McCARTHY & BERLIN LLP
ATTORNEYS AT LAW
100 W. SAN FERNANDO STREET, SUITE 501
SAN JOSE, CALIFORNIA 95113

BARRY F. McCARTHY
C. SUSIE BERLIN
MICHAEL G. NELSON

Tel.: 408-288-2080
Fax: 408-288-2085
sberlin@mccarthylaw.com

Submitted Electronically via CARB's Website

January 11, 2010

Lucille Van Ommering
California Air Resources Board
1001 I Street
Sacramento, CA 95812

Re: **Comments of the Northern California Power Agency on**
Preliminary Draft Regulation for a California Cap-and-Trade Program

Dear Ms. Van Omerring:

The Northern California Power Agency[1] (NCPA) offers these comments on the *Preliminary Draft Regulation for a California Cap-and-Trade Program* (PDR), dated November 24, 2009.

With the PDR, California Air Resources Board (CARB) Staff has compiled a single document that reflects most of the elements of a cap-and-trade program that have been reviewed, discussed, and commented on by staff and stakeholders alike for many months. NCPA appreciates Staff's efforts to present this information in a concise and straightforward manner. While we understand that it is not possible to "fill in all the blanks" at this time, there are a significant number of elements of a proposed program that remain unresolved, and NCPA looks forward to the issuance of a revised Draft Regulation that addresses these items.

Before proceeding with specific comments on the PDR, NCPA restates two points that remain critically important to the effectiveness of AB 32 implementation and the use of a cap-and-trade program. First, California's cap-and-trade program must be viewed in concert with the State's ***entire*** emissions reduction strategy, which is laid out in the CARB Scoping Plan.[2] As the

1 NCPA members include the cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, and Ukiah, as well as the Bay Area Rapid Transit District, Port of Oakland, the Truckee Donner Public Utility District, and the Turlock Irrigation District, and whose Associate Members are the Plumas-Sierra Rural Electric Cooperative and the Placer County Water Agency.

2 *Climate Change Scoping Plan, a Framework for Change,* December 2008, prepared by the California Air Resources Board.

PDR notes, the objective is to design a "broad-based multi-sector cap-and-trade program that will work **with the complementary measures** to reduce emissions to meet the 2020 statewide limit as required by AB 32."[3] Accordingly, the implications associated with compliance with complementary measures in conjunction with participation in a cap-and-trade program cannot be dismissed when considering the overall effects of the proposed cap-and-trade program.

It is also equally important to note that while many see the cap-and-trade program as a key element to attaining the goals of AB 32, it does not account for the majority of the State's emissions reductions and represents just one of many options presented in the Scoping Plan. AB 32 still requires that any market-based program be shown to be a cost-effective and feasible means by which to achieve the mandated reductions. Such a determination is still pending, and the initial economic analysis is still undergoing review and updating, and has yet to be finalized. Further, linkage between other programs, particularly those jurisdictions within the Western Climate Initiative (WCI), must be more fully developed in order to ensure a robust program. Additionally, the concerns associated with market enforcement cannot be trivialized or ignored. The potential for abuse is huge, and because the cap-and-trade program impacts such a large and vital part of California's economy – especially in the first compliance period – the ramifications of adverse markets will result in catastrophic losses for an already floundering economy.

Notwithstanding these concerns, NCPA offers these comments on the PDR in the interest of moving the process forward and continuing the work undertaken by Staff and stakeholders towards developing the best possible program for California's residents and business and meets the lofty and worthy objectives of AB 32 in the event that the cap-and-trade regulation is adopted and implemented by the Board.[4]

COMMENTS ON SELECT PROVISIONS OF THE PROPOSED DRAFT REGULATION[5]

SUBARTICLE 3. APPLICABILITY

§ 95840 Opt-In Participants

The inclusion of opt-in participants creates complications for the program that are not adequately addressed in the PDR. As a practical matter, an opt-in[6] entity does not otherwise have a compliance obligation under the regulation, which means that they are participating in the market for other reasons. While not inherently wrong, such participation creates significant

3 PDR, Overview, p. 3, emphasis added.

4 These comments are not intended to address every aspect of the PDR and the lack of comment on any portion of the PDR should be taken as neither concurrence nor disagreement with other portions of the document.

