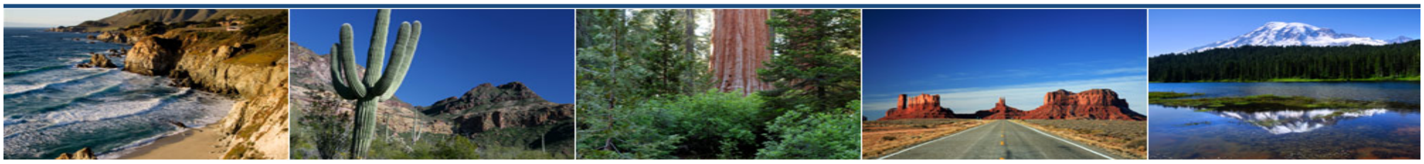
Western Climate Initiative



Western Climate Initiative

Draft Design Recommendations on Elements of the Cap-and-Trade Program

May 16, 2008

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Introduction

The Western Climate Initiative (WCI) began in February 2007 when the Governors of Arizona, California, New Mexico, Oregon, and Washington agreed to:

- join The Climate Registry;
- develop a regional greenhouse gas reduction goal consistent with their state goals; and
- design a multi-sector market-based mechanism by August 2008 to help meet the greenhouse gas reduction goal.

The five Governors invited other states, provinces and tribes to join the WCI or to participate as observers. Since the initial signing, the Premiers of British Columbia, Manitoba, and Quebec and the Governors of Montana and Utah have joined the Initiative. The states of Alaska, Colorado, Idaho, Kansas, Nevada and Wyoming participate as observers, as do the provinces of Ontario and Saskatchewan and the Mexican border states of Baja California, Chihuahua, Coahuila, Nuevo Leon, Sonora, and Tamaulipas.

The WCI Partners issued their regional greenhouse gas reduction goal on August 22, 2007 (see: http://www.westernclimateinitiative.org/ewebeditpro/items/O104F13006.pdf). The regional goal is a 15 percent reduction from 2005 levels by 2020. This regional, economy-wide goal is consistent with the state and provincial goals of the WCI Partners and does not replace the Partners' existing goals. The WCI Partners also re-committed to do their share to reduce regional GHG emissions sufficiently over the long term to significantly lower the risk of dangerous threats to the climate. Current science suggests that this will require worldwide reductions in carbon dioxide emissions of 50 percent to 85 percent below current levels by 2050.

On October 29, 2007, the WCI Partners released their Work Plan of WCI activities through August 2008 for public review and comment. Comments on the Work Plan were requested and more than 100 organizations and individuals submitted comments. As directed by the Governors and Premiers, the Work Plan describes the process for developing design recommendations for a proposed cap-and-trade program as one element of the WCI's effort to identify, evaluate, and implement ways to reduce greenhouse gas (GHG) emissions and achieve related co-benefits.

Developing Design Recommendations for a Cap-and-Trade Program – The Process

Five WCI subcommittees (each chaired by one of the Partners) are working toward a cap-and-trade program design that all Partners can embrace and implement. The five subcommittees and their purposes are:

- **Reporting:** Recommend the reporting system needed to support the WCI program.
- **Electricity:** Define the point of regulation for the electricity industry.
- **Scope:** Identify the other sectors and sources to include in the cap-and-trade program in addition to the electricity sector.
- **Allocations:** Specify how to distribute emission allowances.
- **Offsets:** Examine whether and how emission offset projects should be included.

Each subcommittee is comprised of staff from partner and observer jurisdictions, and each has support from various consultants working under contract to WCI. The subcommittees meet regularly by conference call and at times hold face-to-face meetings.

All subcommittees have incorporated stakeholder involvement and feedback to help design the program. The stakeholder process includes three workshops. The first was held in Portland on January 10, 2008 and was attended by more than 300 people with another 200 people participating via Webinar. Before the workshop, each of the five subcommittees released for public review and comment papers describing the major options under consideration. After the workshop, each subcommittee held a conference call to get extra stakeholder input and answer questions.

Information about the WCI is regularly updated on the WCI website. The website is also the portal through which stakeholders and the public can submit comments to the Partners and sign up for the WCI listserv (www.westernclimateinitiative.org).

Outreach during March – August 2008

The WCI outreach activities described below supplement the individual outreach conducted by each of the partner states and provinces.

Activity	Date
Scope of Work for Economic Analysis ▪ See http://www.westernclimateinitiative.org/Economic_Analysis.cfm for stakeholder involvement opportunities .	March 3, 2008
Initial Draft Design Recommendations Released	
▪ Scope and Electricity	March 5
▪ Offsets, Allocations, and Reporting	April 3
▪ Offsets Workshop in Vancouver, BC	March 26
Stakeholder Workshop in Salt Lake City to discuss draft subcommittee recommendations	May 21
Draft Program Design Recommendations for public review and comment	Mid-July
Stakeholder Workshop in San Diego	July 29
WCI Program Design Recommendations released	Early September 2008

As called for in the WCI agreement, the WCI Partners are working diligently toward a set of recommendations for the design of a regional cap-and-trade program. The Partners will complete their work on this first phase of the regional program by the end of August and will release their report in early September. The report will also describe next steps, including the expected timelines and critical paths for states and provinces to implement the program.

