

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.

Rulemaking 06-04-009
(Filed April 13, 2006)

**ADMINISTRATIVE LAW JUDGES' RULING
REQUESTING COMMENTS ON FLEXIBLE COMPLIANCE POLICIES**

1. Summary

In this ruling, we request that parties respond to a series of questions regarding possible policies for flexible compliance in a cap-and-trade program as it may pertain to the electricity sector. We also incorporate into the record of Rulemaking (R.) 06-04-009 and provide an opportunity for parties to address in their comments two documents prepared by the California Air Resources Board (ARB) and two documents prepared by the Western Climate Initiative (WCI), which address flexible compliance mechanisms and are attached to this ruling. Parties may address these issues and documents as part of their comprehensive comments and reply comments that, pursuant to an April 16, 2008 ruling, are due on, respectively, May 27, 2008 and June 10, 2008.

Parties' comments, along with modeling results, will lead to a joint California Public Utilities Commission (Public Utilities Commission) and California Energy Commission (Energy Commission) proposed decision with recommendations to ARB on remaining policy issues for the electricity and

natural gas sectors, for ARB's consideration as it implements Assembly Bill (AB) 32. The joint decision may include recommendations to ARB regarding allocation of GHG emission allowances, flexible compliance mechanisms, the treatment of Combined Heat and Power (CHP) facilities, emission reduction measures, and the electricity and natural gas sectors' potential contributions toward meeting the economy-wide GHG emission reduction goals set by AB 32. Recent rulings have addressed development of the record on allowance allocation and CHP issues. Today's ruling provides guidance regarding parties' comments on flexible compliance policies. Subsequent ruling(s) will provide additional guidance regarding the scope of comments (which will be due at the same time) addressing modeling results and remaining policy issues.

2. Flexible Compliance Issues

In March 2008, the Public Utilities Commission and the Energy Commission adopted a joint decision (Public Utilities Commission Decision (D.) 08-03-018 and Energy Commission Interim Decision CEC-100-2008-002-F, respectively), which recommends that, in implementing AB 32, ARB adopt a mix of direct mandatory/regulatory requirements for the electricity and natural gas sectors and a cap-and-trade system that uses a deliverer approach for the electricity sector. In that decision, the Commissions stated their plan to undertake further exploration in this proceeding prior to making recommendations to ARB regarding flexible compliance options that ARB could adopt if it chooses a cap-and-trade market structure.

Various flexible compliance mechanisms may be considered as means to provide entities flexibility in meeting their compliance obligations and to allow them to seek low-cost opportunities in the marketplace, thus reducing the cost of compliance.

ARB has commenced work on this issue area, holding workshops on offsets and other cost containment mechanisms on April 4 and April 25, 2008, respectively. ARB's coverage of these issues assumes, for purposes of analysis, a multi-sector cap-and-trade program with flexibility options for all market participants. In addition, WCI has an "offsets" subcommittee devoted to consideration of offsets as flexible compliance options within a WCI cap-and-trade program.

The Commissions' intent within the context of this proceeding is to provide any recommendations or analysis necessary to inform the participation of the electricity sector in a multi-sector cap-and-trade program in California, if ARB chooses to adopt one. Thus, this ruling seeks comment particularly on whether there are unique issues in the electricity sector that warrant consideration by ARB of different rules or flexibility.

To that end, in this ruling we include a number of questions on the subject of flexible compliance mechanisms. Parties are requested to review these questions and respond, in particular, if they believe that unique characteristics of the electricity sector, compared to other sectors that may participate in a multi-sector cap-and-trade program if one is implemented in California, are relevant to the answer. Parties need not respond to every question included below. To the extent that parties do respond, they should explain in detail their reasons for each answer and how unique circumstances in the electricity sector may affect the answer.

