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

Re: **NORTHERN CALIFORNIA POWER AGENCY Comments on April 28  
Workshop “Introduction to Cap Setting in a California Cap-and-Trade  
Program”**

Dear Kevin:

In accordance with the direction provided during the April 28 Workshop, *Introduction to Cap Setting in a California Cap-and-Trade Program* (April 28 Workshop), the Northern California Power Agency<sup>1</sup> (NCPA) hereby submits the following comments.

### **Introduction**

During the April 28 Workshop, California Air Resources Board (CARB) Staff presented an introduction to cap setting for a California cap-and-trade program. California’s historic Assembly Bill (AB) 32 sets forth clear objectives that the agency must meet in determining the statewide cap. Notably, the capped amount must be set so as to ensure overall environmental effectiveness while achieving technological feasibility *and* cost-effective reduction of greenhouse gas (GHG) emissions. The cap setting design should be simple and ensure transparency in the decision making process. California has important logistical considerations in doing so, however. Not only does the State have to set a cap for its own program, but as directed in the Scoping Plan, “major program design elements will include setting an emissions cap in conjunction with the [Western Climate Initiative (WCI)] Partner jurisdictions.”<sup>2</sup> This interaction is extremely important.

Another interaction that is critically important is the linkage between cap setting and allowance allocation. Without question, issues regarding the setting of an appropriate cap are inexorably linked with allowance allocation methodologies. This point has been raised several

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<sup>1</sup> 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.

<sup>2</sup> Scoping Plan, pp. 34-35

times by stakeholders throughout the various cap-and-trade related workshops. Indeed, the WCI has specifically noted the interaction between cap setting and allowance allocation, and has created a single committee to review these issues in concert. Discussions regarding all alternative compliance and allowance usage options would be more robust following a determination of allowance distribution methodologies for the California cap-and-trade program.

In these comments, NCPA addresses Staff inquiries regarding the various aspects of cap setting discussed at the Workshop, as well as the specific inquiries shown on Slide 21 of the Staff presentation regarding the WCI cap setting approach as set forth in the WCI's September 2008 *Design Recommendations for the WCI Regional Cap-and-Trade Program*.

**Slide 21, Question 1**

*How should the WCI cap-setting methodology be expanded upon or otherwise revised for California?*

As a practical matter, all comments received by stakeholders will be limited by the fact that the WCI has not yet discussed cap setting specifics. In the most recent White Papers released by the WCI's Cap Setting and Allowance Distribution Committee, the WCI discusses the use of both offsets and Early Reduction Allowances (ERA), noting that both offsets and ERAs impact how allowances are allocated and how the cap will be set.

Allowance allocation is a critical element of cap setting, and without a thorough review of allowance allocation methodologies being contemplated, it is not possible for stakeholders to make reasoned estimates of the cost and availability of allowances, or the potential impacts of complimentary measures on entities that will be required to effect emissions reductions through both the cap-and-trade program and mandatory regulatory measures. For the electricity sector, the latter depends of realistic expectations for energy efficiency and renewable energy deployment, including the impacts of electrification of the transportation sector.<sup>3</sup>

*Annual Caps:* Of California's proposed overall emission reductions of 427 million metric tons of carbon dioxide equivalent (MMT CO<sub>2</sub>e), the State projects that 365 MMT CO<sub>2</sub>e will come from the cap-and-trade program. As referenced throughout the Scoping Plan, California intends to reach its overall emission reduction target by utilizing not just the cap-and-trade program, but a suite of complimentary measures as well. Many of the complimentary measures applicable to the electricity sector take the form of legislative mandates, not the voluntary reductions that are projected for various other sectors.<sup>4</sup>

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<sup>3</sup> NCPA notes that the projected increase in the number of plug-in electric vehicles over the coming years is going to have a drastic impact not only the overall cap that should be applied to the electricity sector, but to reliable provision of electricity throughout the state.

<sup>4</sup> See, for example, Scoping Plan pp. 17-18, C-16, C-99, Appendix E (List of Measures).

