

**SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY¹
COMMENT ON
ADMINISTRATIVE ALLOCATION OF ALLOWANCES TO
REGULATED RETAIL ELECTRICITY PROVIDERS**

December 1, 2009

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¹ SCPPA is a joint powers authority. The members are Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Los Angeles Department of Water and Power, Imperial Irrigation District, Pasadena, Riverside, and Vernon. This comment is sponsored by Anaheim, Azusa, Banning, Burbank, Cerritos, Colton, Glendale, Imperial Irrigation District, Pasadena, and Riverside.

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The Southern California Public Power Authority (“SCPPA”) strongly supports the November 23, 2009 joint letter to the Economic and Allocation Advisory Committee from the Modesto Irrigation District, Northern California Power Agency, Pacific Gas and Electric Company, Sacramento Municipal Utility District, Southern California Edison Company, and SCPPA recommending that a portion of allowances be administratively allocated directly to regulated retail electricity providers.

The electric sector is different from other sectors. Under the Air Resources Board (“ARB”) Scoping Plan, the electric sector is destined to bear a disproportionate burden in attaining the Assembly Bill (“AB”) 32 greenhouse gas (“GHG”) emission reduction goals. Unlike some of the other sectors, very little of the electric sector’s emission reductions will be obtained by embedding the cost of carbon in electricity prices. Instead, the electric sector will meet its burden almost entirely through a variety of complementary measures, some of which will be much more costly than buying allowances.

The electric sector is also different from other sectors in that allowances can be administratively allocated to the regulated retail electricity providers within the sector with full assurance that the value of the allowances will be used for the benefit of customers and for attainment of AB 32 GHG emission reduction goals without the revenues becoming windfall profits for shareholders.

Given the unique circumstances of the electric sector, the California Public Utilities Commission (“CPUC”) and California Energy Commission (“CEC”) found that there should be

an administrative allocation of allowances to the electric sector.² SCPPA urges the EAAC to consider and to support the CPUC/CEC's recommendation for an administrative allocation of allowances to the electric sector.

I. THE UNIQUE CIRCUMSTANCES OF THE ELECTRIC SECTOR.

The electric sector is different from other sectors in that it is going to be required to attain a disproportionate share of emission reductions through complementary measures at a large cost, with only a small portion of the emission reductions being obtained through the cap-and-trade program. The electric sector is also different from most other cap-and-trade sectors in that allowances could be allocated to fully regulated retail providers within the sector, negating any concern that allowance value would be turned into profit for shareholders without being used for the benefit of consumers or achieving AB 32 emission reduction goals.

A. The AB 32 Scoping Plan Places a Disproportionate Burden on the Electric Sector.

Energy and Environmental Economics, Inc. ("E3") observed in their October, 2009 Final Report to the CPUC and CEC ("E3 Final Report")³ that in 2004 the electric sector was responsible for approximately *25 percent* of California's greenhouse gas emissions, but the ARB Scoping Plan proposes that *40 percent* of California's 2012-2020 emission reductions will come from regulatory measures ("complementary measures") that will be imposed on the electricity sector apart from the cap-and-trade program. Final Report at 2, 4. The complementary measures include increased energy efficiency, achieving a 33 percent renewable portfolio standard ("RPS") by 2020, increased use of combined heat and power ("CHP"), and 3,000 megawatts of rooftop solar installations. *Ibid.*

² CPUC Decision 08-10-037, CEC Adoption Order 2008-10-16-IV ("D.08-10-037").

³ The E3 Final Report is posted at:
http://www.ethree.com/documents/GHG_10.22.09/CPUC_GHG_Final_Report_28Oct09.pdf

Some of the complementary measures are going to be very expensive. E3 projects that, particularly, achieving the RPS will cost \$148/MtCO₂e, greatly exceeding any realistic projection of cap-and-trade allowance prices. E3 Final Report at 34 (Fig. 5).

Cap-and-trade covered entities in other sectors will benefit from the electric sector's pursuit of expensive complementary measures. The electric sector's investment in the complementary measures will reduce allowance prices. As the EAAC observes in its November 16, 2009 Draft Report ("Draft Report"), if measures that are "higher up on the mitigation cost curve" are undertaken in response to regulatory mandates, "they can actually reduce the equilibrium allowance price, even though they may raise overall cost of the regulatory effort." Draft Report at 23.

