



September 21, 2010

James Goldstene, State of California
Robert Noel de Tilly, Province of Quebec
WCI Co-Chairs

VIA WCI weblink

Dear Mr. Goldstene and Mr. Noel de Tilly,

Puget Sound Energy (PSE) would like to thank the Western Climate Initiative (WCI) Partners for your extensive and dedicated work to design and implement a comprehensive greenhouse gas (GHG) emissions reduction plan which includes a cap-and-trade program. PSE reviewed the document, "Design for the WCI Regional Program", and offers comments below.

PSE, Washington State's oldest and largest energy utility, serves more than 1 million electric customers and nearly 750,000 natural gas customers in 11 counties. The company plans to meet our customers' future energy needs through incremental, cost-effective energy efficiency, procurement of sustainable energy resources, and far-sighted investment in the energy-delivery infrastructure.

PSE supports the creation of a comprehensive market-based plan, either by a carbon tax or a cap-and-trade system that will reduce the intensity of GHG emissions around our globe. However, given the worldwide creation and impact of GHG emissions, the most appropriate jurisdiction for implementation of a GHG reduction system is through the Federal government. Energy market activities and physical operations are cross-jurisdictional and highly interconnected (particularly across North America), and regulatory developments in one state or local jurisdiction can influence and impact markets and activities in other jurisdictions, positively and negatively. Additionally, financial practices and the economy are highly globalized; regulations in one area can have quick and significant effects to businesses and individuals countries apart. Technology, improved travel options, and increased communication opportunities make it easier every year to shift business practices and production from one location to another. Consequently, a limited regional or disjointed state-by-state cap-and-trade system has significant potential to cause leakage of energy production and emissions and the externalization of costs to the detriment of neighboring jurisdictions, thereby undermining the objectives and success of the program as a whole. A national plan, consistent and coordinated across all jurisdictions, lessens the likelihood of the shifting of costs, opportunities and environmental impacts and therefore, decreases the possibility of unexpected negative impacts.

The design of a cap-and-trade system is critical to the success of an overall GHG emission reductions system. While we applaud the WCI on its efforts, we continue to have concerns about the design of the program. PSE believes there are four general principles that must be implemented to create and implement efficient and cost-effective cap-and-trade system:

- (i) it should be simple, transparent, and provide cost certainty;
- (ii) it should include the entire economy;
- (iii) it should use revenues to encourage the development of near and long-term advancements in technologies that will reduce greenhouse gas emissions; and
- (iv) it should provide an upper and lower limit on price (safety valve or price collar) to ensure a smooth economic transition and help reduce cost impacts to consumers particularly the low-income.

Our comments below are guided by these four basic principles.

Program Coverage

WCI's plan attempts to create a system that relies on multiple State and Provincial regulations however this disjointed application will lead to confusion, jurisdictional differences, gaps, and inequitable treatment. As an example, the current design program would allow fundamental issues such as cap percentages to be implemented at different levels in each of the various jurisdictions. Minor changes to program definitions could also have significant impacts and duplicative or inconsistent reporting requirements could create a substantial regulatory burden. Inconsistencies between the cap-and-trade programs (or an absence of such a program) in Partner and Observer jurisdictions would exacerbate the possibility of leakage (increased emissions in non- or less regulated areas) and create economic disadvantages and higher costs for entities and ratepayers in jurisdictions where caps are established at higher levels than others.

The lack of a uniform system could also affect existing and developing energy markets, as well as, the development of new generating facilities and the operation of existing facilities. For example, PSE is engaged in marketing, generation and load service activities in the Western Energy Coordinating Council (WECC). Several jurisdictions in the WECC are not WCI Partner jurisdictions. Energy markets in the WECC are highly interdependent and differing allowance and emissions pricing could have a negative impact on market pricing, operations and transparency.

Another area of potential inconsistency in the plan is the newly added section on "Voluntary renewable energy set-aside allocation". Each Partner jurisdiction may choose to maintain a set-aside allowance allocation or choose not to have one. The creation of a separate allocation pool, will affect the base budget of the jurisdictions allowance pool, and thereby reduce the allowance pool available for general distribution. These types of discretionary Partner set asides could impact allowance costs and foster inequitable treatment among compliance entities.

Compliance Instruments

PSE supports the WCI in its continued inclusion of offsets as a compliance instrument. We support the clear WCI definition of an offset as a removal or reduction of one metric ton of CO₂e. This language is consistent with currently accepted standards across the globe and therefore, should facilitate a fungible market across different jurisdictions.

WCI design decisions that emphasize offsets criteria including real, verifiable, additional, permanent, and voluntary, are essential to successful system. Certainty of offset quality and reliability will set the stage for a robust market that provides compliance entities another tool to decrease their cost of compliance and reduces CO₂ emissions.

