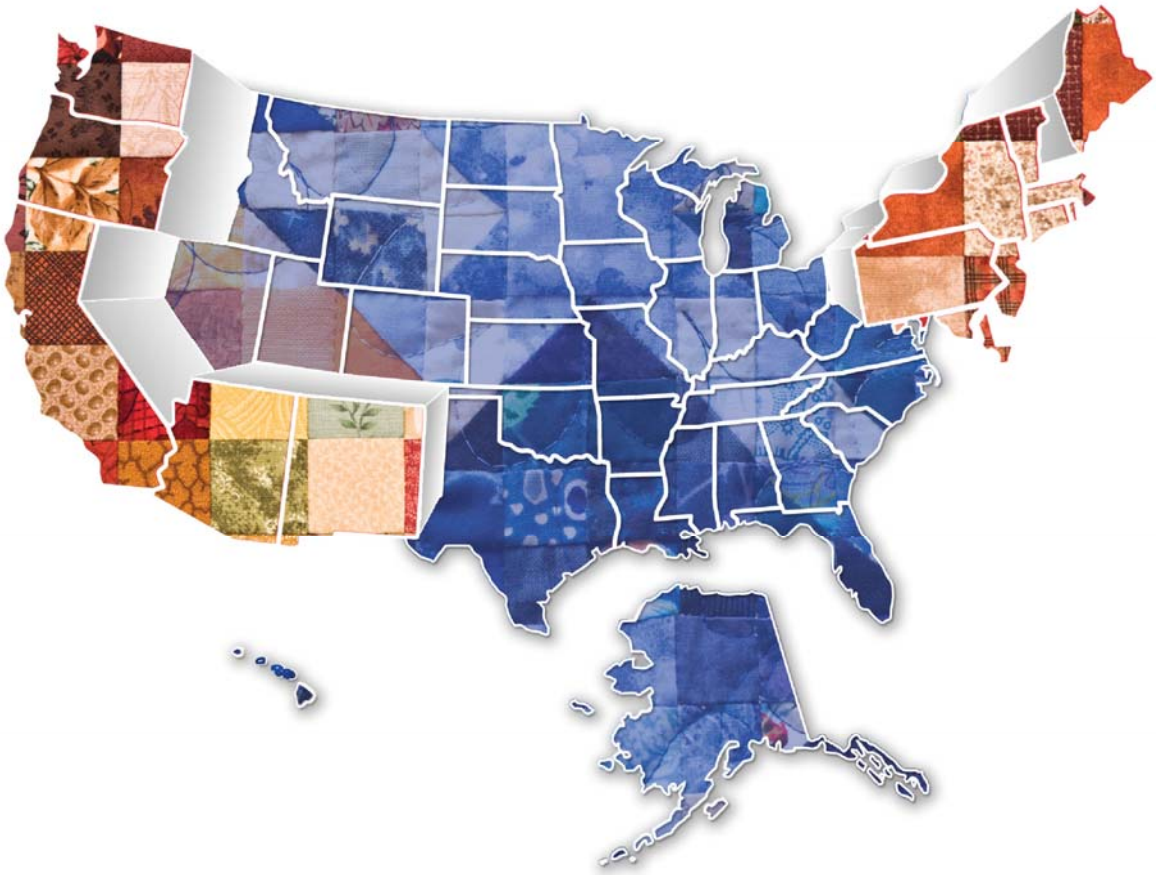
PATCHWORK PROVEN

WHY A SINGLE NATIONAL FUEL ECONOMY STANDARD IS BETTER FOR AMERICA THAN A PATCHWORK OF STATE REGULATIONS



PATCHWORK PROVEN: EXECUTIVE SUMMARY

On March 6, 2008, the administrator of the Environmental Protection Agency (EPA) denied the California Air Resources Board's (CARB) waiver request to implement its fuel economy/motor vehicle greenhouse gas regulation. During consideration of CARB's waiver request, a key issue emerged: whether granting the waiver would lead to a "patchwork" of state fuel economy regulatory regimes. CARB and its supporters argue that automakers need only comply with "at most" two regulatory regimes: a federal standard set by Congress and the CARB regime in states that adopt it. Conversely, supporters of a single, national federal fuel economy standard contend that state regulation of fuel economy/greenhouse gases (GHGs) would produce multiple state regulatory regimes, resulting in reduced consumer choice, economic harm to auto dealers and manufacturers, and the undermining of the recently reformed national corporate average fuel economy (CAFE) program.

Whether a regulatory patchwork would emerge can be determined by a thorough analysis of the regulations of the state and local governing bodies that adopted CARB's rule. After conducting such an analysis, this report finds that there would be a regulatory patchwork made up of all of the "California" or CARB states, except Pennsylvania. This report also identifies serious policy flaws in CARB's regulation that have not been the subject of vigorous national debate or scrutiny.

There is a regulatory patchwork made up of every CARB state, except Pennsylvania.