5 For ease of reading, rather than being listed by priority, the comments on the provisions of the PDR are raised in the order they are presented in the proposed regulation.

6 § 95802(105): "'opt-in participant' means an entity that does not have a surrender obligation under this article but wishes to participate in the market and to be willing to subject to the requirements set forth in this article."

market power and market manipulation potential, and could have adverse impacts on compliance entities. The general economic theory is that more market players will lower costs; however, that is not necessarily the case here. For example, even those with the most altruistic intent and the financial means to affect their intent to simply retire emissions could wreak havoc on the price of available allowances for those that need them for a compliance obligation. There need to be restrictions beyond the high level limitations articulated in § 95840(b) placed on opt-in participants, so that entities with a compliance obligation are not adversely impacted.

SUBARTICLE 4. COMPLIANCE INSTRUMENTS

§ 95850 Compliance Instruments Issued by the Air Resources Board

Allowances and offsets credits properly represent authorization to emit one metric ton of CO_2e. While the compliance instrument is issued in accordance with the provisions of this article, the authority of the Executive Director to limit or terminate the use of the compliance instrument (§ 95859(c)) must be expressly set forth in the regulation, and must only be allowed for cause.

§ 95860 Compliance Instruments Issued by Approved External Greenhouse Gas Emissions Trading Systems

A California-only cap-and-trade program is simply not as viable as a regional program. This fact has been widely acknowledged throughout both the AB 32 implementation process and the WCI development process. Indeed, AB 32 encouraged linking with other programs[7] and the Scoping Plan recommends that the California cap-and-trade program would ideally be linked with the WCI program.[8] Accordingly, this Subarticle should include language that explicitly provides that WCI partner jurisdiction allowances will be treated equivalently in all partner jurisdictions that have adopted the WCI Design Principles to the same extent as California.

SUBARTICLE 5. REGISTRATION AND TRACKING SYSTEM

§ 95870 Registration and Tracking System

In general, California's cap-and-trade regulation should comport with the principles developed and adopted at the WCI, where California has been an active participant. California should continue to work on its own system in concert with its WCI partners, rather than developing a unique, stand-alone system that would need to be modified at a later (and ideally

7 Health and Safety § 38564: The state board shall consult with other states . . . and to facilitate the development of integrated and cost-effective regional . . . programs.

8 Scoping Plan, Appendices, Volume I, page C-11: "Recommended Actions: California Cap-And-Trade Program Linked to Western Climate Initiative."

not-too-distant) time when the California program in fully integrated with a regional program. It is important for the viability of a robust cap-and-trade program to be able to trade amongst a broad range of partners. In order to ensure a seamless transition to a multi-jurisdictional program, the registration and tracking system should be regional, and not unique to each partner jurisdiction.

At a minimum, CARB should ensure that the registration dates and intervals (§ 95870(b)) closely comport with those envisioned by WCI. Additionally, as will be more fully addressed below, ministerial tasks charged to the Executive Director must be carried out in a timely fashion (*e.g.*, approval of an entity's registration and creation of a holding account (§ 95870(c)) and all areas where the Executive Director is given discretion to act must be fully defined and based on established criteria (e.g., restrictions placed on the holding account of a covered entity under § 95870(e)).

SUBARTICLE 6. CALIFORNIA GREENHOUSE GAS ALLOWANCE BUDGETS

§ 95890 Annual Base Allowance Budget for Calendar Years 2012-2020

NCPA urges CARB to present draft language with details regarding the establishment of individual allowance budgets for the initial compliance period as soon as possible. This information should also include an analysis of how the numbers will differ under a WCI-based program. As noted herein, integration with a regional cap-and-trade program is going to be crucial to the success of California's program, and all aspects of California's program should be developed in this context.

§ 95910 Modifications to the Annual Base Budget

§ 95910(a) Administrative Adjustments: NCPA supports the discussion of administrative adjustments and the further development of criteria and processes by which to undertake such adjustments. The need for such mid-term adjustments is clearly evidenced by the drastic changes in the numbers presented in modeling already conducted and the fact that the initial business as usual (BAU) case as anticipated when the Scoping Plan was first released is much different from a BAU case that would be constructed today. Furthermore, ideally, the WCI cap-and-trade program will be a part of a California-only program from the onset, and the opportunity for ever expanding regional partners will further necessitate the need for additional changes. That said, adjustments should never occur within the midst of the 3-year compliance period as compliance entities will have made strategic resource decisions designed for this time period.

