BEFORE THE
AIR RESOURCES BOARD
OF THE
STATE OF CALIFORNIA

SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON PRELIMINARY DRAFT REGULATION

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SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY
COMMENT ON
PRELIMINARY DRAFT REGULATION

The Southern California Public Power Authority ("SCPPA")[1] respectfully submits this comment on the November 24, 2009 Preliminary Draft Regulation ("PDR"). This comment focuses on Subarticles 2 through 14 of the PDR. To facilitate the Air Resources Board ("ARB") staff review of these comments, the comments follow the organization in the PDR. Thus, the points raised in the comments are not necessarily presented in order of importance.

I. SUMMARY OF KEY POINTS

A. Baselines Should Not Be Set Below Conservative Business as Usual Levels.

Statements in Subarticles 2 and 13 indicate that baselines for calculating "additional" emission reductions should be set below business as usual levels. The requirement to set conservative baselines should be sufficient to address issues such as leakage- without taking the additional step of setting baselines below conservative business-as-usual levels or discounting emission reductions even after they are below the baseline.

B. Compliance Instruments Should Constitute Property.

Compliance instruments should constitute property to provide greater levels of confidence in the new carbon market and to prevent the suspicion that the regulator may cancel compliance instruments without compensation to the holders of the instruments.

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[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, Imperial Irrigation District, Pasadena, and Riverside.

C. The 2012 Budget Should Be Set on the Basis of Best Estimate of Expected Annual Emissions from Covered Sources in 2012.

The setting of the emissions budget at the start of the program is important and should be clearly addressed in the Regulation. The ARB should follow the WCI Design Recommendations that the 2012 emissions budget should be set at the best estimate of expected annual emissions from covered sources in 2012. If this estimate materially changes in the period between the adoption of the Regulation and the start of the program or if the scope of covered sources is expanded, the budget should be adjusted accordingly.

The budget may also need to be adjusted if an external cap-and-trade program is linked to the California program, or if the proposed “soft” price collar mechanisms do not succeed in avoiding price extremes.

Specific detailed criteria should be included directly in the Regulation identifying the circumstances that would trigger an administrative adjustment to the base allowance budgets and the extent of the adjustment that would be made. Providing the detailed criteria in the Regulation will help to provide regulatory certainty.

D. Record Retention and Production Requirements Should Be Modified.

The proposed 10 year record retention requirement is unreasonably long. Covered entities should be required to retain records only until the end of the compliance period following the one to which the records relate.

The proposed 15 calendar day time period to produce records upon request is unreasonably short, particularly if the request is received just prior to a holiday period. The period should be extended to 20 working days, which would be consistent with the Mandatory Reporting Regulation (“MRR”) in Article 2.

E. Compliance Periods Should Remain 3 Years.

A compliance period should remain 3 years rather than being reduced to 1 year to retain

the valuable flexibility offered by a 3-year period. However, a covered entity could be required to meet a proportion of its compliance obligation each year to reduce the risk of the emissions cap not being met due to bankruptcy of a covered entity.

F. Fuel Deliverers Should Be Included in the Cap-and-Trade Program in 2012.

Fuel deliverers should be included as covered entities in the California program in 2012 rather than 2015 to avoid the risk of a federal moratorium that would prevent their inclusion in 2015, to avoid their emissions increasing between 2012 and 2015, and to increase the liquidity of the market.

G. Surrender Obligations for Transport Fuels Should Be Calculated on the Fuels' Carbon Content.

Calculating surrender obligations on the basis of net carbon content of transportation fuels (with no obligation on biofuel deliverers) would be administratively simpler than the alternative method of using the lifecycle carbon intensity of each fuel, would be consistent with how the emissions of covered entities are treated, and would avoid duplicating the Low Carbon Fuel Standard program.

H. Use of High-Quality Offset Credits Should Be Unlimited.

The proposed 4 percent limit on the use of offset credits would not be sufficient either to extend significant benefits from emission reduction projects to developing countries or to act as a cost control mechanism for California. High quality offset credits should be permitted to be used for compliance purposes without restriction, following the precedent of the Australian and New Zealand emissions trading systems.

Certified Emission Reductions ("CERs") under the Clean Development Mechanism of the Kyoto Protocol ("CDM") should be regarded as being high-quality offset credits due to the strict and detailed approval requirements for issuance of CERs.

I. If the Use of High Quality Offset Credits Is to Be Limited, the Limit Should Be Beyond 4 Percent.

As a second (and less preferred) option, the proposed 4 percent limit on the use of offset credits should be at least doubled to align more closely with the limits in other cap-and-trade programs. In addition, the limit should be increased if the price of allowances at auction exceeds a specified level. Further, the offset limit for one compliance period should be increased if the maximum allowed number of offset credits was not surrendered in the previous compliance period.

J. The Strategic Reserve Should Be Supplemented with Offset Credits.

If the ARB fails to permit the unlimited use of high quality offset credits, other cost containment mechanisms become increasingly important. A strategic reserve of allowances (those not sold due to auction prices being below a price floor) may be insufficient to check higher prices at a later stage, unless offset credits are also deposited into the strategic reserve.

K. Allowances Should Be Allocated to Electric Utilities.

A portion of the allowances should be administratively allocated to regulated electric utilities to support the disproportionately extensive and costly emission reductions that the Scoping Plan requires of the electricity sector and to smooth the transition to low carbon resources. The administrative allocation of allowances to regulated electric utilities could be made to be consistent with having a robust auction of all allowances for price discovery purposes if he administratively allocated allowances were auctioned for the accounts of the electric utilities to whom the allowances were allocated, with auction revenues being returned to the electric utilities in proportion to the administrative allocation,.

L. Requirements for Linking to Other Cap-and-Trade Programs Should Be Less Restrictive.

Very few external cap-and-trade programs would satisfy the proposed requirements for

linking. The requirement that the other program have a similar limit on the use of offset credits should be removed, unless the offset credit limit in the Californian program is significantly expanded.

M. ARB Should Ensure Sufficient Resources Are Available to Administer its Offset Program.

The review and verification procedures relating to offset programs are extensive. The ARB should avoid the risk of bottlenecks and delays in issuing offset credits by ensuring sufficient numbers of qualified personnel, or approval external entities, are available to conduct these procedures.

N. The Enforcement and Penalties Subarticle Should Be Revised.

An appeal process should be available to compliance entities penalized for incorrect reporting and consequent under-surrender of compliance instruments. Per-day penalties for technical reporting errors are not appropriate in the early stages of the program (considering that these reporting penalties are likely to be accompanied with penalties per missing compliance instrument). While missing compliance instruments must be provided, no multiplier should be applied to the missing instruments. Financial penalties for missing instruments should be proportional to, though somewhat greater than, the market value of the compliance instruments.

II. SUBARTICLE 2, PURPOSE AND DEFINITIONS (PDR at 5-24).

A. Definition of Activity Baseline.

The definition of "activity baseline" is excessively restrictive. The definition reads as follows:

> "Activity baseline" means, in the context of an offset project or activity, the scenario that reflects a conservative estimate of business-as-usual performance or activities for the relevant type of activity or practice such that the baseline provides an adequate

> margin of safety to reasonably calculate the amount of GHG reductions in reference to such baseline.

PDR at 5. Requiring that the baseline provide "an adequate margin of safety" implies that emissions reductions that would be realized from an offset project or activity would be uniformly discounted by a set "margin of safety" discount factor even though the activity baseline would already reflect a "conservative estimate of business-as-usual performance of activities for the relevant type of activity or practice…."

Requiring that any estimate of business as usual performance or activity should be "conservative," defined as meaning "utilizing quantification parameters, assumptions, and measurement techniques that minimize the risk of overstating GHG reductions, avoidances or sequestration credited for a given offset project," should be enough. PDR at 5.SCPPA urges staff to reconsider the merit of applying the uniform discount factor for emission reductions that are calculated by reference to a conservative activity baseline.

B. Definition of Market Index.

"Market index" is defined as meaning "any published index of quantities and prices based on results of market transactions." PDR at 14. This definition is too vague and could be misinterpreted. For example, indices can use different averaging periods. SCPPA recommends that the ARB establish a set formula for establishing the market index in order to provide consistent market information.

C. Definition of Reasonable Assurance.

"Reasonable assurance" is defined as meaning "a high degree of confidence that submitted data and statements are valid." This term is included in the Definitions section of Subarticle 2, but is not found in the body of the Article 5 Regulation. The definition is too vague and should be deleted or refined.

D. Capitalize Defined Terms.

As a general observation about definitions, it would be helpful for the staff to capitalize defined terms as they are used throughout Article 5 to alert readers to the presence of defined terms. For example, the definition of "activity baseline" in Section 958.2, definitions, uses the terms "conservative" and "margin of safety" without any capitalization even though they are defined terms. Thus, the reader is not alerted to the fact that the terms are defined terms and, as such, have special meanings that should be taken into account.

