New and Emerging Developments in California's Cap-and-Trade Program Will Have Significant Impacts on Western Power Markets

Kyle Danish and Ilan Gutherz

Summary: The California Air Resources Board (CARB) has proposed important changes to its greenhouse gas cap-and-trade program and finalized major amendments to its greenhouse gas reporting provisions. These amendments and other emerging developments could significantly impact electric utilities and power marketers throughout the Western Interconnection.

This analysis: (1) provides a background on how California's cap-and-trade regulations affect electricity importers, including a summary of key regulatory provisions; (2) describes the new amendments to the regulations and their impacts; and (3) looks ahead to potential future developments.

I. BACKGROUND

When California enacted its landmark A.B. 32 climate legislation in 2006, legislators identified power generation as a major source of greenhouse gas (GHG) emissions. However, the state *imports* 30 percent of its power, and the imported power is, on balance, more carbon-intensive than power generated in the state. This gave rise to concerns that imposing emission limits solely on in-state power generators would drive more imports from higher-emitting out-of-state generators, resulting in greater overall emissions.

To prevent this emissions "leakage," A.B. 32 required the California Air Resources Board (CARB) to limit GHG emissions from power "consumed" in the state, thereby reaching not only in-state generation but also emissions associated with electricity imports.

As CARB has developed and implemented its A.B. 32 cap-and-trade program, the regulation of emissions associated with electricity imports and the prevention of emissions "leakage" has proved to be among the most complicated and controversial aspects of the program. Recent CARB amendments to the regulations and other emerging developments will result in new complexity for importers of electricity into the state.

In addition, 2013 was the first year in which electricity deliveries to California gave rise to allowance surrender obligations. Therefore, any entity that imported power to California starting January 1, 2013 must report the emissions from this imported power and obtain allowances to cover these emissions.

Key Provisions Affecting Importers of Electricity into California

Key elements of the CARB regulatory program affecting electric power entities in Western power markets include the following:

- ***"Electricity importers" must report emissions and surrender GHG allowances.*** All "electricity importers" must report their emissions and surrender GHG allowances under the CARB program. The regulations define "electricity importer" as the "entity identified on the NERC E-Tag as the purchasing-selling entity (PSE) on the last segment of the tag's physical path with the point of receipt located outside the state of California and the point of delivery located inside the state of California." Notably, the California Independent System Operator (CAISO) is never a PSE, which means that an out-of-state entity selling into the CAISO for delivery into California will be deemed the "electricity importer" – even if the seller delivers power at one of the CAISO inter-ties located outside the state, such as Malin or Palo Verde.

- ***The number of allowances to be surrendered depends on whether an import is from a "specified" or "unspecified" generation source.*** Electricity importers are required to surrender GHG allowances to cover the emissions associated with their imports. In order to calculate these emissions, CARB has established two categories: imports from "specified" sources and imports from "unspecified" sources. An import is from a "specified" source if it 1) comes from a generation source owned by the importer or with which the importer has a written procurement contract and 2) meets certain requirements for "direct delivery." CARB has assigned emission factors to all power plants inside and outside California that the agency recognizes as "specified" sources. The CARB regulations also have created a sub-category of "specified" imports involving power purchased from either of two "Asset-Controlling Suppliers": Powerex and the Bonneville Power Administration (BPA). CARB has calculated aggregate emission factors for each of these two systems. Any import that does not meet the "specified source" test is deemed "unspecified." All "unspecified" imports are assigned a default emission factor that corresponds to the emissions from a relatively efficient natural gas combined cycle power plant. As discussed below, the "specified" and "unspecified" categorizations create uncertainty for importers that make system sales.

- ***The regulations prevent "resource shuffling."*** CARB's regulations prohibit "resource shuffling," which the regulations currently define as "any plan, scheme, or artifice to receive credit for emission reductions that have not occurred, involving the delivery of electricity to the California grid." The classic case of "resource shuffling" involves substituting imports from a low-emitting resource for imports from a high-emitting resource while re-directing the higher-emitting power to another state. CARB also published a guidance document listing a set of "safe harbors" to the resource shuffling rule, i.e., various scenarios involving substitutions of low-emitting imports that CARB will consider not to constitute resource shuffling.