Draft Recommendations on Elements of the Cap-and-Trade Program

The draft recommendations that follow were developed collaboratively by the WCI Partners. As WCI continues to refine and assess these draft recommendations, it welcomes stakeholder feedback on all the concepts presented in this document. **Comments on this document should be submitted to the WCI website by June 6.**

The goal is to present the draft recommendations for a preferred, fully-integrated program at the July 29 stakeholder workshop in San Diego. Between now and then work will continue to create a program design that helps achieve GHG reduction goals fairly and effectively.

The WCI Partners stress that as they continue to evaluate the scope and design of the cap-and-trade program, they will carefully examine economic impacts, including the impact on consumers and businesses in each jurisdiction. The WCI will model the economic impacts for all sectors that may be included to ensure that the program is cost-effective and fair to consumers and businesses while also meeting the environmental objective.

Also, WCI recognizes that policies that complement the cap-and-trade program will be needed to motivate investments in improved efficiency and other measures to reduce emissions. The WCI will examine a full set of complementary policies as part of the analyses supporting implementation of the cap-and-trade program.

Finally, it is important to point out that the programs developed through this regional initiative will ultimately be implemented through laws, regulations, and policies at the state and provincial level. A high degree of regional consistency is important for the success of the program, but the WCI Partners are diverse geographically, economically, and demographically, and each state and province has unique factors that it will have to address when implementing this program.

Therefore, the WCI Partners are focused on developing a program that builds on the strength of consistent regional approaches, while at the same time understanding that each Partner must have the flexibility to implement the program in a way that addresses the unique characteristics of their jurisdiction.

Draft Recommendations

The WCI Partner states and provinces are pleased to present these draft recommendations on the regional cap-and-trade program for ongoing review and comment by stakeholders and the public. The recommendations focus on the following:

- Reporting
- Scope
- Electricity
- Allocations
- Offsets
- Regional Organization

Reporting

A robust and credible reporting system will be the backbone of the WCI cap-and-trade program. This system must ensure that emissions are quantified and reported accurately and transparently. This will allow regulators in participating jurisdictions to assess compliance of regulated sources, measure progress against state, provincial and regional targets, and generate public trust in this progress. Also, all market participants will rely on the reporting system to make decisions that will be the basis for transactions. Confidence in the reporting system will be critical to the success of the WCI program.

The WCI is fortunate that several GHG reporting systems exist that can inform the design of and perhaps even underpin the WCI reporting system. The Reporting Subcommittee has assessed many of these systems and anticipates that the WCI reporting system will be as consistent as possible with existing systems.

The WCI Partners unanimously agree that the WCI reporting system should rely heavily on the infrastructure that The Climate Registry (TCR) is designing. TCR is a collaboration between U.S. states, Canadian provinces and Mexican states to establish a common infrastructure for measuring and reporting GHG emissions. TCR's objective is to provide a common set of tools that will support a broad range of state and provincial policies. All of the WCI Partners are members of the Board of Directors of TCR.

Draft Recommendations for Reporting

- Breadth/Scope of Reporting
  The WCI recommends that reporting requirements apply to the capped sectors and to certain non-capped sectors that may be phased in later (will have to determine which sectors - lower thresholds may apply).

- Initiation of Reporting
  The WCI recommends that reporting start before cap-and-trade commences in order to avoid reporting-related delays to the start of the cap-and-trade program.

- Coordination Among Partner Jurisdictions
  The WCI recommends developing essential requirements for a model WCI reporting rule by the end of 2008 and will incorporate consideration for jurisdictions that already have reporting rules adopted or in process.

- Data Management and TCR Interaction
  The WCI recommends sources report either (a) directly to jurisdictions (which would then upload the data to TCR's central repository), or (b) through TCR's program framework (which would then download the data to the necessary jurisdiction(s)).

- Verification
  The WCI recommends establishing essential quality assurance elements for reported data. These elements will be consistent across jurisdictions. Each jurisdiction will have an oversight mechanism to ensure compliance with the reporting requirements. As part of this mechanism, each jurisdiction will establish procedures to ensure that the quality assurance elements are met. This could include requiring third-party verification, rigorous compliance audits or other appropriate approaches.

- Administrative Costs & Fees
  The WCI recognizes that jurisdictions may collect fees from sources that report directly to them and contract with TCR to administer the program. Jurisdictions may also accept data directly from TCR if they choose to do so; entities that report through TCR may have to pay an additional fee if one is required by the jurisdiction(s).

- Mandatory Federal Greenhouse Gas Reporting
  The WCI recommends getting involved in federal GHG reporting program development in the U.S. and Canada to ensure that federal reporting programs are harmonized with the jurisdictions' interests to the greatest extent possible.

Summary of Major Comments Received to Date on Reporting Recommendations

Stakeholders have expressed general agreement with the WCI Design Principles relevant to reporting. Stakeholders want a reporting system that is fair, easy to manage, and not costly for reporters or Partner jurisdictions. Stakeholders generally support a transparent and robust accounting system for consistent and accurate reporting of emissions across sectors and jurisdictions. WCI's efforts to harmonize WCI reporting and future federal greenhouse gas reporting are also supported.

