August 11, 2011

James Goldstene
Executive Officer
California Air Resources Board
1001 "I" Street, Sacramento, CA, 95812

Re: Comments on Proposed 15-Day Changes to the AB 32 Cap-and-Trade Regulation

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Dear Mr. Goldstene,

The undersigned organizations appreciate the opportunity to comment on the proposed changes to the cap-and-trade regulation developed by the Air Resources Board (ARB). We strongly support ARB's efforts to implement a cap-and-trade program to back up the robust package of clean energy policies in the Scoping Plan and ensure we hit AB 32's greenhouse gas (GHG) emission reduction target. Our comments below touch on various aspects of the program that have either been modified through ARB's proposed 15-day changes or have been the subject of recent discussion.

Our comments are summarized as follows:

1. We support ARB's proposed modifications to:
    a. Take an additional year to ensure the program functions as designed;
    b. Hold auctions in 2012;
    c. Require the state's utilities to report on the amount and use of allowance value;
    d. Clarify what constitutes a violation under the rule; and
    e. Build on the Industrial Audit measure in 2012 to require that each industrial facility implement all cost-effective and feasible reduction measures identified in its audit
2. We urge ARB to retain provisions currently in the rule regarding:
    a. The investor-owned utilities' (IOUs) use of allowance value;
    b. The prohibition on borrowing;
    c. The allowance multiplier applied to excess emissions;
    d. The allocation of allowances unsold at auction; and
    e. The purchase limit for individual entities at auction
3. We ask ARB to provide additional clarity related to:
    a. The prohibition on resource shuffling; and
    b. The treatment of replacement electricity and null power; and
4. We express our concern that ARB's allocation methodology to the electric utilities undermines California's leadership on clean energy and sends the wrong signal for future climate action

DISCUSSION

1. We Support ARB's Proposed Updates and Modifications to the Following Aspects of the Program

Enforcement Date

We support ARB's decision to begin enforcement of the program in 2013 to ensure the program functions as designed. Launching the nation's first economy-wide cap-and-trade program to curb GHGs requires careful planning and scrutiny, and we appreciate ARB's concern that it take sufficient time to test and monitor various aspects of the program before beginning enforcement. It is imperative, however, that ARB maintain its commitment that commencing enforcement in 2013 will not impact the stringency of the cap or the environmental performance of the program. We are encouraged to see that commitment reflected in the proposed 15-day changes. Similarly, to facilitate the creation of a broader Western carbon market (which will benefit California entities and drive even greater emission reductions), it is critical that ARB's decision to begin enforcement in 2013 not lead to any delay in the launch or operation of the program.

Auctions in 2012

We support ARB's proposal to make one third of vintage 2013 allowances available to entities in 2012 through two auctions scheduled in August and November.[1] Following ARB's decision to begin enforcement of the program in 2013, we agree with staff that there is still opportunity and value to the program to begin auctioning of allowances in 2012. Holding an auction for the electric utility sector in August 2012, as proposed, will reinforce confidence in the market that the program will continue as planned and help facilitate early price discovery. In addition, the proceeding underway at the California Public Utilities Commission (CPUC) will ensure that the electric utilities have the authorization they need in time to begin collecting costs and distributing revenues from the sale of emission allowances.

Reporting of Allowance Value

We strongly support ARB's modification of the rule to ensure there is transparency with respect to both the amount and distribution of allowance value allocated to the state's utilities, including California's publicly-owned utilities (POUs).[2] ARB designed the allocation scheme for the utility sector to mitigate the bill impacts of the program on retail electricity customers by returning allowance value through retail electricity providers. While the rule is clear that allowance value must be used for the exclusive benefit of customers,[3] adding reporting provisions will enable ARB to assess more effectively whether and how the utilities are fulfilling this obligation.

