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

STATE OF CALIFORNIA
ENERGY RESOURCES CONSERVATION
AND DEVELOPMENT COMMISSION

AB 32 Implementation	Docket No. 07-OIIP-01

REPLY COMMENTS OF THE COALITION OF CALIFORNIA UTILITY EMPLOYEES AND THE CALIFORNIA UNIONS FOR RELIABLE ENERGY ON GREENHOUSE GAS EMISSION ALLOWANCE ALLOCATION METHODOLOGIES AND OTHER MATTERS

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I. INTRODUCTION

The Coalition of California Utility Employees ("CUE") and the California Unions for Reliable Energy ("CURE") (collectively, "Unions") submit this reply brief. As shown in our opening brief, and supported by a broad cross section of other parties, it is premature and unsupportable for the Commissions to recommend a system of cap and trade to CARB for California's electricity sector at this time. The record does not support a conclusion that California's electricity sector is a good forum to experiment with a free market trading system. Further, it is abundantly clear that there is no consensus that a market-based mechanism is a desirable or even viable path to reduce greenhouse gases ("GHG") in California.

II. DISCUSSION

California is at a crossroads and must soon decide whether it will embark upon an unproven scheme to reduce GHG through a market-based mechanism. In our view, cap and trade is simply smoke and mirrors. Rather than go down that path, we urge the Commissions to instead rely upon and expand the direct programmatic regulations in place that are proven to be effective (e.g. energy efficiency and renewables). In various stakeholders' opening comments, it became clear that many parties are now questioning or have rejected the basic premise that market mechanisms will accomplish the goals of AB 32 in California's electricity sector. We highlight some of those positions here that we find especially noteworthy.

Many parties have expressed concern that cap and trade may be more trouble than it's worth. For example, The Utility Reform Network ("TURN") correctly cautions that a market-based system may unfairly saddle California's electric ratepayers with higher electric prices, the costs of emissions reductions, and profit taking by unregulated generators.[1] The Division of Ratepayer Advocates ("DRA") noted that the complexity of designing a cap-and-trade regime that could accomplish AB 32's GHG reductions when compounded by the potential for adverse unintended

[1] Comments of TURN on Allowance Allocation and Other AB 32 Implementation Issues p. 6.

consequences begs the question whether a cap-and-trade regime is the best way to accomplish those reductions.[2] Los Angeles Department of Water and Power ("LADWP") pointed out that the risks of this untested market scheme would be borne solely by California ratepayers.[3] These parties and others made clear that implementing AB 32 through market mechanisms is risky at best and does not offer California any net gains in emission reductions.

A. The Electricity Sector is Ill-suited for a Cap and Trade System

The primary justification for implementing a cap and trade system is market optimization. Specifically, a market participant's ability to reduce compliance costs through the buying and selling of allowances. However, as pointed out by the Green Power Institute ("GPI") and others, there can be a crippling disparity between theory and practice.

> "[A] common weakness in both the source materials and the Staff Paper is their over reliance on theoretical economic constructs, such as perfect markets, and market participants acting with perfect information and exclusively profit-maximizing behavior. Theoretical economic analysis of perfect markets provides valuable insights, which certainly should be considered in formulating the joint Commissions' next set of recommendations to the ARB for the implementation of AB 32. However, in the real world markets are not perfect, and market participants do not always display the tendencies predicted by economic theory. This, too, must be

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[2] Corrected Comments of the Division of Ratepayer Advocates on Electricity Sector Responsibility, Allowance Allocation, Flexible Compliance Mechanisms, and Modeling, p.1.
[3] Opening Comments of the Los Angeles Department of Water and Power on Policies Regarding Emission Allowance Allocation, Flexible Compliance, Treatment of Combined Heat & Power, Non-Market-Based Emission Reduction Measures and Emission Caps, and Greenhouse Gas Modeling Results, p.4.