Most stakeholders agree that reporting should not be limited to sectors and sources within the cap, but should also include sectors that are likely to be phased in to the market system later. Opinion is divided on whether reporting should extend beyond this scope to sources that are not likely to be in the cap-and-trade system.

Stakeholders overwhelmingly support the idea of beginning reporting before cap-and-trade commences. Many commenters cited the need for WCI to have accurately measured emissions as a basis for allocating allowances.

Commenters generally support development of a single WCI reporting rule, citing the advantages of administrative simplicity and cost effectiveness. Stakeholders are concerned that a lack of consistency would undermine confidence in the use of reported data in a market system. For some commenters, however, continuity with existing jurisdictional reporting systems was a higher priority, and these commenters favored more loosely coordinated rules with common core elements.

Stakeholder opinion remains divided on whether reporting should made directly to The Climate Registry (TCR) or to the Partner jurisdictions for upload to TCR. In part, this disagreement may reflect the different interests of reporters with sources in multiple jurisdictions versus those with sources in only a single jurisdiction. Multi-jurisdictional reporters tend to favor direct reporting to TCR for the simplicity of one-stop reporting, while single-jurisdiction reporters tend to favor combining greenhouse gas emissions reporting with their existing air pollutant reporting directly to the jurisdictions.

Stakeholders also differ on whether third-party verification should be required, either WCI-wide or as an option for individual jurisdictions. Supporters generally see third-party verification as essential to ensuring the accuracy and consistency of data that will be converted to financial credits or liabilities, and point to corporate financial audits as an appropriate analogy. Others see third-party verification as redundant to the jurisdictional compliance and enforcement provisions that will be applicable to reported data. This latter view is held most strongly by electricity generation commenters, who cite their existing requirements for continuous emissions monitoring of carbon dioxide from power plants. Reducing uncertainty over verification costs may help to resolve this issue.

Commenters are divided on whether reporting fees should go directly to TCR or to Partner jurisdictions which would then contract with TCR for its data management services. This issue is related to the question of where the data should be reported, and similar considerations are raised on either side. Some commenters are also concerned that governmental accountability for funds will be lacking or diminished if fees go directly to a non-profit entity.

Design of the reporting system will continue beyond the September 2008 announcement of WCI Program Design. Completion of the essential requirements for GHG reporting rules is scheduled for December 2008. During this period, the Reporting Subcommittee will develop more specific proposals and will seek stakeholder comment. Greater specificity may help to resolve some stakeholder concerns. Comment will be sought on key issues including:

- Emissions quantification methodologies for specific sectors and source types;
- Design of the reporting system, including the user interface and the relationship to TCR's mandatory reporting support function;
- Thresholds for reporting;
- Operational boundaries for reporting;
- Verification and/or other quality assurance requirements; and
- Other details in the essential requirements for Partner GHG emissions reporting rules.

Scope

Scope defines the GHG emissions that are included in the cap-and-trade program, including:

- The sectors that fall under the cap.
- The emissions sources that fall under the cap.
- The greenhouses gases that fall under the cap.
- The point(s) of regulation where the cap would be enforced.

From the scope definition, any entity or facility must be able to tell whether it has a compliance obligation under the cap, and which of its emissions are subject to the obligation. The "point of regulation" is the portion of the scope definition that identifies the entities that have the obligation to surrender GHG emission allowances to cover GHG emissions.

The draft recommendations are based on the WCI's analysis and assessment of the Major Options released in January 2008. The WCI developed and applied evaluation criteria to the major options, taking into account stakeholder comments received in writing and during conference calls.

Draft Recommendations for Scope

- Industrial and Commercial Sources
  The WCI recommends a base program from the start of the cap-and-trade program that includes the electricity sector, large stationary combustion sources, industrial process and waste management emissions, and fossil fuel production and processing. (Please see Electricity section for information on recommended approaches for that sector.) All six GHGs are recommended for inclusion.

  The WCI recommends that high priority be placed on developing GHG reporting protocols for the fossil fuel production and processing sector so that as much of this sector as possible can be included in the cap-and-trade program from the start.

- Transportation Fuels
  Emissions from transportation fuels are the single largest source in the region (about 36 percent of total emissions), and must be addressed through an effective combination of near-term and long-term policies. Most Partners have a strong interest in including transportation fuels in the cap-and-trade program. However, before recommending how best to reduce emissions in this sector, analyses of the economic impacts of various options for including transportation fuels in the program will be examined, including the potential effectiveness of alternative policies for reducing these emissions. Options to be considered include the potential to phase in transportation fuels in a later stage of the program, other fiscal measures to regulate this sector, and special consideration for low-income populations and other communities most adversely impacted by consequent price change in the sector. It is anticipated that a decision on how to address transportation fuels will be informed by economic modeling and additional analysis in the coming months.

- Residential and Commercial Fuel Combustion
  The WCI recommends including residential and commercial fuel combustion in the cap-and-trade program and acknowledges that individual jurisdictions may instead utilize comparable

fiscal measures, such as British Columbia's carbon tax, to regulate these sectors. The WCI is also considering whether to include these emissions within the program beginning with the first or second compliance period. The point of regulation for including the emissions from this fuel use would be at the point where these fuels are distributed, including: local distribution companies for natural gas; an appropriate upstream point for propane (LPG), such as refineries and wholesalers; and fuel oil distribution points (which may vary among partner jurisdictions).

