SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT TO THE COMMODITY FUTURES TRADING COMMISSION ON THE OVERSIGHT OF EXISTING AND PROSPECTIVE CARBON MARKETS UNDER THE DODD-FRANK ACT

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Dated: December 17, 2010

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I. INTRODUCTION

The Southern California Public Power Authority ("SCPPA") [1] respectfully submits this comment to the Commodity Futures Trading Commission ("CFTC") in relation to the study regarding the oversight of existing and prospective carbon markets under section 750 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173, Public Law No: 111-203, enacted July 21, 2010).

SCPPA is a joint powers authority. Its members are 12 publicly-owned utilities: Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, the Los Angeles Department of Water and Power, the Imperial Irrigation District, Pasadena, Riverside and Vernon, California. SCPPA members serve over two million residential and business customers in Southern California and a population of approximately 4.6 million people. As of the end of 2010, coal-fired generation represents approximately 35% of the energy SCPPA members deliver to customers, 30% comes from natural gas, and the remainder comes from a mix of nuclear and renewable energy.

Due to the nature of their operations, SCPPA members will be covered entities with significant compliance obligations under the California greenhouse gas emissions cap and trade program adopted yesterday (December 16, 2010) and scheduled to commence in 2012. As the new California carbon market will play a key role in allowing SCPPA members to meet their

[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, the Imperial Irrigation District, Pasadena, and Riverside.

compliance obligations, it is important to SCPPA members that the carbon market is appropriately regulated to ensure efficient operation and minimize market manipulation.

II. CALIFORNIA CAP AND TRADE PROGRAM

On December 16, 2010, the California Air Resources Board ("ARB") voted 9-1 to approve Resolution 10-42 adopting the Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms ("Cap and Trade Regulation"), subject to various changes as outlined in the resolution. The ARB also approved a resolution revising the ARB's emissions reporting regulation to support the cap and trade program. Resolution 10-42 is attached below for reference.

ARB Resolution
10-42 Adopting Cap-a

The full text of the Cap and Trade Regulation is available at http://www.arb.ca.gov/regact/2010/capandtrade10/capv1appa.pdf. The ARB staff's Initial Statement of Reasons for the Cap and Trade Regulation, including a summary of the cap and trade program, is available at http://www.arb.ca.gov/regact/2010/capandtrade10/capisor.pdf.

In response to question 2 in the CFTC's request for comments, there are many features of the California cap and trade program that may have an effect on market oversight provisions. Some key features are briefly summarized below.

Basic characteristics of allowances	• Entitlement to emit one metric ton of carbon dioxide equivalent. • Allowances are not property rights.
Cost containment provisions	• Three-year compliance periods. • Offsets, limited to 8 percent of an entity's compliance obligation. • The allowance reserve, from which covered entities can buy allowances at set prices.

	• Banking of allowances (subject to the holding limit).
Frequency of allocations and auctions	• Some allowances are administratively allocated to electric distribution utilities and industrial entities in January each year. • Allowances are auctioned quarterly. • Covered entities can access the allowance reserve quarterly.
Provisions to reduce the potential for market manipulation	• Purchase limit: limit on the number of allowances each entity can purchase at the allowance auctions (10 percent of the auctioned allowances for covered entities, 4 percent for non-covered entities). • Holding limit: limit on the number of allowances each entity can hold at any one time (approximately 6 million), with a limited exemption for allowances equal to the entity's compliance obligations. • Disclosure of corporate associations. Purchase limits and holding limits are applied across all entities with corporate associations.

III. WESTERN CLIMATE INITIATIVE

California is a member of the Western Climate Initiative ("WCI"). The ARB expects that the California cap and trade program will link to the cap and trade programs of other WCI members in 2011, after a review and rulemaking procedure. The other WCI members that may establish cap and trade programs are New Mexico, British Columbia, Quebec, and Ontario. Linked members would accept, for compliance with their own program, allowances and offsets issued by other linked members, resulting in a WCI-wide carbon market.

The WCI requested stakeholder feedback on carbon market oversight recommendations in April 2010. The WCI paper on market oversight, together with other market-related materials, can be accessed at http://westernclimateinitiative.org/component/remository/Markets-Committee-Documents/. SCPPA's comments on the market oversight recommendations are attached below for reference.

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IV. GENERAL COMMENTS

In relation to the goals of regulatory oversight mentioned in question 1 of the CFTC's request for comments, the CFTC should bear in mind that the California/ WCI carbon market is not just a commodity trading market but is being established to effect and facilitate an environmental regulatory purpose – the reduction of greenhouse gas emissions.

Electric sector entities will be key participants in the California/WCI carbon market and any future national carbon market. Electric sector entities do not enter these markets by choice but are required to do so in order to comply with the cap and trade program. Their overriding concern is to continue to provide reliable and affordable electric energy to their customers, while complying with all applicable regulations. They are unlikely to speculate or transact in carbon markets for profit.

As SCPPA members are publicly owned utilities, the ratepayers of the SCPPA members are also the shareholders. Consequently, 100 percent of the cost of the cap and trade program, including the costs of participating in the carbon market, will be borne by households and businesses in the SCPPA communities.

The electric sector in California is already heavily regulated and is subject to the oversight of various bodies including the California Public Utilities Commission, the California Energy Commission, and the local governing boards of publicly owned utilities such as the SCPPA members. Under the cap and trade program electric sector entities will also be subject to the oversight of the ARB. Any new carbon market oversight provisions imposed by the CFTC should take into account existing regulations.

V. CONCLUSION

SCPPA requests the CFTC to consider these comments when preparing recommendations for the oversight of carbon markets. SCPPA appreciates the opportunity to submit these comments to the CFTC and would be happy to provide more information upon request.

Respectfully submitted,

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Dated: December 17, 2010

PROPOSED WITH 15-DAY MODIFICATIONS

State of California
AIR RESOURCES BOARD

California Cap-and-Trade Program

Resolution 10-42

December 16, 2010

Agenda Item No.: 10-11-1

WHEREAS, sections 39600 and 39601 of the Health and Safety Code authorize the Air Resources Board (ARB or Board) to adopt standards, rules, and regulations and to do such acts as may be necessary for the proper execution of the powers and duties granted to and imposed upon the Board by law;

WHEREAS, the California Global Warming Solutions Act of 2006 (AB 32; Chapter 488, Statutes of 2006; Health & Safety Code §38500 et seq.) declares that global warming poses a serious threat to the economic well-being, public health, natural resources, and environment of California and creates a comprehensive multi-year program to reduce California's greenhouse gas (GHG) emissions to 1990 levels by 2020;

WHEREAS, AB 32 added section 38501 to the Health and Safety Code, which expresses the Legislature's intent that ARB coordinate with State agencies and consult with the environmental justice community, industry sectors, business groups, academic institutions, environmental organizations, and other stakeholders in implementing AB 32; and design emissions reduction measures to meet the statewide emissions limits for greenhouse gases in a manner that minimizes costs and maximizes benefits for California's economy, maximizes additional environmental and economic co-benefits for California, and complements the State's efforts to improve air quality;

WHEREAS, section 38501(c) of the Health and Safety Code declares that California has long been a national and international leader on energy conservation and environmental stewardship efforts, and the program established pursuant to AB 32 will continue this tradition of environmental leadership by placing California at the forefront of national and international efforts to reduce GHG emissions;

WHEREAS, section 38501(d) of the Health and Safety Code confirms that national and international actions are necessary to fully address the issue of global warming, but action taken by California to reduce GHG emissions will have far reaching effects by encouraging other states, the federal government, and other countries to act;

WHEREAS, section 38510 of the Health and Safety Code designates ARB as the State agency charged with monitoring and regulating sources of GHG emissions in order to reduce these emissions;

WHEREAS, section 38560 of the Health and Safety Code directs ARB to adopt rules and regulations in an open public process to achieve the maximum technologically feasible and cost-effective GHG emission reductions from sources or categories of sources;

WHEREAS, section 38562 of the Health and Safety Code requires ARB to adopt GHG emission limits and emission reduction measures by regulation to achieve the maximum technologically feasible and cost-effective reductions in GHG emissions in furtherance of achieving the statewide GHG emissions limit, to become operative beginning on January 1, 2012;

WHEREAS, section 38562 of the Health and Safety Code requires ARB, to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit, to do all of the following:

> Design the regulations, including distribution of emissions allowances where appropriate, in a manner that is equitable, seeks to minimize costs and maximize total benefits to California, and encourages early action to reduce greenhouse gas emissions;
>
> Ensure that activities undertaken to comply with the regulations do not disproportionately impact low-income communities;
>
> Ensure that entities that have voluntarily reduced their greenhouse gas emissions prior to the implementation of this section receive appropriate credit for early voluntary reductions;
>
> Ensure that activities undertaken pursuant to the regulations complement, and do not interfere with, efforts to achieve and maintain federal and state ambient air quality standards and to reduce toxic air contaminant emissions;
>
> Consider cost-effectiveness of these regulations;
>
> Consider overall societal benefits, including reductions in other air pollutants, diversification of energy sources, and other benefits to the economy, environment, and public health;
>
> Minimize the administrative burden of implementing and complying with these regulations;

Minimize leakage; and

Consider the significance of the contribution of each source or category of sources to statewide emissions of greenhouse gases.

WHEREAS, sections 38562(c) and 38570 of the Health and Safety Code authorize ARB to adopt regulations pursuant to section 38562 that utilize market-based compliance mechanisms;

WHEREAS, section 38570 of the Health and Safety Code also directs ARB, to the extent feasible and in furtherance of achieving the statewide GHG emissions limit, to do all of the following before including any market-based compliance mechanism in the regulations:

Consider the potential for direct, indirect, and cumulative emissions impacts from these mechanisms, including localized impacts in communities that are already adversely impacted by air pollution;

Design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants; and

Maximize additional environmental and economic benefits for California, as appropriate.