We reiterate our request, however, that ARB go one step further and provide guidance to the state's POUs should they consign allowances to auction.[4] Unlike the IOUs, the POUs will not be subject to a decision from the CPUC that will develop a framework and methodology for returning auction revenues to customers. Building on ARB's expertise and extensive examination of this issue,

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[1] Section 95910(a)(1)
[2] Section 95892(e)
[3] Section 95892(a) and (f)
[4] See NRDC, UCS, EDF and Sierra Club California "Comments on the Proposed Regulation to Implement the California Cap-and-Trade Program" (Dec 7, 2010).

identifying the potential uses that ARB deems consistent with the goals of AB 32 will help steer the POUs in the right direction.

Violations
We also support and appreciate ARB's revision of Section 96014, which specifies what constitutes a violation under the rule and triggers the penalty provisions in the Health and Safety Code.[5] The previous iteration of the rule left some ambiguity on what conduct, short of a covered entity failing to meet its compliance obligation, constituted a "violation" and thereby authorized ARB to pursue administrative penalties as an enforcement mechanism. ARB's retooled approach in section 96014(c) eliminates any uncertainty and will help encourage compliance from all entities who participate in every aspect of the program.

Industrial Audit Measure
Finally, we strongly support ARB's commitment to build on the existing Regulation for Energy Efficiency and Co-Benefits Assessment of Large Industrial Facilities (Industrial Audit Measure) to require that each industrial facility implement all cost-effective and feasible reduction measures identified in its audit.[6] The industrial sector accounts for roughly one fifth of California's total GHG emissions[7] and has significant co-pollutant impacts, but is not subject to any mandatory direct regulation currently in development under the Scoping Plan. We are supportive of ARB's approach to consider this apart from the cap-and-trade rulemaking, as we appreciate the legal and practical complications that could entail. ARB can also draw from the results of the first round of audits in developing the regulation in 2012. But it is incumbent on ARB to follow through on its commitment to ensure the AB 32 package of policies includes a requirement that will secure GHG emission and co-pollutant reductions in the industrial sector.

2. We Urge ARB to Retain the Following Provisions in the Rule to Safeguard the Integrity of the Program's Design and Maximize the Program's Environmental Performance

Guidance on Use of Allowance Value
We urge ARB to retain the provisions in the rule providing guidance to the electric IOUs on how to return auction revenue for the benefit of their retail customers.[8] The issue of how to allocate revenue generated from a California cap-and-trade program has been analyzed extensively by a host of expert bodies, including the Economic and Technology Advancement Advisory Committee (ETAAC), the Economic and Allocation Advisory Committee (EAAC), the California Energy Commission (CEC), the CPUC and ARB. While the recommendations from these various entities on the most appropriate uses of allowance value have not been uniform, one aspect of them has remained constant – that any return of allowance value to electricity customers to offset bill impacts associated with the program should not undermine the incentive, reflected in the carbon price embedded in retail rates, to promote customer end-use efficiency and conservation.[9] The joint

[5] Section 96013
[6] ARB, "Notice of Public Availability of Modified Text and Availability of Additional Documents," p.2 (July 25, 2011).
[7] ARB, "California GHG Inventory for 2000-2008."
[8] Section 95892(d)(3)
[9] CPUC, D.08-10-037 at 227; EAAC, "Allocating Emissions Allowances Under a California Cap-and-Trade Program: Recommendations to the California Air Resources Board and California Environmental Protection Agency," p.66 (March 2010) (noting using allowance value to prevent rate increases "would undercut a main purpose of AB 32: to

CEC-CPUC proceeding that addressed this very question, for example, with the support of many parties (including, at the time, PG&E)[10] concluded that it is "imperative" that any mechanism providing bill relief through auction revenue be designed "so as to not dampen the carbon price signal" reflected in retail rates.[11]

Building off these recommendations and analysis, ARB has conditioned the free allocation of allowances to the electric IOUs on a few general provisions designed to achieve this widely shared objective.[12] First, to the extent the IOUs use auction revenue to provide customer rebates, they must provide them on "the fixed portion of ratepayers' bills or as a separate fixed credit or rebate."[13] Heeding the advice of the CEC, CPUC, and EAAC, this ensures that auction revenues are not used to blunt the carbon price in retail rates. Second, to the extent the IOUs use auction revenue to provide customer rebates, they must not base them "*solely* on the quantity of electricity delivered to ratepayers from any period after January 1, 2012" (emphasis added).[14] This simply ensures the IOUs do not tie the return of allowance value exclusively to how much electricity each customer consumes, which undercuts incentives for improved efficiency and conservation.

