COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY TO THE CALIFORNIA AIR RESOURCES BOARD ON ITS PROPOSED REGULATION TO IMPLEMENT THE CALIFORNIA CAP-AND-TRADE PROGRAM

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I.

INTRODUCTION

Southern California Edison Company ("SCE") appreciates this opportunity to comment on the California Air Resources Board's ("CARB's") Proposed Regulation to Implement the California Cap-and-Trade Program ("Proposed Regulation").[1] SCE has been working with CARB throughout the rulemaking process and recognizes the hard work of CARB's staff, stakeholders, and other agencies in developing the Proposed Regulation to implement the Global Warming Solutions Act of 2006 (Assembly Bill 32; Stats. 2006, Chapter 488), more commonly known as Assembly Bill ("AB") 32.[2]

While SCE acknowledges the difficulties inherent in creating such a detailed and complex regulation, SCE has major concerns with the current allowance auction and cap-and-trade market design and cannot support its implementation as scheduled. SCE strongly advocates a delay in the implementation of the cap-and-trade program until there has been adequate review and testing of the auction structure and market design. Should CARB choose to move forward as scheduled when it votes on December 16, SCE cannot support the cap-and-trade market rules. Nonetheless, if CARB proceeds with the cap-and-trade regulation, SCE urges CARB to outline a comprehensive process of market tests and simulations designed to pinpoint potential market failures and design issues. Moreover, regardless of whether CARB delays implementation, CARB should implement the market fixes suggested by SCE and other stakeholders before beginning any allocation or auction of allowances.

AB 32 provides that CARB, among other things, may develop market-based compliance mechanisms such as a cap-and-trade program for reducing greenhouse gas ("GHG") emissions in California. Although SCE believes GHG reduction programs should be undertaken at the national level rather than at regional or state levels, SCE has worked with CARB over the last

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1 Proposed Regulation to Implement the California Cap-and-Trade Program ("Proposed Regulation"), dated October 28, 2010, *available at* http://www.arb.ca.gov/regact/2010/capandtrade10/capandtrade10.htm.

2 Cal. Health and Safety Code § 38500 et seq.

several years to implement AB 32 in the most effective manner possible. SCE especially champions market-based GHG reduction measures, and supports a cap-and-trade program in general as the most cost-effective way to reduce GHG emissions. To this end, SCE has worked on several fronts to encourage, promote, and assist the development of cap-and-trade programs. SCE supported the Waxman-Markey cap-and-trade bill[3] in the U.S. Congress, and worked with the Edison Electric Institute ("EEI") to secure EEI's support for that bill. Within California, SCE enthusiastically participated in CARB's cap-and-trade rulemaking through active SCE representation at relevant CARB workshops, discussions with CARB staff, and submission of constructive comments after the workshops. Additionally, SCE has engaged in active discussions with the California Environmental Protection Agency to bring California utilities to a consensus on the development of an electric sector allowance distribution mechanism within the cap-and-trade program.

SCE recognizes CARB's open process in developing much of this crucial and complex regulation. Specifically, SCE appreciated the opportunity over the course of the rulemaking to communicate its concerns and comments about several of CARB staff's proposals regarding the cap-and-trade rules. SCE is pleased that CARB staff incorporated many of SCE's and other stakeholders' suggestions in the Proposed Regulation. For example, SCE applauds CARB staff for creating three-year compliance periods to provide covered entities with sufficient flexibility to reduce emissions and for supporting the banking of allowances for use in future compliance periods. SCE supports CARB's continued efforts to develop rules to address the critical issue of cost containment through providing allowances to reduce costs to electric utility customers and achieve the goals of AB 32. While SCE opposes any quantitative limit on the use of offsets, SCE recognizes that the current expansion of the offset limit from 4% to 8% of an individual entity's compliance obligation is an improvement to the regulation. Furthermore, SCE supports CARB's direct allocation of allowances to investor-owned utilities ("IOUs") and other covered

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[3] H.R. 2454, American Clean Energy and Security Act of 2009 (passed in the House of Representatives on Jun. 26, 2009).

entities in order to promote a smooth transition to the market, to prevent industry leakage, and to limit the financial burden of AB 32 on electricity customers.[4]

However, in light of California's historical experience with new markets related to the reliable and cost-effective supply of electricity for our citizens, SCE continues to have significant concerns with the Proposed Regulation. In 1994, California led the nation in planning an overhaul to its electricity industry, trying to move to a more competitive wholesale and retail structure in a process known as "restructuring the electricity markets." The State and stakeholders spent several years designing a market structure that everyone involved believed would be effective, and by 1998 had implemented that new market structure.

At that time, electricity wholesale market restructuring in one form or another was spreading in many other states and regions throughout the United States. When California's market failed in 2000, all movement towards restructuring the electricity markets nationally stopped, and in some cases, reversed. During the last decade, largely due to California's failed market, no new restructuring has occurred.

Once again, California is taking a leadership role in designing a new market structure, as it is one of the few remaining examples of a large subnational government taking active measures to use cap-and-trade as a tool to address global warming. Consequently, it is critical that California design and implement a successful GHG market. SCE believes that CARB must take careful measures to ensure as few mistakes as possible in its market program design. Failure in California's program could be a significant setback for cap-and-trade development and climate change regulation, both federally and internationally.

California understands all too well the devastating effects of a prematurely implemented and complex market ripe for manipulation. The State retains deep economic scars from the energy crisis of 2000-2001, and electricity customers continue to pay for this harm in their rates. The primary cause of that economic disaster for the State, and the electricity sector in particular, was excessively high energy prices in California's electricity markets due largely to unforeseen

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[4] *See* Proposed Regulation, Staff Report: Initial Statement of Reasons ("ISOR") at II-24.

manipulation of the market. The proposed GHG cap-and-trade rules outlined in the Proposed Regulation leave GHG allowance prices unregulated, and may allow significant opportunities for market participants to manipulate prices, recreating the potential for excessive prices and allowance shortages with consequent impacts on electricity markets. Should GHG allowance prices rise to unanticipated and excessively high levels, the cost of electricity passed on to customers through rates will also rise to potentially unacceptable levels.

California would be irresponsible if it ignored its previous experience and assumed market prices could not again reach excessively high levels. For example, during the week of June 12-16, 2000, hot weather resulted in higher-than-normal loads in the California electricity markets. Though these loads were well short of record levels, prices in the electricity markets reached the "hard cap" set by the California Independent System Operator of $750/megawatt hour, approximately 15 times the cost of production from the most costly generators in the market. This aberration in prices occurred because many of the sellers in the markets submitted bids to sell power at very high prices – so many, in fact, that the market cleared at this excessive price of $750/megawatt hour to satisfy the demand for power. As structured, CARB's allowance auction permits entities to acquire allowances at exorbitant prices. For example, prices could rise if and when the Allowance Price Containment Reserve ("Allowance Reserve") is exhausted, or if market participants have created incentives for high prices based on their positions outside the GHG market. If the number of allowances available in the auction is insufficient to meet the demand without exhausting these bids, then the market will clear at these extreme levels. Then, not only will all compliance entities be faced with exorbitant costs, but electricity prices will also increase significantly throughout the California markets and, ultimately, throughout the western United States – which would be a detriment to customers.

While such a dramatic rise in prices is not currently expected, neither was the 2000-2001 energy crisis. Ultimately, the crisis was traced back to the aggressive and manipulative behavior of dozens of market participants which led to these unforeseen consequences. The current cap-and-trade rules allow for similar behavior, which could potentially lead to a similar economic crisis**.** Like the restructured electricity market, this new structure is complex and untested.

Similarly, the market contains too many incentives for some parties to manipulate the market to achieve profits. AB 32 was written with cost containment in mind in order to prevent potential adverse economic impacts under a carbon-constrained regime. Not only is this containment of costs and cost manipulation important for the well-being of California's economy, but it is also absolutely crucial to ensure the economic and environmental success of this landmark cap-and-trade program, which will set the stage for carbon regulation on both a national and international scale.

Therefore, after examination of the Proposed Regulation, SCE cannot support going forward with the cap-and-trade program rules as outlined in the Proposed Regulation. SCE urges greater scrutiny and adequate testing demonstrating that the market would not be vulnerable to manipulation.

First, the complexity of the untested market creates numerous opportunities for manipulation and for market participants to potentially "game" the market. In addition, distinct rules for different market participants (for example, different rules for IOUs and publicly-owned utilities ("POUs"), or different rules for the electric sector compared to industry) exacerbate the potential for market manipulation by certain parties.