§ 95910(b) Adjustments for Voluntary Investments in Renewable Electricity Generation: Investments in renewable electricity generation should be recognized in some manner. However, at this time, it is premature to reduce the overall amount of emissions allowances based on such investments, especially if the adjustment for such investments is not limited to the allowance budgets of compliance entities. The notion of measuring renewable electricity in terms of a GHG metric is currently being discussed in the context of the Renewable Electricity Standard (RES) proceeding at CARB. While it is important to recognize and encourage investments of all kinds in technologies that reduce GHG emissions and help California achieve the goals of AB 32, it is prudent to address this issue in the context of the RES proceeding.

SUBARTICLE 7. SURRENDER REQUIREMENTS FOR COVERED ENTITIES

§ 95920 General Requirements

The record retention requirement of 10 years is excessive (§ 95920(b)). Once compliance has been certified, associated records should not have to be retained for more than one additional compliance period. Additionally, § 95920(c) requires that records be retained at the covered entities designated place of business. In addition to being inconsistent with the requirements already mandated in the Mandatory Reporting Regulations, this requirement is problematic in light of today's document storage technologies that employ not only physical retention of documents at offsite storage facilities, but also utilize document management systems which may be hosted in other states altogether. These additional administrative burdens are unnecessary and cost prohibitive, and should be removed from the draft regulation.

§ 95930 Duration of Compliance Period

NCPA supports a three-year compliance period. In the *Discussion of Concept*, the PDR seeks comments on the interaction between the issuance of allowances, reporting, verification, and surrender of compliance instruments. The compliance cycle proposed in the PDR should be retained. The three year compliance cycle is one of the most important flexible compliance and cost control mechanisms available to a compliance entity. Requiring the surrender of compliance instruments at regular intervals during the compliance period effectively negates these benefits. The three-year compliance cycle proposed in the PDR should be retained.

§ 95940 Phase-in of Surrender Obligation Covered Entities

The cap-and-trade program should accelerate the inclusion of fuel deliverers to be part of the initial compliance period commencing in 2012. As proposed, the "narrow source" that will be part of the initial compliance period would bear the burden of the entire cap-and-trade program, without the benefit of the majority of the emissions contemplated for inclusion under the program. Accordingly, rather than phase-in the "broad scope" sources in the second compliance period, in order to fully capture the benefits of a cap-and-trade program for all market participants and to avoid adversely impacting those few that are subject to the first compliance period, fuel deliverers should be included in the onset of the program. The two stage compliance period puts an unnecessary burden on the first compliance group to incur additional expense and administrative compliance costs that will benefit future compliance groups as "lessons learned." It is not equitable to place the entire burden of the learning curve on the first compliance group.

§ 95960 Timing for Calculation of Covered Entity's Surrender Obligation

In the *Discussion of Concept,* Staff presents two separate options to address concerns that have been raised regarding instances where a compliance entity may declare bankruptcy. While the concern is certainly not trivial, the options presented – either surrendering a specified number of allowances during each year or moving to a single-year compliance period – do not appear to be viable solutions. As discussed above, mandating the surrender of compliance instruments at intervals during the compliance period (essentially the equivalent of a single-year compliance period) effectively eliminates one of the few flexible compliance tools available to compliance entities. Additionally, single-year compliance periods simply do not take into account the vagrancies and market fluctuations that compliance entities are sure to face. Imposing onerous restrictions on viable entities is not going to reduce the likelihood that some entities will fail to surrender the proper amount of compliance instruments.

The risk of bankruptcy is an enforcement risk and not a compliance risk, and accordingly, altering the compliance structure is not an effective means of reducing such a risk. CARB is well positioned to seek specific remedies from individuals who fail to adhere to their compliance obligations. Other options should be explored, such as provisions that take compliance instruments owned at the time of bankruptcy outside of bankruptcy protection for entities with an outstanding compliance obligation. Similarly, CARB can seek to require some financial guarantees from entities that have demonstrated that they are not creditworthy. NCPA believes that these and other options are viable and looks forward to working with Staff to explore such mechanisms that can be employed to address CARB's concerns without unduly restricting the program or eliminating valuable flexible compliance and cost control mechanisms.

