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January 11, 2016

Craig Segall
Senior Staff Counsel
California Air Resources Board
1001 I Street
Sacramento, CA 95184

Re: Comments in Response to Public Workshop on California's Plan for Compliance with the Clean Power Plan and Potential 2016 Amendments to the Cap-and-Trade Program

Dear Mr. Segall:

On behalf of the Natural Resources Defense Council, and our more than 72,000 members in California, we appreciate the opportunity to comment on the material and issues presented by staff at recent workshops regarding the state's plan for complying with the Clean Power Plan (CPP). The CPP sets the first-ever federal limits on carbon pollution from power plants, the nation's largest source of the pollution driving dangerous climate change. While California has been implementing an aggressive portfolio of policies for many years to reduce carbon pollution across the economy, the CPP provides an important boost to expand clean energy, level the playing field throughout the country, and drive the pace of change needed to avert the worst impacts of change.

The CPP also presents new opportunities for California to link its existing programs with other states, which holds the promise of achieving greater reductions at lower cost. However, if California is to pursue this opportunity, it must carefully maintain the environmental integrity of its existing programs. This letter focuses specifically on those challenges in the context of evaluating mass-based trading pathways for California under the CPP.

I. Compliance Plan Overview And Timing

We offer brief comments below on staff's initial direction as presented in the September 2015 Clean Power Plan Compliance Discussion Paper.[1]

A. ARB Should Develop A Compliance Plan Through A "State Measures" Approach Based On The Cap-And-Trade Program And A Federally-Enforceable Backstop For Affected EGUs

We support staff's inclination to develop a compliance plan via a "state measures" approach that builds off California's existing suite of regulatory measures to reduce carbon emissions from the power sector. While this approach would likely not be the preferred approach for most states, California's existing

[1] http://www.arb.ca.gov/cc/powerplants/meetings/2015whitepaper.pdf

economy-wide cap means a standalone mass- or rate-based plan for affected EGUs would likely be both burdensome and unnecessary. The state measures framework is better designed to accommodate California's existing programs (which include but extend beyond the power sector) and ensure they can be integrated smoothly to meet the requirements of the CPP. As the discussion paper notes, the cap-and-trade program "bakes in" the reductions achieved by California's diverse array of energy efficiency and renewable energy policies without having to develop a separate accounting and verification framework.

California's economy-wide carbon market does require the inclusion of a federally-enforceable "backstop" for affected EGUs. However, the probability of that backstop ever being triggered is very low.[2] The potential difficulty of deploying a backstop should accordingly not force the state to redesign its functional carbon market for a less optimal solution (e.g. as a reason to sever the power sector from the economy-wide cap). Finally, a state measures approach maintains greater flexibility for California to adjust its regulatory portfolio as needed to meet both federal and state climate goals without subjecting each component to federal jurisdiction.

B. ARB Should Submit A Final Compliance Plan By September 6, 2016

We recommend ARB finalize its compliance plan by the September 6, 2016 deadline established by EPA in the rule. While EPA has allowed states to submit a more general "initial submission" and request an extension of up to two years, we see no reason to delay, and substantial benefits from an on-time submission. ARB may need to make adjustments to the cap-and-trade program to sync with the CPP, as discussed at the workshop,[3] but the core of its compliance plan is already in place and operating successfully. By moving first, ARB has an opportunity to influence and strengthen the design of other states' plans by specifying the conditions on which it would trade with other states for CPP compliance.[4] As discussed below, there are several threshold design features for state plans that will have significant consequences for the expected environmental outcomes of future linkages California may pursue and for the CPP broadly (such as whether new sources are included in compliance plans for existing sources). Many states are currently undecided on these key design features. Submitting a plan on time provides the opportunity to shape the resolution of these choices facing every state, on which California has extensive technical expertise and experience, and establish the rules of the road for trading.

