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

Re: **NORTHERN CALIFORNIA POWER AGENCY Comments on May 18 Workshop "*Use of Allowance Set-Asides in a Cap-and-Trade Program*"**

Dear Kevin:

The Northern California Power Agency[1] (NCPA) is pleased to provide the following comments in accordance with the direction provided during the California Air Resources Board (CARB) May 18 Workshop, *Use of Allowance Set-Asides in a Cap-and-Trade Program* (May 18 Workshop). Prior to responding to the "Key Questions for Stakeholder Discussion" outlined by CARB Staff, NCPA offers some general observations about the proposed use of allowance set-asides in a California cap-and-trade program.

As a practical matter, any allowance set-aside program must be fair and equitable to all entities involved. To that end, three fundamental issues must be determined before undertaking the development of a set-aside program: (1) the *need for the program* to incent or reward actions beyond programs already in place, (2) the economic efficiency of using set-asides compared to traditional utility programs, and (3) whether or not such a program would *adversely impact the availability of allowances and compliance cost* for compliance entities.

The predetermination of need and cost is necessary because development of the allowance set-aside program itself will entail making detailed and difficult determinations regarding many administrative factors, including the types of renewable energy projects available for recognition, the size and types of energy efficiency measures that will be awarded allowances as incentive, and the measurement and verification procedures to be used to determine the total energy efficiency savings realized. These issues are addressed in more detail below.

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.

Need for Set-Aside Allowances Must be Established

First and foremost, CARB must establish whether or not a set-aside program is even needed. To the extent that a program is developed to provide rewards or incentives for additional and voluntary greenhouse gas (GHG) emissions reductions, CARB must first determine what necessitates this additional reward or incentive. Absent such a review and affirmative finding, arguments could be made that existing incentives are sufficient.

Consider the following examples. The first relates to renewable energy. Non-compliance entities already paying a premium for renewable energy believe their actions to invest in renewable energy sources and reduce the use of fossil fuel-generated electricity is reward enough. If that is the case, then further resources should not be expended to develop an allowance set-aside program, especially if doing so comes at the expense of compliance entities that must meet a mandated trajectory of emission reductions. Example two was raised by several stakeholders during the May 18 Workshop, related to energy efficiency. Presently, there are a number of energy efficiency program incentives already in place, many of which are ratepayer funded. It can certainly be argued that these programs are sufficient. At a minimum, a review should be undertaken to determine if existing energy efficiency programs (and command and control mandates) prevent achievement of desired levels or thwart individuals from obtaining additional GHG reductions.

Cost Effectiveness of Set-Asides Allowances as an Emission Reduction Tool Must be Determined

Before undertaking the development of the allowance set-aside program, CARB must determine, based on empirical data, that the allowance set-aside program will not only provide even greater total emissions reductions than existing measures and mandates, but will also do so without costing more than the existing programs. As noted, the development of a viable allowance set-aside mechanism is not a simple undertaking. Various criteria must be considered and program parameters must be designed. There must be a structure for administering the reward of the allowances and tracking the allowances awarded. However, before allowances can be awarded, applications for awards must be reviewed and total emissions reductions must be calculated. CARB must establish a matrix by which to measure and verify reductions from energy efficiency projects, and assign a means by which to allocate set-aside allowances between competing interests. Each of these steps involves a complex process and will require significant staff resources.

Before such a costly process begins, CARB must evaluate the accomplishments of existing energy efficiency and renewable energy programs. If the existing programs are successful and cost-effective, CARB should consider policies which promote expanding those programs before adding new ones. Growing existing programs is administratively simple and also involves a higher level of certainty regarding the success of the program than starting a brand new endeavor.

Set-Aside Approach Depends on Allowance Allocation Methodology

Although the Scoping Plan notes that "allowance set-asides could be used with any method of allocation,"[2] the total number of set-asides made available cannot properly be determined until after the allowance allocation methodology has been presented. In reaching this conclusion, it is important to closely consider how the term set-aside is defined. As stated in the Scoping Plan, set-asides are a "pool of allowances which are distributed using criteria alternative to the primary method of allocation. Allowance set-asides direct a certain portion of allowances from within the cap to recognize actions previously taken or further incentivize future actions which benefit the policy goal."[3]

By this definition, the allowances available for distribution come directly from the pool of allowances from which compliance entities must draw in order to meet the GHG emission reductions mandated under the cap-and-trade program. Because set-asides come directly from the cap,[4] the entire set-aside program is linked to the cap setting exercise, and the mandate in the Scoping Plan that caps be realistic.[5] Hence, *CARB must answer the fundamental question of how taking allowances out of the market still ensures that the cap is realistic in terms of the emission reduction opportunities for entities with a compliance obligation*.

