

April 8, 2008

**To: THE CALIFORNIA AIR RESOURCES BOARD  
Assembly Bill 32 Technical Stakeholder Working Group**

**From: Modesto Irrigation District**

**Subject: COMMENTS OF THE MODESTO IRRIGATION DISTRICT ON  
ALLOWANCE ALLOCATION ISSUES**

The Modesto Irrigation District (“Modesto ID”) appreciates the opportunity to provide its comments (“Comments”) on greenhouse gas (GHG) emission reduction allowance allocation issues. At its March 17, 2008 Program Design Technical Stakeholder meeting staff of the California Air Resources Board (“ARB”) provided a Framework for Discussion of issues related to the distribution of allowances within a cap-and-trade-system. ARB presented four questions related to the allocation of emission allowances, and Modesto ID responds to these questions below.

Modesto ID generally recommends that in a market based system implemented to meet emission reduction goals under AB 32 emission allowances should be allocated administratively based at least initially on point of regulations’ historic emissions and accounting for forecasted as well as mandated load growth. Auction of allowances should be minimized and delayed until a robust market has matured. Proceeds from any allowance allocation should be used to reduce emissions, including investments in research and development of new non-emitting generation, renewable energy resources, and programs to encourage energy efficiency. Any market system put in place must be closely monitored by a single, identifiable regulatory body to avoid manipulation, fraud and other abuses.

Compliance with AB 32 should be achieved with the lowest possible impact on ratepayers. In any cap-and-trade system that is adopted emission allowances will play a critical role in meeting this goal. Allocation of allowances within the electric sector must account for growth of electric load, due both to electrification of other sectors and to increases in population. Free direct emission allowances should be provided to the electric sector, reduced on a periodic basis to achieve the overall emission reduction required from the electric sector. Allowances that are in excess of the recipient's need should be returned for free to form a bank for use by those that need an interim loan of allowances. Charges for such allowance "loans" can also be used for emission reduction.

## **BACKGROUND**

Modesto ID is an irrigation district, organized and operated under the laws of the State of California, which undertakes both electric and water operations. It is a vertically integrated publicly owned utility providing electric services to over 110,000 customers in California's Central Valley. With regard to its electric operations, Modesto ID owns and operates facilities for the generation, transmission, distribution, purchase and sale of electric power and energy at wholesale and retail. Modesto ID is a fully integrated, fully resourced, credit worthy utility. Modesto ID served a peak summer load of almost 700 MW and had retail sales of over 2,500 GW-hours in 2006. Modesto serves this load through a mixture of owned and purchased resources, including wind, hydro, natural gas and coal generation. Modesto ID's projected annual average load growth over the next twenty (20) years is forecast to be 2.79%. Modesto ID is located in the central San Joaquin Valley where population growth has been consistently higher than the State average. The forecast growth is consistent with Modesto ID's historical load growth which has averaged 3% over the last 25 years.

## RESPONSES TO QUESTIONS

### *Question 1: What method should we use to distribute the allowances?*

Emission allowances should be allocated administratively, in the pattern of the existing acid rain allowance mechanism. This will allow the market to develop gradually. A one hundred percent allocation method can be ratcheted down over time toward an auction once the trading platform has matured. The acid rain example indicates that such a market would likely take at least five years to establish, after which time a gradual creation and building of an emission allowance auction could occur.

Allowances should be allocated administratively based at least initially on point of regulations' historic emissions and accounting for forecasted as well as mandated load growth. AB 32 was signed into law in 2006; this seems a logical base year for emission based allocations to be determined. The system design must provide the flexibility for regulated entities to factor mandated activities into meeting their emission reduction obligations. Thus, early reduction activities, including those undertaken in response to mandates and related or similar programs, such as energy efficiency and renewable portfolio standards, should not be discounted in determining reduction obligations and related needs for emission allowances.

Modesto ID's recommended methodology would provide for a proportional impact to regulated entities. Those having a higher carbon resource mix would necessarily bear a larger burden for carbon reductions; however, all sector participants would bear the burden of accomplishing the state mandates. Where apportionment of allowances are based, at least initially, on historical emission levels and include allocation for future forecasted load growth at least through the regulatory period, allowances would be allocated where they are needed and no disparate impact should result.