2.1 Party Proposals

1. Please explain in detail your comprehensive proposal for flexible compliance rules for a cap-and-trade program for California as it pertains to the electricity sector. Address each of the cost

- containment mechanisms you find relevant including those mentioned in this ruling and any others you would propose.
- a. Discuss how your proposal would affect the environmental integrity of the cap, California's ability to link with other trading systems, and administrative complexity.
 - b. Address how your various recommendations interact with one another and with the overall market and describe what kind of market you envision being created.
 - c. Describe and specify how unique circumstances in the electricity market may warrant any special consideration in crafting flexible compliance policies for a multi-sector cap-and-trade program.
 - d. If your recommendations are based on assumptions about the type and scope of a cap-and-trade market that ARB will adopt, provide a description of the anticipated market including sectors included, expected or required emission reductions from the electricity sector, and the role that flexible compliance mechanisms serve in the market, e.g., purely cost containment, catalyst for long-term investment, and/or protection against market failures.
2. With respect to flexible compliance mechanisms, what should California keep in mind in designing its system when considering the potential transition to regional and/or national cap-and-trade programs in the future? Are there mechanisms that California should avoid or embrace in order to maximize potential compatibility with other cap-and-trade systems?
 3. What evaluation criteria should be used in assessing flexible compliance options?

2.2 Market Design and Scope

4. To what extent should the recommendations to the ARB for flexible compliance in the electricity sector depend on the ultimate scope of the multi-sector cap-and-trade program and other market design issues such as allocation methodology and sector emission reduction obligations? Can the Commissions make meaningful recommendations on flexibility of market

operations when the market itself has not yet been designed?
Why or why not?

5. Should the market for GHG emission allowances and/or offsets be limited to entities with compliance obligations, or should other entities such as financial institutions, hedge funds, or private citizens be allowed to participate in the buying and selling of allowances and/or offsets? If non-obligated entities are allowed to participate in the market, should the trading rules differ for them? If so, how?

2.3 Price Triggers and Other Safety Valves

Price triggers and other safety valves could be used if there is a need to intervene in normal market dynamics to restore allowance prices back to acceptable levels.

6. Should California incorporate price triggers or other safety valves in a cap-and-trade system? Why or why not? Would price triggers or other safety valves affect environmental integrity and/or the ability to link with other systems? Address options including State market intervention to sell or purchase GHG emission allowances to drive allowance prices down or up; a circuit breaker or accelerator which either slows down or speeds up reductions in the emission cap until allowance prices respond; and increasing or decreasing offset limits to increase or decrease liquidity to affect prices. Address how these various strategies would be utilized in conjunction with other flexible compliance mechanisms.
7. Should California create an independent oversight board for the GHG market?¹ If so, what should its role be? Should it intervene

¹ In its Final Report adopted February 11, 2008, the Economic and Technology Advancement Advisory Committee recommends that ARB create a California Carbon Trust that could, among other functions, manage the carbon market in California similar to the way that the Federal Reserve Bank manages interest rates by adjusting the supply of emission allowances and credits through sales and purchases. That report is available at <http://www.arb.ca.gov/cc/etaac/etaac.htm>.

in the market to manage the price of carbon? If such an oversight board were created, how would that affect your recommendations, e.g., would the oversight board obviate the need to include additional cost containment mechanisms and price-triggered safety valves in the market design?

2.4 Linkage

The issue of linkage addresses the ability of obligated entities to buy and sell GHG emission allowances or credits with other carbon-trading systems like the Regional Greenhouse Gas Initiative and the European Union Emissions Trading Scheme.

8. Should California accept all tradable units,² i.e., GHG emission allowances and offsets, from other carbon trading programs? Such tradable units could include, e.g., Certified Emission Reductions, Clean Development Mechanism (CDM) credits, and/or Joint Implementation credits.
9. If so, what effects could such linkage have on allowance prices and other compliance costs of California obligated entities? Under what conditions could linkage increase or decrease compliance costs of California obligated entities? To what extent would linkage subject the California system to market rules of the other systems? What analysis is needed to ensure that other systems have adequate stringency, monitoring, compliance, and enforcement provisions to warrant linkage? What types of verification or registration should be required?
10. If linkage is allowed, should it be unilateral (where California accepts allowances and other credits from other carbon trading programs, but does not allow its own allowances and offsets to

² Tradable units refer to (1) GHG emission allowances that permit emission of a ton of carbon equivalent (CO₂E) and (2) offsets that reflect a reduction in GHG emissions of a ton of CO₂E, as addressed in Section 2.8 of this ruling. A credit is a broad term used in this ruling to refer to any tradable unit other than a GHG emission allowance issued by California.

be used by other carbon trading programs) or bilateral (where California accepts allowances and other credits from other carbon trading programs and allows its allowances and offsets to be used by other carbon trading programs)?

11. If linkage is allowed, should allowances and other credits from other carbon trading programs be treated as offsets, such that any limitations applied to offsets would apply to such credits? If not, how should they be treated?