> considered in formulating the joint PUC / CEC recommendations. In the opinion of the GPI, rigid application of theoretical economics to the process of deregulation, without due consideration of market imperfections, was a key contributor to the California electricity-sector meltdown of 2000 – 2001. It is extremely important to avoid letting that happen in conjunction with the design of a greenhouse-gas reduction system."[4]

California's "energy crisis" provides critical lessons on how deregulation and free market economics can paralyze California's energy system and put ratepayers at the mercy of corporate greed. To this day, the California electricity sector continues to have limitations that make it unable to function as a unencumbered market. Many parties support this point.

Calpine pointed out that other factors such as transmission constraints, contractual obligations, and other regulatory requirements (e.g., must run obligations) act to prevent the wholesale electricity market from being fully competitive, which, according to Calpine, would result in generators not being able to fully recover allowance costs.[5] The Independent Energy Association correctly noted that electricity is not like other commodities because there is little margin for error with electricity.[6] Further, the Energy Producers and Users Coalition and the Cogeneration Association of California commented that electricity is an essential service, and material restructuring of the industry can have dramatic and adverse

[4] Comments of the Green Power Institute on Allocation, Modeling, and Flexible Compliance, p. 6.

[5] Comments of Calpine Corporation on Emission Allowance Allocation Policies and Other Issues, p. 9.

[6] Comments of the Independent Energy Association on Emission Allowance Allocation, Flexible Compliance, and Combined Heat and Power, p. 4.

consequences.[7] They too referenced the crisis California experienced in 2000-01 in their comments. According to the Northern California Power Agency, cap and trade may enable some generators to withhold their capacity from the market and thereby potentially manipulate the price.[8]

Unquestionably, electricity's unique characteristics prevent it from fitting perfectly into a market scheme, making cap and trade a poor choice for regulating California's electricity sector. Further, market based measures pose potentially great risk of harm to ratepayers, the environment and the infrastructure as a whole.

B. A Number of Less Risky Options Warrant Further Evaluation

As described in our opening comments, direct regulation, without complicated and risky market mechanisms, is the most logical method of reducing GHG emissions in California and should be studied in greater detail by the Commissions. Indeed, according to the California Municipal Utilities Association, it would be "premature, at best" to recommend an auction without more detail.[9] TURN outright opposed including the electricity sector in a multi-sector cap and trade and instead supported a cap and auction that prohibits secondary trading that would unnecessarily raise electricity prices.

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[7] Comments of the Energy Produces and Users Coalition and the Cogeneration Association of California on Allowance Allocation, Combined Heat and Power, Modeling and Flexible Compliance, p. 7.
[8] Northern California Power Agency Comments on Assigned Administrative Law Judges' Rulings and Staff Papers Regarding Recommendations to the California Air Resources Board for the Electricity Sector, p. 11.
[9] Opening Comments of the California Municipal Utilities Association on Recommended Greenhouse Gas Emission Reduction Policies, p. 3.

We are not necessarily suggesting that these other options are superior to cap and trade, however, the Commissions would do well to pause here and fully investigate all of the ramifications, pro and con, on whether an auction is even a good idea for California's electricity sector. This overarching question is simply too important to rush through.

C. The Commissions Should Adhere to the Explicit Requirements of AB 32

First and foremost, the Commissions must strictly adhere to the requirements carefully outlined in AB 32's statutory mandate. These requirements are *foundational* to the design of a cap and trade program and must be considered early on in this process. Although both Commissions have shown a preference for leaving adherence to AB 32's specific criteria to CARB, AB 32's requirements directly apply to the electricity sector and therefore must be considered by the Commissions as they develop their recommendations for regulatory design of the electricity sector to CARB.

For example, the Independent Energy Producers Association adeptly summarized a number of AB 32 requirements that should be incorporated into the Commissions' recommendations:

- Minimize costs and maximize benefits for California's economy;
- Improve and modernize California's energy infrastructure;
- Maintain electric system reliability;

- Maximize additional environmental and economic co-benefits for California; and
- Complement the state's efforts to improve air quality.[10]

Natural Resources Defense Council and the Union of Concerned Scientists also requested that the Commissions use the statutory requirements in AB 32 as criteria to evaluate program options.[11] In addition to the parties, a letter submitted by five California Senators[12] also urged the Commissions to adhere to the requirements of AB 32; "AB 32 establishes detailed policy and process requirements that must be met before market-based compliance mechanisms like 'cap and trade' may be adopted." In short, the Commissions must adhere to the statutory mandates outlined in AB 32 in establishing their recommendation for the electricity sector.

