Electronically filed at: http://www.arb.ca.gov/lispub/comm2/bcsubform.php?listname=mrr-cpp-ct-amend-ws&comm_period=1

March 11, 2016

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Rajinder Sahota, Chief
Cap-and-Trade Program
California Air Resources Board
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Re: Comments on public workshop on potential revisions to ARB's Regulation for the Mandatory Reporting of Greenhouse Gas Emissions and the Cap-and-Trade Regulation

Dear Mr. Segall and Ms. Sahota:

On behalf of the Natural Resources Defense Council, and our more than 72,000 members in California, we appreciate the opportunity to comment on staff's proposal for aligning California's economy-wide cap-and-trade program to comply with the Clean Power Plan (CPP) and the inclusion of a federally enforceable backstop.

I. Backstop Design

ARB is proposing to comply with the CPP through California's existing economy-wide trading program pursuant to a "state measures" plan. The state must therefore include a "backstop" standard that ensures compliance with EPA targets for affected power plants (emission generating units, or EGUs) if the broader program fails to achieve the required reductions from the electric sector. California's aggressive suite of climate and clean energy policies make it very unlikely that the state's EGUs will exceed the emission limits established by EPA. But the backstop ARB proposes would likely not meet EPA's key requirement: that the backstop ensures affected EGUs as a group meet the emissions limits established by EPA.

A. ARB's proposed backstop

ARB staff proposes to create a set-aside of allowances from the post-2020 economy-wide program, equal to around 10 million metric tons, which would be available only to EGUs. If the backstop is triggered, each EGU would be required to purchase and retire a pro rata share of allowances equal to the sector's aggregate emissions that exceed the federal limit. If the set-aside is depleted, staff proposes to refill it with allowances from the Price Containment Reserve proportional to EGUs' aggregate share of emissions for the most recent compliance period.

As staff recognizes, "the backstop standard must ensure that smokestack emissions reductions from affected EGUs are achieved."[1] Staff's proposal, however, does not meet that requirement. In the unlikely event the backstop is invoked, under staff's proposal, EGUs would be required to purchase and retire allowances from the set-aside. However, those allowances are set-aside from the economy-wide emissions budget, not an emissions budget available only to affected EGUs; retiring them thus represents economy-wide emission reductions, not necessarily emission reductions from the power sector. Purchasing these allowances will impose additional cost on the emissions from the EGUs, but that alone is no assurance that EGU emissions will fall below EPA's emission limits in the future. Accordingly, staff's proposed backstop does not ensure that EGU emissions going forward would adhere to EPA's emission limits.

Compare that result to what would happen if the backstop consisted of emission limits that required EGUs to hold power sector-only allowances, and ARB created a number of power sector-only allowances equal to the EPA mass-based emission limit. In this case, mathematically, the power sector would be forced to meet EPA's mass-based emission limit. As proposed below, in order for a backstop based on an allowance set-aside to be effective, the allowance pool must represent EGU emissions.

B. Backstop recommendations

While a backstop is extremely unlikely to be invoked, if it is, it must effectively reduce EGU emissions to come into compliance with EPA's mass-based limits. In comments on the December 14, 2015 workshop, PG&E proposed a backstop that, if triggered, would separate cap-and-trade allowances into two categories in the following compliance period: 1) allowances that may only be used by EGUs in California regulated by the CPP (Category 1), and 2) allowances available to all covered entities under the economy-wide cap (Category 2).[2] In that event, EGU emissions that exceeded EPA's limit would be deducted from the quantity of Category 1 allowances available to EGUs for compliance in the subsequent period, thereby ensuring the emissions "debt" would be made up by the affected EGUs, as EPA requires.[3]

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[1] http://www.arb.ca.gov/cc/capandtrade/meetings/022416/arb.cpp.feb2016.pdf (at 2).
[2] http://www.arb.ca.gov/lists/com-attach/8-capandtradecpplan-ws-AnJcPVI2BQkBZAZp.pdf (at 9).
[3] As PG&E notes, banked allowances from previous compliance periods and offsets would also not be available for use by an EGU during the period of a backstop.

