

**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**

MICHAEL D. MONTOYA  
CATHY A. KARLSTAD  
NANCY CHUNG ALLRED

Attorneys for  
SOUTHERN CALIFORNIA EDISON COMPANY

2244 Walnut Grove Avenue  
Post Office Box 800  
Rosemead, California 91770  
Telephone: 626-302-1096  
Facsimile: 626-302-1935  
E-mail: Cathy.Karlstad@sce.com

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## I.

### INTRODUCTION

Southern California Edison Company (“SCE”) thanks the California Air Resources Board (“CARB”) staff for the opportunity to provide comments on their June 22, 2010 workshop presentations on cost containment options and offsets and linkage in a California cap-and-trade program. SCE appreciates CARB staff’s recognition of the need for cost containment measures to prevent the Assembly Bill (“AB”) 32 cap-and-trade program from leading to unacceptably high costs. Indeed, cost-effectiveness and cost containment are critical element of CARB’s effort to implement AB 32. The Legislature expressly stated that: “It is the intent of the Legislature that the State Air Resources Board design emissions reduction measures to meet the statewide emissions limits for greenhouse gases established pursuant to this division in a manner that minimizes costs and maximizes benefits for California’s economy....”<sup>1</sup> Moreover, AB 32 requires CARB to design regulations in a manner that “seeks to minimize costs.”<sup>2</sup> Additionally, the long-term success of any emission reduction program relies on the public acceptance of such efforts. Implementing the program at the lowest possible cost is a critical part of this acceptance.

As SCE explained in prior comments, a comprehensive cap-and-trade market that reaches across geographic and economic sectors will most effectively achieve real, long-term, and cost-effective greenhouse (“GHG”) emission reductions. Cost containment measures are also needed within the cap-and-trade program.

Under appropriate conditions, SCE supports a price collar, i.e., a floor and ceiling price for allowances, as a cost containment measure. The price collar must have reasonable floor and ceiling prices that reflect appropriate cost considerations. Moreover, the treatment of the floor and ceiling prices must be consistent. If there is a hard floor price, there must also be a hard ceiling price. SCE also supports the general direction of CARB staff in developing an allowance

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<sup>1</sup> AB 32, Cal. Health & Safety Code § 38501(h).

<sup>2</sup> *Id.* § 38562(b)(1). Cost-effectiveness and cost minimization are also mentioned in several other parts of the legislation. *See id.* §§ 38560, 38561(a), 38562(a), 38562(b)(5), 38562(c), 38564.

reserve to provide additional allowances at the price ceiling. However, it is critical that the allowance reserve be implemented in a manner that will actually reduce compliance costs. As discussed below, SCE believes the allowance reserve should be filled from multiple sources. Those sources should include the difference between the GHG emission cap trajectory projected in the AB 32 Scoping Plan and any updated GHG emission cap trajectory reflecting the downturn in economic conditions; any allowances that are not sold in the allowance auction; additional offsets beyond those allowed for compliance in the cap-and-trade program; and, if necessary, allowances borrowed from future compliance periods that would be refunded through additional offsets in future compliance periods.

A robust offset policy that allows for a large supply of verifiable and sustainable offsets is another critical cost containment measure.<sup>3</sup> SCE has repeatedly emphasized the need for a greater supply and greater use of low-cost offsets than currently proposed. CARB's offset protocols must ensure that approved offsets are real, permanent, quantifiable, verifiable, and enforceable. However, CARB's protocols should not be so restrictive that they hinder the development of an offsets market that will provide true cost containment. As a means of assuring early availability of high quality offsets, SCE supports CARB linking with existing offset systems such as the Climate Action Reserve ("CAR") and the European Union Emissions Trading Scheme ("EUETS").

CARB should also develop an approach to dealing with offset performance challenges. If CARB certifies that the emission reductions from an offset have occurred, CARB should clarify that such offset cannot later be ruled ineligible for compliance with the cap-and-trade system. In addition, CARB should provide compliance flexibility to compliance entities to address circumstances beyond their control, including situations where an offset does not provide the anticipated emission reductions. CARB should also clarify that it will continue to honor offsets

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<sup>3</sup> As the Governor stated, "CARB should carefully consider how to assure an ample supply of high-quality offsets to help companies comply with carbon reduction strategies in a cost-effective manner." Letter from Governor Arnold Schwarzenegger to CARB Chairwoman Mary D. Nichols at 2 (March 24, 2010).

developed under approved offset protocols and rules, even if such offset protocols and rules are subsequently changed.

