McCARTHY & BERLIN LLP

ATTORNEYS AT LAW
100 W. SAN FERNANDO STREET, SUITE 501
SAN JOSE, CALIFORNIA 95113

BARRY F. McCARTHY
C. SUSIE BERLIN
MICHAEL G. NELSON

Tel.: 408-288-2080
Fax: 408-288-2085
sberlin@mccarthylaw.com

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Mike Tollstrup
California Air Resources Board
1001 I Street
Sacramento, CA 95812

Re: Comments of the **Northern California Power Agency** on the May 17, 2010 Cap-and-Trade Workshop

Dear Mr. Tollstrup:

The Northern California Power Agency[1] (NCPA) appreciates the opportunity to submit these comments to the California Air Resources Board (CARB) on the May 17 Workshop Regarding Cap-and-Trade Regulation (Workshop) and the presentation made by Staff during the Workshop (Workshop Presentation).

INTRODUCTION

Assembly Bill (AB) 32 requires the State to reduce greenhouse gas (GHG) emissions to 1990 levels by 2020. In furtherance of this mandate, CARB developed a comprehensive Scoping Plan that includes myriad measures – both recommended and mandatory – to facilitate reaching the State's goal. One such measure is the cap-and-trade program anticipated for implementation on January 1, 2012. The many programmatic measures already set forth in the Scoping Plan, together with the advancement of low-carbon technologies, are likely to go further in reducing GHG emissions and moving the State towards the AB 32 emissions objectives than a single-state cap-and-trade program, especially one that includes limited participation from the onset. An effective market-based program should include as much of the carbon market as possible, and

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 Associate Members Plumas-Sierra Rural Electric Cooperative and Placer County Water Agency.

should be linked with California's neighbors throughout the western region, and eventually the country. Despite best intentions, NCPA continues to be concerned with the implementation of a single-state cap-and-trade program that essentially includes only two industries in the first compliance period.[2] With that said, NCPA intends to continue to work with CARB and other stakeholders in the development of this program, and offers these comments in furtherance of the stated objective to develop a comprehensive cap-and-trade program that can be seamlessly merged with regional, federal, and potentially international programs.

Free Allocation of Allowances is Justified and the State Should Undertake a Cautious and Gradual Transition to the Auctioning of all Allowances. Staff acknowledged the concerns raised by many stakeholders, including Governor Schwarzenegger, with the implementation of a cap-and-trade program that begins with 100% auctioning of allowances without addressing free allocation for certain vulnerable segments of the State's economy that are likely to be the most impacted by the mandates of AB 32 (not just the proposed cap-and-trade program, but the Scoping Plan programmatic measures, as well). Accordingly, NCPA supports Staff's current proposal to use the free allocation of allowances to address both leakage and transition assistance, and not embark on a program that begins with auctioning of all allowances.[3]

Allowance Allocation to the Local Distribution Companies is an Effective Means to Ensure Customer Benefits. In the Workshop Presentation and during oral comments, Staff acknowledged the importance of using allowance value to further the mandates of AB 32. Staff also recognized the written comments made by the Joint Utilities,[4] noting the significant number

2 Despite the fact that both the Western Climate Initiative and the federal government are working on the development of cap-and-trade programs, until such time as those programs have been formally adopted, California's program will essentially be adopted and implemented as a single-state program, a fact that should not be discounted when designing the program itself..

3 As more fully addressed herein, NCPA also supports valuing the allowances instrument itself, and making them available to all compliance entities on an equal basis.

4 The Joint Utilities are comprised of Bear Valley Electric Service**,** California Municipal Utilities Association, Modesto Irrigation District, Mountain Utilities, NCPA, Pacific Gas & Electric Company, PacifiCorp, Sacramento Municipal Utility District, San Diego Gas and Electric Company, Sierra Pacific Power Company, Southern California Edison Company, and Southern California Public Power Authority.

of complementary measures set forth in the Scoping Plan that impose direct – and often, uneconomic – costs on electric retail utilities. NCPA appreciates Staff's recognition of the costs associated with the renewable electricity standard (RES) and the proposal to allocate allowance value to local distribution companies (LDCs) for their ratepayers' benefit in defraying some of these costs. Many economists, Staff, and the Economic and Allocation Advisory Committee (EAAC) have stressed the importance of sending consumers a signal regarding the cost of carbon, and many laud a cap-and-trade program as the most effective means of accomplishing this. However, as NCPA has noted (and which is reflected in the Joint Utilities March 25, 2010 correspondence to CARB Chairman Nichols), electricity customers should not be forced to bear the double rate impact of both a carbon price signal <u>and</u> supporting GHG reduction measures that may be effective, yet uneconomic. By designing a program that allocates allowance value to the LDCs on behalf of their customers for pursuing and procuring renewable energy and other GHG reducing measures, CARB ensures that the State can continue to effect GHG reductions and pursue renewable electricity resources and send a price signal about the cost of carbon, while at the same time insulating – to the greatest extent possible – the state's electricity customers from the significant rate impacts that are sure to result from these complementary measures.

