FILED WITH
Executive Secretary
October 12, 2009
IOWA UTILITIES BOARD

MidAmerican ENERGY
OBSESSIVELY, RELENTLESSLY AT YOUR SERVICE®

Overview of a State Alternative Compliance Mechanism – Meeting Real Emissions Caps without the Unnecessary Costs of Allowance Trading

I. EXECUTIVE SUMMARY:

MidAmerican Energy Company ("MidAmerican") and PacifiCorp will reduce greenhouse gas emissions to a level at or below the caps set by Congress. We will do so at the lowest cost to customers by continuing to invest in zero- and low-emissions generation and offering customers energy efficiency programs. Congress can help us reduce the costs to customers by billions of dollars if it will simply provide an alternative to its proposed mandate that requires pollution permits be purchased by utilities for emissions below the caps. The pending federal climate change bills (Waxman-Markey bill and Kerry-Boxer bill) do not establish real emissions caps and do not allow utilities such as MidAmerican and PacifiCorp to reduce emissions at the lowest cost. There is a cleaner way to emissions reductions than mandatory allowance trading with customers' money, and we are asking Congress to give it fair consideration.

MidAmerican is actively participating in ongoing discussions regarding federal climate legislation, including the recently House passed, *American Clean Energy and Security Act of 2009* (House of Representatives 2454) ("ACES") and the Senate's Kerry-Boxer bill. MidAmerican is fully supportive of the goal to reduce greenhouse gas emissions through mandatory "caps" to achieve the desired emissions reduction target by the year 2050. However, MidAmerican is concerned that currently pending federal climate legislation:

1. fails to establish meaningful emissions caps;
2. provides emitting utilities with no alternative for compliance other than an untested allowance trading scheme for buying and selling allowances and offset credits;
3. mandates that emitting utilities and their customers incur the cost of allowances and offset credits for every ton of emissions even when the utility is at or below the cap; and
4. allocates allowances in ways that are unfair to customers of utilities that generate significant amounts of energy with coal and renewables.

The federal trading scheme would require the purchase of allowances at an as-yet-unknown price. The procurement of these allowances does not result in a reduction in emissions; indeed, the federal trading schemes do not set real caps because emitters are allowed to readily exceed the caps as long as they have enough allowances and offsets. To actually achieve emissions reductions, emitting utilities will be working with their state (not federal) regulators to identify the changes in generation, energy efficiency and fuel mix that will achieve emissions reductions at a reasonable cost for retail customers. Thus, for emitting utilities, the cost to their customers of procuring allowances is an unnecessary and duplicative cost – on top of the cost of the investments and programs that actually reduce emissions.

As an alternative to mandating that emitting utilities participate in an allowance trading scheme, MidAmerican is promoting the availability of an **Alternative Compliance Mechanism**. Under this proposed alternative compliance mechanism, each individual state, on a utility-by-utility basis, would designate how each utility that provides retail electric service in that state will comply with the emissions reductions caps. States could require a utility that serves retail consumers in that state to procure allowances and offset credits to demonstrate compliance (as proposed under the pending federal bills) or, in the alternative, to achieve actual emissions not exceeding the emissions cap through implementation of supply and energy efficiency resource planning overseen by the utility's state regulatory authority. Individual states electing the alternative compliance mechanism must certify that the state regulatory authority has the ability to (i) consider the interests of retail electric consumers served by the utility and (ii) require the utility to satisfy the emissions reduction caps. A utility subject to the alternative compliance mechanism in a given state would not receive any allocation of free allowances from the federal government for its emissions attributable to serving customers in that state. Further, the alternative compliance approach does not relieve a utility of the responsibility to comply with the emissions reduction caps established by Congress; states would not be authorized to waive compliance. In fact, the alternative compliance mechanism requires the utility to actually reduce emissions to meet the caps. In contrast, the ACES allowance trading scheme merely requires that a utility procure allowances or offsets equivalent to its emissions, even if emissions increase.