## II.

### **SCE SUPPORTS A REASONABLE PRICE COLLAR WITH A PROPERLY STRUCTURED ALLOWANCE RESERVE**

As discussed above, SCE supports a price collar under appropriate conditions. If designed appropriately, a price collar can be an effective cost containment measure in the AB 32 cap-and-trade program. However, any price collar must have reasonable floor and ceiling prices that that will effectively prevent compliance entities under the cap-and-trade program from incurring excessive costs. SCE suggests that CARB further explore how the price floor and ceiling will be set.

Furthermore, the treatment of the floor and ceiling prices must be consistent (i.e., if there is a hard floor price, there must be a hard ceiling price). The June 22<sup>nd</sup> workshop presentation states that CARB plans to set a minimum auction reservation price below which allowances would not be sold at auction.<sup>4</sup> This floor price is characterized as a “soft price floor.”<sup>5</sup> SCE disagrees with staff that a minimum auction reservation price is a soft price floor. If no allowances will be sold below the minimum auction reserve price, that is a hard price floor. For example, in the workshop presentation on “Allowance Price Containment” given by the Nicholas Institute for Environmental Policy Solutions, the same type of minimum auction reservation prices in the federal Waxman-Markey and Kerry-Lieberman proposals are both called “hard price floors.”<sup>6</sup>

SCE recommends that CARB adopt a price collar with both a hard price floor and a hard price ceiling. Assuming both the floor and ceiling prices are reasonable and that the price floor

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<sup>4</sup> Cost Containment Options in a California Cap-and-Trade Program, CARB Staff Workshop Presentation at 7 (June 22, 2010).

<sup>5</sup> *Id.*

<sup>6</sup> Allowance Price Containment, Nicholas Institute for Environmental Policy Solutions Workshop Presentation at 8, 10 (June 22, 2010).

and price ceiling are treated consistently, SCE does not oppose setting a minimum auction reservation price.

With respect to the price ceiling, SCE supports the general direction of CARB staff in developing an allowance reserve. Reserve allowances should be made available at the hard ceiling price. In order to facilitate this, SCE supports a “reserve allowance window” similar to the Federal Reserve Bank’s “discount window.” A reserve allowance window will discipline both the secondary and primary market for allowances, which is a crucial component of true cost containment. An open reserve allowance window will also reduce compliance risk and enable compliance entities to engage in reasonable compliance planning.

A key question is how the allowance reserve will be filled. If improperly implemented and administered, an allowance reserve could needlessly increase compliance costs. CARB staff have indicated one potential option is to populate an allowance reserve with allowances carved out of the initial compliance period in the cap-and-trade program. As SCE indicated in previous comments, such an approach would cause an increase in compliance costs because it reduces the supply of allowances to compliance entities. Such an approach would also place stress on the allowance market that could push prices to the ceiling level.

In order to maintain true environmental integrity while protecting against onerous long-term compliance costs, SCE proposes that multiple sources from outside the cap be used for filling the allowance reserve. As discussed below, those sources should include any difference between the GHG emission cap trajectory projected in the AB 32 Scoping Plan and any updated GHG emission cap trajectory, which would reflect the downturn in economic conditions; any allowances that are not sold in the allowance auction; additional offsets beyond those allowed for compliance in the cap-and-trade program; and, if necessary, allowances borrowed from future compliance periods that would be refunded through additional offsets in future compliance periods.

**A. Differences in the GHG Cap Trajectory in Response to Temporal and Fluctuating Economic Conditions**

SCE understands that CARB staff intend to set the initial 2012 GHG cap based on an updated estimate of 2012 emissions, which is likely to be significantly below the level included in the AB 32 Scoping Plan since estimated 2012 emissions have decreased due to the impact of the recent economic downturn on economic activity and emissions, early actions to reduce GHG emissions,<sup>7</sup> and other factors that have contributed to a lower estimate of 2012 emissions. Economic fluctuations occur and CARB should recognize that the long-term conditions of the economy will drive emissions more than short-term fluctuations. Setting the 2012-2010 GHG cap trajectory based on an estimate of 2012 emissions that is significantly impacted by the economic downturn could place the State in a difficult position when the economy recovers, making compliance with the cap more difficult and expensive.

Had CARB set the 2012-2020 cap based on the business-as-usual assumptions in the AB 32 Scoping Plan, a much larger number of allowances would have been available in the cap-and-trade program, compared to a 2012-2020 cap based on a current estimate of 2012 emissions. The State may need these additional allowances as the economy recovers. Accordingly, SCE believes that CARB should calculate the difference between the two starting points and reduction trajectories. The difference in the allowances available under the two reduction trajectories should be placed in the allowance reserve and made available at the price ceiling as a cost containment measure.

