

**COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY TO THE  
CALIFORNIA AIR RESOURCES BOARD ON 15-DAY CHANGES TO THE  
CALIFORNIA CAP-AND-TRADE PROGRAM TO ALLOW FOR LINKAGE**

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Southern California Edison Company (“SCE”) respectfully submits its comments to the California Air Resources Board (“ARB”) on its 15-day amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms to Allow for the Use of Compliance Instruments Issued by Linked Jurisdictions (“Proposed Modified Regulation Order”), issued January 8, 2013.<sup>1</sup>

**I.**

**INTRODUCTION**

The Proposed Modification Regulation Order contains the second set of modifications issued by the ARB regarding linkage to the cap-and-trade programs of other jurisdictions. The first set of proposed linkage modifications was released in May of 2012. After the passage of Senate Bill (“SB”) 1018, which was codified in Section 12894 of the Government Code, linkage was delayed until the Governor could make four findings regarding linkage that were outlined in the legislation.<sup>2</sup> In June 2012, the ARB passed changes to the regulation that did not include linkage, but directed the Executive Officer to make the requisite findings. The current 15-day modification language again considers linkage, which would be effective only after the Governor made the required findings.

In the cap-and-trade context, SCE has historically supported broad regional or national markets in order to ensure effective carbon reductions. However, SCE’s support has always

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<sup>1</sup> California Air Resources Board, Proposed Modified Regulation Order, *available at* <http://www.arb.ca.gov/regact/2012/capandtrade12/2nd15dayattachment1.pdf>.

<sup>2</sup> See California Air Resources Board, Discussion of Findings Required by Government Code Section 12894, January 2013, *available at* <http://www.arb.ca.gov/regact/2012/capandtrade12/2nd15dayatta6.pdf>.

included the caution that linkage should not be attempted until California’s program has been shown to be functional and that the carbon market is robust. The ARB should postpone linkage until 1) all linking jurisdictions have demonstrated both well-functioning markets and consistent rules and enforcement policies, and 2) the ARB has developed regulatory language allowing for potential de-linking. However, should the ARB move forward with linkage in spite of the advice of its own Emissions Market Assessment Committee (“EMAC”) and many of its stakeholders, it should modify its Proposed Modified Regulation Order as discussed in Section VI below.

## **II.**

### **EXECUTIVE SUMMARY**

SCE congratulates the ARB on the implementation of its first auction and reiterates its commitment to pursuing the success of the cap-and-trade program by actively engaging as a regulated entity and stakeholder. SCE continues to support a broad and efficient cap-and-trade market to achieve the goals of Assembly Bill (“AB”) 32. Given the lack of meaningful action at the national level, linking California’s cap-and-trade program to Western Climate Initiative (“WCI”) partners or other programs could be an important step toward developing such a market. While SCE supports and encourages linkage in principle, SCE urges the ARB to postpone any such activity until issues raised in these comments are addressed.

To that end, the ARB should:

- Postpone linkage until all jurisdictions have demonstrated well-functioning markets;
- Ensure all jurisdictions have a consistent understanding of rules and enforcement;
- Develop reasonable regulatory language addressing the possibility of future “de-linking”; and
- Revise specific sections of the proposed amendments as outlined in these comments.

SCE shares the ARB’s desire for a successful carbon market that serves as an example to others. In order to ensure that California’s example is a positive one, the ARB must resolve

these outstanding concerns before linking with other jurisdictions to dispel unnecessary and damaging market uncertainties.

### III.

#### **THE ARB SHOULD POSTPONE LINKAGE WITH OTHER JURISDICTIONS UNTIL ALL MARKETS ARE DEEMED WELL-FUNCTIONING**

##### **A. The ARB Should Collaborate with Stakeholders and the EMAC to Craft Success Metrics to Determine Readiness for Linkage.**

The ARB must focus its efforts on maintaining the success of the market it has created. While SCE agrees with the ARB that creating a broader cap-and-trade program through linkage is an important goal, SCE recommends that the ARB postpone linkage activities until both the California and the Québec cap-and-trade programs are shown to be well-functioning – a belief opinion shared by the EMAC, the ARB’s own market assessment committee, in its September 2012 report.<sup>3</sup> In addition, Québec’s cap-and-trade program is a brand-new untested market which has yet to hold auctions, or demonstrate effective program operations. The success of each program should be evaluated on a stand-alone basis and linked only after both market oversight committees demonstrate that the two programs are robust.