E. Include Additional Definitions.

It would be helpful if the staff would review the proposed Article 5 for terms that may need definition. For example, in the definition of "California greenhouse gas emissions allowance" the staff uses the phrase "1 metric ton of $CORR_2$" without defining the term "$CORR_2$." Also, there are terms which one might assume would be defined terms but which are defined in the body of the Regulation. Two examples are the term "Electricity Deliverers" and "Natural Gas Deliverers," both of which are defined in Section 95820 of Subarticle 3. Other examples are the terms "Initial Surrender" and "Final Surrender."

III. SUBARTICLE 3, APPLICABILITY (PDR AT 24-28).

Section 95830 sets forth the inclusion threshold for covered entities. Under 95830(a) the threshold for operators of facilities, electricity deliverers, or fuel deliverers to be classified as a "covered entity" as of a given date or year is 25,000 metric tons CO_2e. PDR at 27. The 25,000 ton threshold is the same as the threshold in the proposed Australian cap and trade program ("Australian ETS"). SCPPA supports the proposed threshold.

By contrast, the Regional Greenhouse Gas Initiative ("RGGI"), the European Union emissions trading scheme ("EU ETS") and the New Zealand emissions trading scheme ("New

Zealand ETS") prescribe participation in their emissions trading programs by type of facility (e.g., power generators) and in some cases also by reference to the production capacity of the facility. The United States Climate Action Partnership ("USCAP") January 29 Blueprint for Legislative Action ("Blueprint") recommended that the threshold for being a covered entity should be 25,000 metric tons per year for *existing* facilities but 10,000 metric tons for *new* facilities:

> Large stationary sources should be defined as facilities that emit a covered GHG at a CO_2 equivalency rate of 25,000 metric tons or more per year for existing facilities and 10,000 metric tons or more per year for new facilities.

USCAP Blueprint at 7.

SCPPA considers that the 25,000 ton emissions threshold is to be preferred as being simple to administer and transparent. It is particularly preferable to the USCAP proposal. SCPPA is not aware of another program that proposes a lower emission threshold for new facilities. A lower emission threshold for new facilities may disadvantage new entrants as compared to existing facilities.

IV. SUBARTICLE 4, COMPLIANCE INSTRUMENTS (PDR AT 28-29).

Section 95850(c) provides: "A compliance instrument issued by the Executive Officer does not constitute any form of property or confer any property rights." PDR at 29. The term "compliance instrument" is defined in §95802 as follows: A "compliance instrument" means an allowance or offset credit. Each compliance instrument can be used to fulfill a surrender obligation equivalent to up to one metric ton of CO_2e." PDR at 9. Thus, the provision in Section 95850(c) stating that a "compliance instrument issued by the Executive Officer does not

constitute any form of property or confer any property rights" means that allowances or offset credits as issued by the Executive Officer would not constitute property.

This is similar to the position under the EU ETS. By contrast, the proposed Australian ETS explicitly provides that an allowance constitutes personal property and thus cannot be extinguished by the government without payment of compensation. This decision was made on the grounds that if allowances did not constitute property and could be extinguished by the government without compensation, this would:

> reduce the demand for permits with 'vintages' beyond the current year because of the risk that those permits could be cancelled without compensation. This may hamper the emergence of a forward price for permits, reducing the carbon price information available to firms making decisions about how to manage their emissions, and to investors in low-carbon technologies. It could also reduce confidence in a credible government commitment to the Scheme's long-term operation.

Carbon Pollution Reduction Scheme: Australia's Low Pollution Future, White Paper, December 2008 ("Australia White Paper", available at http://www.climatechange.gov.au/publications/cprs/white-paper/cprs-whitepaper.aspx), at 8-4.

On this basis SCPPA recommends that the ARB reconsider its position that compliance instruments should not constitute property.

V. SUBARTICLE 5, REGISTRATION AND TRACKING SYSTEM (PDR AT 30-31).

Subarticle 5 should be expanded to clarify how the Holding and Compliance Accounts will operate, to identify the "operator" of the California Cap-and-Trade Market Tracking System, and to explain how allowances or offset credits that are issued by linked systems such as those of the WCI Partners will be accommodated within the scheme of Holding and Compliance accounts.

A. Operation of Holding and Compliance Accounts.

Subarticle 5 introduces the concept of "Holding Accounts" and "Compliance Accounts." It appears from Section 95870(d) that there will be Holding and Compliance accounts for individual registered entities:

> (d) *Creation of Holding and Compliance Accounts*
>
> (1) When the Executive Officer approves registration for an entity qualifying as an opt-in participant under Section 95840(a), the operator of the California Cap-and-Trade Market Tracking System will create a Holding Account for the registered entity.
>
> (2) When the Executive Officer approves registration for a covered entity or an entity qualifying as an opt-in participant under Section 95840(a)(1), the operator of the California Cap-and-Trade Market Tracking System will create a Compliance Account for the registered entity.

PDR at 30-31. However, there will also be a Holding Account and a Compliance Account which are separate from the Holding Accounts and Compliance Accounts of individual registered entities. Section 95870(f) provides for these accounts which will be under the control of the Executive Officer:

> (f) *Accounts Under the Control of the Executive Officer*
>
> The operator of the California Cap-and-Trade Market Tracking System will create and maintain the following accounts under the control of the Executive Officer:
>
> (1) A Holding Account containing the serial numbers of compliance instruments to be distributed by the Executive Officer; and
>
> (2) A Compliance Account to which compliance instruments will be transferred to be retired by the Executive Officer

PDR at 31. Section 95870 should be expanded to specify how and under what conditions compliance instruments will be moved from the Executive Officer's Holding Account to Holding Accounts for registered entities and to specify how and under what conditions compliance

instruments that are contained in the Compliance Accounts of registered entities will be moved into the Compliance Account of the Executive Officer.

B. Operator of Tracking System.

There needs to be a definition either in Subarticle 5 or in Section 95802, Definitions, to identify the "operator" of the California Cap-and-Trade Market Tracking System. The "California Cap-and-Trade Market Tracking System" is defined as being "an information system to support the California Air Resources Board's implementation of this article, including recording of transactions, allowance and offset credit issuance and retirements, and compliance evaluation." PDR at 7. If the operator of the "California Cap-and-Trade Market Tracking System" is going to be an entity other than the ARB, there should be a section in Article 5 that identifies the operator and delineates the extent of the operator's authority with an exceptionally high degree of specificity. The failure of the PDR to contain any information about the potentially powerful but murky "operator" is a significant gap in the PDR that should be filled in the next iteration.

In line with other cap and trade systems, SCPPA considers that the market operator should be a non-political entity, independent of the entity that makes decisions on emission reduction targets.

C. Treatment of Allowances and Offset Credits from External Programs.

There needs to be an explanation about how allowances or offset credits that are issued by linked systems such as those of the WCI Partners will be accommodated within the scheme of Holding and Compliance accounts. On its face, the scheme of Holding and Compliance accounts that are set forth in Subarticle 5 appears to be coherent only if one assumes a California-only emission trading scheme in which the only instruments are those that are created or issued by the Executive Officer under Section 95850, Subarticle 4. PDR at 28-29. However, if allowances or

offset credits that are issued or approved in a linked system are to be accepted into a covered entity's Holding Account by the Operator of the California Cap-and-Trade Market Tracking System, there needs to be some provision for how the non-California compliance instruments will be moved into an entity's Holding Account that is under the control of the Operator. This may require a link between the registry used to track those allowances in the linked system and the California Cap-and-Trade Market Tracking System.

VI. SUBARTICLE 6, CALIFORNIA GREENHOUSE GAS ALLOWANCE BUDGETS (PDR AT 31-34).

Subarticle 6 sets forth the base budgets of California GHG allowances for the nine years 2012 through 2020. The subarticle also provides for the ARB's Executive Officer to "issue allowances from any base budget at any time by assigning them a unique serial number and placing them into an entity's Holding Account." PDR at 32. Lastly, Subarticle 6 provides for the Executive Officer to modify the schedule base budgets for the nine years 2012-2020 based on criteria that are yet to be developed.

A. Subarticle 6 Should Be Modified to Provide that the 2012 Budget Should Be Set on the Basis of the Best Estimate of Expected Actual Emissions From the Sources that Would Be Covered in 2020.

