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

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.	Rulemaking 06-04-009 (Filed April 13, 2006)

**BEFORE THE
ENERGY RESOURCES CONSERVATION AND DEVELOPMENT COMMISSION
OF THE STATE OF CALIFORNIA**

In the Matter of: Order Instituting Informational Proceeding on a Greenhouse Gas Emissions Cap	Docket 07-OIIP-01

REPLY COMMENTS OF THE NORTHERN CALIFORNIA POWER AGENCY REGARDING ALLOWANCE ALLOCATION ISSUES

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In accordance with Rules of Practice and Procedure of the California Public Utilities Commission (CPUC), and the instructions set forth in the October 15, 2007 Administrative Law Judge's Ruling Requesting Comments and Noticing Workshop on Allowance Allocation Issues (October 15 Ruling), the Northern California Power Agency[1] (NCPA) submits these reply comments in response to the October 31, 2007 comments (October 31 Comments) filed

[1] NCPA is a Joint Powers Agency whose 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.

by parties to this proceeding. As directed in the October 15 Ruling, these comments are being concurrently filed with the CPUC in Rulemaking 06-04-009 and with the California Energy Commission (CEC) in Docket 07-OIIP-01.

NCPA appreciates the opportunity to submit these reply comments, as it did the opportunity to file written responses to the October 15 Ruling and participate with other stakeholders in the joint CPUC/CEC November 5, 2007 workshop (November 5 Workshop). As directed by Assigned ALJ TerKeurst, these comments do not reiterate the positions and observations raised by NCPA in its opening response to the October 15 Ruling. Rather, they respond to issues and positions raised by the various parties in their October 31 Comments and during the November 5 Workshop. Further, as with its initial response, filed on October 31, 2007, NCPA limits the scope of its comments to matters regarding the electricity sector, and unless specifically noted otherwise, NCPA does not address inquires regarding the natural gas sector.

I. INTRODUCTION

As the CPUC and CEC work to develop a recommendation to provide to the California Air Resources Board (CARB) on a methodology for the distribution of greenhouse gas (GHG) emissions allowances, several important factors must be kept in mind.

- Entities responsible for reducing GHG emissions must be permitted to focus their limited resources on attainment of actual reductions;
- Allowances should be administratively allocated for free to retail electric providers;
- Allowances should be allocated based on a retail provider's retail sales, and not historic emissions;
- Emissions allowances will become an increasingly scarce resource over time;
- The allowance allocation methodology should be based on updated retail sales, and factor in real reductions achieved through energy efficiency and other demand reduction programs;
- The allowance allocation process should be updated annually based on the most recent and verifiable information available;

- The base year used for setting the reduction targets should be as close to 2012 as possible and should be established utilizing the most recent data available; using a base year that is close to the AB32 implementation date acknowledges entities that are actively working on early voluntary reductions in their current GHG emission levels, recognizes clean energy portfolios, and takes into account current population and growth trends; the test year should also consider normalization of hydroelectric conditions; the use of a test year that falls anywhere prior to the passage of AB32 may create unintended consequences for low carbon utilities to the advantage of utilities with higher carbon footprints.

II. EMISSIONS ALLOWANCES SHOULD BE ALLOCATED BASED ON THE BENCHMARK OF RETAIL SALES

A. Emissions Allowances Should be Provided to Retail Providers and Should be Sales-Based.

NCPA supports the comments of several parties that the emissions allowances should be freely allocated to retail service providers.[2] Furthermore, NCPA supports a methodology for allocation of emissions allowances that is based on total retail sales of electricity, with an ongoing adjustment to recognize reductions effected by successful energy efficiency programs.[3] An allowance allocation that ignores *past* investments in higher-cost, clean resources, yet recognizes investments in low-cost, higher emitting resources is contrary to sound public policy and *not* in the best interest of the state.

Only a sales-based or output-based methodology links the retail providers' obligation to serve its customers to the total GHG emissions goal, and recognizes the investments already made in reducing GHG emissions. As one party correctly noted, "[i]n order to avoid

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[2] *See* October 31 Comments of the Los Angeles Department of Water and Power (LADWP) at p. 6; the Sacramento Municipal Utilities District (SMUD) at p. 5; Southern California Public Power Authority (SCPPA) at p. 21; and Division of Ratepayer Advocates (DRA) at p. 4. See also, "allocation of emissions allowances [should] be linked to the entities that are regulated under the GHG program and reward investments in low-GHG technologies and fuels." Calpine at p. 6; "Administrative allocation is likely preferable under a load-based approach.' TURN at pp. 11-12.