Second, it is unclear whether the auction and market design has been vetted by independent professionals. An independent evaluation by experts and comprehensive market simulation with the assistance of experimental economists[5] should assist CARB in improving the market design and limiting the potential for manipulation. California does not know the degree to which this market will be threatened; nor can it know how the market will respond. CARB needs time to test the market, and install proper oversight and safeguard controls needed to protect it. The Proposed Regulation and the related appendices, including many of the details of the auction and market rules, were not released to the public until October 29, 2010. CARB's vote on the Proposed Regulation is scheduled for December 16, 2010, which provides inadequate time for a detailed independent evaluation of the market. Further, although CARB has scheduled

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[5] Prominent experiment economists include Nobel Laureate Vernon Smith and his team at Chapman University and Dr. Charles Plott at the California Institute of Technology.

trading in the cap-and-trade market to commence in 2012, one year is insufficient time to properly implement such a complex auction and market. If CARB approves the cap-and-trade regulation on December 16, CARB's adopting resolution should include specific instructions to staff to undertake the necessary testing of the market design.

Third, stakeholders were not adequately involved in the market design process. SCE has been an enthusiastic participant in CARB's stakeholder forums and has actively contributed to many aspects of the AB 32 cap-and-trade rulemaking. However, CARB's development of the auction and market design rules has not utilized the same inclusive forums or provided adequate opportunity for stakeholder input. As a result, these rules are less robust and well-informed than other parts of CARB's implementation plan.

For example, stakeholders may be subject to regulatory rules that affect their participation in the market. IOUs will be major players in the cap-and-trade markets. In California, however, IOUs are regulated by the California Public Utilities Commission ("CPUC"), which can restrict their participation in the GHG market. These restrictions may alter the operation, efficacy, and protections of the market; however, they are not addressed or accounted for in the Proposed Regulation. Full IOU participation in the cap-and-trade market may not be possible if CARB does not set aside sufficient time to coordinate with the CPUC on market design and rules, and to gain an understanding of CPUC requirements.

As discussed above, SCE recommends a delay in implementation of the Proposed Regulation. CARB must ensure that ample time exists to create, test, and implement new systems to track and trade allowances, educate market participants, and evaluate the market framework and design. Moreover, CARB should engage in an extensive stakeholder process allowing compliance entities and market participants to identify issues and to provide potential alternatives for the auction and market design. California cannot let this market fail. Not only would the State's economy be threatened, but California would have set a precedent that would ultimately impede any national GHG program for years to come.

II.

EXECUTIVE SUMMARY

SCE is not an expert in auction and market design. Nor has its examination of CARB's proposed auction and market design been exhaustive. However, in the short time since the release of the Proposed Regulation, SCE has identified a number of potential market and auction design issues within the proposed rules.

The Proposed Regulation adopts a complicated and problematic design for the auction and sale of GHG allowances.[6] As noted above, this auction design may lead to unintended consequences that CARB staff may not have foreseen when crafting the auction rules. For example, SCE supports the Auction Purchase Limits for individual entities, but without additional group limits on auction purchases, compliance entities may be unable to acquire sufficient allowances at auction. Entities without cap-and-trade compliance obligations could then drive up allowance prices with the knowledge that compliance entities are short. In addition, while SCE recognizes the need for disclosure of corporate affiliations to prevent market manipulation,[7] the application of Holding Limits and Auction Purchase Limits to associated entities as if they were one entity[8] is unworkable for regulated electric utilities like SCE that are subject to firewalls and other corporate affiliation regulations. SCE also believes the Holding Limit placed on all parties in the cap-and-trade market is too low for IOUs. While CARB provides an exemption for direct compliance burdens, SCE will likely need to acquire allowances to fulfill its indirect compliance burdens on behalf of independent power producers in accordance with its contractual obligations. SCE suggests that CARB seek out an independent, professional evaluation of its auction design to limit the potential for what could be drastic, unforeseen consequences.

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6 *See* Proposed Regulation, Appendix A Proposed Regulation Order ("Proposed Regulation Order"), Subarticle 10.

7 Proposed Regulation Order § 95914(a), at A-99.

8 Proposed Regulation Order §§ 95914(e)(1) and 95914(f)(1), at A-100 to A-101.

Furthermore, CARB asserts that the allowance allocation system is fair within and across sectors.[9] If so, fairness dictates that IOUs should be subject to the same rules as POUs with respect to the mandatory consignment of allocated allowances, which is not the case under the Proposed Regulation. Because of these unequal rules, any adverse impacts of the auction process will fall far more heavily on IOU customers than POU customers.

Additionally, CARB has dramatically reduced the 2020 allowance budget for the cap-and-trade program, which will increase the economic burden on California's electric customers. CARB has lowered the 2020 allowance budget to 334 million metric tons ("MMT") of carbon dioxide equivalent ("CO_2e") (from 365 MMT CO_2e in its 2008 Scoping Plan), but has not changed its overall 2020 carbon goal from 427 MMT CO_2e (1990 emissions levels, consistent with AB 32). SCE requests clarification as to why CARB's adjustment in its allowance budget appears to shift the burden of carbon reduction more heavily to capped sectors.

As currently drafted, the Proposed Regulation also lacks sufficient, effective, and appropriate cost containment measures. The Allowance Reserve does not provide a true ceiling on allowance prices, and CARB should implement a hard price ceiling. In addition, CARB should not require unsold, unallocated allowances to be transferred to the Allowance Reserve. Further, the bidding process for the allowances in the Allowance Reserve is confusing and inefficient and will lead to higher costs and increased risk for compliance entities. While SCE endorses unlimited banking of allowances, the Proposed Regulation is currently unclear as to the extent a covered entity may bank allowances when combined with Holding Limits and Auction Purchase Limits. SCE seeks clarification from CARB on this point.

These major concerns with the market and auction design make it impossible for SCE to support the Proposed Regulation as currently written. As explained above, SCE supports a delay in implementation of the cap-and-trade program for a full evaluation of the market rules. However, SCE has identified a number of additional issues with the Proposed Regulation, and offers some observations and suggestions for improvement in these comments.

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[9] ISOR at ES-9.

In particular, offsets are a crucial part of compliance entities' cost containment strategies. Accordingly, CARB should modify its offsets program to expand the available supply of offsets, especially in the first compliance period. Below, SCE offers suggestions for ensuring that a ready supply of offsets is accessible to compliance entities early in the cap-and-trade program. In addition, SCE asks that CARB ensure that the 8% quantitative limit on offsets is flexible over compliance periods. SCE also seeks clarification on the extent to which offset projects can be renewed.

SCE also seeks clarification on a few additional sections of the Proposed Regulation. First, CARB should clarify whether industrial covered entities must consign their directly allocated allowances to auction. Second, while SCE applauds CARB's efforts to clarify the Proposed Regulation's penalty provisions, the penalty sections adopted from AB 32 remain confusing and inapplicable in the cap-and-trade context and should be further clarified. Third, SCE requests that CARB clarify whether Low Carbon Fuel Standard ("LCFS") credits can be used in the cap-and-trade program, as LCFS credits can provide another way for covered entities to meet their compliance obligations. Finally, SCE offers suggestions to correct a number of clerical issues within the Proposed Regulation.

III.

THE ALLOWANCE AUCTION DESIGN IS UNNECESSARILY COMPLEX AND MUST BE REVISED

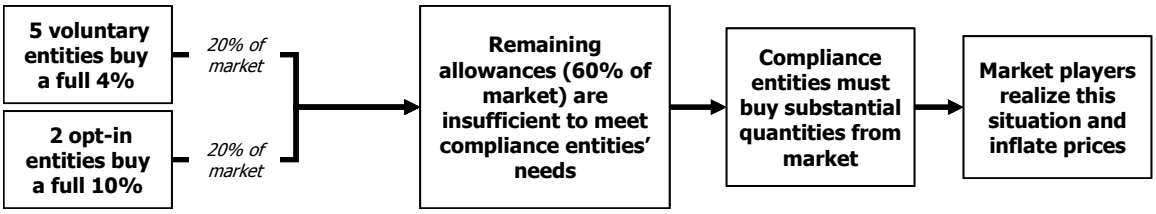
A. CARB Should Impose a Group Limit on Auction Purchases for Opt-In and Voluntary Participants and Seek Broad Participation in Adjusting Limits in the Future

The Proposed Regulation creates an Auction Purchase Limit for individual entities participating in the allowance auctions.[10] During the first compliance period, for covered entities and opt-in covered entities, the limit is set at 10% of the allowances; IOUs are not subject to a

[10] Proposed Regulation Order § 95911(c), at A-88.

purchase limit; for all other auction participants, the limit is set at 4%.[11] SCE strongly supports CARB's creation of these purchase limits to ensure that a few entities (particularly non-compliance entities) do not claim undue market power due to purchases at the allowance auctions.[12] However, the possibility remains that a large group of entities can purchase enough allowances to push covered entities out of the market. Therefore, SCE recommends that CARB create an additional limit on the total number of allowances that non-covered entities, as a class, can purchase from the auction.