- Thresholds
  The WCI recommends using an emission threshold to define the facilities that would have a regulatory compliance obligation under the cap-and-trade program. The WCI recommends setting the threshold so that at least 90 percent of non-power plant stationary source fuel combustion emissions WCI-wide are covered by the program. Based on an initial review of available data, the WCI believes that a threshold within the range of 10,000 to 25,000 metric tons of CO_2e per year per facility may achieve this objective and to assure consistent coverage of facilities within industries and across jurisdictions. The WCI is continuing to evaluate this threshold range, and is examining whether categories of facilities should be included or excluded from coverage regardless of their annual emissions rate. WCI is still considering whether, and at what level, to apply thresholds to electricity sector entities that have compliance obligations.

- Future Program Expansion
  The WCI recommends that the scope of the cap-and-trade program be capable of expanding over time. Possible factors for bringing in additional sources into the program include:

  - Advancements in monitoring technologies, procedures, and/or protocols which would enable the cost-effective inclusion of additional sources and types of greenhouse gas emissions, or smaller-sized sources within currently covered categories, particularly if mandatory reporting data show these sources to be larger contributors than expected;
  - Sources or sectors whose exclusion from the program leads to emissions leakage or competitiveness issues;
  - Resolution of legal or administrative issues that had precluded the inclusion of a source or sector; and
  - Addition of new jurisdictions to the cap-and-trade program.

  Sources that are considered as viable offset projects at the start of the cap-and-trade program may become part of the program at a future date.

Summary of Major Comments Received to Date on Scope Recommendations

The WCI Scope Subcommittee has received public comment at in-person meetings, on conference calls for stakeholders, and in written form. These public comments responded to the options papers released by the WCI in January 2008 and the draft recommendations released in March 2008.

The WCI received written comments from 38 organizations in response to the major options paper, and from 43 organizations in response to the draft recommendations. Many of these organizations represented multiple entities, including businesses and non-profits. Stakeholders also provided comments at teleconferences on February 12 and March 11, 2008 and at the public workshop in Portland on January 10, 2008. The subcommittee requested and received comments on a large number of topics, including sector coverage, point of regulation, thresholds for inclusion of specific sources, greenhouse gas coverage, phasing of source inclusion, coverage of transportation fuels and residential and commercial natural gas, as well as specific concerns for various industries, sectors and sources.

In general, most comments supported a broad coverage of sources under a cap-and-trade program with a point of regulation as close to the point of emissions as possible. Stakeholders asked the subcommittee to include as many sources as administratively and technically possible in order to increase the availability of low-cost emission reductions and to lower the total cost of the cap-and-trade program. Comments also addressed the following:

- Many comments emphasized the importance of available and correct quantification methods in order to include a source in the program, and of reliable data for the design and operation of the program. These comments focused on a desire to avoid double counting emission reductions and to ensure the integrity of a trading system.
- Comments also reflected a desire for certainty about which sources would be included, especially if the program phased in new sources over time.
- Some comments asked for further analysis of outstanding issues such as the inclusion of transportation fuels and commercial and residential natural gas, and suggested varying approaches for these sources. These issues, particularly the inclusion of transportation fuels, received substantial attention. One-third of the comments received after the release of the major options paper related to the issues of transportation fuels.
- Many comments expressed concern that sources not covered under a cap-and-trade program remain responsible for the emission reductions necessary to achieve the regional greenhouse gas emissions target.

The subcommittee remains interested in receiving stakeholder comments. The subcommittee's recommendations include a number of topics that will require further consideration, including transportation fuels and emission source thresholds. The subcommittee has carefully reviewed and considered stakeholder comments in order to formulate the draft recommendations contained in this document.

Electricity

Draft Recommendations for Electricity

- Point of Regulation and Coverage
  The WCI recommends a point of regulation for the electricity sector that maximizes coverage and minimizes emissions leakage.

    - A generator-based approach to covering the electricity sector is preferable.

    - The generator-based option will be most effective with universal participation throughout the Western interconnect.

    - A proposal to bring in additional generators serving the Western interconnect will be developed, including a date by which those other jurisdictions will join the WCI. If the additional Western Electric Coordinating Council (WECC) jurisdictions do not join by that date, the WCI will continue to develop the first jurisdictional deliverer approach described below.

    - Because not all generators serving the western interconnect are currently within the WCI, additional measures are needed to maximize coverage and minimize leakage.

    - The first jurisdictional deliverer approach should address the coverage and leakage issues during the transition to full WECC participation in the WCI:

        - The first jurisdictional deliverer approach covers all emissions generated in WCI and all emissions attributable to electricity delivered in WCI but generated outside WCI.

- Leakage
  The WCI recommends exploring additional complementary measures to reduce leakage.

- Allocation in the Electricity Sector
  The point of regulation does not dictate the method of allocation, and the Partners are continuing to work on the allocation issue.

