COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY TO THE CALIFORNIA AIR RESOURCES BOARD ON MARKET-RELATED REPORTING AND COST CONTAINMENT WORKSHOP

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I.

INTRODUCTION

Southern California Edison Company ("SCE") respectfully submits its comments to the California Air Resources Board ("ARB") on its Market-Related Reporting and Cost Containment Workshop, held June 25, 2013 ("June 25 Workshop"). SCE appreciates the opportunity to comment on the topics discussed, including cost containment, information disclosure, and compliance instrument retirement. These topics are important to a well-functioning cap-and-trade program and deserve careful consideration.

SCE's comments address three themes stemming from the June 25 Workshop: (1) SCE's recommendations for a portfolio of cost containment actions, (2) the market hazards of releasing individual compliance account balances, and finally (3) the importance of letting compliance entities determine the instruments they will surrender to satisfy their compliance obligation. As a market participant interested in controlling costs for its customers, SCE welcomes this opportunity to share its perspective and recommendations.

II.

SCE SUPPORTS A PORTFOLIO APPROACH TO COST CONTAINMENT

In Resolution 12-51,[1] the ARB Board directed staff to develop one or more mechanisms to ensure that allowance prices would not exceed the highest price tier of the Allowance Price Containment Reserve ("APCR").[2] Resolution 12-51 followed recommendations from stakeholders and the Emission Market Advisory Committee ("EMAC").[3] SCE appreciates this

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1 California Air Resources Board, Resolution 12-51, October 18, 2012, at 2 (*available at* http://www.arb.ca.gov/cc/capandtrade/final-resolution-october-2012.pdf)

2 The APCR is created by taking allowances from the program's allowance budget across all three compliance periods. The allowances in the APCR are made available for sale at a pre-established price once each quarter to covered entities.

3 *See* Bailey et al, "Issue Analysis: Price Containment Reserve in California's Greenhouse Gas Emissions Cap-and-Trade Market," September 20, 2012, at 1-2 (*available at* http://www.arb.ca.gov/cc/capandtrade/emissionsmarketassessment/pricecontainment.pdf).

discussion and supports the robust cost containment proposal offered by the Joint Utilities Group at the June 25 Workshop. The Joint Utilities Group offered proposed mechanisms for reducing the likelihood of exhausting the supply of compliance instruments, including measures to be implemented immediately, measures with mechanisms that would be triggered by a market event, and measures for providing needed compliance instruments in the event that the APCR is depleted. SCE supports a broad portfolio of cost containment measures, including the following:

A. Measures That Could Be Implemented Immediately to Reduce the Likelihood of Prices Rising Above the APCR in the Future

The cap-and-trade regulation currently includes cost containment mechanisms such as allowance banking and multi-year compliance periods. SCE suggests that the ARB also:

- **Approve more offset protocols to increase the supply of offsets**;
- **Increase the offsets usage restriction**[4] **above the current 8% limit**;
- **Exempt offsets created from California projects from the 8% offset limit**;
- **Allow each covered entity to carry over any unused portion of its 8% offset limit, to use for future compliance**;
- **Address constraints imposed by the current holding limit**; and
- **Hold an additional auction after the end of each compliance period**. The ARB should redistribute allowances between auctions to allow for one additional auction per compliance period, and/or acquire more allowances for auction. This auction should be held between September 1 of the year following the end of a compliance period, when

[4] Offsets are subject to a quantitative usage limit when used for meeting a covered entity's compliance obligation in a compliance period. This quantitative usage limit is 8% of the total number of compliance instruments surrendered to fulfill a compliance obligation.

verification statements for prior-year emissions are due,[5] and November 1, when compliance entities are required to demonstrate compliance.[6]

B. Measures Triggered By a Specific Price That Could Constrain Upward Pressure on Market Prices

Allowance prices could gradually move to unacceptable prices, but it is unlikely that market participants and regulators could easily and quickly determine whether price movements are short-term outliers or indicative of a longer-term trend. SCE recommends that the ARB develop mechanisms that would be triggered when allowance auction prices rise to a pre-determined "trigger" level. For example, an appropriate price may be linked to the APCR, but the following measures should be triggered before regulated parties begin to purchase allowances from the APCR. SCE supports the following mechanisms:

1. **Unused Offset Proposal**: Currently, a compliance entity is limited in its use of offsets to 8% of its compliance obligation per compliance period. Under the Unused Offset Proposal, when the trigger is reached, the ARB would calculate the program-wide shortfall of unused offsets from earlier compliance periods, and allow compliance entities to apply the difference to later compliance periods. This in effect will increase the quantitative usage limit for entities in a single compliance period, thus reducing upward price pressure on allowances in the short term, while maintaining the quantitative usage limit over the entire term of the program.
2. **Compliance Account Proposal**: When the trigger is reached, the ARB could allow covered entities to transfer surplus allowances from their compliance accounts to their limited use holding accounts. This would allow entities that have built up a bank of

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[5] Regulation for the Mandatory Reporting of Greenhouse Gas Emissions, Cal. Code Regs., tit. 17, § 95103(f).

[6] Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms ("Cap-and-Trade Regulation"), Cal. Code Regs., tit. 17, § 95856(f)(1).

excess allowances to re-inject those allowances in the market, which will improve market liquidity.

3. **Limited Borrowing Proposal**: When the trigger is reached, the ARB could allow covered entities to surrender current-year vintage allowances and next-year vintage allowances (not applicable post-2020).[7]
4. **Offset Geographic Scope Proposal**: When the trigger is reached, the ARB could increase the number of compliance-grade offsets by expanding the geographic scope of the approved offset protocols to North America.
5. **Offset Project Start Date Proposal**: When the trigger is reached, the ARB could increase the number of compliance-grade offsets by changing the Offset Project Commencement date established in Sections 95973(a)(2)(B) and (c) of the cap-and-trade regulation to an earlier date.

C. Measures Triggered Only If the Third Tier of the APCR is Depleted

Board Resolution 12-51 directed staff to develop a mechanism to ensure that prices would not exceed the third tier of the APCR. To do so, the ARB must provide additional compliance instruments even if the APCR is depleted. The key challenge is protecting the environmental integrity of the cap-and-trade program in the long term. This is possible using emissions reductions from regions beyond the geographic or economic scope of the current cap-and-trade program.

Upon depletion of the highest tier of the APCR, the Executive Officer should place an unlimited number of allowances in excess of the cap into the APCR (in the amount necessary to satisfy the demand of compliance or opt-in compliance entities) at the price set for the highest tier of the APCR in the relevant year. Creating such a "hard price cap" will provide certainty to

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[7] Currently, the compliance obligation surrender date is always one year after the last vintage year of allowable allowances.

market participants and will reduce the overall cost of the cap-and-trade program.[8] The Executive Officer could then use the funds raised by the sale of these additional allowances to ensure greenhouse gas ("GHG") reductions equal to or larger than the number of additional allowances sold. For example, the Executive Officer could:

- Commission a third party to obtain and retire high-quality offsets not otherwise eligible to satisfy the compliance obligations of compliance entities;
- Commission a third party to purchase and retire allowances from emissions trading programs outside of California and linked jurisdictions;
- Commission a third party to invest funds in emission reduction projects outside the capped sectors;
- Mandate emission reductions in sectors not covered by the California cap-and-trade regulation; or
- Utilize the anticipated GHG reductions from project investments in the ARB-developed and Legislature-approved Three-Year Investment Plan[9] to underwrite the additional creation of allowances.

III.

RELEASING INDIVIDUAL COMPLIANCE ACCOUNT BALANCES WILL UNFAIRLY EXPOSE SENSITIVE POSITION INFORMATION FOR COMPLIANCE ENTITIES AND COULD LEAD TO A LESS COMPETITIVE MARKET

Consistent with its previous comments[10] and those of many other covered entities, SCE strongly opposes the ARB's proposal to release information about individual account balances.

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[8] By eliminating the possibility that prices will exceed the highest tier of the APCR, the expected value of allowances is lower, thus reducing the efficient price of allowances. For example, if there is just a 1% chance that prices will reach $200/metric ton, that will add $2 (1% x $200) to the price of an allowance. Guaranteeing a 0% chance of extraordinarily high future allowance prices will reduce the market price.

[9] "Cap-and-Trade Auction Proceeds Investment Plan, Fiscal Years 2013-14 through 2015-16," May 14, 2013 (*available at* http://www.arb.ca.gov/cc/capandtrade/auctionproceeds/final_investment_plan.pdf).