SCE suggests that the ARB develop, in conjunction with stakeholders and the EMAC, success metrics that can be used to determine if the markets are ready for linkage. Possible metrics suggested by the EMAC include determining whether GHG prices appear to be tied to abatement costs and the convergence of allowance prices over procurement venues, among others.<sup>4</sup> This analysis takes time. According to EMAC, the success of the California market is

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<sup>3</sup> “We [the EMAC] believe that linking with well-functioning GHG C&T markets in other jurisdictions should be pursued once the California market can be deemed to be well-functioning.” “Issue Analysis: Linkage with Quebec in California’s Greenhouse Gas Emissions Cap-and-Trade Market,” Emissions Market Assessment Committee, September 20, 2012.

<sup>4</sup> “Issue Analysis: Linkage with Québec in California’s Greenhouse Gas Emissions Cap-and-Trade Market,” Emissions Market Assessment Committee, September 20, 2012, at 2.

unlikely to be determined before 2015, or the beginning of the second compliance period.<sup>5</sup>

Linking with Québec before the markets are proven successful on a stand-alone basis exposes both the California and Québec cap-and-trade programs to unnecessary risk.

**B. The ARB Should Create Objective Methods to Assess the Potential Costs, Benefits, and Risks of Linkage.**

Linkage, especially with foreign jurisdictions, creates additional complexity that could threaten the success of California's cap-and-trade program. These added complexities, which include legal concerns, establishing consistent rules and enforcement procedures, and currency and language barriers, can pose significant challenges to an equitable market between the linked jurisdictions. SCE recommends that the ARB develop a set of criteria for assessing any potential linkages to ensure that the economic and environmental impacts of such partnerships are in line with California's cap-and-trade goals.

Québec alone does not offer California the opportunity to develop a comprehensive and robust cap-and-trade market. Additionally, the environmental benefits of linking with Québec are relatively insignificant given Québec's small size compared to California and the negligible amount of emissions-intensive goods traded between the two jurisdictions.<sup>6</sup> Since there is limited benefit to linking with Québec, the ARB should not rush into linkage while the programs are still immature. It should consider linkage only after the California program and any other potential linking partners have proven, viable, and stable markets.

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<sup>5</sup> "While no time frame should be imposed, finding that both the California market and the Quebec market are well functioning is unlikely to be determined prior to the implementation of the second phase of California's cap-and-trade program, in 2015." "Issue Analysis: Linkage with Quebec in California's Greenhouse Gas Emissions Cap-and-Trade Market," Emissions Market Assessment Committee, September 20, 2012, at 5.

<sup>6</sup> "Issue Analysis: Linkage with Quebec in California's Greenhouse Gas Emissions Cap-and-Trade Market" Emissions Market Assessment Committee, September 20, 2012, at 2.

#### IV.

### **THE ARB SHOULD ENSURE THAT ALL JURISDICTIONS HAVE A CONSISTENT UNDERSTANDING OF RULES AND ENFORCEMENT**

The ARB and any linked jurisdictions must maintain consistent rules and enforcement to provide a truly united WCI cap-and-trade program. To do so, the ARB and any linked jurisdictions should provide guidance as to how they will reconcile inevitable regulatory discrepancies between jurisdictions. There is no common authority to which both California and Québec have to answer, making the success of the programs reliant on mutual agreement of rules and enforcement. One linked jurisdiction could change its program in a manner unacceptable to the other jurisdiction; the other jurisdiction will have no power to object. Given that California is committing to accepting any compliance instrument issued by linked jurisdictions,<sup>7</sup> California's program will be either directly or indirectly affected by any program changes made by Québec, and vice versa. Therefore, as a prerequisite to linking, jurisdictions should create a process for the resolution of conflicts. A mutually-agreed upon process for rectifying discrepancies will allow the WCI to move forward with its regional market even if confronted with discrepancies that may conflict with one jurisdiction's standards.

Already there are some differences between the regulations in how offsets are treated and how auction purchase limits are applied. Québec has not yet approved forestry and urban forestry offset protocols, but has approved a landfill methane destruction protocol not approved by the ARB. In addition, Québec handles offset invalidation quite differently from California; it plans to retire credits from a collective Environmental Integrity Account while California assigns buyer liability in the case of invalidation.

Also, in California, only electric distribution utilities can buy up to 40% of a single auction,<sup>8</sup> while in Québec, purchase limits are set at 40% for a larger group of entities –

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<sup>7</sup> Proposed Modified Regulation Order, Section 95942(e), at 13.

<sup>8</sup> Final Regulation Order, Section 95911(d)(4)(B).

including firms involved in mining and quarrying, electric power generation, steam and air-conditioning supply, and manufacturing.<sup>9</sup> While the existing discrepancies between the regulations are not critical, it is possible that a jurisdiction would make changes to its program that are in conflict with the standards of a linked jurisdiction. Without a process for resolution, such a change could be so in conflict with a jurisdiction's standards that it causes the programs to de-link and pursue their goals individually.