II. NEW AMENDMENTS TO THE GREENHOUSE GAS REGULATIONS

At the close of 2013, CARB proposed amendments to both its cap-and-trade regulations and its regulations for reporting emissions (known as the Mandatory Greenhouse Gas Reporting Regulations or MRR). The amendments to the MRR have been finalized and were approved by CARB on December 31, 2013. Amendments to the cap-and-trade regulation are still pending, but are expected to be finalized by the middle of 2014. Several of the approved and proposed amendments could have far-reaching implications for power entities throughout the Western Interconnection. Most changes—including those outlined in the proposed amendments to the cap-and-trade regulation—will go into effect in 2014.

A. Approved Changes That Went Into Effect January 1, 2014

- ***New seller warranty requirement for imports from "specified sources."*** In Western power markets, renewable resources often have a competitive advantage because they do not have associated allowance surrender requirements and may be eligible to help utilities meet California's Renewable Portfolio Standard. Accordingly, owners of such resources have strong interests in ensuring that imports from such sources qualify as "specified." However, as a result of the most recent amendments, importers that own renewables or other low-emitting resources will have to contend with a new "seller warranty" requirement. Under this new requirement, imports can be deemed "specified" only if every seller in the transaction chain has warranted that the power was sold "as specified" from the particular source (as opposed to an unspecified generation resource). Absent such warranties, the import will have to be designated as "unspecified," with the consequence that the importer would have to report the potentially higher "default" emissions factor.

  This regulatory amendment could lead to new contract issues. For example, the Western Systems Power Pool (WSPP) recently approved Appendix C-SS, a document that can be attached to new power contracts and trade confirmations to assure buyers that they are purchasing "specified power" associated with a particular emission factor. The WSPP document also addresses situations in which power sold as "specified power" is later deemed "unspecified," as well as situations in which the emission factor for the specified source changes after the transaction is executed (e.g., in response to an adverse CARB emissions verification report).

- ***System power reporting requirements dropped.*** Many sellers in the West sell electricity from a system, rather than making unit-contingent sales. For many such system sales, E-Tags do not provide information on the particular generation resource that supplied the electricity, resulting in confusion about whether the imports should be deemed "specified" or "unspecified." In the latest round of rulemaking, CARB initially proposed a new "system power" categorization of imports—essentially a weighted-average emission factor for all generation sources within the system's generation portfolio. For many electricity importers selling system power and reporting as "unspecified," this proposed change would have meant an increase in their compliance obligations. In the face of significant criticism, CARB withdrew the proposed "system power" amendments, leaving in place the existing structure, along with its uncertainties. It is possible that CARB will begin more closely scrutinizing "unspecified" claims by systems known to have coal-fired power plants or relatively higher-emitting gas-fired resources.

- ***Changes to accounting for electricity from Asset-Controlling Suppliers.*** Under California's GHG regulations, certain low-emitting systems can qualify for a lower, system-wide emission factor for power delivered from their system if they meet certain threshold requirements. As discussed above, only two entities—BPA and Powerex—have qualified for this so-called "Asset-Controlling Supplier" emission factor. The new amendments change existing requirements to clarify that only contracts that specify that power must be delivered from the assets of the ACS system qualify for the lower emission factor; contracts that merely require an ACS entity to provide power but do not specify the generation source(s) would be treated as higher-emitting "unspecified" power contracts. This amendment could cause entities to renegotiate long-term electricity supply contracts with ACS entities to ensure that electricity from these entities can continue to be assigned the relatively low ACS emission factor.

B. Pending Changes to the Cap-and-Trade Regulation

- ***New resource shuffling "safe harbors."*** As discussed above, the CARB regulations prohibit "resource shuffling," but the agency has outlined several "safe harbors" in regulatory guidance. The recently proposed changes to the cap-and-trade regulations would codify many of these safe harbors. Safe harbors that would be added to the regulation include electricity deliveries that are made to comply with the California Renewable Portfolio Standard (RPS); certain short-term electricity sales; deliveries necessitated by the retirement of a generation source; and deliveries that are required by law, regulation, judicial order, or the needs of the transmission system. CARB has also proposed to remove a controversial "attestation" provision that currently requires electricity importers to annually attest that they have not engaged in resource shuffling activities. However, as currently proposed, the "resource shuffling" prohibition would remain ambiguous and problematic for many entities throughout the Western Interconnection. CARB has yet to attempt to enforce the provision, although the agency has indicated its intent to do so in appropriate cases.

