here, abatement costs are more inclusive than the direct control costs of reducing carbon emissions.

<sup>15</sup> The equivalent values for a historical baseline LCFS operating only in California range from \$28 to \$236 per ton of CO<sub>2</sub>e and are significantly lower than costs under the comparable energy-based LCFS.

TABLE 1—COMPARISON OF VARIOUS CARBON POLICIES

	Can the policy ...			
	correct the relative prices of high and low carbon fuels?	correct the price of driving?	provide an incentive to reduce carbon emissions rates?	provide an incentive to improve fuel efficiency?
R&D support for reducing carbon emissions	N	N	Y	N
CAFE standard	N	N	N	Y
Energy-based LCFS	Y	N	Y	N
Fuel economy LCFS	Y	N	Y	Y
Fuel tax	N	Y	N	Y
Carbon tax	Y	Y	Y	Y
Historical baseline LCFS	Y	Y	Y	Y

LCFS proposals mirror our energy-based LCFS rather than our fuel economy LCFS. Second, a fuel tax neither corrects the relative prices of fuels nor provides an incentive to reduce carbon emissions rates. This suggests that a fuel tax and an energy-based LCFS may be complementary policies. In fact, a fuel tax combined with an energy-based LCFS can attain the efficient allocation.<sup>16</sup> Unfortunately, LCFS proposals have not been coupled with an increase in fuel taxes.

Our theoretical analysis is similar to John E. Kwoka's (1983) study of an auto manufacturing monopolist facing linear demands and a CAFE standard.<sup>17</sup> He shows that under a CAFE standard total vehicle sales can increase and fuel savings can be partially or fully offset.<sup>18</sup> Our theoretical results are even stronger along several dimensions. First, we demonstrate that rate regulation cannot be efficient. Second, we show that the best rate regulation may be nonbinding. Third, we show that the results are not due to market power, but rather are an optimal response to the policy. Fourth, our results hold for general supply and demand functions. Fifth, we illustrate the underlying supply and demand conditions which lead to the counterintuitive result. Finally, we analyze alternative baselines and trading.

While we analyze a low carbon fuel standard, our results are immediately applicable to any policy that regulates a rate when the true target of the policy is the level. The analysis is even applicable beyond environmental policy. For example, No Child Left Behind (NCLB), which requires a certain percentage of students to pass standardized tests, essentially regulates the test failure rate of public schools. Our analysis shows that NCLB places an implicit tax on low-achieving students and a subsidy on high-achieving students. If this tax leads to a reduction in the number of low-achieving students taking the tests, then NCLB would lead to a *decrease* in the number of

<sup>16</sup> To see this, note that equation (4) becomes  $p_i = MC_i(q_i) + \lambda(\beta_i - \sigma) + t$  with an LCFS of  $\sigma$  and a fuel tax of  $t$ . Note that this attains the first best if the LCFS is set such that  $\lambda = \tau$ , and the fuel tax is set such that  $t = \tau\sigma$ .

<sup>17</sup> Gloria E. Helfand (1991) considers a number of regulatory instruments for regulating pollution including a standard expressed as emissions per unit output. As in our analysis, Helfand finds that the "constraint could lead to the perverse result that pollution increases." Her analysis does not, however, include our other theoretical results.

<sup>18</sup> An LCFS can be thought of as regulating the carbon efficiency of fuel. Daniel Khazzoom (1980) first identified the "rebound" or "take-back" effect of energy efficiency regulations, and Paul R. Portney et al. (2003) discuss the rebound effect in CAFE standards. Since motorists do not directly pay for carbon emissions, regulating carbon efficiency with an LCFS does not directly affect the cost of driving, and the LCFS does not have a "rebound effect." However, an LCFS may decrease the equilibrium price of the low carbon fuels.

students passing the exams.<sup>19,20</sup> Although, public school administrators at the primary and middle school levels may have little scope for altering the mix of students taking the exams, our analysis illustrates the incentives these administrators face.

### I. Efficient Fuel Production and Carbon Emissions

The model considers a negative externality, carbon emissions, associated with energy production. To illustrate the main theoretical effects, we focus on two fuels with different costs and carbon emissions rates. The theoretical analysis readily generalizes to multiple fuel sources.

One fuel source, the high-carbon fuel, e.g., gasoline, has production costs  $C_H(q)$  with  $C'_H > 0$  and  $C''_H > 0$  and carbon emissions rate  $\beta_H$ . A second fuel source, the low carbon fuel, e.g., ethanol, has production costs  $C_L(q)$  with  $C'_L > 0$  and  $C''_L > 0$  and emissions rate  $\beta_L$ .<sup>21</sup> Assume  $\beta_H > \beta_L \geq 0$  but  $C_H(q) < C_L(q)$  for every relevant  $q$ . Further, assume the quantities of each fuel source,  $q_H$  and  $q_L$ , are measured in some equivalent energy unit, e.g., mmBtu, with  $q_i \in \mathbb{R}_+$ . Suppose a unit of carbon does  $\tau$  dollars of damage, so the environmental damage from fuel  $i$  is  $\tau\beta_i q_i$ .

Let the benefit from consumption of energy be  $U(q_H, q_L)$  with  $U$  increasing, differentiable, and concave. This function, which captures consumer surplus, is quite general and allows for a wide range of assumptions about the substitutability of the fuels. Importantly, the marginal benefits, i.e., the partial derivatives, capture the demands for the fuels.<sup>22</sup>

Efficient fuel production, consumption, and carbon emissions in the model can be found from the following maximization problem:

$$(1) \quad \max_{q_H, q_L} U(q_H, q_L) - C_H(q_H) - C_L(q_L) - \tau(\beta_H q_H + \beta_L q_L).$$

Letting  $MC_i = \partial C_i / \partial q_i$ , the first-order conditions can be written as

$$-\frac{\partial U}{\partial q_i} = MC_i(q_i) + \tau\beta_i,$$

for  $i \in \{H, L\}$ . Thus, in the efficient allocation, the marginal benefit of consumption equals the marginal social cost of production for each fuel.

As is well known, perfectly competitive firms cannot, in general, achieve this efficient allocation and produce too much of any good which causes a negative

<sup>19</sup> Edward B. Fiske and Helen F. Ladd (2004) observe precisely this effect in post-apartheid South Africa. Although pass rates for matriculation exams increased after 1997, the total number of passes declined slightly over this period of time. The authors attribute part of this to a "variety of responses by individual schools to political pressure to raise their particular pass rates."

<sup>20</sup> David N. Figlio and Lawrence S. Getzler (2002) observe that Florida schools tended to reclassify lower performing students as disabled and exempt from standardized testing at higher rates following the introduction of the Florida Comprehensive Assessment Test in 1996.

<sup>21</sup> We assume costs are additively separable:  $C(q_H, q_L) = C_H(q_H) + C_L(q_L)$ . Nonzero cross derivatives could be incorporated with additional notation.

<sup>22</sup> This formulation assumes additive separability from other goods. Income effects could be easily incorporated at the cost of additional notation.

externality. For prices  $p_i$ , the inefficiency arises in this model since firms produce such that  $p_i = MC_i(q_i)$ , but ignore the marginal social damage,  $\tau\beta_i$ . Because  $p_i = \partial U/\partial q_i < MC_i(q_i) + \tau\beta_i$  in equilibrium, too much of each good is produced. This over-production could be corrected with market mechanisms such as Pigouvian taxes, here  $\tau\beta_i$ , or a system of tradeable permits. Importantly, the Pigouvian taxes, which internalize the externality, impose a positive carbon tax on production of each fuel with a lower Pigouvian tax on the low carbon fuel.

## II. An Energy-Based Low Carbon Fuel Standard

Consider a low carbon fuel standard expressed as a limit on the emissions per energy unit of fuel produced. This is equivalent to a limit on the average emissions rate weighted by output shares, i.e., the carbon intensity. To emphasize the tradeoffs between production of the two fuels, we focus on a single, representative, price-taking firm which produces both fuels. The analysis is easily extended to symmetric price-taking firms. Firms that are not price takers are analyzed in the section on market power, and asymmetric firms are discussed in the section on trading.

Let  $\sigma$  be the low carbon fuel standard, for example, in metric tons of CO<sub>2</sub>e per mmBtu. The LCFS constraint facing our representative firm is

$$(2) \quad \frac{\beta_H q_H + \beta_L q_L}{q_H + q_L} \leq \sigma.$$

Note that since the constraint implies that the weighted average of  $\beta_H$  and  $\beta_L$  must be less than  $\sigma$ , the constraint set is empty if  $\sigma < \beta_L$ . Similarly, the constraint set contains the entire positive orthant if  $\sigma > \beta_H$ .<sup>23</sup> In what follows, we assume that  $\beta_L \leq \sigma \leq \beta_H$ .

If we write the constraint as  $\beta_H q_H + \beta_L q_L \leq \sigma(q_H + q_L)$ , the Lagrangian for the firm's profit maximization can be written

$$(3) \quad \max_{q_H, q_L} p_H q_H + p_L q_L - C_H(q_H) - C_L(q_L) + \lambda[\sigma(q_H + q_L) - \beta_H q_H - \beta_L q_L],$$

where  $\lambda$  is the shadow value of the LCFS constraint. The firm's first order conditions are

$$(4) \quad p_i = MC_i(q_i) + \lambda(\beta_i - \sigma),$$

and

$$(5) \quad \lambda[\sigma(q_H + q_L) - \beta_H q_H - \beta_L q_L] = 0,$$

<sup>23</sup> Intuitively, if the standard is stricter than the lowest emissions rate, it is impossible to meet. Alternatively, if the standard is weaker than the highest emissions rate it is never binding.

where  $\lambda \geq 0$ . The first condition is that the firm equates price and marginal opportunity cost, where the opportunity cost includes the production cost as well as the effect on the LCFS constraint. The second condition, (5), is the complementary slackness condition which states that either the shadow value of the constraint is zero or the LCFS constraint binds. Since (4)–(5) characterize supply, and demand for fuel  $i$  is characterized by  $p_i = \partial U / \partial q_i$ , we have:

*Characterization of the energy-based LCFS equilibrium.*—If the LCFS binds, the LCFS equilibrium  $(q_H^e, q_L^e, \lambda^e)$  is characterized by

$$(6) \quad \frac{\partial U(q_H^e, q_L^e)}{\partial q_i} = MC_i(q_i^e) + \lambda^e(\beta_i - \sigma)$$

for  $i \in \{H, L\}$  and the constraint equation  $\sigma(q_H + q_L) = \beta_H q_H + \beta_L q_L$ .

The LCFS equilibrium introduces a wedge,  $\lambda^e(\beta_i - \sigma)$ , between marginal benefit, i.e., demand, and marginal cost, i.e., supply. Intuitively, this LCFS wedge can be analyzed like any tax wedge. To analyze this wedge, note that  $\beta_H - \sigma \geq 0$  and  $\beta_L - \sigma \leq 0$  since the standard is between the two emissions rates. For fuels with emissions rates higher than the standard, the LCFS wedge is nonnegative. Thus, the high-carbon fuel is taxed in the LCFS equilibrium. However, for fuels with emissions rates lower than the standard, the LCFS wedge is nonpositive, and the low carbon fuel is subsidized in the LCFS equilibrium.<sup>24</sup> This leads to our first result.<sup>25</sup>

**PROPOSITION 1:** *The energy-based low carbon fuel standard cannot achieve the efficient allocation of fuel production and carbon emissions if  $\beta_L > 0$ . If  $\beta_L = 0$ , the efficient allocation can be attained (by setting  $\sigma = 0$ ) if and only if  $\partial U(0, q_L^*) / \partial q_H \leq MC_H(0) + \tau\beta_H$  (i.e., it is optimal only for fuel to be produced).*

Proposition 1 follows since production of each fuel causes a negative externality. The efficiency conditions show that marginal benefit should be above the marginal production cost for each fuel. However, with a standard, the firm faces an additional incentive to produce the low carbon fuel. Namely, increasing production of the low carbon fuel means the firm need not decrease production of the high-carbon fuel as severely. This additional incentive means that the low carbon fuel is produced so that its price (equal in equilibrium to its marginal benefit) is less than its marginal cost. This is not efficient. In short, the carbon in the low-emissions fuel faces a negative price even though it produces the same damages as the carbon in the high-emissions fuel, which faces a positive carbon price.<sup>26</sup>

<sup>24</sup> More precisely, we can define  $\lambda^e(\beta_H - \sigma)$  as the *LCFS tax* and  $\lambda^e(\sigma - \beta_L)$  as the *LCFS subsidy*.

<sup>25</sup> All proofs are in Appendix A.

<sup>26</sup> Alternatively, rearranging the first order conditions, an LCFS taxes carbon but subsidizes energy use.

The second part of the proposition follows since if one fuel has zero emissions, and production of the other fuel is socially inefficient, then setting the LCFS to zero can prohibit production of the high-carbon fuel.

Proposition 1 does depend on the differentiability of  $U$ . To see this, consider the case of perfectly inelastic demand. In this case, the efficient allocation, the unregulated equilibrium, and the LCFS equilibrium each have the same energy output. The efficient allocation is then fully characterized by an output ratio that can also be attained by an LCFS.

Since Proposition 1 shows that the energy-based LCFS generally cannot attain the efficient allocation, the question arises as to how effective the LCFS can be in reducing carbon emissions. This leads to our second result.

**PROPOSITION 2:** *The energy-based low carbon fuel standard may either increase or decrease carbon emissions and may either increase or decrease total energy production. If the LCFS increases emissions, then it increases energy. Similarly, if the LCFS reduces energy, then it reduces emissions.*

Proposition 2 follows for two separate reasons that are reflected in the two independent proofs of the proposition. The first proof uses an example that shows the LCFS can increase carbon emissions and energy, for a given standard, depending on the relative slopes of the marginal benefit and marginal cost curves. The second proof uses an example that shows the LCFS can increase carbon emissions if the standard is not stringent enough.

