

**Comments of the Independent Energy Producers Association
On
The California Cap-and-Trade Market
Public Workshop Convened March 23, 2008**

The Independent Energy Producers Association ("IEP") is pleased to offer these comments on the California Air Resources Board (CARB) "California Cap-and-Trade Market" Workshop convened on March 23, 2009. IEP represents over 20,000 MWs of independently owned generation resources in the west, particularly California and Nevada. IEP has been active in the joint CPUC/CEC efforts to implement AB32 as well as at CARB.

I. Overview and General Comments

The CARB workshop on the California Cap and Trade Market (C&T) primarily addressed design options for auctioning allowances. [NOTE: IEP comments related to the second workshop, "Implementing A Quantitative Limit on the Use of Offset" will be provided under separate cover.] As a general matter, IEP recommends the following general rules to designing an allowance-based C&T program for California.

- 1. It May Not Be Necessary or Desirable To "Re-invent the Wheel."** It is not necessary, nor is it desirable, that the CARB propose to design an allowance-based C&T program from "whole cloth." Designing a program from the ground up risks undermining the CARBs objectives of ensuring linkages to other similar programs, many of which are currently operational in the US (e.g. RGGI) and the world (EU market design). Furthermore, avoiding the opportunity to learn lessons from the implementation of similar programs in other contexts risks exacerbating the potential for unintended consequences.

IEP recommends that that the CARB look to RGGI as an example of a C&T allowance-based model that seems to be operating relatively well and efficiently. RGGI has had to address issues such as (a) access to allowances and associated participation limits, (b) transparency, financial assurance requirements, (c) purchase limits, (d) frequency of auctions, and (e) setting the auction price. So far, the evidence suggests that the RGGI model is working effectively. This suggests that replication of the core RGGI design elements may be useful for California, particularly as a point of initial discussion.

- 2. Simplicity and Transparency Should Be Key Objectives.** The more complex and opaque program design becomes, the more likely that unintended consequences arise. In the context of a C&T design, the core elements that should drive the design are (a) clear identification of "obligated entities," (b) transparency regarding the means for obligated entities to become compliant

from a regulatory perspective, and (c) clear statements and rules that will be used to govern the regulatory environment.

IEP envisions three primary market structures to arise in anticipation of a new GHG emission reduction regulatory requirement: a Primary Market related to the issuance of allowances from the regulatory bodies to the marketplace; a Secondary Market to facilitate the buying and selling of allowances among market participants, including but not limited to “obligated entities” to facilitate market liquidity and least-cost regulatory compliance; and, a Tertiary Market (sometimes referred to as a Derivatives Market) through which market participants, including but not limited to obligated entities, hedge the financial risk of a regulatory environment.

IEP recognizes the need for California regulators to exercise rules, governance, and accountability overseeing the Primary Market as this is the market in which the regulators are releasing allowances to the marketplace. The Secondary Market and the Tertiary/Derivatives Market demand less regulatory oversight from CARB as the regulator of GHG emission reduction, recognizing that these latter markets are, should be, and will be regulated and/or monitored by federal entities overseeing markets in general. CARB need not duplicate the regulation and oversight of these highly complex and volatile markets, as they are not directly related to CARB’s mission of regulating compliance from the sources of emissions that will be obligated entities.

- 3. Obligated Entities Must Have Reasonable Access To Necessary Allowances. Accordingly, regulatory agencies should not cede to the regulated utilities any role related to allowance issuance, particularly the conduct of an auction if that path is chosen.** Obligated entities must have reasonable means to access allowances directly from the regulatory body responsible for their issuance. Assigning the responsibility for auctioning/issuing allowances to third parties such as the regulated utilities is (a) inefficient and (b) inequitable. The utilities retain a strong *shareholder* interest in the issuance of allowances; separate from any interest they may have representing ratepayers. For example, utility-owned generation (UOG) will be competing with independent power producers (IPPs) in the energy markets in which GHG emission reduction costs are critical to determining winners and losers. Due to this clear conflict of competitive interest, regulatory agencies should not cede to the regulated utilities any role related to allowance issuance, particularly the conduct of an auction if that path is chosen.
- 4. Obligated Entities Must Have Reasonable Means For Cost Recovery.** Obligated entities must have a reasonable means to recover the cost of the allowances they need to purchase to meet their regulatory obligation. This is fundamental to any efficient and effective program design.