§ 95970 Quantitative Usage Limit on Designated Compliance Instruments

One essential element of the PDR that has yet to be more fully developed is the cost implications and economic impacts associated with the cap-and-trade program. The quantitative use limit of four percent offset credits effectively removes the use of offsets as a viable cost containment tool within the cap-and-trade program. NCPA concurs with the recognition of an offset credit synonymously with an emissions allowance, and with the ability to trade and surrender allowances and offsets in a like manner and with an equivalent value. However, NCPA is concerned that the 4% cap on the use of offsets by an individual entity, especially at the beginning of the program, could be unduly restrictive and hinder attainment of emissions reduction goals as well as the development of innovative offset projects.

SUBARTICLE 8. DISTRIBUTION OF ALLOWANCE VALUE

The PDR includes placeholders for receipt of information from the Economic & Allocation Advisory Committee (EAAC). It is important to note that not only stakeholders, but the State's energy regulatory agencies have expended considerable time and resources reviewing this issue and looking specifically at the impacts unique to the electricity sector. NCPA urges

CARB to carefully review all of the materials developed over the last two years regarding allowance allocation and the electricity sector when compiling this section of the draft regulation, including the Waxman-Markey bill, H.R. 2454,[9] which passed the House of Representatives last year and S.1733,[10] a bill that passed out of Senator Boxer's Committee, all of which recommend administrative allocation of allowances. NCPA also urges CARB to take these recommendations into account and include an administrative allocation of allowances to retail electricity providers as part of its allocation scheme, including the details regarding such distribution in Subarticle 10.

While the recommendations of the EAAC should be reviewed by CARB, the agency should not view this as the only recommendation on this issue. Indeed, the efforts of the EAAC, while extensive in several regards, were limited in many respects. Most notably, EAAC recommendations on allowance allocation are being submitted in advance of any analysis that addresses the economic impacts on compliance entities. Additionally, the recommendations are based on a review of the cap-and-trade program in isolation, not in concert with other emission reduction measures mandated in the Scoping Plan. These analytical shortcomings significantly skew conclusions reached about the expected impacts on entities already subject to many additional compliance obligations under the Scoping Plan and the electricity sector in particular.

The PDR states that free allocation mechanisms generally are based on the assumption that the free allocation is being done primarily to "compensate covered entities." As it pertains to the electricity sector, this is a gross misrepresentation. The electric sector is responsible for about 25 percent of California's greenhouse gas emissions, but the Scoping Plan proposes that approximately 40 percent of the emission reductions be obtained through programmatic measures undertaken by electric utilities and their customers. Many of these complementary measures, such as the procurement of additional renewable energy resources, are projected to be expensive. The associated investments in transmission, energy storage, and smart grid technology will also be costly. Electricity ratepayers – individuals and businesses across the State – will need to pay these costs without an equivalent allocation of allowances or allowance values to electricity providers. Even with a free allocation of allowance value, electricity costs will increase for consumers, since the sector is disproportionately impacted by the CARB program. The proposed allowance return to the electricity sector does not begin to adequately cover the expense this sector will incur in meeting the requirements of AB 32, but can be used to further the objectives of AB 32 in cost-effective and well established ways.

Further, any allocation scheme must recognize the importance of using allowances and allowance value in a manner that maximizes the ability of the State and affected entities to meet the goals of AB 32. The three primary claims on allowance value identified by the EAAC process do not entirely allow for this, especially in the proportions being preliminarily recommended in the EAAC process. Indeed, a dividend or tax refund to the general public will

9 2009-2010 (111th Congress), American Clean Energy and Security Act of 2009.

10 2009-2010 (111th Congress), Clean Energy Jobs and American Power Act, September 30, 2009, introduced by Senators Kerry and Boxer.

do little or nothing to advance the goals or AB 32, nor address the AB 32 related costs incurred by the economy as a whole not directly linked to the "price signal" of carbon.