The WCI Design Recommendations provide that the regional WCI-wide cap for 2012 "will be set at the best estimate of expected actual emissions for those service sources covered in the initial year of the program (i.e., 2012)…." WCI Design Recommendations at 4. At the December 15, 2009 workshop on the PDR, the ARB staff was asked whether the ARB would follow the lead of the WCI Design Recommendations and establish a budget for 2012 on the basis of the ARB's best estimate of expected annual emissions from the sources that would be

covered in 2012. The staff replied that, yes, the intent was to set the 2012 budget at the level of the best estimate of expected actual emissions for covered sources in 2012.

Subarticle 6 should be expanded to contain a provision establishing that the budget for 2012 should be set at the best estimate of expected actual emission from covered sources in 2012. The starting point for the downward slope to the base budget for 2020 is important. The starting point will determine the steepness of the slope. Thus, there should be a specification of the basis for establishing the starting point in Subarticle 6.

B. The Criteria Governing the Executive Officer's Issuance of Allowances from Base Budgets Should Be Clarified.

The proposed Section 95890 provides that the Executive Officer "may issue allowances from any base budget at any time by assigning them a unique serial number and placing them into an entity's Holding Account. PDR at 32. The implication is that the Executive Officer may issue allowances from some future year's base budget and place them into an entity's Holding Account for a current year. Thus, entities for which Holding Accounts have been created would be able to borrow allowances from future year's base budget.

SCPPA supports permitting the Executive Officer to have the flexibility to borrow allowances from future year's budgets. As discussed below, borrowing could be an important tool to remedy price volatility and price spikes in the market for allowances.

C. Modification of the 2012-2020 Schedule of Base Budgets.

The staff proposes three reasons that would justify adjustments of annual base budgets as established in Subarticle 6, which is projected to be adopted at the October 21, 2010 ARB meeting.

1. Modify Budget if Estimate of Emissions Changes.

The first reason for adjustment of annual base budgets is that estimated emission levels for the initial years of the program may change:

- If a revised estimate of expected emission levels conducted by ARB after the adoption of this regulation demonstrates that emissions from covered entities are expected to be significantly different than the base budgets for the initial years of coverage (197,230,261 metric tons of CO_2e for narrow scope sources in 2012 using the example numbers);

PDR at 33. It appears that the staff contemplates the possibility that after the Board acts to adopt Article 5 on October 21, 2010, new information may become available prior to the start of the cap-and-trade program at the start of January 1, 2012, that would warrant a revision of the Board's estimate of expected emissions for the initial year 2012. Changing the allowance budget for 2012 would, presumably, change the budgets for subsequent years.

SCPPA supports the WCI concept that the initial 2012 cap should be "set at the best estimate of expected actual emissions" for covered sources in 2012. Thus, SCPPA supports adjusting the 2012 budget if, during the period after adoption of the Regulation on October 21, 2010, but before the outset of the program on January 1, 2012, new information becomes available indicating that whatever estimate of expected actual emissions for 2012 is established in October 2010 is wrong, the budget for 2012 can be reset so as to be as accurate as possible.

2. Modify Budget if Scope is Changed.

The second criterion suggested by the staff for changing annual base budgets is: "If a change in scope or thresholds for covered entities is expected pursuant to Subarticle 3 or Subarticle 7…." As discussed below, SCPPA strongly supports accelerating the inclusion of fuel deliverers in the cap-and-trade program from 2015 to 2012. Presumably, the Board will decide upon the appropriateness of accelerating fuel deliverers' inclusion in the program by the time of the Board's October 21, 2010 meeting. However, if the decision comes later, any base budgets established for 2012-2015 that are established on the assumption that only "narrow scope" entities are to be included in the program for that period should be adjusted to accommodate the

inclusion of fuel deliverers in the program as of 2012.

3. Modify Budget if External Programs are Linked.

The third reason given by the staff for adjusting base budgets is: "If addition or suspension of a linkage pursuant to Subarticle 12 impacts the scope of the program." PDR at 13.

The addition or suspension of linkage with another jurisdiction's program could dramatically affect base budgets. The proposed California cap-and-trade program covers emissions associated with imported electricity. If Utah, New Mexico, or any other state that hosts coal-fired generation facilities which export electricity to California were to adopt a cap-and-trade program and link the program to California's program, emissions associated with the electricity that is generated outside of California could no longer be counted as California emissions if the linked jurisdiction claimed that the emissions from the coal-fired power plants were its emissions and not California's. There would be a clear need to adjust California's base budgets if linkages occur and the emissions associated with imported electricity were to be attributed to the duly linked jurisdiction rather than to California to avoid the double counting of emissions.

D. Adjusting Budgets to Relieve an Under-Allocation or Over-Allocation of Allowances.

The staff does not propose modifying annual base budgets to accommodate an under-allocation of allowances which results in extraordinarily high allowance prices or an over-allocation which results in low prices. The occurrence of dramatic under-allocations or over-allocations could potentially be resolved by adopting a price collar mechanism as discussed below. However, if the ARB fails to adopt a price collar approach that would be effective in guarding against significant under-allocations or over-allocations, the Executive Officer should

be permitted to modify the annual base budget schedule to address severe under-allocation or over-allocation scenarios.

For circumstances that warrant administrative adjustments, SCPPA recommends that specific detailed criteria be included directly in the Regulation identifying the set of circumstances that would trigger an administrative adjustment to the base allowance budgets.

VII. SUBARTICLE 7, SURRENDER REQUIREMENTS FOR COVERED ENTITIES (PDR AT 34-35).

Subarticle 7 raises a number of issues, including record retention requirements, excluding biomass emissions, including fuel deliverers in the cap-and-trade program in 2012 rather than 2015, the scope of fuels that are regarded as being transportation fuels, the surrender obligation of transportation fuel deliverers, and the quantitative limit on the use of offset credits as compliance instruments. These issues are discussed in the sequence in which they arise in the text of Subarticle 7.

A. Record Retention Requirements.

Section 95920(b) requires covered entities to retain "copies of all data and reports submitted to the Executive Officer" and "records used to calculate a surrender obligation" for "at least ten years…." PDR at 36. The ten year record retention requirement is unreasonably long. The record retention requirement under the MRR is five years. MRR §95105(d).

Given the compliance periods will be three years in duration, covered entities should be required to retain records from a given compliance period for no more than the duration of the succeeding compliance period. The result would be that records would be held for 3-6 years, depending upon the point in a compliance period at which a record was developed. For example, if a record were developed during year 1 of a 3 year compliance period, that record would need

to be retained by the covered entity for the entire 3 year duration of the compliance period in which the record were developed plus the 3 years of the succeeding compliance period totaling up to 6 years. Alternatively, if a record were developed at the end of a 3 year compliance period, the record would have to be retained for the 3 years of the following compliance period. As a result, the average record retention period would be approximately 4-5 years, which would be about the same as the 5 year record retention period that is contained in the MRR.

B. Record Surrender Obligation.

Section 95920(b) would require that a covered entity produce records "within 15 days of receiving a written request from the Executive Officer…." PDR at 36. Requiring the production of records that may be years old within 15 calendar days would be unreasonable. If, for example, the Executive Officer elected to issue a demand for records a week before Christmas, the employee or employees that are responsible for maintaining records could easily be on vacation until the expiration of the 15 calendar days allowed for producing the records. The MRR provides 20 *working* days to produce records:

> Upon request by ARB, the operator shall provide to ARB within 20 working days all documents, including data, used to develop an emissions data report.

MRR §95105(b). The 20 working day requirement that is contained in the MRR should be adopted for purposes of Article 5. This alteration should also be made to other sections of the PDR that also require production of records within 15 days, such as Section 96290(e).

C. Three Year Duration of Compliance Periods.

The PDR proposes triennial compliance periods, with the first period starting in January 1, 2012, the second compliance period starting January 1, 2015, and the third compliance period starting on January 1, 2018. PDR at 37.

SCPPA has consistently supported triennial compliance periods. Triennial periods allow for some flexibility that could assist in containing a covered entity's costs. For example, if an electric generator brings a low or zero emission resource online at the beginning of the third year of a 3 year period, the step reduction in emissions that would occur in the third year could be averaged with a higher emissions with the first 2 years, effectively allowing the electric generator to borrow allowances from the third year to cover the higher emissions during the first 2 years.

Staff points out that covered entities might declare bankruptcy or cease operation before fulfilling their surrender obligations at the end of a compliance period, resulting in a default which would "threaten ARB's ability to meet the cap." PDR at 41. To solve this problem, the ARB staff proposes two options. As "Option 1", staff proposes to require covered entities to cover a portion of their annual reported emissions by retiring compliance instruments at specific periodic intervals, presumably, annual intervals, within the 3 year compliance period. PDR at 41. As "Option 2", staff proposes shortening the compliance period to 1 year.