The IOUs currently assert, however, that ARB should eliminate these provisions as they intrude on the exclusive jurisdiction of the CPUC to set electricity rates. We disagree. We do not contest that the California Constitution vests jurisdiction in the CPUC over matters in which the Legislature has granted the CPUC regulatory authority.[15] That includes a broad grant of authority under section 701 of the Public Utilities Code, which authorizes the CPUC to "do all things…which are necessary and convenient" in the exercise of its jurisdiction, including setting rates.[16] At least one appellate court has construed the CPUC's jurisdiction in such matters as exclusive, to provide uniformity throughout the state and eliminate the potential for conflicting local regulations (but which are not a concern here).[17]

The CPUC's jurisdiction is not exclusive, however, where that jurisdiction is made concurrent by a later legislative enactment, such as AB 32.[18] Under AB 32, ARB is tasked as the lead agency responsible for ensuring California achieves its GHG reductions target.[19] To fulfill that role, the Legislature vested ARB with broad authority to adopt regulations to achieve the maximum technologically feasible and cost-effective GHG reductions in furtherance of the statewide emissions

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provide incentives for reduced electricity consumption (and associated emissions reductions);" ARB, "Allowance Allocation" (Appendix J), at J-61.

[10] CPUC, D.08-10-037 at 224.

[11] Id. at 227.

[12] ARB, "Allowance Allocation" (Appendix J), at J-61, (noting "staff believes that any rebates to residential customers should be made as separate payments and not simply deducted from customer bills. *The purpose of this restriction is to ensure the carbon price is reflected in residential electric rates*.") (emphasis added).

[13] 95892(d)(3)(B)

[14] 95892(d)(3)(C)

[15] Cal. Constitution Article XXII, sec. 8.

[16] Cal. Pub. Util. Code section 710.

[17] See *City of Anaheim v. Pac. Bell Tel. Co.*, 119 Cal. App. 4th 838, 842-43 (Cal. Ct. App. 2004). The California Supreme Court has also recognized the "undoubted fact," however, that "it has never been the rule in California that the commission has exclusive jurisdiction over any and all matters having any reference to the regulation and supervision of public utilities." *See San Diego Gas & Electric Co. v. Sup. Ct.*, 920 P.2d 669, 700 (Cal. 1996) (citing *Vila v. Tahoe Southside Water Utility* 233 Cal.App.2d 469, 477 (Cal. Ct. App. 1965)).

[18] *Orange County Air Pollution Control Dist. v. Public Util. Com.*, 4 Cal.3d 945, 954 (Cal. 1971).

[19] Cal. Health and Safety Code sections 38510 and 38560.

limit, including as part of a market-based program.[20] As highlighted above, ARB has determined that preserving the carbon price in retail rates will encourage additional efficiency and conservation from retail customers, which will contribute to achieving the ambitious reduction targets set out by ARB for the electricity sector under the Scoping Plan. Accordingly, the provisions relating to the IOUs' use of allowance value are not intrusions into an area outside of ARB's jurisdiction, but are in furtherance of ARB's mandated responsibility to achieve compliance with AB 32. In addition, the limited restrictions ARB has placed on the IOUs' receipt of allowance value do not encroach on the CPUC's jurisdiction over rate setting. The provisions afford ample room and discretion to the CPUC to determine how the costs and revenues associated with buying and selling allowances will ultimately flow to retail customers.