Based on SCE's internal analysis, it appears that the Auction Purchase Limit will always be less than the Holding Limit[13] for voluntary and opt-in participants, and thus will likely be the limiting factor on the number of allowances these parties can purchase at auction. As noted above, voluntary and opt-in participants are limited in their individual purchases of the total allowances available at auction. However, the Auction Purchase Limit does not adequately mitigate the risk of inadequate allowances being available for compliance participants. If, for example, 5 voluntary participants and 2 opt-in participants all purchase allowances up to their auction limits, these participants could cumulatively purchase 40% of the available allowances in that auction, assuming the prices they bid were higher than the market clearing price.[14] The remaining 60% of allowances would be substantially short of what compliance entities need to meet their obligations. The following diagram illustrates this scenario.



This would force compliance entities to purchase a large portion of their compliance burden in the secondary markets. Given that the markets will be aware of compliance shortfalls,

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11 Proposed Regulation Order §§ 95911(c)(1)-(3), at A-88 to A-89.

12 *See* ISOR at IX-72.

13 Proposed Regulation Order § 95920(b)(3), at A-105.

14 In this example, the 5 voluntary participants purchase 20% of the allowances available at auction, and the 2 opt-in participants purchase an additional 20% of the allowances available at auction.

prices in these markets are likely to soar, which will cause an undue burden on electric customers. Thus, CARB should limit the total number of allowances that voluntary and opt-in participants can purchase in the auction as a class in order to provide adequate protection against covered entities being pushed out of the market due to market manipulation by non-covered entities.

CARB has noted that it is only setting Auction Purchase Limits for the first compliance period and will set limits for subsequent periods in a later rulemaking in order to gather and learn from actual market experience.[15] SCE strongly supports allowing CARB the opportunity to adjust the rules based on data gathered from early compliance years, as it should retain as much flexibility as possible in writing the current regulation. CARB should ensure that cap-and-trade market participants, particularly compliance entities, are actively involved in the next rulemaking process, as these entities will provide valuable information gained in early market experiences. Compliance entities should have adequate time and notice for comments and a thorough workshop process in order to properly inform CARB staff about their experience in the market during the first compliance period.

B. The Auction Purchase Limits Related to Direct and Indirect Corporate Associations Must Be Modified for Regulated Electric Utilities

Section 95914 of the Proposed Regulation requires entities registered pursuant to Section 95830 to disclose direct and indirect corporate associations with other registered entities.[16] The Proposed Regulation further provides that the total number of compliance instruments that may be purchased in a single auction by a group of entities with a disclosed corporate association is limited pursuant to Section 95911(c), and that entities that are a part of a corporate association may allocate shares of the purchase limit among themselves.

These provisions are entirely infeasible for California's investor-owned electricity distribution utilities. There are long-standing affiliate transaction restrictions imposed on the

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15 ISOR at IX-72.
16 Proposed Regulation Order § 95914, at A-99 to A-102.

utilities by the CPUC[17] and the Federal Energy Regulatory Commission ("FERC")[18] (collectively, "Affiliate Rules"). These restrictions generally limit the types of transactions that a regulated utility may enter into with its unregulated affiliate, as well as the transfer of non-public transmission and other proprietary information to affiliates that may create the opportunity for preferential treatment, unfair competitive advantage, or cross-subsidization.

Specifically, as a utility, SCE is subject to the CPUC's "Affiliate Transaction Rules for Large Energy Utilities" ("CPUC Affiliate Rules") that were most recently revised in Decision ("D.") 06-12-029. SCE is also subject to the CPUC's rules concerning non-tariffed products and services, including the CPUC-approved Gross Revenue Sharing Mechanism adopted in D.99-09-070, as well as some of the Holding Company Conditions set forth in D.88-01-063. The CPUC Affiliate Rules, as well as the CPUC's holding company decision, also require that SCE and its affiliates maintain structural separation, and ratepayer indifference to transactions, between the utility and its affiliates. In implementing these principles, the CPUC has concluded that utilities must maintain complete procurement planning independence from their affiliates. Finally, SCE is subject to the FERC Standards of Conduct and FERC affiliate restrictions.

SCE has implemented the Affiliate Rules and developed comprehensive compliance plans and manuals to ensure compliance with these rules. SCE has developed an affiliate compliance website, employee training programs, affiliate expertise, personnel, and other internal infrastructure to manage its compliance. SCE has also made organizational structural decisions and changes based on the Affiliate Rules.

Collectively, these Affiliate Rules require a very high level of separation of business activities between regulated utilities (such as SCE) and unregulated affiliates (such as Edison Mission Group ("EMG")), that operate in California and nationwide in unregulated wholesale

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17 Various rules and requirements related to Affiliate Transactions are captured, in part, in Rule VI.A of the CPUC's Affiliate Transaction Rules adopted in its decision D.97-12-088, as subsequently amended by D.06-12-029.

18 FERC's Standards of Conduct generally prohibit the transfer of non-public transmission information to SCE's marketing function employees as defined in FERC Order No. 717, 125 FERC ¶ 61,064 (2008), codified at 18 C.F.R. §§ 358.2(c), 358.3(c), and 358.3(d). Further, the FERC's Affiliate Restrictions generally prohibit the transfer of market information from SCE to its market affiliates if such information could be used to the detriment of captive retail customers, as defined in Order 707, 122 FERC ¶ 61,155 (2008).

electricity markets. For example, CPUC Affiliate Rules require that transactions between a utility and its affiliates shall be limited to tariffed products and services, to the provision of information made generally available by the utility to all market participants, and to Commission-approved resource procurement by the utility.[19] Further, the rules require that the sale or purchase of goods, property, products or services be made generally available by the utility or affiliate to all market participants through an open, competitive bidding process.[20]

Due to such regulatory firewalls, SCE will be accruing its own GHG compliance obligation without any knowledge of the corresponding compliance obligations of its unregulated affiliates. SCE may not discuss, let alone act in concert, with EMG regarding its electricity purchases and sales activities in the California wholesale markets. When the cap-and-trade program begins, SCE will not be allowed to share with EMG its forecast of emissions based on the projected emissions from its power plants and emissions related to electricity imports; nor will it be allowed to coordinate its participation in CARB's allowances auction with EMG. SCE and other EMG companies, such as Edison Mission Energy, will be expected to separately register with CARB and will be expected to separately report their emissions, to the extent their respective emissions need to be reported pursuant to CARB's mandatory reporting regulations.

Given these regulatory screens, SCE believes that it should have its own Holding, Limited Use Holding, and Compliance Accounts, which will be distinct and separate from any such similar accounts of its affiliates. SCE also believes that it should transfer compliance instruments to its own compliance account, and that any such transactions will be separate and uncoordinated with similar transactions by its affiliates. SCE and its affiliates will also separately submit verification statements.

In light of rigid and long-standing regulatory firewalls between regulated and unregulated affiliates in the electricity industry, CARB's proposed regulation to apply a single limit to the combined purchase by a group of entities who have an direct or indirect corporate association is

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[19] CPUC Affiliate Rule III.B.
[20] *Id.*

simply not workable for such entities and *must* be modified. CARB needs to create an exception from this regulation that exempts regulated electric utilities from having to comply with a combined Auction Purchase Limit jointly with its unregulated affiliates.

Indeed, it seems CARB itself has acknowledged this issue and has created precisely such an exemption in its proposed regulations for Holding Limits. Section 95920(b)(6) states that "the application of the holding limit will treat holdings of entities with a corporate association pursuant to section 95914 as being held by a single entity unless existing law or regulation prohibits coordinated market activity by the associated entities, including the transfer of instruments between accounts controlled by associated entities."[21] However, Section 95914(e)(1), in laying out the "Application of the Corporate Association Disclosure to the Holding Limit," claims that the "total number of compliance instruments which may be purchased in a single auction by a group of entities with a disclosed corporate association is limited pursuant to section 95911(c)."[22] SCE seeks confirmation that Section 95920(b)(6) allows regulated entities such as SCE to be free from joint Holding Limits with its corporate associate(s). Additionally, SCE requests that CARB provide entities with existing regulated barriers to trade – such as investor-owned electric distribution utilities - an exemption from the joint Auction Purchase Limits as currently expressed in Section 95914(e)(1).[23]

C. The Holding Account Limit Should Be Revised to Provide a Compliance Path for Existing Contractual Commitments

In its Initial Statement of Reasons ("ISOR"), CARB notes that in order to combat the ability of an entity to "corner" a market, it has created a Holding Account limit which establishes the "maximum share of available compliance instruments that an entity or group of affiliated entities may own."[24] Specifically, the current proposed limit is as follows:

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21 Proposed Regulation Order § 95920(b)(6), at A-106 (emphasis supplied).
22 Proposed Regulation Order § 95914(f)(1), at A-100.
23 Proposed Regulation Order § 95914(e)(1), at A-100.
24 ISOR at II-39.

