

**COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY TO THE
CALIFORNIA AIR RESOURCES BOARD ON ITS GREENHOUSE GAS CAP-AND-
TRADE REGULATION STATUS UPDATE**

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I.

INTRODUCTION

Southern California Edison Company (“SCE”) thanks the California Air Resources Board (“CARB”) staff for their time and effort in presenting their current thinking on crucial issues surrounding the proposed cap-and-trade regulation, including the allocation of allowances. At the May 17, 2010 workshop, CARB staff acknowledged that a free allocation of allowances could significantly reduce the economic burden of complying with Assembly Bill (“AB”) 32. SCE welcomes this recognition, and supports the overall direction of CARB staff since the initial release of the Preliminary Draft Regulation (“PDR”) for a cap-and-trade program.

However, SCE believes that CARB should not base its allocation of allowances to the electricity sector only upon the costs associated with the renewable electricity standard. Instead, similar to CARB staff’s proposed allocation to the industrial sector and consistent with Governor Schwarzenegger’s recent recommendation,¹ CARB should allocate sufficient greenhouse gas (“GHG”) allowances to the electricity sector to offset the cost of its compliance with the cap-and-trade program based on 100% of the sector’s emissions, even if CARB later requires such allowances to be introduced in the marketplace via CARB-administered auctions. In other words, CARB should allocate allowances to the electricity sector based on the sector’s historical emissions. Once CARB has determined the total amount of allowances to be allocated to the electricity sector, it should allocate these allowances according to a ratio of historical emissions and retail sales. Such an approach recognizes existing investments in low emission technology and will best mitigate the economic harm resulting from the implementation of the cap-and-trade program, consistent with SCE’s economic harm-based allowance allocation proposal.

Additionally, SCE emphasizes the need for cost containment measures in CARB’s cap-and-trade program, including allowing a greater supply and use of low-cost offsets than currently

¹ Letter from Governor Arnold Schwarzenegger to CARB Chairwoman Mary D. Nichols, at 2 (March 24, 2010).

proposed. The CARB staff proposal to create an allowance reserve needs to be clarified, as it may not provide sufficient protection against excessive costs and might unnecessarily inflate the costs at the outset of the program due to a lack of liquidity in the allowance market caused by CARB's withholding of allowances necessary to create a reserve. A reasonable price collar, if paired with a mechanism to develop additional compliance instruments, would provide real cost containment while sending a reliable price signal to green technology investors.

II.

CARB SHOULD ALLOCATE ALLOWANCES TO THE ELECTRICITY SECTOR BASED ON 100% OF THE ELECTRICITY SECTOR'S EMISSIONS

A. CARB Should Not Use Incremental Renewable Energy Procurement Costs as the Basis for Allocating Allowances

CARB staff suggested at the May 17 workshop that CARB should allocate allowance value to the electricity sector in a manner that offsets retail providers' costs of investments in renewable power. However, CARB staff did not provide sufficient details on this proposal. Specifically, assumptions such as the costs of reaching renewable energy targets or how CARB would actually take these costs into account in determining the number of allowances allocated to the electricity sector are missing. For example, the California Public Utilities Commission's ("CPUC") recent 33% Renewables Portfolio Standard Implementation Analysis Preliminary Results indicated that it would require approximately \$115 billion in new infrastructure investment in the electricity sector for the State of California to reach a 33% RPS goal, compared to around \$52 billion investment needed to reach a 20% RPS goal.² It is unclear whether CARB will be able to allocate sufficient allowances to the electricity sector to offset such high costs.

Furthermore, while CARB staff is correct in judging the 33% renewable electricity standard as a direct regulatory measure whose costs to the electricity sector should be offset by

² CPUC 33% Renewables Portfolio Standard Implementation Analysis Preliminary Results, at 53 (June 2009).

allowance allocation, CARB should also recognize that other proposed complementary measures to reduce GHG emissions, such as additional energy efficiency and increased combined heat and power, will also impose substantial and disproportionate costs on electricity customers. CARB should not use the cost of renewable energy targets as the basis for allowance allocation to the electricity sector. First of all, this proposal appears to be inconsistent with Governor Schwarzenegger's recent public letter to CARB Chairwoman Mary Nichols, in which he stated that a free allocation system "should reward companies that have already made significant investments in energy efficiency and carbon reduction."³ The Governor noted that "[i]t is critically important that California's program be designed in a way that gives businesses and industries in the state sufficient time to reduce their emissions in a cost-effective manner without unnecessary short-term costs."⁴ SCE recommends that CARB use the electricity sector's historical emissions as a basis for allocating allowances to the sector. Allocating free allowances based on historical emissions will provide the most appropriate basis for CARB to recognize and mitigate the economic burden that the cap-and-trade program will impose on the electricity sector and its customers, while still fundamentally altering the fuel mix of the total portfolio of generation resources that are used to serve the electricity sector's customers in California.