2.5 Compliance Periods

12. What length of compliance periods should be used? Should compliance periods remain the same throughout the 2012 to 2020 period? Should compliance periods be the same for all entities and sectors? Should dates be staggered so that not all obligated entities have the same compliance dates?
13. Should compliance extensions be granted? If so, under what circumstances?

2.6 Banking and Borrowing

Banking would allow an entity to buy and hold GHG emission allowances and/or credits across compliance periods; borrowing would allow an obligated entity to use its allowances from a future compliance period to meet the obligation under a current compliance period.

14. Should entities with California compliance obligations be allowed to bank any or all tradable units, including allowances, offsets, or credits from other carbon trading programs? Should entities that do not have compliance obligations be able to bank tradable units? If so, for how long and with what other conditions? Should allowances, offsets, or credits from other carbon trading programs banked during the program between 2012 and 2020 be recognized after 2020? If the California system joins a regional, national, or international carbon trading program, how should unused banked allowances, offsets, or credits from other carbon trading programs be treated?

15. Should limitations be placed on banking aimed at preventing or limiting market participants' ability to "hoard" allowances and offsets or distort market prices?
16. Should entities with compliance obligations be allowed to borrow allowances to meet a portion of their obligation? If so, during what compliance periods and for what portion of their obligation? How long should they be given to repay borrowed allowances? Should there be penalties or interest payments? Should there be other conditions on borrowing, such as limitations on the ability to borrow from affiliated entities? Also address the extent to which borrowing might affect environmental integrity and emission reductions.

2.7 Penalties and Alternative Compliance Payments

This issue addresses the amount of money charged or other requirements that could be placed on an obligated entity that does not meet its full compliance obligation.

17. Should there be penalties for entities that fail to meet their compliance obligations? If so, how should the penalties be set? If not, what should be the recourse for non-compliance?
18. Instead of penalties, should there be alternative compliance payments? What would be the distinguishing attributes of alternative compliance payments versus penalties? How would the availability of alternative compliance payments affect the environmental integrity of the cap?
19. Would penalties and/or alternative compliance payments allow obligated entities to opt out of the market? Would this add too much uncertainty for other market participants?
20. How should California use the money that would be generated by penalties and/or alternative compliance payments?

2.8 Offsets

In general, the GHG emissions cap in any given compliance period would be established by the number of GHG emission allowances available during the compliance period, either through direct distribution

or due to banking or borrowing. Offsets and other allowed credits essentially would raise the cap for the sectors in the cap-and-trade program but would yield emission reductions elsewhere. Questions in Section 2.4 of this ruling address, among other things, whether and the extent to which credits from other trading programs should be treated as offsets for purposes of compliance with AB 32 requirements.

21. Should California allow offsets for AB 32 compliance purposes?
22. If offsets are permitted, what types of offsets should be allowed? Should California establish geographic limits or preferences on the location of offsets? If so, what should be the nature of those limits or preferences?
23. Should voluntary GHG emission reduction projects, i.e., projects that are not developed to comply with governmental mandates, be permitted as offsets if they are within sectors in California that are not within the cap-and-trade program? In particular, should voluntary GHG emission reduction projects within the natural gas sector in California be permitted as offsets, if the natural gas sector is not yet in the cap-and-trade program?
24. Should there be limits to the quantity of offsets? If so, how should the limits be determined?
25. How should an offsets program be administered? What should be the project approval and quantification process? What protocols should be used to determine eligibility of proposed offsets? Are existing protocols that have been developed elsewhere acceptable for use in California, or is additional protocol development needed? Should offsets that have been certified by other trading programs be accepted? Should use of CDM or Joint Implementation credits be allowed?
26. Should California discount credits (i.e. make the credits worth less than a ton of CO₂e) from some offset projects or other trading programs to account for uncertainty in emission reductions achieved? If so, what types of credits would be discounted? How would the appropriate discount be quantified and accounted for?