In other words, if the backstop is invoked, the number of Category 1 (EGU) allowances would be limited to the quantity equal to EPA's mass-based emission limit, minus the number of tons by which EGUs as a whole exceeded the limit in the prior compliance period. The quantity of Category 1 allowances would ensure that California's EGUs as a whole meet EPA's emission limits in the compliance period in which the backstop is invoked, minus any overage.

Taking this proposal further, if the backstop is invoked, EGUs would remain part of the economy-wide market, and could continue to trade Category 2 allowances within the broader market. However, EGUs would be able to use only Category 1 allowances to comply with the CPP's mass-based emission limits, and would be able to trade Category 1 allowances amongst themselves. As we suggested previously, ARB could continue its current allocation approach for the power sector by distributing Category 1 allowances to utilities for the benefit of customers.

ARB could also evaluate allowing EGUs to purchase allowances from other states' CPP programs, using them alongside Category 1 allowances if the backstop is invoked. If ARB allows this, it should ensure the other states' mass-based emissions limits include new sources to prevent leakage, and that the backstop applies to both new and existing EGUs in California.

While the backstop approach above would interfere with the operation of the economy-wide market in the event the backstop is invoked, the CPP unambiguously requires that the backstop standard ensure reductions come from the affected EGUs. Given the extremely low probability of the backstop ever kicking in, staff should err on the side of adhering to the CPP's clear legal requirements – and avoid setting a bad precedent – rather than attempt to balance hypothetical concerns for the economy-wide system.

II. Additional Recommendations

A. Compliance periods

We support staff's proposal to adjust the cap-and-trade program's compliance period schedule after 2020, for all sectors, to align with the compliance periods defined by the CPP.[4] While the proposed "bridge" would shorten compliance periods from 3-years to 2-years for the initial two compliance periods after 2020, the need for alignment with the CPP compliance schedule necessitates a change, and 2-year compliance periods is preferable from a flexibility standpoint than a 1-year bridge. Ensuring alignment keeps open the possibility of expanding the overall market significantly, thereby increasing flexibility and lowering costs. Moreover, the initial compliance period was shortened to two years (2013-2014) without detriment to the market, and the program retains other mechanisms – including unlimited banking and offsets – that can readily provide the flexibility needed to account for annual variations in hydro availability and other unforeseen emissions drivers. Moving temporarily to 2-year compliance periods to align with the CPP should accordingly not dictate any other program changes, such as a higher offset usage limit, that could provide more flexibility but at the expense of other objectives.

[4] 40 C.F.R. § 60.5770; § 60.5880.

B. Glide path

We support staff's inclination to set the interim CPP target at the final limit for each compliance period. As the state's modelling indicates, even under an extreme stress case (e.g., continued drought, loss of Diablo Canyon without replacement by zero emissions resources, significant electrification, etc.) California's affected EGU emissions will in all likelihood be well below the final limit in 2030.[5] And even this modelling is overly conservative in not accounting for the significant power-sector reductions that will come from the renewable energy and energy efficiency requirements in SB 350. Unlike in other states where the CPP targets will be a driver of reductions to stay on the glide path, there is no basis for California to set less stringent interim targets.

C. Allocation, Banking and Borrowing

We concur with staff's assessment that the CPP does not require changes to the cap-and-trade program's current rules regarding allocation, banking and borrowing. In particular, we agree that the CPP's prohibition on borrowing is neither aimed at nor encompasses the limited instances in which the current cap-and-trade program permits implicit borrowing from future vintage or vintage-less allowances.

Thank you for considering these comments. We look forward to engaging with staff and stakeholders to develop a compliance plan that meets the requirements of the CPP and sets a strong precedent for other states to follow.

Sincerely,

Alex Jackson
Dylan Sullivan
Noah Long

[5] http://www.arb.ca.gov/cc/capandtrade/meetings/20151214/cppmodeling.pdf (slide 21).