WHEREAS, section 38570(c) of the Health and Safety Code further directs ARB to adopt regulations governing how market-based compliance mechanisms may be used by regulated entities subject to GHG emissions limits and mandatory emissions reporting requirements to achieve compliance with their GHG emissions limits;

WHEREAS, section 38571 of the Health and Safety Code directs ARB to adopt methodologies for the quantification of voluntary GHG emissions reductions and regulations to verify and enforce any voluntary GHG emissions reductions that are authorized by ARB for use to comply with GHG emissions limits established by ARB; the adoption of methodologies is exempt from the rulemaking provisions of the Administrative Procedure Act;

WHEREAS, section 38561 of the Health and Safety Code directed ARB to approve a Scoping Plan for achieving the maximum technologically feasible and cost-effective reductions in greenhouse gas emissions;

WHEREAS, the Board approved the Climate Change Scoping Plan, which includes a recommendation that California adopt a portfolio of emission reduction measures, including, if appropriate, a California greenhouse gas cap-and-trade program that can link with other programs to create a regional market system;

WHEREAS, in 2007, California helped establish the Western Climate Initiative (WCI), a cooperative effort of seven U.S. states and four Canadian provinces that are collaborating to identify, evaluate, and implement policies to reduce GHG emissions, including the design and implementation of a regional cap-and-trade program;

WHEREAS, section 38591 of the Health and Safety Code directed ARB to create an Environmental Justice Advisory Committee (EJAC) and an Economic and Technology Advancement Advisory Committee (ETAAC) to advise ARB on implementation of AB 32;

WHEREAS, the Board has considered the comments and recommendations provided to date by EJAC and ETAAC on a cap-and-trade program;

WHEREAS, in May 2009, the Economic and Allocation Advisory Committee (EAAC) was appointed to advise on the implementation of AB 32 and a cap-and-trade program; the EAAC consisted of economic, financial, and policy experts, and provided advice on allocation of allowances and use of their value;

WHEREAS, the Board has considered the comments and recommendations provided to date by EAAC on a cap-and-trade program; in addressing allowance allocation, the EAAC recommended that the cap-and-trade program employ free allocation only for the purpose of addressing emissions leakage associated with energy-intensive trade-exposed industries, and only in circumstances where the alternative of some form of border adjustment is not practical;

WHEREAS, the high emissions intensity of cement production relative to the value of the product produced makes the cement sector particularly well-suited as a pilot project for the development and consideration of a border adjustment approach to addressing the potential for leakage that could result from increases in cement importation;

WHEREAS, the EACC recommended that ARB adopt policy instruments that can be substantially modified or eliminated as leakage problems change with the emergence of regional or federal policies;

WHEREAS, staff has proposed a new regulation establishing a cap-and-trade program for California; the draft regulation is set forth in Attachment A hereto and includes the following elements:

Addresses emissions of carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), sulfur hexafluoride (SF_6), and nitrogen trifluoride (NF_3);

Identifies the program scope: starting in 2012, electricity, including imports, and large (>25,000 metric tons carbon dioxide per year) industrial facilities are included; starting in 2015, distributors of transportation fuels, natural gas, and other fuels are included;

Establishes a declining aggregated emissions cap on included sectors. The cap starts at 165.8 million allowances in 2012, which is equal to the emissions forecast for that year The cap declines approximately 2 percent per year in the initial period (2012–2014). In 2015, the cap increases to 394.5 million allowances to account for the expansion in program scope. The cap declines at approximately 3 percent per year between 2015 and 2020. The 2020 cap is set at 334.2 million allowances;

Provides for distribution of allowances through a mix of direct allocation and auction in a system designed to reward early action and investment in energy efficiency and GHG emissions reduction. Allowances will be distributed for the purposes of price containment, industry transition and assistance, and fulfillment of AB 32 statutory objectives;

Establishes a market platform for allowance auction and sale;

Establishes cost-containment mechanisms and market flexibility mechanisms, including trading of allowances and offsets, allowance banking, three-year compliance periods, the ability to use offsets for up to 8 percent of an entity's compliance obligation, and an allowance reserve that provides allowances at fixed prices to those with compliance obligations;

Establishes a mechanism to link with other GHG trading programs and approve the use of compliance instruments issued by a linked external GHG trading program;

Establishes requirements and procedures for ARB to issue offset credits according to offset protocols adopted by the Board;

Includes four offset protocols to be considered by the Board as part of this regulatory package;

Establishes a mechanism to include international offset programs from an entire sector within a region;

Establishes a robust enforcement mechanism that will discourage gaming of the system and deter and punish fraudulent activities;

Provides an opt-in provision for entities whose annual GHG emissions are below the threshold to voluntarily participate in this program; and

Incorporates adaptive management to mitigate potential adverse environmental effects.

WHEREAS, staff conducted forty public workshops regarding the proposed cap-and-trade regulation during the period 2008–2010, and also participated in numerous other meetings with various stakeholders to include them in the regulatory development process;

WHEREAS, the Board strongly supports the critical role that U.S. EPA plays in the design of national strategies to reduce GHG emissions;

WHEREAS, the Board is committed to a continued, strong state-federal collaboration that maximizes California's long-standing and growing investments in low-carbon technologies, fuels, and energy efficiency;

WHEREAS, the Board believes that this state-federal collaboration can advance climate policies that significantly reduce GHG emissions while reinvigorating the nation's industrial base and energy sector;

WHEREAS, the Board has considered the community impacts of the proposed regulation, including environmental justice concerns;

WHEREAS, the Board believes that the success of a cap-and-trade program is predicated on GHG regulations that are clear, consistent, enforceable, and transparent;

WHEREAS, staff has prepared a document entitled "Staff Report: Initial Statement of Reasons for Proposed Regulation to Implement the California Cap-and-Trade Program," (ISOR) which presents the rationale and basis for the proposed regulation and identifies the data, reports, and information relied upon;

WHEREAS, a public hearing and other administrative proceedings have been held in accordance with the provisions of Chapter 3.5 (commencing with section 11340), part 1, division 3, title 2 of the Government Code;

WHEREAS, the ISOR and proposed regulatory language were made available to the public at least 45 days prior to the public hearing to consider the proposed regulation;

WHEREAS, in consideration of the ISOR, written comments, and public testimony it has received to date, the Board finds that:

GHG emissions associated with entities covered by the cap-and-trade regulation account for about 80% of GHG emissions in the State;

Covered entities would be able to reduce emissions to comply with the cap-and-trade regulation using a variety of currently available GHG reduction strategies, including those complementary measures identified in the Scoping Plan;

The cap-and-trade regulation is expected to significantly reduce GHG emissions; together with the complementary measures identified in the Scoping Plan, by 2020 the cap-and-trade regulation is expected to reduce GHG emissions to 1990 levels;

The cap-and-trade regulation was developed using the best available economic and scientific information and will achieve the maximum technologically feasible and cost-effective GHG emission reductions from covered entities and offset projects;

The GHG emission reductions resulting from the implementation of the cap-and-trade regulation are expected to be real, permanent, quantifiable, verifiable, and enforceable by ARB, and the cap-and-trade regulation complements, and does not interfere with other air quality efforts;

The proposed cap-and-trade regulation meets the statutory requirements identified in section 38562 of the Health and Safety Code;

The cap-and-trade regulation meets the statutory requirements for a market-based mechanism identified in section 38570 of the Health and Safety Code;

The cap-and-trade regulation was developed in an open public process, in consultation with affected parties, through numerous public workshops, individual meetings, and other outreach efforts, and these efforts are expected to continue until a final decision is made;

The benefits to human health, public safety, public welfare, or the environment justify the costs of the cap-and-trade regulation;

The cost-effectiveness of the cap-and-trade regulation has been considered, and the regulation will achieve cost-effective GHG emission reductions;

The cap-and-trade regulation is consistent with ARB's environmental justice policies and will equally benefit residents of any race, culture, or income level;

Robust reporting and verification requirements associated with the cap-and-trade regulation are necessary for the health, safety, and welfare of the people of the State; and

No reasonable alternative considered to date, or that has otherwise been identified and brought to the attention of ARB, would be more effective at carrying out the purpose for which the regulation is proposed or would be as effective and less burdensome to affected entities than the proposed regulation;

WHEREAS, the Board further finds that;

Staff performed economic modeling to consider the impact of the proposed regulation on the economy of the State and the potential for adverse economic impacts on California business enterprises and individuals as required by California law; the conclusions and supporting documentation for this analysis are set forth in the ISOR;

Increased investment in efficient buildings and technologies and in advanced fuels, spurred by the cap-and-trade program, will reduce fuel use by 2 to 4 percent in 2020, while economic growth between 2007 and 2020 is projected to continue at a rate virtually on par with the projected rate of 2.4 percent; and

Implementation of the California cap-and-trade program will reduce California's dependence on fossil fuels, thereby reducing vulnerability to price spikes.

