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California Regulators Recommend In-State Cap-and-Trade System for the Power Sector *Regulation Would Cover Domestic and Out-of-State Suppliers*

On February 8, 2008, Michael R. Peevey, president of the California Public Utilities Commission (“CPUC”), issued an Interim Opinion on Greenhouse Gas Strategies (“Opinion”) as part of a joint effort with the California Energy Commission (“CEC”) to recommend greenhouse gas (“GHG”) emission reduction strategies to the California Air Resources Board (“CARB”). Under AB 32, the Global Warming Solutions Act of 2006, CARB is tasked with developing and implementing a plan to reduce California’s GHG emissions to 1990 levels by 2020. Reduction measures are likely to include regulations and market-based mechanisms.

AB 32 requires CARB to consult with the CPUC, the CEC and other agencies on all elements of the plan as they pertain to energy-related matters, including the electricity sector. In the latest Opinion, the CPUC proposes adopting and forwarding to CARB recommendations for establishing for the power sector a cap-and-trade system that would cover importers providing electricity to the California grid.

The Opinion, the result of a series of workshops, filings by interested parties, and administrative hearings jointly conducted by the CPUC and CEC, covers four mat-

ters: type of regulation, point of regulation, allowance distribution, and GHG policies for the natural gas sector.

→ **Type of Regulation:** The Opinion recommends that CARB adopt a mix of direct mandatory and regulatory requirements — such as energy efficiency and enhanced use of renewable energy — for the electricity and natural gas sectors, and a multisector cap-and-trade program that includes the electricity sector. The Opinion finds that a cap-and-trade system would efficiently produce at a lower cost additional GHG emission reductions beyond the mandatory programs, encourage investment and help manage risk.

→ **Point of Regulation:** The Opinion concludes it is vital that a regulatory program cover electricity imports. It recommends that compliance obligations attach at the “deliverer” stage, *i.e.*, the entity that is responsible for the electricity when it is delivered onto the California electricity grid (except for the few multi-jurisdictional utilities in the State that would be regulated on a retailer basis). The Opinion concludes that the “deliverer” approach: (1) achieves greater environmental integrity than other approaches, such

as only regulating in-state generators or retail providers; (2) is compatible with potential regional and federal market-based systems; (3) allows for accurate and easy reporting, tracking and verification; and (4) works with wholesale and retail energy market reforms.

The Opinion's recommendation on point of regulation is particularly significant for out-of-state generators, retail providers, marketers and other entities that deliver power to the California grid because they would be required to surrender allowances associated with their GHG emissions. Recognizing the potential Constitutional issues associated with this approach, the Opinion attempts to justify the regulations as only regulating activities taking place within California, *i.e.*, the generation or delivery for consumption of electricity, without affecting extraterritorial regulation.

→ **Allowance Allocation:** The Opinion discusses, but does not recommend at this time, how allowances should be allocated in a cap-and-trade system. It does assert, however, that an auction of at least some allowances would promote market liquidity and provide revenues to offset GHG reduction costs. Parties will be given further opportunity to comment on allocation methods.

→ **Natural Gas Sector:** The Opinion does not recommend including the natural gas sector in a cap-and-trade program, largely due to a relative lack of further cost-effective emission reductions or alternative sources. The Opinion does conclude, however, that natural gas providers should be required to deliver energy efficiency to consumers.

The Opinion is open for public comment through February 28, 2008, and

is subject to review and adoption by the CPUC. Reply comments are due five days after opening comments are filed. It is noteworthy that the Opinion references the development of the Western Climate Initiative ("WCI"). There is a possibility that CARB may forgo a statewide cap-and-trade program in favor of the regional cap-and-trade program now under discussion among the seven western states and two Canadian provinces in the WCI.

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