When considering a basis for allocating allowances, CARB should also be aware that its cap-and-trade design will be looked upon as a model for other regional and national cap-and-trade programs. It appears unlikely that a national cap-and-trade program would allocate allowances based on the costs of renewable energy procurement. Indeed, both of the major federal cap-and-trade programs proposed in Congress recognize the electricity sector's historical emissions burden. The Waxman-Markey bill has proposed to allocate GHG allowances to local distribution companies based on a 50-50 split between historical emissions and retail sales. The Kerry-Lieberman proposal similarly allocates allowances based on a 75-25 split between

³ Letter from Governor Arnold Schwarzenegger to CARB Chairwoman Mary D. Nichols, at 2 (March 24, 2010).

⁴ *Id.*

historical emissions and retail sales. Each proposal recognizes the need to provide a transition to a regime in which carbon prices drive investments.

If a federal program were to use the costs of achieving renewable energy targets as the basis for allowance allocation, such an allocation basis would likely place California compliance entities at a severe economic disadvantage relative to other states. For example, if a national cap-and-trade program were to allocate allowances to the electricity sector based on the incremental costs to achieve a national 20% renewables portfolio standard, California entities that have already reached 20% renewables would theoretically not incur any incremental costs and would therefore receive no allowances, even though the cap-and-trade program itself would place a sizeable economic burden on such entities. This burden would include not only the direct cost of allowances, but also an increased market price of electricity based on the GHG costs of the generation resource on the margin.

B. Regulated Utilities Can Transfer Allowance Value to Customers While Sending an Appropriate Carbon Price Signal

CARB can deliver the value of allocated GHG allowances to retail customers in the electricity sector via their utility distribution companies, under the regulatory oversight of their respective governing bodies. Further, it can facilitate this task while sending a price signal based on the cost of GHG emissions in retail rates paid by electricity customers. As noted in the Waxman-Markey bill, retail sellers such as SCE can transfer funds back to their customers through mechanisms other than marginal rates, such as rebates. SCE recommends that the CARB staff focus on methods to alleviate the total economic burden on electricity sector customers, while still sending a strong price signal to customers to reduce marginal consumption, rather than making an upfront assumption that the electricity sector's customers should not be given any free allocations in order send a strong price signal.

SCE agrees with the position of the Joint Utilities, stated in their March 26 letter to Chairwoman Mary Nichols.⁵ In that letter, the Joint Utilities supported allocating allowances to the electricity sector based on historical emissions. Allocating on this basis will better approximate the economic burden to the sector.

III.

WITHIN THE ELECTRICITY SECTOR, CARB SHOULD ALLOCATE ALLOWANCES BASED ON A MIXTURE OF RETAIL SALES AND HISTORICAL EMISSIONS

SCE supports allocation of allowances within the electricity sector based on the economic harm incurred due to compliance with the cap-and-trade program. The CPUC and the California Energy Commission (“CEC”) have suggested transitioning over time from an allocation based mainly on emissions to an allocation based mainly on retail sales.⁶ While retail sales should be an important component of any allocation methodology, historical emissions should continue to be included in the calculation. An allocation utilizing a blend of retail sales and historical emissions would most closely mitigate the economic harm to compliance entities as a result of the cap-and-trade program. Such blends have been proposed in national climate change legislation, such as Waxman-Markey and the recently-released Kerry-Lieberman proposal. CARB should consider both factors when apportioning allowances within the electricity sector.

⁵ Letter from Bear Valley Electric Service, California Municipal Utilities Association, Modesto Irrigation District, Mountain Utilities, Northern California Power Agency, Pacific Gas & Electric Company, PacifiCorp, Sacramento Municipal Utility District, San Diego Gas and Electric Company, Sierra Pacific Power Company, Southern California Edison Company, and Southern California Public Power Authority (“Joint Utilities”) to CARB Chairwoman Mary D. Nichols, at 2 (March 26, 2010).

⁶ See Final Opinion on Greenhouse Gas Regulatory Strategies, Decision 08-10-037 (October 16, 2008). Citation is to CPUC version of the decision.

IV.

CARB SHOULD DEVELOP AN EFFECTIVE COST CONTAINMENT PROPOSAL WITHOUT SETTING ASIDE COMPLIANCE INSTRUMENTS

A. A Broad and Robust Emissions Market that Includes an Adequate Supply of Low Cost Offsets is Crucial to Containing Costs

To most effectively achieve real, long-term, and cost-effective emission reductions, CARB should create a robust cap-and-trade market that reaches across geographic and economic sectors, including appropriate measures to contain costs. The need for cost containment is especially crucial if the cap-and-trade program is limited to California only, or only includes a few sectors.

