
MEMORANDUM

TO: California Air Resources Board

FROM: Modesto Irrigation District
Redding Electric Utility
Turlock Irrigation District

SUBJECT: Use of Allowance Set Asides in a Cap-and-Trade Program

DATE: June 15, 2009

Introduction

The California Air Resources Board (CARB) has requested stakeholder input regarding the use of allowance set asides to promote programs supported by state policy such as renewable energy resources, energy and water efficiencies, more effective land use, voluntary emission reductions, and aid to disadvantaged communities. Set asides would be carved out from the cap, reducing the number of allowances available for allocation or auction to entities within the capped sectors that have mandated compliance obligations ("compliance entities"). Modesto Irrigation District (MID), Redding Electric Utility (REU) and Turlock Irrigation District (TID), collectively referred to herein as the "Utilities," submit the following comments regarding the use of set asides.

Under the proposals presented at the May 18, 2009 workshop, set asides would be defined as "a pool of allowances reserved for specific purposes." The set aside allowances would be deducted from the cap and would be allocated to entities within the capped sectors that do not have compliance obligations. It is suggested that set asides would be used to incent and recognize specific activities that reduce emissions from sources under the cap.

The Utilities believe that a set aside program would be complicated and difficult to understand and access for those it is intended to incent and that have the greatest ability to respond to the incentive. Such a program has the potential to drive costs up and endanger compliance by capped entities. Set asides are not an effective or efficient way to achieve emission reduction objectives. CARB's cap and trade design should ensure valid policy goals are met in the most cost effective manner that does not take compliance opportunities away from compliance

entities. A combination of early action credits, offsets and the return of allowance value to retail providers can better achieve the policy goals identified by staff. The maximum reduction of emissions can only be achieved through the most cost effective and efficient manner possible.

Policy Considerations

CARB asked for input from stakeholders in response to three questions:

Can allowance set-asides provide a useful tool for achieving AB 32 goals?

Set asides have the potential to promote emission reductions simply because they will reduce the number of allowances available for emission compliance. However, it would be difficult to measure the incremental reduction realized by entities receiving the set aside allowances that wouldn't have occurred otherwise. Is the increased cost to capped entities with compliance obligations, costs that will of necessity be borne by all Californian's who need the services and products provided by such capped entities, worth such incremental benefit?

The Utilities don't believe so. Set aside "incentives" become counterproductive and the costs of compliance will increase as allowances become scarcer. If allowances become too scarce, especially in early compliance periods while entities with compliance obligations struggle to change the course of their long term planning and commitments, anticipated technologies are not yet available, and constraints to develop and implement emission reductions (eg., lack of sufficient renewable resources, transmission constraints, existing unanticipated load growth) remain in place, the entire cap and trade market is at risk. Such compression of available compliance mechanisms could make compliance unachievable for compliance entities resulting in greater pressures on California's already impacted economy. Other less risky options should be considered.

Would this type of incentive and recognition approach achieve more than alternative approaches?

The Utilities do not think so. A set aside component in any cap and trade program would require rules regarding eligibility, processes for obtaining and deriving value from the set aside allowances, and oversight including tracking, monitoring and enforcing the set asides. A set aside program would have to meet the same standards as other emission reduction programs. Such a system would be too complicated and likely difficult for those most in need of the incentive/recognition to understand and access.

Would allowance set-asides strengthen or complicate the cap-and-trade program?

The Utilities believe set asides would both weaken and complicate a cap-and-trade program.

Setting aside allowances from within the cap will undoubtedly cause the cost of the remaining allowances to increase. By reducing the number of allowances available under the cap, remaining allowances that are not administratively allocated will be more expensive, especially if those allowances are retired. Even for set aside allowances permitted to be sold in a secondary market, prices will be volatile and their availability uncertain, requiring compliance entities to

pay more to achieve some level of planning certainty for meeting their individual emission reduction requirements.

Assuming clarity can be achieved regarding the definition of eligible projects and appropriate pool of project proponents, such project proponents will still be challenged to understand when and how to access set asides, how many allowances would be available for any project, and what their value would be. Again, without assurance of receiving a certain level of value from the set asides, project proponents cannot include such value as part of project planning and the incentive anticipated from such set asides is lost.

Program Constraints

If set asides are incorporated into CARB's cap and trade system, the set asides program would have to be carefully designed. Although, the Utilities do not believe set asides are in the best interests of the State in reaching the goals of AB 32, if such a program is developed, there are minimum design recommendations that must be included to minimize the negative impacts of a set aside program.

The number of allowances to be set aside would have to be limited. Set aside allowances would be awarded only within California (ie., within the geographic area that emission reduction compliance obligations would apply) to ensure that the goal of reducing emissions within the cap is achieved. Like secondary insurance coverage, set asides would only be awarded where no other incentive for reduction is available.

Set asides, if not used, would have to be allocated back to entities with compliance obligations, through administrative allocations.

If set asides are issued, they should not be retired but must ultimately be made available to entities with compliance obligations at a fair market price. Such an approach would help provide certainty to program proponents and help stabilize compliance costs for compliance entities.

Alternative Approach

Early action credits as proposed by the Utilities in their May 15 submittal¹, together with a broad offset program, could achieve almost all of the policy goals identified by CARB staff for set asides. These program components, together with the direct savings of reducing energy consumption, provide enough incentives to engage in efficiency and renewable programs beyond those mandated to be met by electric utilities, thus reducing the need for set asides.

Additional incentives for reductions could be better achieved through use of allowance revenues than through allowance set asides. A revenue allocation approach would be simpler and more cost effective. A small percentage of allowance prices could be retained by CARB and directly granted to qualified programs. Electric utilities that have been asked to take on the greatest burden under CARB's Scoping Plan are also in a position to ensure investment of allowance

¹ The Utilities proposal on "Voluntary Early Action Design" dated March 31, 2009 can be found on the CARB website at <http://www.arb.ca.gov/cc/capandtrade/meetings/031009/mar10pcmidreutid.pdf>.

revenues into programs that will lead directly to emission reductions can be accomplished. Allocating the allowance value to retail providers with a mandate to invest in the policy supported programs identified by CARB would achieve policy and program objectives more effectively and with lower costs.

Conclusion

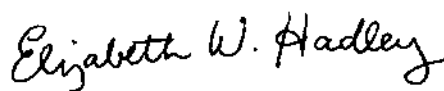
Compliance entities must be given every opportunity to comply with their allowance obligations under CARB's cap-and-trade program, and encourage CARB to look to the use of Early Action Credits, Offsets and allocation of allowance value to meet the goals they believe would be achieved through set asides.

The Utilities appreciate the opportunity to put forth the above proposal and would welcome the chance to work with CARB and a designated working group to develop these concepts further.

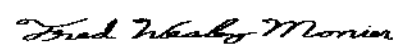
Respectfully submitted,



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