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January 11, 2010

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

Re: Preliminary Draft Regulation for a California Cap-and-Trade Program

Dear Mr. Goldstene:

The South Coast Air Quality Management District (SCAQMD) staff appreciates the opportunity to comment on the Preliminary Draft Regulation for a California Cap-and-Trade Program. As you know, the SCAQMD is the regional air quality agency responsible for Orange County, the non-desert portions of Los Angeles and San Bernardino Counties and Riverside County to the eastern edge of the Coachella Valley. This area of 10,743 square miles is home to over 17 million people - about half the population of the state of California. It is the second most populated urban area in the United States and one of the smoggiest. Many of the facilities that would be in the cap-and-trade program will be in our area.

These comments are provided to help develop a robust, enforceable program that will help California reach its AB 32 greenhouse gas reduction goals. Our experience in the development, and extensive experience (sixteen years) in implementation of the REgional Clean Air Incentives (RECLAIM) program, the first multi-industry cap-and-trade program in the United States, enables us to offer comments from first-hand experience.

Our comments focus on the following areas:

- Structure of the compliance period to facilitate timely compliance, effective enforcement, and early price discovery, and to prevent hoarding;
- Adequate mechanisms to deter non-compliance;
- Inclusion criteria and verification/audit needs;
- The proposed limit of offsets and using allowances from outside California;
- Potential problems with unlimited banking;
- Not limiting participation in auctions;
- Recommendations on offset life;
- Workload management; and
- Comments on market design.

More detail is provided in the attachment. If you have any questions or would like to discuss this further, please call me at (909) 396-3131. My staff is available to help as you continue to develop this very important regulation.

Sincerely,

Jill Whynot for
Barry R. Wallerstein

Barry R. Wallerstein, D.Env.
Executive Officer

EC/BB/MN:JW

Attachment

Attachment – SCAQMD Staff Comments on
Preliminary Draft Regulation for a California Cap-and-Trade Program

1. Topic: CARB is recommending a 3-year compliance period but is seeking comment on whether to make this annual and/or to require surrender of compliance instruments at a more frequent interval (perhaps annual) than at the end of the 3-year period.

   Discussion: *SCAQMD staff has commented previously that a shorter compliance period is much more effective from an enforcement perspective. RECLAIM participants have an annual compliance determination, but also submit certified quarterly emission reports to help them (and us) track progress and identify potential shortfalls in holdings early in each compliance period.*

   A 3-year compliance period presents significant enforcement difficulties. Compliance determinations in any market-trading program rely heavily on facility audits to determine and verify the amount of emissions from the source compared to the allowances it surrenders for the subject period. Reconstructing and reviewing a year of operations at a facility is difficult enough – taking on 3 years as the period of review will be daunting. If there is a long compliance period, a facility could emit excessive GHGs over this time period and then have to cover those emissions after the fact.

   Historic inspection data clearly shows that if there is a long time between compliance checks, facilities tend to get complacent and not pay as much attention to environmental requirements. Our experience is that facility managers are often rotated, and staff changes, so the lack of continuity over a 3-year period could make it more difficult to verify records. CARB's own staff is likely to change due to retirements and other changes. Over time, memories fade, records disappear, and the enforcement trail can grow cold.

   A 3-year compliance period may also make it very difficult for a facility to adequately plan, budget, and implement changes at their operations in response to market fluctuations. One of the primary lessons learned in RECLAIM was that many businesses did not act rationally or plan ahead. If a facility waits until the end of the 3-year compliance period and assumes they can buy compliance instruments, they may not be available or be at high prices. This does not leave any time for the facility to react and make changes. After the 2000/2001 California electricity crisis and credit shortage in the RECLAIM program, compliance plans were required for the largest emitters, which ensured that the facility operators evaluate their options and can implement changes at the facility more quickly.

   It is also better from a price discovery perspective to have more frequent compliance true ups. If the compliance period is 3 years with no interim surrender of compliance instruments, there is a risk that at the end of the compliance period that the majority of facilities will either be long (hold more compliance instruments that are needed, which can cause prices to plummet) or worse, be short (not have enough compliance instruments and not be able to buy them from others). Having to cover emissions on an annual basis would result in better price and market signals which would give facilities a

better indication of the availability and price of compliance instruments. This should lead to better planning by entities in the program, and give more time to plan and implement changes at a facility that would reduce their emissions.

