NORTHERN CALIFORNIA POWER AGENCY COMMENTS ON MARCH 17, 2008 *WHITE PAPER ON ALLOCATION OF ALLOWANCES*

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To: California Air Resources Board

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The Northern California Power Agency[1] (NCPA) appreciates the opportunity to offer these comments to the California Air Resources Board (CARB) on the *White Paper on Allocation of Allowances* (White Paper), prepared for the March 17, 2008 Assembly Bill (AB) 32 Technical Stakeholder Working Group Meeting.

The White Paper does not address allowance allocations for individual sectors, yet clearly, due to the diversity of the various sectors, there is no single allocation scheme that would work economy-wide. Rather, the distribution of allowances must be carefully tailored to address each sector's specific structure. Both the allocation of emissions allowances and proceeds generated from such allowances must be determined on a sector-specific basis.

In these comments, NCPA addresses allocation of allowances and allowance values within the electricity sector. To that end, it is important to note the work being done by the California Public Utilities Commission (CPUC) and California Energy Commission (CEC) in developing recommendations to CARB for the electricity sector. Specifically, the anticipated ruling and staff report from the Joint Commissions regarding allowance allocations for the electricity sector, which is scheduled for release in the near future. Because the CPUC/CEC process is focused exclusively on the electricity sector, it is prudent to forego further electricity-sector specific detailed discussions until after the CPUC/CEC has issued the staff report and conducted a comprehensive workshop on this issue.[2]

1. What method should CARB use to distribute allowances?

The White Paper notes that auctioning of allowances provides the "fairest and most transparent way" to distribute allowances and ensure that proceeds are paid to the State, which would then be able to use the revenue for public benefit (p. 4). NCPA disagrees with this assertion and maintains the position that a free distribution of

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.

2 On April 2, 2008, the Western Climate Initiative (WCI), Allocations Subcommittee issued its *Draft Allocations Design Recommendations*. Given CARB's stated intent to facilitate implementation the ability to broaden the scope of the state's emissions reduction program, the WCI recommendations should also be utilized as a resource in this process.

allowances within the electricity sector is the best means to minimize costs and maximize the beneficial use of allowances.

At this juncture of the debate, NCPA is concerned that the White Paper's extensive discussion regarding several perceived positive aspects of auctioning allowances does not provide a balanced perspective by ignoring the problems associated with auctions. NCPA offers the following considerations:

- Administrative Costs of an Auction - There has been no meaningful discussion regarding the administrative costs associated with establishing and running an auction. An auction, by design, must involve an administrative structure – such a regime would likely be funded by auction revenues, which means those funds would not be available to effect actual emission reductions. In the end, the State's electricity consumers would be forced to pay twice for compliance. In addition, the costs associated with establishing an auction must include thoughtful consideration of a number of factors, including seven key elements raised in the WCI Allocations Recommendation. There is no reason to believe that these costs will be insignificant or *de minimus.*

- Distribution of Auction Revenues - Under an auction approach, distribution of auction revenues to the State will substantially diminish the potential value that could be returned directly to consumers. That value will be best realized if decisions regarding the distribution of the proceeds are left to those that are most closely connected to the needs of local constituents – the retail electricity providers with the compliance obligation.

- Impacts on Electricity Prices – In the electricity sector, free allocation will enable the most cost-effective reductions, as it will reduce the need for burdensome administrative procedures and expenditures, and will allow entities with the compliance obligation to channel resources directly into emissions reductions measures – such as the acquisition of lower greenhouse gas (GHG) emitting resources and the expansion of energy efficiency programs.

- Potential for Market Manipulation –Within the electricity sector, there are several proven examples of how the markets are susceptible to gaming, which puts the State's electricity consumers at risk. It is true that third parties may increase the liquidity of the markets (p. 5), yet the opposite is also true – the same entities that have the resources to purchase allowances, with no corresponding obligation to reduce emissions, would be incentivized to game those allowances. The assertions set forth in the White Paper (p. 5), which support a conclusion that auctions are not likely to be manipulated, do not specifically take into account the nature of the electricity sector. The electricity sector is unique in several respects, and in fact, has been the victim of market manipulation in the past. It is absolutely imperative that the lessons learned during that difficult time be used to ensure that any market-based implementation procedures provide a workable solution for the

State's electricity consumers.