The Electricity Subcommittee is now in the process of working through questions raised by the Partners, including how additional generation in the WECC can be brought into the WCI, and how the first jurisdictional deliverer approach would actually be implemented in Partner jurisdictions.

Summary of Major Comments Received to Date on Electricity Recommendations

To date, the WCI Electricity Subcommittee has received more than 100 comments from more than 60 parties, or coalitions of parties. The comments have come from utilities, trade groups, environmental NGOs (non-governmental organizations), religious institutions, and public interest groups interested in social justice.

Some commenters have noted that a federal approach would be preferable to WCI because leakage would be reduced. Others have called for no action by the WCI because a federal approach may eventually appear. Initially, the subcommittee suggested five options for the point of regulation for electricity. Each option had some support from at least a portion of those who commented, while many parties have requested that WCI not make a final decision until economic modeling is completed. However, consensus seems to have emerged around two approaches: generator-based and first jurisdictional deliverer (FJD).

Many commenters have called for a generator-based approach if all WECC jurisdictions participate in the WCI. Some commenters have argued that additional measures beyond a generator-based approach would be necessary to prevent contract shuffling and windfalls to electricity importers. Parties have suggested that the additional measures could include complementary measures, a load-generator hybrid, and FJD.
Some commenters have advocated starting with a generator-based approach and eventually shifting to FJD. Others have called for optional phasing in of FJD. Still others have advocated using FJD as the starting point. Some parties are concerned about the tracking necessary for load-based approaches and FJD, and they are worried that either method may have high administrative costs. Commenters have also expressed concern about the potential for gaming the system under the hybrid approaches. Some commenters are concerned about grid stability with any approach. The WCI Partners are still assessing the public comments and other analyses to determine the appropriate point of regulation for this sector within the regional program.

Many parties have commented on allowance allocation in the electricity sector. Requests have run the gamut from advocating for 100 percent auctioning to promoting 100 percent free allocation. Many parties have called for auctioning with auction revenues used for the benefit of consumers by giving the auction proceeds to rate-regulated entities or directly to consumers. Many commenters have worried about competitive impacts to businesses in the WCI under designs that include auctions. Some parties have requested that one or more economic sectors be exempted from auctioning. Parties have advocated allocation protocols based upon historical emissions, load, or output singularly or in combination. Similarly, commenters have advocated for apportionment among Partners based upon Partner targets, averaging of Partner targets, historical emissions, load, output, population, and GDP (gross domestic product), singularly or in combination.

Many parties have commented that combined heat and power (CHP) facilities should be covered under a separate sector and given credit for lower emissions. Other parties have noted that if a CHP facility produces fewer emissions, it should do well if it is regulated under the electricity sector like other generators. Some parties have called for unique treatment for their particular situations, while other commenters have requested even treatment for all entities across the sector. Parties have also called for a set-aside of allowances for the voluntary renewables market to ensure that market’s viability.

Allocations

Draft Recommendations for Allocations

- Regional Cap and Allowance Budgets
  The WCI recommends establishing a regional cap that will decline over time, and each Partner will have an allowance budget within the cap. Actual emissions from any given Partner could be greater or less than its allowance budget, depending on the extent of inter-jurisdictional allowance trading.

  The regional cap will be equal to the sum of the Partner allowance budgets. Reductions achieved by the cap plus reductions from uncapped sources resulting from complementary measures should achieve the WCI regional goal of a 15 percent reduction below 2005 levels by 2020.

  The initial regional cap and Partner allowance budgets will be set through 2020. The regional cap and each Partner's allowance budget will not be adjusted except as necessary to account for changes in WCI membership, sectors added to the cap, errors discovered in data used to determine the cap or the Partner budgets, which may become apparent after the start of mandatory reporting, or errors that resulted in either under-allocation or over-allocation of allowances. Such adjustments will take effect at a regionally coordinated and designated time, such as the beginning of the relevant compliance period.

- Distribution of Allowances by Partners
  The WCI recommends that once the allowance budget has been established for each Partner, allowances will be issued by each Partner rather than issued by a regional organization. Allowances will be of equivalent use and value throughout the WCI region, regardless of which Partner issues the allowances.

- Establishment of Cap-and-Trade Partner Budgets
  The WCI recommends that each Partner's allowance budget will be established in a transparent manner. This will be consistent with the emission reductions that the WCI must realize from the sources covered by the cap-and-trade program in order to achieve the WCI economy-wide emissions reduction goal.

  The Partners will develop a methodology for calculating the Partner allowance budgets. The methodology should set the Partner allowance budgets at the levels needed to achieve the WCI economy-wide emissions reduction goal.

  The WCI seeks comments from stakeholders on the methodology for establishing Partners' allowance budgets and the factors to be included in the methodology.

- Partners' Initial Allowance Budgets
  The WCI recognizes the potential conflict between the need to begin the cap-and-trade program as soon as possible to reduce GHG emissions, and the need for accurate data to calculate allowances for the regional cap and individual Partner budgets. Substantial emissions data is already available due to reporting under existing regulatory requirements for other pollutants and energy consumption, as well as the GHG emissions inventories and forecasts compiled by the Partners, but data from mandatory reporting of GHG emissions may be necessary for more precise allocations of allowances. With this in mind, the calculation of the regional cap and the Partner allowance budgets for the initial years of the cap-and-trade program will recognize potential concerns about data accuracy and will be adjusted in ensuing years as necessary if mandatory reporting reveals significant data errors.

