M E M O R A N D U M

TO: California Air Resources Board
Economic and Allocation Advisory Committee

FROM: Modesto Irrigation District
Redding Electric Utility
Turlock Irrigation District

SUBJECT: Comments on Allowance Allocation

DATE: December 9, 2009

Introduction

The 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 issues surrounding the allocation of allowances in a cap-and-trade program to the Economic and Allocation Advisory Committee (Committee).

General Statement

The Utilities believe that allowances should be allocated administratively to those capped entities with compliance obligations and joined in the letter submitted on November 23, 2009[1] by a coalition of investor and publicly owned utilities. Administrative allocation of allowances meets the four criteria identified by the Committee (fairness, cost effectiveness, environmental effectiveness, and simplicity), serves multiple uses for the allowance value including compensating those who bear the greatest burden of emission reduction, investment in new abatement programs and technologies, and a direct return to consumers, and provides a mechanism to achieve the goals of AB 32 within existing legal confines.

Whether allowances are allocated among sectors and subsequently within each sector, or directly allocated to capped entities on a proportional basis, the allowance allocation methodology should support all efforts made towards meeting the goals of AB 32. The State's consumers will ultimately bear the financial burden of California's greenhouse gas (GHG)

[1] REU and TID are members of the Northern California Power Agency, a signatory of this letter.

emission reduction programs whether directly or indirectly by California business passing the costs on to the consumer to stay competitive. The Utilities understand there are also potential "costs" involved with not mitigating the impacts of climate change; however the financial burdens realized by consumers do not have to be extreme. Protecting consumers through the most efficient design of programs will protect the State's economy which will in turn protect jobs in California. Ensuring that the greatest reduction of GHG emissions per dollars spent will ensure that California's economy is not overly burdened and must be a priority when establishing the methodology for allowance allocations. "Price signals", and other incentives to achieve the abatement of emissions, should be designed in accordance with this priority.

Free Allocation of Allowances

Exponential effect of electric sector's AB 32 compliance. The Utilities believe that the costs incurred by the electric sector to abate carbon emissions will have an exponential impact on consumers. Compliance entities will incur significant costs to meet their obligations under AB 32. These costs will, for the most part, be passed on to the consumer. For publicly owned utilities, their rates are the only source of revenue to recover these costs. The Utilities believe the effect of increasing electric rates will exponentially impact the consumer. Not only is the consumer paying his own increased electric bill, but also the increased costs associated with every good and service the consumer must purchase. Industrial producers who have their own compliance costs will of course also have to bear the impacts from increased electricity costs. The resulting increase in costs for the industrial producer will then be passed on to the next in the supply chain. The next entity would have those increased costs along with their own increased electricity costs to pass along. This ripple effect will continue through the chain and finally to the consumer. If any one entity within this chain cannot bear the costs, there is the risk that the chain will be broken or the entire system will collapse. The exponential impact of AB 32 compliance can be minimized by providing allowance value directly back to local distribution companies (LDCs).

LDCs have the ability to apply the value of the allowances directly to emission abatement programs and consumer relief. Money not spent on purchasing allowances by LDCs will result in real, additional GHG reductions through increased investments in renewable and other low emission resources to replace existing higher GHG emitting electricity generation, additional energy efficiency and demand response programs, and direct investments in the development of new technologies. Any savings derived from the free allocation of allowances will not eliminate all cost impacts on the utilities and their consumers, but rather will provide the utilities with the opportunity to direct funding into areas that may reach abatement goals sooner and reduce the overall program compliance costs. Thus, one of the prime directives of AB 32 – cost effectiveness – is achieved.

Meeting criteria identified by the Committee. The Committee identified four criteria for choosing among allocation options: fairness, cost-effectiveness, environmental effectiveness, and simplicity. Administratively allocating allowances to LDCs meets each of these criteria. The criteria of fairness is achieved as the electric sector will bear a disproportionate burden for attaining the mandates of AB 32 under CARB's Scoping Plan and the allocation of allowances will help to offset this burden. The criteria of cost-effectiveness is achieved since free allocation

to LDCs limits the exponential impact of compliance costs on consumers, as explained above, and provides a direct incentive to invest in additional abatement projects under existing regulatory schemes. The environmental effectiveness criterion is achieved through free allowance allocation because compliance entities will have more financial capital to invest in lower emission resources and consumer education/incentives to reduce emissions. Finally, allocation to LDCs meets the criteria of simplicity. It is, more direct, and more certain to achieve the desired carbon abatement results.