Holding Limit = 0.1 * Base + 0.025 * (Annual Allowance Budget – Base)

where "Base" equals 25 MMT CO_2e.[25] In order to avoid undue restrictions on covered entities' ability to meet their compliance obligation, the Proposed Regulation includes an exemption for covered entities from the Holding Limit for allowances they place in their Compliance Accounts up to the amount of their most recent year's verified emissions, or that covered entity's direct obligation.[26]

SCE agrees that a Holding Limit is necessary to address concerns about market participants hoarding allowances with the intent to manipulate market prices. However, covered entities also need flexibility to meet their legitimate compliance obligations. The Holding Limit for each covered entity should be proportional in size to its compliance obligation. Moreover, the Proposed Regulation's Holding Limit and exemption fail to address the needs of covered entities such as IOUs that, as a result of electricity deregulation, purchase a large portion of their customer's energy requirements through contracts with non-IOU-owned power plants. Many of these contracts require the IOU to directly provide allowances to counterparties for their compliance needs. This creates significant indirect GHG compliance obligations, where the IOU is responsible for the delivery of allowances but not directly responsible for surrendering these allowances to CARB through its own Compliance Account.

SCE supports CARB's intent in creating the Holding Limit exemption, as it allows entities to accumulate compliance instruments to meet their direct obligation without violating the Holding Limit. In the case of IOUs, however, the Holding Limit exemption is based upon verified emissions of only utility-owned generation – its direct obligation – and not the emissions of the counterparties that will be passed allowances from the IOUs original allocation – its indirect obligation. Thus, the Holding Limit exemption alone does not provide a sufficient mechanism to address an IOU's full obligation associated with existing electric utility contracts, and consequently will not adequately provide some covered entities a path to compliance without

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25 Proposed Regulation Order § 95920(b)(3), at A-105.
26 *See* ISOR at II-39; Proposed Regulation Order § 95920(b)(6), at A-106.

exceeding their Holding Limits. Under the current Holding Limit, an electric utility may be unable to procure sufficient allowances from a quarterly auction to meet its total (direct and indirect) obligations under existing agreements.

SCE proposes a revised Holding Limit calculation for Section 95920(b)(3) of the Proposed Regulation to better accommodate the indirect obligation of a compliance entity:

Holding Limit = the higher of

(a) the Proposed Regulation's formula of

0.1 * Base + 0.025 * (Annual Allowance Budget – Base) or

(b) 50 percent of a covered entity's allowance allocation.

SCE believes its suggested Holding Limit formula balances two objectives. First, it maintains the Proposed Regulation's Holding Limit to address potential market manipulation concerns. Second, it allows entities that have obligations under existing contractual agreements (signed prior to the issuance of the Proposed Regulation) the ability to satisfy those obligations without exceeding the Holding Limit.

In addition, CARB should clarify the limited exemption from the Holding Limit in Section 95920(a)(4)(A) to reflect the Proposed Regulation's intent that the exemption apply as long as the allowances are transferred to a compliance account by the end of a calendar year. SCE proposes that the language of Sections 95920(b)(3) and (4) be revised to read:

(3) Calculation. The holding limit will be calculated and applied within each calendar year using the following formula:

Holding Limit = the higher of

(a) the Proposed Regulation's formula of

0.1 * Base + 0.025 * (Annual Allowance Budget – Base) or

(b) 50 percent of a covered entity's allowance allocation.

In which:
"Base" equals 25 million metric tons of CO_2e.

"Annual Allowance Budget" is the number of allowances associated with the current budget year pursuant to Subarticle 6.

(4) Limited Exemption from the Holding Limit.

(A) Allowances up to an amount equal to the emissions reported in a positive or qualified positive verification statement covering the previous calendar year shall not count towards a covered entity's or an opt-in covered entity's holding limit provided the covered entity or opt-in covered entity transfers those allowances to its compliance account during a single calendar year.

IV.

CARB SHOULD REQUIRE FAIR AND EQUAL RULES FOR IMPLEMENTING AB 32 ACROSS AND WITHIN SECTORS

A. Fairness Dictates that CARB Treat IOUs and POUs Equally in the Allowance Auction

CARB staff state that "the allowance allocation system is equitable within and across sectors of the California economy."[27] However, by requiring the IOUs to consign their allowances to auction without requiring the same of POUs,[28] the Proposed Regulation is inconsistent in its treatment of IOUs and POUs. POUs have the choice to consign their allocated allowances to auction or place the allocated allowances directly in their Compliance Accounts. As stated in previous comments, SCE believes POUs and IOUs should be subject to the same rules under this regulation. Both IOUs and POUs are freely allocated allowances, some of which will be used for direct compliance and some of which will be used for compliance with regard to purchased power. Thus, SCE and other IOUs should be afforded the same flexibility in auction participation as POUs, and be permitted to either consign allowances to auction, or transfer allowances to their compliance accounts. Alternatively, SCE suggests that POUs should be subject to the same rules as IOUs with regard to their freely allocated allowances. If 100% of the

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27 ISOR at ES-9.

28 Proposed Regulation Order §§ 95892(b)(1)-(2), at A-83.

direct allocation for IOUs must go to their Limited Use Holding Accounts for consignment in auction, then the same should apply for POUs. This is true for several reasons.

First, CARB's primary reason for requiring IOUs to consign allocated allowances to auction is to ensure that the "amount of value given to distribution utilities is transparent to the public, and that this value is used on behalf of utility ratepayers."[29] This reasoning applies just as strongly to POUs and their customers.

Second, SCE believes that the rate impact of the cap-and-trade program should be felt equally by both IOU customers and POU customers to avoid perception issues and cross-customer class distortion. SCE supports the process of monetizing its direct allowance allocation; a rise in rates will increase energy consumption sensitivity, while periodic rebates can serve to minimize customer hardship. However, POUs should be required to similarly adjust their rates in order to maintain relative parity between IOU and POU rates. Otherwise, customer confusion or dissatisfaction may result. IOU rates will likely be much higher in dollars per kilowatt hour than POU rates, and while the periodic refunds from IOUs should offset the rate increase, it is unlikely that customers will see their separate refunds as directly related to their rate increases. Moreover, IOU customers will be doubly disadvantaged as the IOUs are forced to establish and implement what will likely be a costly mechanism for returning this allowance value to their customers, while POU customers are spared this additional cost.

Third, CARB's unequal treatment of IOUs and POUs will negatively affect the availability of allowances during the crucial early days of the auction. If POUs can withhold allowances from the auction, IOUs will be placed at a competitive disadvantage. Without the consignment of allowances by industry and all utilities, the total available allowances in each auction in the first compliance period could be limited to those consigned by IOUs and a minimal amount placed in the auction by CARB. IOUs will be forced to compete for these allowances with other covered entities, voluntary participants, and opt-in participants. This could crowd IOUs out of the market in the auction while POUs need not enter the auction in the

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[29] ISOR at IX-62.

first place, creating an unfair advantage for POUs. Additionally, as noted in SCE's discussion of group limits above, if the market is aware that IOUs are forced into the secondary market to purchase allowances, prices will likely soar, causing an undue burden on electricity customers. Especially during the first compliance period, requiring POUs to consign their allowances to the auction will increase the likelihood that the markets are broad enough to prevent this burden.

To address this inequality, CARB should provide the same rules for IOUs and POUs. CARB can modify the IOU rules to parallel those for the POUs and allow IOUs to retire some allocations directly into their compliance accounts. Alternatively, CARB can modify the rules for POUs such that they too must auction off and then re-purchase their allowances.

