Comments of the Western Power Trading Forum
On the California Air Resources Board's
Proposed Regulation Order
For a California Cap and Trade Program

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Clare Breidenich
WPTF GHG Consultant
Email: clare@wptf.org

I. Introduction and Overview

The Western Power Trading Forum[1] (WPTF) appreciates the opportunity to provide comments to the California Air Resources Board (ARB) on its Proposed Regulation Order for a California Greenhouse Gas Cap and Trade Program (PRO).

WPTF supports establishment of a cap and trade program as the most cost-effective and efficient means of achieving emission reductions under Assembly Bill 32 (AB32). Subject to the recommended modifications and clarifications described herein, we consider ARB's proposed regulation to meet these goals and support its adoption by the Board. The recommended modifications and clarifications, each of which is discussed in more detail below, are summarized as follows:

- Once issued, offset credits should not be subject to later invalidation. The current provision for possible invalidation of ARB-issued offsets would penalize capped entities for the misconduct of others, raise transaction cost for capped entities and thus increase overall compliance costs. Offset quality should instead by ensured by enforcement of offset requirements on project developers and verifiers.
- Publicly-owned utilities (POUs) must not be able to reserve directly allocated allowances to meet the emission reduction obligations of their own generation.
- There should be no auction purchase limit. If an auction purchase limit is adopted, it should be increased and Investor-owned utilities (IOUs) should not be exempt.
- Limits on holding of compliance instruments should be removed. If holding limits are established they should be set at a level that is greater than an entity's annual emission obligation.
- Use of allowance revenue by electrical utilities should be limited to providing consumer rate relief and should not be permitted for direct technology investments that will

[1] WPTF is a diverse organization comprising power marketers, generators, investment banks, public utilities and energy service providers, whose common interest is the development of competitive electricity markets in the West. WPTF has over 60 members participating in power markets within California, western states, as well as other markets across the United States.

create a competitive advantage for them over independent transmission and generation providers.

- Allowances should be directly allocated to independent power producers that do not have the ability to recover the cost of compliance instruments in existing, long-term power contracts.
- The timing of the first auction should be advanced from February 2012 to the fourth quarter of 2011 to provide allowance price discovery for the electricity market in advance of January 1, 2012.
- Regulations for access to allowance price reserve auction should not require early retirement of allowances.
- Implementation of the cap and trade program should be deferred if necessary rules and infrastructure to enable entity compliance are not in place in a timely manner.
- Enforcement penalties are overly punitive and should be modified.
- The regulation should provide for program review and possible modification.
- The definition of specified power should be modified to avoid emission leakage and distortion of competition in electricity power markets.

We urge the Board to adopt the PRO with these changes and to direct ARB staff to make the technical modifications to the regulation necessary to reflect these changes through a 15-day process next year.

WPTF looks forward to working with ARB staff over the coming year on these issues.

II. Comments

A. Offsets should not be invalidated after issuance

Section §95985 of the PRO (Invalidation of Offset Credits) provides that a California offset credit may be invalidated by ARB after issuance and that in the event of such an invalidation, the user of that offset credit would be required to replace it with another compliance

instrument. The possible invalidation of offsets after issuance is often referred to as 'buyer liability', because it places responsibility for offset quality on the buyer and end-user of offsets, rather than on offset developers and suppliers. A buyer liability approach would:

- Increase transaction costs associated with offsets, and thus overall compliance costs, because it would require offset purchasers to duplicate the validation efforts already undertaken by ARB, and would require offset purchasers to enter into additional transactions to protect themselves in the event of invalidation.
- Reduce efficiency by moving responsibility for offset quality away from the entities best able to ensure it – project verifiers and suppliers - and placing it on offset buyers;
- Disadvantage California offset projects vis-à-vis offset projects in the Western Climate Initiative (WCI) and elsewhere, since these other offsets would not be subject to later invalidation;
- Create a high degree of market uncertainty for offset users and stifle investment in offset projects.