If an auction process is developed, it will be important to ensure that the overall market system for emissions be established and matured, and that emission allowance trading be developed and experienced, prior to initiation of the auction process. It is also important that any market based system not provide any windfall or any undue burden for the regulated entities. The system should not create a market power or bias among competitors. Nor should it shift responsibilities among industry sectors. The market must be stable and have integrity.

Market system design and the allocation of allowances must be consistent with existing laws and should incorporate emission reductions achieved through existing and future mandatory schemes. For example, renewable resources obtained to meet mandatory renewable portfolio standards and conservation measures obtained through required energy efficiency spending must be taken into account. Such system must balance any shifting of emission reductions from one sector to another. Of significant importance, allowance distribution must be designed to balance emission reductions achieved through fuel switching and other electrification measures.

Whether the cap-and-trade system designs incorporates an administrative allocation or an auction, the distribution of emission allowances must be coordinated with the compliance period in a manner that permits regulated entities to incorporate the market system into their business planning and to structure their compliance programs in the most cost efficient and effective manner.

***Question 2: How should allowance value be used? And, if the allowance value should be used to ease the costs of regulation for entities, who should receive them and how many allowances should each entity receive?***

Any monies accumulated through a market based system, whether through auction process, market enforcement, or some other mechanism such as an emission allowance loan

program, should be applied toward emission reduction goals in a manner that will help retail providers minimize the rate impact reduction mandates will cause. Proceeds from any allowance allocation should be used to reduce emissions, including investments in research and development of new non-emitting generation, renewable energy resources, and programs to encourage energy efficiency. The value of allowances should be apportioned to reduce impact to utility ratepayers who will bear the burden of emission reductions both directly and indirectly.

Modesto ID supports administrative allocation of emission allowances based initially on historical emissions attributed to the point of regulation, using consistent calculation of emissions at all measuring points. Historical emissions could be calculated based on the regulated entities' 2006 emission footprint. Adjustments would be required for early reduction activities undertaken by the entities. Adjustments would also be required to account for electrification activities undertaken to reduce emissions in other sectors and other anticipated electric load growth. This methodology will ensure that allowances are apportioned where they are needed.

Market power advantages and market manipulation are a significant concern with any market based system. Any such system must be monitored and enforced by a single identifiable regulator that will assume responsibility for avoidance of market skewing activities and fraud.

***Question 3: How should allowances be distributed to new entities and how should entities that cease operating in California be treated?***

New market entrants would receive allocations from those sources initially receiving "credit" for the emission source or load being served by the entrant. Allowances should follow the load being served or the emissions being replaced, and should be administratively reallocated

to new market entrants from such load or emissions. Where new load or emissions are created by the new market entrant, allowances can be loaned from a bank as mentioned above.

***Question 4: How should the methods of distributing allowances in a cap-and-trade program change in future years?***

Allocations should be updated based on reports submitted to the market regulator. Ideally, no new reporting requirements would be needed. Adjustments would be required to account for load growth, both in terms of forecasted customer growth and electrification of other sectors. In addition, adjustments would be required for load balances (types of customers served by the provider) and climate impacts to load. Other forecasted or mandated load growth should likewise be accounted for.

Transition to a load based or other per capita allocation method is appropriate after the market system has matured and sufficient time for regulated entities to integrate their reduction programs into their long term planning.

Gradually, after the market system is well established, and regulated entities have had sufficient time to incorporate reduction obligations into their long term business planning, an emission based allowance allocation could transition to another allocation methodology. Time must be provided for such transition in order to ensure electric resource adequacy and reliability are protected and rate impacts are equalized.

**CONCLUSION**

Modesto ID generally recommends that in a market based system implemented to meet emission reduction goals under AB 32, emission allowances should be allocated administratively based at least initially on point of regulations' historic emissions and accounting for forecasted as well as mandated load growth. Auction of allowances should be minimized and delayed until a

robust market has matured. Proceeds from any allowance allocation should be used to reduce emissions, including investments in research and development of new non-emitting generation, renewable energy resources, and programs to encourage energy efficiency. Any market system put in place must be closely monitored by a single, identifiable regulatory body to avoid manipulation, fraud and other abuses.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read 'Joy A. Warren', with a long horizontal flourish extending to the right.

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