Serving multiple uses. The Committee's report identifies four potential uses for the allowance value – (1) compensating those that bear the burden of the GHG emission reduction programs which helps balance the costs and avoid leakage, (2) providing dividends to the public to represent the "purchase" of the public's air quality which avoids the regressive impacts of higher utility costs, (3) tax reduction, and (4) investment in new technologies, energy efficiency education, green job training, low income assistance, land use and transportation improvements, remediation, and other adaptation programs. By apportioning allowances directly to regulated entities, such as the LDCs, all of the allowance value uses outlined in the report (with the exception of tax reductions) can be served, and served more cost effectively, by avoiding the administrative costs of having the State manage such programs. LDCs would use the value of the allowances simply, transparently, and with the oversight of the utility's regulating body and CARB's AB 32 program. Equally as important, distributing allowances to LDCs will accomplish the goals outlined in the report without the potential for the value to be "hi-jacked" for other uses, such as government deficit reduction or programs unrelated to GHG emission reductions, while most likely creating a form of leakage

Importance of addressing load growth. The allocation of allowances to LDCs also provides a mechanism for addressing such utilities' load growth. Even as consumers are educated and encouraged to participate in energy efficiency programs, such load growth can result naturally from population changes. Load growth can also result from carbon abatement programs implemented in other sectors that shift their fuel use to electricity. Some examples being examined by CARB include plug-in hybrid vehicles, truck idling restrictions, and port electrification.

Protecting the "price signal". The Committee's report discusses the importance of preserving the "price signal" of higher electricity costs, and identifies this as the prime objection raised against distributing allowances freely to LDCs. As set forth above, the Utilities believe such distribution will not eliminate the price signal; rather, utilities will still incur significant costs that will be reflected in rates.

H.R.2454 and S. 1733

The Utilities urge CARB to take under consideration the allowance distribution structure set forth in H.R.2454 as passed by the U.S. House of Representatives.[2] Below, the Utilities have

[2] The Utilities reserve right to change their position on HR 2454 based on the fluidity of the debate and the final version of the Senate legislation.

highlighted a number of elements of H.R.2454 and the current Senate version S. 1733 in order to discuss the merits or problems with each as they would apply to a California program.

The Utilities recognize that H.R.2454 has not yet been sent to the President and that the Senate has introduced its own climate change legislation with S. 1733 whose form is still not finalized. We also recognize that additional climate change legislation may be introduced. However, the push to create some form of a national cap-and-trade program is inarguable and inevitable. The Utilities believe that any program California creates needs to have the flexibility to be integrated with a larger, national program, and H.R.2454 and S. 1733 have some elements which the California program can borrow from.

Sector Allocation – The Utilities support the approach presented in H.R. 2454 and S. 1733 which designates a significant portion of allowances to the electric sector. As stated above, the Utilities believe this is appropriate because of the significant disproportionate burden being placed on the electric sector to combat climate change. This also creates a means of dealing with load shifting that will inevitably occur from other sectors.

In addition to the concept of load shifting from other sectors moving to electrification of their activities is the concept of delayed entrance. Some sectors will not be capped until 2015, three years after the other sectors begin operating under the cap. This delayed entrance should not add additional burden to those already capped sectors. The Utilities recommend that the EAAC encourage CARB to include all sectors at the beginning of the cap-and-trade program in 2012.