WHEREAS, the California Environmental Quality Act (CEQA) and Board regulations at California Code of Regulations, title 17, section 60006, require that no project which may have significant adverse environmental impacts be adopted as originally proposed if feasible alternatives or mitigation measures are available to reduce or eliminate such impacts;

WHEREAS, CEQA allows public agencies to prepare a plan or other written documentation in lieu of an environmental impact report (i.e., a functional equivalent environmental document) once the Secretary of the Resources Agency has certified an agency's program pursuant to section 21080.5 of the Public Resources Code;

WHEREAS, pursuant to section 21080.5 of the Public Resources Code, the Secretary of the Resources Agency has certified that portion of ARB's program that involves the adoption, approval, amendment, or repeal of standards, rules, regulations, or plans;

WHEREAS, the Board's regulations under ARB's certified program provide that prior to taking final action on any proposal for which significant environmental issues have been raised, the decision maker shall approve a written response to each such issue;

WHEREAS, pursuant to the requirements of CEQA and the Board's regulations under its certified regulatory program, ARB staff prepared a functional equivalent document (FED), which contains the following analyses and elements:

The FED determined that the proposed regulation is expected to improve air quality in California on a statewide and regional basis by reducing GHG and criteria and toxic pollutants, based on the best available data;

Because the proposed regulation provides covered entities flexibility to select the most cost-effective strategies to reduce GHG emissions, the potential exists for increases in co-pollutant air emissions levels, but not beyond permitted levels. Because ARB cannot determine the exact locations of possible local emission increases, the FED conservatively determined that such increases, although unlikely, could result in a potentially significant adverse impact;

An adaptive management strategy has been incorporated into the project to address any potential adverse impacts. ARB will monitor the implementation of the cap-and-trade regulation to identify and address any situations where the program may cause an increase in criteria or toxic pollutant emissions. If unanticipated adverse environmental effects are identified that are substantial enough to interfere with or undermine the achievement of the objectives for the cap-and-trade program as defined by AB 32, ARB will develop and implement appropriate responses to rectify any identified environmental issues;

The FED determined that there may be potentially significant adverse impacts from project-specific construction and ground-disturbing activities, and associated increases in truck traffic.

The FED determined that there may be potentially significant and unavoidable project-specific impacts to biological resources, cultural resources, geology, soils and mineral resources, hydrology, water quality and water supply, land use, noise, transportation and traffic. The FED identified mitigation that would substantially reduce these identified impacts, but not to a level of insignificance for all resource areas;

The Board does not have the authority to impose mitigation measures for these identified project-specific impacts for future projects outside ARB's regulatory purview and must rely on the agencies that will ultimately conduct project-level review and approve those projects to impose required mitigation;

The FED also considered feasible alternatives to the proposed regulation that could reduce potentially significant adverse impacts;

WHEREAS the FED was circulated for public comment from October 28, 2010 until the date of this hearing, and no final decision will be made until comments on the FED are fully considered and addressed by the decision maker;

WHEREAS the Executive Officer is the decision maker for the purposes of title 17, California Code of Regulations (CCR), section 60007.

NOW, THEREFORE, BE IT RESOLVED that the Board directs the Executive Officer to take the following actions:

1. Before making modified regulatory language available for formal public comment, hold one or more workshops on the modifications as set forth in Attachment B to provide an opportunity for public input on the details of the suggested modifications;

2. Make the modified regulatory language set forth in Attachment B, with such other conforming modifications as may be appropriate, available for public comment for a period of 15 days, provided that the Executive Officer shall consider such written comments as may be submitted during this period, shall make such modifications as may be appropriate in light of the comments received, and shall present the regulation to the Board for further consideration if he determines that this is warranted.

3. Evaluate all comments received during the public comment periods, including comments raising significant environmental issues, and prepare and approve written responses as required by CEQA, ARB regulations under its certified regulatory program (title 17, CCR, section 60007), and Government Code section 11346.9.

4. Determine whether there are feasible alternatives or mitigation measures that could be implemented to reduce or eliminate any potential adverse environmental impacts, while at the same addressing the serious economic recession and its impact on industry and residents of the State.

5. Make findings as required by Public Resources Code section 21081 if the regulation would result in one or more significant adverse environmental effects.

6. Take final action to adopt the proposed regulation set forth in Attachment A, with the modifications set forth in Attachment B, any additional conforming modifications that may be appropriate, and any modifications that are necessary to ensure that all feasible mitigation measures or feasible alternatives that would substantially reduce any significant adverse environmental impacts have been incorporated into the final action; or return the proposed amendments and findings to the Board for further consideration before taking final action, if he determines that this is warranted.

BE IT FURTHER RESOLVED that as part of the modifications to be made available for a 15-day public comment period, the Board directs the Executive Officer to finalize a proposal for the allowance allocation system as described in Attachment B, including finalizing benchmarks for allocation to industry and allocation to electric distribution utilities, and to report to the Board on the final allocation system prior to the start of the cap-and-trade program.

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to review the treatment of combined heat and power facilities in the cap-and-trade program to ensure that appropriate incentives are being provided for increased use of efficient combined heat and power;

BE IT FURTHER RESOLVED that as part of the modifications to be made available for a 15-day public comment period, the Board directs the Executive Officer to finalize a proposal for establishment of a set-aside for voluntary renewable electricity, and to initiate a process for quantification of greenhouse gas emission reductions that result from voluntary renewable projects, and rules for retiring allowances from the set-aside based on those projects;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to review the technical and legal issues related to implementation of a border adjustment to impose obligations on importers of cement that are equivalent to those faced by California cement manufacturers under the cap-and-trade regulation, and to implement such a provision (either as part of the 15-day modifications, if it is feasible, or as part of another process) and if it is necessary to avoid leakage in the cement sector;

BE IT FURTHER RESOLVED, the Board directs the Executive Officer to work with the interested stakeholders to review the appropriate point of regulation for transportation fuels to ensure that all transportation fuels imported and/or delivered into California are covered under the program once and only once, and, if necessary, to incorporate in the 15-day modifications any revisions to the regulation necessary to achieve that end;

BE IT FURTHER RESOLVED, the Board directs the Executive Officer to review the requirements of the compliance offset program, the compliance protocols, the early action offset provisions, and the role of approved offset project registries, and, if necessary, to incorporate in the 15-day changes any revisions to the regulation necessary to ensure consistency throughout the offset program;

BE IT FURTHER RESOLVED, that the Board directs the Executive Officer to deposit a minimum of 10 percent of annual revenues generated from the direct auction of allowances in the Air Pollution Control fund for appropriation by the Legislature on programs and projects that reduce greenhouse gas emissions or mitigate direct health impacts of climate change, and promote green collar employment opportunities in the

most impacted and disadvantaged communities in California. The Board directs the Executive Officer to initiate a public process to develop recommendations to the Legislature and Governor describing the types of projects and programs to be funded; eligibility criteria; and the selection, oversight and accountability process for the projects and programs to be funded;

BE IT FURTHER RESOLVED that staff will further develop requirements to ensure changes in reported emissions from imported electricity that serves California does not result merely in a shift of emissions within the Western Electricity Coordinating Council region, but reduces overall emissions;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to continue working with stakeholders and regulated entities to make such modifications as may be appropriate to the proposed enforcement provisions of section 96014;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to initiate a public process for the review of additional compliance offset protocols no later than February 2011, for the purpose of bringing additional protocols to the Board for consideration as soon as is practical;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to work with U.S. EPA on the development of a the federal regulatory framework to grant delegation or equivalency to California's climate program where appropriate;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to work with the California Public Utilities Commission (CPUC) and the Publicly Owned Utilities (POU) to ensure that the proposed allowance value directed to the electric distribution utilities is used for the benefit of residential, commercial and industrial ratepayers that might otherwise face indirect costs from implementation of this regulation, and for the purposes of AB 32;

BE IT FURTHER RESOLVED that the Board encourages the CPUC and the POU governing boards to work with local governments and non-governmental organizations to direct a portion of allowance value, if the cap-and-trade regulation is approved, into investments in local communities, especially the most disadvantaged communities, and to provide an opportunity for small businesses, schools, affordable housing associations, and other community institutions to participate in and benefit from statewide efforts to reduce greenhouse gas emissions;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to work with the CPUC, the California Energy Commission, the California Independent System Operator and other interested parties to monitor the proposed greenhouse gas cap-and-trade market, including the effect of the cap-and-trade program on the state's energy

markets, and monitoring to the extent feasible the ability of affected entities to pass on costs;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to contract with an independent entity with appropriate expertise that will monitor and provide public reports on the operation of the market, including auctions and reserve sales, on a quarterly basis and recommend corrective action if needed;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to report to the Board no later than July 31, 2011, on the progress being made on implementing the cap-and-trade program, provided the cap-and-trade regulation is approved, including information on the status of the following:

- Finalization of the allowance allocation system;
- implementation of cap-and-trade programs by other Western Climate Initiative (WCI) partner jurisdictions, and the expected timing of Board consideration of linking with WCI partner programs;
- implementation of a market tracking system, and a schedule for initial deployment of the system and making training available for covered entities and others that will need to register in the system and use it for participating in the program;
- implementation of an auction system;
- implementation of an offset tracking system, and information on any entities that have indicated an interest in applying to become third-party registries under the cap-and-trade regulation;
- work with other agencies and other interested parties on market oversight, including any market simulation efforts;
- review of additional compliance offset protocols and the schedule for bringing them to the Board for consideration;
- estimates of expected offset supply during the first compliance period based on the four compliance protocols that are part of this rulemaking and on additional protocols that are currently under review; and
- identification of any remaining tasks that must be completed before the start of the cap-and-trade program, and a schedule for completing these tasks.