The first proof of Proposition 2 follows because a given tax or subsidy affects output more if demand and supply are more elastic. For example, if the standard is set at the average emissions rate  $(\beta_H + \beta_L)/2$ , then the tax and subsidy are equal. If demand and supply of the high-carbon fuel are flatter than those of the low carbon fuel, then the tax decreases production of the high-carbon fuel more than the subsidy increases production of the low carbon fuel. In this case, carbon emissions clearly decrease under the LCFS. However, if demand and supply of the low carbon fuel are relatively flatter, then the tax decreases production of the high-carbon fuel less than the subsidy increases production of the low carbon fuel. If the difference in relative slopes is large enough, the resulting large increase in low carbon fuel can lead to an increase in carbon emissions, despite the lower emissions rate of the low carbon fuel.

The first proof might suggest that the energy-based LCFS only has perverse effects when the slopes of the marginal benefit and marginal cost curves are dramatically different. As shown in the second proof, however, the energy-based LCFS can lead to an increase in carbon emissions, even when the slopes are identical, if the standard is not set sufficiently tight. This follows because the relative sizes of the tax and subsidy depend on the stringency of the LCFS standard. If the standard is set relatively tight, i.e., close to  $\beta_L$ , then the subsidy is smaller than the tax. In this case, production of the low carbon fuel increases less than production of the high-carbon fuel decreases, and the LCFS decreases carbon emissions. However, if the standard is relatively lax, i.e., close to  $\beta_H$ , then the subsidy is larger than the tax. In this case, production of the low carbon fuel increases more than production of the high-carbon fuel decreases.

Under certain conditions, the relative increase can be large enough that the LCFS can increase carbon emissions without differences in the relative slopes.<sup>27</sup>

The necessary conditions developed in Proposition 2 are quite intuitive. Since an LCFS reduces the carbon intensity of fuel, if it increases carbon emissions, then energy must have increased. Similarly, if the LCFS reduces energy, then it must also reduce carbon emissions. This proposition also points to an interesting possibility, an LCFS can reduce carbon emissions while slightly increasing energy production.

### A. The Best Energy-Based LCFS

Propositions 1 and 2 show that an energy-based low carbon fuel standard is not efficient and may even increase carbon emissions. However, if this is the only feasible policy option, the regulator may prefer to use the policy tool. This section analyzes the best LCFS,  $\sigma^*$  a regulator can choose.

If the regulator can determine the level of the standard but not firms' responses to the standard, the LCFS equilibrium is characterized above as, where  $(q_H^e, q_L^e, \lambda^e)$  depends on  $\sigma$ . The regulator's problem is

$$(7) \quad \max_{\sigma} U(q_H^e, q_L^e) - C_H(q_H^e) - C_L(q_L^e) - \tau(\beta_H q_H^e + \beta_L q_L^e)$$

with  $\beta_L \leq \sigma \leq \sigma^0$ , where  $\sigma^0$  is the carbon intensity in the unregulated equilibrium.<sup>28</sup> Here, the regulator, whose only policy tool is the energy-based LCFS, puts equal weight on consumer surplus, producer surplus, and environmental damages.

Kuhn-Tucker first order conditions (FOC) necessary conditions for the regulator's problem are

$$(8) \quad \left( \frac{\partial U}{\partial q_H} - MC_H(q_H) - \tau\beta_H \right) \frac{dq_H^e}{d\sigma} + \left( \frac{\partial U}{\partial q_L} - MC_L(q_L) - \tau\beta_L \right) \frac{dq_L^e}{d\sigma} \geq 0,$$

and  $\sigma^0 - \sigma^* \geq 0$  plus the complementary slackness condition.<sup>29</sup> Substituting in the firm's optimality conditions shows that the FOC for an interior solution can be written

$$(9) \quad [\lambda^e(\beta_H - \sigma^*) - \tau\beta_H] \frac{dq_H^e}{d\sigma} = -[\lambda^e(\beta_L - \sigma^*) - \tau\beta_L] \frac{dq_L^e}{d\sigma}.$$

This equation says that the differences between the implicit tax/subsidy,  $\lambda^e(\beta_i - \sigma^*)$ , and the optimal taxes,  $\tau\beta_i$ , weighted by the changes in output, should be equal at the best LCFS. Equivalently, (9) is the standard efficiency result that the marginal

<sup>27</sup> A standard close to  $\beta_H$  may not be binding so even a relatively lax binding standard may imply a larger implicit tax than subsidy.

<sup>28</sup> Formally, if we let  $q_i^0$  be the equilibrium production of fuel  $i$  in the absence of regulation, then the carbon intensity in the unregulated equilibrium, i.e., most lax binding standard, is  $\sigma^0 = (\beta_H q_H^0 + \beta_L q_L^0) / (q_H^0 + q_L^0)$ .

<sup>29</sup> Since the constraint imposed on the regulator by the LCFS equilibrium is highly nonlinear, care must be taken to ensure that this necessary condition is indeed sufficient.

deadweight loss from changing  $\sigma$  should be zero. By rearranging, this equation can be written as

$$(10) \quad (\lambda^e - \tau) \frac{d(\beta_H q_H^e + \beta_L q_L^e)}{d\sigma} = \lambda^e \sigma^* \frac{d(q_H^e + q_L^e)}{d\sigma},$$

which relates the marginal change in carbon emissions from a change in the standard with the marginal change in energy. We can now state the following proposition.

**PROPOSITION 3:** *The best LCFS optimum may have  $\sigma^* = \sigma^0$ . At an interior solution, i.e., if  $\sigma^* \in (\beta_L, \sigma^0)$ , the best LCFS optimum has*

- (i)  $d(\beta_H q_H^e + \beta_L q_L^e)/d\sigma > 0$ ,
- (ii)  $\lambda > \tau$  if and only if  $d(q_H^e + q_L^e)/d\sigma > 0$ ,
- (iii)  $\lambda^e(\beta_L - \sigma^*) < \tau\beta_L$  if  $\beta_L > 0$ , and
- (iv)  $\lambda^e(\beta_H - \sigma^*) < \tau\beta_H$  if  $\beta_L > 0$ ,  $dq_H^e/d\sigma > 0$ , and  $dq_L^e/d\sigma < 0$ .

Proposition 3 first shows that it may be optimal to choose a nonbinding energy-based LCFS. This result has a strong implication, namely, under these conditions, any energy-based LCFS would decrease welfare relative to imposing no LCFS regulation.

For an interior solution, Proposition 3 derives several results about the best LCFS. First, relaxing the optimal standard cannot reduce emissions. This is intuitive since, otherwise, the regulator would presumably relax the standard. Second, the optimal  $\lambda$  is greater than  $\tau$  if and only if tightening the standard reduces energy. With carbon trading, the regulator can attain the efficient allocation by comparing the shadow value of the carbon constraint with the marginal damages. This result shows that the best LCFS cannot be attained by a simple comparison of the shadow value of the LCFS constraint and the marginal damages. The third result, that the implicit tax/subsidy on the low carbon fuel is less than the optimal tax, is unsurprising since the implicit tax is negative. The fourth result shows that the optimal standard also under taxes the high-carbon fuel in the intuitive case where the standard decreases high-carbon fuel but increases low carbon fuel. Thus, the best LCFS under taxes both fuels.<sup>30</sup>

### B. Graphical Illustration of the Propositions

To illustrate Propositions 1 and 2, consider the function  $U(q_H, q_L) - C_H(q_H) - C_L(q_L)$ . By assumption the function is concave and has a unique global maximum.

<sup>30</sup> The Appendix shows that  $dq_H^e/d\sigma < 0$  and  $dq_L^e/d\sigma > 0$  lead to a contradiction, i.e., tightening the standard cannot lead to more high-carbon fuel but less low carbon fuel. Other sign combinations are possible, however.

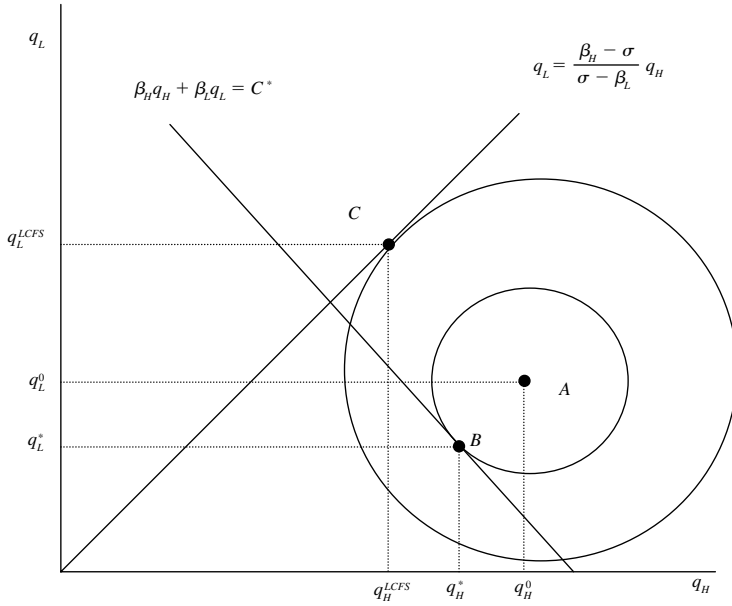


FIGURE 1. ISO-PRIVATE-SURPLUS CURVES WITH LCFS CONSTRAINT AND EFFICIENT CARBON TRADING CONSTRAINT

Define the iso-private-surplus curves as the level curves of this function, which are illustrated by circles in Figure 1. The unconstrained maximum of the function is shown by point A. By simple inspection of the first order conditions, this maximum is the (inefficient) perfectly competitive equilibrium which would result without regulation of the externality.

Now consider optimization of this function subject to the constraint  $\beta_H q_H + \beta_L q_L \leq C^*$ . This constraint set requires total carbon emissions to be less than  $C^*$ . If we define an iso-carbon line for  $C^*$  as the locus of points with carbon emissions  $C^*$ , then the constraint set is the area below this iso-carbon line.<sup>31</sup> The constrained optimum is point B. If  $C^*$  is chosen such that the shadow value of the constraint equals  $\tau$ , this constrained optimum is the efficient outcome (seen again by simple inspection of the FOCs).

Finally, consider optimization of this function subject to the LCFS constraint  $\beta_H q_H + \beta_L q_L \leq \sigma(q_H + q_L)$ . This constraint set is the area above and to the left of the line  $q_L = [(\beta_H - \sigma) / (\sigma - \beta_L)] q_H$ . Again, by simple inspection of the FOCs, this optimum, given by point C, is the LCFS equilibrium. Since points B and

<sup>31</sup> We can think of  $C^*$  as a cap on total carbon emissions from transportation fuels. The constraint set is then all feasible allocations under a transportation sector cap and trade program.

$C$  are different, the LCFS is not efficient. This inefficiency is the main result in Proposition 1.<sup>32</sup>

Proposition 2 is illustrated in Figure 2 showing two iso-private-surplus curves along with the unconstrained optimum,  $A$ . The iso-carbon line,  $\beta_H q_H + \beta_L q_L = K$ , shows the locus of points with the same carbon emissions as the unconstrained maximum. Thus, points below the iso-carbon line decrease carbon emissions while points above the iso-carbon line increase emissions. The LCFS equilibrium is illustrated by point  $B$ . The elliptical iso-private-surplus curves arise because of differences in the marginal surplus cost of increasing the low carbon fuel above the unconstrained optimum, relative to decreasing the high-carbon fuel below the unconstrained optimum. As illustrated, the surplus loss from increasing  $q_L$  by a given amount is less than the surplus loss from decreasing  $q_H$  by the same amount.<sup>33</sup> The LCFS equilibrium at  $C$  thus induces a relative increase in production of the low carbon fuel and as illustrated, the LCFS increases carbon emissions.<sup>34</sup>

The best LCFS is illustrated in Figure 3. Here, the iso-private-surplus circles are illustrated by the dashed circles, and the unregulated optimum is point  $A$ . The iso-welfare curves are illustrated by the solid ellipses and attain a maximum at the efficient allocation, point  $B$ .<sup>35</sup> The locus of LCFS equilibria with different standards is illustrated by the curve connecting points  $A$  and  $D$ .<sup>36</sup> Point  $C$  is the LCFS equilibrium on the highest iso-welfare curve and is, thus, the best allocation. In this example, a modest standard is the best LCFS. The proof of Proposition 3 describes an example in which a nonbinding LCFS is the best LCFS.

### C. Market Power

Our results assume perfect competition in both markets but could easily be extended to alternative models of firm conduct. While market power is unlikely to change our main results, it has two effects in the model. For one, market power tends to mitigate the negative externality associated with carbon.<sup>37</sup> Market power is, itself, a market failure. In the absence of a negative externality, market power leads to under-consumption of the good. In the presence of a negative externality, whether a good is under- or over-consumed depends on the size of each market failure. If the markup for fuel  $j$  equals  $\tau\beta_j$ , then the market outcome is efficient.<sup>38</sup>

<sup>32</sup> Figure 1 also illustrates an additional problem with the LCFS. Namely, the efficient allocation of fuel production may itself violate the LCFS constraint.

<sup>33</sup> Equivalently, the supply and demand curves of the low carbon fuel are relatively flatter than the supply and demand curves for the high-carbon fuel. In this case, the implicit LCFS subsidy would lead to a larger increase in low carbon fuel production than the decrease in high-carbon fuel production from the implicit LCFS tax. See Stephen P. Holland, Christopher R. Knittel, and Jonathan E. Hughes (2007).

<sup>34</sup> Elliptical iso-private-surplus curves that correspond to a lower relative surplus loss from decreasing high-carbon fuel would illustrate an LCFS which decreases emissions.

<sup>35</sup> Including the environmental costs changes the circles to ellipses since increasing  $q_H$  has a greater environmental cost than increasing  $q_L$  by the same amount.

<sup>36</sup> Point  $A$  is the equilibrium with a nonbinding LCFS, and point  $D$  is the equilibrium with a standard equal to  $\beta_L$ .

<sup>37</sup> However, if oligopolistic producers have heterogeneous costs, market power can exacerbate the negative externality. See Dan Levin (1985).

<sup>38</sup> See James M. Buchanan (1969). It is important to note that for this result, the relevant markup is the sum of markups over each facet of the fuel's production. This includes extraction/feedstock growth, refining, and retail.

