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California Finally Establishes Market for Tradable Renewable Energy Credits (TRECs)

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On January 13, 2011, the California Public Utilities Commission (CPUC) voted to authorize the use of tradable renewable energy credits,[1] which will facilitate a California TREC market subject to temporary price and quantity caps.

The CPUC provided the structure and rules for the integration of TRECs for compliance with the Renewables Portfolio Standard (RPS), and largely reaffirmed the previous order issued in March 2010, which was subsequently stayed. The new order imposes two temporary caps on TREC use: 1) California's three large investor-owned utilities (IOUs) may use TRECs only for up to 25% of annual procurement targets for RPS compliance, and 2) all IOUs are permitted to pay only up to $50 per TREC. These two caps are intended to balance the promotion of renewable energy with protections for California ratepayers while the TREC market is being developed; the caps are set to expire at the end of 2013.

Bundled transactions, whereby the renewable energy credit is sold together with the underlying renewable energy, will continue to be the primary means for IOUs to achieve RPS compliance. The CPUC also narrowed the definition of what constitutes a bundled contract for out-of-state renewable energy, as compared to the CPUC's prior approvals of bundled contracts. However, the temporary 25% limit does not apply to deliveries under such previously approved bundled contracts that would cause the utility to exceed the limit.

This new restriction reflects a growing divide among stakeholders on the objective of the RPS. Labor representatives, politicians, and some developers view the RPS as a vehicle to promote in-state economic development, including job creation associated with project development. IOUs and other project developers view the RPS's primary drivers as emission reduction and resource diversification.

Ultimately, the two TREC caps will be a test case for future legislation or regulatory action. The decision applies only to the 2010 20% RPS mandate and the RPS program going forward.[2] Further legislative or

[1] CPUC Dec. 12-95-217, January 16, 2011, *available at* http://docs.cpuc.ca.gov/published/Final_decision/129517.htm

[2] This decision also discussed the use of distributed generation (DG) as a source of TRECs, but the CPUC stated that customer-sited DG will not qualify absent obtaining project-specific approval from the California Energy Commission.

regulatory action will be needed to address the use of TRECs for meeting the California Air Resources Board's 33% Renewable Electricity Standard.

A. Defining a TREC

A TREC, which is equivalent to 1 MWH of renewable energy from a qualified source,[3] is an unbundled purchase of a REC by a load-serving entity (LSE) for RPS compliance, without the accompanying energy. Conversely, a bundled transaction includes both the REC and energy from a renewable energy facility. Prior to this order, only qualified bundled transactions could be used by LSEs for RPS compliance. By permitting the use of TRECs for up to 25% of RPS compliance, IOUs have an additional method for meeting part of their RPS obligations.

The order set forth additional rules governing the use of TRECs. First, only RECs associated with renewable energy generated on or after January 1, 2008 may be used for compliance. Second, only RECs tracked by Western Renewable Energy Generation Information System (WREGIS) are eligible. Third, the RECs from bundled contracts may be unbundled by the purchasing LSE unless, for contracts signed before January 1, 2005, the contract did not explicitly transfer ownership of the RECs to the LSE. Last, RECs that are associated with contracts pursuant to the Public Utility Regulatory Policies Act of 1978 (PURPA) signed after January 1, 2005 cannot be traded by the purchasing LSE.

B. Qualifying out-of-state generation as a bundled transaction

In its most controversial aspect, this decision limits the ability of LSEs to use out-of-state renewable energy generation for RPS compliance. Prior to this decision, the CPUC approved firm transmission agreements[4] as bundled transactions from out-of-state renewable energy facilities. However, future firm transmission contracts will require CPUC review to ensure the renewable energy generated is delivered and consumed in California, and some may not qualify as bundled.

LSEs have other options to qualify out-of-state renewable energy projects as bundled transactions. First, dedicated transmission lines can be constructed to connect the out-of-state facility with a California balancing authority. Second, either a dynamic scheduling agreement or pseudo-tie arrangement will qualify as a bundled transaction.[5] Third, and most importantly from an LSE's point of view, contracts for energy and RECs approved by the CPUC prior to March 10, 2010 are grandfathered as bundled transactions.