D. Programmatic Direct Regulations are Critical to Real GHG Reductions

Direct regulations are California's best path forward. This is especially clear when programmatic direct regulations are contrasted with the endless complexities that arise in an expensive and untested cap and trade proposal. No one disputes that the bulk of emissions reductions can be derived from direct regulations. In fact, many parties agree that direct

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[10] Comments of the Independent Energy Producers Association on Emission Allowance Allocation, Flexible Compliance, and Combined Heat and Power, p. 7.
[11] Comments of the Natural Resources Defense Council and the Union of Concerned Scientists on Allowance Allocation, Flexible Compliance, CHP, Emission Reduction Measures and Modeling Issues, p. 20.
[12] California Chronicle, *Senate Democrats Challenge Administration's AB 32 Regulations*, 3/14/08. This letter was drafted by Senators Perata, Padilla, Steinberg, Kuehl and Kehoe.

regulations offer the most promise for emissions reductions. For example, according to Sacramento Municipal Utility District, non-market mechanisms presently provide the great majority of GHG reductions needed to meet AB 32 goals and that a carbon market is needed only to supplement existing state policies.[13] The Energy Producers and Users Coalition and the Cogeneration Association of California also agree.

> "A focal point of the Commissions' program design should be to incorporate program features that encourage the deployment of valuable and proven GHG reduction tools. Existing programs, such as the renewable portfolio standard and energy efficiency programs will contribute significantly to GHG reduction efforts."[14]

The Northern California Power Agency also supports direct regulation as the path forward: "[T]he primary emphasis in the electricity sector should be on achieving GHG emissions reductions through non-market mechanisms."[15]

Parties' comments revealed widespread agreement that direct regulation has other benefits that meet the requirements of AB 32 such as reducing co-pollutants and address environmental justice concerns. LADWP made this point most clearly:

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[13] Sacramento Municipal Utility District's Comments on Administrative Law Judge's Ruling Requesting Comments on Emission Allowance Allocation, Combined Heat and Power, and Flexible Compliance Policies, p. 6.

[14] Comments of the Energy Producers and Users Coalition and the Cogeneration Association of California on Allowance Allocation, Combined Heat and Power, Modeling and Flexible Compliance, p. 2.

[15] Northern California Power Agency Comments on Assigned Administrative Law Judges' Rulings and Staff Papers Regarding Recommendations to the California Air Resources Board for the Electricity Sector, p. 5.

> The LADWP's approach to reducing emissions through direct investments in renewable energy and energy efficiency is the most direct means of implementing AB 32 reductions and is in harmony with the recommendations of the environmental justice community. In a cap-and trade program, it is not just an outflow of ratepayer dollars away from Los Angeles communities, but it is also the local economic impacts that are imposed on those that can least afford it. Rather than use local ratepayer dollars to buy allowances that ultimately create shareholder profits and job opportunities elsewhere – whether it is through other utilities, sectors, or linkages to other trading programs – Los Angeles' investments must reap long-term local economic LADWP benefits in green jobs, healthier communities, and reliable, low-cost power. Market economists suggest that such redistribution of wealth would be acceptable if society overall achieved emission reductions at the lowest cost. However, no short-term auction allowance price signal will ever be able to place a value on the rippling effect such a drain of resources would have on Los Angeles' local economy.[16]

The statement above highlights the unnecessary wealth transfer and lost opportunities for social improvements that could arise from implementing a cap and trade proposal.

Also, according to the GPI, cap and trade should not replace direct regulation because the modeling thus far demonstrates that emissions credits would have to be traded at very high prices before they will promote innovation. (High prices that will cost some ratepayers dearly).