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to hold public consultations over the next year to identify potential obstacles to compliance and, as necessary, incorporate or enhance compliance assistance mechanisms into the program, provided the cap-and-trade regulation is approved;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to initiate a public process to establish a protocol for accounting for sequestration of CO_2 through geologic means and recommendations for how such sequestration should be addressed in the cap-and-trade program, including separate requirements for carbon capture and

geologic sequestration performed with CO_2-enhanced oil recovery; carbon dioxide injected underground for the purposes of enhanced oil recovery will not be considered to be an emissions reduction without meeting ARB's monitoring, reporting, verification, and permanence requirements;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to continue to review information concerning the emissions intensity and trade exposure of different industries in California, and to recommend to the Board changes to the leakage risk determinations, if needed, to be implemented prior to the initial allocation of allowances for the first compliance period starting in 2012 for industries not identified in Table 8-1 of the cap-and-trade regulation, or prior to the initial allocation of allowances for the second compliance period starting in 2015 for industries identified in Table 8-1 of the cap-and-trade regulation;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to initiate a public process for determining whether allowances should be allocated directly to natural gas utilities on behalf of their customers and, if so, to recommend to the Board what method should be used for that allocation to be implemented prior to the initial allocation of allowances for the second compliance period starting in 2015;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to evaluate the cross-sectoral equity issues related to the treatment of transportation fuels in the cap-and-trade program, including the effects of allowance distribution to different sectors and the expected increased use of electricity in the transportation sector, and to recommend to the Board any changes to the program, if needed, to be implemented prior to the initial allocation of allowances for the second compliance period starting in 2015;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to make information periodically available to the public relating to the operation of the market, including timely provision of information on the results of each auction and each sale from the allowance reserve;

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to update the Board annually on the status of the cap-and-trade program, including:

- information on the operation of the California program and any linked programs;
- actions being taken by covered entities to comply with the program;
- shifts in fuel use in different sectors, including information on the use of electricity in the transportation sector, and the use of biofuels and biomass;
- any sales of allowances from the allowance reserve;
- the supply of offset credits registered in ARB's tracking system, approved third-party registries, or the tracking systems of linked programs;
- the expected offset supply from projects listed on these systems; and
- any changes to linked cap-and-trade programs.

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to evaluate the operation of the market if all allowances are sold from any tier of the allowance reserve, and to report to the Board on the reasons that the reserve is being depleted, and make recommendations within six months for any corrective action that is required to ensure that the cap-and-trade program's cost containment mechanisms remain robust; and

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to develop regulatory amendments to the cap-and-trade regulation at least once each compliance period, timed to adjust the program prior to the start of the next compliance period to make any modifications to the regulation needed based on information gained through the implementation of the cap-and-trade program, monitoring of the market, interaction of the cap-and-trade program with other AB 32 measures, the adaptive management program initiated to monitor implementation of the program, and changes in regional, federal or international climate policy, or to report to the Board that no rulemaking is needed.

Resolution 10-42

December 16, 2010

Identification of Attachments to the Board Resolution

Attachment A: Proposed Regulation Order for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms, title 17, California Code of Regulations, sections 95800 to 96022, as set forth in Appendix A to the Initial Statement of Reasons, released October 28, 2010.

Attachment B: Staff's Suggested Modifications to the Original Proposal, distributed at the December 16, 2010 Board hearing.

ATTACHMENT B

PUBLIC HEARING TO CONSIDER ADOPTION OF A PROPOSED REGULATION TO IMPLEMENT A CALIFORNIA CAP-AND-TRADE PROGRAM

Staff's Suggested Modifications to the Original Proposal

TO BE PRESENTED AT THE DECEMBER 16, 2010 HEARING
OF THE AIR RESOURCES BOARD

Note: shown below are staff's suggested modifications to the originally proposed regulatory text set forth in Appendix A to the Staff Report: Initial Statement of Reasons, released October 28, 2010. Only those portions containing the suggested modifications are included.

Comments and Suggested Modifications to the Original Regulatory Proposal Set Forth in Attachment A to Resolution 10-42

This document is printed in a style to indicate changes from the originally proposed regulatory language. All originally proposed regulatory language is indicated by plain type. Staff's suggested modifications to the original proposal are shown in underline to indicate additions to the original proposal and ~~strikethrough~~ to indicate deletions. All proposed modifications will be made available to the public for a fifteen-day comment period prior to final adoption. For proposals without specific proposed regulatory language, staff provides an outline of the approach to be taken to construct necessary regulatory language. Because of the scope and complexity of some of the proposed changes, staff plans to will solicit stakeholder input through holding public workshops on those issues prior to making specific regulatory language available to the public in a fifteen-day comment period prior to final adoption.

PROPOSED CHANGES FOR WHICH STAFF DOES NOT PLAN TO HOLD PUBLIC WORKSHOPS

Modifications to section 95852, Emissions Categories Used to Calculate Compliance Obligations.

1. Staff recommends modifying §95852.2 to clarify emissions without a compliance obligation.

Modify title 17, CCR, §95852.2 to read:

§ 95852.2. Emissions without a Compliance Obligation.

Emissions from the following source categories as identified in sections 95100 through 95199 of the Mandatory Reporting Regulation count toward

applicable reporting thresholds but do not count toward a covered entity's compliance obligation set forth in this regulation. ~~These source categories~~ Emissions without a compliance obligation include:

(a) CO_2 ~~Combustion~~ combustion emissions from the following biomass-derived portion of biomass-derived fuels ~~(except biogas from digesters) from the following sources~~:

(1) Solid waste materials, including the biogenic content of solid waste materials that are not 100 percent biomass, as determined by the methodology specified in ASTM D6866, based on exhaust sampling or fuel sampling (and fuel usage recordkeeping) at the specified frequency;

(2) Waste pallets, crates, dunnage, manufacturing and construction wood wastes, tree trimmings, mill residues, and range land maintenance residues;

(3) All agricultural crops or waste; or

(4) Wood and wood wastes identified to follow all of the following practices;

(A) Harvested pursuant to approved timber management plan prepared in accordance with the Z'berg-Nejedly Forest Practice Act of 1973 or other locally or nationally approved plan;

(B) Harvested for the purpose of forest fire fuel reduction or forest stand improvement; and

(C) Do not transport or cause the transport of species known to harbor insect or disease nests outside zones of infestation or quarantine zones identified by the department of Food and Agriculture of the Department of Forestry and Fire Protection, unless approved by these agencies.

~~(b)~~(5) Biodiesel:

~~(1)~~(A) Agri-biodiesel derived solely from virgin oils, including esters derived from virgin vegetable oils from corn, soybeans,

sunflower seeds, cottonseeds, canola, cramble, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, and camelina, and from animal fats.

~~(2)~~(B) Biodiesel is defined as monoalkyl esters of long chain fatty acids derived from following plant or animal matter that meets the requirements of the American Society of Testing Materials (ASTM) D6751:

~~(A)~~(i) Waste oils;

~~(B)~~(ii) Tallow; or

~~(C)~~(iii) Virgin oils.

~~(c)~~(6) Fuel ethanol:

~~(1)~~(A) Cellulosic biofuel produced from lignocellulosic or hemicellulosic material that has a proof of at least 150 without regard to denaturants;

~~(2)~~(B) Corn starch; or

~~(3)~~(C) Sugar cane.

~~(d)~~(7) Municipal Solid Waste (biogenic fraction only as determined by methodology specified in ASTM D6866):

~~(1)~~(A) Direct combustion; or

~~(2)~~(B) Conversion to a clean burning fuel:

~~(A)~~(i) Technology does not use air or oxygen in the conversion process except to maintain temperature control;

~~(B)~~(ii) Technology produces no discharges or emissions of air contaminates, including greenhouse gases;

~~(C)~~(iii) No discharges to surface or groundwater;

~~(D)~~(iv) Produces no hazardous wastes as identified in ASTM D6866;

~~(E)~~(v) Removes recyclable and green waste compostable materials, and recycles or compost these materials;~~or~~

~~(F)~~(vi) Any wastes that come to a facility come from an agency that diverts al least 30 percent of all solid waste collected through solid waste reduction, recycling, and composting~~.~~; or

(vii)Tires.

~~(e)~~(8) Biomethane and biogas from the following sources:

~~(1)~~(A) All animal and other organic waste; or

~~(2)~~(B) Landfills ~~gas~~ and wastewater treatment plants.

~~(f)~~(b) Fugitive and process emissions from:

(1) CO_2 emissions from geothermal generating units;

(2) CO_2 and CH_4 emissions from geothermal facilities;

(3) CO_2 emissions from hydrogen fuel cells;

(4) At petroleum refineries: asphalt blowing operations, equipment leaks, storage tanks, and loading operations;~~or~~

(5) At the facility types listed in section 95101(e) of the Mandatory Reporting Regulation, Petroleum and Natural Gas Systems: leak detection and leaker emission factors, and stationary fugitive and "stationary vented" sources on offshore oil platforms;~~.~~

(6) Methane from landfills; or

(7) CH_4 and N_2O from municipal wastewater treatment plants.

Modifications to section 95854. Quantitative Usage Limit on Designated Compliance Instruments—Offset Credits.

1. Staff recommends modifying §95854 to provide greater flexibility to use offset credits to fulfill a compliance obligation.

Modify title 17, CCR, §95854 to read:

§ 95854. Quantitative Usage Limit on Designated Compliance Instruments—Offset Credits.

(a) The number of offset credits that each covered entity may surrender to meet its annual or triennial compliance obligation must conform to the following limit:

O_O/S must be less than L_O

Where:

O_O = Total number of compliance instruments that are designated as subject to this quantitative usage limit pursuant to subarticle 4, section 95821(b), (c), and (d), including sector-based offset credits as defined in section 95821.

~~Sector-based offset credits as defined in section 95821 cannot represent more than 25% of O in the first and second compliance periods and 50% of O in all other periods.~~

S = Covered entity's annual or triennial compliance obligation.

L_O = Quantitative offset credit usage limit, set at 0.08.

(b) The number of sector-based offset credits that each covered entity may surrender to meet its annual or triennial compliance obligation must conform to the following limit:

O_S/S must be less than L_S

Where:

O_S = Total number of sector-based offset credits as defined in section 95821.

S = Covered entity's annual or triennial compliance obligation.

L_S = Quantitative offset credit usage limit, set at 0.02 for the first compliance period, and at 0.04 for the second and third compliance periods.

Modifications to section 95857. Untimely Surrender of Compliance Instruments by a Covered Entity.