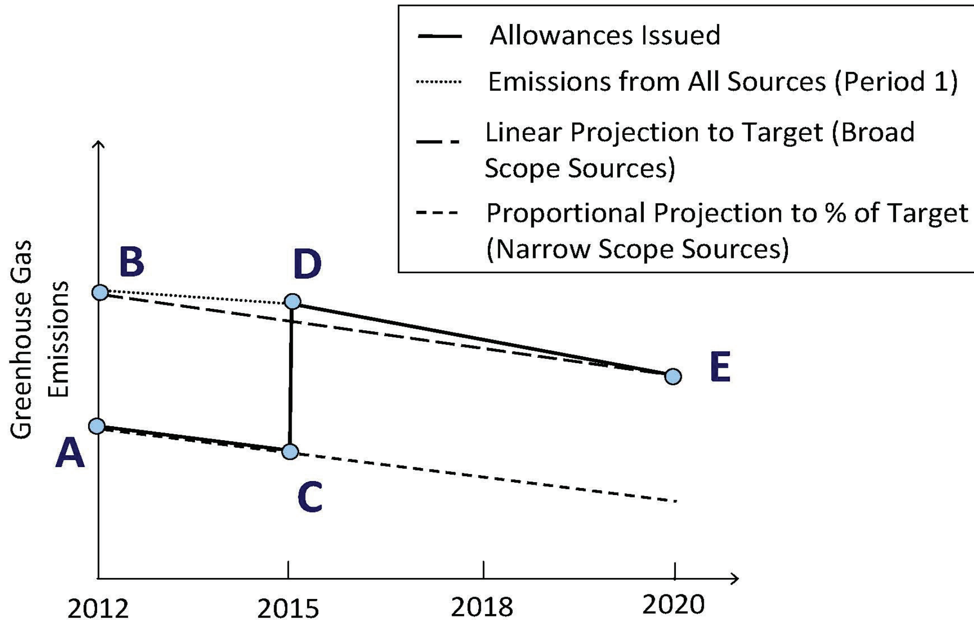
The currently proposed triennial compliance period should not be shortened to 1 year. That would result in a complete loss of the flexibility that is allowed under the triennial compliance period approach. However, staff's "Option 1" could be implemented to retain most of the flexibility that is afforded though having 3 year compliance periods while reducing the risk to ARB that a covered entity would cease operations or become bankrupt during a triennial compliance period. Some portion, for example, 50 percent, of a covered entity's compliance obligation could be met at the end of the first and second years of the triennial compliance period, cutting ARB's supposed risk of the customer becoming bankrupt or going out of business.

D. Including Fuel Deliverers in a Cap-and-Trade Program in 2012.

The Scoping Plan proposed to include fuel deliverers in the cap-and-trade program in two phases, with electric generating facilities, first deliverers, and large industrial facilities being included in the program in 2012 but with fuel deliverers being included in the program in 2015. Scoping Plan at 31. The staff suggests accelerating inclusion of fuel deliverers to 2012. PDR at 37.

For multiple reasons, fuel deliverers should be included in the program in 2012. First, proposed federal legislation--both Waxman-Markey in the House of Representatives and Kerry-Boxer in the Senate--propose a moratorium on the implementation of state programs when the federal cap-and-trade program takes effect. Both Waxman-Markey and Kerry-Boxer assume that the federal program would take effect on January 1, 2012, but given that 2009 has passed without climate change legislation being adopted by Congress, it is likely that a federal program would not take effect until 2013 or 2014. If the moratorium provision survives with a federal program commencing, for example, in 2013, California could be prevented from including fuel deliverers in a cap-and-trade program if inclusion of the fuel deliverers were deferred to 2015. Thus, in order to avoid the potential for a moratorium to preclude inclusion of fuel deliverers in a cap-and-trade program, the inclusion should be accelerated to 2012.

Second, fuel deliverers should be included in the program in 2012 to avoid backsliding during the 2012 to 2015 period. If fuel deliverers were omitted from the program between 2012 and 2015, their emissions would be permitted to increase during that period without being subject to the declining cap, as shown in the following chart:



ARB Staff Presentation on Cap Setting and Data Review, Slide 16 (November 16, 2009). As the staff's chart demonstrates, if fuel deliverers were left out of the cap-and-trade program until 2015 and were then brought in to the program, the rate of decline from 2015 to 2020 would be represented by a steeper slope than if fuel deliverers were brought into the program in 2012 with all sectors being subject to the same straight-line declining cap for the nine years 2012 to 2020.

Third, including fuel deliverers in the program in 2012 would provide a cost containment benefit. Fuel deliverers represent over half of the ultimate cap-and-trade market. Thus, the cap-and-trade market would be much larger and more liquid if the fuel delivers were included in the market in 2012. If fuel deliverers were omitted from the program until 2015, the "narrow scope" program that would be implemented in 2012 would only cover approximately 600 California

stationary sources, resulting in a much less liquid market that would be more exposed to volatility as well as market manipulation and abuse.

Fourth, fairness requires all sectors to be included in the program in 2012. The electric sector is going to be burdened by both expensive complementary measures and the cap-and-trade program. It would be inequitable to subject the electric sector to the cap-and-trade program while others are allowed to escape from the program until 2015.

E. Exclusion of Emissions from the Stationary Combustion of Biomass Fuels.

Sections 95950(a) and (b) would exclude CO_2 emissions from the stationary combustion of biomass fuels in the calculation of the surrender obligation for both electricity deliverers and operators of covered facilities. However, the PDR suggests that there would be exceptions to the exclusion under provisions that are to be developed.

The need for providing for any exceptions is unclear. Absent a clear and convincing explanation of the need for exceptions, the provisions for exceptions should be eliminated. As recognized in the PDR, "biofuel carbon content is offset by feedstock carbon sinks", PDR at 40. As a result, there is no need to apply a surrender obligation to emissions from biomass.

F. Scope of the Term "Transportation Fuels."

Under the PDR, gasoline, diesel, and liquid biofuels fall under the term "transportation fuels". PDR at 39. Electricity, hydrogen, and natural gas are excluded from the category of transportation fuels insofar as electricity, hydrogen, natural gas are "primarily used in stationary applications…." PDR at 39-40. Emissions associated with the transportation use of electricity, hydrogen, natural gas "would be accounted for consistently across all uses."

The exclusion of electricity, hydrogen, and natural gas from the category of "transportation fuels" is appropriate for the reasons suggested in the PDR.

G. Surrender Obligation for Transportation Fuels (Gasoline, Diesel, and Biofuels).

The staff proposes several options for the surrender obligation for transportation fuels (gasoline, diesel and biofuels). The simplest approach would be for transportation fuels to have a surrender obligation based upon the net carbon content of the fuel. Providers of gasoline and diesel would have an obligation to surrender compliance on the basis of direct combustion emissions of the fuel they sell. Biofuel deliverers would have no obligation for biofuels insofar as the biofuel carbon content would be offset by feedstock carbon sinks. PDR at 40.

Alternatively, the surrender obligation for transportation fuels could be based upon the life cycle carbon intensity of each fuel for gas, diesel, and biofuels as determined in LCFS. This would be unduly complex. For example, the "already-covered portion of the fuel production pathway" such as emissions from refineries "would need to be netted out from the emissions factor." Additionally, the life cycle carbon intensity factor for gasoline, diesel, and biofuels is already accounted for through the LCFS.

It would be preferable to adopt the more administratively feasible approach and base the surrender obligation for transportation fuels on the net carbon content of gasoline and diesel, with biofuel deliverers not being obligated to surrender allowances to cover emissions associated with biofuels.

H. Timing for Calculating a Covered Entity's Surrender Obligation.

Under the proposed Section 95960, an entity that is not a covered entity at the start of the compliance period but becomes a covered entity during the first or second year of the compliance period would be required to calculate a surrender obligation from the first day of the year in which it exceeded the threshold through the last day of the compliance period. PDR at 41. Conversely, an entity that becomes a covered entity during the third year of the compliance

period would be permitted to calculate its compliance responsibility from the first day of the year in which it exceeded the threshold through the last day of the subsequent 3 year compliance period, giving the entity a total of 3 years before it would need to surrender compliance instruments.

Requiring entities that become covered entities during the second year of a compliance period to surrender compliance instruments on the last day of the compliance period would be unduly harsh. An entity that would become a covered entity during the second year of a 3 year compliance period would only have a year to obtain allowances to cover 2 years' worth of emissions. Compliance entities that exceed the threshold during the second year of a 3-year compliance period should be treated the same as entities that become covered entities during the third year of a compliance period.