- <u>Partner Discretion to Issue Allowances</u>
  The WCI recommends each Partner initially have flexibility to issue, beyond the minimum percentage auction amount discussed below and subject to the sector-specific assessments discussed below, its remaining allowances as it sees fit, including:
  - auctioning more than the minimum amount of allowances;
  - issuing some or all of the remaining allowances for free;
  - holding some or all of the remaining allowances within a compliance period; and/or
  - retiring some or all of the remaining allowances.

  The WCI recommends each Partner initially have discretion to issue allowances differently to different sectors within its jurisdiction. Each Partner may decide how and to whom to issue the allowances in its allowance budget, subject to the minimum auction requirement and the sector-specific assessments of competition outlined below.

  While each Partner initially will have flexibility in how it allocates the allowances beyond the minimum auction amount, at the beginning of the relevant compliance period, each Partner will be required to advise the other WCI Partners how it intends to allocate the remaining allowances, so that the WCI can make the Partners' plans public in a coordinated fashion. This procedure will help reduce the potential for adverse impacts on auction prices by preventing allowances from being "dumped" into the market unexpectedly.

  Any Partner that chooses to hold allowances must allocate or retire those allowances by the end of the applicable compliance period. A Partner will not be able to hold allowances beyond the end of the compliance period. These requirements will help reduce market instability by providing more certainty about the volume of allowances available during a compliance period.

  The Partners will continue to examine the impacts of Partners using different approaches to allocate allowances to the same sectors and will seek comments from stakeholders on this issue.

  The Partners also will continue to consider the impacts of Partners making different use of auction proceeds and will seek comments from stakeholders on this issue.

  While the Partners initially will have flexibility to issue allowances, over time, the WCI will seek to standardize distribution of allowances as much as possible.

  - *Sector-Specific Assessment of Competition Among WCI Jurisdictions*:
    While the Partners initially will have significant flexibility in issuing allowances, a diverse array of allocation procedures could yield significant cost differentials among competing firms or industries among WCI jurisdictions. There may be cases where it is necessary to assess whether allocations to a particular sector should be treated uniformly by all Partners in the WCI region to address competition among entities within the WCI region. This potential could be minimized through a continued dialogue among the Partners and harmonization of allocation procedures and the use of auction proceeds where appropriate.

    The Partners believe that only a few sectors face significant risks of unfair competition from differing allocation methods among the WCI Partners, and a harmonized approach would be limited to carbon-intensive industries facing significant competition among WCI jurisdictions. For such cases, a case-by-case sector-specific analysis will be conducted jointly by the WCI Partners to determine whether consistent allocation is needed to address such disparities within the WCI. This approach will provide for an efficient cap-and-trade program while providing the Partners flexibility to address their individual priorities.

- *Sector-Specific Assessment of Competition with Non-WCI Jurisdictions*:
  While the Partners initially will have significant flexibility in issuing allowances, a diverse array of allocation procedures could yield significant cost differentials among competing firms or industries within the WCI and those outside the WCI, resulting in leakage outside the WCI region. There may be cases where it is necessary to assess whether allocations to a particular sector should be treated uniformly by all Partners in the WCI region to address competition and leakage from entities outside the WCI region. This potential can be minimized through a continued dialogue among the Partners and harmonization of allocation procedures and the use of auction proceeds where appropriate.

  The Partners believe that leakage of this type is likely an issue only for bulk commodity sectors with high GHG emissions per unit of output that face significant non-WCI competition, and a harmonized approach would be limited to carbon-intensive industries facing significant competition outside the WCI region. For such cases, a sector-specific analysis will be conducted jointly by the WCI Partners to determine whether consistent allocation is needed to address non-WCI region leakage. This approach will provide for sufficient standardization for an efficient cap-and-trade program while providing the Partners flexibility to address their individual priorities.

- Minimum Auction Percentage
  The WCI recommends each Partner auction a minimum percentage, between 25 percent and 75 percent, of its allowance budget through a coordinated regional auction process. Each Partner will auction allowances throughout the WCI region and will receive the proceeds of the auction.

  The Partners will determine a specific minimum percentage auction amount. The WCI seeks comments from stakeholders on this question.

  Because multiple Partners would be simultaneously auctioning allowances through a single pool, the auction could result in Partners auctioning or selling some of their allowances to entities in other jurisdictions. This outcome is fully consistent with the concept of regional trading and the importance of allowances having equivalent use/value for compliance purposes throughout the WCI region.

- Phased Increase of Auctioning
  Greater emphasis could be given to free allocation in the early years of the program (and more to auctions in later years) as a means to mitigate business and consumer cost impacts and to provide transition assistance, in addition to using auction proceeds for these purposes. Some Partners may choose to provide more time for an allowance market to develop before capped entities must purchase larger portions of their allowances in an auction.

The minimum percentage of allowances to be auctioned should be increased over time, potentially to 100 percent. Even before such an increase, each Partner will have discretion to auction more than the minimum percentage of its allowances as it sees fit.

