

Carbon Allocation Task Force Subcommittee Meeting

July 6, 2006

Two World Trade Center, River Room
121 SW Salmon, Portland, OR

Attendees: Mike Burnett, acting chair; Jim Edelson, Tom O'Connor,
Kyle Davis, Wayne Lei, Jim Lobdell, Michael Early,
Jeremiah Baumann, Lisa Adatto, Stacey Davis (by phone)
Staff: Phil Carver and Sam Sadler
Technical Advisor: Hal Nelson

Trading. Kyle Davis stated that trading is an attractive compliance mechanism. He said one could look at bi-lateral contracts or trading desks. He also noted that trading interacts with the auction mechanism, which creates a market. With 100 percent auction, there would need to be trading, but with minimal auction, there would be a question of how robust the market could be. He is supportive of an auction because it provides flexibility. However, if others than Oregon LSEs were allowed into the auction, it would decrease liquidity and increase costs. While he is supportive of trading, specifics of how it would work are still open for discussion.

He noted that he would like to see any auction funds recycled back to the LSEs as they are in the SO₂ trading scheme. He would be less supportive of an auction if the LSEs didn't receive the revenues back in some manner.

Jim Edelson recommended that while the state should not create a market that can be distorted, it should look into working with other markets.

Phil Carver stated that the purpose of trading is to provide flexibility, not to create a market per se. He also noted that the group still needs to consider how trading and auctions would affect self-generators and EESs.

Carver suggested that Oregon not allow non-LSEs to buy allowances through the auction. However, he recommended that the state might allow a designated entity to purchase allowances for resale to individuals who wished to retire them. LSEs could offer the same option to their customers. Jim Lobdell said the latter approach could be similar to the renewable energy programs that IOUs offer their customers. Mike Burnett endorsed the idea of LSEs voluntarily making allowances available for retirement. Edelson suggested this would be a way for the public to pay for retirement of coal plants.

KDavis suggested that if LSEs were allocated all the allowances for free, then an LSE should be able to retire allowances on behalf of another party, which would not be a trade per se. KDavis said an LSE might need a prudency review by the PUC before retiring allowances.

KDavis said he would object to creating competition for allowances. Any market for allowances should be limited to those regulated by the rule. He suggested that individuals

could achieve the same ends through purchasing offsets. Carver noted that purchasing RECs could serve the same purpose as offsets.

Hal Nelson stated that one should not assume that outside buyers would simply be hoarding. More parties in the market would add liquidity. It's not really a market with only two large players.

KDavis suggested that if the state auctions allowances to others, it should recycle the funds back to LSEs to lower the impact of the higher costs that will come from competition. He agreed the revenues could be earmarked for energy efficiency and renewable energy. Lobdell concurred that the revenues should be used to reduce carbon emissions. KDavis said there could be different designs of the mechanism to do that; it would not be dollar-for-dollar. He noted the model that the SO₂ auction uses as an example.

Nelson noted that it is misleading to say that costs would increase if there were an auction. Costs of compliance for an LSE would remain the same because they reflect the mitigation costs. He suggested that recycling should be limited to the entity with the highest cost of compliance. An entity with a large amount of grandfathered allowances shouldn't benefit just because it receive a large allocation of free allowances at the beginning.

Burnett suggested that the recycled payment should be used as an incentive payment. He also suggested that an entity such as the Energy Trust of Oregon might be an eligible recipient of recycled revenues, but KDavis objected to that idea. Sadler noted that if funds went back to LSEs, it would simply reduce their cost of compliance in the next period. Carver noted that this was still an unresolved issue for alternative compliance payment revenues as well.

Edelson raised a question of whether the state could limit the auction participants. Carver thought it could.

KDavis asked staff to come back with some proposed mechanisms for how revenues from an auction could be handled.

Tom O'Connor asked what the advantage was for a COU in an auction. He asked how a very small utility could participate in a market. He does not like the auction concept and is concerned how small players would fare in a market dominated by two large players.

Wayne Lei and Carver said it gave COUs a simple way to comply with the cap. Nelson noted that small COUs could participate in a purchasing pool.

KDavis stated that there is a problem of judging allowances from other systems if they are allowed into the Oregon system. Likewise, if California LSEs could buy Oregon allowances for compliance there, they could overwhelm Oregon LSEs. He suggested not

allowing trading outside the Oregon system. The legislature could revisit the issue later. Carver suggested the issue could be left to rulemaking.

Offsets. Stacey Davis joined the meeting via conference call. The starting point for the discussion was her May 25, 2006, memo to the CATF with her straw proposal on offset design.

SDavis noted that she had recommended allowing offsets that are real and additional, but with limits on the total number to 25 percent of the reduction from the baseline for the compliance period. She noted that it was a conservative proposal, based on the comments she received while preparing it.

KDavis supported offsets as a cost-mitigation measure. He said the percentage allowed should vary by the type of offset. He would support allowing a higher percentage as the cap declined.

Edelson said using offsets in effect borrows from other sectors that will be capped later. Using offsets doesn't reduce total emissions and doesn't reduce emissions from the electricity sector. Jeremiah Baumann agreed that if there are cost-effective measures to reduce emissions from the electricity sector, those should be done before allowing offsets. If you use low-cost measures from other sectors as offsets now, that will hurt them later.

KDavis said that the full CATF would have to decide on offsets. How many would be allowed is a policy decision.

Sam Sadler noted that offsets may be a cheap, one-time way to meet the cap, but they don't reduce emissions from the LSE, so they don't help with its longer-term compliance as the cap declines.