Appropriate Criteria for Allowance Set-Asides

CARB presented a list of criteria that should be considered in the development of an allowance set-aside program. If a positive determination is made regarding the need for such a program, the criteria should be clearly established, unambiguous, and subjectively applied. Furthermore, if all of the criteria are met, set-asides should be equally available to any entity – regardless of compliance obligation – that meets the minimum requirements. There is nothing in the definition of a set-aside that says this type of allowance should be reserved exclusively for non-compliance entities. Furthermore, no rationale or justification has been provided to address why set-asides would not be available to compliance entities if those entities meet all of the objective criteria adopted by CARB.

Distribution of Set-Asides: Once the program has been established, eligible entities that meet the criteria would apply to CARB for set-aside allowance – either in the form of a reward or incentive payment. First, however, the administrative structure must be established that tracks the availability of set-aside allowances, the award of the allowances, and the total number of allowances distributed under the program.

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2 Scoping Plan, Appendix C, page C-20.

3 Scoping Plan Appendix B, p. B-14.

4 The Western Climate Initiative Design Recommendations also propose that set-asides be taken from the cap, Design Recommendation § 8.12.

5 The Scoping Plan specifically notes that the "cap must also be realistic in terms of the emission reduction opportunities within the capped sectors." Scoping Plan, Appendix C, p. C-16.

Award limitations must also be built into the eligibility requirements. Will energy efficiency programs receive set-aside awards based on ongoing emissions savings in perpetuity or will each project be awarded a set amount? To award a project in perpetuity creates an incentive for large scale emissions savings programs, but threatens to deplete the pool of available allowances for entities that come along later in the program. As it pertains to voluntary renewable energy purchase programs, will the reductions realized be awarded for as long as a single "applicant" continues to make reductions, or will each applicant be limited to a set number of allowances? Limits on the total reward to any single recipient may reduce their desire to be recognized. However, failure to limit the awards could mean that the recognition is only available to the very first entities to participate. Each of these issues must be examined and reviewed.

For energy efficiency projects, CARB must determine whether the incentive is given "up front," regardless of actual reductions realized, or held until a certain emission reduction level has be achieved. Regardless of the reductions realized, CARB must first address the complexities involved in create a matrix for measuring and calculating the total GHG reductions realized through the energy efficiency project.

Calculation of Reductions: As with any GHG reduction, CARB must be able to measure, verify, and periodically update the calculation used to determine the award of set-aside allowances.

Program Limitations: Staff asked that stakeholders comment on what program limits should be considered, including quantity and location. If the need for a set-aside program is established, then such a program should be robust, yet acknowledge the link between the reductions recognized and the California cap. Accordingly, set-asides should only be awarded for reductions and actions taken within California that result in direct GHG emissions within the geographic boundaries of the State. Compliance entities would be adversely impacted by the retirement of an allowance for emissions reductions outside of California when the compliance entities must still acquire allowances within the capped amount.

The total quantity of available off-set credits cannot properly be determined until the allowance allocation methodology has been decided. As noted above, cap setting and determination of an allowance allocation methodology are inexorably linked to the need for set-asides and the impact of set-asides on compliance entities' ability to meet the mandated cap.

Existence of Co-benefits: While an emission reduction project that also has co-benefits adds value overall, the existence of co-benefits should not be a separately considered criteria. Establishing specific parameters and definitions for co-benefits will create additional administrative burdens and complexity, require another level of review, and would further increase the costs of administering the allowance set-asides.

Quantification Criteria: The criteria for quantification of the total emissions reduction and criteria, if any, for reviewing and approving eligible energy efficiency programs and renewable energy projects, must be objective. Like review and approval of offset projects and offset protocols, this exercise and review process requires a complex analysis that is administratively burdensome.

Funding Source: If GHG emissions are realized, the funding source should be irrelevant. It is more important to ensure that the project and or action being rewarded is not already subject to allowance recognition through early actions or as an offset.

Eligibility Requirements: Staff asked stakeholders to comment on specific eligibility criteria that should be imposed, consistent with AB 32 goals.

In essence, the eligibility requirements are a compilation of all of the above discussed criteria. CARB must define the programs and actions that are eligible for set-aside awards. The eligibility requirements must be administratively simple and not overly burdensome. All qualifying California entities should be equally eligible for set-aside allowances, regardless of their compliance obligation.

Allowance Set-Aside Program Administration

The cost implications of administering an allowance set-aside program must be considered in concert with the overall cost-effectiveness and necessity of such a program. Establishing, implementing, and maintaining a robust allowance set-aside program is not going to be a simple endeavor. By Staff's own admission, setting up a set-aside program will be complex, and must include ongoing processes for review of projects, applications for rewards, and enforcement. Such a multifaceted program has implications on entities that must pay the AB 32 Cost of Implementation Fee (AB 32 Fee). As proposed, absent 100% pass through, the entities most likely to be liable for the payment of the AB 32 Fee are not the intended beneficiaries of the allowance set-asides. However, even if the allowance set-asides are made available to compliance entities, the entire set-aside program creates an additional layer of administration that must be funded.

Answers to CARB Questions

Q.1: Can allowance set-asides provide a useful tool for achieving AB 32 goals?