Even though other sectors will benefit from having the electric sector undertake the complementary measures, electricity consumers would be required to bear the full burden of the mandated complementary measures if there were no administrative allocation of allowances to the electric sector. The burden would be imposed on consumers in the form of higher electricity rates. For example, E3 projects that the rates of the Los Angeles Department of Water and Power ("LADWP"), the only SCPPA member that was individually modeled by E3, would be nearly 30 percent higher than E3's Reference Case rates by 2020. The Reference Case includes the cost of attaining a 20 percent RPS by 2010. *See* E3 Final Report at 36 (Fig. 24).

E3 emphasizes that the projected 30 percent rate increase for LADWP would be due solely to LADWP undertaking the complementary measures. E3's projected increase in LADWP rates does not include any cost of buying cap-and-trade allowances. If LADWP were required to buy allowances to cover its projected 2020 emissions, there would be a further seven

percent increase in its average rates, assuming that allowances cost \$30 per metric tonne of CO₂. E3 at 73 (Fig. 29).

B. In Comparison to the Complementary Measures, Including the Electric Sector in the Cap-and-Trade Program to Send a Price Signal to Electricity Consumers Will Produce Only a Small Increment of Emissions Reductions.

In comparison to the substantial emissions reductions that will be obtained through the complementary measures, only a small increment of emissions reductions will be attained as a result of including the electric sector in the cap-and-trade program. E3 concludes in its Final Report:

We find that a California-only cap-and-trade system is likely to increase costs in the electricity sector without achieving meaningful additional GHG reductions, beyond the level of complementary policy reductions, unless one of the following, or a combination of the following, conditions occur:

- Carbon prices reach high levels (\$100/tonne CO₂e or more);
- Natural gas prices increase significantly (100% or more from the Reference Case Assumption of \$7.85/MMBtu in 2020, in 2008 dollars);
- Technology innovation reduces the relative cost of low-carbon electricity resources compared to natural gas generation, or technology improves the performance of low-carbon technologies significantly;
- Lower-cost emission reduction opportunities are available from other sectors under the cap-and-trade program (though in this case the GHG reductions would come from those sectors and not the electricity sector. This condition would serve to reduce the cap and trade compliance costs to the electricity sector, but would not reduce emissions from the electricity sector).

E3 Report at 9-10.

Three reasons drive E3's conclusion that including the electric sector in a cap-and-trade program will most likely result in only a small amount of emissions reductions in comparison to the large amount of emission reductions that will result from the complementary measures. First, although electricity generators in California are currently dispatched in economic order on the

basis of their marginal cost, the order in which generators are currently dispatched coincides with how they would be dispatched if the dispatching were done on the basis of emissions intensity. Hydropower, nuclear power, and renewable energy resources are already dispatched first insofar as they have no marginal cost as well as no GHG emissions. Likewise, the gas-fired generators are dispatched in an economic order which parallels their emissions intensity. E3 explains:

In the wholesale electricity market in California, generators bid into the market based on their marginal cost, and are dispatched from lowest to highest bid... [A]s long as California generators are dispatched in economic order, then they are also dispatched in order of their emissions intensity: hydropower, nuclear power and renewable energy have basically no marginal cost, as well as no GHG emissions, and are dispatched first. Gas generators in California are also dispatched in economic order, from the most efficient combined cycle units (CCGTs) first to the least efficient combustion turbines (CTs) last. This dispatch order corresponds with their emissions intensity rank order. The introduction of a CO₂ price increases the variable cost of natural gas generation. However, it does not change the relative costs of different natural gas generators.

E3 Report at 64-65.

Second, while including electricity generation in a cap-and-trade program may result in natural gas-fired generation eventually displacing coal-fired generation, a significant amount of displacement would not start to occur until allowance prices reach a relatively high level, \$50/MtCO₂e. E3 Final Report at 61.