> "[W]hen E3 announced, during the April 21 – 22, 2008, workshop on allocation and modeling, their finding that it would take an allowance price in the neighborhood of $150 per allowance to elicit a significant market response, our resolve to support the existing programmatic approach (RPS and EE) to greenhouse-gas emissions reductions was strongly reinforced." [17]

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[16] Opening Comments of the Los Angeles Department of Water and Power on Policies Regarding Emission Allowance Allocation, Flexible Compliance, Treatment of Combined Heat & Power, Non-Market-Based Emission Reduction Measures and Emission Caps, and Greenhouse Gas Modeling Results, p. 14.

[17] Comments of the Green Power Institute on Allocation, Modeling, and Flexible Compliance, p. 28.

However, other parties' comments show that direct regulation is not complimentary to a cap and trade proposal – because if cap and trade is implemented, direct regulation should be deemphasized. According to the Division of Ratepayer Advocates (DRA):

> The purpose of a cap-and-trade system is to allow the market to find the lowest-cost reductions. By increasing regulatory mandates, the cap-and-trade program will be responsible for a smaller portion of the reductions, and therefore the overall economic gains from instituting a cap-and-trade program will be limited. Given the design complexity of a cap-and-trade program and the costs of administering and monitoring such a program to prevent market manipulation and to ensure compliance, ARB should not rely too heavily on direct regulations to complement a cap-and-trade program in order to meet the goals of AB 32.[18]

Of course, there are parties seeking to deemphasize the importance of direct regulations, supporting cap and trade instead. According to Southern California Edison, additional energy efficiency or renewable mandates are unnecessary if a broad-based cap-and-trade mechanism is implemented. The "higher market price for electricity will provide greater incentives for EE and renewable energy development."[19] The Solar Alliance argued that cap and trade could undermine the voluntary market: "Cap and Trade design under AB32 could jeopardize existing voluntary renewable and carbon markets, and should not restrict future growth of this market. Instead, cap and trade design under AB 32 should build on current popular momentum to maximize

[18] Corrected Comments of the Division of Ratepayer Advocates on Electricity Sector Responsibility, Allowance Allocation, Flexible Compliance Mechanisms, and Modeling, p. 4.
[19] Comments of Southern California Edison Company (U-338-E) on Administrative Law Judges' Ruling Updating Proceeding and Requesting Comments on Emission Allowance Policies and Other Issues, p. 40.

market-driven GHG reduction opportunities in compliance and non-compliance economic sectors."[20] However, cap and trade is a giant gamble, equivalent to trading something that we know will work for something completely unproven.

There is a valid question as to whether cap and trade and direct regulation are complimentary, whether these two programs could actually undercut each other, or whether it is wasteful to proceed with both. However, it would be a grave mistake to forego or deemphasize our tried and true direct regulation for an unproven cap and trade program.

E. Only Obligated Entities Should Be Allowed To Trade

If a cap and trade program is implemented, it is imperative that the Commissions recommend that only entities with compliance obligations be allowed to participate. Hedge funds and speculators are already heavily engaged in auctions for firm transmission rights in California. For example, according to the California Municipal Utilities Association, the ISO auction for transmission rights "resulted in a large part of the auctioned rights going to hedge funds and not to retail providers."[21] There are a number of other reasons why it is a bad idea for hedge funds and other non-obligated entities to be able to obtain emissions credits in the carbon trading context, the most important being market distortion.

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[20] Comments of the Solar Alliance on Allowance Allocation Methodologies and Other Matters, p. 4.

[21] Opening Comments of the California Municipal Utilities Association on Recommended Greenhouse Gas Emission Reduction Policies, p. 3.

Today people worldwide are bearing the burdens of highly inflated prices for critical commodities such as oil and food in part because speculators and hedge funds have artificially increased their prices, resulting in tragic consequences for communities on all continents. Earlier this month, the Senate held hearings on the skyrocketing increases in gas prices and found that investors have had a big impact on the escalating prices. Testimony of consumer advocates before a Senate panel described a speculative bubble in energy commodities that has cost households, on average, about $1,500 over the past two years in increased costs for gasoline and natural gas.[22] Two of the key factors that led to this increase are a commodity that is vulnerable to abuse and a new market that is under-regulated. This cannot occur in California's electricity market.