NCPA will offer more detailed comments regarding allowance allocation once CARB completes this section of the draft regulation. In the interim, NCPA looks forward to reviewing the final EAAC recommendations which it is hopeful will reflect the comments submitted jointly by utilities approximately 100% of California's retail electric load,[11] and working with Staff and other stakeholders in the development of this section of the regulation in the coming months.

SUBARTICLE 9. AUCTION DESIGN MECHANISMS FOR DISTRIBUTING AUCTION PROCEEDS

Cost Containment

Cost containment measures must be a part of California's cap-and-trade program. Compliance entities must be able to meet their compliance obligations while continuing to carry on their businesses. This is especially true in the electricity sector, where retail electricity providers must provide safe and reliable electricity to customers while at the same time comply with the emissions reduction measures set forth the Scoping Plan, including participation in the cap-and-trade program. NCPA is pleased that the PDR discusses cost containment measures, but feels that the limited discussion should be expanded to cover additional options.

Reserve Account: Creation of a reserve account should not be used as a cost containment tool. First of all, in order to fund the reserve account some allowances would need to be held in abeyance, which will create an immediate shortage in allowances and contribute to allowance price variations. Additionally, the use of a reserve account has only limited cost containment benefits, and no direct correlation to the entities actually faced with compliance difficulties.

Increased Use of Offsets: Offsets create emissions reductions; they have the added benefit of providing flexible compliance and cost containment. NCPA strongly encourages CARB to consider allowing entities to use offsets beyond the four percent threshold currently being proposed.

Expanded Offset Projects: Unless the list of expanded offset projects meets all of the prescribed criteria, it should not be considered, even for cost containment purposes. The integrity of the program must be preserved, and if compliance entities are allowed to invest in and use a reasonable number of offsets (increased quantitative limits) to achieve

11 See January 8, 2010 letter from Bear Valley Electric Service**,** Modesto Irrigation District, Mountain Utilities, Northern California Power Agency, Pacific Gas & Electric Company, PacifiCorp, Sacramento Municipal Utility District, San Diego Gas and Electric Company, Sierra Pacific Power Company, Southern California Edison Company, and Southern California Public Power Authority to the Economic and Allocation Advisory Committee.

real reductions, there is no need to compromise the program by lessening the quality of the kinds of offsets authorized.

Borrowing: As a cost containment mechanism, borrowing from future compliance periods should be allowed. This gives compliance entities the flexibility to meet short term needs with future allowances without jeopardizing their ongoing businesses or the State's overall objectives. This strategy is complimentary to the proposed three-year compliance window and should be utilized.

Soft Price Floor: The use of an auction reserve price floor as a cost containment tool should be further explored and developed for discussion in the draft regulation.

SUBARTICLE 10. FREE ALLOCATION MECHANISM

As discussed more fully under Subarticle 8 above, allowances should administratively allocated to retail electricity providers to be used for the benefit of their customers and for the carrying the provisions of AB 32. NCPA looks forward to working with CARB staff to fully develop these provisions of the draft regulation regarding the free allocation of allowances.

SUBARTICLE 11. TRADING AND BANKING

§ 96080 Trading

As discussed above, the inclusion of opt-in participants can be problematic and must be closely monitored. In § 96080(c), the PDR discusses restrictions on market participants and notes that the CARB Executive Director may impose restrictions on the number of compliance instruments that may be owned by opt-in participants or covered entities that have violated market rules. NCPA recommends that the draft regulation be expanded to provide additional restrictions on the number of allowances that can be owned by opt-in registrants, and that their participation in the market be banned, rather than restricted, in the event of malfeasance.

Market Oversight

This Subarticle contains several provisions regarding the conduct of parties and the oversight of the Executive Director over the actions and conduct of individuals with surrender obligations, but it is devoid of substantive discussion on true market oversight. The *Discussion of Concept* notes that CARB's ability to review information on "exchange trading of secondary and derivative products is *likely to be sufficient* for monitoring trades in those venues."[12] However, it is not clear that such information will be sufficient – or sufficiently monitored – to prevent abuses from occurring.

12 PDR, p. 52, emphasis added.

NCPA requests that a robust market monitoring system be put into place, one that can be aligned with the WCI, one that provides access to information regarding bilateral trades and non-exchange traded derivatives. NCPA concurs with the observation that something more needs to be done to track and monitor such transactions and looks forward to working with Staff and Stakeholders to develop more rigorous market oversight, including the potential for transaction disclosure rules for bilateral trades.