Third, the higher electricity prices that would result from embedding the cost of cap-and-trade allowances in electricity prices would result in minimal incremental emission reductions insofar as the elasticity of demand for electricity is fairly low. E3 explains:

How much might electricity demand fall due to higher electricity prices? This is a question that economists have investigated for many years, using a metric known as the elasticity of electric demand. In general, prior research suggests that in the short run the elasticity of demand for electricity is fairly low, on the order of -0.1 to -0.3, because electricity is usually a necessity rather than a

luxury good. This means that a rate increase of 10% due to the introduction of a CO₂ price on electricity would reduce consumption by 1% to 3% between 2008 and 2020. This level of demand reduction would save about 2 million metric tons of CO₂. In the short-run, we do not believe that reductions in electricity demand, due to higher electricity prices, represent a major source of GHG savings.

E3 Final Report at 68. E3 recognizes that in the long run consumers may respond to electricity prices that are increased by including the cost of cap-and-trade allowances in electricity prices: “In the long-run, consumers can adapt to higher electricity prices by finding ways to reduce their electricity consumption, largely through the adoption of more energy efficient technologies.” However, absent an administrative allocation of allowances to the electricity sector, electricity prices will be driven up much more by embedding the cost of complementary measures in electricity prices than by embedding the cost of cap-and-trade allowances in electricity prices. Compare E3 Final Report at 73 (Fig. 29) to E3 Final Report at 56 (Fig. 24).

C. Allowances Can Be Administratively Allocated to Regulated Retail Electricity Providers With Assurance that the Allocation Will Not Result in Windfall Profits to Shareholders.

In addition to the disproportionate complementary measure burden that will be placed upon the electric sector and the proportionally low amount of emission reductions that will be obtained by including the electric sector in the cap-and-trade program, a third hallmark of the electric sector that differentiates it from most other sectors is that allowances can be administratively allocated to the regulated retail providers in the electricity sector with assurance that the value of the allowances will flow to consumers and otherwise be used for AB 32 emission reduction purposes instead of resulting in windfall profits to shareholders.

In the absence of regulation, an entity that receives administratively allocated allowances could sell the allowances and take the allowance value as profit. However, the public can be assured that this would not happen if allowances were allocated to the regulated retail electricity

providers. The CPUC regulates investor-owned utilities. Local governing boards regulate publicly owned utilities. The CPUC and the local governing boards would assure that the full value of administratively allocated allowances would be used for the benefit of consumers and to attain AB 32 emission reduction goals. As recognized in the Draft Report, the regulated retail providers “can be expected to act as trustees on behalf of consumers with respect to the disposition of free allowances or allowance value they receive.” Draft Report at 36.

There would be no similar assurance if allowances were administratively allocated to unregulated entities in other sectors. At the November 18, 2009 EAAC meeting, a spokesman for BP America, Inc. (“BP”) argued that if there were to be an administrative allocation of allowances to the electric sector, there should also be an allocation of allowances to the transportation sector to offset the impact of the cap-and-trade program. BP ignores the critical point that electric sector retail providers are pervasively regulated, but the transportation sector covered entities like BP are unregulated. If there were an administrative allocation of allowances to the transportation sector, there would be a risk that the value of the allowances would flow to shareholders instead of flowing to consumers or being used to attain AB 32 emission reduction goals.

Given the unique circumstances of the electric sector, SCPPA urges the EAAC to join the CPUC and CEC in supporting an administrative allocation of allowances to regulated retail electricity providers.

II. AN ADMINISTRATIVE ALLOCATION OF ALLOWANCES TO REGULATED ELECTRICITY PROVIDERS COULD BE CONSISTENT WITH AUCTIONING AND SENDING A PRICE SIGNAL.

Various EAAC members have expressed a preference for full auctioning of allowances. Likewise, the EAAC’s November 16, 2009 Draft Report (“Draft Report”) says that “it is crucially important that the program provides strong price signals” to consumers about the cost

of carbon. Draft Report at 37. An administrative allocation of allowances to regulated retail electricity providers could be consistent with both auctioning and sending a price signal about the cost of carbon to consumers.