Some obligated entities may operate under existing contracts for which the opportunity to recover the costs of GHG compliance may not be available.¹ This phenomenon is a transitional problem and ends upon expiration of any existing contract. Accordingly, IEP recommends that obligated entities such as electric generators, operating under contracts entered into prior to the passage of AB 32 and for which a reasonable means of cost recovery is not available, should either (a) be deemed compliant with AB 32 obligations during the pendency of that pre-existing contract or, alternatively, (b) be administratively allocated sufficient free allowances to enable that generation facility to continue to operate through the duration of its pre-existing contract. During a transitional period only, this approach provides a measure of fairness and regulatory certainty to the electric generator. This approach also will help ensure that electric grid stability and reliability are maintained during the transition to an environment in which all obligated entities are capable and able to be treated equivalently.

In addition to the general comments provided below, IEP provides specific comments to many of the critical issues raised by CARB staff in the workshop on March 23, 2009.

II. Specific Comments re Draft Design Recommendations

Regarding the specific auction design features raised by the staff presentation at the March 23, 2009 Workshop, IEP addresses specific issues below. Our comments do not address all the issues posed in the workshop, and we look forward to working with the CARB and staff on further delineating necessary and sufficient design elements in an allowance-based C&T program design.

1. Financial Assurance Requirements. IEP recommends consideration of the RGGI rules/regulations regarding financial assurances. Electric generators participating in the RGGI GHG environment of which IEP is aware are comfortable with the structure(s). IEP understands that RGGI provides multiple means for providing financial assurances, including Letters of Credit (LOC), cash deposits, etc. These are posted one week ahead of the market to ensure timely compliance. The financial assurances are scaled (to match allowance market penetration), and the financial commitments represent a set limit on the market participants' exposure. Credit support should be returned to market participants promptly after transactions clear.

2. Participant Restrictions. As noted above, the "marketplace" in which

¹ This phenomenon will be contract and/or context specific. For example, many QF contracts may not afford a reasonable means for cost recovery. Of particular note, some electric generators operate pursuant to tolling agreements which may not provide for a reasonable means of cost recovery of GHG emission reduction costs.

GHG allowances will be allocated, traded, and hedged represents conceptually three discrete “markets” from the perspective of regulators. IEP has repeatedly noted in the GHG discussion to date that obligated entities must have reasonable access to GHG allowances, particularly in the context of the Primary Market/Auction. If an obligated entity chooses not to participate in the Primary Market/Auction, then so be it but at least access was not foreclosed.

From an obligated entity perspective, naturally concern arises if non-obligated market participants have an equal opportunity to participate in the Primary Market/Auction, as this access could foreclose reasonable access for obligated entities. For example, some parties have proposed the concept of a “screen” to ensure either (a) that only obligated entities have access to the Primary Market/Auction or, alternatively (b) limits are place on the amount of allowances a single entity may acquire in the Primary Market/Auction.

IEP has concluded that creating limits on participation in the Primary Market/Auction is impractical. The rules and regulations addressing any such limits would undermine the equally important goals of simplicity and transparency. For example, how would developers of “new generation” be afforded access to needed allowance? If “new gen” was afforded different access than existing generators, might not this raise concerns of discrimination? In addition to the practical considerations, little expectation exists that any such rules or regulations would provide any meaningful barrier to non-obligated entities that strongly desired to participate.

No limits are required or desired in either the Secondary Market or the Tertiary/Derivatives market in any case.

In all cases, protections need to be included in the design elements to guard against market manipulation which, ultimately, can undermine the efficient and proper execution of the market. IEP notes the following necessary market design elements to protect against market manipulation:

- **Market Monitor.** An entity needs to serve as “market monitor” to protect against market power, hoarding, etc.
- **Flexible Compliance Rules.** Rules need to be instituted that provide obligated entities a reasonable timeframe to acquire the necessary allowances for compliance. IEP recommends a rolling, three year flexible compliance timeframe, i.e. obligated entities will have up to 36 months to acquire the allowances needed to show compliance in a

single year. For example, obligated entities would have until the end of 2014 to acquire the allowances needed for compliance in 2012; and, obligated entities would have until the end of 2015 to acquire the allowances need for compliance in 2013. However, entities must retire allowances when used, and entities must not be allowed to borrow offsets from a time frame beyond the 36 months, afforded under the flexible compliance rules, in order to meet a regulatory obligation. For example, allowances released in year 2015 and beyond would not be eligible for use against a 2012 obligation.