H.R. 2454 and S. 1733 call for the same percentages of allowances allocated to the electric sector and entities within the sector. However, there are fewer allowances given to the electric sector under S. 1733 because the cap is lower in later years, there is a larger market reserve, and some allowances are proposed to be taken off the top of the initial allocation for deficit reduction – thus a smaller pool of allowances is left to be divided amongst the remaining entities. The number of allowances stated to be allocated to the electric sector in both bills is 35%, however, as outlined above, because there will be allowances removed from the total pool prior to any allocation, S. 1733 in reality would only allocate 30% of the total allowances to the electric sector, not 35%. The Utilities believe that this amount is not sufficient given the significant burden placed on the electric sector.

Local Distribution Company (LDC) Allocation – H.R. 2454 and S. 1733 allocate additional allowances to small LDC's. A small LDC is defined as one that delivered less than 4 million MWHs of electric energy directly to retail customers. The Utilities believe this is appropriate because it recognizes the disproportionate burden put on the smaller utilities and the greater difficulty they will have absorbing the cost of emission reductions. The Utilities also support the allocation of allowances based on both historic emissions and sales equally (known as the 50/50 split). The 50/50 split in H.R.2454 is similar to the idea proposed in the CPUC/CEC joint decision[3]. The 50/50 split recognizes a balanced approach. The split does not penalize an LDC for historic emissions or any growth it may incur beyond its control in the future.

[3] See CPUC Rulemaking 06-04-009 Title 5. Distribution of GHG Emission Allowances in a Cap-and-Trade Program

The 50/50 split calculated the allowances distributed based on retail sales using average retail electricity deliveries for 2006-2008, or any other three consecutive years between 1999 and 2008 that the LDC chooses. The Utilities support this approach because it allows for variability in climate, hydro availability, and resources and is a tool to ensure credit is given for early action. Every three years, the allocation based on retail sales would be updated to reflect increases in the number of customers in an LDC's service territory. The updating of allowance allocations every three years is important in recognizing load growth.

H.R. 2454 and S. 1733 would not allow an entity to obtain more free allowances than they need by not allocating beyond what is necessary. This will not eliminate the overall financial impacts from GHG reduction activities due to other complimentary measures, but can help to alleviate increased electricity costs (due to enactment of Title III) to the LDC's retail ratepayers, the Utilities believe this is an important element that should be included in California's program to prevent gaming. The Utilities, however, oppose allocating a portion of the electricity sector allowances directly to owners of unregulated merchant coal generation units and long-term contract generators as recommended in HR 2454. Electric sector allowances given directly to merchant generators means that the value of those allowances would not be available to benefit ratepayers through the direct application of such value to the most cost-effective carbon reductions. Moreover, since these generators are not owned by regulated utilities, California would have no way to ensure that its consumers receive the benefits from these free allowances.

Allowance Value and Auction Revenue – The Utilities fully support the provisions in H.R. 2454 and S. 1733 that require LDC allowances must be used exclusively for the benefit of retail ratepayers. The Utilities believe, however, that the specific methods for designing this requirement should be left up to the individual utilities as every utility's load, programs, customer base, and local environment play a large role in determining what resource mix would be most efficient and beneficial to their ratepayers.

The Utilities applaud the concept of cost containment. However, the use of a strategic allowance reserve in H.R. 2454 as a cost containment mechanism appears problematic. It appears akin to set asides which, as stated in previously filed comments[4], we believe would both weaken and complicate a cap-and-trade program. By removing allowances from the marketplace, fewer allowances are available for compliance entities, which in effect reduces the cap below what the goal has been set by legislation. S. 1733 also includes a form of strategic reserve, called the market stability reserve. The market stability reserve calls for a larger percentage of allowances to be withheld initially for the reserve, as compared to the strategic reserve. The Utilities disagree with the use of a strategic reserve and market stability reserve, in any form, because of their restricting effects on the overall market and costs to compliance entities. Cost containment mechanisms that the Utilities believe will be effective in both a federal and California cap-and-trade program could include a price cap or price triggers, banking, borrowing and the use of offsets.