Even with an administrative allocation of allowances, there could still be auctioning of all allowances. The CPUC and CEC envision allowances being administratively allocated among regulated retail electricity providers with the allowances then being re-aggregated and sold through an auction. Auction proceeds would be returned proportionally to the regulated retail electricity providers that received the administratively allocated allowances:

[All] of the electricity sector allowances that are to be auctioned should be given to the retail providers of electricity, on behalf of their customers. The retail providers should then be required to sell the allowances in a centralized auction undertaken by the ARB or its agent. * * * Each retail provider should receive all auction revenues from the sale of the allowances that were distributed to it. ARB should establish a centralized auction with safeguards to ensure that this result is obtained. If ARB cannot design an auction that is legally separated from other State revenues, we suggest an alternate mechanism be designed.

D.08-10-037 at 15-16. As a result, the cap-and-trade auction would be as robust as it would if no allowances had been administratively allocated to the regulated retail electricity providers.

Similarly, an administrative allocation of allowances could be consistent with sending a price signal to electricity consumers about the cost of carbon. If all or a portion of the value of the administratively allocated allowances were to be returned to consumers, the value could be returned to consumers without affecting the price per kilowatt hour of electricity that is charged to consumers. For example, under HR 2454 (“Waxman-Markey”), “to the extent an electricity local distribution company uses the value of emission allowances distributed under this subsection to provide rebates, it shall, to the maximum extent practicable, provide such rebates

with regard to the fixed portion of ratepayers' bills or as a fixed credit or rebate on electricity bills." HR 2454 §783(b)(5).

The EAAC and the ARB should be cautious, however, about the extent of the price signal that is sent to electricity consumers. A price signal that goes beyond the cost of carbon as revealed through the cap-and-trade auction could be counter-productive and have the unintended consequence of generating a popular backlash. If there were no administrative allocation of allowances to regulated retail electricity providers, electricity consumers would most likely be exposed to experiencing electricity rate increases that are caused by the high cost of complementary measures as well as by embedding the price of allowances in the cost of electricity.

The carbon cost that should be reflected in electricity prices to give a "price signal" to consumers is the cost of cap-and-trade allowances as revealed through an auction. Regulated retail providers should be permitted to use the value of administratively allocated allowances to cover the cost of complementary measures including the potentially expensive renewable energy projects. The cost of the complementary measures should not be part of the price signal that the EAAC advocates sending to consumers.

III. ADMINISTRATIVELY ALLOCATING ALLOWANCES TO REGULATED RETAIL ELECTRICITY PROVIDERS WOULD NOT BE EXPOSED TO THE SAME LEGAL PITFALLS AS USING ALLOWANCE VALUE TO REDUCE MARGINAL INCOME TAX RATES OR TO PROVIDE "DIVIDENDS" TO HOUSEHOLDS.

Some members of the EAAC (notably, Mr. Goulder and Mr. Fisher) advocate full auctioning with allowance value being used primarily to reduce marginal income tax rates. Other members (notably, Mr. Burtraw and Mr. Boyce) urge full auctioning with allowance value being returned as a "dividend" to households. These two favored options are unrealistic to the extent that they are intended to be recommendations for actions that would be undertaken by the

ARB. They ignore the constitutional role of the Legislature in appropriating funds that flow into the California Treasury, and they ignore constraints on the use of funds that are accumulated through a fee rather than a tax. An administrative allocation of allowances to LDCs would not be exposed to the same problems.

A. Full Auctioning Without any Administrative Allocation of Allowances Would Result in Auction Revenues Being Subject to Appropriation by the California Legislature.

If there were full auctioning without any administrative allocation of allowances by the ARB, auction revenues would flow into the California General Fund and be subject to appropriation by the California Legislature, not the ARB. Absent any other provision of law, funds received by a state agency are to be deposited in the General Fund under Government Code sections 16300 and 16301:

16300 The General Fund consists of money received into the Treasury and not required by law to be credited to any other fund.

16301 Except as otherwise provided by law, all money belonging to the State received from any source whatever by any state agency shall be accounted for to the Controller at the close of each month, or more frequently if required by the Controller or the Department of Finance, in such form as he prescribes, and on the order of the Controller be paid into the Treasury and credited to the General Fund, provided that amounts received as partial or full reimbursement for services furnished shall be credited to the applicable appropriation.