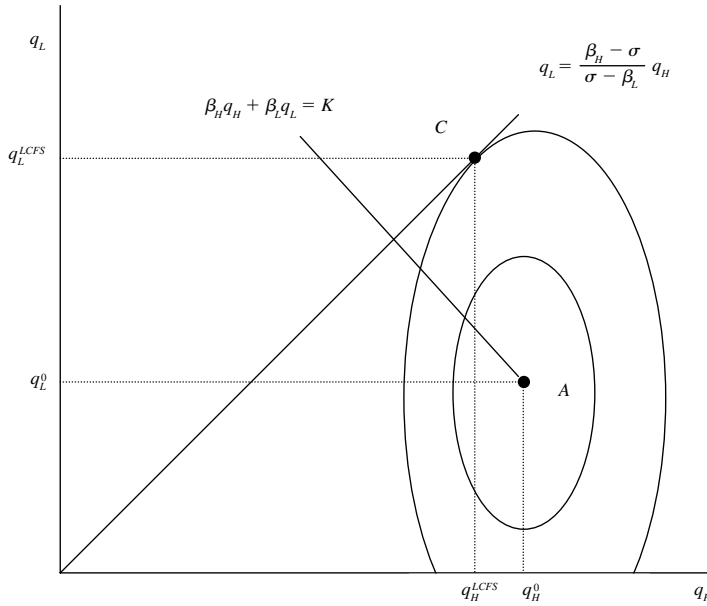


FIGURE 2. ISO-PRIVATE-SURPLUS CURVES WITH LCFS CONSTRAINT AND ISO-CARBON LINE WHERE THE LCFS INCREASES EMISSIONS

While market power does not change Proposition 2, asymmetric levels of market power across the two fuels would affect the likelihood an LCFS would lead to an increase or decrease in carbon. Market power ultimately drives a wedge between demand and marginal revenue.<sup>39</sup> With linear demand, market power steepens the marginal revenue curve. Whether an LCFS increases or decreases carbon then depends on the relative slopes of the marginal revenue and marginal cost curves across the two fuels. To illustrate this point, consider a monopolist operating in these two markets. The firm’s first order condition for fuel  $i$  is

$$(11) \quad \frac{\partial U(q_H^e, q_L^e)}{\partial q_i} + \frac{\partial^2 U(q_H^e, q_L^e)}{\partial q_i^2} q_i + \frac{\partial^2 U(q_H^e, q_L^e)}{\partial q_H \partial q_L} q_{-i} = MC_i(q_i^e) + \lambda^e (\beta_i - \sigma),$$

where  $-i$  represents fuel other than  $i$ . Comparing this set of first order conditions with those under perfect competition, we see that the left-hand side of the first order condition replaces the marginal benefit for fuel  $i$  with the marginal revenue associated with the fuel.

It is difficult to speculate as to the relative levels of market power in gasoline and ethanol refining. Market power concerns are common in gasoline refining, but given the small amount of ethanol currently consumed, the same concerns may not be vocalized for ethanol. A recent Federal Trade Commission (FTC) study of

<sup>39</sup> Here, the relevant market power is at the refining and retail levels, since the LCFS is set at the refining level. Upstream market power simply corresponds to a shift in the marginal cost curves.

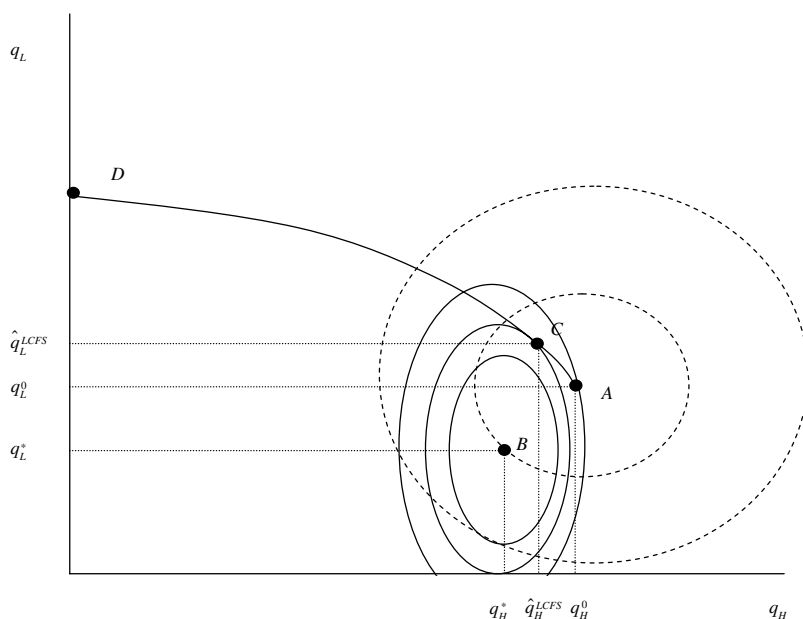


FIGURE 3. ILLUSTRATION OF THE BEST LCFS AT C WITH LOCUS OF LCFS EQUILIBRIA, ISO-PRIVATE-SURPLUS CURVES, AND ISO-WELFARE CURVES

the ethanol market reports an Herfindahl-Hirshman Index (HHI) range of 499 to 1,613 depending on whether a firm is defined as a producer or marketer and whether capacity or production is used (Federal Trade Commission 2005) These calculations assume the relevant market is national. In the gasoline refining market, the Federal Trade Commission has traditionally viewed the relevant market to be smaller than a “Petroleum Administration for Defense District” (PADD), where PADD-level HHIs range from 1,000 to 2,000.<sup>40</sup> Applying a consistent market size assumption increases the estimated HHI for ethanol.

Given this range and the likelihood that the ethanol industry is in a state of change, we leave the issue of relative market power in the two industries for future work.

### III. Trading

If firms with different production costs must each meet the same low carbon fuel standard, then trading can potentially reduce compliance costs. Policymakers can take advantage of the cost savings from trading in a number of ways. For one, reducing the cost of compliance might increase the support of legislation among fuel producers. Alternatively, for a given level of costs, policymakers can increase the stringency of the standard by allocating production more efficiently.

<sup>40</sup> See Diana Moss (2007).

To illustrate trading, extend the model to two different (types of) firms, A and B, with different marginal production costs. Suppose that firms trade “low carbon energy,” where  $x_j$  is the (net) quantity of low carbon energy demanded by firm  $j \in \{A, B\}$ ;  $\beta_x$  is the emissions rate of low carbon energy with  $\beta_x < \sigma$ ;<sup>41</sup> and  $p_x$  is its price. Firm  $j$ ’s profit maximization is now

$$(12) \quad \max_{q_{Hj}, q_{Lj}, x_j} p_H q_{Hj} + p_L q_{Lj} - C_{Hj}(q_{Hj}) - C_{Lj}(q_{Lj}) - p_x x_j \\ + \lambda_j [\sigma(q_{Hj} + q_{Lj} + x_j) - \beta_H q_{Hj} - \beta_L q_{Lj} - \beta_x x_j].$$

This maximization is identical to (3) except the firm can also purchase (or sell) low carbon energy at cost  $p_x x_j$  but must incorporate additional emissions  $\beta_x x_j$  and additional energy  $x_j$  in its LCFS constraint. The firm’s FOCs for energy are  $p_i = MC_{ij}(q_{ij}) + \lambda_j(\beta_i - \sigma)$ , and its FOC for low carbon energy is  $p_x = \lambda_j(\sigma - \beta_x)$ . In the Appendix, we show that the firm’s net demand for low carbon energy is downward sloping,  $dx_j/dp_x < 0$ . The trading equilibrium for two firms (taking energy prices as given) is then characterized by the six FOCs, the two LCFS constraints, and market clearing in low carbon energy, i.e.,  $x_A + x_B = 0$ .

Three points are worth noting. First, by writing the firm’s LCFS constraint with trading as  $(\beta_H - \sigma)q_{Hj} + (\beta_L - \sigma)q_{Lj} = (\sigma - \beta_x)x_j$ , it is easy to show that the market clearing condition implies  $(\beta_H - \sigma)(q_{HA} + q_{HB}) + (\beta_L - \sigma)(q_{LA} + q_{LB}) = 0$ . Thus, with trading, the LCFS constraint holds for the market, even though it need not hold for any single firm. Second, the firms’ first order conditions for low carbon energy purchases imply that  $\lambda_A = p_x/(\sigma - \beta_x) = \lambda_B$ . The first order conditions for energy then imply that  $MC_{iA}(q_{iA}) = MC_{iB}(q_{iB})$ . Thus, trading equates equilibrium marginal production costs for each fuel across firms with different costs. Finally, the shadow value of the LCFS constraint is  $\lambda_j = p_x/(\sigma - \beta_x)$ . Since the units of the numerator are, for example, dollars per mmBtu, and the units of the denominator are CO<sub>2e</sub> metric tons per mmBtu, the shadow value of the LCFS constraint is the price of carbon, i.e., the units are dollars per CO<sub>2e</sub> ton.

Since the shadow value of the constraint is the price of carbon, a question arises as to whether the firms could equivalently trade carbon emissions permits.<sup>42</sup> If  $p_c$  is the price of a carbon permit, and  $c_j$  is firm  $j$ ’s net demand for carbon permits, then firm  $j$ ’s profit maximization with carbon trading would be

$$(13) \quad \max_{q_{Hj}, q_{Lj}, c_j} p_H q_{Hj} + p_L q_{Lj} - C_{Hj}(q_{Hj}) - C_{Lj}(q_{Lj}) - p_c c_j \\ + \lambda_j [\sigma(q_{Hj} + q_{Lj}) - \beta_H q_{Hj} - \beta_L q_{Lj} + c_j].$$

<sup>41</sup> If  $\beta_x > \sigma$ , the traded commodity would be “high-carbon energy” and would have a negative price.

<sup>42</sup> This might be particularly useful if the program were eventually subsumed into a global carbon trading framework such as Kyoto.

As above, this maximization includes purchases of carbon permits, and the LCFS constraint subtracts permitted emissions,  $c_j$ , from the numerator. It is easy to show that, with trading, the LCFS constraint again holds for the market and marginal production costs are equal across firms. Moreover,  $p_c = \lambda_j$ , so the shadow value of the constraint is simply the price of a carbon permit.

Since the carbon permits and low carbon energy trading equilibria are both characterized by marginal production costs equal across firms and the LCFS constraint holding for the market, it follows that the two equilibria lead to identical energy production profiles. Moreover, the transfers are identical since  $(\sigma - \beta_x)x_j = (\beta_H - \sigma)q_{Hj} + (\beta_L - \sigma)q_{Lj} = c_j$  and  $p_x/(\sigma - \beta_x) = \lambda_j = p_c$ . Since trading low carbon energy with  $\beta_x = 0$  is equivalent to trading energy, then it follows that the equilibria resulting from trading carbon emissions permits, low carbon energy, or energy are equivalent.

Trading is equivalent to minimizing production costs subject to a market LCFS constraint since in equilibrium only the market LCFS constraint is relevant. Thus, trading reduces (cannot increase) production costs. The cost savings from trading could be essentially zero if firms are nearly identical. On the other hand, gains from trading could be quite large if there are substantial cost differences or economies of scale. The magnitude of gains from trade is thus an empirical question.

One final point about trading is that the supply of permits (whether of carbon emissions, low carbon energy, or energy) is not fixed. Firms can produce additional permits by increasing production of any fuel with a carbon emissions rate less than the standard. This flexible supply of permits makes trading under an LCFS very different than a usual cap and trade program.

#### IV. Distributional Effects of the LCFS

Since the LCFS imposes an implicit tax on the high-carbon fuel and an implicit subsidy on the low carbon fuel, the distributional analysis is similar to tax incidence analysis. However, unlike with a tax imposed by the government, the LCFS tax/subsidy transfers occur within firms. To analyze separately the surplus to producers of high- and low carbon fuel, we utilize the carbon permit trading framework developed above.<sup>43</sup>

First, consider the changes in consumer surplus from energy consumption under an LCFS. Figure 4 illustrates the supply and demand curves for the low- and high-carbon fuels.<sup>44</sup> Since the LCFS subsidizes the low carbon fuel, the quantity increases (from  $q_L^0$  to  $q_L^{LCFS}$ ) and its price drops (from  $p_L^0$  to  $p_L$ ). Thus, consumer surplus from the low carbon fuel increases by Area(D + E + F) with an LCFS. Since the LCFS taxes the high-carbon fuel, the consumer surplus from the high-carbon fuel decreases by Area(W + X).

Consumer surplus, which changes by Area(D + E + F - W - X), can either increase or decrease with an LCFS. Note that if the demand for the high-carbon fuel is

<sup>43</sup> Even within a large energy firm, low carbon and high-carbon fuel production would likely be in separate accounting centers.

<sup>44</sup> In order to simplify the graphical representation in Figure 4, we assume a zero cross-price elasticity between the low- and high-carbon fuels.

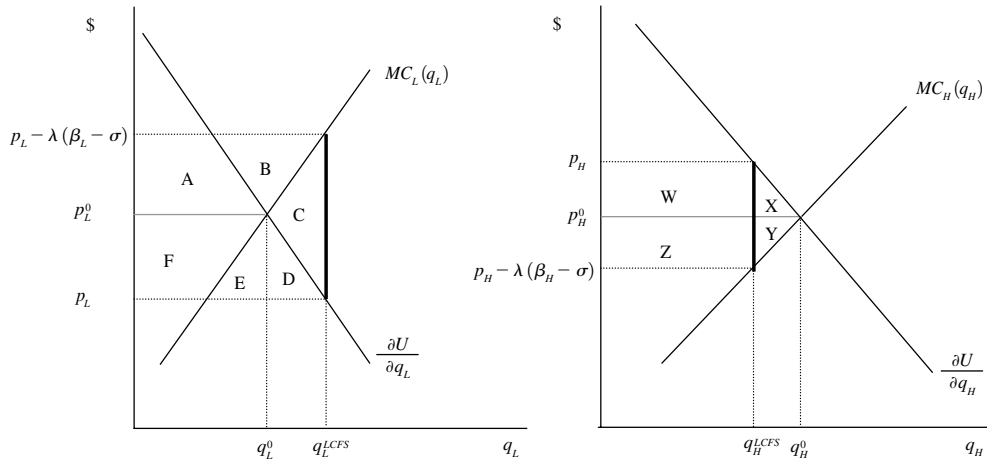


FIGURE 4. THE DISTRIBUTIONAL EFFECTS OF AN LCFS

perfectly elastic, then  $\text{Area}(W + X) = 0$ , and consumers do not bear any of the burden from the LCFS. Conversely, if supply of the low carbon fuel is perfectly inelastic, then  $\text{Area}(D + E + F) = 0$ , and consumers are worse off under the LCFS.