II. MIDAMERICAN'S CONCERNS WITH MANDATORY PARTICIPATION IN AN ALLOWANCE TRADING SCHEME:

MidAmerican is fully supportive of the goal to reduce greenhouse gas emissions through mandatory "caps" to achieve the desired target by the year 2050. However, MidAmerican is very concerned about the mandatory *trading* component of the legislation. The trading mechanism, such as that in ACES, will in effect impose a huge double cost on customers: first to pay for emission allowances which will not reduce greenhouse gas emissions, and then for the construction of new low- and zero-carbon power plants and other actions that will actually reduce emissions. Under the current structure of this legislation there are clear winners and losers

due to the significant inequities that result across customer segments, companies and geographical regions of the United States. These existing inequities and the related costs created by the ACES legislation are not necessary to achieve the emissions reduction goals.

Fundamental to these inequities is the approach in ACES that allocates allowances based on a 50%-50% split between retail emissions and retail sales. Allocating any number of allowances based on retail sales will only lead to inequities in the allowance distributions. For example, utilities with large nuclear or hydro resources will receive significantly more allowances than are needed for compliance, which reduces the available allowances for utilities that need them for compliance, driving up compliance costs and transferring wealth between retail customers. The House attempted to fix this problem at the last minute, but their "fix" is ineffective and administratively cumbersome.

ACES also penalizes companies (like MidAmerican and PacifiCorp) that built renewable generation during the baseline period thus reducing their actual greenhouse gas emissions intensity. The allocation formula under ACES requires the use of a utility's baseline carbon dioxide emission rate multiplied by its electricity sales to retail customers. Wind energy production during the baseline period has reduced our companies' emission rates during that period, thus decreasing our allocation of free allowances and forcing us to buy more allowances. This methodology penalizes our customers for every kilowatt-hour produced by wind generation. If the goal of the trading program is to incentivize generators to build low- and zero-emissions generation, it is illogical to penalize the customers of utilities who did exactly that – before ACES's enactment.

III. ALTERNATIVE COMPLIANCE MECHANISM FRAMEWORK:

In order to address its concerns with mandatory allowance trading, MidAmerican is proposing that Congress include in the federal climate bill an alternative mechanism for complying with the emissions reduction caps. This alternative compliance mechanism would allow each state, on a utility-by-utility basis, to designate how each utility that provides retail electric service in that state will comply with the emissions reduction caps. States could then require a utility that serves retail consumers in that state to procure allowances and offset credits for all of its emissions above and below the cap to demonstrate compliance (as proposed under ACES) or, in the alternative, to achieve actual emissions not exceeding its allowable emissions cap through implementation of supply and energy efficiency resource planning overseen by the utility's state regulatory authority (e.g. Iowa Utilities Board). For utilities subject to the alternative compliance mechanism, the emissions cap is just that – a cap; the utility cannot buy allowances that would permit it to emit above the cap as it can under the allowance trading provisions of ACES. All utilities continue to be subject to the same 2020, 2030 and 2050 emissions reduction caps (i.e. 17% or 20% below 2005 levels by 2020, 42% below 2005 levels by 2030, and 83% below 2005

levels by 2050) regardless if they elect to participate in the trading scheme or the alternative compliance mechanism.

This alternative compliance approach would be implemented by state utility regulatory and environmental bodies and overseen by the U.S. Environmental Protection Agency.

One potential program framework is detailed below:

Applicability – For purposes of the alternative compliance mechanism, a "covered electric utility" is defined as an electric utility that is an investor-owned utility, municipal utility, electric cooperative or public utility district; has a legal, regulatory, or contractual obligation to deliver electricity directly to retail consumers in one or more states; is subject to the greenhouse gas emissions restrictions and prohibitions; and is subject to oversight by a state regulatory authority.

Implementation – Selection and implementation of this alternative compliance mechanism commences with each state, not individual utilities, determining whether a utility will be required to participate in the allowance trading scheme or to use the alternative compliance approach. Selection of the appropriate option for each utility requires state legislative action approved by the state's governor. States selecting the alternative compliance mechanism for a utility must certify that the state regulatory authority, governing board or supervising state or political subdivision that oversees a covered electric utility (i.e. Iowa Utilities Board) has the ability to (i) consider the interests of retail electric consumers served by the utility, and (ii) require the utility to satisfy the emissions reduction caps.