Auctions should be limited to those capped entities that have compliance obligations. California should not recommend engaging in an auction with only California entities. At a

[4] See "Use of Allowance Set Asides in a Cap and Trade Program" filed with CARB on June 15, 2009.

minimum, California could participate in a regional auction with other states that have a mandatory program as well. Any auction design should be transparent, including open bids and the disclosure of winning bidders, bid prices and purchased quantities. Auctions may be held regularly but some form of purchase limit should be adopted. All successful bidders should pay the same price per allowance. Legislation has been introduced in Congress to deal with the issue of market oversight and prevention of market manipulation. The legislation outlines measures for a national program and California should look to that legislation to guide creation of market oversight mechanisms within the California program.

As stated in the previous section, the Utilities believe that to the extent allowances are auctioned, revenue generated from such auction should go to programs that help achieve reductions and help reduce the overall cost of AB 32 to all ratepayers. This should include, but not be limited to, low income programs and rebate checks to customers. Energy efficiency programs and additional renewable resource investments are both major sources of reductions and are a benefit to ratepayers and so should be included the list of benefits to receive auction revenues. Apportioning auction revenue back to LDCs can also achieve these goals.

A secondary market for allowances will most likely emerge. If such a market develops, participation may or may not be limited, however additional oversight will need to be developed. The Utilities support the ideas in H.R.2454 Subtitle E – Additional Market Assurance, Section 351 - regarding derivative markets and encourages California to adopt a similar provision.

CPUC/CEC Joint Decision

The CPUC/CEC (also referred to as the "Joint Agencies") issued a Joint Decision (Rulemaking 06-04-009) on the allocation of allowances within the electric sector. The Joint Agencies received substantial stakeholder input and spent a significant amount of time and resources, working through all the varying interests, to develop a proposal that reflects a balanced approach for the electric sector. The Utilities also encourage the Committee to thoroughly review and consider this proposal.

Considerations for Auction Design

The Scoping Plan ultimately calls for phasing-in a 100% auction methodology for allocation allowance values. Phase-in to an auction should be gradual and dependent on the development of a vibrant and secure allowance market. Any auction design should include the following components.

- As the auction market develops, only entities with a compliance obligation should be eligible to participate. This will ensure that allowances are available to those who will need them and that allowance prices are not inflated or manipulated by speculators.

- The purchase price mechanism, whether uniform or discriminating, must be simple and create a level playing field for all participants. Setting a limit on the amount of allowances a participant can purchase based on a bandwidth of their obligation will

help prevent hoarding. It will ensure allowance prices are not inflated or manipulated by those participants.

- More frequent auctions are preferable – this will enable compliance entities to adjust their bid strategies to respond to their resource and load changes, price fluctuations, and other real time impacts similar to the strategies currently used by electric utilities in their resource planning work. Compliance entities will require this flexibility and fluidity. The Utilities believe that holding more frequent auctions will be reflective of existing markets, such the natural gas market, however the increased costs and administrative complexity of doing this will need to be assessed before proceeding.

- California's annual allowance budget should be equally divided among all auctions to be held within that year. Any unused or unsold allowances should be carried-over and included in the next auction. This approach will ensure overall compliance with the AB 32 reduction goals is met while at the same time alleviating the effects of fluctuating water years, weather, etc.

- Allowances should not be vintaged. Once an allowance is released into the market, that allowance should retain its value throughout all compliance periods until it is surrendered.

- Price control mechanisms are an important part of an auction design.

- The Utilities do not believe that any allowance reserves are necessary.

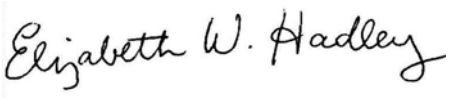
- All auctions should be open and transparent, including price(s) and amounts of the successful bids. Clear rules and effective oversight must be established and understood by all participants before the inception of any auction process.

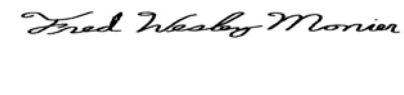
- California's carbon emission markets should be linked with regional, national and international systems as such other markets develop and meet environmental stringency and market protection measures similar to those put in place in California.

Conclusion

The Utilities appreciate the opportunity to put forth the above comments and would welcome the chance to work with the Economic and Allocation Advisory Committee as well as CARB to develop these concepts further.

Respectfully submitted,





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