PSE agrees with the general criteria for early reduction allowances matching those of offsets to ensure quality reductions. However, we have concerns about the specific criteria WCI has chosen to add to the design document with respect to early reductions. Those entities who made voluntary investments early to reduce their emissions may find it difficult to qualify under the detailed specifications as they were not in place at the time of reduction.

Distribution of Allowances

PSE continues to oppose the use of the First Jurisdictional Deliverer (FJD) model for addressing emissions associated with the production and delivery of electricity. PSE advocates for a generator based compliance model for any cap-and-trade system. As we have previously commented, the FJD model will be difficult to implement in the WECC for several reasons.

Marketing activities in the WECC are centered on several “hubs” at which energy is transacted (dropped off, picked up, booked out, etc) more often than not with little to no indication as to the originating generation source for the energy or capacity being transacted. The FJD approach is entirely contrary to the “hub” approach. Application of the FJD approach in the WECC would cause significant operational difficulties and would either have a substantial negative impact on the ability of the entities in the WECC to conduct necessary real time, short-term, and longer-term transactions or in the ability of market participants to comply with WCI reporting, tracking and other requirements.

Considering the way in which energy is traded and subsequently scheduled in the WECC there is rarely any indication of the upstream source of generation and little to no means to track MWs to a specific generator after-the-fact.¹ This makes it impossible to identify generator specific information associated with a transaction, including emissions content, both at the time of the transaction and after-the-fact. Therefore, energy is bought and sold without knowledge of the emissions content. Introducing a carbon

¹ Several Investor Owned Utilities (IOUs) in the Northwest, including PSE, make sales on a slice of system basis rather than a unit-by-unit basis due to the physical operations on their systems and the inability to track individual MWs from generator to delivery.

content/emissions component to transaction reporting and tracking would likely cause significant disruption to market activities and physical operations in the WECC, including a possible increase in costs and inefficient transmission use and congestion as entities might attempt to develop and trade products with specific emission attributes.

It is possible that in response to the FJD model, entities may try to shift the market towards unit-specific or unit-contingent products (which are less firm than existing firm power sales). This would create a significant reliability concerns for the WECC region, including transmission congestion and resource adequacy issues. For example, numerous entities in the Northwest meet their operational adequacy and reliability requirements through their participation in the Northwest Power Pool (NWPP), which operates in a Reserve Sharing Program. Several NWPP participants conduct operations (including generating and marketing activities) in jurisdictions that are not participating in WCI. By coordinating with adjacent utilities and allowing for entities to call on a pool of “generic” energy and capacity, NWPP participants are able to individually carry fewer reserves while better ensuring reliability. Moving to unit-specific or unit-contingent power contracts will undermine existing markets as well as this reserve sharing methodology and therefore require utilities to carry unsustainably high reserve levels. That will lead to a decrease in reliability as well as additional costs for utility customers.

WCI has attempted to accommodate an alternative to FJD by suggesting the “less preferred” option of an Administrative Approach to import emissions. The Administrative Approach is a woefully inadequate alternative and does not address the fundamental problems with attempting to implement FJD in the WECC. Nor does the Administrative Approach address how WCI Partner jurisdictions will “monitor and track emissions from imported energy” that originates outside of their jurisdictional reach – required reporting of fuel sources for sales that source in your jurisdiction is in no way comparable to requiring reporting and tracking of sources that sink in your jurisdiction, particularly in light of how markets in the WECC operate. The Administrative Approach would also have a significant negative impact on energy markets by creating false or distorted price signals and implementation of import thresholds as a condition to applying the Administrative Approach would create an unnecessary barrier to importing power – negatively impacting market liquidity and system reliability and increasing costs to utility customers.

Early Action Credits

The fuel switching provisions for early actions will not incentivize the types of activities that would result in a net reduction in emissions. For example, PSE has been encouraging the direct use of natural gas for its efficiency, environmental benefits, and cost payback. From a GHG emissions perspective, the direct use of natural gas results in a net emissions reduction (discussed in more detail below). The direct use natural gas is most commonly consumed for space heating, water heating, cooking and clothes drying. Commercial and residential sectors both use natural gas for similar applications, and space heating is by far the largest application use for natural gas in both sectors.

The reason overall emissions are less from direct use of natural gas is because the total delivery efficiency of natural gas, from the point of extraction to use in an appliance, is

close to 90%. The total delivery efficiency for comparable units powered by electricity range from approximately 25% to 50%, so by comparison it is clear that appliances that run on natural gas are much more efficient than their electric counterparts. Our analysis has shown that this gain in efficiency translates to a net reduction in emissions. Lowered electricity demand has a direct impact on the dispatch of generating units used to meet demand. Generally speaking, efficiency gains at homes and in businesses means less dispatch of the region's marginal generation unit. In the WECC that unit represents a combined-cycle combustion turbine. States in the WCI are in the WECC boundaries, so direct use conversions in any of those States can use the same marginal resource benchmark to measure avoided emissions. In other parts of the country, coal marginal represents the marginal resource, meaning avoided emissions have an even greater potential, which is why we believe a direct use conversion policy should be a national endeavor. As a recommendation to the WCI Design, we would encourage a provision that allows for credits to projects that result in a fuel switch conversion from inefficient electricity to the efficient direct use of natural gas.