- 3. Auction Frequency.** With regards to the Primary Market/Auction, RGGI holds auctions quarterly (i.e. 4 times per year). IEP supports this approach. This approach affords greater flexibility and, hopefully, liquidity in the process of allowance issuance. Furthermore, multiple auctions in a single year provide a means for obligated entities to “true up” their operations against compliance obligations in that year which will likely be the preferred strategy for most market participants.²
- 4. Award Process.** Here again, IEP recommends the RGGI model. Essentially, the RGGI model employs the following: (a) closed bid, (b) lowest winning bid clears market.
- 5. Auction Reserve Price.** IEP does not believe that a “minimum” floor is neither necessary nor desirable. A minimum floor design essentially says to the marketplace that the C&T program is a tax in all but name.

On the other hand, assuming a minimum floor is employed, then it would be reasonable to design a parallel construct for protection against high prices. In this regard, IEP recommends a damage control, “fail-safe” mechanism, much like occurs in other markets. For example, adoption of a rule to close an auction if prices rise to a point where they exceed for a sustained period of time the cost of achieving compliance through other measures (e.g. installing control measures, investing in offset projects, etc.). Alternatively, a “fail safe ceiling price” would prevent excessive volatility in the market. In the latter case particularly, obligated entities would have the means to best manage against the rise of such a contingency while still maintaining regulatory compliance. Fail-safe

² Obligated entities may have a strong incentive to acquire all needed allowances in the years in which the obligation is created because, presuming a declining “cap” over time, then one might assume that the cost of allowances will increase in future years as the supply of allowances declines over time (all else remaining equal).

mechanisms such as proposed, coupled with the above mentioned flexible compliance rules, would provide a much needed safety net to participants in a market (a) unconstrained as to participation, and (b) where it is known, going in, that allowance values will increase over time as allowance supply declines.

6. Treatment of Non-Competitive Bids. IEP would define “non-competitive bids” as bids that exceed for a sustained period of time the cost of achieving compliance through other measures. Bids such as these risk undermining the marketplace. In addition to consideration of fail-safe measures such as the “shut off” valve approach discussed above, IEP recommends consideration of a government held “reserve account” for application when market dynamics become unreasonably volatile, etc. The presence of such a reserve, assuming clear and transparent rules in place as to its application and use, would provide a tool to help stabilize the marketplace in a time of uncertainty and volatility.

7. Penalties. In order to provide the necessary regulatory certainty to market participants, penalties must be (a) transparent, (b) well defined, and (c) stable over time.

III. **Conclusion.**

The CARB need not, and should not, spend endless hours and resources debating the full range of options associated with the myriad of design elements. Rather, IEP recommends borrowing design elements from markets deemed functioning properly and efficiently, and putting those elements in front of stakeholders to comment on why they are not sufficient. This rebuttable presumption approach may help ensure that the debate stays as focused as practical given the circumstances.

Where additional and/or new design elements are properly positioned for discussion, IEP recommends the CARB address each design element comprehensively, yet as part of a conceptual whole where the goals are to ensure that (a) obligated entities have reasonable access to needed allowances, (b) market structures, including rules and regulations, are in place to maximize the probability that the compliance obligations can be met in a timely, reasonable, and cost-effective manner, and (c) the market serves as a means to GHG regulatory compliance and not as a goal unto itself.

IEP thanks CARB for the opportunity to submit these comments on the California Cap & Trade program.

Respectfully submitted,

A handwritten signature in black ink that reads "Steven Kelly". The signature is written in a cursive style with a large, looping "y" at the end.

Steven Kelly
Policy Director
Independent Energy Producers Association
1215 K Street, Suite 900
Sacramento, CA 95814
916/448-9499
steven@iepa.com

May 31, 2009