Now, consider changes in producer surplus. The LCFS tax decreases production of the high-carbon fuel and increases its price. Thus, producer surplus from the high-carbon fuel would increase by  $\text{Area}(W - Y)$ .<sup>45</sup> However, this firm (division) would not be in compliance with the LCFS and would need to purchase  $(\beta_H - \sigma)q_H^{LCFS}$  carbon permits at an equilibrium price of  $p_c = \lambda$  to come into compliance. Since this expenditure on permits is equal to  $\text{Area}(W + Z)$ , producers of the high-carbon fuel are worse off by  $\text{Area}(Y + Z)$  under the LCFS. The producers of the high-carbon fuel cannot be better off under the LCFS.

For the low carbon fuel, the implicit LCFS subsidy increases its production and decreases its price. Thus, producer surplus from the low carbon fuel would decrease by  $\text{Area}(C + D + E + F)$ . But this firm (division) would exceed the standard and could still sell  $(\sigma - \beta_L)q_L$  carbon permits at a price of  $p_c = \lambda$  and remain in compliance. Since the revenue from permit sales is  $\text{Area}(A + B + C + D + E + F)$ , producer surplus from the low carbon fuel increases by  $\text{Area}(A + B)$  under the LCFS, and producers of the low carbon fuel cannot be worse off under the LCFS.<sup>46</sup>

Total producer surplus, which changes by  $\text{Area}(A + B - Y - Z)$ , can either increase or decrease with an LCFS. For example, if the supply of the low carbon fuel is perfectly inelastic,  $\text{Area}(A + B)$  is zero, and producers are worse off. Conversely, if supply of the high-carbon fuel is perfectly elastic, then  $\text{Area}(Y + Z) = 0$ , so producers are better off with the LCFS. Note that, in this case, the burden of the LCFS is borne entirely by the consumers of the high-carbon fuel.

<sup>45</sup> This is the increase in profit that a monopolist would attain by restricting output by an equal amount.

<sup>46</sup> Since revenues and expenditures on carbon permits are equal,  $\text{Area}(W + Z) = \text{Area}(A + B + C + D + E + F)$ .

Combined consumer plus producer surplus decreases with the LCFS by  $\text{Area}(C + X + Y)$ . This private surplus loss is the abatement cost of any  $\text{CO}_2\text{e}$  reductions from the LCFS. Whether or not the LCFS increases welfare depends on whether or not the benefit from the  $\text{CO}_2\text{e}$  reductions exceed the abatement cost from the LCFS.

## V. Alternative Baselines

The energy-based LCFS limits carbon emissions per unit of current energy production, i.e., limits carbon emissions as a fixed factor of the energy baseline. However, an alternative low carbon fuel standard could use some other baseline. This section analyzes LCFSs using fuel economy, historical energy production, a rolling average of energy production, and fixed proportions of total energy production as baselines.

### A. Fuel-Economy LCFS

One alternative definition of a low carbon fuel standard, the fuel-economy LCFS, is based on carbon per transportation mile. While the energy-based LCFS treats each mmBtu of energy the same, the fuel-economy LCFS recognizes that the energy in some fuels can be converted more easily into miles driven. For example, hydrogen fuel cell or battery electric vehicles can achieve higher miles per mmBtu than conventional gasoline vehicles.<sup>47</sup>

To analyze a fuel-economy LCFS, let  $\gamma_i$  be the mileage of fuel  $i$  expressed as, for example, miles per mmBtu. The fuel-economy standard,  $\tilde{\sigma}$ , is the ratio of carbon to miles driven, and the constraint becomes

$$(14) \quad \frac{\beta_H q_H + \beta_L q_L}{\gamma_H q_H + \gamma_L q_L} \leq \tilde{\sigma},$$

which is equivalent to  $q_L \geq [(\beta_H - \gamma_H \tilde{\sigma}) / (\gamma_H \tilde{\sigma} - \beta_L)] q_H$ . Let  $\beta_i / \gamma_i$  be the fuel-economy adjusted emissions rate for fuel  $i$ —measured, for example, in  $\text{CO}_2\text{e}$  metric tons per mile. As with the energy-based LCFS, the fuel-economy LCFS is unattainable if  $\tilde{\sigma} < \min\{\beta_H / \gamma_H, \beta_L / \gamma_L\}$  and is nonbinding if  $\tilde{\sigma} > \max\{\beta_H / \gamma_H, \beta_L / \gamma_L\}$ . Thus, a relevant standard must lie between the two fuel-economy-adjusted emissions rates, and the boundary of the constraint is an upward sloping ray through the origin. This constraint set is mathematically very similar to the constraint set for the energy-based LCFS, except that the “low carbon fuel” is now the fuel with the lower fuel-economy adjusted emissions rate. Since  $\beta_H > \beta_L$  does not imply that  $\beta_H / \gamma_H > \beta_L / \gamma_L$ , the equilibrium and the distributional effects of the fuel-economy LCFS may be very different from the energy-based LCFS.

<sup>47</sup> This baseline was called the “per-mile metric” by the technical report analyzing California’s LCFS. The report compared at-the-pump, at-the-wheel, and per-mile metrics and recommended adoption of the at-the-wheel metric, which adjusts the at-the-pump metric for different drive train efficiencies. The at-the-pump and at-the-wheel metrics are equivalent to our energy-based LCFS if drive train efficiencies are the same. See Alexander E. Farrell et al. (2006).

If we write the constraint as  $\beta_H q_H + \beta_L q_L \leq \tilde{\sigma} (\gamma_H q_H + \gamma_L q_L)$ , the firm's first order conditions can be written

$$(15) \quad p_i = MC_i + \tilde{\lambda}(\beta_i - \tilde{\sigma}\gamma_i),$$

where  $\tilde{\lambda}$  is the shadow value of the constraint. Since the standard must lie between the fuel-economy-adjusted emissions rates, the LCFS again taxes one fuel and subsidizes the other fuel. Using the fuel-economy-adjusted emissions rates, the analysis of the fuel-economy LCFS is identical to the energy-based LCFS. In particular, the fuel-economy LCFS cannot attain the efficient fuel production and carbon emissions, and it may or may not reduce carbon emissions.

### B. Historical Baseline LCFS

A second alternative baseline would be to base each firm's baseline on historic energy production.<sup>48</sup> For example, the firm's baseline could be energy produced in 2003, or the average energy production between 2001 and 2004. If we let  $\bar{q}_H$  and  $\bar{q}_L$  be the firm's historic production of energy, the LCFS constraint becomes

$$(16) \quad \frac{\beta_H q_H + \beta_L q_L}{\bar{q}_H + \bar{q}_L} \leq \sigma.$$

Two points are relevant for the analysis. First, any  $\sigma$  is feasible, i.e., the standard is not bounded below by the lower emissions rate. Any standard, no matter how stringent, can be met by simply reducing output. Second, the slope of the boundary of the constraint set is negative. Thus, the constraint set looks like the constraint set from a carbon cap and trade program.

Since historic production is exogenous to the firm's production decisions, the firm's FOC is now

$$(17) \quad p_i = MC_i(q_i) + \lambda\beta_i,$$

where  $\lambda$  is the shadow value of the historical baseline LCFS constraint. Since  $\lambda \geq 0$ , production of both the high- and low carbon fuels are taxed. In fact, if the standard is chosen such that  $\lambda = \tau$ , then the historical baseline LCFS can attain the efficient fuel production and carbon emissions. Moreover, any standard reduces carbon emissions.

The historical baseline LCFS is surprisingly like carbon trading. Indeed, the historical baseline LCFS is equivalent to carbon trading in the sense that any emissions reduction that could be attained by carbon trading can be attained at the same cost by the historical baseline LCFS and vice versa. This LCFS can even incorporate

<sup>48</sup> Pizer (2005) advocates regulating carbon intensity targets where the baseline is GDP. This is similar to the historical baseline LCFS because the denominator is exogenous to any firm, and firms treat the standard similar to a cap on carbon emissions.

banking, if firms are allowed to use emissions reductions from an earlier year to meet the current year LCFS. Clearly, the historical baseline LCFS has many desirable properties.

### C. Rolling Average LCFS

Although the historical baseline LCFS is desirable, distributional effects, abatement costs, and emissions are highly dependent on the baseline chosen. This is likely to make agreement on a baseline year or years very difficult, since the baseline years essentially set allowable carbon emissions for the life of the program. On the other hand, if firms anticipate the baseline years, they may have an incentive to overproduce during these years. A final difficulty with the historical baseline LCFS is that over time allowable emissions may be very different than actual emissions. With liquid trading, this does not reduce efficiency, but it may represent a large wind-fall profit for a firm which had planned to cease fuel production regardless of the LCFS.

If firms are allowed to build their own baseline over a period of years, these difficulties can be mitigated. We call such a LCFS the rolling average LCFS. For concreteness, we analyze a baseline which is the average energy production of the preceding five years. The analysis is easily extended to analyze a longer baseline period or a baseline period which ends at some other time.<sup>49</sup>

Let  $q_{it}$  be production of fuel  $i$  at time  $t$ . If the baseline for the LCFS is averaged over the last five years, the LCFS constraint is

$$(18) \quad \frac{\beta_H q_{Ht} + \beta_L q_{Lt}}{0.2(q_{H(t-5)} + \dots + q_{H(t-1)}) + 0.2(q_{L(t-5)} + \dots + q_{L(t-1)})} \leq \sigma_t,$$

where  $\sigma_t$  is the rolling average LCFS in year  $t$ . For a myopic firm, this constraint set looks identical to the constraint set for the historical baseline LCFS. In addition, note that any standard is feasible, since even a very stringent standard can be met by simply reducing current production.

A forward-looking firm has an incentive to increase current production in order to make its LCFS constraints in the future less strict. Analysis of this incentive requires extending the model to multiple time periods. If the discount factor is  $\delta$ , the forward-looking firm's FOC for optimal production at time 0 is

$$(19) \quad p_{i0} = MC_i(q_{i0}) + \lambda_0 \beta_i - 0.2(\delta \lambda_1 \sigma_1 + \dots + \delta^5 \lambda_5 \sigma_5),$$

where  $\lambda_t$  is the shadow value of the LCFS constraint in year  $t$ .<sup>50</sup> The marginal benefit of increasing current production has two components. First is the current price, and second is the effect on all the future constraints. Since  $\lambda_t$  is the shadow value of the

<sup>49</sup> Our analysis of the rolling average baseline is quite similar to the analysis of the research and experimentation credit created by the Economic Recovery Act of 1981. See Rosanne Altshuler (1988).

<sup>50</sup> As above, both sides of the constraint equation have been multiplied by the denominator of the left-hand side.

constraint in year  $t$ , the future benefit in year  $t$  of increasing current production by one unit is  $0.2\lambda_t\sigma_t$ . Averaging this future benefit across five years and discounting gives  $0.2(\delta\lambda_1\sigma_1 + \dots + \delta^5\lambda_5\sigma_5)$ .

In the stationary solution, where  $\sigma_t = \sigma$  and hence  $\lambda_t = \lambda$ , the FOC becomes

$$(20) \quad p_{i0} = MC_i(q_{i0}) + \lambda[\beta_i - 0.2\sigma(\delta + \dots + \delta^5)].$$

First, note that if  $\delta = 1$ , the first order condition is  $p_{i0} = MC_i(q_{i0}) + \lambda(\beta_i - \sigma)$ , which is identical to the FOC for the energy-baseline LCFS. In this case, the standard cannot attain the efficient allocation and may or may not decrease carbon emissions. At the other extreme, with  $\delta = 0$ , the FOC is identical to the FOC for the historical baseline LCFS. In this case, the standard can attain the efficient allocation, and any standard decreases carbon emissions.

With  $\delta \in (0, 1)$ , the standard cannot attain the efficient allocation.<sup>51</sup> The standard taxes production of the high-carbon fuel, and may either tax or subsidize production of the low carbon fuel.<sup>52</sup> If the standard subsidizes production of the low carbon fuel, carbon emissions may or may not increase. The incentives with this standard are better than the incentives with the energy-based LCFS since  $\lambda[\beta_i - 0.2\sigma(\delta + \dots + \delta^5)] > \lambda(\beta_i - \sigma)$ , i.e., the rolling average LCFS tax is higher and the subsidy is smaller than under the energy-based LCFS.

Although the rolling-average LCFS does not have all the desirable efficiency properties of the historical baseline LCFS, it is potentially more feasible politically since it can lessen disagreement over the baseline period and will accurately reflect current production. The efficiency of the rolling-average LCFS can be improved by lengthening the averaging window, or shifting the averaging window further into the past, since these both increase the LCFS tax and decrease the LCFS subsidy.

#### D. Fixed-Proportion LCFS

One advantage of the energy-based LCFS is that it allows for higher carbon emissions in a year in which demand is unexpectedly high. Although the historical baseline and rolling average LCFSs may have better static efficiency properties, they do not have flexibility to allow additional carbon emissions in a year with high demand. The fixed proportion LCFS uses a firm's incentive to free ride to reduce the incentive to overproduce the low carbon fuel while still allowing carbon emissions to respond to current demand conditions.

The fixed proportion LCFS has a baseline which is a fixed proportion of current production by all other firms.<sup>53</sup> Suppose firm  $j$  would hypothetically produce the fraction  $\alpha_{jt}$  of total energy production. If the firm is assumed to produce this proportion, then this proportion can be used to define the fixed proportion LCFS for year  $t$  by the constraint

<sup>51</sup> The proof of Proposition 1 holds for any  $k$  where the LCFS tax/subsidy is  $\lambda(\beta_i - k)$ .