- Credits for Early Reductions
  The WCI recommends each Partner have discretion to give credit for early actions, but any credit for early action must come from within the cap and will come out of the individual Partner's allowance budget. Early action credits will not be added to or be on top of the amount of allowances in each Partner's allowance budget.

- Banking
  The WCI recommends purchasers and covered entities be allowed to bank allowances, without restrictions on the amount of allowances that may be banked or on how long they may be banked.

- Borrowing
  The WCI recommends that borrowing of allowances from future compliance periods not be allowed.

- Compliance Periods
  The WCI recommends the compliance periods be three years long.

  Multi-year compliance periods will provide covered entities with flexibility for compliance and in planning for (or responding to) large and unexpected changes in the allowance market or in other markets, such as energy markets, which may affect allowance prices. They also will provide programmatic flexibility for the WCI—for example, to ensure a steadily declining cap. The Partners note that three years is the length of the compliance periods chosen by the Regional Greenhouse Gas Initiative (RGGI).

- Initial Compliance Period
  To accommodate start-up issues, both from the covered entity standpoint and the regulatory standpoint, the WCI recommends that the initial compliance period include special rules, such as a two-year period, or other measures to assist in the transition into a cap-and-trade system, while maintaining the integrity of the cap and value of the allowances.

- New Partners
  The WCI recommends allowances for new Partners be in addition to the existing allowance budgets for current Partners. The regional cap will be expanded to accommodate emissions from the new Partner.

  Once the cap-and-trade program has been instituted, new Partners will come into the cap-and-trade program at a regionally coordinated and designated time, such as the beginning of the relevant compliance period.

- Timelines for Partner Activities
  The Partners will develop a schedule for various WCI efforts, including launching the cap-and-trade program, establishing emissions baselines and Partner allowance budgets, undertaking any case-by-case discussions on competition or leakage issues which may affect Partner allocation plans and other various allocation-related efforts.

Summary of Major Comments Received to Date on Allocations Recommendations

The WCI Allocations Subcommittee issued its Draft Design Recommendations for public comment on April 2, 2008. Fifty-six (56) comments were received from stakeholders by the April 16, 2008 deadline, with an additional five (5) comments received after the deadline. The subcommittee is still reviewing the comments and has not yet determined whether any of the draft allocations recommendations should be modified in light of the comments.

A diverse group of stakeholders provided comments on the draft allocations recommendations, including industry/trade associations (15), utilities (13), NGOs (11), government agencies (3), private citizens (2), and miscellaneous business entities (12). Nineteen (19) of the comments came from stakeholders with multi-state operations or interests; the remainder came as follows: Washington (10), California (9), Oregon (5), British Columbia (4), Arizona (4), Canada (3) and New Mexico (2).

Not surprisingly, the commenters provided a wide diversity of comments on the draft recommendations, with little consensus on several key issues. For example, comments on the WCI's draft recommendations regarding the regional cap and the Partner allowance budgets included the following divergent perspectives:

- The allowance budgets should be based on load or output.
- The allowance budgets should be based on historical emissions.
- The allowance budgets should be based on the state and provincial goals.
- Partner budgets should be identical to Partner commitment to the regional goal.
- Budgets should not be determined until accurate data are available.
- Budgets should include some set aside (3-5 percent) of allowances for new entrants.

Similarly, while some commenters called for free allocation of allowances to utilities, others argued for auctioning a significant percentage of the allowances. A number of commenters (e.g., NGOs) called for 100 percent auctioning, while others (e.g., utilities) argued that only a very small percentage (5 percent or less) of allowances should be auctioned, if at all.

There also were differences of opinion about the degree of flexibility that Partners should have to allocate allowances. Some who opposed flexibility expressed concern that the lack of uniformity could result in leakage. To minimize potential for leakage, one commenter suggested adopting consistent rules for reporting, tracking and compliance obligations. Another suggested distributing allowances to a third party.

There was a general level of support expressed for the WCI's draft recommendation regarding credits for early reductions, but a few commenters preferred that credits come from outside each Partner's allowance budget.

By the same token, more commenters than not supported the WCI's draft recommendations to allow unlimited banking but prohibit borrowing of allowances. Commenters supported the recommended three-year compliance periods by a wide margin. And to the extent that comment was received on the desirability of a regional organization, it was well received.

Finally, some commenters offered advice on topics not directly addressed in the draft allocations recommendations, including the following:

- Develop an independent Market Oversight Committee to develop best practices to guard against market manipulation, hold down consumer costs and avoid burdens on state economies.
- Consider more practical alternatives to address hoarding of allowances.
- Have a cost containment mechanism
- Have a safety valve.
- Do not have a safety valve.
- Have a price ceiling for allowances for a defined period.
- Allow only emitters to participate in auctions.
- Allow anyone to purchase allowances at auctions.

The WCI appreciates the range of ideas and perspectives expressed in the comments and will give them serious consideration as we move develop the draft design document.