B. CARB's Adjustment of the 2020 Cap-and-Trade Target from Scoping Plan Levels Using Mandatory Reporting Data is Flawed and Inconsistent with AB 32

As CARB has acknowledged, the 2008 Scoping Plan's estimate of the target for the 2020 allowance budget was 365 MMT CO_2e.[30] The Scoping Plan also clearly detailed the components of the target: emissions reductions under the cap, reductions outside of the cap,[31] and the projected 2020 Business-as-Usual ("BAU") Emissions.[32] The Proposed Regulation reduces the 2020 allowance budget from 365 MMT CO_2e to 334 MMT CO_2e, but lacks a clear discussion of the new numbers behind this adjustment. In the absence of this data, SCE requests clarification on CARB's methodology and updated emissions estimates. SCE is particularly concerned that the burden for emissions reduction will fall much more heavily on capped sectors, while the burden for reduction on uncapped sectors has correspondingly contracted.

CARB provides a short explanation of this adjustment in the Proposed Regulation, Appendix E: Setting the Program Emissions Cap.[33] Briefly, CARB staff state that due to improved emissions estimates, they have revised the 2008 broad scope emissions number from 440 MMT CO_2e to 403 MMT CO_2e, a decrease of 8.5%. Accordingly, CARB staff decreased

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30 Proposed Regulation, Appendix E Setting the Program Emissions Cap, at E-8.
31 California Air Resources Board, *Climate Change Scoping Plan*, issued Dec. 2008 at 17.
32 *Id.* at 32 (Table 5).
33 Proposed Regulation, Appendix E Setting the Program Emissions Cap, at E-8.

the cap by 8.5%, from 365 MMT CO_2e to 334 MMT CO_2e. This revision in the 2020 cap number lacks satisfactory reasoning, and supporting data and details are not present in the Proposed Regulation.

SCE requests that CARB clarify its adjustment in emissions reductions by providing stakeholders with detailed information, including:

1. A full breakdown of the initial, unadjusted estimates used in the Scoping Plan to define the emissions reductions required to meet AB 32 targets by 2020. These data points include but are not limited to:
    a. 2012 emissions levels;
    b. Total 2020 BAU emissions levels and 2020 emissions levels under AB 32;
    c. A breakdown of the 2020 BAU emissions levels and 2020 emissions levels under AB 32 between the capped and uncapped sectors; and
    d. Emissions reductions (from 2012 to 2020) required by each measure under AB 32.
2. The adjusted numbers corresponding with each initial data point listed above.
3. CARB's methodology and reasoning relating to this adjustment.

SCE also requests that CARB allow for stakeholder input concerning the implementation of any changes to the 2008 Scoping Plan's reductions requirements.

V.

THE PROPOSED REGULATION LACKS SUFFICIENT COST CONTAINMENT MEASURES

In the text of AB 32, the California legislature expressed its concerns regarding the costs of the newly-established emissions reduction program. The statute includes provisions asking CARB to ensure that in pursuing its GHG reduction targets, it would minimize costs and maximize benefits to the State's economy.[34] AB 32 also requires CARB to consider the cost-

[34] Cal. Health and Safety Code § 68501(h).

effectiveness of its regulations[35] and provides for a one-year delay in implementation of the program if faced with the threat of significant economic harm.[36] Although SCE applauds CARB's sincere efforts at ensuring cost containment, including the expansion of the quantitative limit on offsets from 4% to 8% of the overall compliance burden, the adopted offset protocols still may not provide sufficient offset compliance instruments to reach those limits. The Proposed Regulation should include additional cost containment measures in order to ensure that the costs of emissions reductions are not overly burdensome for the State and stakeholders. SCE offers three suggestions for CARB: (1) including a price ceiling on allowances in the auction, (2) allowing covered entities to keep their unsold allowances and roll them over to the next auction, and (3) improving and simplifying the current structure for bidding on the Allowance Reserve.

A. The Proposed Price Floor is Problematic Without a Corresponding Price Ceiling

In earlier comments,[37] SCE expressed its support for a reasonable price collar, and opposed a price floor without a corresponding price ceiling. The Proposed Regulation provides only a price floor known as the Auction Reserve Price,[38] reasoning that the Allowance Reserve would provide a measure of cost containment and act as a price ceiling.[39] This reasoning is faulty since allowances can be purchased over the Allowance Reserve prices. Though a rational market participant would not purchase allowances above the reserve price if allowances are available in the reserve, it is not clear that supply in the Allowance Reserve will be sufficient to meet market demand. Therefore, allowances may be sold and purchased at higher prices in quarterly auctions and secondary markets if and when the Allowance Reserve is depleted. A hard cap on GHG allowance prices would be a more effective cost containment measure. Absent

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35 Cal. Health and Safety Code § 68562(b)(5).
36 *Id.*
37 Comments of Southern California Edison Company to the California Air Resources Board on Its Greenhouse Gas Cap-and-Trade Regulation Status Update (June 7, 2010), at 9.
38 Proposed Regulation Order § 95911(b)(6)(A), at A-88.
39 ISOR at IX-71.

such a cap and under the proposed structure, CARB cannot ensure that the legislature's concerns regarding cost containment will be addressed.

California learned the importance of a hard price ceiling from the energy markets during the California energy crisis. When buyers could benefit from higher prices, many engaged in aggressive bidding strategies, which resulted in extreme prices without actual supply shortages in the energy markets. These unreasonably high bids effectively withheld reasonably-priced supply from the markets. In that market, however, the incentive to push up prices was somewhat limited by the existence of hard price caps. Absent such price caps, California's energy crisis would have been far more severe, and economic disaster would have come much sooner. When FERC ultimately replaced these hard price caps with soft caps (similar to the even weaker price controls in CARB's cap-and-trade market design), it resulted in greater withholding of power, leading to shortages in the form of rolling blackouts. These shortages occurred even though the supply of power was more than adequate; it was simply withheld from the market.

While allowance markets are not as vulnerable as electricity markets (since allowances can be stored more easily than electricity), the possibility for rampant abuses still remains due to the financial connection between GHG markets and electricity markets. If prices do reach intolerably high levels, then at least one of two preventable catastrophic outcomes will occur. First, the California economy could suffer undue economic harm, which is an unacceptable outcome. Second, excessive prices could undermine the very purpose of AB 32. A California-only program cannot adequately mitigate the climate change impacts of increased global GHG concentrations. What it can do is set an example of how to effectively and efficiently mitigate GHG at reasonable economic and social costs. If prices are allowed to reach excessively high levels, California's GHG regulation will be viewed as a failure and a deterrent to future GHG regulation. It has been over a decade since California's failed electricity market structure halted restructuring markets nationally, if not internationally. As discussed above, no U.S. state has restructured since that time. CARB's cap-and-trade design cannot allow such failure to occur. If a hard cap is not put in place, such failure may still be possible.

If no specific hard price cap is implemented, CARB must incorporate provisions in this cap-and-trade regulation allowing CARB to halt any quarterly auction to avoid excessively-priced GHG allowances that could cause irreversible harm to both the economy and the success of the GHG reduction program.

B. Unsold Allowances Should Remain in the Auction Process and Should Not Be Transferred to the Allowance Reserve

The Proposed Regulation requires non-allocated allowances that are unsold in the auction to be transferred to the Allowance Reserve.[40] This decision lacks a sufficient basis in economic efficiency or environmental impact. Given AB 32's mandate to reduce GHG emissions at the lowest possible cost,[41] CARB should treat allowances designated for auction by CARB that are unsold from prior years in the same manner as non-allocated allowances from the current period by placing them in the quarterly auction, rather than the Allowance Reserve.

In justifying this treatment of unsold allowances, CARB staff claim that adding unsold allowances to the next quarterly auction will simply sustain excess supply in the auctions.[42] That is not the case for several reasons. First, the cap consistently declines over the nine years of the program. Since the cap declines annually, supply scarcity can be expected to increase over time, and CARB does not need to create artificial scarcity by removing allowances from future auctions.

Second, covered entities and voluntary participants will not be entering the market in set patterns. Auction participation patterns are inherently lumpy. While some participants may engage evenly, many will buy or sell in one auction, but not the next. As a result, it is unreasonable to assume that excess supply in one auction will remain in any future auction.

Finally, placing unsold allowances in the Allowance Reserve will needlessly increase long-term compliance costs. This could create an incentive for compliance entities to purchase

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40 Proposed Regulation Order § 95911(b)(4), at A-87 to A-88.
41 Cal. Health and Safety Code § 38560.5(a).
42 ISOR at II-24 to II-25.

many more allowances in early auctions than they need for compliance. If covered entities fear that unsold allowances will quadruple in price as a result of being placed in the Allowance Reserve, they will likely bid for much larger purchases in early auctions than necessary and plan to bank those allowances for later use. This behavior will create an artificial demand for allowances in early auctions with the potential to artificially inflate prices in the early allowance market overall.