1. Staff recommends modifying §95857(d) to distribute allowances surrendered based on the untimely surrender obligation across all three tiers of the Allowance Price Containment Reserve.

Modify title 17, CCR, §95857(d) to read:

(d) When the covered entity or opt-in covered entity meets its obligations pursuant to subsection (c) above, the Executive Officer shall:

(1) Remove the restrictions on transfers from the holding accounts controlled by the covered entity and affiliated entities;

(2) Transfer the allowances used to fulfill the untimely surrender obligation in the following manner:

(A) ~~Three fourths~~ One fourth to ~~the highest-priced~~ each tier of the Allowance Price Containment Reserve Account; and

(B) One fourth to the Retirement Account.

Modifications to section 95911. Format for Auction of California GHG Allowances.

1. Staff recommends modifying §95911(b)(4) to distribute allowances that remain unsold when the auction settlement price equals the auction reserve price be distributed across all three tiers of the Allowance Price Containment Reserve.

Modify title 17, CCR, §95911(b)(4) to read:

(4) Allowances designated by ARB for an auction which remain unsold when the auction settlement price equals the auction reserve price shall be transferred equally to the ~~highest-priced tier~~ three tiers in the Allowance Price Containment Reserve Account. If the number of allowances unsold is not divisible by three, the transfer of the final allowances shall be to the lowest-price tiers.

Modifications to section 95913. Sale of Allowances from the Allowance Price Containment Reserve.

1. Staff recommends modifying §95913(c)(1) to provide easier access for covered entities (including opt-in covered entities) to allowances in the Allowance Price Containment Reserve.

Modify title 17, CCR, §95913(c)(1) to read:

(c) Timing, Eligible participants, and Limitations.

(1) Eligible participants.

~~(A)~~ Only covered entities (including opt-in covered entities) registered as provided in sections 95811 or 95813 shall be eligible to purchase allowances from the Allowance Price Containment Reserve.

~~(B) Only covered entities (including opt-in covered entities) which hold no compliance instruments in their holding accounts or limited use holding accounts may purchase allowances from the Allowance Price Containment Reserve.~~

PROPOSED CHANGES FOR WHICH STAFF PLANS TO SOLICIT STAKEHOLDER INPUT THROUGH PUBLIC WORKSHOPS

Modification to subarticle 7. Compliance Requirements for Covered Entities.

1. Staff proposes to adjust deadlines to ensure that mandatory reporting and cap-and-trade compliance cycles are complementary.

Modifications to subarticle 8. Allowance Dispositions, and subarticle 9. Direct Allocations of California GHG Allowances.

1. Staff will explore expanding the prorating of allowances for distribution included in section 95870(d) to include all allowances distributed for free in the first compliance period, not just allowances distributed to industrial sources with leakage-exposed risk. If allowance dispositions proposed in subarticle 8 are modified, each disposition will have a respective modified section in subarticle 9.

2. Proposal on allowance allocation for the electricity sector: see Appendix 1.

3. Staff will explore the feasibility of modifying the allocation system to allow the output factor used in the allocation formula in section 95891 to be adjusted so that the final allocation to industries under the formula would be based on current year output rather than a rolling average of the three most recent years for which data is available.

4. Staff will review the thermal energy based allocation calculation methodology in section 95891(c) to ensure that the provisions for new entrants appropriately addresses facility expansions.

5. Staff will work with interested stakeholders to ensure proper treatment under the regulation of any electricity generators or combined heat and power facilities with pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse gas emissions.

6. Staff will evaluate the treatment of non-electricity generation sources covered at the start of the program to determine whether some form of transition assistance is needed for those not included in the industrial sectors listed in Table 8.1 in section 95870.

Modification to subarticle 8. Allowance Dispositions.

1. Staff recommends setting aside 0.5% of allowances each year to incentivize the in-state production of voluntary renewable energy. Staff will also develop rules for retiring allowances from this set aside and provisions for disposition of any allowances in this set aside account that remain unused.

Modifications to section 95891. Allocation for Industry Assistance.

1. Staff will modify Table 9.1 to incorporate specific GHG emissions efficiency benchmarks for each industry. Greenhouse gas emissions efficiency benchmarks will be used to determine the quantity of free allocation to leakage-exposed sectors. Since the process of determining the benchmark for each sector involves extensive data gathering and stakeholder engagement, staff recommends taking the following steps to finalize the analysis: 1) define the sector and products on which a benchmark will be established, 2) determine the sample population based on which the benchmark will be derived, 3) collect data for production and emissions, and 4) consult with stakeholders to ensure the reliability of the values to appropriately reflect GHG emissions efficiency of a given manufacturing process.

2. For the petroleum refining sector, staff recommends evaluating an Energy Intensity Index approach for allocation in the initial period if it is possible to implement with an adequate degree of transparency in the allocation process. If that is not possible, staff will incorporate a simple barrel allocation approach into the regulation. In either case, staff will work to transition to a more complex carbon-weighted barrel approach for the petroleum refining sector as soon as possible. For refineries that do

not report to Solomon Associates and therefore do not have an Energy Intensity Index, staff will evaluate other allocation methods including a simple barrel approach.

3. As a pilot project for the cement sector, staff will investigate use of a border adjustment, as recommended by the Economic and Allocation Advisory Committee (EAAC), to address residual leakage concerns that may remain after the allocation to cement producers using the updated output-based benchmark system. If necessary to address leakage concerns and feasible to complete in the 15-day change process, staff will incorporate a border adjustment system into the regulation.

New section on periodic regulation review.

Staff proposes to incorporate into the regulation specific requirements for a review of the program at least once every compliance period. The new regulatory text will include specific deadlines for completion of the review, a list of topics that must be addressed in the review, and minimum requirements for public input during the review process.

Appendix 1: Staff Proposal for 15-day Changes to Address Electricity Sector Allowance Allocation

The Initial Statement of Reasons (ISOR) included the following discussion of issues related to allocation of allowances within the electricity sector:

> This diversity of resources and emissions-reduction opportunities across utilities creates challenges for defining an allowance allocation method that provides proper incentives, is affordable for all utilities, and is considered equitable. Approaches proposed by stakeholders, the California Public Utilities Commission (CPUC), and the California Energy Commission (CEC)[1] have suggested balancing historical emissions and electricity sales to allocate allowances. By considering historical emissions, allocation can recognize the diversity of generating resources across utilities. Recent investments to reduce emissions can also be rewarded by using historical emissions that, for example, preceded the enactment of AB 32. By considering retail sales, allocation can reflect differences in the amount of electricity delivered by each retail provider. The sales metric would reward utilities that achieve lower emissions intensities, consistent with the long-term goal of reducing GHG emissions from the sector overall.
>
> To date, staff's analyses of options based on historical emissions and sales have not identified an allocation method that provides appropriate incentives for emissions reductions and is considered affordable and effective for all utilities. The contracts for high-emitting resources pose a particular challenge. Some contracts expire as soon as 2016, providing substantial opportunity for emissions reduction prior to 2020. Other commitments run past 2020, limiting the opportunity to reduce emissions from the existing resource in the next 10 years, even as substantial investments are made to acquire new low-emitting resources. Simply considering historical emissions and sales does not adequately reflect these divergent circumstances. Also, the allocation method must avoid inadvertently providing an incentive to continue using high-emitting resources, but rather must provide incentives to ensure that all cost-effective efforts are undertaken to achieve necessary emissions reductions.
>
> Staff is continuing to examine options and obtain feedback. With input from stakeholders, staff's analysis is examining additional factors that could be considered beyond historical emissions and sales, including, among other things, the dates of contract expirations, the rate of achievement of renewable and other low-emitting resources, incentives for early reductions in commitments for high-emitting resources, and other program design features. Staff will continue to work with stakeholders and will review comments received during the comment period on this proposal. Staff may bring a more detailed proposal to the Board based on this ongoing effort, and will circulate any such proposal for review in a subsequent 15-day comment period. [ISOR, pp. II 34-35]

[1] The California Public Utilities Commission and the California Energy Commission presented recommendations to ARB about the design of a cap-and-trade program for the electricity sector in October 2008. Those recommendations are included as Appendix M of the ISOR.

Since publishing the ISOR, staff has discussed the issue of how to allocate allowances within the electricity sector with stakeholders, including intensive discussions with an informal electricity distribution utility working group, the Joint Utility Group (JUG). Based on analyses of emissions reporting data and considering the overall allowance allocation approach for the program, staff has developed a recommendation for the policy objectives for the electricity sector allowance allocation. Also, using preliminary data, staff has evaluated a range of methods for allocating allowances to achieve the recommended policy objectives. Based on this evaluation, staff has identified multiple methods that show particular promise for satisfying the proposed policy objectives. Staff finds that these methods, described below, provide a basis for finalizing the allocation of allowances within the electricity sector. The details of the final allocation system will be developed following additional data review and analysis.

Policy Objectives

California's energy and climate policies have helped keep the state's GHG emissions from the electricity sector significantly below the national average, and continued implementation of energy efficiency, renewable electricity, combined heat and power, distributed generation, and the emissions performance standard will lead to further decreases in emissions from the sector through 2020.[2] As shown in Figure 1, the statewide average emissions intensity of electricity supplied to California (including imports) are forecast to decline substantially by 2020 based on these existing energy and climate policies.