I. The Four Percent Quantitative Limit on Using Offset Credits.

The PDR proposes to impose a quantitative usage limit on a covered entity's use of offset credits to meet its surrender obligation. Staff proposes that the quantitative uses be set at 4 percent of a covered entity's surrender obligation. Thus, a covered entity would be permitted to surrender a maximum of 4 offset credits for every 96 allowances that it surrenders. PDR at 43. Staff explains that the 4 percent quantitative limit reflects the provision in the Scoping Plan that the use of offset credits be limited to no more than 49 percent of the required 2012 to 2020 emission reductions that would be obtained through the cap-and-trade program. PDR at 42-43. While there should be qualitative restrictions on offset credits, there should not be a quantitative restriction on their usage. If there is a qualitative limit, it should be more liberal than 4 percent.

1. There Should Not Be a Quantitative Restriction on Using Offset Credits.

The 4 percent quantitative limit as well as the 49 percent limit of the use of offset credits

that was adopted in the Scoping Plan should be eliminated. There should be a *qualitative* restriction so that any offset credits that are permitted to be used are high quality offset credits that are real, permanent, quantifiable, verifiable, and enforceable by the ARB. Cal. H&S §38562(d)(1). If those standards are met, an offset credit should be usable in lieu of an allowance. From the atmosphere's standpoint, it does not matter whether the emission reduction occurred in California or in some other jurisdiction. A ton of emission reductions would have been obtained somewhere in the world.

Other jurisdictions have adopted a qualitative rather than the quantitative approach to limiting offset usage. Both the Australian and New Zealand emissions trading schemes permit unlimited use of offset credits for compliance purposes. The proposed Australian ETS has justified this approach as follows, after carefully considering the policy arguments and public submissions as to whether or not a limit should be imposed on the use of international offset credits:

> The Government's final policy position is to allow an unlimited number of eligible international units to be accepted for Scheme compliance, recognizing that the implementation risks posed by acceptance of an unlimited number of eligible international units are likely to be minimal, and that accepting international units has the potential to:
>
> - control domestic costs
> - provide support for the international Kyoto architecture
> - promote technology transfer, and
> - facilitate Australia's involvement in international carbon markets.

Australia White Paper at 11-9.

In relation to the issue of domestic abatement, the Australian White Paper notes that:

> The Government does not consider it necessary to set minimum requirements through the Scheme for the amount of abatement that must occur in Australia. Domestic abatement will occur under the Scheme even with unlimited access to international units. …

> Economic modeling by the Treasury … suggests that even with unlimited access to international units, the Scheme will drive significant reductions in Australia's domestic emissions from what they would otherwise have been.

Australia White Paper at 11-8.

In addition to an offset being functionally equivalent to an allowance in terms of greenhouse gas reductions, the unfettered use of high-quality offset credits has important benefits.

a. Benefits of Offset Programs for Developing Countries.

First, the use of offset credits facilitates the deployment of emission reduction technologies and investments in developing countries, where the governments of those countries would not otherwise be able to undertake emission reduction projects. The importance of such programs is recognized in the PDR at 78-79. A robust offsets program is an efficient vehicle for utilizing the resources of advanced economies such as California's to realize the potential of these opportunities. The Stern Review Report on the Economics of Climate Change notes:

> The private sector drives significant transfers of relevant technology [to developing countries] through markets, joint ventures, foreign direct investment and within policy frameworks such as the CDM. Governments have a role to play in creating the enabling environments for private sector transfers...

Stern Review Report, 2006 (available at http://www.hm-treasury.gov.uk/stern_review_report.htm), Chapter 23 at 7.

A 4 percent limit on offset credits would not permit significant support to offset programs such as the sectoral crediting projects and forestry projects the ARB wishes to champion. PDR at 78-79. Highly cost effective opportunities for emission reductions would not be funded, and the social, environmental, and health co-benefits that can accompany greenhouse gas emission reductions in, especially, developing countries would be forfeited.

b. Expanded Use of Offset Credits Provides Cost Containment Benefits.

Second, the use of offset credits as an effective cost-control measure, which is particularly important given the lack of other cost control measures, would be impaired by the proposed percentage limit. The Australian Government considered this issue when designing the Australian ETS:

> It is important to note that if Australia pursued equivalent emission reduction targets without allowing access to international credits, the domestic carbon price would need to be higher to stimulate additional domestic abatement. This would impose higher aggregate costs on the Australian economy.

Australia White Paper at 11-8.

2. At a Minimum, the Offset Usage Limit Should Be Increased.

As a far less preferable alternative, SCPPA recommends that the quantitative restriction on offset credits be increased to a level similar to levels set by other broad-based cap-and-trade schemes. The EU ETS currently has country-specific offset limits which range up to 20 percent of compliance requirements. The Midwestern Greenhouse Gas Reduction Accord also has a 20 percent limit, and the Chicago Climate Exchange allows offset credits for 50 percent of compliance requirements.

3. The Offset Usage Limit Should Be Increased when Allowance Prices Reach a Threshold.

Further, SCPPA recommends that any quantitative limit on offset credits be increased when the price of allowances at auction reaches a specified level as cost containment measure, as proposed by the USCAP. USCAP Blueprint at 9. Such a provision might, for example, provide for the offset limit to be increased by a specified percentage for each dollar by which an allowance price at an auction exceeds the specified price level. However, it may not be appropriate to identify the price level and percentage increase until further modeling has been

completed.

4. Increase Offset Limit if Maximum Allowable Offset Credits Not Used in Previous Period

In addition, if there is to be a quantitative limit on the use of offsets, SCPPA supports the WCI recommendation to increase the offset limit for a compliance period by the amount by which the actual number of offset credits surrendered in the previous compliance period fell short of the offset limit for that period. If this is not supported at a California-wide level, it should be allowed on a facility-specific level, so that if a facility does not use the full allowed number of offset credits in one compliance period it can use increased offset credits in the next compliance period.

J. Surrender of Compliance Instruments.

Under Section 95980, covered entities would be required to make an initial surrender of emission allowances followed by a final surrender of emission allowances. The final surrender acts as a "true up" of emissions allowances to conform to reported emissions. If excess allowances were surrendered in the initial surrender, they would be returned to the covered entity. If there is a shortfall, then the covered entity has 30 days to make a remedial transfer into the Compliance Account.

SCPPA supports the concept of having an initial surrender followed by a final surrender of emission allowances. Having an initial surrender followed by a final surrender would help covered entities to comply without being subject to daily violation. For example, if there was only one surrender, a covered entity would be inclined to make sure that more than adequate allowances are in the Compliance Account in order to avoid a violation. In practice, this could be as much as 10 percent excess allowances. Such a practice, if wide spread, would have detrimental impacts on allowance price and availability. However, SCPPA suggests some

modifications of the details of the proposal.

1. 90 Days to Make Remedial Transfer.

The ARB staff proposes that auctions be held quarterly. In order to align the timing of the surrender of allowances with the availability of allowances at auction, SCPPA recommends that the ARB consider giving covered entities 90 days instead of only 30 days to make the remedial transfer. This would allow a covered entity an opportunity to purchase such allowances at a quarterly auction as opposed to purchasing allowances in the secondary market for a higher price. This approach would also have the benefit of minimizing the incentive for covered entities to hoard excess allowances in order to meet compliance under circumstances where they may be short in their Compliance Account at the time of the final surrender.

2. Define Initial Surrender and Final Surrender.

SCPPA recommends that definitions of “Initial Surrender” and “Final Surrender” be included in Subarticle 2. In defining “Final Surrender”, SCPPA recommends that the definition make it clear that the Final Surrender takes place *after* the ARB conducts its audit of the covered entity and determines the entity’s ultimate surrender obligation based on reported emissions. If the Final Surrender took place *before* ARB audited a covered entity, the covered entity would possibly be subject to additional daily violations if the ARB audit concluded that reported emissions were incorrect (i.e., higher than reported and subject to additional allowances being surrendered after the Final Surrender already took place).

VIII. SUBARTICLE 8, DISTRIBUTION OF ALLOWANCE VALUE (PDR AT 45-48).

The PDR contains a “place holder” for the portion of Article 5 that would address the distribution of allowance value, pending the release of a report from the Economic and Allocation Advisory Committee (“EAAC”). On January 7, 2010 the EAAC released a Draft

Report that proposes to use at least 75 percent of allowance value for either per capita-rebates or "dividends" or as cuts in individual income tax rates. Little or no allowance value would be allocated to electric utilities for the benefit of their customers. SCPPA strongly opposes the recommendation of the EAAC that no allowances or allowance value be allocated to electric utilities for the reasons set forth in the January 8, 2009 letter from the Joint Utilities, a diverse group of electric utilities that account for approximately 100 percent of the electricity consumed in California. The letter is posted on the EAAC portion of the ARB website under "Submitted Comments."

