

**Comments of the Western Power Trading Forum
To the California Air Resources Board
On Linking to the Quebec
Cap and Trade Program**
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The Western Power Trading Forum¹ (WPTF) appreciates the opportunity to provide input to the California Air Resources Board (CARB) on its consideration of linking the California cap and trade program to that of Quebec. Because California and Quebec cap and trade regulations were developed in parallel following the design framework agreed under the Western Climate Initiative, the programs are, for the most-part, highly consistent. Both set hard caps of comparable stringency² and contain rigorous reporting and enforcement provisions. For these reasons, we are confident that linkage of the two programs will not in any way undermine the environmental integrity of California's program.

Further, linking of California's cap and trade program to Quebec's will increase the number of participants in the market and the quantity of compliance instruments (allowances and offsets) available. While the relative GHG mitigation costs in the two programs, and thus the impact of linkage on allowance prices, is not clear, on balance the benefits of an expanded market and increased market liquidity will be beneficial for California. We therefore fully support linkage of the two programs.

At the February 3rd workshop, CARB staff requested stakeholder input on which elements of the program require harmonization for consistency and effective program administration. WPTF's comments on each of the areas identified is provided below, in the order addressed at the workshop.

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

² "Carbon Flash: Due North – Quebec Cap and Trade", Barclay's Capital, 9 February 2012

Auction Procedures

CARB staff indicated that California and Quebec aim to auction allowances from both programs jointly under a single quarterly auction. Staff identified several modifications that would be necessary for this to occur: harmonization of the auction floor price and tie-breaking rules across the two programs; modification of auction rules to allow bidding in either currency and bundling of allowances from each jurisdiction. WPTF agrees that these changes are needed to ensure efficient administration of a joint auction. However, we urge CARB staff to evaluate which changes would necessitate formal revision of the regulation and which could be effected through administrative procedures of the auction operator and financial services operator.

For instance, because the auction floor price is set out in each regulation, one or both of the regulations may need to be changed to provide flexibility for fluctuations in currency exchange rates. Conversely, California's regulation appears to give the auction administrator discretion regarding auction procedures and the form of bids. This discretion may enable bundling of California and Quebec allowances or bids in other currencies without requiring formal revision of the regulation.

Price Containment Reserve Sales

CARB proposes that Quebec and California would operate separate Price Containment Reserve (PCR) sales, in which only capped entities from the respective jurisdiction could participate. While there are currently minor differences in the rate at which Quebec and California's PCR tiers escalate, staff indicate that these will be harmonized prior to linking.

Given the fact that under both programs allowances purchased from the PCR must immediately be moved to compliance accounts and cannot be transferred to another entity, we

see no benefits to conducting joint PRC sales. WPTF therefore supports CARB's proposal for separate PCR sales, provided that tier prices and escalation rates are harmonized across the programs.

Auction Purchase Limits

CARB indicated at the February 3rd workshop that it is reevaluating the 15% auction purchase limits for current vintages in light of the October Board resolution.

WPTF and other stakeholders have previously raised concerns that the 15% auction purchase limit is overly restrictive on covered entities with large compliance obligations. When the Western Climate Initiative first recommended adoption of auction purchase limits, eleven jurisdictions were expected to adopt cap and trade programs. The anticipated breadth of the WCI market and volume of allowances to be auctioned led the Markets Committee to conclude that setting auction purchase limits would not pose an excessive burden on capped entities because "... WCI market participants will have small compliance obligations, relative to the total pool of available allowances³..." Since that time, however, most participating jurisdictions have dropped out of the WCI, with the result that the size of the allowance market is a fraction of what was originally anticipated.

Because Quebec's cap is only about a sixth of the size of California's, linkage of the programs will increase the quantity of allowances available at any individual auction by less than 10% - which means the quantity of allowances that may be purchased by any individual entity will increase by less than 2%. Such a miniscule increase is not sufficient to allay concerns about the constraining effect of the purchase limit on large California entities.

³ "Markets Committee Task 6: Auction Design White Paper" at <http://www.westernclimateinitiative.org/document-archives/Markets-Committee-Documents/Auction-Design-White-Paper/>

WPTF therefore continues to support elimination of the auction purchase limit for the first compliance period. If purchase limits are retained, we recommend raising them to 25% for all market participants in both jurisdictions. This limit is consistent with that used in the Regional Greenhouse Gas Initiative.

Holding Limits

CARB staff indicated that they are also reviewing the regulation's holding limits in response to the October Board direction. One revision under consideration is the calculation of the holding limit for entities in both jurisdictions based on the sum of the allowance budgets for each jurisdiction.