- ***Greenhouse Gas Emissions Budget(s) for Each Utility*** - When a state selects the alternative compliance mechanism for one or more utilities, the U.S. Environmental Protection Agency Administrator establishes a separate greenhouse gas emissions budget for each affected utility in that state for each calendar year, in an amount equal to the reduction targets for specified sources from the federal cap-and-trade program [provision comparable to ACES section 703].

- ***Adoption of State Implementation Plan*** - States selecting the alternative compliance mechanism must then adopt the U.S. Environmental Protection Agency calculated greenhouse gas emissions budgets for each utility through a State Implementation Plan ("SIP")-like process.

- ***Filing of an Alternative Compliance Plan*** - To ensure that a utility will meet its emission reduction requirement, the state regulatory authority, governing board or supervising state or political subdivision that oversees a covered electric utility will adopt an alternative compliance plan for **e**ach covered utility. The plan must outline the generation resources and environmental control projects necessary to meet the performance standards. It is anticipated that these plans will be

developed in proceedings similar to integrated resource planning proceedings. Within thirty days after adoption by the state regulatory authority, governing board or supervising state or political subdivision, an alternative compliance plan or update shall be filed with the state environmental agency delegated enforcement authority under U.S. Code Title 42, Chapter 85. The state environmental agency delegated enforcement authority shall file the alternative compliance plan or update with Administrator of the Environmental Protection Agency as a State Implementation Plan ("SIP") control measure.

- ***Alternative Compliance Plan Updates*** - Alternative compliance plans must be updated at least every four years. States will develop other procedures as necessary to ensure compliance with the alternative compliance provisions.

- ***Federal Implementation Plan*** - If a state fails to timely submit a satisfactory SIP, the U.S. Environmental Protection Agency would have the authority through federal rulemaking to prescribe a plan for the state (i.e., a Federal Implementation Plan or "FIP").

Retirement of Allowances – A utility that is subject to a state alternative compliance mechanism will receive no free federal allowances for the utility's emissions attributable to that state. That portion of the federal allowances will remain with the federal government and be permanently retired from the federal trading program.

Use of Offsets – The state regulatory authority, governing board or supervising state or political subdivision that oversees a utility that is subject to the alternative compliance mechanism is not precluded from permitting the utility to use domestic offset credits as one means of reducing emissions and complying with the established caps. The goal of the alternative compliance mechanism is to make actual reductions for the affected sources. As a result, to ensure emission reductions remain "local", only domestic offsets should be allowed under this program (i.e. international offsets would not be allowed). This would help preserve the domestic offset market, and give utilities another compliance alternative to meet the emission reduction requirements, especially in the early years of the program. Continuing to allow the use of domestic offsets will also help preserve the development of opportunities for the agricultural sector.

Compliance/Penalty Provisions – The penalty for non-compliance would not be changed under the alternative compliance mechanism. The same penalties (such as ACES Section 723) would apply for non-compliance regardless of the compliance method selected by the state. However, under the alternative compliance approach, the penalty first falls on the state. If action or inaction by a covered utility is the cause for incurring the penalty, the state can pass the responsibility for payment of the penalty on to the covered utility.

IV. ALTERNATIVE COMPLIANCE MECHANISM – KEY QUESTIONS AND ANSWERS:

- **Would this Alternative Compliance Mechanism Undermine the Existing ACES Cap and Trade Program?**

No, the use of the alternative compliance mechanism would not undermine the allowance trading program for the other affected utilities and other affected sectors. The electricity sector is initially allocated 35% of the total allowance pool; this transitions to zero between 2026 and 2030. It is extremely unlikely that every state would select this alternative compliance mechanism for every utility. For example, there would be no incentive for a state to select the alternative for a utility that had a minimal compliance obligation (e.g., few emissions or free allowances covering all emissions). Therefore, the remaining allowance pool would be between 65% and 100% of the original total – or at least several billion allowances per year. Thus, this alternative program would not undermine the allowance trading program, and an allowance market could continue to support investment in research and development to enable utilities to meet the reduction caps. Also note that required emissions reductions under the alternative compliance mechanism will require needed investment in research and development.