At the July 25 Workshop, ARB staff suggested that releasing individual compliance account balance information will lead to better public knowledge of market fundamentals and a more efficient market generally. As SCE has stated in previous comments, releasing such information into an imperfectly competitive market will not lead to a more efficient market and could, in fact, lead to a less competitive market.[11] Releasing entity-specific compliance account balances could put a covered entity at a competitive disadvantage because other market participants would be able to estimate its net position and adjust auction bidding behavior and market prices accordingly.

Consider the following numerical example for ABC Corporation ("ABC"):

- ABC's annual in-state emissions = 20 million metric tons (the approximate value will be public due to the reported emissions in 2011-2013) ;
- ABC's compliance account holdings as of July 2014 equals 10 million allowances; and
- Maximum of ~6 million allowances in ABC's holding account.

From this information, other market participants would be able to deduce that ABC was short by roughly 24 million metric tons for the first Compliance Period. This public knowledge would place ABC at a distinct competitive disadvantage in negotiating for procurement of compliance instruments. ABC would have 16 months to cover its short position over the Intercontinental Exchange (where typical trades are in small 5,000 or 10,000 allowance blocks) or the two auctions remaining in the compliance period. Assuming flat net positions for other covered entities, this could result in more aggressive bidding in the August 2014 and November 2014 auctions and higher offer prices in the secondary markets. This disadvantage would be exacerbated for highly regulated entities such as investor-owned utilities ("IOUs"), which are

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[10] "Comments of Southern California Edison Company to the California Air Resources Board on the January 25, 2013 Information Sharing Workshop," February 5, 2013, at 1-7 (*available at* http://www.arb.ca.gov/lists/jan-25-info-share-ws/1-2013-02-05_sce_comments_on_arb_information_sharing_workshop.pdf).

[11] *Id.* at 4.

restricted by the California Public Utilities Commission in the financial positions they may take and products they may procure in the secondary market.

By contrast, releasing aggregated compliance account holdings combined with compliance surrender information would likely address the underlying issues to which the ARB is responding. Aggregated compliance account holdings data will allow the market to determine the overall supply of tradable compliance instruments. The market can simply calculate the total number of allowances held in holding accounts (that can be resold) by subtracting the aggregate number of compliance instruments in compliance accounts from the total number of allowances issued and consigned to date. In this way, the ARB can provide useful market supply account balance information to the market without exposing sensitive position information.

At their January 25 Information Sharing Workshop, ARB Staff indicated that they intend to publicize compliance account balances in large part to confirm the compliance status of regulated entities. The ARB plans to release entity-level compliance obligation data and is now considering releasing information on retired compliance instruments by surrendering entity.[12] While SCE would prefer a less detailed compliance report, this approach would still clearly reveal the compliance status of covered entities and is more desirable than releasing compliance account holdings.

SCE believes that no regulatory change is required for the ARB to release aggregated compliance account holdings as opposed to individual account information. However, in the interest of clarity, SCE recommends that the ARB make the following change to Section 95921(e)[13] of the cap-and-trade regulation:

> The Executive Officer will protect confidential information to the extent permitted by law by ensuring that the accounts administrator: […] (4) Releases

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[12] "Cap-and-Trade Workshop: Compliance & Information Requirements," ARB Public Workshop to Discuss Market-Related Reporting and Cost Containment in the Cap-and-Trade Program ("ARB Workshop Presentation"), June 25, 2013, at 25, 29 (*available at* http://www.arb.ca.gov/cc/capandtrade/meetings/062513/arb-cr-mrr-present.pdf).

[13] Cap-and-Trade Regulation § 95921(e).

aggregated information on the quantity and serial numbers of compliance instruments contained in all compliance accounts in a timely manner.

Revealing individual compliance account information can lead to less competitive offers, greater inefficiency, and higher compliance instrument prices, which will result in long-term higher compliance costs passed along to California customers. The ARB should not force California customers to bear the risk of this outcome. The ARB can provide data on market fundamentals and compliance by simply releasing aggregated compliance instrument holdings data and compliance instrument retirement data.

IV.

THE ARB SHOULD ALLOW COVERED ENTITIES TO SELECT WHICH COMPLIANCE INSTRUMENTS IT WILL USE TO MEET THEIR COMPLIANCE OBLIGATIONS

At the June 25 Workshop, ARB Staff stated that they "need to specify retirement order in [the] Regulation."[14] SCE does not agree. It is in the best interest of both the ARB and covered entities to allow covered entities to determine their own retirement order to meet their individual compliance obligations.