Even these allowances are not likely to be sufficient to fully fill the allowance reserve, especially if the economy recovers. Therefore, as addressed in further detail below, other sources should also be used to populate the allowance reserve.

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<sup>7</sup> As explained in prior comments, when CARB determines its best estimate of actual emissions in 2012, CARB should adjust the 2012 cap upward to reflect early emission reduction efforts. Such an adjustment will appropriately credit voluntary early actions and reflect true business-as-usual conditions. *See* Comments of Southern California Edison Company to the California Air Resources Board on Cap Setting and Data Review: Establishing Surrender Obligations and Examining Historical GHG Data Trends at 5 (December 14, 2009).

**B. Allowances Not Sold at Auction**

SCE agrees with the CARB staff proposal that allowances that remain unsold in any CARB auction be automatically added to allowance reserve to be provided at the price ceiling.

**C. Additional Offsets Beyond Those Allowed for Compliance**

SCE opposes quantitative limits on the use of offsets in the cap-and-trade program. Compliance entities should be allowed to use valid offsets to the full extent of their compliance obligations. If quantitative limits on the use of offsets are adopted, however, additional offsets beyond the amount allowed for compliance should be used to fill the allowance reserve. Such offsets would be sold at the price ceiling, thus maintaining the price signal in the market despite the additional use of offsets.

**D. Allowances Borrowed From Future Compliance Periods and Refunded Through Additional Offsets in Future Compliance Periods**

As noted in the June 22<sup>nd</sup> workshop presentation, one problem with relying on additional offsets to fund the allowance reserve is that such offsets may not be available in a timely manner.<sup>8</sup> The supply of offsets does not necessarily react immediately to changing market conditions and price volatility. Moreover, there may be fewer offsets available in the early compliance periods, given the time needed to implement CARB's offset protocols and develop the offsets market.

Accordingly, if there are not sufficient allowances available to fund the allowance reserve from the sources discussed above, CARB should borrow allowances from future compliance periods and offer them at the price ceiling. This borrowing from future compliance periods will provide short-term cost containment and minimize excess price volatility. The borrowed allowances should be from compliance periods that are sufficiently far in the future so as to minimize the effect on the demand for allowances in the current compliance period.

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<sup>8</sup> Cost Containment Options in a California Cap-and-Trade Program, CARB Staff Workshop Presentation at 9 (June 22, 2010).

In order to maintain long-term cost containment and prevent higher costs in future compliance periods due to the reduced supply of allowances, these borrowed allowances must be refunded. SCE recommends that the borrowed allowances be refunded through additional offsets in future compliance periods beyond those that are allowed for compliance. More offsets are likely to be available in the later compliance periods once the offset market has had a chance to develop. One option to refund the borrowed allowance would be for a third party oversight group to purchase additional offsets beyond those allowed for direct compliance demonstration by compliance entities.

### **III.**

#### **CARB SHOULD LINK TO EXISTING OFFSET SYSTEMS ON AN EXPEDITED BASIS**

SCE continues to support the broad use of offsets as a crucial cost containment measure in the cap-in-trade program. SCE is concerned that CARB staff's planned approach for creating offsets is too restrictive to yield sufficient offsets at prices that will provide true cost containment and compliance flexibility. In particular, a "protocol" or categorical approach to approving offset projects could easily take one to two years, which would not provide a sufficient early supply of offsets for the first compliance period. CARB's offset protocols must ensure that approved offsets are real, permanent, quantifiable, verifiable, and enforceable. However, CARB's protocols should not be so restrictive that they hinder the development of an offsets market that will provide true cost containment.

SCE supports CARB staff's proposal to link with existing offset programs in the short-term. Such linkage will provide an early supply offsets as CARB's protocols are being established and implemented. Two immediate candidates for linkage are existing voluntary CAR offsets and the Clean Development Mechanism used by the EUETS. CARB can benefit from the extensive offset experience in these other systems. Despite some criticism, the EUETS's approach to developing offsets has succeeded and is operational, and California can benefit from the European experience.



SCE also endorses the use of offsets that may be developed by the Western Climate Initiative (“WCI”). A number of WCI Partners are implementing offset programs concurrently with California. Linking with these offset programs will provide additional offsets and the benefits of a regional system with more cost-effective emission reduction opportunities.