As noted in the Scoping Plan, allowance set-asides may provide a useful tool for achieving additional GHG reductions. However, in order to maximize the usefulness of allowance set-asides and minimize the impact on compliance entities, stringent requirements and program oversight must be put in place. Further, the costs of ongoing administration of the overall program must be reviewed and included in a cost-effectiveness determination. Accordingly, while set-asides may be a useful tool, it has not been demonstrated that they are necessarily the most useful tool available, nor even a cost-effective tool.

Other tools are available that should be closely examined before moving forward with implementation or development of an allowance set-aside program. For example, to the extent an allowance auction is utilized, using an approach that returns auction proceeds to retail electricity providers to fund additional energy efficiency programs and develop greater renewable energy resources, and these efforts would serve the same purpose as a set-aside program. However, these established programs are also less complex to administer, more cost-effective in terms of reducing overall compliance costs for the retail provider, and spread the benefits of the dollars invested across a wider segment of the economy.

Q.2: Would this type of incentive and recognition program approach achieve more than alternative approaches (monetary incentives, energy efficiency programs)?

Until a comprehensive cost-effectiveness analysis has been undertaken, it is not possible to know whether or not the existing programs need to be supplemented by a set-aside program. Such an analysis would need to review not just economic impacts, but societal behavior as well.

As noted above, many Californians have already decided to effect GHG reductions by voluntarily paying a premium to receive electricity generated by renewable resources. These individuals and business receive no rewards for purchasing green power, so the question must be asked: is a reward necessary? Furthermore, there are myriad energy efficiency programs already in place that are having positive effectives on reducing energy consumption. Before the State decides to allocate resources to a select few individuals or businesses that want to install greater energy efficiency technologies, there must be a finding that utilizing those same resources for a wider based program would not result in greater overall energy savings, as well as economic efficiencies. Simply put, without a needs analysis, there is no way to make a finding that the use of set-aside allowances would be any more effective than existing programs in reducing GHG emissions.

Q.3: Would allowance set-asides strengthen or complicate the cap-and-trade program?

Any time another element is added to the cap-and-trade program, it is likely to complicate the overall program. The real issue is whether or not such complication is worth it. Only a detailed economic analysis regarding the potential benefits and likelihood of use by consumers would tell for certain. The benefits, if any, must also be weighed against the significant administrative costs that are likely to be a part of the program. Developing, implementing, and overseeing a program that properly recognizes the emissions reductions targeted for allowance set-asides rewards is no mean feat, and such a program will require the same level of administration, review, oversight and enforcement as an offset program.

In light of the lack of evidence to support the need for a set-aside allowance program, and in the face of existing programs that could accomplish the same outcome in a less administratively complex manner, a set-aside program is more likely to complicate the cap-and-trade program, and provide very little additional benefits to mitigate such impacts.

Q.3.a: Would set-asides raise the cost of remaining allowances?

Simply stated, the use of set-asides would clearly raise the cost of remaining allowances. This is a simple matter of economics. As long as set-asides are held in reserve and not awarded, there are fewer allowances available to compliance entities, which, if the market is effective, will result in an increased price for the allowances. This is why it is imperative that CARB undertake an analysis of the overall impact of such a program on the cost of remaining allowances.

The use of set-asides for energy efficiency incentives would also likely increase the cost of remaining allowances. When addressing "incentives" for energy efficiency projects, CARB must make a determination on when the reward would be given and what metric will be used to measure the *anticipated* energy savings. As evidenced by proceedings currently before the California Public Utilities Commission, measurement and verification of energy efficiency savings requires a complex analysis. Furthermore, the total success of improvements would be unknown at the time the award is given, and not only are emission reductions from energy efficiency programs not immediately realized, they may never be realized.

Q.3.b: Would set-aside requirements raise compliance costs to project proponents or capped sources enough to discourage their use?

The impact of set-asides on project proponents and capped sources may not be the same, depending on whether or not the program is established such that compliance entities also have an opportunity to be awarded the set-asides if they achieve all of the established criteria.

For capped sources, the set-aside program is likely to increase compliance costs, especially in the beginning. As noted above, the number of allowances will be limited from the onset by the total amount allotted to the program even before emissions reductions are realized. Furthermore, the imposition of such a program is likely to raise administrative costs, which creates a greater burden on entities taxed with paying the proposed AB 32 Fee.

The cost implications on project proponents depend on the type of project and the availability of other incentive mechanisms in place.

Conclusion

As CARB considers the creation of a set-aside program, it is imperative that before initiating such a potentially complex program, it must be determined there is *both* a need for a program and that such a program will not have adverse economic impacts on capped entities. To that end, any allowance set-aside program must be fair and equitable to all entities involved, not adversely impact any one sector or entity, not reduce the availability of allowances for compliance entities, and not create an undue administrative burden that would increase the overall AB 32 Fee.

NCPA appreciates the opportunity to offer these comments to CARB on the use of set-aside allowances in a 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.

Sincerely,
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