*Narrow Scope Sources*<sup>5</sup>: CARB must ensure that the overall cap is one that is achievable, an important feature for the initial stage of the program. As specifically stated in the Scoping Plan, the “cap must also be realistic in terms of the emission reduction opportunities within the capped sectors.”<sup>6</sup> This is especially crucial for those sectors that will be included in the first compliance period of the cap-and-trade program. The Narrow Scope Sources will be called upon to make the most reductions when cap-and-trade and complimentary measures are combined, and the limited number of participants (in-state electricity generation, imported electricity, large industrial) in the initial compliance period commencing in 2012, will make achieving the emissions reductions goals more challenging. Any cap setting design must include an analysis of the impacts of complimentary measures on the compliance entity.

To fully ascertain how realistic achieving the mandated goal might be, CARB must view not only the opportunities for cost-effective and technologically feasible emission reductions, but also the availability of flexible compliance mechanisms and cost-containment measures, such as the use of offsets, banking, and borrowing. To that end, it is necessary to look closely at the entities within the Narrow Scope Sources, which includes retail electric providers, and determine the direct impacts on electricity customers – both business and residential – throughout the State. The cap must be set at a *realistic level* in light of *today’s* economic environment, which may necessitate a review of the original cost-benefit analysis undertaken as part of the development of the Scoping Plan itself.

*Broad Scope Sources*:<sup>7</sup> After determining the cap for the first compliance period, CARB must set the cap for entities subject to the cap in 2015 (for the most part upstream sources of fuel combustion where the fuel enters into commerce). Staff anticipates using data based on the 1990-2004 emissions inventory, and actual emissions from 2005-2008, to the extent that it will be available, in setting the cap for the Broad Scope Sources.

Setting the cap for Broad Scope Sources is separate and distinct from the initial cap setting exercise for the first compliance period. Using the WCI proposal, CARB is looking to establish the 2015 “best estimate” of proposed emissions. Currently, Staff has expressed no preference between a cap setting methodology that would make a specific determination for the Broad Scope Sources or merely add a “step-up” to the already established cap for Narrow Scope Sources. It is absolutely essential that the cap be based on the most current available information, making a step-up approach too arbitrary and ambiguous. Between the time that the initial cap is set and the beginning of the second compliance period, the State can expect many changes that necessitate additional analyses of then-current economic and technological circumstances in order to ensure that the cap ultimately set is realistic.

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5 Narrow Scope Sources are those sources that are included in the 2012-2014 compliance period, and include: in-state electricity generation facilities (>25,000 metric tons CO<sub>2</sub>e/year), imported electricity, and large industrial facilities (>25,000 metric tons CO<sub>2</sub>e/year); see Staff Presentation, Slide 8, Scoping Plan, p. 31.

6 Scoping Plan, Appendix C, p.C-16.

7 Broad Scope Sources include sources that will be a part of the second compliance period – 2015-2020, and include small industrial fuel use (for facilities < 25,000 metric tons CO<sub>2</sub>e/year), residential and commercial fuel use, and transportation fuel use; see Staff Presentation, Slide 8, Scoping Plan, p. 31.

*Data Used to Set the Cap:* The credibility of the cap set by CARB will depend on the credibility of the emissions data that parties report to CARB. The use of 2008 data (filed in 2009) is considered a best efforts offering by stakeholders and may not be as reliable as verified data, although verified data will not be available until almost the end of 2010. In addition to looking at reported data, CARB must also consider several other factors, including economic and population growth, as well as the availability of hydroelectric power (which is heavily utilized in California's electricity portfolio) and weather factors (which is specifically endorsed by WCI).<sup>8</sup>

Annual caps should be set, and for the first compliance period (2012-2014), CARB should establish the caps prior to commencing the cap-and-trade program.<sup>9</sup> However, it is imperative, especially during the first compliance period and in the beginning years of the overall cap-and-trade program, that the cap be set *after* the allowance allocation methodology has been fully vetted by stakeholders and adopted by CARB. The current federal debate regarding the division between freely allocated and auctioned allowances provides a good basis for further discussion in California.<sup>10</sup> Realistic cap setting is so interlinked to potential prices and financial exposure that it cannot be determined in the absence of a clearly defined methodology for allocation of emissions allowances. Furthermore, the establishment of annual caps should not interfere with an entity's ability to meet its individual compliance obligation as part of the multi-year compliance period.