In order to avoid such an artificial price increase, CARB should roll over all unsold allowances to the next auction in the same manner as the allowances consigned to auction.[43] Simply because an entity may be in a long position in one quarter is no reason to assume it will maintain that long position in subsequent quarters. Moreover, there is no reason to arbitrarily increase the price for those allowances from the auction settlement price to the reserve price.

The Allowance Reserve is intended to operate as a cost containment mechanism. The current design uses the Allowance Reserve to reduce supply in the allowance market and drive up prices. In order to provide real long-term cost containment, CARB should not reduce the supply of allowances in the auction. Sustained low allowance prices in the cap-and-trade should be welcomed as a signal that regulated entities are able to secure compliance at the lowest possible cost. CARB should not see this as an opportunity to arbitrarily increase allowance prices.

C. CARB Should Develop a Mechanism for Populating the Allowance Reserve that Does Not Remove Allowances from Distribution

AB 32 mandates that CARB's regulations be implemented at the lowest possible cost.[44] SCE supports cost containment as an integral component of the program design. However, as designed, the Allowance Reserve does not provide true long-term cost containment. At the beginning of the program, the Allowance Reserve will be fully populated with allowances drawn

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[43] *See* Proposed Regulation Order § 95911(b)(5)(B), at A-88.
[44] Health & Safety Code § 38562(b)(1).

from future compliance periods.[45] Thus, in the early years of the cap-and-trade program, covered entities should be able to meet allowance shortfalls with purchases from the first tier of the Allowance Reserve.[46] However, because the allowances filling the Allowance Reserve are pulled from under the cap, compliance entities will eventually have to use them. Thus, over time, the availability of sufficient reserves in any of the tiers to meet market demand becomes less and less certain. In the long term, the Allowance Reserve will only increase the prices of allowances. At best, the Allowance Reserve can only delay cost increases. CARB should develop a mechanism to populate the Allowance Reserve without reducing the number of allowances available for distribution or auction.

For example, SCE believes CARB should populate the Allowance Reserve by using the proceeds from reserve procurement to purchase emissions offsets. In the alternative, CARB could develop detailed rules stipulating that the Allowance Reserve be replenished with additional compliance instruments once a predetermined number of reserve instruments have been purchased. This would create stronger assurances to regulated entities that the Allowance Reserve will always be available as a source of compliance instruments and can operate as a true long-term cost containment mechanism.

D. The Current Structure for Bidding on the Allowance Reserve Will Lead to Increased Risks and Costs for Compliance Entities

As currently designed, the Allowance Reserve is inaccessible, punitive, and potentially ineffective. The Proposed Regulation creates three tiers for the Allowance Reserve, with three initial price levels of $40, $45, and $50.[47] Assuming a modest 2% inflation rate, these prices could reach around $69, $77, and $86 in 2020. Given the potential impact on the State economy and on electricity customers, these prices are set too high.

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45 Proposed Regulation Order § 95870(a), at A-74.

46 SCE's calculations show that initially 25% of the 2012 statewide compliance burden will be available in each tier of the Allowance Reserve.

47 Proposed Regulation Order § 95913(d)(2), at A-96.

To protect the integrity of the California cap-and-trade program and to serve as an example for regional or federal emissions trading programs, CARB must avoid burdening California consumers with excessive costs as a result of the cap-and-trade program. Pulling allowances for the Allowance Reserve from under the cap (and thereby reducing the supply of available allowances) does not provide true long-term cost containment and will do little to alleviate the cost burden on covered entities and their customers.

In addition, the bidding process for the Allowance Reserve is confusing, inefficient, and will lead to higher costs and increased risk for compliance entities. A bidder in need of additional allowances from the Allowance Reserve must submit bids for a quantity of allowances from each tier, but the total must not exceed their unmet compliance need for that year.[48] Moreover, because the bidder will not know whether that tier will be fully subscribed through bids from other covered entities, there is uncertainty about whether it will receive the bids it submitted. As a result, the bidder may choose to bid in a lower tier than the price he is willing to pay, risking that that tier will not be oversubscribed. This situation where bidders attempt to beat the system could be avoided by simplifying the Allowance Reserve. Bidders should be able to bid in their willingness to pay, and all bids should be met starting at the lowest reserve price, increasing to the next tier if bid quantities exceed the allowance quantity in the lowest tier.

An improved auction design could mitigate, if not eliminate, these uncertainties. For example, CARB could simplify the bidding process by allowing the unmet need from one tier to carry forward as a bid into the next lowest tier. Bidders should bid at their willingness to pay ($40, $45, or $50[49]) and the market should clear at the lowest bid available. For instance, if bids are made for less than one-third of the Allowance Reserve, then all allowances from the Reserve should be sold at $40. If the number of bids exceed one-third of total allowances, then all bids made at $40 should be fulfilled at $40, and those remaining bidders (at $45 or $50) should get the remaining $40 allowances pro-rated, and fill the remainder of their bids at $45. This bidding

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48 Proposed Regulation Order § 95913, at A-94.

49 SCE's example uses the Allowance Reserve prices set for the first compliance period.

mechanism is consistent with the process used in the general auction, where bidders pay the settlement price even if their maximum bid was initially greater than the settlement price.

Although SCE advocates for bids to roll down into the lowest available tier, should a tier be over-subscribed, the bids should not roll up into the next tier. Market participants bid only their willingness to pay, and should not be forced to pay more than this due to a shortage. A market participant may bid into the $40 tier of the reserve, but have a reduction measure available to them at the cost of $43/ton, and therefore be unwilling to pay $45 per allowance. Therefore, when a tier is oversubscribed, a bidder should receive a pro rata reduction in allowances from its bid,[50] and the shortfall should not carry over to a higher-priced tier as the Proposed Regulation currently requires. Doing so could mitigate price uncertainty while eliminating uncertainties as to quantity (except in the case where the Allowance Reserve is completely exhausted).

E. CARB Should Clarify the Extent to Which Compliance Entities Can Bank Compliance Instruments for Future Use

SCE requests clarification on the extent to which compliance entities can bank compliance instruments for future use. CARB describes its desire to allow unlimited banking numerous times in the ISOR,[51] and SCE strongly supports this position. However, the Holding Limit restricts the amount of allowances compliance entities may have in each Holding Account (initially, around 6 million allowances and 11 million beginning in 2015). If CARB proposes to allow for unlimited banking of allowances, SCE requests that CARB clarify that compliance entities may effectively "bank" allowances in their Compliance Accounts. Under this interpretation, any excess compliance instruments in a Compliance Account on any compliance

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[50] Proposed Regulation Order §§ 95913(f)(4)(A)-(B), at A-97 to A-98.

[51] ISOR at II-4, II-5 ("In a cap-and-trade program, banking allows participants to hold spare allowances and use them for compliance in a later period. The ability to bank allowances provides an incentive for covered entities to make early reductions since the declining cap could push allowance prices higher over time. Staff proposes to allow banking of allowances without restriction."); ISOR at IV-11 ("The proposed cap-and-trade regulation allows for unlimited banking of allowances"); ISOR at VIII-3 ("Banking of allowances for future use is allowed without limitation"); ISOR at IX-112 ("ARB will allow account holdings to hold allowances until they need them for compliance for voluntary retirement purposes").

dates (either annually or triennially) would then remain in the account for use in future periods, effectively "rolling over" to these future periods. SCE requests that CARB confirm this analysis of the Proposed Regulation. Otherwise, as proposed, the "unlimited" banking of allowances would be extremely limited and do little to control costs.

VI.

A ROBUST OFFSETS PROGRAM CAN PROVIDE MORE OPPORTUNITIES FOR COST CONTAINMENT

A. CARB Should Expand the Number of Available Offsets in Order to Provide Real Cost Containment and Allow Flexibility in the Offsets Limits

SCE strongly supports the use of offsets as compliance instruments for cost containment. SCE applauds CARB staff for recognizing that "a robust supply of offset credits can help to contain the costs of a cap-and-trade program" because offset credits can provide covered entities a source of low-cost emissions reductions.[52] As SCE has noted in earlier comments, however, arbitrary quantitative limits or geographic limits on offsets will result in unnecessarily high compliance costs.[53] The Proposed Regulation would only allow a maximum of 232 MMT CO_2e of offsets through the year 2020.[54] This limit will be enforced through a limit on the use of offsets for each covered entity equal to 8% of its annual compliance obligation.

The ISOR correctly notes that by removing 121 million allowances from underneath the cap and placing them in the Allowance Reserve, the level of stringency within the program is increased and could lead to higher allowance prices.[55] CARB staff reasons in the ISOR, however, that this increased stringency can be addressed by allowing additional offsets in the

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52 ISOR at III-2.