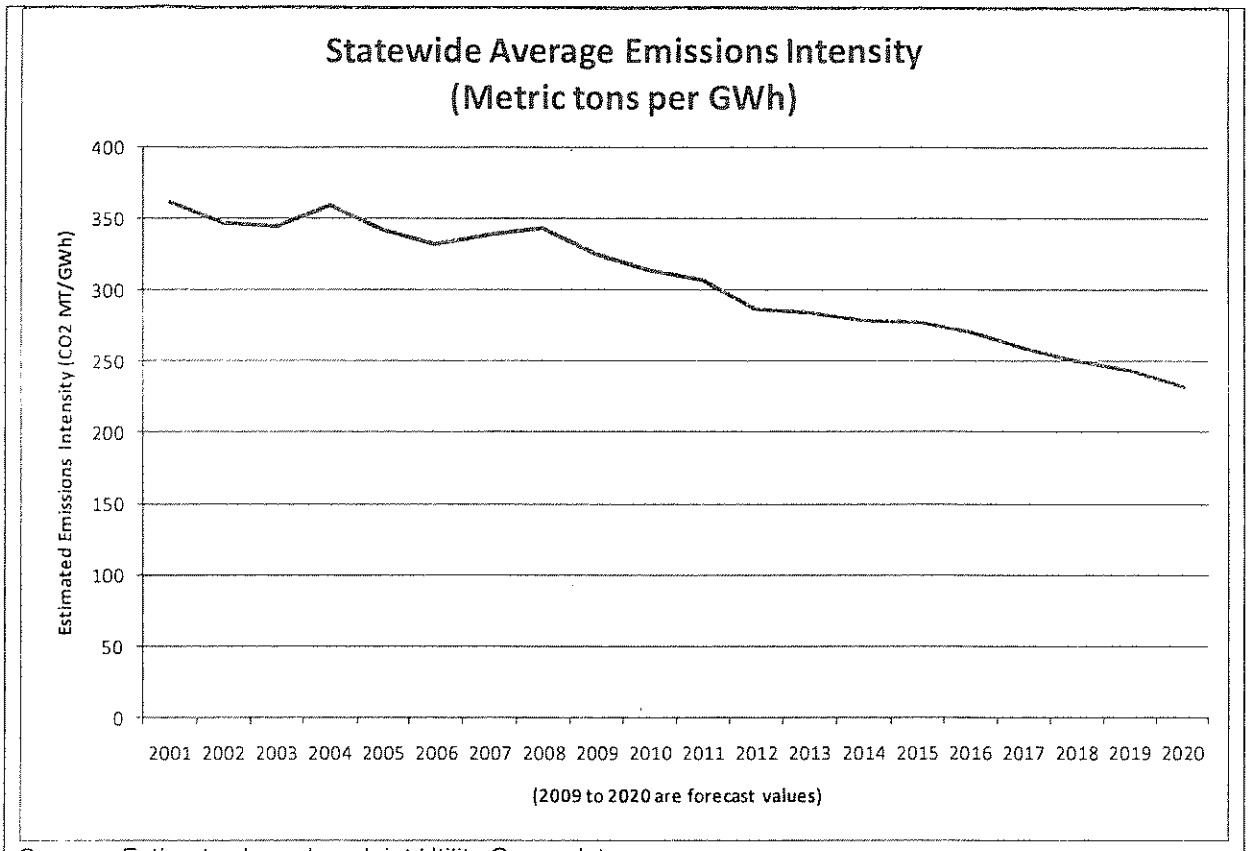
Staff proposes an allocation system that builds on these policies, and that will provide further incentives to the distribution utilities to meet or exceed the emissions reductions they expect to achieve through implementation of these policies. The proposed allocation system helps reinforce the emission reductions associated with those other policies.

As discussed in the ISOR, staff has proposed providing free allowances to the electricity sector for two primary reasons: to support policies and programs that are reducing GHG emissions from the electricity sector; and to ensure that electricity ratepayers do not experience sudden increases in their electricity bills associated with the pricing of carbon emissions in the cap-and-trade program. To support these two purposes for free allocation, staff recommends the following policy objectives for the allocation of allowances within the electricity sector:

- reflect the expected ratepayer "cost burden" associated with the cap-and-trade program emissions costs that is anticipated to be borne by the ratepayers for each distribution utility;
- incorporate the expected benefits of energy efficiency investments, so that energy efficiency accomplishments are rewarded; and
- recognize early action by incorporating the use of State-defined eligible renewable energy from 2007 to 2011.

[2] A summary of California's energy and climate policies is presented in *California's Clean Energy Future. An Overview on Meeting California's Energy and Environmental Goals in the Electric Power Sector in 2020 and Beyond*, California Energy Commission Report CEC-100-2010-002, September 2010, at: http://www.climatechange.ca.gov/energy/index.html.

Figure 1: Anticipated Reductions in Average Emissions Intensity



Source: Estimates based on Joint Utility Group data.

The proper assessment of ratepayer "cost burden" that is being offset through the allocation is clearly an important aspect of the approach. Staff proposes that the estimate of the ratepayer cost burden include the full range of costs expected to be passed through to electricity ratepayers as a result of the pricing of GHG emissions in the cap-and-trade program, including the emissions costs for the following:

- Emissions from owned/committed coal-fired resources.
- Equivalent emissions price premium from non-emitting resources priced at market.
- Anticipated emissions costs for Qualified Facilities (QF) fossil fuel resources purchased under the terms of the pending PUC settlement.
- Emissions from gas-fired generation, residual purchases (evaluated as gas fired), and unspecified imports.

Each component has associated with it a cost for GHG emissions. By reflecting the ratepayer cost burden in the allocation method, the allowance allocation can be designed with the goal of ensuring that the each utility's allowance allocation is sufficient to offset the ratepayer cost burden for the ratepayers of each utility in each compliance period.

Preliminary Evaluation

ARB staff evaluated the ability of a range of allowance allocation methods to achieve the recommended policy objectives. These evaluations used preliminary data to demonstrate how

the key components could be estimated, including: ratepayer cost burden; energy efficiency; and early action.

The starting point for determining the ratepayer burden was the resource plans each utility filed with the California Energy Commission as part of the 2009 Integrated Energy Policy Report proceeding.[3] The resource plans were adjusted to reflect achieving a 33% renewable energy mix by 2020 for each utility.[4] The ratepayer cost burden, as described above, was developed based on these adjusted resource plans for each year through 2020.

The evaluation of energy efficiency achievements was based on the past performance and expected execution of aggressive energy efficiency programs by each utility.

ARB staff examined a range of methods for recognizing early action. Understanding that the concept of "early action" can be interpreted in various ways, ARB staff identified investments in qualifying renewable resources as the preferred metric of early action. Furthermore, ARB staff focused on recent investments in these resources, examining recent and planned investments from 2007 to 2011. By focusing the early action metric on these investments during this period, the approach is designed to reward action taken specifically to reduce GHG emissions from the electricity sector.

ARB staff acknowledge that there are differing opinions regarding how to measure early action. In particular, some distribution utilities have substantial portfolios of non-emitting hydro-electric and nuclear resources that have been developed over many years. ARB staff concluded that these resources do not themselves indicate early action taken in response to AB 32. Also, recognition of these resources does not contribute to the other policy objectives of the allowance allocation. Consequently, these resources are not recommended as part of the early action metric.

Using preliminary data, ARB staff found that multiple methods can achieve the policy objectives, including the ability to allocate sufficient allowances to cover the expected ratepayer cost burden. The energy efficiency and early action metrics enabled the allocation to recognize these efforts as well. Figure 2 shows the preliminary estimates of allowance allocations for two methods based on the initial evaluations. The evaluation also showed that the allocation results can vary based on the precise metric used to recognize early action (i.e., the small differences between the two methods shown in the figure, labeled as Method 5R and Method 6). Consequently, ARB staff recommends that prior to defining the final allocation algorithm, the final dataset be developed for all the utilities and the most promising candidate methods be evaluated using the final data.

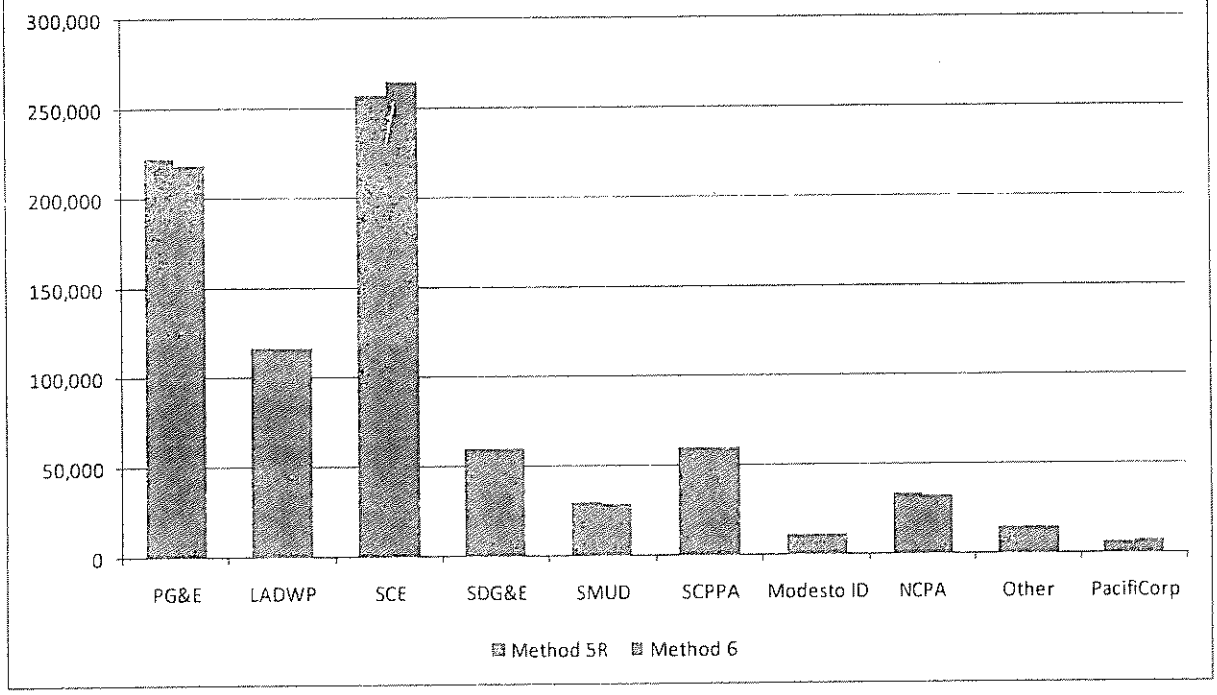
While developing this proposed approach to allocating allowances to the electricity sector, ARB staff have been mindful that Congress may again consider developing a cap-and-trade program to reduce U.S. GHG emissions. The allowance allocation method proposed here may be examined as a model for national allocation. ARB staff considers it important that the appropriate lessons be taken from the proposed method. In particular, the proposed policy objectives and methods rely on a comprehensive suite of electricity sector policies to achieve the goals of AB 32. All the California utilities and their ratepayers are expected to achieve the full suite of requirements. Applying these concepts nationally must start with requiring all

[3] The smaller distribution utilities in the State are not required to submit these data to the Energy Commission. ARB staff are working with the smaller utilities to develop the data needed to apply the methods to those utilities.