In recognition of these facts, emission trading systems, such as the European Emission Trading System (EU ETS) and the Regional Greenhouse Gas Initiative (RGGI), have avoided placing validation risk on offset buyers, and instead have established rigorous requirements and procedures for ensuring that offset credits are additional, verified and real, coupled with strong oversight of offset verifiers. Even within the WCI, British Columbia is contemplating rejection of the buyer-liability approach in favor of a framework under which offsets, once certified and issued, could not be revoked and would be fully fungible within the WCI.[2]

ARB does not need to rely on buyer-liability to ensure the quality of California offsets. The PRO subjects developers and verifiers of California offsets to all the requirements and enforcement mechanisms established under the cap and trade program under ARB's authority. This legal authority means that ARB *itself* can enforce the validity of offsets, and ensure that additional compliance instruments are surrendered to cover any deficient offsets. Rather than

[2] Proposed Offset Regulation Consultants paper, page 17 at: http://www.env.gov.bc.ca/cas/mitigation/ggrcta/offsets-regulation/index.html#Intentions

invalidating offsets after issuance, ARB should instead require that, as a condition for accreditation of project verifiers and as a condition for issuance of offset credits to project developers, those entities must retire additional compliance instruments in the event that any offsets are found deficient due to that entity's negligence or misconduct. This approach would ensure that the environment is made whole in the event that deficient offsets are issued, while providing certainty to offset buyers that all issued offsets could be used for compliance.

B. <u>Electric utilities who own generation must not be allowed to reserve allowances from their direct allocation to meet the emission reduction obligations of their generation.</u>

Section §95982 (Allocation to Electrical Distribution Utilities for Protection of Electricity Ratepayers) exempts POUs from a requirement to make all allowances that it has received through direct allocation available for sale at auction. This exemption would permit POUs to use directly allocated allowances to cover emissions by their own generation, while other generation resources will have to purchase compliance instruments. The staff report asserts that this exemption is warranted on the grounds that POUs have a different business model than IOUs, and no not compete with independent power producers. However, those statements are not categorically true, as POUs do frequently participate in wholesale power markets to sell surplus power. To allow POUs to reserve directly allocated allowances to cover emission reduction compliance of their own generation would give them an unacceptable advantage over independent power producers in these wholesale markets. WPTF therefore urges that the regulation be modified to require POUs to monetize all allowances received through direct allocation and to acquire allowances for their own generation and imports through auction.

C. <u>There should be no auction purchase limit. If an auction purchase limit is adopted, it should be increased and IOUs should not be exempt.</u>

Section §95911 of the PRO (Format for Auction of California GHG Allowances) establishes a ten percent auction purchase limit that applies for all auction participants except Investor-owned Utilities (IOUs). WPTF appreciates that ARB is trying to prevent market

manipulation. However, we challenge the premise that a purchase limit is in fact necessary. Participants in the allowance auctions will be subject to existing state and federal laws prohibiting unfair competition. Those statutes permit criminal prosecutions in some instances and provide the basis for significant civil penalties.

Further, the proposed limit fails to take into consideration the fact that the other regulated entities, beyond IOUs, will also have large compliance obligation. Because independent power producers will have to purchase all their allowances through auction or the secondary market, the proposed auction limit would greatly constrain the ability of some entities to procure sufficient allowances.

Under these circumstances, WPTF recommends that ARB initiate its auctions without artificial market limitations. If it later becomes apparent that existing unfair competition laws do not adequately address any perceived market irregularities, then ARB could consider a purchase limit, but at a higher level, such as the 25% adopted under RGGI. In any event, there should be no exemption for IOUs; such an exemption has the potential to further tilt the playing field in favor of utility-owned generation with no real benefit to the efficient operation of the market.

D. <u>The limits on holding of compliance instruments should be removed. If holding limits are established they should be set at a level that is greater than an entity's annual emission obligation.</u>

Similar to the above issue, Section §95920 (b) limits the number of allowances a regulated entity can hold in any given year. As we noted above, there are already existing laws to prohibit unfair competition. Further, other provisions of the regulation, including participation by non-covered entities, disclosure of auction and transaction information, periodic distribution of allowances, including through an auction mechanism, and annual surrender of allowances will together prevent hoarding of compliance instruments. For this reason, WPTF opposes establishment of holding limits. Neither the EU ETS nor RGGI have established holding limits on market participants and to our knowledge market manipulation problems have not arisen in those programs. We therefore recommend that holding limits be eliminated.

If holding limits are applied, they must be set at a level that enables larger participants to manage their compliance during a compliance interval and for future compliance intervals. As currently formulated, the holding limit would severely restrict the compliance flexibility for large entities, because it could prevent holding of an amount of allowances in active holding accounts greater than 70% of the previous year's emissions (since 30% of allowances must be retired annually). Instead, the PRO should tie each entity's holding limit to the level of the previous year emissions and at a percentage greater than 100%.