<sup>52</sup> This LCFS taxes production of the low carbon fuel if and only if  $\beta_i > 0.2\sigma(\delta + \dots + \delta^5)$ .

<sup>53</sup> This is similar in spirit to a Vickery auction which links a player's payoffs to the bids of other players and eliminates the incentive to manipulate his/her own bid.

$$(21) \quad \frac{\beta_H q_{Ht} + \beta_L q_{Lt}}{[\alpha_{jt}/(1 - \alpha_{jt})](Q_{-1t} + Q_{-2t})} \leq \sigma_t,$$

where  $Q_{-it}$  is production of fuel  $i$  by all other firms in year  $t$ , and  $\alpha_{jt}$  is the fixed proportion. Note that if production were equal to the hypothetical production of all firms, then the denominator of the constraint would be equal to the denominator of the energy-based LCFS, i.e.,  $[\alpha_{jt}/(1 - \alpha_{jt})](Q_{-1t} + Q_{-2t}) = q_{Ht} + q_{Lt}$ .

To analyze the firm's incentives, we, again, turn to a dynamic model to capture the effects of current production on future constraints. The firm's FOC in year  $t$  is now

$$(22) \quad p_{it} = MC_i(q_{it}) + \lambda_t \beta_i - \delta \lambda_{t+1} \sigma_{t+1} [Q_{-1(t+1)} + Q_{-2(t+1)}] \frac{d}{dq_{it}} \left( \frac{\alpha_{j(t+1)}}{1 - \alpha_{j(t+1)}} \right).$$

The marginal benefit of increasing production in year  $t$  has two components: the current price and the relaxing of the next year's LCFS constraint. First, if the proportions are fixed, based on some historic baseline period, then  $d/dq_{it}(\alpha_{jt}/(1 - \alpha_{jt})) = 0$ . In this case, the first order condition becomes  $p_{it} = MC_i(q_{it}) + \lambda_t \beta_i$ , which is the FOC for the historical baseline LCFS. Since production from both fuels is taxed, this LCFS can attain the efficient allocation and decreases carbon emissions. In contrast to the historical baseline LCFS, the fixed proportion LCFS does allow for higher carbon emissions in a year with high demand.

If the proportion is allowed to vary during the program, then increasing current production changes the future standard. If the allowed proportion is simply the fraction of total production in the prior year, then  $d/dq_{it}(\alpha_{j(t+1)}/(1 - \alpha_{j(t+1)})) = 1/(Q_{-1t} + Q_{-2t})$ . The firm's FOC is then

$$(23) \quad p_{it} = MC_i(q_{it}) + \lambda_t \beta_i - \delta \lambda_{t+1} \sigma_{t+1} \frac{Q_{-1(t+1)} + Q_{-2(t+1)}}{Q_{-1t} + Q_{-2t}},$$

which in the stationary solution is simply  $p_{it} = MC_i(q_{it}) + \lambda(\beta_i - \delta\sigma)$ . This FOC is equivalent to the one-year rolling average LCFS. As with the rolling average LCFS, this LCFS cannot attain the efficient allocation and may or may not decrease carbon emissions. Similarly, the incentives are better with a longer average and more distant window. However, unlike the rolling average LCFS, the fixed proportion LCFS allows for current carbon emissions to increase in years with higher demand.

## VI. The Incentive to Innovate

Reducing greenhouse gas emissions to recommended levels at a reasonable cost will require technological innovation. Thus, the incentive to innovate under each policy is a crucial component across which the policies should be compared. In this section, we analyze the incentive to reduce carbon emissions rates and to increase fuel economy (mileage) under the various proposals. This incentive, i.e., the marginal benefit of innovation, could then be compared with the marginal cost of innovation to determine an optimal level.

### A. Carbon Emissions Rates

The unregulated equilibrium does not depend on  $\beta_i$ . Thus, there is no incentive to reduce carbon emissions in the absence of regulation. On the other hand, the efficient incentive to reduce carbon emissions can be found from the objective function for the optimization in (1). The efficient incentive, i.e., the marginal benefit of decreasing  $\beta_i$  is  $-dL/d\beta_i = -\partial L/\partial\beta_i = \tau q_i^*$  by the envelope theorem.<sup>54</sup> Thus, the emissions rate should be reduced further as long as the marginal cost of reducing  $\beta_i$  is less than  $\tau q_i^*$  and emissions rates are too high in the unregulated equilibrium.

To analyze the firm's incentive to reduce carbon emissions rates, we consider the most general version of the producer's optimization problem in (13). Again, by the envelope theorem, the incentive to reduce the carbon emissions rate for fuel  $i$  for the various low carbon fuel standards is  $\lambda q_i$ .<sup>55</sup> This incentive can either be correct, too large, or too small. For the historical baseline LCFS, the efficient allocation can be attained. In this case, the incentive is correct, since  $\lambda = \tau$ . For the energy-based LCFS, the shadow value of the constraint is zero when the constraint is  $\sigma^0$ . Since the shadow value is continuous in  $\sigma$ , for a small constraint the incentives to reduce each emissions rate can be too small, i.e.,  $\lambda^e q_H^e < \tau q_H^*$  and  $\lambda^e q_L^e < \tau q_L^*$ .<sup>56</sup> On the other hand, if the constraint is set such that  $\lambda^e (\beta_H - \sigma) = \tau \beta_H$ , then  $\lambda^e > \tau$ ,  $q_H^e = q_H^*$ , and  $q_L^e > q_L^*$ .<sup>57</sup> In this case, the incentives to decrease the carbon emissions rates are too great for both fuels.<sup>58</sup>

With the other LCFS variants, the incentives generally can be either too large or too small. Thus, analysis of the incentives to reduce carbon emissions rates is mainly an empirical question.

### B. Fuel Economy/Mileage

As with the incentive to improve emissions rates, the incentive to improve mileage can be found from the various Lagrangians. First, note that fuel economy affects the consumer surplus from energy usage. To make this explicit, assume that consumers only care about miles driven, so  $U = U(\gamma_H q_H + \gamma_L q_L)$ .<sup>59</sup> Now, the benefit of increased mileage from fuel  $i$ ,  $dL/d\gamma_i$  is given by  $U'(\cdot)q_i$ .

The efficient incentive is  $U'(\cdot)q_i^*$ , the marginal benefit of an additional mile per mmBtu. The incentive under the energy-based LCFS is  $U'(\cdot)q_i^e$ . This incentive could be too high or too low depending on fuel production. With the fuel-economy LCFS, the incentive is  $U'(\cdot)q_i^e + \lambda \sigma q_i^e$ . This has an additional incentive for fuel economy, namely the benefit of relaxing the firm's LCFS constraint. Interestingly, this benefit

<sup>54</sup> The intuition is that reducing the emissions rate by one ton per mmBtu reduces damages by  $\tau$  for each mmBtu and  $q_i^*$  mmBtu's are produced.

<sup>55</sup> The marginal change in producer surplus for a change in  $\beta_i$  is  $q_H \times dp_H/d\beta_i + q_L \times dp_L/d\beta_i - c \times dp_c/d\beta_i - \lambda q_i$ . The price taking assumption implies that the firm's incentive is simply  $\lambda q_i$ .

<sup>56</sup> This would require a constraint that is lax enough such that  $\lambda < \tau \min\{q_H^*/q_H^0, q_L^*/(q_L^0 + \varepsilon)\}$ .

<sup>57</sup> This result assumes a zero cross-price elasticity between the low- and high-carbon fuels consistent with Figure 4. We relax this assumption in the simulations.

<sup>58</sup> Interestingly, if emissions rates are too low, emissions could be optimal since the LCFS induces too much driving. Of course, this is not the efficient way of achieving the optimal level of emissions.

<sup>59</sup> In other words, the consumer likes a Prius because she can drive farther, but doesn't get any additional utility from the higher mileage by itself, i.e., there is no "warm glow."

would be hard to decentralize, since it is a positive externality. In other words, the firms get an external benefit from the customer's fuel economy purchase decision.

## VII. Simulations

To investigate the likely effects and the economic significance of our results, we numerically simulate the model using a range of parameters representative of the US market for gasoline in 2005.<sup>60</sup> The simulation, which is meant to capture relatively short-term adjustments, analyzes two representative firms: a gasoline producer and a low carbon fuel producer, in this case ethanol.<sup>61,62</sup> A representative consumer demands fuel energy measured in units of gasoline gallon equivalents (gge) where gasoline and ethanol are assumed to be perfect substitutes.<sup>63</sup> Our analysis focuses on a range of parameters, rather than specific values, to describe the characteristics of the fuels and fuel market.

Given the extremely wide range of carbon damage estimates, any welfare calculations would likely be sensitive to the choice of damage estimate. Therefore, our strategy is to calculate the lost private surplus from a particular LCFS. This lost surplus, i.e., the abatement cost, can then be compared with the carbon reduction and a given damage estimate to evaluate whether or not the LCFS increases welfare.<sup>64</sup>

In a world with no other distortions, the abatement cost of the LCFS would simply be the sum of the losses of consumer surplus from transportation fuel, of producer surplus from ethanol, and of producer surplus from gasoline. However, markets for transportation fuels have four main additional distortions: transportation fuel taxes (applied to both gasoline and ethanol), ethanol subsidies, negative externalities from driving (e.g., other emissions, congestion, national security risks and accidents), and positive externalities from biofuels (e.g., innovation spillovers). If these taxes and subsidies are Pigouvian, they cover the damages and external benefits. The primary analysis assumes the taxes and subsidies are Pigouvian, so the abatement cost is the lost consumer and producer surplus.<sup>65</sup>

The assumption that taxes and subsidies are Pigouvian is certainly not correct, and there is a substantial literature that argues the fuel tax is less than the marginal damage from noncarbon externalities.<sup>66</sup> If the fuel tax is less than the marginal noncarbon damage and the LCFS reduces fuel consumption, the abatement cost is reduced by the amount the avoided damages exceed the lost tax revenue. Parry

<sup>60</sup> Following California, we focus on light-duty vehicles. However, an LCFS could easily include other segments of the transportation sector such as diesel fuel used in heavy-duty vehicles.

<sup>61</sup> Discussions with fuel refiners suggest that initial compliance strategies will center around blending more ethanol into the fuel supply.

<sup>62</sup> For gasoline and ethanol, the at-the-pump and at-the-wheel metrics described in Alexander E. Farrell et al. (2007) are equivalent to our energy-based LCFS since there is no adjustment for drive train efficiencies.

<sup>63</sup> The assumption of perfect substitutes is correct if vehicles can use any mixture of ethanol and gasoline. Most current vehicles are limited to moderate blends of 10 percent–20 percent ethanol (by volume), but "flex-fuel" vehicles can operate on much higher blends.

<sup>64</sup> Refer to footnote 14 for our definitions of private surplus, welfare, and abatement costs.

<sup>65</sup> Intuitively, lost fuel tax revenue is irrelevant from a social perspective since it is exactly offset by a loss in damages from driving.

<sup>66</sup> See, for example, Ian W. H. Parry and Kenneth A. Small (2005), Aaron S. Edlin and Pinar Karaca-Mandic (2006).

and Small (2005) calculate noncarbon damages of \$0.69 per gge, which exceeds the average state-level fuel tax of \$0.38 per gge.<sup>67</sup> The abatement cost would be reduced (increased) by this damage less the tax (\$0.31 per gge) times the amount that fuel consumption is reduced (increased). In general, adjusting for noncarbon damages reduces the abatement costs, but reduces the abatement costs of an efficient policy even more since fuel consumption under the LCFS exceeds that of the efficient policy.<sup>68, 69</sup>

There is little evidence calculating the national security risks and even less evidence regarding innovation spillovers. Thus, we do not attempt to correct the abatement costs for these effects. Note, however, that if an LCFS increases ethanol production and ethanol subsidies are too low, then our abatement cost calculations are biased upward. However, if subsidies are too large, our calculations are biased downward.

To parameterize the model, we assume demand for transportation energy in gasoline gallon equivalents is a constant elasticity demand curve calibrated to US gasoline consumption in the baseline year 2005.<sup>70</sup> Demand for transportation energy is generally considered inelastic, so we assume demand elasticities range from 0.1 to 0.5, consistent with Molley Espey (1998) and Hughes, Knittel and Daniel Sperling (2006).

Gasoline and ethanol supply are represented as constant elasticity supply curves with 2005 as the baseline year. We assume supply elasticities vary between 1.0 and 4.0 for ethanol and 0.5 and 2.0 for gasoline. These supply elasticities are consistent with Stephen B. Webb (1981) for ethanol and Carol Dahl and Thomas E. Duggan (1996) for gasoline. These wide ranges reflect considerable uncertainty in the literature, particularly about ethanol costs.

Producer revenue is calculated from retail price less the federal gasoline tax and weighted average state gasoline tax. The tax rate on the blended fuel is equivalent to the tax rate on gasoline.

The CO<sub>2</sub>e emissions rate of gasoline, 11.29 KgCO<sub>2</sub>e per gasoline gallon equivalent, comes from Michael Wang (2007). In most cases, we use a carbon emissions rate for ethanol of 8.42 KgCO<sub>2</sub>e per gasoline gallon equivalent.<sup>71</sup> Estimates of carbon emissions from ethanol production vary greatly, see Farrell et al. (2006), including estimates higher than the emissions rate for gasoline.<sup>72</sup> For this reason, we

<sup>67</sup> While Parry and Small (2005) consider costs due to tax interactions and congestion feedback, we limit our analysis to distance-related pollution, congestion, and traffic accidents.

<sup>68</sup> For an energy-based LCFS that reduces carbon intensity by 10 percent, adjusting private surplus for non-carbon damages reduces the abatement cost from \$80.5 billion to \$76.5 billion and from \$760.4 billion to \$754.2 billion in the more and less elastic scenarios, respectively. Abatement costs for a historical baseline LCFS producing equivalent emissions reductions decrease from \$15.8 billion to \$8.6 billion and from \$290.5 billion to \$281.9 billion in the more and less elastic scenarios. As a result, adjusting for noncarbon externalities increases the ratio of average abatement costs for the energy-based LCFS, compared to the historical baseline LCFS, from 5.1 to 8.9 and from 2.6 to 2.7 in the more and less elastic scenarios, respectively.