At the May 17 workshop, CARB staff noted that they would continue to review cost containment measures, including offsets. As SCE has noted in earlier comments, arbitrary quantitative limits or geographic limits on offsets will result in unnecessarily high compliance costs. A large supply of offsets will be critical to CARB's cost containment efforts. As the Governor stated, "CARB should carefully consider how to assure an ample supply of high-quality offsets to help companies comply with carbon reduction strategies in a cost effective manner."⁷ SCE looks forward to participating with CARB staff in the upcoming public discussions on offset demand and supply and offset protocols.

B. CARB Should Clarify Its Allowance Reserve Proposal

CARB staff have proposed developing an "allowance reserve" that would allow for an increase in the supply of compliance instruments if prices approached a predetermined ceiling price. While SCE supports the general direction of CARB staff in developing such a proposal,

⁷ Letter from Governor Arnold Schwarzenegger to CARB Chairwoman Mary D. Nichols, at 2 (March 24, 2010).

significant questions remain. For example, it is unclear how such an allowance reserve would be populated with compliance instruments. Additionally, it is unclear how regulated entities would access the allowances from a reserve.

1. An Allowance Reserve Should Not Be Populated With Allowances From the Current Compliance Period

If the allowance reserve is populated by “holding back” compliance instruments from the current compliance period, then the real cost containment will not occur. If CARB arbitrarily removes allowances from distribution in a current compliance period, the reduction in the supply of allowances will result in increased market prices for allowances in that period. Maintaining a reserve to release these allowances for distribution in a future period will only shift the increase in allowance prices from one period to another. To provide real cost containment, an allowance reserve must be populated by a combination of future period allowances, an increased number of offsets, and additional compliance instruments. Such a reserve could provide real cost containment without increasing current period costs.

2. Regulated Entities Must be Able to Access Reserve Compliance Instruments at Any Time, Not Just During an Allowance Auction

CARB staff’s proposal did not clearly state how regulated entities would access the allowance reserve. For example, it is unclear whether the allowances in the reserve would be made available only if the prices reached a certain level during an allowance auction, or whether CARB will also take into account prices in the secondary market. CARB must design a price trigger mechanism and related allowance reserve so that regulated entities can access reserve allowances at any time during the compliance period, not just during an allowance auction.

3. An Allowance Reserve Must Provide a Hard Price Ceiling

It is important that an allowance reserve enable regulated entities to purchase compliance instruments at a price no higher than the ceiling price. CARB should clarify that this is the intent

of the allowance reserve. It is possible for the allowance reserve to provide a short-term increase in compliance instruments while not limiting the price to the ceiling price. For example, if reserve allowances are released into the market to provide a short-term increase in supply when prices reach a point “higher than anticipated,” this additional supply should mitigate the increase in short-term prices. However, there is no guarantee that prices would still not exceed the ceiling price. CARB must develop a mechanism to enable regulated entities to purchase compliance instruments at a price no higher than the ceiling price.

C. Properly Designed, an Allowance Reserve Can Facilitate a Price Collar

Under appropriate conditions, SCE supports a price collar, or a floor and ceiling price for allowances. Such a price collar must have reasonable floor and ceiling prices that reflect appropriate cost considerations. Moreover, the treatment of the floor and ceiling prices must be consistent (i.e., if there is a hard floor price, there must also be a hard ceiling price). SCE encourages CARB staff to continue to evaluate how an allowance reserve could be used to establish a reasonable price collar.

The floor price could be established by setting an auction reserve price at a level that would send a reliable minimum price signal to the carbon markets and green technology sector without imposing an excessive economic burden on regulated entities. While CARB may use a number of approaches to identify the floor price, SCE suggests starting with a low floor price early in the cap-and-trade program, and gradually increasing the floor over time.

The ceiling price should be established at a level that provides real cost control and economic protection without risking the sort of undue economic distress that could cause the Governor to suspend AB 32 regulations. As stated above, CARB could maintain the ceiling by utilizing an allowance reserve populated by expanding the use of offsets or borrowing allowances from future compliance periods. CARB may decide to use these cost containment measures separately or in tandem. For example, once allowance prices approach the ceiling, CARB could first expand the use of offsets. Should prices continue to climb, CARB could then

allow for borrowing. However, borrowing should not be the sole mechanism by which the allowance reserve is populated. CARB should evaluate how a reserve can facilitate a real long-term increase in the supply of compliance instruments. Doing so would enable the development of a price ceiling without imposing additional economic stress on regulated entities in future periods.

V.

CONCLUSION

SCE appreciates the opportunity to comment on the Greenhouse Gas Cap-and-Trade Regulation Status Update and the current staff thinking on allowance allocation. SCE looks forward to working closely with CARB in the upcoming workshops to develop regulations that provide sufficient cost containment measures, and urges CARB to adopt regulations in line with the recommendations contained herein.

Respectfully submitted,

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