[3] Natural Resources Defense Council/Union of Concerned Scientists (NRDC/UCS) at pp. 4, 5, 6; PG&E at pp. 7,10.

penalizing programs and policies that have already achieved significant GHG reductions, the allowances should be allocated based on current retail sales, and adjusted for incremental customer energy efficiency and for changes in retail sales over time."[4] Such a methodology does not, contrary to one commenter's observation,[5] send the wrong signal regarding continued energy efficiency programs that work to reduce overall load growth. The cornerstone of any effective energy efficiency program is the ability to measure and verify the actual reductions achieved through the program. Accordingly, accounting for the success of energy efficiency reductions can easily be tracked through the GHG program when measuring an entity's allowance allocation based on retail sales. DRA correctly notes that "under a load-based system, the allocation would be based on the sum of electricity sales ***and*** energy efficiency savings to encourage the [retail provider] to maximize energy efficiency savings."[6]

AB32 mandates statewide reductions in total GHG emissions. In order to meet this mandate, *all* retail providers are going to have to continue to serve the same and growing retail load with lower emitting resources, regardless of their current resource mix. Further exacerbating this effort is the fact that NCPA believes that the electricity sector – and its customers – will likely be called upon to make reductions in excess of the sector's share of the total 1990 Baseline.[7] To that end, a retail-sales based approach is not inconsistent with meeting program goals regarding inventory tracking and reporting mandated by AB32.[8] To the contrary, since emissions are produced based on an entity's need to serve its retail customers, a sales-based methodology directly links that need to the reduction efforts and goals of both the individual retail provider and the state. As noted by DRA, "distribution of allowances . . . should recognize early action to reduce greenhouse gas emissions rather than rewarding the use of high carbon fuel."[9]

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[4] PG&E at p. 7.

[5] LADWP at p. 16.

[6] DRA at p. 15, emphasis in original.

[7] The 1990 Baseline is currently being developed by CARB.

[8] See LADWP at p. 14.

[9] DRA at p. 2.

B. Allowance Allocation Must Recognize Early Voluntary Reductions in GHG Emissions

Several parties correctly noted that implementation of AB32 must be consistent with the underlying direction of the legislation, which includes a mandate to insure fair treatment of those that have taken proactive steps to reduce GHG emissions (Health and Safety Code section 38562(b)(1)), and those that engage in early voluntary reductions (Health and Safety Code section 38562(b)(3)), as well as promote continued investments in low GHG technologies (Health and Safety Code section 38562(a)).[10] The only way to achieve this goal is to allocate emissions allowances based on a methodology that accounts for total retail-sales by retail electricity providers. This approach appropriately recognizes retail electricity providers across the state that have already made significant financial investments in cleaner generation resources, and continue to increase the amount of those investments; a recognition that AB32 mandates.

There is a misconception by some that all entities with currently low-GHG emissions levels achieved those levels through serendipitous means associated solely with geography. That is simply not the case, and such a simplistic interpretation of early actions must be rejected by the Commissions. Recognition of proactive decisions to invest in both energy efficiency programs and costly low-carbon emitting resources is not tantamount to issuing brownie points or merit badges.[11] Rather, it is simply a means by which to acknowledge and comply with the state's own mandate that those prior actions not be ignored – or worse yet, penalized – in an overall implementation scheme. Entities that have supported early actions, by investing in energy efficiency programs, renewables, and other low-GHG emitting resources need to be recognized, and those efforts to obtain alternate resources to provide electric energy to their retail customers must be acknowledged. As several parties aptly noted, the state of California itself supports a federal program that discourages free allocation based on historic emissions: "*Free distribution based solely on historic emissions will only*

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[10] *See* also, NRDC/UCS at pp. 9, 12; PG&E at p.13; SMUD at p. 4; Calpine at pp. 6, 15.

[11] Hearing Transcript at p. 112: 23-25.

serve to reward the biggest polluters at the expense of consumers and penalize early leadership."[12]

C. Allowances Cannot be Based on Historic Emissions

AB32 compliance will require all retail providers to reduce their emissions. The total amount of generation required by a retail provider is based on what is needed to serve that provider's retail load, and not on its current or historic generation portfolio. Allowances, therefore, do not – and indeed should not – be based on a one-to-one "correlation to a retail provider's actual historical emissions."[13] Several parties have provided extensive comments regarding the problems associated with allocating emissions on a "grandfathering" or historic emissions-based approach;[14] NCPA does not reiterate those comments herein, but rather notes its concurrence with those positions.