<sup>69</sup> Including noncarbon environmental damages specific to ethanol, such as soil erosion and nitrogen runoff, would increase the abatement costs of the LCFS relative to an efficient policy.

<sup>70</sup> The supporting online materials discussed the parameters in more detail and describe the numerical solution algorithm. These online materials can be found at <http://www.aeaweb.org/articles.php?doi=10.1257/pol.1.1.106>.

<sup>71</sup> These emissions rates are for the full fuel cycle and are intended to capture emissions associated with both fuel production and fuel consumption.

<sup>72</sup> Actual ethanol emission rates may be even higher when land use impacts are considered. Timothy Searchinger et al. (2008) find that switching croplands to energy crop production emits large quantities of seques-

also analyze a range of ethanol emissions rates including a rate representative of the emissions rate for cellulosic ethanol.

The LCFS standard,  $\sigma$ , is normalized by the 2005 carbon intensity of transportation fuel. Binding, attainable standards are thus in the interval  $[0.75, 1]$ , assuming a normalized emissions rate of ethanol equal to 0.75. The standards have a natural interpretation, e.g.,  $\sigma = 0.9$  represents a 10 percent reduction in the carbon intensity of transportation fuel.

We investigate seven scenarios. The first two scenarios vary the elasticities of supply and demand and are intended as upper and lower estimates of the welfare changes of the LCFS. The second two scenarios vary the relative supply elasticities of ethanol and gasoline while holding the demand elasticity at 0.3. These scenarios are intended as upper and lower estimates for CO<sub>2</sub>e emissions reductions. The last three scenarios, which hold elasticities at intermediate ranges, use normalized ethanol emissions rates of 0.65, 0.85, and 0.20, respectively. These scenarios capture the considerable uncertainty about the carbon emissions rate of ethanol, as well as the possibility that cellulosic ethanol achieves marginal costs comparable to corn-based ethanol. Specific parameter values for each scenario are reported in the respective tables.

Tables 2–5 summarize the results. The first column in each table presents the unregulated equilibrium,  $\sigma = 1$ . The LCFS standard becomes increasingly strict moving from left to right. The equilibrium price and quantity for the unregulated scenario are the 2005 baseline values of \$2.27 per gasoline gallon equivalent and 117 billion gasoline gallon equivalents. For each value of  $\sigma$ , the abatement cost of the LCFS is calculated as the sum of changes in producer and consumer surplus relative to the unregulated case. Finally, the average abatement cost of CO<sub>2</sub>e is calculated as the abatement cost divided by the change in emissions relative to the unregulated equilibrium.

To provide context for our estimates, the tables also present simulations using the historical baseline LCFS to attain the same reductions in CO<sub>2</sub>e emissions implied by the LCFS. The results are presented at the bottom of each table. Because the abatement cost under the historical baseline LCFS is equivalent to the abatement cost under a transportation sector cap and trade system, these results enable a direct comparison between the energy-based LCFS and an efficient trading system.

Since the range of outcomes is primarily covered by the scenarios varying the elasticity ranges, we discuss Tables 2 and 3 in detail. Discussion of the remaining scenarios is more brief since these cases largely support our main results in Tables 2 and 3.

### A. Elasticity Range Scenarios

Tables 2 and 3 present simulation results for the energy-based LCFS for relatively less and more elastic supply and demand curves. The less elastic scenario, shown in Table 2, assumes that the two supply elasticities and the demand elasticity take on

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tered carbon. These initial emissions are slowly offset by the lower fuel cycle emissions of biofuels produced from crops grown on converted lands. Net reductions may not occur for decades, however.

TABLE 2—SIMULATION RESULTS USING LEAST ELASTIC PARAMETER VALUES IMPLYING THE HIGHEST WELFARE CHANGES

	LCFS simulation results: less elastic scenario			
	$\sigma = 1^a$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,313.96	99%	87%	75%
Fuel price (\$/gge) <sup>b</sup>	\$2.27	\$2.33	\$5.43	\$14.94
Fuel quantity (billion gge)	117.00	116.66	107.20	96.89
Ethanol quantity (billion gge)	2.56	7.12	23.32	40.02
ΔCS (billion \$)		\$(7.88)	\$(352.69)	\$(1,313.63)
ΔPS gasoline – transfers (billion \$)		\$(21.26)	\$(104.70)	\$(151.42)
ΔPS ethanol + transfers (billion \$)		\$19.49	\$237.22	\$704.64
Carbon market transfer (from gasoline to ethanol)		\$28.18	\$353.63	\$817.44
Abatement cost (billion \$) <sup>c</sup>		\$9.65	\$220.18	\$760.41
Shadow value λ (\$/MTCO <sub>2</sub> e)		\$1,468.34	\$6,752.45	\$12,124.13
Average abatement cost (\$/MTCO <sub>2</sub> e) <sup>d</sup>		\$569	\$1,293	\$2,272
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.58	\$8.70	\$33.43
Fuel quantity (billion gge)		115.51	102.27	89.39
Ethanol quantity (billion gge)		2.60	3.92	10.53
Abatement cost (billion \$) <sup>c</sup>		\$0.27	\$41.75	\$290.50
Shadow value λ (\$/MTCO <sub>2</sub> e)		\$32.79	\$622.42	\$2,864.96
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$16	\$245	\$868

Notes: Assumed parameter values: elasticity of demand, 0.1; gasoline supply elasticity, 0.5; ethanol supply elasticity, 1.0; normalized ethanol emission rate, 0.75. ΔCS, ΔPS, abatement cost and the percent change in emissions are calculated relative to the unregulated equilibrium.

<sup>a</sup>  $\sigma = 1$ , represents the unregulated case with the LCFS standard normalized by the current carbon intensity.

<sup>b</sup> The fuel quantity in gasoline gallon equivalents (gge) reflects the adjustment for the lower volumetric energy density of Ethanol.

<sup>c</sup> Abatement cost is (ΔCS + ΔPS).

<sup>d</sup> Average abatement cost is (ΔCS + ΔPS)/(CO<sub>2</sub> equivalent abatement).

the smallest values in their assumed ranges. This maximizes the costs of increases in ethanol production, maximizes the lost profit from decreases in gasoline production, and maximizes the consumer surplus loss for a given change in quantity. Since the LCFS requires a change in the quantities produced, as in a quota, the relatively inelastic supply and demand imply a large abatement cost of the LCFS. In the more elastic scenario in Table 3, elasticities take their largest values, and the abatement cost of the LCFS is smaller.

The simulation outcomes are largely as would be expected. For tighter standards: energy prices generally increase, energy production generally decreases, the fuel mix shifts to include more ethanol, CO<sub>2</sub>e emissions fall, abatement costs are greater, and the shadow value of the constraint and average abatement costs are higher.

In most cases, energy production falls and energy prices increase with a tighter LCFS. However, Proposition 2 shows that it is possible for energy production to increase, and the 99 percent intensity standard in Table 3 does show a small increase in energy production (with a decrease in the energy price). This is perhaps the best case for the LCFS since carbon emissions actually fall slightly without affecting energy prices. However, this outcome is not very robust across our parameters and is unlikely to occur.

TABLE 3—SIMULATION RESULTS USING MOST ELASTIC PARAMETER VALUES IMPLYING THE HIGHEST WELFARE CHANGES

	LCFS simulation results: more elastic scenario			
	$\sigma = 1^a$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,313.96	99%	92%	80%
Fuel price (\$/gge) <sup>b</sup>	\$2.27	\$2.26	\$2.43	\$2.87
Fuel quantity (billion gge)	117.00	117.05	113.07	104.04
Ethanol quantity (billion gge)	2.56	7.14	24.59	42.98
$\Delta$ CS (billion \$)		\$0.25	\$(18.45)	\$(66.03)
$\Delta$ PS gasoline – transfers (billion \$)		\$(5.08)	\$(27.67)	\$(52.72)
$\Delta$ PS ethanol + transfers (billion \$)		\$3.02	\$18.44	\$38.23
Carbon market transfer (from gasoline to ethanol)		\$4.74	\$38.39	\$73.88
Abatement cost (billion \$) <sup>c</sup>		\$1.81	\$27.67	\$80.52
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$246.19	\$694.94	\$1,020.41
Average abatement cost (\$/MTCO <sub>2</sub> e) <sup>d</sup>		\$144	\$257	\$307
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.31	\$2.68	\$3.52
Fuel quantity (billion gge)		115.89	107.51	93.94
Ethanol quantity (billion gge)		2.58	2.72	3.22
Abatement cost (billion \$) <sup>c</sup>		\$0.03	\$2.37	\$15.77
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$4.83	\$45.65	\$132.63
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$2	\$22	\$60

Notes: Assumed parameter values: elasticity of demand, 0.5; gasoline supply elasticity, 2.0; ethanol supply elasticity, 4.0; normalized ethanol emission rate, 0.75.  $\Delta$ CS,  $\Delta$ PS, abatement cost and the percent change in emissions are calculated relative to the unregulated equilibrium.

<sup>a</sup>  $\sigma = 1$ , represents the unregulated case with the LCFS standard normalized by the current carbon intensity.

<sup>b</sup> The fuel quantity in gasoline gallon equivalents (gge) reflects the adjustment for the lower volumetric energy density of ethanol.

<sup>c</sup> Abatement cost is ( $\Delta$ CS +  $\Delta$ PS).

<sup>d</sup> Average abatement cost is ( $\Delta$ CS +  $\Delta$ PS)/(CO<sub>2</sub> equivalent abatement).

The shift in fuel mix is quite extreme. For a 90 percent intensity standard in Tables 2 and 3, the proportion of ethanol in the fuel supply would need to increase from the current 2 percent to approximately 40 percent (60 percent by volume). Since most current vehicles can only accept up to a 20 percent ethanol mix (by volume), our results suggest that attaining a 10 percent reduction in carbon intensities would require substantial expansion of the number of flex-fuel vehicles.<sup>73</sup>

CO<sub>2</sub>e emissions fall in all cases in Tables 2 and 3. This suggests that CO<sub>2</sub>e emissions are unlikely to increase with an LCFS despite the theoretical possibility identified in Proposition 2. In fact, we find that emissions reductions are likely to be substantial. The standard reducing carbon intensities by 10 percent leads to a reduction in CO<sub>2</sub>e emissions of 20–25 percent across Tables 2 and 3.

Private surplus decreases substantially for all scenarios. For the less elastic scenario, abatement costs range from \$9.7 billion to \$760 billion per year. Estimates are smaller, though still substantial, for the more elastic scenario and range from \$1.8

<sup>73</sup> This suggests that our assumption of perfect substitutability between gas and ethanol may be invalid for the 90 percent standard. However, the number of flex-fuel vehicles is rapidly increasing due to preferential treatment under the CAFE standard.

billion to \$81 billion per year. To put these numbers in perspective, annual retail sales in the transportation energy market are only \$265 billion in the unregulated case and these abatement costs range from 1 percent to 53 percent of implied transportation energy revenues across these two tables.

These substantial abatement costs are not shared equally. Consumer surplus decreases in every case except when the energy price decreases. The consumer surplus losses are large and account for a substantial proportion (sometimes over 100 percent) of the entire abatement cost. As described in Section IV, it is important to take into account carbon market transfers when analyzing surplus to gasoline and ethanol producers separately. After accounting for these carbon market transfers (which, in many cases, exceed the revenue from ethanol production), ethanol producers benefit quite handsomely. Surplus to ethanol producers increases substantially across all the scenarios. On the other hand, gasoline producers are harmed by the LCFS with surplus losses sometimes exceeding the entire abatement cost.

The shadow values of the LCFS constraint are quite large: ranging from \$250 to \$12,000 across Tables 2 and 3. As explained in Section III, these shadow values are the price the firms would be willing to pay on the margin for an emissions permit for one ton of CO<sub>2</sub>e. These shadow values should be interpreted with caution, however, since Proposition 3 shows that these shadow values can optimally exceed CO<sub>2</sub>e damages for the best LCFS.

Richard S. J. Tol (2005), reviews 103 estimates of the environmental damages from CO<sub>2</sub>e emissions in 28 published studies.<sup>74</sup> The ninety-fifth percentile of these estimates are damages of approximately \$95 per ton, though the author argues that damages are unlikely to exceed \$14 per ton.<sup>75</sup> Even taking the ninety-fifth percentile of damage estimates, welfare decreases under even the most lenient LCFS.<sup>76</sup>

Finally, we compare these results with a historical baseline LCFS that attains the CO<sub>2</sub>e emissions reduction implied by the energy-based LCFS. As explained in Section V, the historical baseline LCFS is equivalent to carbon trading and thus attains the emissions reduction at least cost. The average abatement cost under the historical baseline LCFS is significantly lower than under the energy-based LCFS. The less and more elastic scenario average abatement costs range from \$16 to \$868 and \$2 to \$60 per ton. These costs range from 2–38 percent of the average abatement costs from the energy-based LCFS for the same reduction in emissions. These results suggest that the average abatement costs associated with an energy-based LCFS would be much larger than the costs associated with a cost-effective policy.

The simulations of the historical baseline LCFS provide useful context since they show what could be attained under a cost-effective policy. Our simulations suggest that the average abatement costs under the historical baseline LCFS may

<sup>74</sup> Tol (2005) reports damages in units of dollars per ton of carbon (\$/tC). We convert these values to units of dollars per ton of CO<sub>2</sub>e for comparison with our estimates of average abatement costs.

<sup>75</sup> In addition, the distribution of damages presented in Tol (2005) is strongly right-skewed with mode, median, and mean damages of approximately \$1 per MTCO<sub>2</sub>e, \$4 per MTCO<sub>2</sub>e, and \$25 per MTCO<sub>2</sub>e, respectively.