C. Backstop Design And Considerations

As noted above, in light of the low probability of the backstop ever kicking in, we recommend ARB focus on developing a backstop program that is simple and adheres clearly to the requirements of the CPP that each affected EGU come into compliance. This should not require any changes to the ongoing operation of the existing cap-and-trade program. Rather, ARB should include provisions in its submission to EPA that in the event the required "state measures" demonstration reveals emissions from affected EGUs exceed the maximum deviation from the state's glide path, a separate mass-based power-sector only

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[2] As the modeling results presented by agency staff confirm http://www.arb.ca.gov/cc/capandtrade/meetings/20151214/cppmodeling.pdf

[3] ARB, "Clean Power Plan Compliance Discussion Paper," Sept. 2015 http://www.arb.ca.gov/cc/capandtrade/meetings/20151214/ctamendscpp.pdf

[4] Even though a "state measures" approach would preclude California from distributing the power sector specific allowances available to it under the CPP, the size and buying power of the California carbon market presents an opportunity to ensure strong state programs by other states that wish to trade with California. Assuming California's economy-wide cap declines on a trajectory consistent with achieving Governor Brown's executive order to reduce emissions 40 percent below 1990 levels by 2030 (i.e. well below EPA's CPP target), the opportunity to sell allowances into the California market may well be attractive to a number of states.

program will kick in automatically for affected EGUs that ensures their aggregate emissions come into compliance with EPA's target. These "backstop" allowances could be distributed freely to utilities for the benefit of customers, just as current allowances are distributed to the electric sector, but would be tradable only within the California power sector.[5]

II. Environmental Integrity Considerations In Evaluating Inter-State Trading And Accounting for Imports In The Cap And Trade Program

As discussed above, the state has a unique opportunity to influence the design of compliance plans in other states that stand to benefit from the ability to trade with California.[6] Assuming threshold environmental integrity criteria are met, the benefits of regional cooperation include reduced leakage risk, more stable and aligned long-term climate policy, aligning CPP compliance within the anticipated expansion of the balancing authority operated by the California Independent System Operator (and general direction toward a more integrated Western power market), and promoting efficient dispatch and investment on the basis of a uniform carbon price across the WECC.

However, those benefits largely depend on – and must not come at the expense of – maintaining the environmental integrity of California's program. Accordingly, we strongly recommend ARB evaluate trading opportunities under the CPP *only if* the following conditions are met**:**

1. Allowance Surplus/Headroom

As the modeling results presented at the workshop confirm, even under an extreme stress case California will in all likelihood meet and exceed its emission reduction target under the CPP. The degree of California's "over-compliance" in turn creates a large potential pool of reductions that could be deployed to ease compliance in other states. A state measures approach would foreclose this possibility, as ARB would only issue allowances up to the level required to ensure compliance with California's more ambitious state-level reduction policies (i.e. a 40% statewide reduction by 2030), not EPA's more lenient target. While it is possible to conceive of alternative program designs that taps into this surplus, doing so would undermine, if not eliminate, the ability of the state to meet its own greenhouse gas reduction goals and dampen the incentive to shift to clean energy in power markets. As California is not the only state with significant headroom below its EPA target,[7] it has an important opportunity to lead by ensuring its own state-level reduction goals drive the amount of carbon allowances it makes available.

2. Preventing Leakage To New Sources

As the discussion paper notes, Section 111 of the Clean Air Act establishes distinct processes for new and existing sources. New sources are regulated by U.S. EPA directly under section 111(b), which establishes new source performance standards for new, modified, and reconstructed fossil-fuel-fired EGUs. Existing sources are regulated under emission guidelines issued under section 111(d), which is the purview of the Clean Power Plan. Although in California both new and existing sources are covered under the cap-and-trade program, there is no federal requirement that states include new sources in mass-based caps developed to meet their CPP obligations. Accordingly, absent other safeguards, there is clear potential for

[5] ARB could also explore making Clean Energy Incentive Program credits available to affected EGUs as an additional source of compliance, should California elect to participate in the program.

[6] Subject to the import/export accounting framework required for links between a broader market and a CPP EGU-only market. *See* 40 C.F.R. § 60.5740(a)(2)(ii)(H); *see also* 80 Fed. Reg. at 64894.

[7] Including Oregon and Washington, California's Pacific Coast Climate Action Plan partner states.

leakage from existing to new sources under a mass-based compliance plan: as long as a new source complies with the NSPS standards under section 111(b), there are no regulatory limits on the carbon pollution it may emit. As such, California should employ a strong presumption against trading with any state that excludes major emissions sources from its cap, including new sources subject to 111(b).