IX. SUBARTICLE 9, AUCTION DESIGN AND MECHANISMS FOR DISTRIBUTING AUCTION PROCEEDS (PDR AT 48-50).

A. Appropriation of Auction Revenues by Legislature.

Subarticle 9 provides some detail about the conduct of allowance auctions. Significantly, Section 96040(f)(2) provides for the Executive Officer to "process financial transactions for winning bids and deposit the proceeds in the Air Pollution Control Fund." This brief position is enormously significant. By depositing auction revenues in the Air Pollution Control Fund, revenues should become subject to appropriation by the Legislature:

> The Air Pollution Control Fund is continued in existence in the State Treasury. Upon appropriation by the Legislature, the money in the fund shall be available to the state board to carry out its du ties and functions.

Cal. H&S §43015. This calls into question the purpose of the yet-to-be-developed Subarticle 8 on distribution of allowance value. Although the ARB may develop Subarticle 8, it appears that the subarticle would be little more than hortatory, given that all auction revenues as deposited in the Air Pollution Control Fund would be subject to appropriation by the Legislature.

B. Reserve Account as a Cost Containment Measure.

Subarticle 9 does not, for now, contain any provisions for a cost containment mechanism. However, the staff proposes a "price collar" approach under which there would be a floor and a ceiling on the market price for compliance instruments. As conceived by the staff, if the ceiling price were reached by allowance prices, there would be an additional supply of compliance instruments to the market to contain allowance prices at or below the ceiling level. Likewise, if allowance prices drop below the price floor, allowances would be reserved from being auctioned so as to maintain allowance prices at or above the price floor. The reserved allowances could be accumulated in a Reserve Account for release into the market when prices are high. PDR at 50.

The fundamental problem with the staff's proposed mechanism is that the Reserve Account would not be filled with allowances unless allowance prices drop below the price floor. Thus, the Reserve Account might *never* be filled. If it were filled, the accumulation of allowances in the Reserve Account would most likely be modest, particularly given the allowance budget for 2012 is to be set upon the basis of an estimate of 2012 covered sector emissions to assure no over-allocation of allowances, and the annual budgets decline every year after 2012. Thus, the staff's concept of using a Reserve Account to release additional allowances into the marketplace when prices are high should be supplemented with the other cost containment options that are identified in the PDR.

The concept of developing a strategic reserve could be combined with the use of offset credits by providing that the Reserve Account would be filled with offset credits in addition to unsold allowances, as proposed by USCAP:

> To limit such price spikes and volatility, especially in the early years of the program, USCAP recommends the establishment of a strategic reserve pool that includes: 1) program-based and other governmentally certified offsets, including but not limited to forest carbon tons derived from offsets due to avoided tropical

> deforestation; and b) allowances borrowed from future compliance periods at a system-wide level (as distinguished from a firm level).

USCAP Blueprint at 10. If, as strongly supported by SCPPA, the use of offset credits were *qualitatively* limited so that only high quality (real, permanent, quantifiable, verifiable, and enforceable) offset credits would be usable as compliance instruments but were not *quantitatively* limited, there would be less need for a large reserve pool. It may be sufficient to fill the reserve pool with allowances that were unsold due to the price floor and with borrowed allowances as suggested by USCAP in the discussion quoted above.

C. Quantitative Limits on Offset Credits Should be Removed for Cost Containment.

The staff proposes as a second option for cost containment the relaxation of the quantitative uses limits on offset credits. If the limit on the use of offset credits is not removed altogether, SCPPA strongly supports the approach of increasing the limit on offset credits when the price of allowances at auction reaches a specified level, as discussed in the comments on Subarticle 7.

D. Qualitative Limits on Offset Credits Should Not Be Removed for Cost Containment.

SCPPA does not recommend relaxing the qualitative limit on offset credits, which is mentioned as the third cost containment option in the PDR at 50. In order to assure the integrity of the cap on emissions and to comply with the requirements of AB 32, only high quality offsets should be accepted in the California program. Other cost containment mechanisms that are listed in the PDR and discussed in this comment should be pursued instead.

E. Allowing Use of Allowances from the Next Compliance Period (Borrowing).

The staff proposes, as a fourth option for cost containment, allowing "borrowing" of allowances from the next compliance period. Borrowing would be beneficial for cost containment and market liquidity. Unrestrained borrowing of allowances from future periods

may be problematic if it would lead to shortfalls of allowances in future periods and to calls for the emissions cap to be lifted. However, borrowing could be limited so as not to substantially prejudice the cap-and-trade program in the future. Borrowing could be limited by auctioning only a limited number of allowances from future periods or by allowing a covered entity to use allowances from future periods to meet only a specified percentage of its compliance obligation for the current compliance period.

F. Auction Design – Procedures for Awarding Bids.

SCPPA recommends that the Regulation include the specific auction procedures and administrative provisions for the auction and not rely on the auction operator to make this information available only 90 days prior to an auction. For example, the Regulation should provide clear rules for how allowances are awarded to winning bids.

X. SUBARTICLE 10, FEE ALLOCATION MECHANISM (PDR AT 50).

The PRD contains no provision governing the administrative allocation of allowances. SCPPA strongly supports the administrative allocation of allowances as recommended by the California Public Utilities Commission ("CPUC") and California Energy Commission ("CEC") in Decision ("D") 08-10-037:

> We recommend that ARB assign allowances (or allowance value) to the electricity sector at the beginning of the cap-and-trade program in 2012 based on the sector's proportion of total historical emissions during the chosen baseline year(s) in the California sectors included in the cap-and-trade program (including emissions attributed to electricity imports). We recommend that, in subsequent years, allowance (or allowance value) allocations to each California sector in the cap-and-trade program be reduced proportionally, using the overall trajectory chosen by ARB to meet AB 32 goals by 2020. In this way, while the electricity sector may provide more than its proportional share of GHG emissions reductions through both mandatory programs and market-based reductions occurring due to the cap-and-trade program, the

economic costs of the emissions reductions can be shared equally among all capped sectors. [2]

2. As described in more detail in Section 4.3.2.1 below, it may be appropriate to increase allowance allocations to the electricity sector to reflect increased electricity demand and GHG compliance obligations due to electrification in other sectors, including the transportation sector.

D.08-10-037 at 14 (October 16, 2008).

A. An Administrative Allocation of Allowances to Regulated Utilities in the Electric Sector Would Be Equitable.

It would be equitable to allocate allowances to regulated electric utilities. The electric sector will be disproportionately burdened as California pursues the AB 32 goal of a low carbon economy. The electricity sector represents about 25 percent of California's emissions, but the ARB Scoping Plan makes it responsible for achieving about 40 percent of the AB 32 emission reductions through a variety of complementary measures. The SCPPA members embrace the challenge of meeting the AB 32 and Scoping Plan goals. However, the cost will be high.

The CPUC's consulting firm, E3, projects that for the one SCPPA member that E3 modeled individually, buying allowances at $30 per metric ton would increase rates by 7 percent in 2020, but implementing the complementary measures would increase rates by nearly 30 percent by 2020. E3's projections assumed the achievement of a Renewable Portfolio Standard ("RPS") of 33 percent.

Other sectors will benefit from the electricity sector shouldering its disproportionate burden of achieving AB 32 emission reductions by 2020. As a result of the electric sector achieving such a large amount of emissions reductions through the complementary measures, the cost of allowances would be depressed to the benefit of the other sectors. An administrative allocation of allowances to the electric sector would be appropriate insofar as it would cushion the impact of bearing the disproportionate emission reduction burden on electricity ratepayers.

Additionally, the administrative allocation of allowances to regulated electric utilities would facilitate the transition to a low carbon economy by cushioning the impact of volatile allowance prices on electricity consumers. The price elasticity of electricity consumers, especially in the short run, is very low. An administrative allocation of allowances could be used by regulators of the electric utilities to cushion the impact of the volatility on electric ratepayers.

Insofar as both publicly-owned electric utilities and investor-owned electric utilities are subject to pervasive regulation in California, the ARB can be assured that the full value of allowances that are administratively allocated to the electric utilities would be used for the benefit of consumers.

B. It is Necessary to Administratively Allocate Allowances to the Regulated Electric Utilities.

In order to assure that the value of allowances will flow to California electric utilities for the benefit of their customers, it is necessary to administratively allocate the allowances to the electric utilities. If all allowances were to be auctioned by the ARB without a preceding administrative allocation of allowances to regulated electric utilities, the auction revenues would flow into the ARB's Air Pollution Control Fund. As discussed above, appropriations may be made out of the fund only by the Legislature. Given California's chronically dire fiscal circumstances, it is highly probable that little or none of the allowance value generated by auctioning allowances would flow to electric utilities for the benefit of their customers.