53 *See, e.g.,* Comments of Southern California Edison Company to the California Air Resources Board on Cost Containment Options and Offsets and Linkage in a California Cap-and-Trade Program (July 13, 2010), at 6; Comments of Southern California Edison Company to California Air Resources Board on Criteria for Compliance Offsets in a Cap-and-Trade Program (May 21, 2009), at 2-6.

54 ISOR at II-5.

55 ISOR at II-23 to II-24.

cap-and-trade program, up to the 232 MMT CO_2e maximum.[56] This reasoning is flawed. Although the increase in the quantitative limit on offsets from 4% to 8%[57] is a positive step, it does not fully counteract the pulling of allowances from under the cap to populate the Allowance Reserve. There is no guarantee that the four offset protocols currently proposed by CARB will provide a sufficient supply of offsets to reach the 8% limit, particularly in the crucial first compliance period. SCE believes it is unlikely that there will be enough offsets to meet that limit.

If CARB imposes a quantitative offsets limit, SCE recommends that the limit be flexible between compliance periods to address the likelihood of a limited supply of offsets in the early years of the program. Currently, the 8% quantitative limit is imposed on the use of offsets for each regulated entity for each compliance obligation, be it annual or triennial.[58] In order to address concerns regarding the limited supply of offsets, especially in the early stage of the regulation, CARB should allow compliance entities to make up any shortfall of offsets in later compliance submissions.

For example, in the first year of the program, if a covered entity can only purchase enough offsets in the market to fulfill 5% of its annual compliance obligation, the covered entity should be allowed to carry over the number of offsets equal to the unused additional 3% to later compliance periods.[59] Alternatively, CARB could allow the 8% limit to apply to a compliance entity's entire obligation over the nine-year duration of the cap-and-trade program. Otherwise, the 232 MMT CO_2e limit might never be reached and the opportunity for lower-cost emissions reductions – and the subsequent control on program costs – is lost.

SCE recognizes that CARB is attempting to ensure that offset credits represent emissions reductions that are real, permanent, quantifiable, verifiable, enforceable, and additional, as

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56 *Id.*

57 Proposed Regulation Order § 95854, at A-68 to A-69.

58 *Id.*

59 To maintain the integrity of the offsets limit, this additional 3% should be calculated from the initial compliance burden in which the compliance entity submitted only 5% offsets, not from the compliance obligation for which an entity intends to retire these excess offsets.

required by AB 32.[60] Nonetheless, SCE is concerned that CARB staff have created overly complex processes for the development and approval of offsets that may unduly limit the available supply. For example, the four initial offset protocols that were recommended simultaneously with the Proposed Regulation must first go through a complicated, and likely lengthy, approval process by CARB and then a complex implementation design process involving CARB staff.[61] For these four initial protocols, all of these steps must take place between January 2011 and December 2011 in order for covered entities to include tradable offsets in their compliance strategies by January 2012, when the cap-and-trade program begins. Currently, this scenario seems extremely unlikely.

All other offset projects must go through the same approval process and sequence, and even the four offset protocols already in motion are unlikely to provide a robust supply of offsets until late in the first compliance period. Accordingly, those covered entities planning to use offsets as part of their compliance strategies are left with great uncertainty as to whether such offsets will be available.

SCE offers the following recommendations for CARB to quickly increase the supply and use of available high-quality, low-cost offsets.

- CARB should remove the geographic limits on the first four offset protocols.[62] Expansion to projects throughout North America would provide more incentives for offset development. SCE continues to support CARB's determination during the

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60 Cal. Health and Safety Code §§ 38562(d)(1)-(2).

61 Proposed Regulation Order § 95972, at A-111 to A-112. The project developers or providers must then submit their plans to CARB for review and project listing. Proposed Regulation Order § 95975, at A-114 to A-118. Once the emissions reductions have been achieved, then the project developers or offset providers must submit the documentation, CARB must review it, and then provide a verification. Proposed Regulation Order § 95977, at A-124 to A-144. Approved credits are then listed in a CARB-operated registry before a compliance entity can purchase the credits. Proposed Regulation Order § 95975, at A-114 to A-118.

62 *See* ISOR III-10 ("While staff proposes to allow offset projects from North America to be credited under ARB-approved protocols, staff is only taking protocols to the Board for approval as part of this rulemaking package that are applicable for projects in the United States and its territories. Staff plans to evaluate how the four protocols being taken to the Board can be expanded to include projects in Mexico and Canada. . . . [staff] recognizes out-of-state projects will expand the scope of the program to allow for more low-cost GHG reduction possibilities to be incorporated and reduce the overall costs of the program.").

Scoping Plan process that it would not place geographic limits on the origin of offset credits.

- CARB should provide for expeditious approval of offset credits from existing and future offset projects operating under specific offset protocols beyond the four currently being proposed. For example, the Climate Action Reserve ("CAR") has already developed and is continuing to develop about 60 MMT worth of additional voluntary offset credits through its existing offsets protocols and registration program.[63] CARB should consider these CAR offsets as part of a pre-compliance offsets pool which can be quickly approved to meet the CARB offsets project design criteria (available in December 2010).
- CARB should provide for early approval for linkage to other cap-and-trade programs, with a focus on Western Climate Initiative ("WCI") jurisdictions. CARB is already familiar with the offset program parameters and should be able to easily harmonize them with the California cap-and-trade program once the WCI finalizes its regulatory approach. Linkage with the WCI program should be easily and quickly brought to the Board and approved.[64]
- CARB should create a specific framework for approving offset credits from individual projects that meet CARB's criteria.[65] CARB should establish a framework for evaluating and accepting additional, individual projects outside of the sector-based projects. New technological approaches are being developed and new companies are being established to create offsets, which should have a direct pathway to approval.
- CARB should expeditiously approve external offset registries to issue offsets that use CARB-approved protocols and follow regulatory requirements. An existing third-

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63 Climate Action Reserve, "Projections of CRT Issuance," November 5, 2010, *available at* http://www.climateactionreserve.org/.

64 As CARB has noted, New Mexico, British Columbia, Ontario, and Quebec are positioned to join WCI's regional cap-and-trade program in 2011. *See* http://www.arb.ca.gov/newsrel/2010/capandtrade.pdf.

65 ISOR at ES-5.

party organization with experience in offsets supply management (including establishment of protocols, development of projects, reductions verifications, and credits documentation) would provide immediate resources to help implement key elements of CARB's overall offsets program, while operating under the agency's authority. The CAR is one example; other entities may also be qualified to serve in this role. These external offset registries should be put in place in early 2011.

- In order to ensure an adequate supply of offsets at the beginning of the first compliance period, CARB should create a preparatory program that includes establishment of CARB-approved registries, certification of sufficient verifiers to check offset credits, and a schedule with a list of major procedural tasks with completion dates scheduled prior to January of 2012.[66]

B. CARB Staff Should Clarify Whether Offset Project Renewals are Limited

Section 95980(c) of the Proposed Regulation provides for the timing and duration of renewed crediting periods for offset projects.[67] SCE asks that CARB staff clarify whether there is a limit on the number of times an offset project can be renewed.

VII.
CLARIFICATION QUESTIONS

SCE seeks clarification on a few other issues with respect to the Proposed Regulation.

A. CARB Should Clarify the Role of Industrial Covered Entities in Consigning to Auction

The Proposed Regulation requires clarification as to how allowances that are directly allocated will be treated once distributed. Section 95831(a)(3) of the Proposed Regulation

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66 Currently, CARB's proposal, as outlined in Appendix Q to the Proposed Regulation, only delineates activities for compliance entities without a list of CARB's preparatory steps. Proposed Regulation, Appendix Q Compliance Cycle and Program Activities, at Q5 to Q9.

67 Proposed Regulation Order § 95980(c), at A-154.

creates a Limited Use Holding Account for entities that qualify for a direct allocation of allowances to consign their allowances to auction, but does not state how this Limited Use Holding Account will be populated.[68] In Section 95870, it appears that the direct allocations for both public utilities and industrial covered entities will be transferred to the individual Holding Accounts of those parties.[69] Yet a few sections later, the Proposed Regulation states that direct allowances to IOUs are placed directly into their Limited Use Holding Accounts, while POUs have a choice of placing their allowances in either their Compliance Account or their Limited Use Holding Account.[70]

Section 95891 of the Proposed Regulation governs direct allocation of allowances to industry for "Industry Assistance."[71] This section lacks any discussion of which account – the Limited Use Holding Account or the Holding Account – the allocated allowances will be placed. As noted above, Section 95870 states as a general matter that allowances directly allocated will be transferred to individual Holding Accounts, which implies that industrial covered entities are not required to consign its allowances to auction, nor use them directly for compliance. This raises the question of whether industrial covered entities will have Limited Use Holding Accounts, and if so, what purpose those accounts will serve. Because of this inconsistency, SCE requests that CARB clarify the role that industrial covered entities will play in the auction and whether they will be required to consign any of their allocated allowances to auction.