III. POTENTIAL FUTURE DEVELOPMENTS

Possible legal challenges to regulation of electricity importers. The shadow of potential litigation has loomed over the regulations affecting electricity importers since their original promulgation. Lawyers have discussed at least two types of challenges. One possible theory for challenging the regulations would be that the regulations improperly burden interstate commerce, and therefore run afoul of the Dormant Commerce Clause. Another potential claim is that the regulations are pre-empted by the Federal Power Act, which vests in the Federal Energy Regulatory Commission exclusive jurisdiction to regulate wholesale sales of electricity.

Claims that California's Low-Carbon Fuel Standard violated the Commerce Clause and were preempted by federal regulation were recently rejected by the Ninth Circuit (the full opinion is available here: http://cdn.ca9.uscourts.gov/datastore/opinions/2013/09/18/12-15131.pdf); however, a similar lawsuit, if successful, could potentially jeopardize major elements of California's GHG regulations for the electric sector.

To date, no entities have filed such a legal challenge. This could mean that electricity importers have decided to live with the regulations. Alternatively, it could mean that they have been waiting until such a challenge would be unquestionably "ripe." Such a moment could come in November 2014 (when electricity importers are first required to hold in a special account an amount of allowances sufficient to cover their 2013 emissions) or November 2015 (when importers are required to surrender to CARB allowances sufficient to cover their 2013 and 2014 emissions). Another triggering event could be CARB's enforcement of the "resource shuffling" prohibition as it applies to a power transaction that occurs out of the state.

Future regional linkages and additional developments. In October 2013, CARB finalized regulations that will allow California to link its GHG cap-and-trade program with a similar program in Quebec, Canada. Starting January 1, 2014, participants in the two programs can transfer GHG allowances between the jurisdictions and use allowances issued by one jurisdiction for compliance in the other jurisdiction.

In addition, California, Oregon, Washington, and British Columbia recently concluded a regional agreement (the Pacific Coast Action Plan on Climate and Energy) to coordinate their action on climate change and ocean acidification. The plan specifically calls on the states and Canadian province to develop additional state programs to impose a price on GHG emissions and to work toward linking these state- and province-level programs. Although the agreement is not binding, it could eventually lead to a large regional emissions trading market.

Finally, State Senator Fran Pavley (D), who was a principal author of A.B. 32, recently indicated her intention to introduce legislation to extend the California cap-and-trade program beyond its current end date of 2020. The impact this legislation could have on electricity importers and electricity generators is still uncertain.

Will EPA's section 111(d) regulations change the California calculus? In 2014, EPA is expected to propose regulations under section 111(d) of the Clean Air Act. These regulations will require each state to limit CO_2 emissions from its fossil-fueled electric generating units. State regulatory plans will be subject to EPA review and approval. For California, the section 111(d) rulemaking raises a number of legal and policy design questions. For example, it is possible that EPA's rulemaking could require California to modify its cap-and-trade program in order to satisfy the EPA requirements. In addition, an important question for electricity importers is whether California could continue to justify regulating imports of electricity from out-of-state generators if all of its neighboring states have imposed section 111(d) CO_2 emission limits on their power plants.

CONCLUSION

New and emerging developments in California's cap-and-trade regulations could have far-reaching impacts on Western power markets, including new compliance obligations, contractual arrangements (and disputes), and litigation. Entities importing electricity into California will need to understand and analyze these developments and to continue to monitor developments at both the state agency and federal level.

###

Van Ness Feldman has an active practice advising power sector entities, offset project developers, and others affected by the California cap-and-trade program. In 2012, Environmental Finance magazine named Van Ness Feldman partner Kyle Danish one of 10 "California Carbon Market Movers." For more information on the firm's work in this area, please contact Kyle Danish, Malcolm McLellan, Doug Smith, Ilan Gutherz, or Avi Zevin in Washington, D.C. at (202) 298-1800 or in Seattle, WA at (206) 623-9372.