[4] The data used in evaluating different allocation options were developed and checked by the members of the JUG. Before the final allocation method and numbers are developed, ARB staff will collect and review the data and evaluate the allocation methods against the final data.

utilities to achieve similar stringent requirements, so that early action by California utilities is protected and rewarded. Allowance allocation at the national level can then be used to reinforce the full suite of stringent requirements.

Figure 2: Preliminary Allowance Allocation Estimates for Two Example Allocation Methods (000 Metric Tons, 2012-2020)



Estimates based on preliminary data that require review and validation. The two methods differ in the manner in which early action is recognized.

Recommendation

ARB staff recommends the following steps to finalize the allowance allocation method for the electricity sector.

Data: ARB staff recommends working with stakeholders to verify the data needed to evaluate and execute the allowance allocation methods. ARB staff recommends that the dataset developed by the JUG be the starting point for the data work, but that ARB staff independently validate the data and their sources.

Sector Allocation: The ISOR recommends that a set number of allowances are set aside each year for the electricity sector, starting with the 2012 allocation at 90% of 2008 electricity sector emissions and declining linearly to 85% of that value by 2020. Using the mandatory reporting data, the 2008 emissions from electric generating facilities and imports were 98.9 million metric tons (MMT), so that 90% would be 89 MMT. Additionally, a portion of the electricity produced at facilities that identified themselves as cogeneration facilities was purchased by electricity distribution utilities. Using publicly filed data for 2008 and a heat rate based on the pending PUC QF settlement, the estimated equivalent emissions from QF purchases is 9.67 MMT, so that 90% of this value is 8.7 MMT. The recommended 2012 allowance allocation to the electric sector is therefore 97.7 MMT (89 MMT plus 8.7 MMT). The recommended sector allocation declines linearly to 83 MMT in 2020.

Utility Allocation: ARB staff recommends that the promising allocation methods developed based on the evaluation using preliminary data be refined and evaluated using the final data developed by ARB staff. ARB staff recommends that the method incorporate the three main elements discussed above: ratepayer cost burden; energy efficiency accomplishment; and early action as measured by investments in qualifying renewable resources.

Updating: ARB staff recommends that allowances be allocated to individual utilities at the start of the program for 2012 to 2020. The allocation will not be automatically updated, so that each utility would know its allocation for the nine year period and could plan accordingly. If needed, the periodic program review could recommend adjustments to the allocation during the program.

Public Process: ARB staff recommends that the process for developing the final method for allocating emission allowances to electricity distribution utilities include at least one public workshop at which the data and methods are reviewed and public comment is received.

BEFORE THE
WESTERN CLIMATE INITIATIVE

SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT ON MARKET OVERSIGHT DRAFT RECOMMENDATIONS

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SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY COMMENT TO WESTERN CLIMATE INITIATIVE ON MARKET OVERSIGHT DRAFT RECOMMENDATIONS

I. INTRODUCTION AND SUMMARY

The Southern California Public Power Authority ("SCPPA") [1] respectfully submits this comment on the paper by the Western Climate Initiative ("WCI") dated April 1, 2010, entitled *Market Oversight Draft Recommendations* ("Markets Paper").

SCPPA considers that market oversight provisions are a crucial element of the WCI cap-and-trade program, given the real risk of market manipulation, and appreciates the focus given to this issue by the Markets Committee.

SCPPA supports a number of the draft recommendations ("DR") set out in the Markets Paper, and proposes some modifications to other recommendations, as summarized in the table below.

Table: Summary of SCPPA comments on Draft Recommendations

No.	Draft Recommendation	SCPPA comments
DR 1	*Treat compliance instruments as commodities for market oversight purposes*	Agree.
DR 2	*Information on derivatives positions*	Information on derivative positions should be collected on an ongoing basis from those with accounts in the tracking system or ownership interest in a compliance instrument. The regulator should only disclose aggregated derivatives information.
DR 3	*Treat allowances and offset certificates identically for market oversight purposes*	Agree.
DR 4	*Establish legal relationship with market participants*	This is acceptable in principle, but it is unclear what instrument ownership interests will exist if compliance

[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, the Imperial Irrigation District, Pasadena, and Riverside.

No.	Draft Recommendation	SCPPA comments
	through compliance instrument ownership interest and tracking system	instruments do not constitute property or convey any property rights, as is proposed in California.
DR 5	*Do not limit market participation to compliance entities*	Agree, as long as sufficient market oversight mechanisms (which may include holdings limits and/ or auction purchase limits) are put in place.
DR 6	*Require registration of intermediaries as market professionals*	Agree.
DR 7	*Holdings limits*	Holdings limits may be desirable to avoid market manipulation, particularly if non-covered entities can participate in the market. If a holdings limit is set, it should take into account not only the maximum emissions of the largest emitter, but also the ability (and desirability, from a market perspective) of banking compliance instruments for later use. Limits on maximum auction purchases should be considered as well.
DR 8	*Require use of a central limit order book for secondary market transactions*	Parties should not be required to use a single platform, but should be able to choose between various different exchanges. Greatest transparency could be provided if information from multiple exchanges is linked to a single quotation system.
DR 9	*Require reporting of beneficial ownership*	Agree.
DR 10	*Information required for compliance instrument transfer*	Agree, as long as information is gathered from the tracking system rather than requiring a separate report from the counterparties.
DR 11	*Secondary market holdings and transfer information disclosed to public*	Only tracking system account information should be publicly disclosed. There is no reason to disclose covered entities' compliance account holdings.
DR 12	*Market monitoring*	A third party contractor may perform a useful monitoring role. However, any such entity should be carefully chosen and its performance should be regularly reviewed.

II. DR 1: TREAT COMPLIANCE INSTRUMENTS AS COMMODITIES FOR MARKET OVERSIGHT PURPOSES.

SCPPA agrees that it is appropriate to treat compliance instruments (allowances and offsets) as commodities, so that they are subject to existing laws and regulations, rather than attempting to create a separate framework for them. This is consistent with the approach taken in

other emissions trading markets. This approach has the advantage that parties that trade other commodities (such as energy) will already be familiar with the applicable laws and regulations.

On a separate issue, the discussion of DR 1 in the Markets Paper includes the statement (on page 10) that "high volatility and higher-than-expected prices in compliance instrument markets have the potential to undermine public support for a cap-and-trade program, which could make achievement of environmental goals more difficult." SCPPA sees this as a strong argument for the WCI Markets Committee to consider, as part of its work in market design and oversight, cost containment options such as lifting the cap on the use of offsets if allowance prices reach specified levels.

III. DR 2: INFORMATION ON DERIVATIVES POSITIONS.

The Markets Paper sets out several options for the collection and public disclosure of information on derivative positions, but does not provide a draft recommendation.

Given the recent financial upheavals caused, at least in part, by derivatives trading, it may be preferable to collect more information on WCI compliance instrument derivatives than is currently collected on derivatives in other markets.

For increased transparency, SCPPA considers that information on derivative positions should be collected on an ongoing basis from those with accounts in the tracking system or ownership interest in compliance instruments. This is Option A in the list of information collection options in section 4.1.2.2 of the Markets Paper.

As information on derivative positions is likely to be commercially sensitive, it should only be disclosed at an aggregated level, similar to the US Commodity Futures Trading Commission ("CFTC") Commitments of Traders reports (Option C in the list of information disclosure options in section 4.1.2.2 of the Markets Paper).

Of the options listed in the Markets Paper for how derivatives market information could be disclosed, SCPPA considers that Options A, B and C would be acceptable. More than one method can be used. Daily reporting may not be required, but reporting should be at least quarterly.

IV. DR 3: TREAT ALLOWANCES AND OFFSET CERTIFICATES IDENTICALLY FOR MARKET OVERSIGHT PURPOSES.

SCPPA agrees that it is appropriate to treat allowances and offsets in the same manner for market oversight purposes; both should be treated as commodities. One concern raised in the Markets Paper is that allowances and offsets are created in different ways. However, the rules that will govern the creation of offsets will sufficiently address this issue. Once issued, offsets are fungible with allowances and should be regulated in the same manner. Any differences in risk profiles will be reflected in the market by means of differential pricing, as currently occurs in the European Union emissions trading system.

V. DR 4: ESTABLISH LEGAL RELATIONSHIP WITH MARKET PARTICIPANTS THROUGH COMPLIANCE INSTRUMENT OWNERSHIP INTEREST AND TRACKING SYSTEM.

SCPPA understands that in order to enforce market rules against entities that are active in the WCI carbon market but do not have a surrender obligation under the cap and trade program ("non-covered entities"), regulators must have some form of legal relationship with non-covered entities.

