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Kevin Kennedy
California Air Resources Board
1001 I Street
Sacramento, CA

Re: **NORTHERN CALIFORNIA POWER AGENCY Comments on March 23
Workshop Regarding Overview of a California Cap-and-Trade Market**

Dear Kevin:

In accordance with the direction provided by the Staff of the California Air Resources Board (CARB) during the March 23 Workshop, the Northern California Power Agency¹ (NCPA) submits the following comments focusing on how allowances and offsets enter the market through auctions.

The ultimate market structure is a crucial and key element to the development of a successful cap-and-trade program. Any recommendation for a mandatory auction is problematic at this juncture without first addressing the details regarding governance and administration of the overall market, and not just a single element of that market. As a practical matter, the structure of an auction must ensure that all entities with a compliance obligation have adequate access to emissions allowances, and that allowances are accessible at a reasonable price. Any market structure that can ensure those two elements should, on its face, be successful. However, when it comes down to the more detailed minutia of the auction structure itself, there is a great deal of room in which to adopt or design program features that may have adverse results. These additional features, although no less important, are much more "fact" specific, and recommendations on those elements are premature or speculative outside of a more definitive market structure proposal or "White Paper" from CARB.

NCPA and other stakeholders in this process have expressed concerns regarding the piecemeal fashion in which the market structure is being developed. To be sure, NCPA is aware of the significant challenges faced by CARB in developing a brand new market, especially in this

¹ NCPA members include the cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, and Ukiah, as well as the Bay Area Rapid Transit District, Port of Oakland, the Truckee Donner Public Utility District, and the Turlock Irrigation District, and whose Associate Members are the Plumas-Sierra Rural Electric Cooperative and the Placer County Water Agency.

economy. Those challenges are many, and are coupled with the ongoing need to monitor and track developments at the regional and federal level to ensure that the State develops a program that is compatible with state and/or regional efforts. Like all stakeholders actively participating in this proceeding, CARB is also faced with limited resources, further impacting its ability to develop a comprehensive program within the time constraints set forth in AB 32. In the face of such challenges, it is imperative upon CARB to develop a fundamental framework in which stakeholders can provide comments and constructive input in the most efficient manner.

Key Variables Must be Addressed In Advance of Agreeing to an Auction Structure

At this time, too many variables remain unresolved, resulting in infinite combinations of possible outcomes. Until such time as CARB provides greater clarity with regard to fundamental structural features of the proposed cap-and-trade program, designing specific elements for an auction of allowances is speculative at best, as all stakeholders can do is offer proposals based on hypothetical situations. Before stakeholders can provide realistic insights to CARB regarding the type of auction that should be developed, the following questions must be addressed:

- How will allowances be allocated between various sectors? If some sectors are going to be given more allowances than their “proportional” share, then the number of compliance entities will be drastically different, which will result in a very different auction structure.
- How will allowances be allocated between entities within a single sector? If some sources or sectors are going to be allocated allowances – or even a portion of their allowances – for free with no requirement to participate in the auction, then the auction structure could be fundamentally different from one that includes more allowances or more varied auction participants.
- How many allowances will be part of the auction? If the total number of auction allowances is small, then the overall structure of the auction could look different.
- Is the auction intended to be the primary source for allocation of allowances?
- How many allowances will a single entity be required to purchase from the auction? An auction that is structured for the purchase of a minimal number of allowances may look different than one into which all of the State’s allowances will be funneled.
- Will all sectors of the economy be included in the cap-and-trade program be required to participate in the auction?
- Other key considerations should also be resolved in advance of a comprehensive discussion regarding the auction structure:

- How does the State plan to protect trade exposed industries?² If a program is put into place that either exempts or subsidizes some market participants from mandatory caps or market purchases of their necessary allowances, the total number of allowances in the auction will be reduced. Further, a funding mechanism for this subsidy would need to be developed. Is the auction going to be used to fund not only its own administrative costs, but also to raise revenue for the state in order to subsidize its trade exposed industries?
- Will the State allow set-asides? How will they be administered? Who will be eligible for set-asides? The number of set-asides the State agrees to employ (if any) and the manner in which they will be distributed will impact the size and scope of an auction.