<u>*Cost Containment Measures Must be More Fully Developed, and Must Not Cause Allowance Shortages at the Beginning of the Program*</u>. NCPA also appreciates Staff's recognition of the importance of cost containment measures that can be put in place to ensure that in the event this nascent market does not act as anticipated, California's compliance entities – and its residents and businesses – are not significantly adversely impacted. This is especially important to the LDCs, to the extent that the provision of reasonably priced, safe electricity is essential to not only the State's economy, but welfare. It is imperative that any cost containment measures, such as the proposed allowance reserve, not be structured in such a way that the creation of the measure itself creates a scarcity that will necessitate its use. Accordingly, NCPA is concerned with any program design feature that would fund the allowance reserve account by reducing the capped amount within a specified compliance period to fund a reserve.

Short Term Program Design Principles Must Remain Paramount. In the Workshop Presentation, Staff noted that four key principles were driving development of the current draft of the cap-and-trade regulation: (1) protect California consumers, (2) keep California industry competitive, (3) recognize investments in early actions in energy efficiency and GHG reductions, and (4) encourage investments in efficiency and clean energy. Each of these principles, which was also articulated in Governor Schwarzenegger's March 24, 2010 letter to Chairman Nichols, is essential not only to implementation of the cap-and-trade program, but ensuring that California businesses and industries are able to meet the broader mandates of AB 32, which essentially requires a statewide transition to a low-carbon economy. Each of these principles must be given equal weight and carefully considered when designing the cap-and-trade regulation.

ALLOCATION TO LDCs

LDCs Should Receive Free Allocation of Allowances in the First Tier.

During the Workshop, Staff acknowledged certain costs to LDCs that go beyond the price of procuring allowances for compliance purposes. While the Workshop Presentation focused on the costs associated with procuring renewable electricity and complying with the renewable electricity standard (RES), mandatory complementary measures mandated of the electric utilities go beyond renewable electricity, and have far reaching cost implications for California's electricity customers. NCPA supports the allocation of allowances to retail electric providers – to be used for the benefit of their customers – to implement the programs and comply with the measures set forth in the Scoping Plan. All of these investments – and not only the RES – should be funded through allowance values in the first tier.

Staff correctly noted the significance of the electricity deliverers as a means by which to deliver – subject to direct regulatory oversight by their local governing boards or the California Public Utilities Commission – allowance value directly to electricity customers. This demonstrated and rigid oversight ensures that allowance value will be spent in furtherance of the State's goals and objectives as set forth in AB 32, since the point of regulation for RES and other related reduction programs provides a delivery mechanism for the allowance value that is easy to administer and ensures the value is returned to consumers. Each of these factors weighs in favor of freely allocating allowance value to the utilities in the first tier to offset the RES and other programmatic costs, as well as addressing industry leakage and assisting in the transition to a low carbon structure. Furthermore, it has been widely noted that electrification of other industries – such as transportation, will provide significant GHG reductions overall, but those reductions will result in higher electricity sector emissions. Accordingly, allocation of allowances to electricity retail providers also helps address the GHG impacts of electrification of other sectors.

Allowances Should be Used for all Scoping Plan Mandatory Measures.

The cost of the complementary measures mandated of the electric utilities pose the same concerns and threats to the electric utilities' customers as those articulated by Staff for the industrial sector, and thus should receive allowance value on the same par. Allocation of allowances to the electric utilities for these purposes clearly falls within the principles noted by Staff and articulated by the Governor. As proposed by Staff, allowance value in the first tier would be allocated to the industrial sector to address both transition and leakage costs and in the second tier, electricity deliverers would receive allowance value to offset investments in renewable energy. To address transition and leakage (caused by the cost of higher energy and possible export of industry), allowance value should also be allocated to the electricity deliverers in the <u>first tier</u>, and that value should be used for the benefit of all utility customers in the investment of renewable energy, <u>and</u> other measures mandated by the Scoping Plan or utilized by the utilities to further the reduction of GHG emissions and meet the mandates of AB 32.

Notably, Staff's objective in proposing the two-tier allocation method – (1) to send a uniform economy-wide carbon price signal, (2) recognize who bears the program costs, and (3) the need for gradual transition to a low carbon economy – are all met with the allocation to LDCs in tier one.

Carbon Price Signals Can be Retained by LDCs.

The EAAC strongly recommended that the allocation of free allowances not be used in a manner that blunts or distorts the price signals for carbon. As demonstrated by the utilities, the use of allowance value to offset the costs associated with renewable power and other complementary measures enables utilities to preserve the carbon price signal for the electricity sector without skewing that signal by adding on the cost of renewable energy and other complementary measures. Indeed, the best way to preserve the price signal for the cost of carbon is to ensure that the cost of measures the State has deemed necessary (even if not entirely economic) are not included in rates.