E. <u>Use of allowance revenue by IOUs must be limited to consumer rate relief.</u>

The PRO directly allocates allowances to IOUs for monetization through auction. Section §95892 of the PRO addresses how the auction revenue from directly allocated allowances may be used by IOUs:

- Auction proceeds must be used for the benefit of retail ratepayers only and be consistent with the goals of Assembly Bill 32;
- IOUs must ensure equal treatment of their customers and those of electricity service providers and community choice aggregators;
- Auction proceeds cannot be used to reduce the variable portion of ratepayer bills and cannot be based solely on the quantity of electricity delivered;
- Additional limitations on the use of auction proceeds may be established by the California Public Utilities Commission;

WPTF urges ARB to provide specific regulations that specifically preclude the IOUs from being able to use the auction revenues for direct capital investment in energy technologies and infrastructure, including renewable resources, or in service offerings such as energy efficiency or demand response, that are also provided by competitive merchant generators and other competitive market participants. Allowing the use of auction revenue for these purposes would erode competitive markets by subsidizing utility-owned generation, transmission, and energy management programs at the expense of independent generators, transmission developers, and competitive providers of energy management services.

WPTF therefore recommends that a provision be added to the regulation to prohibit the use by IOUs of auction revenue for direct capital investments in emission reduction technologies, and instead should be used only for direct consumer rate relief that is available to all rate-payers.

F. Allowances should be directly allocated to independent power producers that do not have the ability to recover the cost of compliance instruments in existing, long-term power contracts

Both the staff report and Appendix J (Allowance Allocation) note that there are independent power producers who, due to terms in pre-existing contracts, are unable to pass-through the cost of allowances in their electricity prices, and that modification of the regulation may be needed to include provisions to address these situations. WPTF urges inclusion of provisions in the regulations that:

- Define the conditions under which an independent power producer would be eligible to receive allowances (e.g., contracts entered into after adoption of AB 32 would not be eligible for such relief);
- Require documentation by the producer to demonstrate that it meets these conditions;
- Provide for direct allocation of allowances to independent power producers to cover emissions associated with these contracts;
- Reduce the direct allocation of allowances to individual electrical utilities that are counter-parties to these contracts by the amount of allowances directly allocated to independent power producers.

G. The timing of the first auction should be advanced to provide necessary allowance price discovery for electricity market in advance of January 1, 2012.

Although the first surrender of allowances by capped entities is not required until May 2014, electricity generators will need to include the cost of allowances in bid prices for electricity as of January 1, 2012, when the first compliance period begins. Until a secondary

market for compliance instruments develops, auctions will be the only means available for price discovery of allowances. Because the first auction is currently scheduled for February 2012, generators would have little direct information on which to base their assessment of the allowance price component of the power production for the January-February period. Given that generators need to ensure that the power price they receive is sufficient to recoup their allowance costs, earlier auctions will enhance allowance price transparency, and therefore eliminate market uncertainty that could cause prices to be higher than necessary.

WPTF therefore recommends that the first auction be moved up to the last quarter of 2011.

H. Rules for access to the price reserve should not require entities to pre-retire all allowances.

Section §95913 of the regulation pertains to the sale of allowances from the "Allowance Price Containment Reserve." In keeping with the goal stated in the staff report that allowances purchased from the reserve are used for compliance purposes, this section provides several restrictions on access to the reserve allowance auction: that only covered entities may participate, and that covered entities must "hold no compliance instruments in their holding accounts or limited use holding accounts." It further provides that allowances purchased from the reserve will be put directly into covered entities' compliance account.

WPTF agrees with ARB's goal of ensuring that allowances purchased in the auction price reserve must be used for compliance. However, we believe that the requirement that covered entities must "hold no compliance instruments in their holding accounts or limited use holding accounts" is unnecessary and would limit the utility of the price reserve auction as a cost-containment mechanism. In effect this requirement would require covered entities to 'pre-retire' all allowances – even those which have been purchased or banked for use in later years - to compliance accounts (or sell them off) to remove them from holding accounts. This outcome would greatly restrict the flexibility of covered entities to plan for compliance and respond to market conditions.

Because allowances purchased from the reserve are placed directly into compliance accounts (from which they cannot be further transferred), there is no need to additionally require that a covered entities' holding accounts are empty as a condition for participation in the auctions. WPTF therefore recommends that this requirement be removed from the regulation.