- Early Action – NCPA and its members support CARB's Policy Statement on Early Actions to Reduce GHG Emissions (February 28, 2008), and indeed have invested significant resources in early actions of their own. Accordingly, NCPA is supportive of an allowance allocation methodology that recognizes pre-AB 32 efforts to reduce GHG emissions. However, an auction is not the only means by which this can be accomplished. The free distribution of allowances based on a benchmark serves this important objective, and does so without the burdensome and significant administrative costs associated with an auction. (p. 6)

- Auction Design – The White Paper references the report prepared for the Regional Greenhouse Gas Initiative (RGGI) (p. 5) on the design of an auction. This document is certainly a valuable resource, yet it is also important to note that it was prepared *specifically* for the RGGI process, where the development and design of an auction has been going on for over five years. A public debate that builds on that effort is clearly warranted in California, certainly before full consideration can be given to the value of an auction-based allocation approach.

2. How should allowance values 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?

The value of allowances should be allocated directly to entities with the compliance obligation. Such value should be used to implement direct emissions reduction measures. Within the electricity sector, retail providers with the compliance obligation are going to be called upon to reduce their GHG emissions using new and innovate technologies and resources that are traditionally more costly than those that have been employed in the past. At the same time, retail providers are going to be required to do so while continuing to deliver a safe and reliable essential service to their customers. In order to do this in the most cost-effective manner, the value of any allowances should be directly controlled by those responsible for effecting the reductions.

The White Paper notes that there are two general categories for the use of allowance values; (1) for public benefit and (2) to ease the cost of regulation. (p. 6) As it pertains to the electricity sector, these two are not mutually exclusive, and in fact, are often complementary. For example, investments in cost-effective programs that reduce GHG emissions – such as energy efficiency – also reduce compliance costs, and at the same time benefit consumers by lowering energy bills and electricity consumption.

The White Paper provides a list of key public benefits that can be supported by funds generated from allowances (p. 6), and a list of issues raised by use of the funds to reduce regulatory compliance costs (p. 7). Allocating the value of allowances to the retail providers with the compliance obligation serves both of these important objectives. It enables entities that have the most direct relationship with the reduction goals the opportunity to custom-fit programs designed to achieve the greatest total benefit for any given community. The most direct connection to electricity consumers is their retail electricity provider; accordingly, there should be a direct correlation between the allocation of allowances and the amount of electricity load served by the retail provider. An allocation methodology should thus be developed that allows for the free distribution of allowances to retail providers.

With respect to the leakage issue, NCPA acknowledges that CARB's concern about emissions potentially shifting from California to other states and regions is very real. However, it is more important at this point to implement a cost-effective and well-reasoned program that focuses on a fair allocation of allowances, administrative feasibility, and the least impact to state consumers, than to focus on a program whose primary objective is elimination of leakage. While this problem should not be dismissed, it cannot be fully or significantly mitigated until a comprehensive regional – and ultimately, national – program is developed and implemented.

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

Within the electricity sector, new entrants would be reflected as load growth, therefore, an allocation of allowances based on retail sales will best account for new entrants. That distribution should be adjusted on an ongoing basis to account for emissions reductions achieved and achievable through energy efficiency measures. This methodology not only fairly addresses the issue of new entrants, but also serves other purposes in that it would (1) mitigate adverse impacts that could result with the departure of market participants, and (2) recognize early actions.

Any perceived or real incentives to accumulate free allowances and subsequently leave the state would be mitigated through ongoing adjustments to allocations based on current load.

Entities who have demonstrated responsible environmental stewardship, such as NCPA and its members, by taking concerted actions in the past to minimize their carbon footprint and reduce their total GHG emissions should not be adversely impacted by the allocation methodology. Therefore, allocation of allowances based on retail load would not only allow for new retail providers to receive a fair share of emissions allowances, but would also avoid any punitive impacts on retail providers with lower-GHG emissions.

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

It is conceivable that an allocation scheme will involve allocating allowances based on a methodology designed to compensate – at the beginning – entities or sectors with historically high emissions. In the event the state adopts such a methodology for any sector, it is imperative that such allocation is utilized for the minimum amount of time necessary to meet the stated objective. To do otherwise would result in penalizing other sectors (and entities) that will necessarily be called to upon to make even greater emissions reductions. The same is true for an analogous intra-sector allocation methodology.

As noted above, an auction is not the best means by which to initiate allocation of allowances within the electricity sector. In the event that CARB does determine to move forward with an auction for the electricity sector, such a transition should be gradual, and should not be initiated until the myriad of issues regarding establishment and administration of an auction have been fully resolved.

NCPA thanks CARB Staff for its ongoing efforts and for the opportunity to comment on the White Paper. 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.

Respectfully submitted,

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