As stated by Calpine, allocation based on historical emissions levels is "inconsistent with an important goal of AB32 – rewarding entities that have already invested in low-GHG technologies and fuels."[15] Further, while on its face a sales-based approach provides entites with low-carbon resources a greater proportion of allowances relative to higher emitting utilities, those same lower-GHG entities will be more challenged in attaining actual reductions. As noted by several parties in their October 31 Comments and during the November 5 Workshop, the large picture mandates review of a broad set of objectives, goals, and past actions, beyond merely the total number of allowances received by any one entity.[16]

Furthermore, it is simply not in the best interest of the state to adopt an allocation methodology that is either based solely on historic emissions and/or undefined. Some parties have advocated for use of an emissions-based allocation methodology with a transition in the

[12] *State of California Recommendations for Federal Climate Policy*, October 2007, p. 2.

[13] SCPPA at p. 32.

[14] See, for example, NRDC/UCS at pp. 4, 11; DRA at p. 19; Calpine at p. 15; PG&E at pp. 10-11. *See also*, Morgan Stanley at p. 8: "grandfathering" is the least desirable methodology for administrative allocation of allowances.

[15] Calpine at p. 15.

[16] See PG&E at p. 18; comments of SMUD, Hearing Transcript p. 177: 6-7.

future to some other benchmark.[17] However, at least as it pertains to one proposal, the actual "benchmark" is undefined. Indeed, in response to oral comments made during the November 5 Workshop, LADWP's representative noted that the agency has neither a rough calculation of how that benchmark will be determined, nor an idea of how the transition would occur.[18]

Accordingly, NCPA urges the use of a sales-based or output-based methodology that includes calculation of energy efficiency related load reductions. Determination of actual allowance under such a scenario would be subject to a clear and facile process, would easily account for new entrants and load-growth, and would equitably distribute the allowances in proportion to the amount of load served.

D. AB32 Creates a Scarce Resource.

The adoption of any AB32 implementation plan presents the state with a scarcity issue; especially in the beginning years, there will be greater emissions than emissions credits in the state. This means that there will always be entities that will have to pay for credits and those that may be able to sell credits, which, in the minds of some, means that there will be entities receiving "windfall profits." The notion of windfall profits has been oversimplified to pit retail providers with high-emitting resources against those with low-emitting resources; this is simply not the case, and the discussion cannot end there.

By virtue of the fact that the state is going to have to scale back allowances over time in order to meet the 1990 Baseline, emissions credits will become an increasingly scarce resource. The end result is that costs associated with AB32 compliance will be linked to the

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[17] SMUD at p. 3; LADWP pp. 2, 13.

[18] Question by Jane Luckhardt for SMUD: "Did you have a rough calculation of what you thought that could be -- that would be?" Response by Leilani Johnson for LADWP: "I do not. And that is because of a number of things. One is the 1990 inventory has not been adopted; plus we have to still go through economic modeling to understand what is feasible from electric sector. But the intent is -- or our goal is to come to this same ultimate benchmark goal for everyone in the electric sector." Question by SMUD: "And how would you calculate that? Or do you know, yet?" Response by LADWP: It is not known at this point. Hearing Transcript pp. 21:2-16. *See* also, Question from Scott Murtishaw for the CPUC: "Does the allocation mechanism that you're talking about start with some percentage that would be allocated based on historic emissions, which -- and then another percentage that's allocated based on the common benchmark? And then those two percentages change over time? How do you transition from the historic emissions as a common benchmark from 2012 to 2020?" Response from Leilani Johnson for LADWP: "I don't think we're at a point of knowing what the details are in terms of that level is something to continue evolving as this process goes forward." Hearing Transcript pp. 22:24-22:10.

attainment of reduction goals and the accumulation of the necessary emissions allowances. There will be purchases and sales of allowances between retail providers. This alone does not create a windfall profit. Windfall profits are profits attributed to businesses that are unrelated to GHG reductions[19] – that is not the case when dealing with a limited and well-structured trading program that allows only those entities responsible for emissions reductions – in this case the retail providers – to participate. The fundamental policy issue that must be addressed is which utilities should be net purchasers: either those that have already taken significant steps to have a low-carbon foot print, or those that have not.

Likewise, the final impact on <u>current</u> electricity rates should not be a significant factor in determining the best overall mechanism for allocating allowances. During the November 5 Workshop, it was suggested that some utilities, specifically those in Northern California, are advantageously situated due to their current low electric rates.[20] NCPA does not believe that a comparison of current electricity rates has a place in this debate. First and foremost, not all utility rates have a direct correlation to costs. Second, many rate classes are structured so that low income customers are subsidized by other classes of customers. Furthermore, costs associated with past investments in higher-cost, lower-emitting resources are included in current the rate base, and to the extent that past higher rates have helped finance those investments, affected customers should not be denied the benefit of those investments by not realizing the resulting long term reduction in GHG emissions costs.

