

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

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Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.

R. 06-04-009

**REPLY COMMENTS OF THE WESTERN POWER TRADING FORUM
ON ALLOWANCE ALLOCATION ISSUES**

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November 14, 2007

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I. Introduction

In accordance with the direction provided in the October 15th, 2007, Administrative Law Judge's Ruling under Rulemaking 06-04-009, the Western Power Trading Forum ("WPTF") respectfully submits the following reply comments regarding distribution of allowances under a greenhouse gas (GHG) emission trading program for the electricity sector.

WPTF notes that many Parties to this proceeding, notably the investor-owned utilities and environmental and public interests organizations, advocate full auction of allowances under a first-seller cap and trade system, with auction revenue to be distributed to load-serving entities. Further, Pacific Gas and Electric and Southern California Edison support allocation of allowances directly to LSEs for subsequent sale to first-sellers. WPTF has substantive concerns with these recommendations:

- o An initial 100% auction of allowances under a first seller approach would create unreasonable economic harm for generators and the potential for stranded costs. WPTF advocates administrative allocation as the principle

means of distributing allowances in the early years of the trading system, combined with a gradual phase-in of allowance auctioning

- Allocation of allowances to retail providers under a first-seller approach would be inherently unfair to independent power producers and power markets.

We address these two concerns in our comments below.

II. Auction of 100% of Allowances Initially Under a First-Seller Approach Would Cause Undue Economic Harm to Generators and Could Result in Stranded Costs.

Many parties cite the potential for windfall profits to electric generators under administrative allocation as a principle concern and recommend auction of allowances to eliminate the potential for these profits. The potential for windfall profits to electric generators is overstated and does not justify immediate full auction of allowances.

Under an auction, the ability of a generator to recover its compliance costs depends on its ability to pass 100% of the allowance price for each MWH through in market electricity prices. But market prices are a function of many factors – gas prices, load, expected load, availability of generation, weather, and transmission constraints, to name a few. Because the carbon cost (i.e. allowance price) is just one factor of many affecting market prices, it should not be assumed that generators will be able to completely pass through this cost.

Costs to fossil generators under a GHG cap will be significant and are not likely to be completely compensated by increased revenues. Fossil generators face a real risk of loss of investment value due to GHG regulation, particularly in the early years of a trading system. These lost profits are in effect stranded costs, and should be compensated through initial administrative allocation of allowances.

Many studies have attempted to quantify the profits lost to fossil generators under GHG regulation, and thus the quantity of allowances needed to compensate for the loss of investment value. While these estimates vary depending on assumptions regarding competition, allowance prices and the ability to pass through allowance prices, they are typically in the range of 35 – 50%.¹ When the effect of carbon prices on individual firms is considered, the proportion of allowances that must be freely allocated to compensate adversely affected firms rises to 70 – 100%.² Further, studies that have looked at the quantity of allowances needed if the period of compensation is temporary – as would occur under a transition to auctioning of permits – have concluded that a much higher proportion of allowances must be administratively allocated than if the allocations occurred in perpetuity.

WPTF agrees that a well-designed GHG cap and trade system should change the economics of generator dispatch and investment in favor of cleaner generation. A distribution approach that begins with administrative allocation and gradually transitions to auctioning would reduce the risk of stranded costs because it allows for generators to plan for compliance with GHG caps and accommodate natural capital stock turn-over. Additionally, such an approach would minimize any windfall profits that may occur to fossil generators because generators would be required to purchase allowances in the later years of the trading system.

¹ See for instance, “Allocating Allowances in a Greenhouse Gas Trading System”, National Commission on Energy Policy, 2007 and “Simple Rules for Targeting CO₂ Allowance Allocations to Compensate Firms,” Palmer, Karen, Burtraw, Dallas and Kahn, Danny, 2006.

² For a review of existing studies on the economic impacts of GHG trading systems for the electricity sector, see “Complexities of Allocation Choices in a Greenhouse Gas Emissions Trading Program,” Harrison, David, Jr., Klevnas, Per; Radov, Daniel; and Foss, Andrew prepared for the International Emissions Trading Association. 2007.

For these reason, WPTF advocates administrative allocation of allowances as the principal means of distribution during the initial years of a cap and trade system, with a gradual transition to auctioning over time.

III. Allocation of Allowances to Load-Serving Entities Under a First-Seller Approach would Unfairly Disadvantage Independent Power Producers and Power Marketers.

Under a first-seller trading system, all in-state generators and importers of power will be competing for emission allowances. To the extent that retail electricity providers own in-state generation, or import power, those entities will also be participants in the carbon market. Any distribution method that allocates allowances to retail providers for subsequent auction/sale to other market participants would be patently unfair as it would advantage retail providers over independent power producers and other marketers.

Further, allocation of allowances to retail providers under a first-seller approach would create an unacceptable risk of market power, as a high proportion of the allowances would be held by a small number of large investor-owned and public utilities.

If California decides to dedicate any portion of allowance value to mitigate consumer rate impacts or to promote other GHG reduction goals, then, for the reasons stated above, it would be far preferable to distribute auction revenue to retail providers rather than actual allowances.

WPTF also notes that our concerns explained above regarding early transition to auctioning would also apply to any variant that distributes allowances to retail providers under a first-seller approach.

IV. Conclusion

WPTF appreciates this opportunity to comment and the Commission's consideration of the discussion provided herein.

Respectfully submitted,

A handwritten signature in cursive script, reading "Daniel W. Douglass", is written over a solid horizontal line.

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November 14, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the **Reply Comments of the Western Power Trading Forum on Allowance Allocation Issues** on all parties of record in R. 06-04-009 by serving an electronic copy on their email addresses of record and by mailing a properly addressed copy by first-class mail with postage prepaid to each party for whom an email address is not available.

Executed on November 14, 2007, at Woodland Hills, California.



Michelle Dangott

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R.06-04-009

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