

**BEFORE THE
AIR RESOURCES BOARD
OF THE
STATE OF CALIFORNIA**

**SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY
COMMENT ON THE MAY 2012 PROPOSED CHANGES TO THE
CAP AND TRADE REGULATION TO LINK WITH QUEBEC**

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SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON THE MAY 2012 PROPOSED CHANGES TO THE CAP AND TRADE REGULATION TO LINK WITH QUEBEC

I. INTRODUCTION AND SUMMARY.

The Southern California Public Power Authority (“SCPPA”)¹ respectfully submits this comment on the proposed amendments to the regulation entitled *California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms*, Title 17 California Code of Regulations, Subchapter 10, Article 5 (“CA Regulation”), providing for linking with Quebec, released by the California Air Resources Board (“ARB”) for public comment on May 11, 2012.

In summary, SCPPA considers that:

- Linking should be approached with caution. The ARB should consider delaying linking until after the California and Quebec programs have started operating. Before working on linking provisions, other key provisions in the CA Regulation should be finalized.
- Certain provisions of the California and Quebec regulations should be harmonized before the programs are linked. Caps should be equally stringent in each jurisdiction; the prices of allowances in the allowance price containment reserves should be harmonized; and similar offset protocols should be approved under each program.
- Linking should not result in an increase to the auction reserve price. The auction reserve price should be the lower of the Quebec and California prices, not the higher.
- The ARB should track market performance and flows of compliance instruments between jurisdictions, for early warning of potential issues caused by linking. A process for

¹ SCPPA is a joint powers authority. The members are Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Los Angeles Department of Water and Power, Imperial Irrigation District, Pasadena, Riverside, and Vernon. This comment is sponsored by Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, the Imperial Irrigation District, Pasadena, Riverside, and Vernon.

delinking should also be included in the regulation to enable a quick response to any severe issues that occur and to mitigate the damage caused by improperly functioning markets.

- Linking appears to involve delegating authority on market operations to WCI, Inc. Given its important role, this organization should become more transparent and allow more public scrutiny and input.

These issues are discussed in more detail below.

II. LINKING SHOULD BE APPROACHED WITH CAUTION.

California's cap-and-trade program should not be linked to cap-and-trade programs in other jurisdictions, such as Quebec, until issues associated with linkage have been fully vetted, some practical experience with the respective cap-and-trade programs has been gained, and there is evidence that linkage can help to contain the costs of the linked programs.

In theory, a larger market for allowances would be a more liquid market and having a larger market would make available more lower-cost opportunities to reduce greenhouse gas ("GHG") emissions. The call to link with Quebec would be more persuasive if these theories were supported by empirical evidence, relating to the particular circumstances of the California and Quebec programs, that linkage will indeed produce the intended benefits. SCPPA encourages the ARB to seek such evidence and disseminate it to stakeholders.

III. CONSIDER DELAYING LINKING UNTIL AFTER EACH PROGRAM HAS STARTED OPERATING.

The ARB wishes to link California's cap-and-trade program with Quebec's in 2012, before either program has become operational. Linking will unavoidably result in making California's program – which is already complex and rife with uncertainties as to how it will operate in practice – even more complicated and less predictable, particularly given that the

linked jurisdiction is outside the United States. Linking at this early stage increases the number of issues that may arise with the new programs, raising the risk that significant problems will occur that would necessitate delinking or major revisions to the programs.

For these reasons, the ARB should consider delaying linking until the California program and the Quebec program have started operating, initial problems have been resolved, and the programs have demonstrated that they are stable and effective.

SCPPA is not alone in holding this view. The California Senate Budget Subcommittee No. 2 recently recommended that a provision be included in the 2012 California budget trailer bills prohibiting the ARB from linking until November 30, 2013, unless linking is approved by the California Legislature in a future statute.²

IV. BEFORE LINKING, OTHER KEY PROVISIONS IN THE CALIFORNIA REGULATION SHOULD BE FINALIZED.

Prior to linking with another cap-and-trade program, outstanding issues with the California program should be addressed. Specifically, priority should be given to resolving electricity issues, including resource shuffling, the position of publicly-owned utilities that are interconnected with the California Independent System Operator, and the treatment of electricity imports. Electricity issues were specifically noted in ARB Resolution 11-32 approving the cap-and-trade regulation in October 2011. These issues affect emissions reports due this year as well as important decisions which must be made by September 1, 2012, regarding the allocation of allowances between a utility's accounts.³ These are not issues that can be delayed until next year.

² At the Subcommittee meeting on May 23, 2012, the Subcommittee approved the following trailer bill language:

“1.f. The State of California, California Air Resources Board, and California Environmental Protection Agency, including its contractors (specifically Western Climate Initiative, Inc.) shall not allow for linkage under the Cap and Trade program with any other state, province or sovereign nation until November 30, 2013, unless approved by the California Legislature in future statute.”

³ CA Reg § 95892(b)(3).