#### IV.

### **CARB SHOULD DEVELOP AN APPROACH FOR DEALING WITH OFFSET PERFORMANCE CHALLENGES**

#### **A. CARB Should Provide Certainty Regarding Certified Emission Reductions and Compliance Flexibility for Issues Resulting from Circumstances Beyond the Compliance Entity’s Control**

During the June 22<sup>nd</sup> update on CARB staff’s plans for offsets and linkage in the cap-and-trade program, CARB staff indicated that CARB may take enforcement action against third-party verifiers, offset project developers, and offset users if offsets are later determined to be ineligible.<sup>9</sup> In addition, CARB staff noted that CARB intends to hold compliance entities responsible for replacing the lost tons for any offsets later deemed ineligible.<sup>10</sup> CARB should clarify this proposal. In particular, it is not clear how CARB intends to grant certified emission reductions.

SCE agrees that compliance entities ultimately bear the compliance responsibility for retiring allowances or providing offsets. As discussed below, however, offset providers and compliance entities that rely on CARB’s approved offset protocols to invest in offset projects should be afforded some measure of certainty. Moreover, in order to provide the regulatory certainty necessary for the development of a robust offsets market, CARB should make clear that once CARB certifies that the emission reductions from an offset have occurred, such offset cannot later be ruled ineligible for compliance with the cap-and-trade system.

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<sup>9</sup> Update on Offsets and Linkage in a California Cap-and-Trade Program, CARB Staff Workshop Presentation at 24 (June 22, 2010).

<sup>10</sup> *Id.*

It is possible that, due to circumstances outside of a compliance entity's control, an approved offset project will not provide the projected emission reductions (e.g., if trees in a reforestation project do not grow as quickly as expected). In that situation, SCE does not object to CARB staff's proposal that the compliance entity be responsible for replacing the lost tons of emission reductions. Although an offset project may not provide the forecasted and accounted-for reductions for a variety of reasons, the compliance entity will generally have to address that possibility in its individual contracts with the offset providers.

However, CARB should develop regulatory language that provides some compliance flexibility to address circumstances in which the compliance entity is prevented from timely complying with its obligations due to circumstances beyond its control. One such situation is when an offset does not provide the anticipated and approved emission reductions due to circumstances beyond the compliance entity's control. This flexibility could include additional time to meet compliance obligations, either through the purchase of allowances or other offsets. This type of flexibility would be similar to that provided in California's Renewables Portfolio Standard ("RPS") program, which includes flexible rules for compliance such as additional time to meet compliance obligations when sellers do not perform due to factors beyond the control of the compliance entity.<sup>11</sup>

Allowing compliance entities reasonable flexibility to deal with circumstances beyond their control will help to facilitate compliance with AB 32's emission reduction goals, without compromising the environmental integrity of the regulation.

**CARB Should Continue to Honor Offsets Developed Under Approved Protocols and Rules Even if CARB's Offset Protocols and Rules are Later Revised**

As outlined at the June 22<sup>nd</sup> workshop, CARB staff is working to develop and approve offset protocols to meet AB 32 standards.<sup>12</sup> SCE is concerned that an offset project may be

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<sup>11</sup> Cal. Pub. Util. Code § 399.14(a)(2)(C); California Public Utilities Decision 03-06-071 at 50 (June 19, 2003).

<sup>12</sup> Update on Offsets and Linkage in a California Cap-and-Trade Program, CARB Staff Workshop Presentation at 4-5 (June 22, 2010).

deemed non-performing simply because CARB's approved offset protocols and rules change. If CARB were to retroactively disallow emission reductions (either direct or indirect) because of a change in an offset protocol or rules, investors would be unwilling to take traditional performance risks under any rules. It is critical that once a rule is developed, any investment undertaken based on that approved rule continues to be eligible for compliance in order to provide both investors and compliance entities with certainty.

Accordingly, CARB should clarify that any offset projects developed or contracted under an earlier-approved protocol or rules must continue to be honored under the original protocol and rules. If an offset protocol or offset rules change for any reason, such changes should not be applied retroactively.

V.

**CONCLUSION**

SCE appreciates the opportunity to comment on cost containment options and offsets and linkage, and looks forward to working closely with CARB in upcoming workshops to develop cost containment measures and offset rules that will allow California to meet its AB 32 goals in the most cost-effective manner.

Respectfully submitted,

MICHAEL D. MONTOYA  
CATHY A. KARLSTAD  
NANCY CHUNG ALLRED

/s/ Cathy A. Karlstad

By: Cathy A. Karlstad

Attorneys for  
SOUTHERN CALIFORNIA EDISON COMPANY

2244 Walnut Grove Avenue  
Post Office Box 800  
Rosemead, California 91770  
Telephone: 626-302-1096  
Facsimile: 626-302-1935  
E-mail: Cathy.Karlstad@sce.com

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