Numerous statutes have provided for the proceeds of regulatory fees to be deposited in special accounts and used for designated purposes. One example is Health & Safety Code §38597, which provides that the AB 32 administrative fees are to be deposited into the Air Pollution Control Fund and are to be available upon appropriation by the Legislature for purposes related to the AB 32 program. There is no corresponding provision in AB 32 concerning auction

proceeds. In the absence of such authorization, the cited provisions of the Government Code require that auction proceeds be deposited in the General Fund.

After funds are deposited in the General Fund, any withdrawal requires a legislative appropriation. Article XVI, section 7 of the California Constitution provides: “Money may be drawn from the Treasury only through an appropriation made by law and upon a Controller’s duly drawn warrant.” In addition, Government Code 12440 provides:

The Controller shall draw warrants on the Treasurer for the payment of money directed by law to be paid out of the State Treasury; but a warrant shall not be drawn unless authorized by law, and unless, except for refunds authorized by Section 13144, unexhausted specific appropriations provided by law are available to meet it.

Thus, the ARB would not have authority to distribute the proceeds of an allowance auction without a legislative appropriation or some specific statutory authorization.

B. Using Auction Revenues for Purposes that Are Unrelated to Achieving AB 32 Goals or Without a Fair or Reasonable Relationship to a Payor’s Regulatory Benefits or Burdens Would Be Unlawful.

Using auction revenues for purposes that are unrelated to achieving AB 32 goals or using auction revenues without a fair or reasonable relationship to a payor’s regulatory benefits or burdens would be unlawful.

Article XIII A, section 3 of the California Constitution requires that any new state taxes must be enacted by a two-thirds vote of the Legislature. However, the two-thirds requirement does not apply to regulatory fees that are imposed under the State’s police power. AB 32 was passed by a majority vote rather than a two-thirds vote. Thus, any revenues that the ARB obtains under authority of AB 32 must be construed as being obtained through fees.

The use of revenues that are obtained through a fee rather than a tax is restricted. The leading case is *Sinclair Paint Co. v. State Board of Equalization* (1997) 15 Cal.4th 866, [64

Cal.Rptr.2d 447] (“Sinclair Paint”). *Sinclair Paint* held that the term “taxes” does “not embrace fees charged in connection with regulatory activities which fees do not exceed the reasonable cost of providing services necessary to the activity for which the fee is charged and which are not levied for unrelated revenue purposes.” *Sinclair Paint*, 15 Cal.4th 866, 876. Thus, the *Sinclair Paint* test for whether a measure to obtain revenues is a fee that can be approved by a majority rather than two-thirds vote has two prongs: (1) the purpose must be to support a regulatory or remedial program adopted under the State’s police power, and (2) the amount of the levy must be reasonably related to the cost of operating the governmental program or to the benefits or burdens associated with the regulatory activity.

In judging the purpose of the revenue measure, a crucial factor for the *Sinclair Paint* court was the use of the money collected. The *Sinclair Paint* fee was imposed to fund a program for the mitigation of lead exposure. The Court noted that the State “must use the funds it collects under section 105310 *exclusively* for mitigating the adverse effects of lead poisoning of children, and not for general revenue purposes.” *Sinclair Paint* 15 Cal.4th 866, 880-881.

Applying this element of the *Sinclair Paint* test to a prospective auction of emission allowances, the State might argue that the overall purpose of the fee was regulatory, namely, to “put a price on carbon” to provide an incentive to reduce greenhouse gas emissions. However, if the auction proceeds were used for purposes unrelated to the goals of the AB 32 program such as reducing marginal income tax rates, there would be a strong argument that the effective purpose of the revenue collection was to enhance general revenue.

On the proportionality element, *Sinclair Paint* stated that “to show a fee is a regulatory fee and not a special tax, the government should prove (1) the estimated costs of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are

apportioned, so that charges allocated to a payor bear a fair or reasonable relationship to the payor's burdens or benefits from the regulatory activity." *Sinclair Paint*, 15 Cal.4th 866, 878. The use of auction revenues to reduce marginal tax rates or to provide an equal "dividend" per household would not "bear a fair or reasonable relationship to the payor's burdens or benefits from the regulatory activity."