B. The Proposed Regulation's Penalty Provisions Are Excessive, Vague, and Require Further Clarification

Currently, the Proposed Regulation's penalty provisions are excessive, unbounded, and vague. SCE recommends that CARB clarify its penalty provisions. Section 95857(b) of the Proposed Regulation requires that a covered entity that has surrendered insufficient compliance instruments in a timely manner (known in the Proposed Regulation as "excess emissions") is

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68 Proposed Regulation Order § 95831(a)(3), at A-49.
69 Proposed Regulation Order § 95870, at A-74 to A-75.
70 Proposed Regulation Order § 95892, at A-83.
71 Proposed Regulation Order § 95891, at A-78.

penalized with a new compliance obligation of four times the excess emissions.[72] A penalty of four times the excess emissions is disproportionately punitive. If a compliance entity could not acquire sufficient allowances to surrender for compliance, it is unlikely that it could acquire four times that amount. Moreover, while the regulation allows for borrowing to meet this penalty provision, a penalty of four times the excess emissions implies a 300% interest rate to borrow.

Subsection 15 of the Proposed Regulation establishes additional consequences for violations of the cap-and-trade regulation, including injunctions and other penalties.[73] Under this section, CARB may assess a separate violation for each required compliance instrument that has not been surrendered, as well as a separate violation per day.[74] CARB staff has noted that these violations are unique to the cap-and-trade program.[75] While these provisions represent an improvement in that they establish violations specific to compliance instruments, the penalty provisions simply provide that "penalties may be assessed pursuant to Health and Safety Code section 38580 for any violation of this article."[76] Section 38580 of the Health and Safety Code codify the enforcement provisions of AB 32. These provisions refer to several other sections of the Health and Safety Code that create criminal, civil, and administrative penalties for emissions violations, including emissions of air contaminants.[77] The provisions include criminal and civil penalties that range from fines of $1,000 to $1,000,000, and up to a year in county jail or state prison per violation. This is a menu of enforcement penalties designed to punish stationary sources for their emissions, and are overly punitive and not readily applicable to the cap-and-trade regulation framework. SCE recommends that CARB revise and clarify the penalty provisions to make them more applicable to the cap-and-trade context.

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72 Proposed Regulation Order § 95857(b), at A-72.
73 Proposed Regulation Order §§ 96010-96014, at A-179 to A-181.
74 Proposed Regulation Order § 96014(a)-(b), at A-180 to A-181.
75 ISOR at II-49.
76 Proposed Regulation Order § 96013, at A-180.
77 Cal. Health and Safety Code § 42400 et seq.

C. CARB Should Clarify Its Definition of an Allowance as Equal to "Up to One Metric Ton of CO_2 Equivalent"

SCE requests clarification on the definition of a "California greenhouse gas emissions allowance" found in Section 95802 of the Proposed Regulation.[78] This definition states that allowances issued by CARB will be "equal to up to one metric ton of CO_2 equivalent." All allowances should be worth the same amount: exactly one metric ton of CO_2 equivalent. SCE requests that CARB confirm this interpretation, as there can be no functioning market for allowances without precise standards and measurements.

D. CARB Should Clarify Which Allowances Can Be Used for Compliance in a Given Year

Section 95856(b)(2) states that with limited exceptions, a compliance entity may only use a compliance instrument "issued from an allowance budget year within or before the year during which the compliance obligation is calculated."[79] SCE requests that CARB clarify whether this "compliance obligation" is calculated in the year on which the payment comes due (e.g., 2015 for the first compliance period) or in the year in which the emissions were released (e.g., through 2014 for the first compliance period). This clarification will assist compliance entities in planning a reasonable and achievable schedule for attaining precisely enough compliance instruments to meet its needs for each compliance period.

E. LCFS Credits Should Be Used For Compliance in the Cap-and-Trade Program Given the Likely Cross-Sector Shift in GHG Compliance Obligations

As part of the discrete early action measures under AB 32, CARB initiated the LCFS rulemaking, intended to create rules to reduce the carbon intensity of transportation fuels used in

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[78] Proposed Regulation Order § 95802 (27), at A-10.
[79] Proposed Regulation Order § 95856(b)(2), at A-70.

California by an average of 10 percent by the year 2020.[80] In the LCFS Final Regulation Order, which became effective April 15, 2010, CARB stated that LCFS credits may be used for compliance with other greenhouse gas reduction programs, including CARB's AB 32 cap-and-trade program.[81] CARB staff raised the possibility of linkage to the LCFS program throughout the cap-and-trade rulemaking process and discussed the possibility with stakeholders in workshops.[82] However, the Proposed Regulation Order makes no mention of LCFS credits for compliance purposes or linkage to the LCFS program.[83] LCFS credits will only be valuable in the cap-and-trade program during the first compliance period, before the transportation sector is added to the program. SCE supports the use of LCFS credits in the cap-and-trade program, and strongly recommends that CARB allow LCFS credits to be used for compliance purposes in the Proposed Regulation's cap-and-trade program.

In April of 2009, CARB issued Resolution 09-31 on the Low Carbon Fuel Standard, which directed CARB staff to "evaluate as part of the cap-and-trade rulemaking whether displacing petroleum transportation fuels with electricity leads to a cross-sector shift in GHG compliance obligations." SCE urges CARB to conduct a long-term study on the cross-sector shift in order to make educated policy decisions early on, especially as plug-in electric vehicles steadily increase their market share.[84]

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[80] California's Low Carbon Fuel Standard, Final Statement of Reasons, December 2009, at 5 (*available at* http://www.arb.ca.gov/regact/2009/lcfs09/lcfsfsor.pdf).

[81] CAL. CODE REGS. tit. 17, § 95485 (c)(1)(C) (2010) ("A regulated party may…export credits for compliance with other greenhouse gas reduction initiatives including, but not limited to, programs established pursuant to AB 32 (Nunez, Stats. 2006, ch. 488), subject to the authorities and requirements of those programs") (*available at* http://www.arb.ca.gov/regact/2009/lcfs09/lcfscombofinal.pdf).

[82] Proposed Regulation, Appendix D Cap-and-Trade Program Design Development Process, at D-321, D-336, D-339, D-341.

[83] The LCFS program is mentioned in the ISOR and other appendices to the Proposed Regulation. In the context of LCFS credits being used for compliance purposes, it is discussed only as a possibility.

[84] Resolution 10-49, issued by CARB on November 18, 2010, correctly concluded that the cross-sector shift was not a major issue with market share at only 1%. However, plug-in electric vehicles are projected to make up 5%-10% of market share in the next ten years, according to the PEV Collaborative. Thus, this is a complex and long-term issue that will increase in importance and is deserving of further stakeholder engagement and study.

VIII.

RECOMMENDED CLERICAL CLARIFICATIONS

SCE proposes a number of clerical corrections to the Proposed Regulation for purposes of clarity.

- Section 95870(d)(3) provides that if the amount allocated to industry exceeds the amount of allowances available, then the number of allowances available will be prorated equally across "all eligible covered entities."[85] SCE seeks clarification as to whether the pro rata cuts to allocation apply to just the industrial sector, or to all parties receiving a direct allowance allocation.
- Section 95911(c) discusses Auction Purchase Limits. For purposes of clarity, SCE believes that within Section 95911(c)(2), "(A)" and "(B)" should read "(1)" and "(2)."
- Section 95983(b)(2) provides that if CARB determines there has been an unintentional reversal of offsets, it will retire a quantity of offset credits pursuant to Section 95985(e).[86] SCE believes this reference should read "Section 95985(f)."

IX.

CONCLUSION

SCE appreciates the hard work from CARB staff in crafting the Proposed Regulation, particularly their willingness to discuss stakeholder concerns. SCE requests that CARB delay implementation of the Proposed Regulation and the cap-and-trade program for a comprehensive review of the auction and market design and to allow participants and compliance entities to identify issues and provide solutions. SCE looks forward to working closely with CARB staff to revise and improve the Proposed Regulation to ensure a workable cap-and-trade market and allowance auction to accomplish the emissions reductions goals of AB 32.

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[85] Proposed Regulation Order § 95870(d)(3), at A-75.
[86] Proposed Regulation Order § 95983(b)(2), at A-158.

Respectfully submitted,

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