Dynamic scheduling agreements and pseudo-tie arrangements

These two types of transactions ensure that the energy produced out-of-state is consumed in California, by mimicking in-state generation. Qualifying for either of these transaction types may be a hurdle for LSEs because both are relatively new concepts. The California Independent Systems Operator (CAISO), the balancing authority which oversees 80% of California's electricity consumption, only recently completed its feasibility study for implementing dynamic scheduling agreements for intermittent resources (which

[3] A qualified source includes biomass, solar thermal, photovoltaic, wind, geothermal, fuel cells using renewable fuels, small hydroelectric generation of 30 megawatts or less, digester gas, municipal solid waste conversion, landfill gas, ocean wave, ocean thermal, or tidal current, and any additions or enhancements to the facility using that technology.

[4] A firm transmission agreement means that the renewable energy facility delivers energy through a dedicated portion of a transmission line.

[5] A dynamic scheduling agreement is where the host balancing authority will automatically transfer and adjust delivery to a California balancing authority based upon the renewable energy facility's output. A pseudo-tie arrangement allows electronic transmission of the out-of-state generator to a California balancing authority such that, from a load perspective, the delivery is analogous to a direct tie-in.

includes most renewable energy generation).[6] Moreover, CAISO only piloted its first pseudo-tie arrangement in June 2010 and has yet to pilot a project utilizing a dynamic scheduling agreement.[7]

Grandfathering

While this decision narrowed the definition of a bundled transaction, the CPUC will allow previously approved firm transmission agreements to count as bundled contracts. In the original order,[8] only out-of-state energy transactions that had either a dynamic scheduling agreement or pseudo-tie arrangement qualified as bundled.[9] This excluded transactions for renewable energy that IOUs contracted for after January 1, 2005 but before March 11, 2010.[10]

As the IOUs pointed out, the CPUC previously approved these contracts as bundled contracts; denying these contracts bundled status would unfairly hinder their RPS compliance strategies as well as the expectations of the renewable generators. To address this concern, the CPUC grandfathered all transmission contracts for energy and RECs approved prior to March 11, 2010 as bundled contracts, with a few caveats. These contracts will be treated as bundled only if the IOUs exceed their TREC allotment by accounting for these previously approved contracts as REC-only contracts. Moreover, to prevent LSEs from exploiting the grandfathering, the CPUC imposed restrictions that will prevent LSEs from modifying those contracts for increased RPS compliance:

1. The contract cannot be extended past its expiration date that was in effect as of March 11, 2010;
2. The maximum amount of energy contracted for delivery cannot be increased beyond the maximum delivery quantity defined as of March 11, 2010.

C. TREC price cap

The CPUC temporarily capped the price the three largest IOUs can pay for TRECs at $50 per MWH. The CPUC asserted that a temporary cap was required because of the infancy of the TREC market (the cap is set to sunset on December 31, 2013). The cap also matches the penalty for not achieving RPS compliance. This avoids providing IOUs an incentive to pay more for the TREC than the RPS compliance penalty since IOU ratepayers pay for TRECs whereas penalties are paid for by IOU shareholders.

D. Future legislation or rulemaking

This decision establishes rules only for TRECs for the initial 2010 RPS target of 20%, and both the price and usage caps will sunset on December 31, 2013. Still unresolved are the rules governing the use of TRECs for compliance with the Renewable Electricity Standard (RES) of 33% mandated by the California Air Resources Board. Although the TREC caps will expire, it remains a question whether the next stage of the TREC market will be less constrained by usage and price caps. It is likely, as seen through this order,

6 CALIFORNIA INDEPENDENT SYSTEMS OPERATOR, FINAL REPORT ON: IMPACT OF DYNAMIC SCHEDULES ON INTERFACES (Jan. 7, 2011) *available at* http://www.caiso.com/2aff/2aff9e9150530.pdf.

7 CALIFORNIA INDEPENDENT SYSTEMS OPERATOR, *Pseudo-Tie Arrangement Sends More Renewable Energy To California* (Jun. 15, 2010) *available at* http://www.caiso.com/27b6/27b6bd7067a40.pdf.

8 CPUC Dec. 10-03-021, Mar. 11, 2010, *available at* http://docs.cpuc.ca.gov/word_pdf/FINAL_DECISION/115056.pdf

9 Out-of-state facilities with a direct link with a California balancing authority would have, of course, qualified as bundled transactions.

10 Only renewable energy facilities constructed after January 1, 2005 count as a bundled transaction.

that the strength of the California economy will play a significant role in determining what, if any, future restrictions govern the use of TRECs to meet California's RPS and RES objectives.

If you have any questions about the content of this publication, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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