



PUBLIC UTILITIES COMMISSION

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September 16, 2008

The Honorable Dave Jones, Member  
California State Assembly  
State Capitol, Room 3146  
Sacramento, CA 95814

*Re: Questions regarding appropriateness of a cap and trade in California's electricity sector*

Dear Assemblymember Jones:

I am writing to you in response to recent inquiries you have made – both formally and informally – during conversations with leaders of the CARB, PUC and Energy Commission. The question, as I understand it, is related to the operation of a cap and trade system in a sector characterized by monopolistic or oligopolistic markets.

Your question is a thoughtful one and unfortunately there is no simple answer. To begin to address it, first we need to distinguish between the greenhouse gas (GHG) allowance market and the various markets for electricity. Further, we should consider the premise of your question: whether the electricity sector is, in fact, a monopolistic or oligopolistic market. I submit that it is not, at least not in all instances. In order to better explain this difference we should break down the electric sector into its three distinct elements – distribution, transmission and generation. The transmission and distribution functions of electricity supply are typically regarded as monopoly markets and are therefore regulated. In order to avoid potential market abuses, the majority of transmission infrastructure in California is controlled by the CAISO. The distribution of electricity, commonly performed by Investor Owned Utilities, is regulated by the CPUC.

In California, the generation portion of electricity supply is not a monopoly or even an oligopoly market. Here in California and more broadly throughout the nation, we have a number of companies that compete, via a competitive market, for the generation of electricity. In fact, the majority of the power generated in California comes from a number of Independent Power Producers.<sup>1</sup> The share of generation resources owned by the IOUs is less than 50% statewide,

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<sup>1</sup> These IPPs include but are not limited to: NRG Energy, Mirant, Reliant, CPV, FPLE, Calpine, Edison Mission Energy, Sempra Generation, Wellhead Electric, Constellation, Dynegy, Horizon Energy, CalPeak. This list does not take into account the IPPs currently competing to provide renewable generation resources to serve California load. Most renewable generation is currently not utility-owned.

and if we were to exclude the zero-emitting resources that will not have a GHG regulatory obligation – nuclear and hydro – that number drops well below 50%.

The fact that the generation sector of the electricity market is robustly competitive is not enough to determine whether, and to what extent there will be benefits to including the electricity sector in a cap and trade market. We also need to look at the type of GHG allowance market under consideration.

The GHG allowance market that is being recommended for AB32 compliance purposes is a multi sector market. The electric industry is only one of several industry segments that would be participating in the GHG allowance market. This would further increase the liquidity and effectiveness of the proposed market and prevent individual participants from exercising market power.

The CPUC has recommended the “deliverer” as the point of regulation in the electricity sector. This places the compliance obligation on the entity that first delivers the power to the electricity grid in California, which will most often be the generation owner, at least for in-state resources. This point of regulation encompasses many types of entities including IOUs, POUs, generators, marketers, brokers, operators, and direct access retail providers. While the deliverer may be the owner or operator of the generating unit, it could also be any entity that purchases or otherwise has a contractual arrangement such that it owns the electricity as it is delivered to the California grid. Under this allowance market design, IOUs will only have compliance obligations – and thus a need to purchase allowances – to the limited extent that they have an ownership stake in fossil-fired generation.

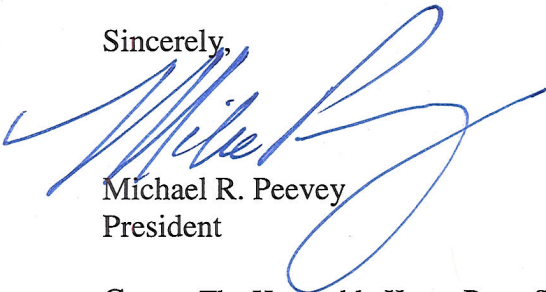
Vigorous competition in the wholesale energy market will limit the ability of participants to pass GHG allowances costs through to power purchasers. In California energy is dispatched through a centralized wholesale energy market operated by the CAISO. The energy is dispatched in merit order from lowest bid to highest bid. This means that generators – regardless of ownership arrangements – are competing against one another on a least-cost basis for the right to be dispatched to serve California’s electricity demand. The generator that is best able to mitigate the price impact of any GHG regulation will be selected for dispatch before a generator that is less able to mitigate the GHG regulation costs. Therefore, through competitive forces in the wholesale energy market, generators may be unable to simply pass through the entirety of their costs to customers. This is true even for IOU generators.

I believe that part of your point is to question whether the larger utilities would not just bid up allowance prices because of their ability to pass through the higher costs to their customers. In theory this could occur directly in the allowance market or indirectly through the wholesale energy market. There are two significant deterrents to such conduct. The first is the wholesale market competition discussed above, and the second is the regulators who will be watching for the cost consequences to consumers. All costs incurred by the IOUs, including direct or embedded GHG compliance costs, are thoroughly scrutinized by PUC staff. This is a core function of the PUC, and I can assure you that I and my fellow commissioners take it extremely seriously.

It is precisely that concern for containing costs to ratepayers that informs our recommended approach to reducing GHG emissions from the electricity sector. The PUC, along with the CEC, concluded that relying exclusively on direct regulatory mandates would be an inefficient and needlessly expensive approach to reducing GHG emissions. A cap and trade system, in conjunction with the continuation and further strengthening of existing policies regarding energy efficiency, and the renewable portfolio standard is likely to be a less costly and more flexible means of complying with AB32 GHG emission reduction requirements. Including GHG emissions trading in our overall suite of GHG reduction policies will maximize flexibility in achieving emission reduction targets by allowing obligated entities to rely on least-cost options across the entire economy. Those cost savings should and will be passed on to consumers.

I hope this response sufficiently addresses your inquiry. Please let me know if I or my staff can provide further information or analysis.

Sincerely,



Michael R. Peevey  
President

Cc: The Honorable Karen Bass, Speaker, California State Assembly  
The Honorable Don Perata, Pro Tem, California State Senate  
The Honorable Darrell Steinberg, Pro Tem Elect, California State Senate  
California State Senate Members  
Assembly Utilities & Commerce Committee Members  
Assembly Natural Resources Committee Members  
Senate Energy, Utilities & Communications Committee