Some parties argue that non-obligated entities should be allowed to participate in the market in order to ensure market liquidity. For instance, Morgan Stanley strongly opposed any limitation of participation of non-obligated entities on the basis that "[m]aximizing the number and type of market participants also maximizes the liquidity and price stability of the market."[23] We disagree. Allowing non-obligated entities to participate can actually reduce liquidity in the event that entities engage in hoarding of

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[22] Testimony of Dr. Mark Cooper on Energy Market Manipulation and Federal Enforcement Regimes before the Senate Committee on Commerce, Science And Transportation, June 3, 2008.

[23] Comments of Morgan Stanley Capital Group Inc. on General Issues, Flexible Compliance Policies and Non-Market-Based Emission Reduction Measures (Other than CHP) and Emission Caps, p. 5.

emissions credits. This could create a false scarcity that would drive up the price of credits with ratepayers paying the premium on their electricity bills.

Morgan Stanley also argued that even if the Commissions wanted to recommend that non-obligated entities not be allowed to participate, they do not have the ability to stop it.

> "It should be recognized that any attempts to prevent entities without compliance obligations from participating are unlikely to succeed. Such excluded entities could simply contract with an eligible participant to undertake trades at the direction of that excluded entity."[24]

This is incorrect. The Commissions hold the authority to make it illegal for non-obligated entities to own emissions credits, and they can require that all credit owners register with CARB. The Commissions must adopt this approach. California's electricity sector is not a liquid market, and trying to make it so will render it vulnerable to distortions with potentially dire consequences.

F. Any Cap and Trade System Must be California-Centric

If cap and trade is going to succeed anywhere, it needs to not only reduce GHG emissions but it also needs to create and maintain a robust economy. If implemented innovatively, AB 32 could very well mean a new way of life for Californians that will transform everything from the way Californians live and work to how resources are allocated. The state's first priority should be creating a system that is sustainable, that creates good jobs and bolsters Californian's economy so that others will want to establish

[24] Id. at p. 5.

their own programs to reap the benefits that we enjoy. For these reasons, the Commissions must focus on creating a robust system of emissions limits, compliance measures, and enforcement mechanisms that will work for California as a whole – and as a secondary consideration – could work for other states and regions.

Contrast these principles with Pacific Gas and Electric's argument that California should focus on the global problem and design its regulatory strategies accordingly:

> "California must avoid designing AB 32 regulations in any way or form that is parochial or overly "California-specific" in addressing the aspects of climate change that are global, not local. In particular, California should avoid regulations that are limited in geographic scope or which "de-position" or "de-link" California from common elements of a regional, national or international greenhouse gas program."[25]

According to PG&E, California should abandon its decision to lead, and instead should choose the lowest common denominator that might be adopted by another jurisdiction at some time in the future. PG&E's argument must be rejected as completely inconsistent with the very purpose of AB 32. If AB 32's purpose were to implement a federal scheme, California would have waited for Congress to act. The California legislature did otherwise.

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[25] Opening Comments of Pacific Gas and Electric Company (U 39 E) on Additional Issues Related to Implementation of AB 32 in the Electric and Natural Gas Sectors, p. 10.

In sum, if California institutes a cap and trade program, it should first and foremost focus on making it robust and sustainable for California before dealing with the endless challenges arising from linking it with other states and nations.

Further, if California implements direct regulations, it would avoid all linkage questions, and could focus on implementing the concrete changes that are so desperately called for.

III. CONCLUSION

In the words of Supreme Court Justice Brandeis, "There are no shortcuts in evolution." Cap and trade is no doubt thought of as a shortcut to creating the most cost effective method of regulating GHG. The shortcut is likely to work much better in theory than in practice. Like the disastrous and unnecessary collapse of California's electricity sector following deregulation, and similar to the frightening rise in world food prices today, California cannot leave its most precious commodities to the vagaries of the marketplace. California must choose more wisely and more carefully this time.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Bonnie Heeley, declare that on June 16, 2008, I served copies of the attached Reply Comments of the Coalition of California Utility Employees and California Unions for Reliable Energy on Greenhouse Gas Emissions Allowance Allocation Methodologies and Other Matters via courier, email or U.S. Mail as follows:

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Executed at South San Francisco, CA on June 16, 2008.

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