While these issues raise just some of the outstanding concerns with market structure, they demonstrate the clear fact that *design* features for an auction must be designed for a *specific* auction within the context of a defined market structure. Without more information regarding essential elements of the overall market structure - including allowance allocation issues, use of offsets and set-asides, and minimum and maximum auction percentages - recommendations on the design and structure of an allowance auction will be speculative and conditional, utilizing considerable stakeholder resources, while not providing real guidance.

Key Market and Auction Essentials

As noted above, the need to provide input on the features of an auction without further definition of the underlying market within which that auction will operate is problematic for NCPA. However, it is important to consider them at this juncture of the debate. Several key principles of a market structure are so crucial to the continued viability of California's economy that they must be established from the onset.

As it pertains to the structure of an auction design, it is imperative that the following elements be established up front:

- market oversight must be in place prior to initiation of an auction,
- participation in the auction must be limited solely to those with a compliance obligation under the cap,
- all auction administration costs must be recognized up front, with proper review of the costs versus benefits analysis of such an administrative structure;
- all auction proceeds associated with the acquisition of allowances for retail electric providers must be directed back to those same providers to be used to support future, additional, and permanent emissions reduction measures; and
- any auction should be phased-in and should include all sectors under the cap.

Any market-based program for the allocation of valuable emissions allowances creates an

2 Trade exposed industries – see materials from April 13 workshop on emissions leakage.

opportunity for gaming. This is especially true in an auction that allows unlimited market participants. The auction design elements should look first and foremost at a structure that limits this potential.

One key means by which to reduce the potential for market abuses is to limit the size of the auction and the number and kinds of market participants. While it is true that high levels of participation can create greater market liquidity in a well-structured auction, the emissions allowance auction at issue is a nascent structure that must have all of the “kinks” worked out before it can be deemed “a well-functioning market.” Until that time, the ability of speculators to purchase allowances will likely lead to increased prices and volatility. Limiting auction participants to those with a compliance obligation will provide an easy to administer safety measure that will help protect California consumers from unpredictable allowance prices.

Regardless of the size of an auction, it is imperative that all of the costs and market implications of an auction be fully addressed at the very start of any cap-and-trade program debate. Each design feature of an auction includes a cost to administer, and should also have a corresponding benefit. Those costs and benefits must be evaluated to ensure that an auction structure is even cost-effective for the State.

One feature of an auction that hinders, rather than facilitates, emissions reductions within the electricity sector is the fact that a centralized auction would effectively remove those most directly impacted by the costs associated with allowance purchases – the State’s electricity customers – from the benefits of the proceeds obtained from the auction. Accordingly, any auction structure must provide that the proceeds from any auction be distributed in a manner that maximizes the return to utility customer-owners.³

Finally, the auction should be designed to allow for a phased-in approach that includes a limited number of allowances available through the auction, with the majority and remaining allowances available through administrative allocation to compliance entities. The phased-in auction should be implemented commencing with no more than 5% of allowances economy-wide, and should include all entities within the cap. Such a structure would allow the State to monitor the auction on a smaller scale, assess the potential for market failures and manipulation, and facilitate the development of appropriate market power mitigation measures.

Conclusion

CARB must establish a clear “critical path” for defining key elements of the cap-and-trade program, including addressing allowance allocation issues. Doing so would facilitate

³ Within the electricity sector, the vast majority of allowances should be freely allocated. Free allocation is the best means by which to minimize costs and maximize the beneficial use of allowances within the sector. The free distribution of allowances would relieve entities with the compliance obligation from the need to expend unknown sums on the purchase of emissions allowances; instead allowing those entities to utilize all of their existing resources on rate mitigation and providing funds for investments that would reduce GHG emissions and avoid the need for future allowances.

deliberations on all aspects of the cap-and-trade program, and would provide both CARB and stakeholders with a more definitive framework in which to provide guidance and comments. Only after key elements have been defined can stakeholders meaningfully participate in the development of the *key design* features of an auction for the distribution of allowances and offsets into the market. To that end, NCPA requests that CARB develop a “White Paper” that sets forth clearly defined parameters within which the agency seeks stakeholder input and assistance.

NCPA appreciates the opportunity to offer these comments, and looks forward to continued efforts towards the development of a viable cap-and-trade program. If you have any questions regarding these comments, please do not hesitate to contact the undersigned or Scott Tomashefsky at 916-781-4291 or scott.tomashefsky@ncpa.com.

Respectfully submitted,

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