V. CERTAIN PROVISIONS OF THE CALIFORNIA AND QUEBEC REGULATIONS SHOULD BE HARMONIZED.

SCPPA understands the ARB's view that not all of the provisions of the linked programs need to be identical in order for linking to be successful. However, certain features of the two programs, discussed in sections V.A to V.C below, should be reviewed and harmonized to ensure that linking Quebec's program to California's will mitigate rather than exacerbate allowance prices.⁴

A. Caps should be equally stringent in each jurisdiction.

The ARB should be careful to ensure that Quebec's cap-and-trade program will not contain features that would counterproductively result in an increase in the cost of allowances, thereby negating the principal benefit – cost containment – that can be obtained through linkage. A key part of this is ensuring that Quebec's program is not so short of opportunities to reduce GHG emissions that covered entities in Quebec would rely on California disproportionately to generate emissions reductions, potentially causing allowance prices to be higher than they would be if California were not linked to Quebec's program.

As a related issue, California should be careful to ensure that the cap set by Quebec is not more stringent than California's cap. Linking to jurisdictions with more stringent caps would tighten the market for allowances in the linked jurisdictions, driving up allowance prices. Some studies (for example the Barclays study in February 2012) have indicated that allowance prices may increase due to linking because Quebec is expected to be a net buyer of allowances. SCPPA requests the release of data and analyses to support statements made by ARB staff that the

⁴ These comments are based on the undated version of the Quebec regulation available at: <http://www.mddep.gouv.qc.ca/changements/carbone/reglementPEDE-en.pdf>, as amended by the amendments released on June 8, 2012, available at: <http://www.arb.ca.gov/regact/2012/capandtrade12/qcaamendpt2.pdf>.

California and Quebec caps are equally stringent and that linking will have no discernible effect on prices.

B. Prices of allowances in the allowance price containment reserves should be harmonized.

The ARB staff has indicated that it was not considered crucial to harmonize the prices of allowances in California's and Quebec's cost containment reserves, as each jurisdiction is independently establishing a reserve and entities will only be able to access the reserve in their own jurisdiction.⁵ However, reserve prices function as a soft cap on the price of allowances. Thus, differences between the reserve prices in each jurisdiction are likely to affect the unified allowance market. If the administratively established prices for allowances in Quebec's cost containment reserve escalate more rapidly than the administratively established prices for allowances in California's allowance price containment reserve, Quebec could put pressure on prices in the unified allowance market, forcing more reliance by California covered entities on the California allowance price containment reserve than would occur otherwise. This could occur despite the fact that entities registered in Quebec will be unable to access California's reserve directly. Thus, the rate of escalation of the prices for reserve allowances should be harmonized.

Section 95913(e)(3) of the CA Regulation and section 58 of Quebec's regulation set the same initial prices for allowances in the allowance reserves (although in different currencies): \$40 per allowance for allowances from the first tier, \$45 per allowance for allowances from the second tier, and \$50 per allowance for allowances from the third tier. The rate of escalation of

⁵ CA Reg § 95913(i) provides that entities registered in an external emission trading program to which California has linked will not be eligible to purchase from the California allowance reserve. Quebec regulation § 56 has a similar effect in relation to the Quebec reserve.

allowance prices is set at five percent annually plus the rate of inflation.⁶ However, the currencies will fluctuate, and the rates of inflation will differ in California and Quebec. If currency and inflation fluctuations cause Quebec reserve allowances to become more expensive than California's, there may be less demand for allowances from Quebec's reserve and greater demand for California allowances which are likely to remain capped at the California reserve prices (at least until the California reserve becomes depleted).

SCPPA suggests that the prices of allowances from the California and Quebec reserves be harmonized by providing that the prices be the lower of the prices that would otherwise apply under the California and Quebec regulations.

C. Harmonize and increase the number of approved offset protocols in each program.

In addition to allowing the use of offsets, a linked program should facilitate the availability of offsets to avoid increasing demand for the limited number of offsets that will be generated pursuant to the California program. This is particularly important given that the full cost containment potential of offsets will not be realized unless each covered entity is able to, and does, acquire offsets up to the eight percent limit, and that some studies (for example by Thompson Reuters Point Carbon) have indicated that there is likely to be a shortage of offsets in the California program compared to the demand from California covered entities only.

The California and Quebec regulations approve the following divergent sets of offset protocols:⁷

- | California | Quebec |
|---|---|
| <ul style="list-style-type: none">• Livestock methane destruction | <ul style="list-style-type: none">• Livestock methane destruction |

⁶ CA Reg § 95913(e)(4); Quebec regulation §58.

⁷ CA Reg Subarticle 13; Quebec regulation Appendix D.

California

- Destruction of ozone depleting substances
- Forestry and urban forestry

Quebec

- Destruction of ozone depleting substances
- Landfill methane destruction

It is unclear why California has not approved a landfill methane destruction protocol and why Quebec has not approved forestry and urban forestry protocols. Nor is it clear whether the currently-approved California and Quebec offset protocols will together produce sufficient offsets to meet the joint demand from the two jurisdictions. To increase the supply of offsets, SCPA urges California to adopt an offset protocol similar to Quebec's landfill methane destruction protocol, Quebec to adopt protocols similar to California's two forestry protocols, and both jurisdictions to put a high priority on investigating and adopting additional protocols.