For GHGs, the timing of emission reductions is not as critical to meeting specific health-based emission standards, as it is for criteria pollutant trading programs that are designed to help meet daily or hourly ambient concentrations. From an economic perspective, a longer compliance period is better for participating facilities to maximize their flexibility. However, this must be carefully balanced with the need for adequate planning by facilities, timely price signals in the market, and time to react to changes in supply or demand of compliance instruments. A longer compliance period without periodic surrender of compliance instruments is also more vulnerable to facilities shutting down prior to the end of the compliance period without covering their emissions.

At the workshop on Monday, December 14, 2009, several utility companies commented that they need the flexibility of a 3-year period to deal with changes in weather and demand. Given the unlimited banking proposed in the cap-and-trade draft regulation, a shorter compliance period (or more frequent surrender of compliance instruments) should not be a problem for facilities with varying operations if they plan for fluctuations and bank compliance instruments.

Recommendation: *Require surrender of compliance instruments each year. This is critical for an effective and adequate compliance and prosecution of violations. An annual compliance period will also help ensure that facilities do adequate planning and have time to react to changing supply and demand. In addition, a compliance plan should be done at least for the larger emitters to make sure they have options identified for on-site reductions for quicker implementation.*

2. Topic: The program needs to have adequate mechanisms to deter non-compliance, such as to make up for any allocation shortfalls from a facility.

   Discussion: *As described above, a 3-year compliance period can make it more difficult to find and cure a violation. The best that any regulatory agency can do is require retirement of allowances for future years in an attempt to compensate for the harm that has been done. With a one-year compliance period, such as we have in RECLAIM, we can at least recoup the emissions in the year following discovery of the violation. A 3-year compliance period makes it much more unlikely that the air can be "compensated" within a reasonable period of time.*

   In order to collect adequate penalties for an annual allocation violation, RECLAIM rules presume a violation for each day of the compliance period. In other words, if a source exceeds its allocation, the rules presume 365 days of violation. Since the Health and Safety Code impose penalties on a daily basis, this gives significant leverage in negotiating a penalty that will deter future violations.

   Under the proposed cap-and-trade rules, it appears that a facility could emit virtually at will for a protracted period of time and then be expected to make good on those

emissions. Penalties, while they may be substantial, don't have adequate deterrent value when they are postponed too far into the future.

For SCAQMD, we operate under a 3-year statute of limitations and this is usually an adequate period of time. However, we have experienced some difficulties when, for example, RECLAIM facilities are reporting their emissions and how they calculated them on a quarterly basis while SCAQMD is not be able to audit those facilities until a year or two after a compliance period ends. Valuable time is lost between the submission of a report which may reveal a violation and the conduct of the audit which will substantiate whether the violation actually occurred. The statute of limitations requires that action be taken after an agency knows or "reasonably should have known" of the violation. This should be taken into consideration in the program design and implementation.

Under a cap-and-trade program, there are many potential areas for problems that need to have clear potential consequences in order to deter non-compliance. An example is that there should be strong enforcement capabilities against third-party verifiers that falsify data or falsely certify data.

Recommendation: *To help ensure adequate deterrence for violations, consider making each day of the compliance period a violation if not enough compliance instruments are surrendered to cover the actual emissions. A shorter compliance period also makes it easier to deal with statute of limitation and resource issues. In addition, there should be strong enforcement provisions to deal with false submittal of data or false certification of data.*

3. Topic: Once a facility reports less than 25,000 MT CO_2e for 6 consecutive years, they no longer have to surrender compliance instruments to cover their emissions. Will this lead to circumvention, leakage or detract from meeting the overall reduction goal?

   Discussion: *If the emission sources at a facility are the result of combustion of one of the upstream fuels, such as natural gas, the emissions would still be covered under the cap once upstream fuel providers are in the cap-and-trade program. However, if emissions are due to non-combustion GHGs (methane, SF6, etc.,) allowing the facility to stop surrendering compliance instruments to cover their emissions would not help to achieve the overall system cap.*

   For example, a facility with 28,000 MT CO_2e could split the operation, which would result in two facilities with emissions that would no longer require reporting or surrendering compliance instruments. This type of circumvention may not occur widely, but it is possible. Over time, the number of facilities that have reduced emissions below 25,000 MT CO_2e will increase. These smaller emitters collectively could still represent enough emissions that might cause the overall emission goal to be missed if they do not have the requirement to surrender compliance obligations.