If DR 1 is adopted, other regulatory agencies, such as the CFTC, will automatically obtain jurisdiction over entities that engage in carbon derivatives transactions.

If rules specific to the WCI carbon market are adopted, and are enforced by agencies that do not currently have jurisdiction over non-covered entities under existing laws (this may be a relatively small category of entities), the fact that non-covered entities have accounts in the tracking system should be sufficient to establish a legal relationship with the regulator. Any entity actively engaged in the WCI carbon market is likely to have one or more accounts in the tracking system. If a non-covered entity trades solely in derivatives that are cash settled, and does not have an account for compliance instruments, it will still be regulated by the CFTC or the Canadian provincial equivalent.

The other option for establishing a legal relationship that is mentioned in the Markets Paper is having an ownership interest in a compliance instrument. While this approach may be useful (particularly if it is extended to beneficial ownership, reported under DR 9), it is unclear how it will operate if compliance instruments do not constitute property or confer any property rights, as is proposed in the California cap and trade program. (Preliminary Draft Regulation for a California Cap and Trade Program, section 95850(c).)

VI. DR 5: DO NOT LIMIT MARKET PARTICIPATION TO COMPLIANCE ENTITIES.

As the Markets Paper discusses, there are potential advantages and disadvantages in allowing non-covered entities to participate in the WCI carbon market.

If appropriate controls are placed on all entities in the market, to increase transparency and reduce the potential for market manipulation, and if there is a robust supply of offsets, SCPPA considers that the potential benefits (in promoting market liquidity and hence helping to reduce price volatility) of allowing non-covered entities to participate are likely to outweigh the potential disadvantages.

SCPPA looks forward to receiving the WCI Market Committee's separate draft recommendations on participation in the auctioning of allowances, as foreshadowed in the Markets Paper and the WCI Auction Design White Paper dated April 14, 2010 ("Auction Paper"). The Auction Paper notes that none of the auction programs it reviewed limited participation by type of entity.

Rather than limiting the types of entities that can trade in allowances and purchase them at auctions, it may be appropriate to consider limits on the extent of participation in the market. This may be done by imposing limits on the number or percentage of allowances an entity can purchase at an auction, and/or by imposing limits on the total number of allowances an entity can hold in its holding account. See the comments in section VIII on DR 7.

VII. DR 6: REQUIRE REGISTRATION OF INTERMEDIARIES AS MARKET PROFESSIONALS.

If non-covered entities are allowed to participate in the WCI carbon market, it will aid confidence in the market if intermediaries, trading on behalf of others or providing investment/trading advice, are required to be screened and registered with an independent regulatory body. SCPPA therefore agrees with DR 6.

It would not be appropriate to require every entity that holds an account in the tracking system to be registered as a commodities market professional (option A in section 4.2.3.2 of the Markets Paper). Covered entities may not be commodities market professionals, and in any case they are already required to provide significant amounts of information to regulators when they report their emissions.

VIII. DR 7: HOLDINGS LIMITS.

SCPPA looks forward to receiving the consultant's report on potential limits on parties' compliance instrument holdings, as foreshadowed in section 4.3.1 of the Markets Paper.

Holdings limits may help reduce the potential for market manipulation by reducing hoarding and limiting the accumulation of market power. They may be particularly important if DR 5 is followed and non-covered entities as well as covered entities may trade in compliance instruments.

However, any holdings limits should be carefully considered. If a limit is proposed, it should be set to take into account not only the maximum emissions of the highest-emitting covered entity over a compliance period, but also the fact that banking of compliance instruments is permitted. Particularly in the early years of the cap and trade program, when allowance prices are expected to be lower than in later years, a covered entity may wish to accumulate and retain significantly more compliance instruments in its account than it requires for the current compliance period. Banking is an important flexibility tool for covered entities, will help stabilize prices, and should not be discouraged through an overly restrictive holdings limit.

A further issue is the potential for entities to avoid being constrained by a holdings limit by participating in the derivatives market, where transfers of ownership of actual allowances may not occur. However, covered entities will always need to obtain, and surrender, actual allowances.

CFTC holdings limits may provide some guidance.

An alternative (or additional) approach to limit the accumulation of market power may be to set a maximum number or percentage of allowances each entity can purchase at an auction. The Regional Greenhouse Gas Initiative has adopted this approach: a single entity can purchase

no more than 25% of the allowances offered for sale at an auction. The Auction Paper notes that "setting a percentage limit will not impose an excessive burden on participating firms because WCI does not anticipate that any one entity will have that large a share of the WCI market."

IX. DR 8: REQUIRE USE OF A CENTRAL LIMIT ORDER BOOK FOR SECONDARY MARKET TRANSACTIONS.

While SCPPA considers that transparency is important, there are some considerations indicating that a requirement to use a hard central limit order book may not be optimal for secondary transactions in the WCI carbon market. Instead, the better option may be to require secondary market transactions to occur on an exchange of the parties' choice, or on one of several specified exchanges – option A in section 4.3.2.2 in the Markets Paper.

If market participants are able to choose between several exchanges on which to conduct secondary transactions, those exchanges will compete with each other. Market participants may benefit from lower fees and a greater range of services than might be available if they were required to use a single platform such as a central limit order book.

Furthermore, if more than one platform can be used, parties can switch to another exchange if one exchange is not operating (for example due to technical difficulties).

Regulators can collect transactional information from all exchanges that offer services to the WCI carbon market. Members of an exchange can access information about transactions on that exchange, and market pricing information is also provided by third parties such as Thompson Reuters.

A degree of transparency similar to that with a central limit order book may be able to be provided, without limiting the choice of exchange systems, if multiple exchange systems are linked to a single quotation system, as is the case in the secondary market for US equity

securities. Has the practicability of introducing a similar system for the WCI secondary carbon market been considered?

X. DR 9: REQUIRE REPORTING OF BENEFICIAL OWNERSHIP.

SCPPA agrees that the beneficial ownership of compliance instruments should be reported to the regulator, upon the establishment of a holding account and upon each change in beneficial ownership of the compliance instruments in that account, to give the regulator the information it needs to conduct its market oversight activities. This information may be needed to enforce a holdings limit or an auction purchase limit, if adopted (see comments in section VIII, on DR 7).

This information should remain confidential, as it is likely to be commercially sensitive.

XI. DR 10: INFORMATION REQUIRED FOR COMPLIANCE INSTRUMENT TRANSFER.

While SCPPA agrees that information should be reported on the transfer of compliance instruments as set out in DR 10, the reporting should be made as simple and streamlined as possible for the parties to the transaction. This information should be collected by the tracking system and reported automatically, without requiring separate reporting by the transacting parties to the regulator.

The tracking system should already hold, and be able to collate, all information required in DR 10 other than the price of the compliance instruments being transferred. If price information is required, the tracking system should require the parties to complete a "price" field in order for the transfer to be processed. There should be some flexibility in how this field is able to be completed (ie, it should allow for a description of a calculation method as well as allowing

for a price to be reported in digits). Prices may not be simple amounts that are known at the time of transfer, but may be determined with reference to market prices at specific dates in the future. A transaction may involve a swap of instruments, or may involve compliance instruments bundled with energy or other commodities or services, without a clear indication of unit prices.

The tracking system should ensure that the information it collects remains secure, particularly pricing and party information, as not all of this information will be made publicly available (as per DR 11).

XII. DR 11: SECONDARY MARKET HOLDINGS AND TRANSFER INFORMATION DISCLOSED TO PUBLIC.

SCPPA agrees that the regulator should collect some information, for market oversight purposes, that should not be publicly disclosed on the grounds that it is sensitive market information.

The public disclosure of the tracking system account information listed in DR 11 appears reasonable. However, public disclosure of compliance account holdings does not appear to be required, and may be detrimental to parties' competitive positions, for the same reasons as the Market Paper recognizes in the case of trading account balances, which DR 11 does not propose to disclose. It is important for the regulator to have access to information on compliance account holdings, throughout the compliance period as well as at the end of each period, but there does not appear to be a good reason to publicly disclose compliance account balances on an ongoing basis.

If market participants assume that the volumes of compliance instruments in an entity's compliance account reflect its overall holdings, then that entity may be subject to the same market detriment that could occur if the balance of its trading account were known. If market

participants do not draw any assumptions about an entity's overall holdings from the balance of its compliance account, on the grounds that it may have many more instruments in its trading account (the balance of which is not made public), then the public disclosure of compliance account balances serves no purpose.

If regulators wish to name and shame covered entities that do not meet their surrender obligations at the end of a compliance period, this can be done in a separate forum, and it should only be done after the due date for surrender of compliance instruments. Until a compliance period has ended and instruments are due to be surrendered, there is no reason to publicly identify entities that do not hold sufficient compliance instruments.

Therefore SCPPA considers that the only information that should be publicly disclosed on an ongoing basis is the tracking system account information listed in section 4.3.5.5 of the Markets Paper.

XIII. DR 12: MARKET MONITORING.

SCPPA looks forward to receiving further details on the proposed role of a third party contractor providing market monitoring services, as foreshadowed in section 4.4.1 of the Markets Paper.

An experienced and appropriately-qualified third party monitor may be helpful in providing oversight over the whole of the WCI carbon market, as US and Canadian government entities may be unable to do this. Any such third party should be carefully chosen and its performance should be reviewed against specified benchmarks at regular intervals. The contract under which the third party is appointed should (on appropriate grounds) allow for that entity to be replaced, or to be required to improve aspects of its performance, or to be required to remove from their role employees of the entity who are found to be biased, negligent or incompetent.

XIV. CONCLUSION

SCPPA urges the WCI to consider these comments in developing the final recommendations on oversight of the carbon market to be established under the WCI cap-and-trade program. SCPPA appreciates the opportunity to submit these comments to the WCI.

Respectfully submitted,

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