EPA recognized this risk in the final rule, and will only approve state plans that adequately demonstrate how to prevent leakage from existing to new sources, including through adoption of an optional "new source compliment" for mass-based plans. EPA is still evaluating the federal and model rules to finalize its requirements on how best to address this concern. But in determining whether or not to trade with another state, CA should maintain a presumption against linkage with any state that fails to include new sources and separately analyze the sufficiency of leakage prevention measures – in particular how the state allocates allowances – if new sources are excluded, even if the state plan is approved by EPA. ARB should also require any EGU not included in a mass-based cap to continue to comply with the imports requirement, as discussed below.

3. Accounting For Imported Power

State law requires California to account for the emissions from imported power in achieving its statewide reduction targets.[8] As a result, the cap-and-trade program assigns a compliance obligation to all power delivered into California, even if it originated out-of-state. This is a critical, albeit insufficient, mechanism to mitigate the potential for leakage to states that lack comparable emissions reduction requirements. Once states that export power to California are subject to the CPP (post 2022), ARB has raised the issue of whether the policy of accounting for the emissions associated with imported power should be revisited, as those emissions will be subject to limits in their state of origin.

Simply having the CPP in effect in states that export power to California, however, is not on its own a legally sufficient basis for ARB to cease accounting for the emissions from imports. California law anticipates these dynamics in evaluating linkages. Senate Bill 1018, passed in advance of California linking its cap-and-trade program with Quebec, requires the Governor, on the advice of the Attorney General, to make a series of findings before any future linkage proceeds, including that the program in the jurisdiction with which California proposes to link is of equal or greater stringency.[9] And for good reason: if not, the resulting dynamics of trade will not reflect efficiencies or least-cost reductions so much as leakage from a program of greater stringency to a program with less stringent reduction requirements.

Accordingly, we strongly recommend ARB retain the import requirement ***unless and until*** a finding is made pursuant to SB 1018 that the state with which California would trade CPP allowances has developed a compliance plan of comparable stringency for all of its fossil EGUs. In that instance, as in the case of full program linkage, specified sources located in those states that export power to California would face the same compliance obligation as in-state generators in the form of a harmonized carbon price applicable to all power generation in the linked market. But to retain a level playing field, the import requirement should remain in effect for all other first deliverers into California, including both unspecified power sources and specified power sources originating from states in which California has not linked through the SB 1018 process. Furthermore, as mentioned above, ARB should retain a strong presumption against linking with a state that excludes new sources. At a minimum, the imports requirement should remain in effect for any source not covered by the mass-based cap.

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[8] *See* Cal. Health & Saf. Code §§ 38505(m), 38530(b)(2).

[9] *See* Cal. Govt. Code § 12894(f)(1).

To accommodate the impact of CPP compliance in states that export power and do not link to California, ARB should evaluate calibrating the compliance obligation on imported power to reflect the gap in stringency (reflected in the carbon price for states that pursue a mass-based plan) between California's program and the CPP plan of the exporting state.[10] This would prevent a disparity from emerging that could facilitate leakage – and violate the legal requirements on accounting for imported power in AB 32 – while avoiding the prospect of "double regulation" (assigning a compliance obligation to the same EGU emissions in both the state of origin and destination).[11] ARB should also calibrate its imports requirement to apply to any state that exports power to California but opts to comply with the CPP through a rate-based plan.

Thank you for considering these comments. We look forward to providing more detailed analysis on these issues in the months ahead and engaging with staff and stakeholders to develop a timely compliance plan that continues California's exemplary climate and clean energy leadership.

Sincerely,

Alex Jackson
Legal Director, California Climate Project

Noah Long
Director, Western Energy Project

[10] For example, if an out-of-state EGU emits 100k MT associated with specified power deliveries into California over the course of a CPP compliance period, and the average carbon price – using, e.g., quarterly auction results – over that same period was $10/ton in the state of origin compared to $15/ton in California, ARB would assign that EGU a compliance obligation of 500k MT ($5/ton differential x 100k MT).

[11] We present this only as an option that warrants further evaluation. We appreciate the legal and market implications require a thorough analysis, which is beyond the scope of this comment letter.