If there were a pre-auction administrative allocation of allowances to the electric utilities, the allowances could be re-aggregated for auctioning with the resulting auction revenues being returned proportionately to the electric utilities for their account. As a result, the auction would be as robust as it would be if there was no administrative allocation of allowances to the electric utilities. However, the electric utilities would be assured that the full value associated with the

allowances that were administratively allocated to them would be returned to them without being used for other purposes.

XI. SUBARTICLE 11, TRADING AND BANKING (PDR AT 50-54).

Subarticle 11 contains a provision for establishing a holding limit: "The Executive Officer will establish a market holding limit calculated as the maximum percentage of outstanding California compliance instrument that may be held by a registrant or a group of affiliated registrants." PD at 51-52. The ARB should establish a holding limit in order to prevent market manipulation and abuse.

However, establishment of a market holding limit should be deferred until the ARB completes its economic analysis and until there is a final determination about whether fuel deliverers would be included in the cap-and-trade program in 2012. If there were broader programs in 2012, the market holding limit could be smaller than otherwise insofar as the market would be much broader and more liquid.

XII. SUBARTICLE 12, LINKAGE TO EXTERNAL TRADING OR OFFSET CREDITING SYSTEMS (PDR AT 54-60).

A. Linking Requirements are Too Restrictive.

SCPPA supports the concept of linking to other cap-and-trade programs, as a method of fulfilling the ARB 32 aim of facilitating the development of integrated and cost-effective regional, national, and international greenhouse gas reduction programs (ARB 32 at 38564). However, SCPPA considers that the requirements for linking in Section 96160 are too restrictive. Section 96160 would prohibit linkage with a system that allowed a more liberal use of offset credits than permitted by California.

If the 4 percent limit were not modified, few other emissions trading programs would be eligible for linking. The EU ETS, by far the largest compliance carbon market in the world, would not be eligible insofar as the EU ETS' restrictions on the use of offset credits are not currently as strict as the proposed California 4 percent quantitative restriction. The Australian ETS, the New Zealand ETS and Midwestern Greenhouse Gas Reduction Accord would also be disqualified due to the offset criterion.

Linking with another program should not be precluded solely on the basis of that program's level of offset use.

B. Programs in Kyoto Countries May Not Wish to Link to California.

As a separate issue, cap-and-trade systems in countries with obligations under the Kyoto Protocol, including the EU ETS and the New Zealand ETS, and the proposed emissions trading systems in Japan and Australia, may not wish to link to programs such as California's which do not assist in achieving Kyoto Protocol targets. If, for example, a California allowance were purchased by a United Kingdom entity, the California allowance could not count towards the United Kingdom's international emissions reduction target because, unlike allowances from cap-and-trade programs in countries that have ratified the Kyoto Protocol, the allowance would not be backed with an assigned amount unit under the Kyoto Protocol. (California seems to assume that Kyoto countries will be eager to link with its program, but the failure of the United States to ratify the Kyoto Protocol may dampen this enthusiasm.) .

XIII. SUBARTICLE 13, OFFSET CREDITS (PDR AT 60-84).

A. Difference Between External Offset Programs and External Cap-and-Trade Programs.

The ARB should clarify its requirements for external offset programs to be subject to the linking requirements of Subarticle 12. The requirements are set out in Sections 96230,

96400(a)(3), 96410(b), and 96420(b)(2) of Subarticle 13. The types of requirements that should apply to linking with another compliance cap-and-trade program, such as having compatible program design elements, e.g., a binding and declining emissions cap, are not applicable to offset programs that are not compliance cap-and-trade programs, such as the CDM under the Kyoto Protocol. A clear distinction should be made between requirements for linking with another cap-and-trade program, which are addressed in Subarticle 12, and requirements for allowing offset credits as compliance instruments, which should be addressed in Subarticle 13 without importing the restrictions of Subarticle 12.

B. ARB-issued Offset Credits.

1. The ARB Must Ensure Sufficient Resources are Available.

The ARB proposes to issue offset credits itself, as well as approving certain external offset programs. The ARB should ensure that, if it undertakes to verify offset projects and issue offset credits itself, it allocates sufficient internal resources (including personnel with the relevant technical skills) to these activities so as not to create delays and bottlenecks in the approval of methodologies, projects and credits. Approving and updating offset project methodologies and reviewing verification statements are very time-consuming exercises.

The appointment of appropriately-qualified independent entities to undertake certain verification procedures for offset projects may assist in reducing the burden on the ARB and avoid delays in issuing offset credits. However, if the ARB chooses to appoint independent entities for such activities, the ARB should establish clear criteria for its approval of independent parties and conduct periodic checks upon their activities, as is done by the Executive Board of the CDM in relation to entities conducting verification procedures for CDM projects.

2. Renewal of Crediting Periods.

In Section 96270 on the renewal of crediting periods, it is unclear whether a crediting period can be renewed more than once. Given the requirements for renewal, particularly those relating to additionality, SCPPA considers that there is no reason why a project that satisfies those criteria should not be able to be renewed more than once. This can be compared to the position under the CDM where projects can have crediting periods of either 10 years, with no renewal, or 7 years, with the option to renew twice (if the project is still additional).

3. Production of Records.

Section 96290(e) allows the ARB to request the production of offset-related documents up to 10 years old within 15 days of the request. The 20 working day requirement that is contained in the MRR should be adopted for purposes of this Section, as commended in SCPPA's comment regarding Section 95920(b).

4. No Lower Limit on Period for Verification of Reductions.

Section 96300(b) contains a one year minimum on the frequency of verifications of reductions. A minimum time limit on the periods between verification of emission reductions is unnecessary. It is unlikely that an offset project operator will choose to conduct very frequent verifications due to the cost of engaging an accredited verifier. However, the operator of a large offset project may wish to have the option of undertaking six-month verifications in order to receive offset credits for sale twice a year.

5. Harmonize Verification Provisions.

Section 96300(d), requiring verifications to be received within 6 months after the end of a calendar year in respect of emission reductions in that year, conflicts with Section 96300(b) which allows verifications to be conducted at intervals greater than 1 year. Section 96300(d) should be revised to require verifications to be completed within 6 months of the end of the

period being verified (whether that period is 6 months or 6 years).

C. Offset Credits From External Offset Programs.

1. Value of Offset Programs Not Supported Under Current 4 Percent Limit.

The Discussion of Concept – International Offset Credits and Sector-Based Crediting (PDR at 77-80) ("Offsets Discussion") notes the value in establishing an international sectoral crediting mechanism and reducing emissions from deforestation and forest degradation ("REDD"). SCPPA concurs with these statements and urges the ARB to remove or increase the quantitative offset limit so as to allow for further market support to be provided to these initiatives.

However, a considerable amount of work and time will be required at an international level in order to establish sectoral crediting. The ARB should not rely on sectoral crediting to provide commercial levels of offset credits for the purpose of containing costs under the Californian cap-and-trade program.

2. Availability and Status of CERs.

On the other hand, offset credits from CDM projects, known as Certified Emission Reductions ("CERs"), are currently available in significant quantities. 2003 CDM projects have been registered, and 365,893,153 CERs have been issued as at January 8, 2010. CERs are internationally recognized as high-quality offset credits and should be eligible for utilization by entities under the California program. The CDM project review and emission reduction review processes are very rigorous, particularly given the increased level of scrutiny by the CDM Executive Board in the last 18 months. Very few offset programs in the world can be considered to be more rigorous than the CDM. This is recognized by cap-and-trade programs including the EU ETS, the New Zealand ETS, and the proposed Australian and Japanese emissions trading

systems, all of which accept or propose to accept CERs as compliance instruments, but do not accept external non-Kyoto Protocol offset credits.