Offsets

Draft Recommendations for Offsets

The primary role of the offset program is to reduce the overall compliance costs for the cap-and-trade system, by enabling the offset market to deliver lower-cost emission reduction options than are available in the sectors/sources included in the cap-and-trade system. In addition, by lowering overall costs, an offset program can potentially offer greater environmental benefits. The offset program can also serve to encourage innovation, co-benefits, greenhouse gas emission reductions from sources not covered by the cap-and-trade system and removals by sinks.

- Offset project types and protocols
  The WCI recommends:
  - development of an initial set of eligible project types and approved protocols prior to cap-and-trade program launch;
  - developing a process to review and approve other project types and related protocols proposed by project developers;
  - using protocols that are standardized to the extent possible; and,
  - making use of, and adapting if needed, existing protocols as appropriate.

- Offset projects approved through the WCI offsets program
  The WCI should consider a method that gives priority to offset projects located within WCI jurisdictions. The method should also consider other roles of the offset system, such as ensuring that co-benefits occur within the region.

  In addition to those offset projects approved within its jurisdictions, the WCI should consider approving offset projects located throughout Canada, the United States, and Mexico, where such projects would be subject to comparably rigorous oversight, validation, verification and enforcement as those located within the WCI jurisdictions and would not undermine the ability for the WCI to link to other trading systems.

- Tradable units from government-regulated GHG emission trading systems
  For compliance purposes, the WCI should consider allowing individual regulated entities to use tradable units (offsets and allowances) from other government-regulated GHG emission trading systems that the WCI recognizes as meeting similarly rigorous criteria for environmental integrity.

  The WCI should ensure accounting systems are in place to prevent using tradable units more than once for compliance.

- Quantity Limits
  The WCI recommends limiting the use of offsets and non-WCI tradable units for compliance by individual regulated entities:
  - to ensure that meaningful emission reductions take place within the sources covered by the cap-and-trade system.
  - in recognition that foregoing emission reductions at facilities covered by the cap-and-trade program in the WCI states has the potential to forego health benefits and other benefits near those facilities.

The WCI Offsets Subcommittee will consider making a specific draft recommendation to the WCI, based on further analysis and considering the level of the cap set for the cap-and-trade system.

Summary of Major Comments Received to Date on Offsets Recommendations

In each of the opportunities for stakeholder engagement on the design of a cap-and-trade system for the Western Climate Initiative, there has been strong support for including an offset program. Stakeholders have expressed a desire to see the offset program focus on ways to reduce the overall cost of meeting GHG emission reduction targets, whether through reduced compliance costs for emitters, reduced economic impact for consumers, or increased economic opportunities to encourage emission reductions. Stakeholders have also shown a strong and consistent concern for the environmental integrity of the offset program, realizing the direct connection between the integrity of the offsets and the integrity of the regional target.

Many stakeholders feel that offsets should be allowed to enter the WCI system from sources outside the WCI, by project approval through the WCI process or as approved trading units from other cap-and-trade systems. A number of stakeholders also believe there are compelling economic, environmental and social reasons to give priority to offset projects from within the WCI or to phase in other regions over time as experience grows. Several stakeholders suggested ways to develop or design limits on the type of offsets, including basing limits on project location. The WCI Offsets Subcommittee recognizes that offset projects must reduce or remove GHG emissions and may have co-benefits regardless of where the project is located, and will continue to examine the balance of economic, environmental and social benefits in the design of the program.

Given the encouragement to focus the offset program on reducing cost for the cap-and-trade system, some stakeholders find the concept of limiting the use of offsets to be counterproductive, reasoning that limiting the use of lower cost compliance alternatives simply means higher cost compliance. Other stakeholders argue that an oversupply of inexpensive offsets could reduce the impetus for capped emitters to make progress on direct emission reductions. The subcommittee invites further suggestions on the design of limits or alternative methods to balance the use of offsets with reductions under the cap.

Stakeholders generally supported the recommendation to establish a centralized administrative body to perform routine processing and management functions.

Regional Organization

Draft Recommendations for Regional Organization

WCI recognizes that a regional organization will be helpful for coordinating Partner activities and improving efficiency by centralizing the execution of administrative tasks. While WCI is continuing to identify suitable roles for a regional organization, the following options have been identified to date:

- Although emission allowances will be issued and distributed by each Partner, a regional organization may be directed to coordinate the regional auction of allowances, track emissions and allowances, monitor and report on market activity, and conduct other activities. A centralized offset registry is also required that integrates with the emissions and allowance tracking system.

- A regional organization may provide a venue for coordinating analyses of competitiveness and leakage issues resulting from potentially divergent allocation procedures among the WCI Partners. Such issues could be resolved through this regional organization or some other forum.

- A regional organization may provide a forum through which each Partner updates the other Partners every two years on its progress toward achieving the regional goal and its individual goal

- The administrative structure of the offsets program should combine optimal aspects of jurisdiction-by-jurisdiction, public-private partnership, and centralized regional approaches, and may draw from existing programs. The role of a regional organization may include:
  - coordinating review and adoption of protocols for offsets;
  - coordinating review and issuing of offsets;
  - providing the criteria and means to accredit service providers to deliver validation and verification services for offsets.

Each jurisdiction will retain its regulatory authority and enforcement responsibilities. By centralizing administrative tasks and coordinating Partner activities, the regional organization will help reduce administrative costs and improve program transparency and consistency.