Auction Format

The ultimate auction format selected is an important component of the overall success of the cap-and-trade system. From our perspective, the critical consideration in determining the auction system is which format will most effectively balance the goals of the program with minimizing the resulting financial impacts to consumers. PSE supports the general design provided by WCI of a sealed bid, single round, and uniform price. The quarterly format will allow opportunity for entities with compliance obligations the flexibility to assess and manage their position in the most cost-effective manner. The selection of this auction format will also facilitate linkage to other trading programs in the future, such as the Regional Greenhouse Gas Initiative.

While we support the inclusion of a reserve price, PSE would prefer a well designed price collar as opposed to the use of a strategic set-aside (of allowances) and the forfeiture of those allowances in instances where they are not utilized (Section 3b). A well designed price collar would do a better job of ensuring against price volatility than a one-sided supply mechanism like a set-aside pool. Moreover, a price collar affects the expectation of future emissions levels and allowance prices and thereby the expectations about the payoff from various investment or reduction strategies. With long lead times for the development of new electric generation resources, the electricity sector will be better positioned to invest in non-emitting technologies if there is certainty around the upper and lower bounds on the price of carbon.

Price Collar

PSE has serious concerns about the continued lack of a clear cost containment mechanism. While the document addresses the possibility of managing compliance costs in a number of ways, it still lacks any significant and sure plan to address unacceptable price fluctuations. A price collar or another specific mechanism to create certainty in price fluctuation will avoid a disproportionately negative effect on consumers. While we support the WCI's overall GHG emissions reduction goal, we fear the short

term cost to consumers of marginal GHG abatement could be excessive without a cost containment mechanism.

An additional benefit of a cost containment mechanism would provide utilities critical information for economic planning. Because utilities are highly regulated, power generation and planning process requires economic knowledge of the technologies we select and the markets they dispatch to.

Program Administration

PSE supports the creation of an administrative body to assist in uniform compliance of the WCI cap-and-trade program. As previously stated we have serious concerns about the lack of a singular, uniform system due to the absence of an appropriate jurisdictional body. Therefore, it is critical that if implemented, the plan design be applied as uniformly as possible, this administrative body could be a critical step in the process.

The specifics of the program administration are helpful in understanding the overall intent of the program; however, it may request unnecessary information. For instance the price for transfer of each compliance instrument seems overly detailed. It is important to remember the cost of administering the program should not become so burdensome to emitters and consumers that it outweighs the benefits of the program.

Reporting accuracy will be an important component of a successful program. However, WCI must take into account the current regulation imposed by both the United States Environmental Protection Agency and individual state requirements. With the release of the EPA Mandatory Reporting Rule (MRR), PSE believes an adequate reporting platform has been established. The electric sector accounts for roughly 40% of all GHG emissions in the United States. EPA estimates their reporting requirements will capture 85-90% of all US emissions in its proposed rule. It is anticipated that the electric sector will be able to report nearly 100% of its emissions under the current EPA proposal, so nearly one-half of the emissions that will be reported to the EPA will come from the electric and gas industries. For this reason, PSE wants to be certain that any data that is collected by a regulatory agency is accurate and consistent nationwide, particularly because this data will likely be used to inform future policy decisions at the national level.

We understand the WCI would like to harmonize its reporting proposal with the standard that has been put in to law by the EPA. The WCI has gone so far as to propose to EPA that it change its' rule to align with the proposals being made by WCI as revealed in the Reporting Committee's May 28, 2010 report. For the purposes of consistency and simplicity in reporting, we recommend the WCI adopt the EPA regulation as it stands. WCI does not have the legal authority to dictate to EPA how it should implement and enforce a final rule, and PSE believes that GHG reporting methods developed by EPA will produce results that are accurate and consistent throughout our sector.

Conclusion

PSE appreciates the opportunity to comment on the document "Design for the WCI Regional Program". Should you have any questions on our comments, please feel free to contact me at 425-462-3170 or Keith Faretra, PSE Senior Resource Scientist, at 425-456-2561.

Sincerely,

A handwritten signature in black ink, appearing to read "Will Einstein". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Will Einstein
Manager, Emerging Technologies & Climate Change

CC: Keith Phillips, WA Office of Financial Management
Janice Adair, WA Department of Ecology
Tony Usibelli, WA Department of Commerce