Compliance with CARB's regulation is based on an automaker "delivering for sale" a fleet in each CARB state that achieves a certain fleet-wide GHG emissions average. As different vehicles emit different GHG levels, and consumers buy different vehicles in different quantities, an automaker's fleet- wide GHG emissions average will vary by state. A regulatory patchwork is thus created when a state adopts CARB's regulation and bases compliance on what an automaker "delivers for sale" in that state, with the variation in state fleets forming the basis for the patchwork. Application of CARB's regulation means that an automaker could comply in California and offer the

exact same choice of vehicles in another CARB state, and yet still not be in compliance, solely due to differing consumer demand.

A state-by-state patchwork of regulations would be complicated to comply with and would result in direct conflicts, as the federal government and CARB battle for regulatory supremacy. But these concerns pale in comparison to some of the patchwork's unintended consequences. For instance, as CARB's standard increases in stringency, the patchwork is likely to cause widespread "mix shifting," whereby an automaker manipulates the composition of its own fleet in a state solely to comply with CARB's GHG emissions average. Mix shifting includes rationing the availability of larger vehicles, discounting smaller size models, and other pricing strategies. With the passage of a much higher federal CAFE standard in 2007, mix shifting is the only realistic avenue for an automaker to ensure compliance in each CARB state. The fuel economy gains once contemplated by CARB's regulation have been supplanted by the new CAFE program, which is national in scope and cannot be evaded by mix shifting. If implemented, the legacy of CARB's regulation will be pervasive mix shifting, which distorts the auto market and does nothing to decrease GHGs or improve fuel economy on a national basis.

Mix shifting also reduces consumer choice in CARB states, as automakers are forced to ration larger vehicles to comply with CARB's statewide fleet GHG average. This reduction in consumer choice gives rise to another patchwork-related problem, the "cross-border sales loophole." This loophole will arise when new car buyers seek to purchase vehicles in neighboring states that are unavailable in their home state due to rationing. This loophole undermines the efficacy of each state's program, as vehicles purchased out of state are not counted towards an automakers' state GHG emissions average under CARB's rules. Thus one of the goals of CARB's program, i.e., to reduce in-state emissions of GHGs, will be frustrated and can be easily evaded. This new loophole also will distort the new vehicle marketplace.

Enforcement of CARB's regulation will be particularly onerous in small CARB states due to the size of the fleets there (e.g., BMW's 2007 new light duty fleet in Maine was under 400 vehicles; Nissan's 2007 new light duty fleet in Vermont was approximately 1,100 vehicles). Because automakers must maintain a separate fleet GHG average in each CARB state, brisk sales of popular models below the fuel economy standard in those states could force an otherwise complying automaker out of compliance. The regulation of such small fleets affords automakers little cushion to achieve the "right" sales mix necessary to comply with CARB's regulation. This result is an unavoidable consequence of applying a regulation written and designed exclusively for the nation's largest auto market (California) to states with much smaller markets and different vehicle sales mixes.

Should America's fuel economy standard be set by Congress or one state agency?

This report also examines the practical application of CARB's patchwork regime. In New Mexico, automakers would have to comply statewide and again in one county. In the District of Columbia, the design of CARB's regulation makes it nearly impossible for Ford to comply, while not affecting any other manufacturer. And at a time when Congress is directly aiding the domestic automakers by providing them tens of billions of dollars in loans, CARB exempts some of their competitors from regulation until 2016, provided they limit their sales into California.

Since over 40 percent of all new vehicle sales in the U.S. occur in CARB states, any granting of the California waiver would undermine the newly restructured federal CAFE program, as automakers struggle to comply with two competing and contradictory regulatory systems. Additionally, CARB's patchwork regime seems particularly gratuitous since the National Highway Traffic Safety Administration, as directed by Congress in 2007, is moving to raise fuel economy standards above what CARB proposes. In effect, the enactment of a new federal CAFE standard has rendered CARB's motor vehicle GHG regulation a costly and unnecessary burden on an industry already reeling from the present economic downturn.

To date, the debate over the California waiver has centered on the process by which it was denied, and the stringency of CARB's regulation compared to the proposed CAFE rule (the final rule is due out no later than April 1, 2009). Little debate and analysis has focused on how CARB's regulation would actually work in practice.

As this report shows, the *structure* of a fuel economy system is as important as the *stringency* it sets. If nearly half of the American auto market is going to be regulated twice for fuel economy under two different systems, policymakers must clearly understand what the ramifications are of such a policy. With the overall fuel economy of our nation's fleet poised to rise substantially irrespective of the California waiver, the utility of CARB's entire GHG program must be called into question. Due to mix shifting and market-distorting loopholes and exemptions, CARB's regulation cannot be characterized as a harmless appendage to the national CAFE program. Finally, the potential practical impact of CARB's regulation raises the important policy question of whether fuel economy regulation should remain under the dominion of Congress, where competing national interests can be balanced, or if such regulation should be ceded to a single state agency.