Ultimately, the details of how the electric IOUs will distribute allowance value will be determined by the CPUC, which we agree is the appropriate forum to address those issues. But removing the current guidance in the cap-and-trade rule sends the wrong message at a critical juncture. We ask that ARB maintain the current provisions in the rule guiding the IOUs' return of allowance value, which are well-within ARB's authority.

Prohibition on Borrowing

We strongly urge ARB to retain the prohibition on borrowing contained in section 95856. Allowing entities to submit future vintage year allowances for compliance at an earlier date encourages entities to delay undertaking the necessary planning and investment decisions to be compliant over the course of the program. Retaining a firm prohibition on borrowing is all the more essential given ARB's proposal to increase the advance auction from two to ten percent.[21] Advance auctioning ten percent of future vintage year allowances will inject liquidity in the market early on at the expense of later budget years, when the cap is much larger. While we see merit in this approach, advance auctioning that amount of future vintage year allowances will become extremely problematic should the firm prohibition on borrowing be relaxed.

Allowance Multiplier

We urge ARB to retain the robust penalty provisions in the draft regulation to safeguard the environmental integrity of the program. Employing an allowance multiplier sends a clear, transparent signal to market participants that noncompliance will never be in their economic interest. We are not persuaded by suggestions from other stakeholders that requiring violators to submit excess allowances as part of their untimely surrender obligation penalizes all participants – by removing allowances from the market and driving up allowance prices – and should therefore be eliminated. ARB's focus should remain on designing a program that sends the strongest possible signal to encourage compliance. Eliminating the automatic penalty provision in section 95857(b)(2) will push all of the enforcement decisions into the murkier waters of administrative penalties, which will introduce uncertainty and require significantly more time and resources on the part of ARB. Moreover, ARB's revised approach to allocating excess allowances eliminates any residual concern related to the automatic penalty provision.[22] By making excess allowances submitted by

[20] *Id.* at 38560, 38562(a), 38570(c). The Legislature has also authorized ARB to "do such acts *as may be necessary* for the proper execution of the powers and duties granted to, and imposed upon, the state board by this division and by *any other provision of law*" (emphasis added), see Cal. Health and Safety Code section 39600, which would include ARB's responsibilities under AB 32.

[21] Section 95870(b)

[22] Section 95857(d)(1)

noncompliant entities available at a subsequent auction, ARB will retain the strong deterrent of a multiplier while guarding against any unwanted pressure on allowance prices.

Allocation of Unsold Allowances

We ask that ARB retain the provision directing allowances unsold at auction to the allowance price containment reserve.[23] In place of the reserve, a few stakeholders at the July 15, 2011 workshop on the Discussion Draft suggested these allowances be made available at the subsequent auction. We agree with staff's position that this could facilitate consistent over-allocation of allowances and inhibit price discovery. Rather than lock-in a mechanism that could lead to consecutive auctions clearing at the floor price, a pitfall of the Regional Greenhouse Gas Initiative (RGGI) system that ARB should strive to avoid, the most appropriate use of unsold allowances is to backfill the allowance reserve. The program's banking provisions provide ample opportunity for entities to guard against the risk of future allowance shortages; should market conditions lead to an unexpected shortage, however, ARB has designed the allowance reserve to introduce additional liquidity. It is vital that ARB maintain a provision to fill the reserve (when allowance prices are at the floor) to provide the cost-containment function of the reserve as envisioned if allowance prices spike.

Purchase Limits

Similarly, we oppose proposals to relax an individual entities' purchase limit should allowances remain unsold at auction. As ARB has designed the program, unsold allowances should fill the reserve to provide a cost containment function that is accessible to all parties. Allowing certain firms to bet on future shortfalls by stockpiling allowances at an auction invites the sort of market speculation and manipulation that can undermine confidence in the program and inhibit performance of the market.