NCPA owns and operates a hydroelectric resource that was the last large hydroelectric project built in California; for many years this facility was, in fact, an uneconomic resource for the agency. Similarly, in the interest of expanding its low-carbon portfolio, NCPA also made significant investments in geothermal facilities – these investments have been more expensive than some higher-emitting resources. For example, while the cost of generation for the hydroelectric facility was $41.6 per megawatt hour for

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[19] *See* Market Advisory Committee's Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California, June 30, 2007, at pp. 8, 56, 58.

[20] Hearing Transcript at p. 138:2-7, by Jim Lazar, consultant to the City of Burbank: "And I mean the northern California municipal utilities, SMUD and Alameda and those, have current rates that are down in the 7 to 10 cent range." See also, Hearing Transcript at pp. 185:21-186:2, response by Susie Berlin for the Northern California Power Agency: "I don't think that there's this notion of windfall profits to low-emitting resources, because as has been mentioned, those are resources that have already been bought and paid for. And those are rolled into ratebase. For example, Alameda's rates are not 7 cents per hour, they're 12.5 cents."

fiscal year 2005-2006, that number was more than double for 2006-2007 (which was a dry hydro year), where the cost was $96.5 per megawatt hour. NCPA's geothermal facilities cost $59.7 per megawatt hour in fiscal year 2006-2007, but were significantly higher in the past, with a 2004-2005 cost of $81.4 per megawatt hour. While these investments were not economic at the time they made, NCPA's governing body knowingly took these proactive measures in the interest of promoting environmental stewardship as directed by the elected officials that comprise NCPA's governing board. These elected officials are directly accountable to their constituencies at the most representative level of government.

III. INTRASTATE REGIONALIZATION IS NOT A WORKABLE SOLUTION

Regional implementation of AB32 is not a practical or workable solution to the challenges associated with allowance allocation. Such an approach assumes that all utilities in one part of the state are low-carbon because of "free" hydroelectric resources, and that all utilities in the other part of the state are high emitters because of low-cost coal contracts; this is simply not true. It has been suggested that consideration should be given to implementing AB32 on a regional basis, basically bifurcating the state into two separate regions – Northern California and Southern California.[21] While this approach may <u>seem</u> attractive in its simplicity to what has been termed a north/south issue regarding allowance allocation, in actuality, it <u>oversimplifies</u> and misconstrues a complex issue.

First and foremost, California is much too diverse to merely divide in half. The geographic, meteorological, and economic differences between the two proposed regions are not isolated within a single region, and do not lend themselves to a clear demarcation between north and south. The City of Redding, for example, while located in Northern California, has a climate more aligned with that found in Riverside County, in Southern California, rather than San Mateo or San Francisco counties which are located in Northern California. Further, low income and disadvantaged customers are not unique to either region and retail providers across the state are faced with the same challenges regarding these customers.

Beyond that, the emissions factors of retail providers in the state do not fall into two simple categories based solely on geography. As noted by the Modesto Irrigation District

[21] SCPPA at pp. 9-10.

during the November 5 Workshop, speaking in terms of the northern utilities and southern utilities, this approach would be *"...somewhat of a simplistic division."*[22]

Again, while this approach may appear desirable in its simplicity, a North/South division is not a viable option for the state. The very simplicity of the approach works to obfuscate and ignore the real details that cannot be dismissed in any allocation scheme.

IV. AUCTIONS SHOULD BE AVOIDED

The majority of the parties filing October 31 Comments noted that an auction should be avoided, especially at the beginning of the program's implementation,[23] and indeed the State has made a similar recommendation to Congress on the structure of a federal program.[24] Despite the obvious risks associated with auctioning of allowances, some parties advocate auction as a means by with to allocate allowances. These parties have not, however, provided information on how an auction can be established and implemented in a cost-effective manner, nor how the potential for market manipulation will be mitigated, or even addressed. Until these issues have thoroughly addressed, California should avoid an auction. It is important to note that only through the *free allocation of allowances to retail providers* are the benefits of GHG emissions reductions most immediately and directly felt by the customers that will ultimately fund such reductions.