<sup>76</sup> There is considerable uncertainty about the true damages from carbon emissions. Factors such as the wide range of ecosystems that may be affected by climate change and the difficulty associated with evaluating both use and nonuse values for the environment make this task extremely challenging. For this reason, we simply present the average abatement cost, which can be compared with the relevant damages.

or may not be consistent with increasing welfare. At the ninety-fifth percentile of damages, \$95 per ton, reductions in CO<sub>2</sub>e emissions of 20 percent would increase welfare under the more elastic scenario in Table 3. However, the maximum welfare would be achieved at a reduction of less than 20 percent since the marginal cost of reductions after a 20 percent reduction is \$133. In contrast, with these damages, a 13 percent reduction in emissions would decrease welfare in the less elastic scenario in Table 2.

It is worth noting that energy prices and consumer surplus changes are lower under the energy-based LCFS as compared to the historical baseline LCFS. For example, in the more elastic scenario an energy-based LCFS that reduces carbon intensity by 10 percent corresponds to an energy price of approximately \$2.87 in the more elastic scenario, versus \$3.52 for a historical baseline LCFS producing an equivalent emissions reduction. In the same example, consumer surplus falls by approximately \$66 billion in the energy-based LCFS versus approximately \$130 billion for a cost-effective policy. These results are perhaps part of the political appeal of an energy-based LCFS.

Nevertheless, the comparison between the two LCFS policies highlights the inefficiencies of the energy-based LCFS. The higher average abatement costs under the energy-based LCFS indicate a much larger private surplus loss for an equivalent quantity of abatement. The inefficiency of the energy-based LCFS largely comes from the fact that too much energy is produced. Based on our simulations, total fuel consumption is between 97 and 104 billion gge for an energy-based LCFS that results in a 10 percent reduction in carbon intensity versus 89 to 94 billion gge for an historical baseline LCFS that produces equivalent emissions reductions. Furthermore, while an energy-based LCFS can result in the correct relative prices for the low- and high-carbon fuels, in general it will not. This is because under an energy-based LCFS, the proportions of low- to high-carbon fuels consumed are fixed by the emissions rates of the fuels. For a 10 percent reduction in carbon intensity, we see that ethanol represents approximately 40 percent of the total fuel consumed under an energy-based LCFS compared to between 3 percent and 12 percent for the historical baseline LCFS.

### *B. Additional Scenarios*

Table 4 summarizes simulation results using more (less) elastic ethanol supply and less (more) elastic gasoline supply while holding the demand elasticity at an intermediate level. These results give guidance as to how CO<sub>2</sub>e levels may be affected by an LCFS. For the upper CO<sub>2</sub>e scenario in Table 4, we choose parameter values within our ranges (namely more elastic ethanol supply and less elastic gasoline supply) that lead to small reductions in CO<sub>2</sub>e. For the lower CO<sub>2</sub>e scenario, we choose the parameters that lead to large CO<sub>2</sub>e reductions.

These two scenarios largely confirm the main results from the simulations in Tables 2 and 3. Namely, carbon emissions decrease with an energy-based LCFS, but the average abatement cost is substantial. In all cases, the average abatement costs are much larger than the average abatement costs under the historical baseline LCFS.

TABLE 4—SIMULATION RESULTS USING LEAST (MOST) ELASTIC GASOLINE SUPPLY AND MOST (LEAST) ELASTIC ETHANOL SUPPLY IMPLYING THE SMALLEST (LARGEST) CO<sub>2</sub>e REDUCTIONS

LCFS simulation results: upper CO <sub>2</sub> e scenario				
	$\sigma = 1^a$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,313.96	100.1%	98%	88%
Fuel price (\$/gge) <sup>b</sup>	\$2.27	\$2.18	\$2.08	\$2.40
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$278.73	\$877.71	\$1,362.94
Average abatement cost (\$/MTCO <sub>2</sub> e) <sup>c</sup>		NA	\$1,065	\$723
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.26	\$2.47	\$3.42
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		NA	\$27.26	\$145.57
Average abatement cost (\$/MTCO <sub>2</sub> e)		NA	\$13	\$69
LCFS simulation results: lower CO <sub>2</sub> e scenario				
	$\sigma = 1$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,313.96	97%	74%	55%
Fuel price (\$/gge)	\$2.27	\$2.44	\$5.21	\$11.61
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$1,385.19	\$5,478.39	\$8,632.92
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$219	\$506	\$836
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.52	\$6.09	\$15.57
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$25.71	\$367.96	\$1,233.65
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$13	\$148	\$388

Notes: Assumed parameter values: elasticity of demand, 0.3; gasoline supply elasticity, 0.5 (upper) and 2.0 (lower); Ethanol supply elasticity, 4.0 (upper) and 1.0 (lower); normalized ethanol emission rate, 0.75.  $\Delta$ CS,  $\Delta$ PS and the percent change in emissions are calculated relative to the unregulated equilibrium.

<sup>a</sup> $\sigma = 1$ , represents the unregulated case with the LCFS standard normalized by the current carbon intensity.

<sup>b</sup>The fuel quantity in gasoline gallon equivalents (gge) reflects the adjustment for the lower volumetric energy density of ethanol.

<sup>c</sup>Average abatement cost is  $(\Delta$ CS +  $\Delta$ PS)/(CO<sub>2</sub> equivalent abatement).

The upper CO<sub>2</sub>e scenario in Table 4, shows one interesting outcome that does not occur in any other scenario. Under the 99 percent standard, carbon emissions increase by 0.1 percent even though the carbon intensity decreases by 1 percent. In this scenario, the supply of ethanol is particularly elastic while the gasoline supply is less elastic. Thus, it is optimal for firms to expand ethanol production relatively more than they decrease gasoline production, energy increases, and CO<sub>2</sub>e emissions increase. Since CO<sub>2</sub>e emissions increase only for these extremes of the supply elasticities and only for a modest standard, the results suggest that an LCFS is unlikely to increase CO<sub>2</sub>e emissions.

The lower CO<sub>2</sub>e scenario shows the other extreme where the LCFS is particularly effective in reducing CO<sub>2</sub>e emissions. Here, a standard reducing the carbon intensity by 10 percent reduces CO<sub>2</sub>e emissions by 45 percent. Despite these large emissions reductions, the energy-based LCFS is still a costly way of attaining this emissions reduction which could be attained at less than half the cost with the historical baseline LCFS.

Table 5 tests the sensitivity of the results to our assumptions about the carbon emissions rate of ethanol. Given the extensive controversy surrounding this emissions rate, we vary the normalized emissions rate between 0.65 and 0.85.

TABLE 5—SIMULATION RESULTS USING A HIGHER (LOWER) ETHANOL INTENSITY RATING

	LCFS simulation results: higher CO <sub>2</sub> e Ethanol			
	$\sigma = 1^a$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,316.90	99%	86%	69%
Fuel price (\$/gge) <sup>b</sup>	\$2.27	\$2.27	\$3.18	\$5.58
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$1,057.07	\$3,024.74	\$4,312.92
Average abatement cost (\$/MTCO <sub>2</sub> e) <sup>c</sup>		\$549	\$624	\$772
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.35	\$3.77	\$7.86
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$9.56	\$161.93	\$561.39
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$5	\$74	\$215
	LCFS simulation results: lower CO <sub>2</sub> e Ethanol			
	$\sigma = 1$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,311.04	99%	93%	83%
Fuel price (\$/gge)	\$2.27	\$2.25	\$2.41	\$2.94
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$235.19	\$770.25	\$1,186.90
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$155	\$333	\$417
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.33	\$2.84	\$4.09
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$7.17	\$64.86	\$196.22
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$4	\$31	\$88

Notes: Assumed parameter values: elasticity of demand, 0.3; gasoline supply elasticity, 1.0; Ethanol supply elasticity, 2.5; normalized ethanol emission rate, 0.85 (upper) and 0.65 (lower).  $\Delta$ CS,  $\Delta$ PS and the percent change in emissions are calculated relative to the unregulated equilibrium.

<sup>a</sup>  $\sigma = 1$ , represents the unregulated case with the LCFS standard normalized by the current carbon intensity.

<sup>b</sup> The fuel quantity in gasoline gallon equivalents (gge) reflects the adjustment for the lower volumetric energy density of ethanol.

<sup>c</sup> Average abatement cost is  $(\Delta$ CS +  $\Delta$ PS)/(CO<sub>2</sub> equivalent abatement).

Again, these scenarios confirm our main results, CO<sub>2</sub>e emissions are unlikely to increase, and average abatement costs are much larger than under a historical baseline LCFS.

Several interesting results arise in these simulations. First, the abatement costs and energy prices are lower under the lower emissions rate. For an energy-based LCFS that reduces carbon intensity by 10 percent, abatement costs are \$91 billion and \$319 billion for the lower and higher emissions rates, respectively. Second, the emissions reductions are higher, 31 percent versus 17 percent for a 10 percent reduction in carbon intensity, when ethanol has a higher emissions rate. This result follows from the output effect since energy output (and hence CO<sub>2</sub>e emissions) is lower when ethanol has a higher emissions rate. Finally, surplus gains to ethanol producers are larger when they have a higher emissions rate. For example, ethanol producer surplus gains for a standard that reduces carbon intensity by 10 percent are \$57 billion and \$136 billion for the lower and higher ethanol emissions rates, respectively. This follows from the fact that prices are higher, and a higher output of ethanol is required when the ethanol emissions rate is only slightly below the standard. This result suggests a rather perverse incentive; ethanol producers acting together may have an incentive to overstate the emissions rate of ethanol once the standard is set.

Finally, we simulate the LCFS for a hypothetical advanced ethanol production technology. Because little is known about the production scale characteristics of technologies such as cellulosic ethanol, we assume that production costs of advanced ethanol are equal to those of corn-based ethanol. Furthermore, we assume that the emissions rate for the new fuel is equal to 0.20.<sup>77</sup> Simulation results using intermediate values of the supply and demand elasticities are reported in Table 6.

With advanced technology ethanol, average abatement costs and energy prices fall relative to our other scenarios. However, abatement costs are still substantially higher under an energy-based LCFS than under a historical baseline LCFS (\$161 versus \$49 per ton for policies that reduce carbon intensity by 10 percent).

Two interesting points arise from Table 6. First, these are generally the smallest average abatement costs and lowest fuel prices across the scenarios. This emphasizes the crucial nature that the development of advanced technologies can play in reducing the costs of carbon reduction policies. However, comparisons across scenarios should be made with care since, although all scenarios have the same reductions in carbon intensity, these imply dramatically different reductions in carbon emissions. In fact, the advanced ethanol simulations, which use a much lower emissions rate, lead to more modest emissions reductions under an LCFS. Second, the emissions reductions in Table 6 match the reductions in carbon intensity much more closely than in the other tables. Intuitively, this arises since the possibilities for emissions reductions from substitution are much greater when the emissions rate of the clean fuel is lower. Since the energy-based LCFS only takes advantage of substitution, the reduction in carbon intensity more closely matches the reduction in emissions as price increases are only modest. Third, the estimated average carbon costs suggest that even with our optimistic assumptions for the carbon benefits and costs of cellulosic ethanol, the LCFS is welfare reducing. In contrast, the historical baseline LCFS may be welfare increasing.

### VIII. Conclusion

As states and the federal government seek policies for regulating greenhouse gas emissions, low carbon fuel standards will be part of the regulatory toolkit. Despite increasing prominence of the standards in policy debates, this is the first work to analyze the economic effects and incentives of the LCFS. We find that an energy-based, low carbon fuel standard cannot be efficient, can decrease or increase carbon emissions, and can increase or decrease efficiency. In fact, a regulator's best option may be to choose a nonbinding LCFS even if the LCFS is its only policy option. By illustrating the LCFS equilibrium, we show that the perverse effects of the LCFS depend on the slopes of the marginal benefit and marginal cost curves, as well as the magnitudes of the implied LCFS subsidy and tax. We show that the

<sup>77</sup> We believe these assumptions offer an optimistic assessment of future cellulosic ethanol technology. For example, Searchinger et al. (2008) report an emissions rate for cellulosic ethanol of 0.30 using the GREET 1.7 model but estimate an emissions rate of 1.50 after accounting for land use changes. Andrew McAloon, Frank Taylor, and Winnie Yee (2000) estimate the production costs of cellulosic ethanol to be 70 percent greater than ethanol produced from corn.

TABLE 6—SIMULATION RESULTS ASSUMING LOW-COST CELLULOSIC ETHANOL

	LCFS simulation results: advanced technology Ethanol			
	$\sigma = 1^a$	$\sigma = 0.99$	$\sigma = 0.95$	$\sigma = 0.90$
Emissions (MMTCO <sub>2</sub> e)	1,298.06	99%	95%	89%
Fuel price (\$/gge) <sup>b</sup>	\$2.27	\$2.26	\$2.27	\$2.37
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$50.82	\$189.17	\$308.47
Average abatement cost (\$/MTCO <sub>2</sub> e) <sup>c</sup>		\$31	\$107	\$161
<i>Historical baseline LCFS</i>				
Fuel price (\$/gge)		\$2.33	\$2.63	\$3.15
Shadow value $\lambda$ (\$/MTCO <sub>2</sub> e)		\$6.98	\$42.10	\$100.15
Average abatement cost (\$/MTCO <sub>2</sub> e)		\$4	\$21	\$49

Notes: Assumed parameter values: elasticity of demand, 0.3; gasoline supply elasticity, 1.0; ethanol supply elasticity, 2.5; normalized ethanol emission rate, 0.20.  $\Delta CS$ ,  $\Delta PS$  and the percent change in emissions are calculated relative to the unregulated equilibrium.

<sup>a</sup>  $\sigma = 1$ , represents the unregulated case with the LCFS standard normalized by the current carbon intensity.

<sup>b</sup> The fuel quantity in gasoline gallon equivalents (gge) reflects the adjustment for the lower volumetric energy density of ethanol.

<sup>c</sup> Average abatement cost is  $(\Delta CS + \Delta PS)/(\text{CO}_2 \text{ equivalent abatement})$ .

LCFS is more likely to increase carbon emissions if supply and/or demand for the high-carbon fuel are relatively steep or the standard is relatively lenient.