   Recommendation: *CARB should no longer require covering emissions by a surrender obligation only when the upstream fuel supplier is included in the program and when the facility emissions fall below 10,000 MT CO_2e.*

4. Topic: Facilities in the program that emit more than 10,000 MT CO_2e, but less than 25,000 MT CO_2e, are required to report their annual emissions but do not need verification by a certified third-party.

   Discussion: *Mandatory reporting has been described as the cornerstone of the cap-and-trade program, and the model being followed for consistency with other programs is to use third-party verifiers to help ensure proper reporting. While this is not a perfect solution, not having the verification for facilities that are in this bracket could cast doubt on the rigor of the program. This could also provide an incentive for facilities to under report their emissions in order to avoid the cost of verification by a certified third-party. There must also be an audit function for all facilities, even when the emissions have been verified.*

   Recommendation: *Pending a determination of resource requirements, consider having all entities have their emissions verified, and/or have a robust audit function so CARB or local air district staff check on each of these facilities to ensure accurate reporting. An alternative would be to have the entity certify that the emissions from all facilities they own in California collectively emit less than 25,000 MT CO_2e. This would also have to be checked and there would need to be appropriate remedies for false information.*

5. Topic: Offsets would be restricted to 4 percent of the surrender obligation for each entity. The program will recognize allowances issued by WCI partners.

   Discussion: *Limiting the amount of offsets is conceptually good due to the difficulty in ensuring reductions that meet all the criteria.*

   As noted in our previous comments, SCAQMD staff would like to see local reductions to obtain the most co-benefits and economic stimulus for California. We understand that each facility will have to comply with relevant direct measures, but are concerned that there is no limit on the amount of allowances that can be used from other linked partners. This could result in less investment financially in California and less co-benefits. There are reduction opportunities in other WCI partner areas that have not been regulated as much as in California, so it is very likely that reductions in other areas would be less expensive to implement than they would be in California. In essence, California will be financing reductions in other states for offsets and projects that result in allowances being available for sale. One example is landfill control, which is very likely to be a source of offsets outside of California. Controlling methane from landfills is relatively inexpensive, and with the multiplier for global warming potential, makes this an affordable offset project. California landfills will be required to do what other landfills will be rewarded for.

   Recommendation: *SCAQMD staff does not have a specific recommendation, but is concerned about potential revenue transfer to other areas and loss of co-benefit reductions. A mechanism should be put in place to moderate these potential impacts and further incentivize reductions in California.*

6. Topic: Unlimited banking of allowances is allowed.

   Discussion: *The draft rules allow use of unused allowances from the current or previous compliance period with no discount. SCAQMD staff understands the need to reward early reductions that this is intended to address. However, if significant amounts of compliance instruments are banked, there will be less pressure for technology advancement, more energy efficiency, and other means to reduce GHGs.*

   Unlimited banking can also exacerbate potential hoarding situations, which are very difficult to monitor and control. If banked allowances never expire or reduce in value, this provides more incentive for speculators to try to obtain and control large portions of the compliance instruments. This can have deleterious impacts for the availability and price of compliance instruments. It may not always be transparent who owns compliance instruments, so this is difficult to monitor and control.

   Under the proposed state cap-and-trade program, an unused allowance from year 1 could be banked and used at full value up to the year 2020, which could be 8 years later. The overall endpoint (matching 1990 emission levels in the year 2020) may not be attainable if allowances are banked and used at the end point.

   Proposed federal legislation has a concept for borrowing with interest that could be a model for banking. For example, under proposed HR 2454 (Waxman-Markey) borrowing from the next year can be done without interest. Up to 15 percent of allowances can be borrowed from the subsequent 1 to 5 years after that with an interest rate of 8 percent per year borrowed. The same, or similar concept, could be applied to banking. This would still encourage early reductions, but the banked allowances would decrease in amount over time to help avoid a spike in emissions in the later years of the program. This would also discourage hoarding of credits by investors purely to spike the prices of credits in future years.

   Recommendation: *SCAQMD staff recommends that there be interest for banked allowances, similar to the manner in which borrowing is treated in proposed federal legislation, so banked allowances reduce in value over time. This will incentivize early reductions, but not deter from changes that will be needed to reduce GHGs over the next ten years and beyond. It will also assist in reducing the incentives to hoard compliance instruments.*

7. Topic: There are restrictions for organizations that might wish to hold compliance instruments that would preclude SCAQMD participation.