3. We Ask That ARB Provide Additional Clarity on the New Provisions Prohibiting Resource Shuffling and the Treatment of Replacement Electricity

Resource Shuffling

We commend ARB's efforts to prohibit resource shuffling from electricity deliverers subject to the program.[24] Resource and contract shuffling enables covered entities to meet their compliance obligations without generating any net emissions reduction, and is therefore at odds with the objectives of the program. While we support ARB's intent to prohibit resource shuffling, we ask that ARB conduct a workshop to flesh out the details and consider the ramifications of implementing the provision and definition of resource shuffling provided in the draft rule. To be effective, it is critical that ARB's definition not create loopholes, send mixed incentives, or unduly inhibit covered entities' efforts to reduce the carbon intensity of their resource mix. We feel additional clarification is required to make that assessment. One modification we recommend ARB make at this stage is to expand the exception for compliance with the Emission Performance Standard (EPS) adopted by the PUC and CEC pursuant to SB 1368. The current definition of resource shuffling excludes electricity no longer serving California load "as a result of" compliance with the EPS.[25] We ask that ARB expand the current language to clarify that actions taken by covered entities to achieve early compliance with the EPS are similarly not prohibited as resource shuffling.

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[23] Section 95911(b)(4)

[24] Section 95852(b)(1)

[25] Section 95802(a)(245)(B)

Treatment of Replacement Electricity
The current language on replacement electricity raises a number of potential concerns in what is a complicated and evolving area. With that in mind, we strongly recommend the ARB consider a workshop on this issue involving CPUC staff and interested parties to ensure consistency among renewable resources and the Renewable Portfolio Standard (RPS) regulation, and to avoid double counting the environmental attributes of Renewable Energy Credits (RECs).

4. We Remain Concerned that ARB's Proposed Allocation of Allowances to the Utility Sector Undermines California's Leadership on Clean Energy and Sends the Wrong Signal for Future Climate Action

Allowance Allocation to the Utility Sector
We note for the record our disappointment in ARB's proposed allocation of allowances among the state's electric utilities.[26] ARB identified two broad policy objectives it set out to achieve (and reconcile) in developing an allocation methodology: to reward early action from utilities who invested in demand-side reductions and a relatively clean resource mix; and to offset the cost burden on customers of utilities who underinvested in efficiency and maintained a higher carbon-intensive resource mix.[27] In December 2010, ARB proposed to allocate allowances based on three factors: early action (defined as qualifying renewable energy investments from 2007-2011), cumulative energy efficiency investments (also indicative of early action), and customer cost burden (a product of the emissions-intensity of each utility's resource mix).[28] But the actual proposal reveals the methodology is largely a product of the third factor, as customer cost burden accounts for more than 90% of each utility's allowance allocation.[29] We maintain that the allocation methodology should give significantly more weight to the other two factors, which would more effectively reward and encourage the transition to clean energy. We appreciate that the methodology has buy-in from the utilities, and recognize ARB's extensive work and collaboration in developing this approach. As proposed, however, we remain concerned that the allocation scheme disadvantages early movers on clean energy and sends the wrong signal for jurisdictions developing or contemplating the development of a carbon market.

CONCLUSION

We continue to support ARB's efforts to develop the cap-and-trade regulation and look forward to participating in the ongoing development and refinement of the program.

Thank you for considering our comments.

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[26] ARB, "Appendix A: Staff Proposal for Allocating Allowances to the Electric Sector" (July 27, 2011).
[27] ARB, "Appendix 1: Staff Proposal for 15-day Changes to Address Electricity Sector Allowance Allocation (Dec. 2010)"; see also Appendix J, at J-55 - J-59.
[28] ARB, "Appendix 1: Staff Proposal for 15-day Changes to Address Electricity Sector Allowance Allocation (Dec. 2010).
[29] ARB, "Appendix A: Staff Proposal for Allocating Allowances to the Electric Sector," p.5 (July 27, 2011).

Sincerely,

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