Given that there will likely be additional policy and thus regulatory differences across linked jurisdictions, the ARB should ensure that all linked jurisdictions have a shared understanding of market rules, enforcement procedures, and how discrepancies between programs will be addressed or resolved. SCE suggests that the ARB work with Québec and the WCI to establish a process for how it will reconcile regulatory asymmetries with other jurisdictions when they arise.

## V.

### **THE ARB SHOULD MINIMIZE THE POTENTIAL HARM IN THE EVENT THAT A LINKED PROGRAM SPLITS**

The ARB must thoroughly evaluate high-impact threats to its program, including the potential for de-linking. Under the current structure, de-linking could cause significant economic harm to California or a failure to meet AB 32 emissions reduction goals. The ARB should shape its regulation to allow California to de-link as easily as possible. Below, SCE outlines some modifications that could mitigate some of the potential adverse consequences of de-linking.

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<sup>9</sup> Regulation Respecting a Cap-and-Trade System for Greenhouse Gas Emission Allowances (“Québec Regulation”), Appendix C, Part I, Table A, *available at* [http://www2.publicationsduquebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=3&file=/Q\\_2/Q2R46\\_1\\_A.HTM](http://www2.publicationsduquebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=3&file=/Q_2/Q2R46_1_A.HTM)

**A. The ARB Must Prepare for the Possibility of De-Linking Given Potential Legal Challenges and Policy Changes in a Multi-Jurisdictional Program.**

While SCE supports a broad cap-and-trade program, the ARB must consider the potential for legal challenges based on linkage to other jurisdictions and plan accordingly. One of the “Findings” required of the Governor by SB 1018 states that AB 32 must be enforceable in any linked jurisdictions to the full extent allowed under the law and the Constitution.<sup>10</sup> Given the barriers to enforcing a California law outside of California posed by the dormant commerce clause of the U.S. Constitution, it is unlikely that the ARB could fully enforce its cap-and-trade regulations in a linked jurisdiction. Moreover, although SB 1018 requires that the linked jurisdictions must have program requirements equivalent to or stricter than California,<sup>11</sup> other jurisdictions are free to modify their regulations at any time. In addition, changing political climates could cause some participants to drop out of the program entirely, resulting in forced severing of the linkage.

Adding to the uncertainty for California market participants is the continued threat of legal challenges. The ARB has defended against a number of legal challenges to its AB 32 programs, including the cap-and-trade program. These lawsuits have reduced market certainty for compliance entities and other market participants. A successful legal challenge to a linked program (whether on commerce clause, compact clause, foreign affairs, or other constitutional or legal grounds identified by program observers) would exacerbate participants’ concerns and

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<sup>10</sup> Government Code Section 12894(f)(2)(“Under the proposed linkage, the State of California is able to enforce Division 25.5 (commencing with Section 38500) of the Health and Safety Code and related statutes, against any entity subject to regulation under those statutes, and against any entity located within the linking jurisdiction to the maximum extent permitted under the United States and California Constitutions.”)

<sup>11</sup> Government Code Section 12894(f)(1)(“The jurisdiction with which the state agency proposes to link has adopted program requirements for greenhouse gas reductions, including, but not limited to, requirements for offsets, that are equivalent to or stricter than those required by Division 25.5 (commencing with Section 38500) of the Health and Safety Code.”)



multiply the potential economic damage. SCE again strongly urges the ARB to delay linkage until the markets are more mature and the program has proven to be stable.

**B. De-linking Under the Current Rules Would Result in Severe Economic Damage or Compromised Environmental Integrity.**

Regardless of why previously-linked jurisdictions would sever ties, the ARB should plan how it would maintain the environmental integrity of its cap-and-trade program and prevent significant economic harm to California in a de-linking scenario. Under the current linkage structure, there is no provision to make buyers aware of the origin of allowances on which they are bidding – in other words, buyers cannot tell whether any given allowance was issued by California or by a hypothetical Jurisdiction A.<sup>12</sup> Any de-linking from Jurisdiction A would likely result in a large transfer of wealth from California to Jurisdiction A, because Jurisdiction A would receive the revenue for all allowances issued. Meanwhile, California would be committed to accepting those allowances even if Jurisdiction A were no longer part of the cap-and-trade program. For example, if Jurisdiction A issues 25 million allowances in the first year and California issues 150 million, the effective program-wide cap on emissions is 175 million allowances for that year. Jurisdiction A would receive the revenue for its issued allowances, totaling \$500 million (assuming allowance prices of \$20/ton). Yet if Jurisdiction A left the program, 175 million allowances would remain in circulation with a California-only cap of 150 million. The ARB would have to either remove from circulation 25 million allowances by devaluing the remaining allowances proportionally or by issuing fewer allowances in future years, reducing the revenue received. Either way, Jurisdiction A would retain the \$500 million it received for issuing those allowances -- at the expense of Californians. If the cost of de-linking is too high, it is possible the ARB could be forced to make more drastic changes that could

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<sup>12</sup> Proposed Modified Regulation Order, Section 95911(a), at 6.

entirely compromise the program. This problem is only exacerbated as additional jurisdictions join the program.