As a practical matter, before implementing any auction, California should look to the nascent Regional Greenhouse Gas Initiative (RGGI) auction process in order to obtain

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[22] "I just want to make a quick point. We've heard a couple times today this idea of a split between north and south, northern utilities and southern utilities. And I just wanted to me it clear that that can be somewhat of a simplistic division in that there are many northern utilities that may have some high carbon resources, and high carbon mix, as well as some southern California utilities that have low carbon, low emission rates. As well as some northern utilities that don't have a lot of hydro. So, it's not a clear distinction or a clear division. And there are many variables that affect the impact that AB-32 reduction requirements and allowances will have on different utilities in the north and south. So we don't want to get caught up in thinking that it's a clear line that splits the state." Hearing Transcript, pp. 195:22 -196:17, Joy Warren for the Modesto Irrigation District.

[23] *See* SCPPA at p. 21; LADWP at pp. 6, 8; SMUD at pp. 5- 6; EPUC/CAC at pp. 2-3; Calpine at pp. 6-7.

[24] While the Recommendations support an auction as an ultimate means to manage the emissions program on a federal basis, the Recommendations also note that freely allocating 20-40 percent of the total allowance pool to industry <u>in the first 5-10 years</u> could be considdered as a way of compensating major carbon-intensive industries for their compliance costs. *State of California Recommendations for Federal Climate Policy*, October 2007, p. 2; fn. 5, emphasis added.

guidance and information on how an auction would actually work. As noted in a recent report prepared for RGGI, auctioning of allowances, rather than providing them for free, is a substantial break from the way things have been done in the past.[25] Accordingly, at this time, an auction should not be pursued and in fact, should be avoided. Especially at the onset of program implementation, it would be prudent for California to implement its GHG emissions program without regard to an auction and utilize the experience that will soon be gained in the Northeastern U.S. with the implementation of its auction.

V. USE OF RESOURCES SHOULD BE FOCUSED ON ACTUAL EMISSIONS REDUCTIONS

In order to insure the most expedient and efficient reduction in overall GHG emissions, retail providers must be allowed to utilize their limited resources in a manner that most effectively meets their own demographics. NCPA concurs with the comments of many parties arguing that any revenues or income associated with allowances should remain with, or be returned to, the retail providers that incurred the costs of reduction on behalf of their customers;[26] proceeds should go to load serving entities for the benefit of their customers. In their combined comments, NRDC/UCS note that the value of allowances should be distributed in the public interest and to further the goals of AB32.[27] Indeed one of the primary concerns that parties raised regarding an auction is the determination of how proceeds will be spent, and concerns that the proceeds will be diverted away from the customers that actually fund them. [28]

There are several parties that noted that emissions reductions can, and will, be achieved through reduction programs that are already in place; programs that have been adopted by the CPUC and the local governing bodies of publicly owned utilities. Accordingly, the vast majority – if not all – of the funds associated with allowances should be

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[25] Report by Resources for the Future and others, entitled "Auction Design for Selling CO_2 Emission Allowances Under the Regional Greenhouse Gas Initiative," October 25, 2007, at p. 5.

[26] *See* SCPPA at pp. 26-27; SMUD at pp. 7- 8; PG&E at pp. 2, 7.

[27] NRDC/UCS at pp. 8-9.

[28] See, for example, SMUD at p. 7; SCPPA at p. 27.

returned to be distributed to retail electric providers under the supervision of the CPUC and the governing bodies of the publicly owned utilities. Indeed, these entities are "uniquely equipped and have well developed public processes to supervise the use of emissions allowance revenues in the most effective and efficient manner to meet the specific needs of customers and communities [they] serve."[29]

VI. CONCLUSION

NCPA concurs with the majority of the parties that favor an administrative allocation of allowances to retail providers in the electricity sector. Further, those allowances should be based on retail sales, which would be updated annually and account for the real reductions in load achieved through energy efficiency programs.

Auctions should be avoided; while based on sound economic principles, auctions are an untried means by which to allocate the scarce resource that will be emissions credits, and add not only greater uncertainty to this market, but also include a greater potential for market abuses.

NCPA appreciates the opportunity to submit these reply comments and to work with the CPUC and CEC in developing a recommendation to CARB on AB32 implementation matters for the electricity sector.

November 14, 2007

Respectfully submitted,

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[29] PG&E at p. 3.

CERTIFICATE OF SERVICE

I hereby certify that, pursuant to the Commission's Rule of Practice and Procedure, I have this day served a true copy of the **REPLY COMMENTS OF THE NORTHERN CALIFORNIA POWER AGENCY REGARDING ALLOWANCE ALLOCATION ISSUES** on all parties on the Service Lists for R.06-04-009, as listed on the Commission's website on November 13, 2007, by electronic mail, and by U.S. mail with first class postage prepaid on those Appearances that did not provide an electronic mail address.

Executed at San Jose, California this 14th day of November, 2007.

Katie McCarthy