§96090 Banking

NCPA supports the banking of allowances for use in a future compliance period.

SUBARTICLE 12. LINKAGE TO EXTERNAL TRADING OR OFFSET CREDITING SYSTEMS

As noted above, the California-only cap-and-trade program is likely to be much less robust or cost-effective than a regional program. Efforts should be taken to ensure that California's program can link with the WCI program from the onset. Further, the PDR properly notes that linkage to any other programs must meet minimum standards in order to ensure the integrity of the California program.

SUBARTICLE 13. OFFSETS CREDITS

Within the electricity sector, the use of offsets can help control costs, and further the development of offset and GHG emission reduction programs and measures that likely would not otherwise be advanced at this time. Real and viable offset programs will require considerable time and capital investments, and unduly restrictive limitations will forestall or impede the development of such projects. Accordingly, NCPA supports the adoption of regulations that recognize these elements of developing offset projects. Additionally, in order to encourage the continued development of offset projects, restrictions should not be placed on the offset credit program in later years. As time passes, current offset projects will become part of the State's mainstream emissions reduction options, while at the same time, new technologies and new projects that do result in real, permanent, quantifiable, verifiable, and additional emissions reductions will continue to be developed. California should not create a program which inadvertently limits or inhibits the advancement of such emissions reduction alternatives.

SUBARTICLE 14. ENFORCEMENT AND PENALTIES

It is imperative that the enforcement of the program be comprehensive and transparent, and that penalties be fairly assessed and administered. NCPA is encouraged to see that the *Discussion of Concept* in Subarticle 14 addresses the fact that CARB is looking further into developing these provisions. NCPA offers the following important factors for consideration in the further drafting of penalty and enforcement provisions for the draft regulation:

> *Executive Director Discreti*on: In this section, and throughout the PDR, the Executive Director is given considerable discretion. While it is clear that the Executive Director should have discretion to direct and monitor the program, conduct should be based on clearly defined and articulated guidelines made clear to all compliance entities. Those guidelines must be referenced in the final regulation.
>
> *Penalties*: It is simply insufficient to say that "penalties may be assessed pursuant to Health and Safety Code § 38580." (§ 96503) Specific language should about what the penalties are and how they are determined must be included in the regulation. Parties should be afforded a view of the due process and penalty structure they may face for failure to comply with the new regulations. Insight into the penalty structure will help send a clear signal to participants about what is expected and how to avoid the additional cost of penalties. The development of such language should be addressed in a public forum,
>
> *Calculation of Monetary Penalties*: In the event that monetary penalties are assessed, the penalty calculation metric should be included in the regulation. Furthermore, the calculation and determination of the penalty should be crafted to deter non-compliance by removing any economic benefits of non-compliance, but not to be so onerous as to preclude the ability of a compliance entity to pay the fee and continue meeting future compliance obligations, especially in the event of a showing of no malfeasance or negligence on the part of the compliance entity.
>
> *Surrender Obligation*: The surrender of additional allowances, rather than monetary penalties, could adversely impact not only the non-complying entity, but all other compliance entities within the same compliance period by reducing the number of compliance instruments available for surrender. Such an outcome should be avoided.
>
> *Calculation of Separate Violations/Transactions*: As with the determination of appropriate penalties and the calculation of monetary penalties, the determination of separate violations/transactions should be included in the regulation. Such a calculation should also take into the account the practical implications and limitations associated with the violation at issue.

CONCLUSION

The PDR, which reflects extensive Staff efforts and stakeholder input, is a good first step in the process of developing the written document that will guide the State in a brand new program. NCPA appreciates the opportunity to provide these comments on this preliminary first step and to continuing to work with Staff and stakeholders to further explore the issues raised in the PDR and to develop the concepts still unresolved. If you have any questions regarding these comments, please do not hesitate to contact the undersigned or Scott Tomashefsky at 916-781-4291 or scott.tomashefsky@ncpa.com.

Sincerely,
MCCARTHY & BERLIN, LLP

C. Susie Berlin
Attorneys for the Northern California Power Agency