Nelson said one should look at offsets from a system risk perspective. The more offsets an LSE uses, the less diversified its portfolio; also, it hasn't reduced its emissions. It makes sense to get ahead of the curve by adding renewables now rather than delaying reductions through offsets. SDavis concurred that LSEs would be more likely to make long-term commitments to renewables if they didn't rely on offsets.

Burnett said that offsets allow time for emerging technologies to develop, to act as a bridge to IGCC with sequestration, as an example. Baumann said conservation and renewables fulfill the same role; and, making it easier to get coal into the grid is not a benefit. Burnett replied that offsets are a prudent approach to allow new renewable technologies to develop. O'Connor asked if there were a scientific reason to get offsets quicker than other reductions. Sadler said that science says we need all reductions, so none is in excess, i.e. an offset.

Burnett noted that Angus Duncan had suggested starting out with a higher percentage of offsets and that the percentage could decline over time.

Carver said there are significant amounts of cost-effective conservation and renewables that should be achieved before going to offsets. He also brought up the issue that we shall have to deal with fuel-switching as it interacts with offset policy.

Michael Early said that whatever is allowed as an offset, there would have to be evaluation criteria to certify them. He suggested not getting into much detail about offsets for now. He added that he doesn't believe load growth can be met with conservation and renewables.

O'Connor suggested that the subcommittee would not be able to pick a limit on offsets now, especially without a decision on auctions. Leave it to the full CATF.

In discussing limits on the location of offsets, Baumann suggested that we should get a head start in Oregon by limiting them to the state. Early recommended looking anywhere the power comes from. Burnett recommended limiting 50 percent of the offsets to Oregon, even though that could mean a higher price and lower quality. KD disagreed that the subcommittee should recommend a specific percentage.

Carver suggested that any RECs only come from the WREGIS system. Burnett stated that any tags should meet an additionality test. Carver replied that additionality is somewhat accounted for by vintage.

KDavis reported that testimony before the US Senate had recommended going for offsets from sectors that would be hard to regulate. He said there was an interest in offsets from direct emissions and from groups such as transportation, where they are harder to get.

KDavis also said that direct emitters would need to understand that they would be selling off their "low-hanging fruit," which could later raise their cost of compliance when they come under a cap. Early said that it is uncertain which other sectors would be regulated and there needs to be a way to mitigate costs of those who are first regulated.

On the subject of timeliness of use of offsets, SDavis reviewed her proposal about how long an offset project could provide offsets before it had to be recertified. She said her proposal is to protect the buyer.

KDavis said that any limit on the offset stream would limit investments in long-term projects. He said risk is captured in the price.

Burnett said developers would need clarity eligibility before they develop offsets. The state should take some risk with offsets, but with a rigorous discounting of baselines.

KDavis said he would want pre-approval of an offset from the state, including the PUC, before he bought it. He was comfortable with a prescribed review at some time by a regulatory agency, but did not want to specify that time now. Baumann supported having a maximum life of an offset in legislation, but with specifics to be set by rule. SDavis

clarified that a specific ton of offset would not expire once it was certified. The expiration was on the lifetime of the project or standard that created the offsets.

Burnett suggested that LSEs could pay someone to set up offset projects, as in a carbon mutual fund. KDavis suggested that project developers and bankers could set up a pool of offsets. Lei said anyone generating offsets would need pre-approval.

Carver suggested that carbon sequestration in soils and forest preservation not be eligible as offsets. He noted the scientific uncertainty about carbon storage in soils and the M&V and leakage issues with forest preservation. Burnett noted the political pressure to include forestry and agriculture in offset programs. KDavis agreed that it would be difficult politically to exclude certain types of offsets, even if would be difficult for some types to meet certification criteria. Lei agreed with not excluding agriculture and forestry. Baumann wanted to exclude any sector that could not clearly show it reduced or sequestered emissions, but he was willing to allow rulemaking to better define what qualifies. Early suggested that excluding sectors would lead to a political fight that might not be worth it.

On the issue of permanence, KDavis suggested that at some point biological sequestration should be considered permanent. Lei said that 100 years is the average life of CO₂ in the atmosphere. Carver replied that carbon absorption is a function of the concentration of carbon in the atmosphere, and as it builds, it may not recycle as quickly. Sadler said that biological sequestration could never be considered permanent compared to not emitting fossil carbon into the atmosphere.

Baumann agreed with SDavis' proposal that sequestration projects should be re-evaluated periodically to ensure that they are still in place. Sadler noted that continual re-evaluation raises the specter that sequestration offsets may not be a cheap alternative over time.

On additionality, Carver suggested that is an issue for rulemaking. Baumann recommended that there be standards in legislation.

Burnett stated that there was no agreement on having the state incentives test that SDavis recommended or on allowing offsets from the top 20th percentile as a performance standard.

Interaction with an RPS. Carver noted that dual use is a large issue. He also noted the likelihood of LSEs buying bundled RECs then selling the power unbundled. He said that accounting for renewables, the use of alternative compliance payments, the percentage of unbundled RECs allowed (equivalent to offsets), and limiting RECs to the NW region or to WREGIS are all issues that need to be consistent between a cap and an RPS.

KDavis observed that compliance with an RPS using bundled RECs should, for practical purposes, already be taken into account when complying with a load-based carbon cap (e.g., the bundled RECs' zero emissions within the numerator and their megawatts within

the denominator). However, if unbundled RECs are used to comply with an RPS, to ensure consistency and transparency when reporting, unbundled RECs should be accounted for/reported as an offset under the load-based carbon cap. Baumann stated that there should be no dual use for unbundled RECs because of additionality problems. An unbundled REC would either have to be used for an RPS or as an offset under a cap, if it could meet additionality tests for the latter case.