I. Implementation of the cap and trade program should be deferred if necessary rules and infrastructure to enable entity compliance are not in place in a timely manner

Covered entities need certainty about all rules, the availability of compliance instruments, and establishment of all necessary systems in a timely manner in order to plan for compliance with the cap and trade program. WPTF is concerned that delays in finalization of the rule, development of infrastructure for the tracking and reporting systems, auctions, or approval of offset rules and linkage to other program will create an unacceptable level of uncertainty that will significantly raise costs and risks. For example, if the registration process, auction and allowance tracking systems are not in place well in advance of January, 2012, WPTF members may not be able to comply with their obligations under the cap and trade program as of that date.

ARB has already had to issue enforcement waivers or administrative enforcement flexibility notices for other regulations related to GHG emission reductions such as the Low Carbon Fuel Standard and emission reporting and should avoid a similar situation for the cap and trade regulation. WPTF therefore proposes a provision in the cap and trade regulation or in the resolution that requires ARB to develop and adhere to a clear schedule for development of the rules, linkages and infrastructure necessary for implementation and compliance by capped entities, and that provides an automatic deferral of the start date for the cap and trade program if the schedule is not met.

J. Enforcement penalties are overly punitive and should be modified.

Sections §95857 of the regulation provides for penalties in the event that an entity fails to surrender sufficient compliance instruments. The regulation would require surrender of

compliance instrument equal to 4 times the deficient quantity of instruments and additionally subject the entity to penalties under the Health and Safety Code. Section §96013 further provides that each deficient compliance instrument will be considered a separate violation and that each day thereafter will also be considered a separate violation.

WPTF has a number of concerns about these penalty provisions. First, the application of the terms of the Health and Safety Code has the potential to quickly result in excessive penalties for a single violation. The same concerns were raised by stakeholders in regard to similar provisions in the regulation for the Renewable Energy Standard, and as a result, the Board directed their modification. WPTF requests that the cap and trade regulation also be modified to address the excessive potential of these penalties.

Second, the regulation should ensure that due process is applied in all enforcement cases under the cap and trade program. Specifically, ARB should provide a mechanism by which respondent entities can review and respond to allegations before penalties are assessed.

K. <u>The regulation should provide for program review and possible modification</u>

The California cap and trade program is an important, complex and new approach to reducing greenhouse gas emissions in the United State. It is extremely important, both for the sustainability of the program and its relevance as a model for other programs at the state and federal level, that California gets the design right. WPTF supports adoption of the regulation with the modifications we propose. But even with these modifications, we believe it is important that the regulation provide for program monitoring and possible modification. Key economic and program indicators should be monitored and a periodic program review mandated so that any inadvertent problems with the program can be corrected before major damage is done to the economy. The provisions for program monitoring and review in the recently adopted Renewable Energy Standard would be an appropriate model for this regulation.

L. The definition of specified power should be modified to avoid distortion of competition in electricity power markets and to reduce emission leakage.

Changes in the economics of power generation based on carbon intensity is an intended and desirable consequence of a cap and trade system – the revenues of low-emission generating resources will increase relative to high-emitting resources. It is this change that will drive long-term investment in low-emission generation.

Unfortunately, the approach proposed by ARB, whereby imports would be attributed a moderate default emission rate unless the imports can claim a facility specific emission rate through a contract with a California retail provider, alters the profitability of the resources based only on their geographic location. The PRO disadvantages in-state resources with an emission rate higher than the default, and out-of-state resources with an emission rate lower than the default.

Most of the detail of the approach for attributing emissions to imported power is laid out in the proposed "Amendments to the Regulation for the Mandatory Reporting of Greenhouse Gas Emissions", rather than the cap and trade PRO. WPTF has provided ARB its specific concerns and recommendations in a separate submission on the proposed reporting regulation, where we have also requested technical modifications to the regulation regarding the attribution of imports. We therefore recommend in this proceeding that ARB incorporate the technical changes to the reporting regulation that WPTF has recommended, and that once completed, the definition of "Specified Source of electricity" in the cap and trade regulation should be modified so that it is consistent with the final technical regulation.

III. Conclusion

WPTF thanks the ARB Board and Staff for this opportunity to submit comments on the PRO, and looks forward to working with you to finalize these important regulations.