Allowances Must be Proportionally Allocated to the Electric Sector.[5]

Staff made no formal recommendation on the total number of allowances to be allocated to the electricity deliverers, nor on the length of the transition period. As it pertains to an allocation to the sector, NCPA supports the proposal set forth by the Joint Utilities that the quantity of allowances that are administratively allocated to the electricity sector be based on the sector's proportionate share of total capped sector emissions. In order to meet the principles of the program formation, address the issues raised in Governor Schwarzenegger's March 24 letter, and ensure that electricity customers throughout the State are not adversely and substantially impacted by the cost of programmatic measures *in addition* to the cost of the cap-and-trade program, the LDCs should receive 100% of the electric sector's emission allowances on behalf of their customers.

NCPA notes that this allocation is especially important during the first compliance period, when costs of the cap-and-trade program are coupled with RES compliance costs, as well as other ongoing GHG reduction programs already required of the utilities. It is also important to note that the allowance value – to be used for the benefit of the customers – can most efficiently be used by the LDCs to effect reductions since proven program designs and delivery mechanisms for reaching customers are already in place.

Basis for Allocation of Allowances Amongst the LDCs Must be Further Developed.

In the Workshop Presentation, Staff suggested an allocation based on "retail sales," which would be simple to administer and consistent with the metric by which the RES is measured. There are a number of factors and principles that must be closely reviewed and evaluated in the context of the retail providers before a reasoned recommendation regarding allocation of

5 It is important to note that the allocation of allowances to the electricity sector and the allocation of allowances to the retail electric providers within the sector are separate and distinct issues.

allowances amongst the utilities can be made. Specifically, it is important that any allocation scheme recognize past and current investments in low carbon resources, as well as current investment commitments. Early actions must be recognized, as should overall rate impacts on customers. The allocation methodology must consider all electric generation resources, appropriately balance allocations based on an entity's retail sales and historic emissions -- as determined by some baseline, and take into account how allocations can best transition over time as overall program objectives are met.

Allowances Freely Allocated Could be Valued and Sold Through an Auction.

The purpose of allocating allowances freely to the electricity delivers is to address the myriad programmatic costs that have been demonstrated to have a significant impact on California electricity rates, above and beyond the costs associated with the cap-and-trade program. Accordingly, the allocation of free allowances should not be done in a manner that provides preferential treatment to utilities to the exclusion of other compliance entities in the electricity sector that do not serve retail customers. To that end, the allocation of allowance value to retail providers on behalf of their customers and the subsequent sale of the allowances instruments themselves in an open auction that all compliance entities can access would ensure non-discriminatory access to allowances by all compliance entities.

COST CONTAINMENT MEASURES SHOULD BE MORE FULLY DEVELOPED

NCPA concurs with the large number of other stakeholders who noted that the preliminary draft of the proposed cap-and-trade regulation contained insufficient cost containment measures. NCPA is pleased to see that CARB is further reviewing this crucial element. In the Workshop presentation, Staff noted that additional workshops will be held to specifically discuss cost containment mechanisms. NCPA looks forward to a more robust discussion regarding the various options that can be incorporated into a cap-and-trade program to address potential fluctuations in the price of allowances outside of acceptable parameters.

Cost containment measures must be a part of California's cap-and-trade program. Compliance entities must be able to meet their compliance obligations while continuing to carry on their businesses, consistent with the specific directives set forth in Governor Schwarzenegger's

March 24, 2010 correspondence to Chairman Nichols. Regardless of the turns the market may take, retail electric providers must be able to continue to provide safe and reliable electricity to customers, while at the same time comply with the emissions reduction measures set forth in the Scoping Plan.

In the Workshop Presentation, Staff also addressed the establishment of an allowance reserve for price mitigation. As described by Staff, the goal of the reserve is to mitigate unexpectedly high or low allowances prices, and a "small amount" of allowances would be dedicated to this strategic reserve. NCPA fully supports the concept of cost containment measures and believes that a price collar and a reserve account are viable options. In order to ensure against causing the very scarcity that could result in the need to access the reserve account, the program must be structured so that allowances from the current compliance period are not used to fund the account. NCPA is concerned with funding of the reserve account from within the cap that compliance entities are already forced to meet.

Furthermore, in the event of higher than anticipated allowance prices, access and utilization of the reserve account should be closely monitored. The reserve account should not be viewed by compliance entities as a hedging tool or used to buffer poor allowance purchase planning. Rather, in the event that this undeveloped market does fall victim to unforeseen circumstances, compliance entities should be able to purchase allowances from the reserve account at a set price. Access to the account must be restricted solely to entities with a compliance obligation in the current compliance period, and any allowances purchased from the reserve account should be surrendered during the same compliance period as the purchase and these reserve allowance should not be freely transferable to other compliance entities.

As noted above, NCPA is greatly encouraged by Staff's recognition of the need for cost containment measures. NCPA looks forward to working with CARB and other stakeholders in the further development of the reserve account mechanisms and additional cost-containment measures that will ensure market stability and the ability of California's compliance entities to continue in their businesses while meeting the mandates of AB 32 and participating in the cap-and-trade program.

CONCLUSION

NCPA appreciates the opportunity to provide these comments on the May 17 Cap-and-Trade Workshop and Workshop Presentation. 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,
MCCARTHY & BERLIN, LLP

C. Susie Berlin

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Attorneys for the Northern California Power Agency