In other environmental compliance trading programs, compliance entities have been able to identify which compliance instruments they intend to use to meet their compliance obligations. For example, under the United States Environmental Protection Agency's Acid Rain Program, compliance entities may use an "Allowance Deduction Form" to identify the SO_2 allowances they would like to retire for compliance. Similarly, under California's Renewables Portfolio Standard program, compliance entities may determine which Western Renewable Energy Generation Information System ("WREGIS") certificates they will retire for compliance. This retirement flexibility allows compliance entities to better manage their portfolios, reduces

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[14] ARB Workshop Presentation at 14.

the administrative burden for the regulatory agency, and reduces the risk of an unlawful taking of property if compliance instruments are removed and not returned or if the "wrong" instruments are retired. In addition, removing compliance instruments from a compliance account without applying them against an entity's compliance obligation (such as offsets held in the compliance account that may exceed the 8% retirement limit) would be inconsistent with the goal of cost containment.

Covered entities should have the ability to choose which compliance instruments are used to meet their compliance obligations under California's cap-and-trade program. Not only does the cap-and-trade program have different vintages of compliance instruments for meeting compliance obligations, it allows different products (allowances and offsets) that affect holding limits differently as well as different project types with different risk parameters.[15] Thus, from a risk management, cost basis, and account limit management standpoint, it is best for compliance entities to determine their own retirement schedule.

Allowing this retirement flexibility is consistent with the existing cap-and-trade regulations. Section 95922 of the regulation states that "A California compliance instrument does not expire and is not retired in the tracking system until:

(1) It is surrendered by a covered entity or opt-in covered entity and retired by the Executive Officer;
(2) An entity voluntarily submits the instrument to the Executive Officer for retirement; or
(3) The instrument is retired by an approved external GHG emissions trading system to which the Cap-and-Trade Program is linked pursuant to subarticle 12.[16]

Therefore, the retirement of a compliance instrument requires an action of surrender or submission by an entity. Further,

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[15] During the June 25 Workshop, ARB Staff indicated that under the current regulations, a compliance entity can control which compliance instruments are retired by transferring only selected compliance instruments into its compliance account. In practice, however, due to holding limit restrictions, a compliance entity may have to transfer allowances it does not want retired immediately into its compliance account to utilize its limited exemption to the holding limit.

[16] Cap-and-Trade Regulation § 95922.

> To voluntarily retire a compliance instrument, the registered entity submits a transaction report to the accounts administrator listing its account number, the serial numbers of the instruments to be retired, and the ARB Retirement Account as the destination account.[17]

A covered entity could use a similar process to meet its compliance obligation by submitting a transfer request to the ARB selecting the serial numbers[18] of the instruments to be retired and the ARB Retirement Account as the destination account.

Some technical changes are necessary in the Compliance Instrument Tracking System Service ("CITSS") to allow account representatives to flag specific allowances and offset credits within their compliance accounts for the ARB to retire. However, the technical changes should be feasible by the first compliance surrender deadline of November 1, 2014.[19]

While modifications to the regulations are not specifically required, SCE suggests one addition to the definitions listed in Section 95802 of the cap-and-trade regulation for additional clarity:

> <u>"Surrender" means, with regard to compliance instruments, that a covered entity identifies the serial numbers for transfer to the Retirement Account in the tracking system.</u>

Covered entities should be able to select which instruments from its compliance accounts are retired to meet their compliance obligations. This will help covered entities from a risk management, cost savings, and account limit management perspective and reduce the number of disputes with the ARB. SCE's suggested regulatory changes are minimal and the suggested technical changes are feasible.

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17 Cap-and-Trade Regulation § 95922(d)(2).

18 The serial number, for these purposes, refers to attributes of a compliance instrument that are visible to account holders, since actual serial numbers—as defined in Cap-and-Trade Regulation § 95802(a)(260)—are not visible to account holders.

19 SCE, along with the other IOUs, flagged this issue during the CITSS Stakeholder Design Webinars early this year.

V.

CONCLUSION

Cost containment and reporting issues are crucial to ensuring the smooth functioning of the cap-and-trade market. SCE appreciates this opportunity to comment on the June 25 Workshop and urges the ARB to make changes to the regulation in accordance with the recommendations contained herein.

Respectfully submitted,

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