**C. Jurisdictions Should Maintain Separate Auctions and Separately-Identified Compliance Instruments to Decrease the Linked Program’s Exposure and Allow for Easier De-Linking.**

All that is needed to form a linked program is the acceptance of compliance instruments from other jurisdictions. Rather than the single joint auction with allowances that are not distinguishable by jurisdiction, as proposed in Section 95911(a)(5) of the Proposed Modified Regulation Order,<sup>13</sup> jurisdictions should have their own auctions and issue their own identifiable compliance instruments. A multi-jurisdictional program will be maintained through the procurement activities of registered entities; they will purchase allowances from the auctions of both jurisdictions and will trade the allowances of both jurisdictions in the secondary market. This will minimize the organizational and accounting complexity that comes with holding a joint auction. Additionally, many of the potential legal challenges described above relate to California’s lack of authority over linked jurisdictions. By holding separate auctions and issuing separate compliance instruments, the direct interaction between the jurisdictions is reduced, which lessens the threat of such challenges.

Furthermore, creating allowances that can be distinguished between jurisdictions would allow jurisdictions to de-link more easily. Separating allowances at the beginning would allow market participants to make informed decisions about where to purchase allowances. For example, any political instability surrounding Québec’s cap-and-trade program could cause the value of Québec allowances to fall relative to the value of California allowances. Risk-averse California entities could then choose to purchase only California allowances, while risk-tolerant entities could purchase Québec allowances at a discounted price. Should de-linking occur,

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<sup>13</sup> Proposed Modified Regulation Order, Section 95911(a), at 6.

jurisdictions could accept only the allowances issued in their jurisdiction thus maintaining the environmental integrity of the cap without causing economic harm. If, as the ARB envisions, a well-functioning program with consistent rules develops, then prices should converge across linked programs. Conversely, if the linked markets do not run as smoothly as expected, the ARB and other market participants will be better positioned to cope with possible de-linking.

Maintaining a well-defined and unchanging regulatory framework is essential for preserving efficient environmental markets. Accordingly, the de-linking process should be established up front to avoid unintended consequences that could prove devastating. Decisions made in haste when adverse situations arise are rarely optimal decisions. The ARB has the opportunity to plan for an optimal de-linking scenario that offers additional clarity to market participants. The ARB should take advantage of this opportunity to implement a simpler linkage structure.

## VI.

### **SHOULD THE ARB MOVE FORWARD WITH LINKAGE, SCE OFFERS SOME ADDITIONAL AMENDMENTS TO THE PROPOSED MODIFIED REGULATION ORDER**

#### **A. Various Subsections of Section 95911(c) Are Inconsistent and Require Revision.**

Sections 95111(c)(3) and (4) of the Proposed Modified Regulation Order state that the Auction Reserve Price will be announced the morning of the auction, while Sections 95111(c)(2) and (5) suggest that the Auction Reserve Price will be announced at the beginning of each December.<sup>14</sup> To address this inconsistency, SCE suggests the removal of Sections 95111(c)(3)(B) and 95111(c)(4). Updating the Auction Reserve Price before each auction adds

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<sup>14</sup> Proposed Modified Regulation Order, Section 95911(c), at 7-8.

unnecessary complexity, and an annual update is sufficient. In addition, Sections 95111(c)(2) and (5) should be reconciled for consistency.

**B. The ARB Should Modify Section 95910(a)(2) to Ensure that Auctions in Linked Jurisdictions Occur on the Same Day.**

In order to properly consider the effect of holidays on the definition of “business days,” the ARB should change Section 95910(a)(2) of the Proposed Modified Regulation Order<sup>15</sup> to read: “auctions shall be conducted on the twelfth ~~business~~ day that is a business day in both California or a ~~and~~ jurisdictions...”

**VII.**

**CONCLUSION**

Linkage to cap-and-trade programs in other jurisdictions must be carefully executed with complete consideration to the legal and policy issues of such a decision. SCE urges the ARB to follow the recommendations of its EMAC and evaluate a California-only program through at least the first compliance period before officially linking to any other jurisdictions. SCE appreciates the opportunity to respond to the ARB’s 15-day changes to the Proposed Modified Regulation Order.

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<sup>15</sup> Proposed Modified Regulation Order, Section 95910(a)(2), at 6.

Respectfully submitted,

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