Analyzing the burden of the LCFS, we find that producers or consumers (but not both) can be better off under the LCFS. Consumers can be better off if the lower prices on the low carbon fuel make up for the higher prices on the high-carbon fuel. With carbon trading, producers of the low carbon fuel are always better off, while producers of the high-carbon fuel are worse off. Incorporating the environmental costs, we find that the LCFS can decrease efficiency if the demand for the high-carbon fuel is relatively inelastic.

Trading across firms can reduce compliance costs if firms have different marginal production costs. The equilibria that result from trading (including any transfers) are identical whether firms trade carbon, low carbon energy, or energy. As in other Coase theorem results, trading minimizes total costs of production.

Because of the efficiency costs and potentially perverse effects of the energy-based LCFS, we explore other baselines for the LCFS. A fuel-economy LCFS is similar to the energy-based LCFS, but regulates emissions per mile and thus favors different fuel types and may have quite different distributional effects. A historical baseline LCFS can be efficient, but would not have flexibility to allow higher carbon in high demand years and would likely lead to disagreement over the baseline year or years. The rolling average and fixed proportion LCFSs can reduce (but not eliminate) these difficulties but also may not be able to attain the efficient allocation.

We also theoretically analyze the incentives to improve carbon emissions rates and fuel efficiency. We find that the incentives can be either too large or too small depending on the standard. Interestingly, the fuel-economy LCFS introduces a positive externality from higher mileage which may be hard to decentralize.

To illustrate the economic significance of our theoretical results, we numerically simulate the model for a range of parameters representative of short-term

adjustments in the US markets for gasoline and ethanol. The functional forms for the simulation are chosen to rely on a minimal number of free parameters. Nonetheless, the main difficulty with our simulations is the lack of credible parameters from the literature. In particular, there is either little evidence or little agreement about the supply elasticities for ethanol and gasoline and about the carbon emissions rate of ethanol. For this reason, we assume broad parameter ranges to approximate the range of possible outcomes from an energy based LCFS. In future work, we hope to develop more precise estimates of the relevant parameters and functional forms.

Despite the simplicity of our calculations, several results are clear. First, CO<sub>2</sub>e emissions are unlikely to increase with adoption of an LCFS in the United States despite the theoretical possibility. We find quite large reductions in CO<sub>2</sub>e emissions resulting even from modest regulation of the carbon intensity with an energy-based LCFS.

Despite these significant reductions in CO<sub>2</sub>e emissions, an energy-based LCFS is an expensive way to reduce greenhouse gas levels. In fact, we find that the average abatement cost of the emissions reduction from the energy-based LCFS is at least twice as large, and under some circumstances, may be an order of magnitude higher than the average abatement cost from a cost-effective policy which attains the same CO<sub>2</sub>e emissions reduction.

These high cost estimates suggest that an energy-based LCFS may not increase welfare. In fact for these parameters, and most estimates of carbon damages, our results suggest that it would be better to have no LCFS (or a nonbinding LCFS) than to adopt an energy-based LCFS.

Policy makers' concerns often extend beyond efficiency, and the distributional effects of an energy-based LCFS are also quite profound. We find that all of the burden of the energy-based LCFS is borne by the consumers and by gasoline producers. In fact, after accounting for carbon market transfers, ethanol producers are better off in each scenario we analyze.

Other market failures such as technology spillovers, learning by doing, an inability of private firms to privately appropriate all of the benefits from developing cleaner alternatives, etc., may suggest subsidizing renewable resources. If regulators lack direct policy instruments to address these other market failures, an energy-based LCFS, which subsidizes low carbon fuels (primarily renewables), may be a second best policy instrument for addressing multiple policy goals with one instrument. Further analysis of multiple policy goals is beyond the scope of this paper. However, even the historical baseline LCFS, which taxes all fuels and can be efficient, places a smaller tax on low carbon fuels, and thus implicitly subsidizes low carbon fuels precisely in proportion to their lower carbon emissions. Thus, it is not clear that an energy-based LCFS would be superior to a historical baseline LCFS even in the presence of multiple policy objectives.

A final consideration is that the LCFS taxes (and subsidies) are implicit and raise no revenue, that could be used to offset other distortionary policies. The importance of the revenue recycling effect, as shown in Goulder et al. (1997), may make the energy-based LCFS even less attractive relative to a carbon tax or to carbon trading with auctioned permits.

Adoption of any policy requires careful comparison of the costs and benefits of the policy along with the consideration of other policy options and any potentially unintended consequences. This paper lays out a framework for analyzing low carbon fuel standards. Explicit comparisons of an LCFS with other policies, such as a transportation sector cap and trade program, depend on the details of the LCFS and the cap and trade program. However, given all the potential problems and excessive costs of an energy-based LCFS identified here, it is unlikely that an energy-based LCFS would be the preferred policy unless the range of alternative options were extremely limited.

#### APPENDIX A: PROOFS

##### PROOF OF PROPOSITION 1:

Assume  $\beta_L > 0$ . Suppose the regulator sets the constraint such that  $\lambda^e(\beta_H - \sigma) > \tau\beta_H$ , but this implies that  $\partial U/\partial q_H = p_H = MC_H(q_H^e) + \lambda^e(\beta_H - \sigma) > MC_H(q_H^e) + \tau\beta_H$ . Thus, efficiency could be increased by increasing  $q_H$  since the marginal benefit is greater than the social marginal cost. Similarly, the efficient allocation is not attained if  $\lambda^e(\beta_H - \sigma) < \tau\beta_H$  since efficiency could be increased by decreasing  $q_H$ . Suppose, instead, the regulator sets the standard such that  $\lambda^e(\beta_H - \sigma) = \tau\beta_H$ .<sup>78</sup> In this case,  $q_H$  is set optimally conditional on  $q_L$ . However,

$$\frac{\partial U}{\partial q_L} = p_L = MC_L(q_L^e) + \lambda^e(\beta_L - \sigma) \leq MC_L(q_L^e) < MC_L(q_L^e) + \tau\beta_L$$

since  $\sigma \geq \beta_L > 0$ . But now efficiency can be increased by decreasing  $q_L$ , so the efficient allocation is not attained.

Now, assume  $\beta_L = 0$ . As above, the efficient allocation is not attained if  $\lambda^e(\beta_H - \sigma) \neq \tau\beta_H$ , so let  $\lambda^e(\beta_H - \sigma) = \tau\beta_H$ . If  $\sigma > \beta_L$ , the efficient allocation is not attained since the first inequality in (24) would be strict. So, let  $\sigma = \beta_L = 0$ . Note that this implies that  $q_H^e = 0$  and  $\lambda^e = \tau$ . Producers set  $q_H^e = 0$  if and only if  $p_H \leq MC_H(0) + \tau\beta_H$  which is efficient if and only if  $\partial U(0, q_L^*)/\partial q_H \leq MC_H(0) + \tau\beta_H$ .

##### PROOF OF PROPOSITION 2:

The proofs of Propositions 2 and 3 rely on examples with linear marginal costs  $MC_H(q_H) = Bq_H$  and  $MC_L(q_L) = 40 + q_L$ , where  $B \in \{0.5, 1, 2\}$  and, with linear demand  $D(p) = 1,000 - 20p$ , where the fuels are perfect substitutes, i.e.,  $p_H = p_L = p$ . Throughout, assume  $\beta_H = 1$  and  $\beta_L = 0.75$ . The first proof of Proposition 2 varies the relative slopes of the marginal cost curves and the second proof varies the stringency of the standard. Let  $q_i^0$  be the output of the unregulated firm and  $q_i^e$  be the equilibrium output of the firm subject to the LCFS.

<sup>78</sup> This may or may not be feasible.

## FIRST PROOF:

This proof varies  $B$ . Begin with  $B = 2$ . The unregulated firm produces  $q_H^0 = 1040/43$ ,  $q_L^0 = 360/43$ , at  $p^0 = 2080/43$  with carbon intensity of 0.936, carbon emissions 30.47, and energy of 32.56. Under an LCFS equal to the average intensities of the two fuels ( $\sigma = 0.875$ ),  $q_H^e = q_L^e = 75/4$ ,  $p^e = 385/8$ , and  $\lambda = 85$ . Since emissions are 32.81 and energy is 37.50, this LCFS increases carbon emissions and increases energy.

Now, let  $B = 0.5$ . Here, the unregulated firm produces such that  $q_H^0 = 2080/23$ ,  $q_L^0 = 120/23$ , and  $p^0 = 1040/23$  with a carbon intensity of 0.986, carbon emissions of 94.35, and energy of 95.65. Under an LCFS of 0.875,  $q_H^e = q_L^e = 600/17$ ,  $p^e = 790/17$  and  $\lambda = 3920/17$ . Here, carbon emissions are 61.76 and energy is 70.59, and this LCFS reduces carbon emissions and reduces energy.

## SECOND PROOF:

This proof varies  $\sigma$ . Let  $B = 1$  so the slopes of the marginal costs are equal. The unregulated firm would produce  $q_H^0 = 520/11$ ,  $q_L^0 = 80/11$ , at  $p^0 = 520/11$  with carbon intensity of 0.967 and carbon emissions 52.73. Under a lax, binding standard of 0.9, the LCFS equilibrium has  $q_H^e = 680/19$ ,  $q_L^e = 1360/57$ ,  $p^e = 2680/57$ , and  $\lambda = 6400/57$ , with carbon emissions of 53.68. This standard increases carbon emissions. Under a more stringent standard of 0.875, the LCFS equilibrium has  $q_H^e = q_L^e = 300/11$ ,  $p^e = 520/11$ , and  $\lambda = 160$ , with carbon emissions of 47.73. This standard decreases carbon emissions.

## PROOF OF ASSERTIONS:

A binding LCFS must reduce the carbon intensity of fuel so

$$\frac{\beta_H q_H^e + \beta_L q_L^e}{q_H^e + q_L^e} < \frac{\beta_H q_H^0 + \beta_L q_L^0}{q_H^0 + q_L^0}.$$

If  $\beta_H q_H^e + \beta_L q_L^e > \beta_H q_H^0 + \beta_L q_L^0$ , it is easy to show that  $q_H^e + q_L^e > q_H^0 + q_L^0$ . Similarly, it is easy to show that  $q_H^e + q_L^e < q_H^0 + q_L^0$  implies that  $\beta_H q_H^e + \beta_L q_L^e < \beta_H q_H^0 + \beta_L q_L^0$ .

## A. Comparative Statics of LCFS Equilibrium

We analyze how the LCFS equilibrium changes with the standard. First, the total derivative of the constraint is

$$(25) \quad \beta_H \frac{dq_H^e}{d\sigma} + \beta_L \frac{dq_L^e}{d\sigma} = q_H^e + q_L^e + \sigma \left( \frac{dq_H^e}{d\sigma} + \frac{dq_L^e}{d\sigma} \right),$$

which can be written

$$(\beta_H - \sigma) \frac{dq_H^e}{d\sigma} + (\beta_L - \sigma) \frac{dq_L^e}{d\sigma} = q_H^e + q_L^e.$$

Since  $\beta_H - \sigma \geq 0$  and  $\beta_L - \sigma \leq 0$ , it is easy to show that  $dq_H^e/d\sigma \leq 0$  and  $dq_L^e/d\sigma \geq 0$  leads to a contradiction. Other sign combinations cannot be ruled out by theory.

### PROOF OF PROPOSITION 3.

The proof of the first statement of the proposition follows from the linear example described in the proof of Proposition 2, where  $B = 1$ . Solving for the LCFS equilibrium with  $\sigma$  as a parameter,

$$q_H = \frac{200(33 - 92\sigma + 64\sigma^2)}{501 - 1120\sigma + 640\sigma^2} \quad \text{and} \quad q_L = \frac{-800(11 - 27\sigma + 16\sigma^2)}{501 - 1120\sigma + 640\sigma^2}$$

are the LCFS equilibrium quantities for an arbitrary  $\sigma \in [3/4, 29/30]$ . Integrating under the demand and supply curves and with  $\tau = 20$ , we have the welfare function

$$W(\sigma) = 50(q_H + q_L) - (q_H + q_L)^2/2 - q_H^2/2 - 40q_L - q_L^2/2 - 20(q_H + 0.75q_L).$$

$W$  has local maximums at  $W(29/30) = 163.64$  and  $W(3/4) = -95.24$ . Thus welfare is maximized when the standard is not binding and any binding standard decreases welfare.

The proof of Proposition 3 (i) follows since (25) can be substituted into (10) to derive

$$\tau \frac{d(\beta_H q_H^e + \beta_L q_L^e)}{d\sigma} = \lambda^e (q_H^e + q_L^e)$$

which implies that  $d(\beta_H q_H^e + \beta_L q_L^e)/d\sigma > 0$ .

The proof of Proposition 3 (ii) follows since (25) can be differently substituted into (10) to derive

$$(\lambda^e - \tau)(q_H^e + q_L^e) = \tau\sigma^* \frac{d(q_H^e + q_L^e)}{d\sigma}$$

which implies  $\lambda^e > \tau$  if and only if  $d(q_H^e + q_L^e)/d\sigma > 0$ .

The proof of Proposition 3 (iii) follows trivially since  $\lambda^e(\beta_L - \sigma^*) \leq 0 < \tau\beta_L$  if  $\beta_L > 0$ .

The proof of Proposition 3 (iv) follows from (9) since the right-hand side is positive from (iii) and the assumption.

### B. Details of Trading Equilibrium.

We show that the net demand for low carbon energy is downward sloping. If  $S_{ij}$  is firm  $j$ 's supply function for fuel  $i$ , then

$$\begin{aligned}
(\sigma - \beta_x)x_j &= (\beta_H - \sigma)q_{Hj} + (\beta_L - \sigma)q_{Lj} \\
&= (\beta_H - \sigma)S_{Hj} \left( p_H - \frac{p_x}{\sigma - \beta_x} (\beta_H - \sigma) \right) \\
&\quad + (\beta_L - \sigma)S_{Lj} \left( p_L - \frac{p_x}{\sigma - \beta_x} (\beta_L - \sigma) \right).
\end{aligned}$$

The first equation is simply the constraint and the second equation follows by substituting in the supply functions at the LCFS price. The derivative of this last equation w.r.t.  $p_x$  is negative which implies that  $dx_j/dp_x < 0$ .

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