WPTF has consistently opposed the establishment of holding limits because of their dampening of market liquidity and because they limit the flexibility of capped entities with high emissions to manage compliance and hedge against allowance price risk. These flaws have also been recognized in a recent report by the California Legislative Analyst's Office⁴. That report noted that restrictive holding limits prevent participants from holding compliance instruments for legitimate business purposes, thereby lowering market efficiency and raising overall compliance costs. Given the potential for raising program costs, and the fact that the regulation's holding limits have not been justified analytically or through empirical data, the report recommended their elimination. Instead, the report recommended market surveillance and significant penalties for entities that engage in market manipulation.

WPTF urges CARB to follow the LAO's recommendation and eliminate allowance holding limits in the cap and trade program. If holding limits are not eliminated, then individual

⁴ "Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program", Mac Taylor, Legislative Analyst, February 9, 2012 at: <http://lao.ca.gov/reports/2012/rsrc/cap-and-trade/cap-and-trade-020912.pdf>

holding limits should be set relative to each entity's most recent emissions data report and all allowances in the compliance account and any allowances banked from previous periods should be exempted from the holding limit. WPTF notes that the alternative approach suggested by CARB staff, whereby holding limits would be calculated on the pooled allowance budgets of Quebec and California, would only minimally increase the holding limits for California entities, due to the small size of the Quebec cap relative to California's. For this reason, CARB's proposed change would *not* address WPTF's concern regarding the ability of large entities to manage their compliance.

Beneficial Holdings

CARB staff noted that the California regulation requires reporting of beneficial allowance holdings, while the Quebec regulation does not. The issue of beneficial holdings is directly related to allowance holding limits. If CARB decides, as WPTF recommends, to eliminate holding limits, WPTF recommends that the beneficial holdings provisions also be eliminated.

In the event that holding limits are not eliminated, then the beneficial holding provisions need to be amended so that they do not disadvantage independent power producers' (IPP) ability to manage their compliance obligation. The beneficial holding relationship was created so that utilities could purchase and manage their contractual obligations to counter-parties without violating their own holding limit. While the regulation requires the agent (i.e. the utility) to confirm with the principal (i.e. the contracted generator) that it is authorized to act on its behalf for any allowances that are acquired by the agent and that will be counted against the holding limit of the principle, the allowances do not have to be transferred for up to one year. This provision imposes an unreasonable limitation to an IPP's ability to manage its holding limit because the allowances held by the agent cannot be transferred by the IPP into its compliance

account and therefore qualify for the limited exemption. WPTF recommends that holding limits and the beneficial holding provisions be eliminated, but if CARB decides not to, then WPTF strongly recommends that CARB bring together the affected parties to develop language that is fair and non-discriminatory.

Corporate Associations

As staff noted, the Quebec regulation sets lower thresholds for reporting of direct and indirect Corporate Associations than that of California. As holding limits apply collectively to entities with a registered Corporate Association, WPTF considers it important to harmonize the requirements for Quebec and California entities to ensure that the same market rules apply to all participants.

Emissions Reporting

Quebec requires entities with emissions below the threshold for inclusion in the cap and trade program, but above the 10,000 MT threshold for reporting to report both combustion and process emissions; California only requires reporting of combustion emissions. WPTF does not consider it essential to harmonize reporting requirements for entities that are not subject to the cap and trade program.

Compliance Deadlines

Quebec's compliance deadlines differ from California's in two ways: the surrender date for the end of the compliance period is two months later than California's, and Quebec's program does not require any annual surrender of allowances. WPTF does not consider the first difference to be problematic. Given the fact that all allowances eligible for use in a compliance period will have been distributed well in advance of the final surrender date for that period, a difference in surrender dates should not impact market dynamics or confer any advantage on

entities from either jurisdiction. Further, we expect that, in order to manage compliance, most entities will accrue allowances sufficient to cover their emissions to date throughout the compliance period (exemption of units held in compliance accounts from holding limits would reinforce this tendency). Therefore, we do not anticipate a run on allowances near the end of a compliance period.

WPTF is however concerned with the lack of an annual surrender requirement in the Quebec regulation. In California, covered entities will be required to surrender annually allowances equivalent to 30% of the previous year's emissions. If Quebec covered entities do not have the same restriction, they will have more flexibility in how they manage their compliance and thus more ability to adapt and respond to market conditions. WPTF recommends that the annual surrender requirement be harmonized between the two jurisdictions to ensure a level playing field for all allowance market participants.