C. An Administrative Allocation of Allowances to Regulated Retail Electricity Providers Would Avoid the Appropriation and *Sinclair Paint* Problems.

An administrative allocation of allowances to LDCs would avoid the appropriation and *Sinclair Paint* problems that would arise if there were full auctioning with the revenues being used either to reduce marginal income tax rates or to send an equal "dividend" to each household.

First, by administratively allocating allowances to regulated retail providers as proposed by the CPUC and CEC, the ARB would not be attempting to usurp the California Legislature's constitutional role of appropriating funds accumulated in the General Fund. Although the allowances would have value, they would not have been monetized so as to constitute revenue that would have to be deposited in the Treasury for subsequent appropriation by the Legislature. As envisioned by the CPUC and CEC, administratively allocated allowances could be aggregated and auctioned by an agent such as the ARB for the account of the recipients of the allowances. Insofar as the auction of the administratively allocated allowances would be for the accounts of the regulated retail electricity providers that had received the allowances, the revenues would flow back to the retail providers instead of being deposited in the General Fund. As recommended by the CPUC and CEC, if the ARB could not assure such a result, some other qualified agent should be identified to be the auctioneer. D.08-10-037 at 16.

Second, administratively allocating allowances to regulated retail electricity providers would avoid the *Sinclair Paint* restrictions on the use of fee revenue. Insofar as allowances instead of fee revenues would be allocated to the retail providers, *Sinclair Paint* would be inapplicable. Furthermore, even if *Sinclair Paint* were applicable, the ARB as well as the CPUC and local governing boards could require that the allowance value be used for purposes related to AB 32 so as to meet *Sinclair Paint* requirements.

IV. AN ADMINISTRATIVE ALLOCATION OF ALLOWANCES TO REGULATED RETAIL ELECTRICITY PROVIDERS WOULD LEAVE ALLOWANCES TO USE FOR OTHER PURPOSES.

An administrative allocation of allowances to regulated retail electricity providers would leave allowances to be allocated by the ARB for other purposes. The CPUC and CEC recommend the ARB allocate allowances to the electricity sector “based on the sector’s proportion of total historical emissions during the chosen baseline year(s) in the California sectors included in the cap-and-trade program...” D.08-10-037 at 14. In subsequent years, the allocation of allowances would be reduced in proportion to “the overall trajectory chosen by ARB to meet AB 32 goals by 2020.” *Ibid.* The CPUC and CEC contend that allocating allowances to the electricity sector in proportion to total historical emissions would be appropriate because of the disproportionate burden that would be borne by the sector:

While the electricity sector may provide more than its proportional share of GHG emissions reductions through both mandatory programs and market-based reductions occurring due to the cap-and-trade program, the economic costs of the emissions reductions can be shared equally among all capped sectors.²

2. As described in more detail in Section 4.3.2.1 below, it may be appropriate to increase allowance allocations to the electricity sector to reflect increased electricity demand and GHG compliance obligations due to electrification in other sectors, including the transportation sector.

D.08-10-037 at 14.

Administratively allocating allowances to the electricity sector as recommended by the CPUC and CEC would leave the majority of allowances to be used for other purposes as may be determined to be appropriate by the ARB. In the Preliminary Draft Regulation (“PDR”) that was released in November 24, 2009, by the ARB Staff, the Staff suggests that all sectors, including the transportation sector, be included in the cap-and-trade program at the outset in 2012. PDR at 37. This would result in roughly 400 MMTCO₂e of allowances being available for allocation in 2012. Only about a quarter of the allowances would go to the electricity sector if allowances were administratively allocated to the sector on the basis of historical emissions as proposed by the CPUC and CEC. Thus, approximately three-quarters of the allowances would remain to be allocated for other purposes by the ARB.

V. CONCLUSION.

For the reasons discussed above, SCPA urges the EAAC to join the CPUC and CEC in advocating an administrative allocation of allowances to regulated retail providers in the electricity sector.

Respectfully submitted,

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