2.9 Legal Issues

27. Under AB 32, is it permissible for GHG emission allowances from non-California carbon trading programs or offsets from GHG emission sources outside of California to be used instead of GHG emission allowances issued in California? Please consider especially the provisions of Health and Safety Code Sections 3805, 38550, and 38562(a) added by AB 32.
28. Do any of the flexible compliance options identified in these questions or discussed in the attachments to this ruling or in your opening comments raise concerns under the dormant Commerce Clause? If so, please explain why that flexible compliance option(s) may violate the Commerce Clause, including citations to specific relevant legal authorities. Also, explain if and, if so, how the flexible compliance option(s) could be modified to avoid the Commerce Clause problem. Address, in particular, whether a policy that limits offsets to only emission reduction projects located in California would raise dormant Commerce Clause concerns.
29. Do any of the linkage options identified in these questions or discussed in the attachments to this ruling or in your opening comments raise concerns under either the Compact Clause or the Treaty Clause of the United States Constitution? If so, please explain why that linkage option(s) may violate one or both of these Clauses, including citations to specific relevant legal authorities. Also, explain if and, if so, how the linkage option(s) could be modified to avoid the Compact Clause and/or Treaty Clause problem.
30. Do any of the flexible compliance options identified in these questions or discussed in the attachments to this ruling or in your opening comments, raise any other legal concerns? If so, please explain the legal concern(s), including citations to specific relevant legal authorities. Also, explain if and, if so, how the flexible compliance option(s) could be modified to avoid the legal concern(s).
31. For reply comments: do any of the flexible compliance options identified by other parties in their comments raise legal concerns? If so, please explain the legal concern(s), including

citations to specific relevant legal authorities. Also, explain if and, if so, how the flexible compliance option(s) could be modified to avoid the legal concern(s).

3. Materials on Flexible Compliance

We incorporate into the record in R.06-04-009 the following attached materials regarding flexible compliance, which parties may wish to consider in preparing their comments:

<u>Attachment</u>	<u>Title</u>
A.	Materials from ARB's April 4, 2008 AB 32 Technical Working Group Meeting Concerning Offsets.
B.	Materials from ARB's April 25, 2008 AB 32 Technical Working Group Meeting Concerning Cost Containment.
C.	"Summary of Major Options for a GHG Offsets System to Support the WCI Program," WCI Offsets Subcommittee, January 3, 2008.
D.	"Draft Offsets Design Recommendations," WCI, April 3, 2008.

4. Filing Requirements

All parties filing comments or reply comments should file them at the Public Utilities Commission's Docket Office and should serve them consistent with Rules 1.9 and 1.10 of the Public Utilities Commission Rules of Practice and Procedure and Resolution ALJ-188. The parties should serve their comments and reply comments on the service list for R.06-04-009 posted at www.cpuc.ca.gov when the filings are due, and should mail a hard copy of the filings to the assigned Commissioner and assigned Administrative Law Judges.

To support the ability of the Public Utilities Commission and the Energy Commission to develop joint recommendations to ARB, we ask that parties submit their comments and reply comments both in R.06-04-009 and to the Energy Commission's docket 07-OIIP-01.

Procedures for submitting the filings to the Energy Commission are included here for the parties' convenience. The Energy Commission encourages comments by e-mail attachments. In the subject line or first paragraph of the comments, include **Docket 07-OIIP-01**. When naming your attached file, please include your name or your organization's name. The attachment should be either in Microsoft Word format or provided as a Portable Document File (PDF). Send your comments to docket@energy.state.ca.us and to project manager Karen Griffin at kgriffin@energy.state.ca.us. In addition to electronic filing, **one paper copy** must also be sent to:

California Energy Commission
Docket Office, MS-4
Re: Docket No. 07-OIIP-01
1516 Ninth Street
Sacramento, CA 95814-5512

IT IS RULED that:

1. As directed in this ruling, parties may file comments no later than May 27, 2008 that address questions in this ruling on flexible compliance and the materials in Attachments A through D. Parties may file reply comments no later than June 10, 2008.

2. Parties shall file their comments and reply comments at the Public Utilities Commission's Docket Office and shall serve them consistent with Rules 1.9 and 1.10 and Resolution ALJ-188. The parties shall serve their filings on the service list for R.06-04-009 posted at www.cpuc.ca.gov when the filings are due, and shall mail a hard copy of the comments to the assigned Commissioner and the assigned Administrative Law Judges.

Dated May 6, 2008, at San Francisco, California.

/s/ CHARLOTTE F. TERKEURST

Charlotte F. TerKeurst
Administrative Law Judge

/s/ JONATHAN LAKRITZ

Jonathan Lakritz
Administrative Law Judge