In addition, to avoid asymmetrical demand for Quebec offsets and differential pricing due to differences in the risk profiles of Quebec and California offsets, California should adopt Quebec's rule regarding the replacement of invalid offsets: Invalid offsets should be replaced by the entity that generated them, not the entity that purchased or surrendered them as in the CA Regulation. Failing that, invalid offsets should be replaced from an offset buffer account maintained by the regulator.⁸ This approach will provide greater certainty in the offset market than the approach in the CA Regulation, and therefore will strengthen the offset program as a whole.

VI. LINKING SHOULD NOT RESULT IN AN INCREASE TO THE AUCTION RESERVE PRICE.

As noted above, one of the key purposes of linking to other cap-and-trade programs is to reduce the cost of compliance. However, one of the changes in the CA Regulation that was

⁸ Quebec regulation § 70.20. Compare CA Reg § 95985.

included to facilitate linking may instead increase the floor price of allowances at auction (“auction reserve price”).

Section 95911(c)(1) of the CA Regulation sets the auction reserve price at \$10 per metric ton for allowances auctioned in 2012. In subsequent years, the auction reserve price will be the higher of the prices established under the Quebec and California programs.⁹ The Quebec and California prices may differ due to differences in inflation rates and currency fluctuations.

Rather than choosing the higher of the two prices, which may result in increasing the floor price above what it would be in the absence of linking, the auction reserve price should be the lower of the two prices. Section 95911(c)(3)(E) of the CA Regulation should be revised as follows:

(E) The auction administrator will use the announced exchange rate to convert to a common currency the Auction Reserve Prices previously calculated separately in U.S. and Canadian dollars. The auction administrator will set the Auction Reserve Price equal to the ~~lower~~^{higher} of the two values.

See also the comments on the level of the auction reserve price in SCPPA’s submission on the non-linking changes to the CA Regulation proposed on May 11, 2012.

VII. PROVIDE PROCESSES FOR TRACKING ALLOWANCE FLOWS AND MARKET PERFORMANCE, AND DELINKING IN SPECIFIED CIRCUMSTANCES.

As noted above, linking increases the complexity of the cap-and-trade program. Issues with one or both programs may arise. If so, prompt action will be required to identify and address the issues to avoid negative impacts on the markets, including related markets such as the electricity market. For this reason, the CA Regulation must contain procedures for tracking the performance of each program and for monitoring and reporting on California’s and Quebec’s

⁹ CA Reg § 95911(c)(3)(E); Quebec regulation § 49 paragraph 3, subsection (2).

markets. The flows of compliance instruments between the two jurisdictions and the trading activities of covered entities and (separately) non-covered entities should be monitored.

Also, the CA Regulation should contain provision for delinking in specified circumstances. However, to provide certainty to the market, the delinking provisions must explicitly allow California entities to continue using Quebec allowances (which will not be identifiable as such by market participants) that have already been issued for compliance after delinking.

VIII. GREATER TRANSPARENCY IS NEEDED REGARDING THE OPERATIONS OF WCI, INC.

Linking with other jurisdictions appears to lead the ARB to rely on private entities, in particular WCI, Inc., and indeed to delegate some authority regarding the operation of the cap-and-trade program to that entity. This causes concern because WCI, Inc., unlike the ARB itself, does not operate in a publicly-accountable manner. SCPA recognizes that as a private Delaware corporation WCI, Inc., is not subject to the “sunshine laws” that apply to public entities in California. However, SCPA requests the ARB to ask WCI, Inc., to consider operating as if those laws did apply to it – for example, by providing notice of its meetings at which cap-and-trade operational issues will be decided and by allowing public attendance and input at those meetings. Information on the method by which WCI, Inc., will resolve disputes regarding the operation of the cap-and-trade program should also be provided.

Furthermore, the voting power of each participating jurisdiction on the WCI board should be commensurate with that jurisdiction’s share of the total emissions covered by the linked cap-and-trade programs.

Others share these concerns regarding WCI, Inc. The California Senate Budget Subcommittee No. 2 recommended on May 23, 2012, that provisions be included in the 2012 budget trailer bills to restrict California funding and staffing of WCI, Inc.¹⁰

IX. CONCLUSION

SCPPA urges the ARB to consider these comments and appreciates the opportunity to submit these comments to the ARB.

Respectfully submitted,

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¹⁰ The Subcommittee approved the following trailer bill language:

“1.d. The department shall provide notice to the Joint Legislative Budget Committee of any funds over \$25,000 provided to the Western Climate Initiative, Western Climate Initiative, Inc., or its derivatives or subcontractors no later than 30-days prior to transfer or expenditure of these funds.

e. No person employed by the State of California shall be a board member of the Western Climate Initiative, Inc., without approval by the California State Senate. Appointments shall be made by the Governor and subject to Senate approval.”