While CARB anticipates setting annual caps for the duration of the cap-and-trade program, it has not yet determined how far in advance the caps will be set. In determining caps in later years, CARB should view the cap-setting exercise as a long-term project. The success of one capped sector or group of entities within the cap in meeting early emissions reductions, including achieving reductions during the earlier part of any one compliance period, should not result in more aggressive caps for that sector in later years, nor in adjusting downward the number of years included in the multi-year compliance period.

As part of the cap setting process, caution should be used when incorporating *anticipated* current reductions into the cap. The Scoping Plan currently incorporates aggressive goals for achieving emissions reductions through energy efficiency and renewable energy programs for the electricity sector. In reality, it is likely that those programs, while clearly beneficial, will not result in the levels of emission reductions targeted. Accordingly, *anticipated* reductions or reduction trajectories should not be incorporated into the cap. In order to set a realistic cap, CARB must measure actual reductions that have occurred to date (using the most recent data available), and balance that information with specific data regarding potential increases in electricity usage, which could result in some increase in net emissions even while decreasing per-capita GHG emissions.

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8 Design Recommendations for the WCI Regional Cap-and-Trade Program, September 2008, § 7.2.

9 NCPA notes that the latest version of H.R. 2454 does provide for the setting of annual caps.

10 [http://energycommerce.house.gov/Press\\_111/20090602/hr2454\\_reported\\_summary.pdf](http://energycommerce.house.gov/Press_111/20090602/hr2454_reported_summary.pdf).

**Slide 21, Question 2**

*How should California implement approaches for (a) projection of future emissions levels and (b) compliance pathway analysis methodologies?*

As it pertains to Narrow Scope Sources, the proposed trajectory for the compliance pathway is simply too steep (Slide 14), as noted by numerous stakeholders in this proceeding. While the straight line trajectory proposed is certainly simpler to employ, it does not allow for any complications or challenges that are likely to arise during the initial compliance period and throughout the State's transition to a low carbon economy. In this case, the federal debate provides a more reasonable approach to consider. H.R. 2454 (pending federal legislation recently approved by the House of Representatives' Energy & Commerce Committee) employs a more realistic method to achieving emission reductions, with allowance distribution transitioning from mostly free distribution to allowances available via an auction that does not even begin until 2025. This structure provides ample time for the economy to recalibrate emission profiles, develop and launch emission reduction projects with long lead times, develop the transmission infrastructure necessary to ensure timely and reliable delivery of renewable energy to electric generation facilities, and determine the full impact of complimentary measures on compliance entities and the economy.

While California's program is more limited by the 2020 timeline set forth in AB 32, it can still function effectively using a less aggressive initial compliance pathway. A flatter initial compliance pathway would also allow the State more time to integrate the essential economic evaluation that is integral to this process. Notably, the more aggressive California timeline also highlights the need for the broadest possible suite of flexible compliance mechanisms, such as the use of offsets, recognition for early reductions achieved prior to the launch of the cap-and-trade program, price caps on allowances in the markets, and the ability of compliance entities to bank and borrow offsets, as needed.

In terms of compliance pathway methods, flexibility and certainty are key elements. NCPA believes that the most efficient means of achieving the mandated reductions is to let compliance entities know their cap (emission reduction requirement), and allow them the greatest flexibility possible to achieve those reductions. California has a dynamic business landscape, and even within the electricity sector, not all participants are similarly situated. Different entities may have different trajectories of reductions that reflect the most cost-effective and technologically feasible options for that entity. These entities should be provided the tools necessary to determine such trajectories on their own.