   Discussion: *The proposed rule specifies that if an organization verifies GHG emissions or offsets, or operates a clearing house for trading of offsets or related products, they cannot hold compliance instruments. This could include many local air districts, such as SCAQMD, that have staff trained as GHG emission verifiers. It does not seem fair that an investor or speculator could purchase and hold compliance instruments for profit, but government agencies and consulting firms that may have legitimate needs for them would be precluded.*

For example, SCAQMD Regulation XXVII includes provisions for our staff to collect fees, pool them, and implement reduction projects or purchase GHG reductions. Currently, these reductions are envisioned to be used for CEQA compliance, but should CARB determine that they would be acceptable for the cap-and-trade program, that would also further limit our agency's options. SCAQMD staff may wish to purchase compliance instruments from the state cap-and-trade program for this purpose.

Firms that verify GHG emissions may wish to hold some compliance instruments to cover potential liability issues that could arise where they need to compensate a client if they made an error that resulted in penalties or surrender of additional compliance instruments from the facility.

Recommendation: *Do not restrict the ability to purchase or hold compliance instruments.*

8. Topic: Offset life must be a minimum of 5 years.

   Discussion: *The rule specifies a minimum of a 5 year crediting period for offsets. There may be opportunities for early reductions that may not be additional for this length of time, but would be important to demonstrate a technology or method for reduction. Offsets with a shorter life may also be an appropriate way to acknowledge early reductions. As long as the offsets can be quantified, verified, are additional, and meet all the criteria for an offset, the 5 year minimum should be reconsidered. SCAQMD staff recognizes that this might be a resource issue for CARB to review protocols, but it is unlikely that protocols would be developed for short term reductions unless they are very cost effective. Having a protocol helps disseminate information on what reductions are possible. Ensuring that all the appropriate criteria are met will help ensure that actions that would happen anyway would not be granted offsets.*

   Recommendation: *Request consideration of shorter period for offset crediting when all other criteria are met so important opportunities to demonstrate cost-effective solutions and advance technology are not precluded if they are additional for less than 5 years.*

9. Topic: All facilities will have a calendar year compliance deadline.

   Discussion: *The cap-and-trade program will result in significant workload increases for CARB staff. Workload spikes will occur when facilities reconcile their emissions and surrender compliance instruments. Our experience with RECLAIM shows a similar spike in trading activity during reconciliation periods. The 2-cycle design in RECLAIM (half the facilities have a calendar year compliance period and half the facilities have a fiscal year compliance period that runs from July 1 through June 30) was recommended to help smooth fluctuations in credit prices and to help spread the agency's workload. As you are aware, RECLAIM credits have similar 2 cycle expiration dates.*

If GHG allowances do not have an expiration date, it would not be necessary to separated them in such a manner. However, by staggering the start date for facilities, the administrative burdens for reviewing emission reports and handling transactions and audits could be spread out more evenly.

Recommendation: *Consider staggering the start date and compliance dates for facilities to even out workload and to help smooth market price spikes.*

10. Topic: CARB staff is seeking comment on the potential design and administration of secondary and derivative markets. CARB staff may promote selected trading facilities for trading allowances, if they registered and are approved. The intent is to ensure that information is disclosed accurately and in a timely manner.

    Discussion: *CARB should retain the official and controlling record of trades, regardless of where the trades occur. This has worked well in RECLAIM. The language in Rule 2007 – Trading Requirements, subdivision (d) RTC Listing is below. Similar language should be added to the cap-and-trade rules.*

    > *The Executive Officer will maintain an RTC Listing specifying all RTCs held by each facility or person. The listing is the official and controlling record of RTC holdings. The Executive Officer will amend the RTC Listing upon any of the following actions:*
    >
    > *(1) RTC transfer;*
    > *(2) change in name of an RTC holder;*
    > *(3) expiration of unused RTCs;*
    > *(4) a reduction of a facility's annual emission Allocation pursuant to Rule 2010 (b)(1)(A) or (b)(3); or*
    > *(5) at the end of each quarter's reconciliation period.*

    Recommendation: *CARB should include language in the rule that they are the official and controlling record of trades, so regardless of where a trade occurs it is not recognized unless it is registered in CARB's data base. Regardless of the market design or mechanisms used, it is very important that there be transparency and timely information available on trades and prices.*