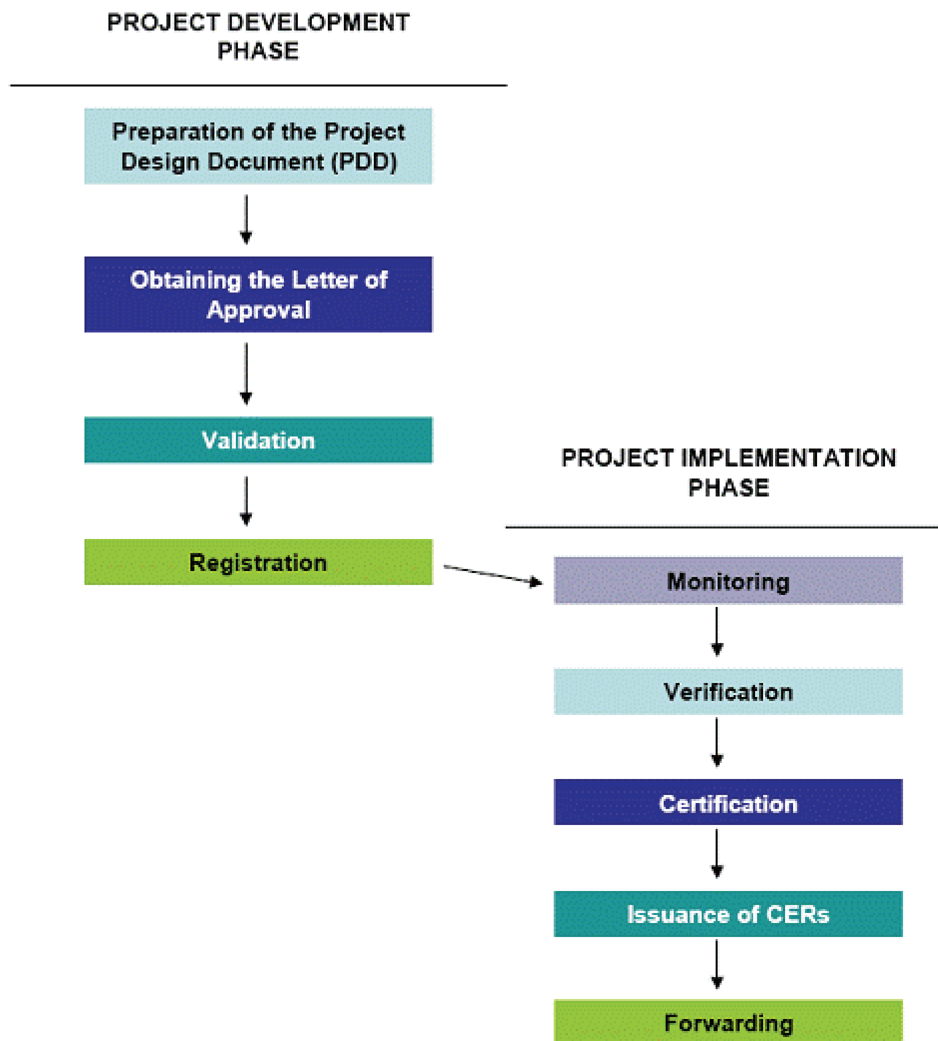
a. Outline of CER Approval Process.

Two sets of approval and verification processes are conducted in relation to CDM projects. First, the offset project itself must be approved. This requires: (1) the preparation of a detailed technical report (called the Project Design Document) on the application of an additionality test and on the proposed methodology and monitoring requirements, (2) the review of the Project Design Document by an independent expert (known as validation), (3) approval by the government of the country in which the project will take place, and finally (4) approval by the CDM Executive Board (known as registration). In addition, all project methodologies that have not been previously approved by the CDM Executive Board in relation to other projects are subject to intensive technical scrutiny.

Second, the emission reductions must be approved before CERs will be issued. The emission reductions must be monitored in accordance with the monitoring plan, verified and certified by a different independent expert, and then approved by the CDM Executive Board.

Each of these processes is governed by detailed requirements and is subject to the oversight of the CDM Executive Board and the CDM Compliance Committee.

The following diagram (from the CDM rulebook, available at www.cdmrulebook.org) presents these procedures in summary form:



b. Choosing Appropriate CDM Methodologies and Imposing Additional Requirements.

The ARB may easily, if it wishes, reject certain CDM project methodologies if it does not consider them suitable, or impose additional requirements. For example, the EU ETS does not accept CERs from hydropower projects over a certain size unless those projects were conducted in accordance with the recommendations of the World Commission on Dams, and the proposed Australian ETS will not accept temporary forestry CERs. Such restrictions will allow the ARB to satisfy its environmental objectives while not materially reducing the benefit of the use of CERs (both to developing countries and to liable entities under the Californian program).

c. Use of CERs Should Not be Limited.

In light of the above comments, SCPPA does not consider that it would be appropriate to impose any sub-limit on the use of CERs as compliance instruments as compared to other types of offset credits, or to phase out the use of CERs and other project-based units over time, as the ARB suggests in the Offsets Discussion (PDR at 79).

D. Query Preference for Offset Projects in Least Developed Countries.

The ARB staff should clarify the meaning and purpose of the statement in Section 96420(c) that preference will be given to the approval of offset credits from offset projects in least developed countries.

E. No Requirement for Memoranda of Understanding.

The provision in Sections 96410(d) and 96420(e) requiring an MOU with the regulatory body for each external offset program should be eliminated. It will take some time to negotiate MOUs with all relevant offset programs. More importantly, MOUs are not necessary. Once the ARB is satisfied that an offset program is acceptable and has undertaken the public comment process mentioned in Sections 96410(c) and 96420(d), the ARB should be able to rely on the review and enforcement mechanisms of that external offset program without needing a separate MOU. In relation to CERs, the Australian government noted that "because the Kyoto Protocol framework already ensures that all CERs are credible, robust, and meet sustainable development objectives, it is not necessary to apply a further layer of assessment (at an additional cost)." Australia White Paper at 11-12.

The only requirement will be a way to link the offset registries so as to track the movements of offset credits and cancel any offset credits that are found to be invalid.

F. Sectoral Crediting Baselines Should Not Be Below Conservatively Estimated Business as Usual Levels.

The crediting baseline for sectoral crediting under Section 96430(d)(2) does not need to

be established at a level of emissions that is lower than business-as-usual if the business-as-usual level is conservatively estimated, for the reasons discussed in relation to Subarticle 2.

XIV. SUBARTICLE 14, ENFORCEMENT AND PENALTIES (PDR AT 85-87).

A. Types of Restrictions on Holding Accounts Should Be Specified.

Section 96501 indicates that the Executive Officer may suspend, revoke, or place restrictions on a Holding Account of an opt-in or covered entity, but it does not specify what those restrictions may be. SCPPA recommends that the Regulation provide specific provisions for the type of restrictions that may be placed on a Holding Account, including criteria for restrictions to be placed on the account, timeline for how long such restrictions will be in place, and what actions by an opt-in or covered entity will trigger the restrictions to be lifted.

B. An Appeal Process is Required.

The Discussion of Concept on page 85 of the PRD and Section 96504 indicate there will be a separate violation, with a separate penalty, for each day that a required report or allowance surrender is late. The financial penalties may therefore be very significant. The PDR does not include an appeal or dispute resolution process, so there is currently no mechanism for a compliance entity to put forward its interpretation of the Regulation. An appeal process is critical for this program, particularly in the early years of the program when differences of interpretation on technical issues such as emissions reporting (with direct consequences for liability for allowances) may arise.

C. Make-Good Penalties for Non-Surrender of Compliance Instruments.

The Discussion of Concept on page 85 of the PRD notes that the staff is considering requiring entities that have not surrendered sufficient compliance instruments by the deadline to

surrender additional compliance instruments, using a multiplier on the missing instruments, in addition to requiring payment of a penalty per day per missing compliance instrument.

SCPPA appreciates the need to require compliance entities that have not surrendered compliance instruments to match their emissions to surrender the missing instruments (a make-good requirement), to ensure the emissions cap is not exceeded. However, a multiplier approach for missing compliance instruments is not necessary, given that per-day, per-instrument financial penalties are also proposed. Compliance instruments should retain their status as one instrument per ton of carbon dioxide equivalent emissions, and additional deterrence should be established by way of a financial penalty (discussed below).

D. Financial Penalties for Non-Surrender of Compliance Instruments.

The ARB notes that it wishes to remove any economic benefits for non-compliance. PDR at 85. Monetary penalties for missing compliance instruments should therefore be in excess of, but proportional to, the potential financial gain from the late surrender, or non-surrender, of compliance instruments (in addition to one-for-one make-good on missing instruments, as discussed above). For example, the Australian ETS proposes a per-unit penalty set at the average auction price for permits auctioned in the previous financial year, plus 10 percent. Australia White Paper at 7-43.

E. Per-Day Penalties for Reporting Errors May Not be Appropriate.

Section 96504 indicates that each day that a report required by this article contains *incomplete or inaccurate information* is a separate violation of this article.

There will be inadvertent human errors and misinterpretation of technical reporting data at the start of this program that should not be subject to daily violations, especially since such human error may go undetected for a period of time. SCPPA recommends that an initial “break in” period be instituted with regard to the enforcement of violations, in which the focus of

enforcement be placed on not submitting reports, or not surrendering allowances, as opposed to technical errors that can be expected with the start of any program of this scale.

Further, heavy penalties should not be applied in the first few years of the program if an entity surrenders insufficient compliance instruments due to inadvertent errors in its emissions report.

XV. CONCLUSION

SCPPA urges the ARB staff to consider these comments in developing a revised draft of the Regulation for a California cap-and-trade program. SCPPA appreciates the opportunity to submit these comments to the ARB.

Respectfully submitted,

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