Since the compliance pathways and economic analysis are interrelated, as noted by Staff in Slide 16, the economic analysis must look at the impacts of not only the initial cap level, but the rate of decline as well (Slide 17). The importance of this review cannot be overstated. As Staff observes, it is necessary to look at overall savings, costs, and cost-effectiveness, and to incorporate into the evaluation the ability to obtain capital for long-term investments, and repayment of loans for such investments. The adverse economic impacts of a cap that declines too steeply could be dramatic, especially for entities that have to make a physical transition to a cleaner resource portfolio. For retail providers, such a transition is also likely to include significant investments in transmission and energy-firming resources and infrastructure, none of

which can be brought on-line overnight. Accordingly, understanding the allowance allocation methodology becomes a key factor in determining the impacts and the best approaches to take, and should be included as part of the overall economic analysis employed.

Additionally, the economic analysis required by the Board must be entity- and sector-specific. While this may seem like a challenging task, it is simply not realistic to expect all entities to achieve the same compliance pathways. The economics will vary widely among individual entities, and among the geographically and climatically diverse regions of the state.

As it pertains to the electricity sector, NCPA supports CARB's desire to develop the appropriate compliance pathways and cap collectively with the California Public Utilities Commission and the California Energy Commission. Such a collaborative process through a formal procedure or proceeding before the regulatory agencies would be helpful. However, all entities involved should be contentions of resource limitations faced by stakeholders (and the agencies), and the number of meetings and workshops on this issue should not be excessive.

### **Interaction with Federal Program**

While California is mandated under AB 32 to move forward with programs that reduce GHG emissions across the State, in today's dynamic environment, it cannot do so without also keeping an eye on developments in Washington. California has been an active player in helping to shape that WCI program, while at the same time ensuring that elements of the State's own program are developed consistently with the Design Recommendations of the WCI. Likewise, remaining cognizant of progress in the emerging federal program will help to keep California positioned to develop a statewide program that will be able to transition seamlessly to a federal program. Accordingly, CARB should look to key elements of HR 2454 that reflect realistic compromises on various policies. CARB would be well served by closely reviewing the discussion documents used in the federal debate, including proposed cap-setting and allowance allocation features.

### **Other Factors That Must Be Considered Concurrently**

*Other Cap-and-Trade Program Features:* As noted above, and acknowledged by the WCI, cap setting cannot be discussed separately from other cap-and-trade related issues, including the overall allowance allocation methodology, quantitative limits on offsets, and use of proposed set-asides (including geographic and quantitative limits on the use of set-asides). Additionally, to the extent that the allowance allocation methodology contemplates any level of auction, the ultimate structure of such an auction also plays a critical part in cap setting discussions.

*Emissions Reductions from Narrow Scope Sources below 25,000 MT CO<sub>2</sub>E:* During the April 28 Workshop, stakeholders inquired how CARB intends to treat emissions reductions that come from electricity sector sources below the 25,000 MT CO<sub>2</sub>E minimum. At that time, Staff noted that they had not yet addressed this issue. NCPA believes that any emissions/reductions coming from the electricity sector must be recognized in the cap set for the electricity sector.

*Adding or Excluding Categories of Emissions:* Staff noted that through the course of the cap-and-trade program, CARB may add or exclude come categories of emissions depending on the relevant accuracy of the information received (Slide 10), including imported electricity. Before such an exercise can be undertaken, CARB must do a further review of the treatment of imported electricity. Whether or not to add or exclude categories of emissions should not be an arbitrary exercise. Rather, there must be specific empirical data to define how and when certain categories will be excluded or added. Such an exercise must also include a proposed timeline so entities have sufficient notice to provide constructive input to the discussion. Along those lines, in order to ensure the accuracy of the information utilized to make such a determination, it is going to be necessary to review and potentially revise the Mandatory Reporting Regulations in order to reconcile the reported information and parties responsible for reporting with the parties responsible for meeting a GHG compliance obligation (i.e., reporting by total quantity of electricity versus fuel source).

## II. CONCLUSION

NCPA appreciates the opportunity to offer these comments and looks forward to continued efforts of stakeholders and Staff in developing the appropriate cap setting mechanism for California's 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](mailto:scott.tomashefsky@ncpa.com).

Sincerely,  
**MCCARTHY & BERLIN, LLP**



C. Susie Berlin

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