- **How would this Alternative Compliance Mechanism work for a Utility with an Emitting Resource Serving More than One State?**

A utility with an emitting resource serving more than one state can be subject to both an alternative compliance plan in one state and the allowance trading scheme in another state. If a utility's retail rates in a state include any of the costs of an emitting resource (whether located inside or outside that state), that state will have the ability to determine the compliance method for the portion of the emissions attributable to that state. For example, in MidAmerican's situation, all of its coal-fueled generation is physically located in Iowa, but a portion of that generation serves its Illinois customers. If Iowa pursued the alternative compliance mechanism for MidAmerican, and Illinois pursued the cap-and-trade approach for MidAmerican, the portion of the emissions from the generation resources attributable to Iowa retail customers would be subject to the firm emissions cap, while the portion of the emissions from the generation resources attributable to Illinois customers would require MidAmerican to hold allowances or offsets.

- **How would this Alternative Compliance Mechanism Work for Jointly Owned/Operated Units?**

A utility owner of a jointly-owned emitting source can be subject to the alternative compliance mechanism while the other joint owner(s) can be subject to the allowance trading scheme. For a utility owner participating in the alternative compliance mechanism, the portion of the affected generation and the associated emissions attributable to its retail customers in that state would not

be included in the allowance allocation methodology. But for the remaining joint owner(s) participating in allowance trading, their portion of the emissions would be included in their allowance allocation methodology.

- **How would this Alternative Compliance Mechanism be Enforceable?**

Under the alternative compliance mechanism, the cap is a real cap that cannot be exceeded. The penalty for non-compliance would be the same under the allowance trading scheme or the alternative compliance mechanism. In other words, the same penalties apply for non-compliance regardless of the compliance method selected by the state. However, under the alternative compliance approach, the penalty first falls on the state. If action or inaction by a covered utility is the cause for incurring the penalty, the state can pass the responsibility for payment of the penalty on to the covered utility. Also note that if a state fails to submit a satisfactory SIP, the U.S. Environmental Protection Agency would have the authority through federal rulemaking to prescribe a plan (a FIP for the state).

- **If the Emissions Caps are Required to be Met on Specific Dates rather than on an Annual Basis, would the Alternative Compliance Mechanism result in a Higher Level of Carbon Accumulating in the Atmosphere?**

No, the alternative compliance mechanism will result in the same or even lower levels of emissions than the allowance trading scheme. For utilities subject to the alternative compliance mechanism, the emissions cap is just that – a real cap; the utility cannot buy allowances that would permit it to emit above the cap as it can under the allowance trading scheme. All utilities would continue to be subject to the same 2020, 2030, and 2050 emissions reduction caps (i.e. 17% or 20% below 2005 levels by 2020, 42% below 2005 levels by 2030, and 83% below 2005 levels by 2050) regardless if they participate in the trading scheme or the alternative compliance mechanism.

- **How would this Alternative Compliance Mechanism Impact Low Income Customers?**

The alternative compliance mechanism does not change assistance to low income customers as provided for in the Waxman-Markey bill. The allowance allocation under Section 782(d) would be preserved and function as originally intended. Low income consumers who qualify would still receive the necessary additional assistance. In addition, the electric rate increases for low-income consumers will be mitigated for utilities subject to the alternative compliance mechanism since (i) such utilities will not incur the cost of procuring allowances and (ii) a state is only likely to choose the alternative compliance approach for a utility if it is a more cost-effective option than allowance trading.

V. ALTERNATIVE COMPLIANCE MECHANISM IMPLEMENTATION SCENARIO:

To demonstrate how the alternative compliance mechanism would work between different states, with various generation resources, and numerous joint owners; an example was developed using the following assumptions.

- Iowa and South Dakota would pursue the alternative compliance mechanism.
- Illinois would pursue the cap-and-trade approach.
- Iowa and South Dakota currently are allocated 100% of Walter Scott Unit 4, Greater Des Moines Energy Center, and all of MidAmerican's wind generation.
- All of MidAmerican's other generation resources are allocated 90% to Iowa and South Dakota, and 10% to Illinois.
- Retail sales are similarly split at 90% to Iowa and South Dakota, and 10% to Illinois **c**ustomers.
- Wholesale sales and associated emissions are allocated to the retail customers receiving the wholesale sales margins as credits against retail revenue requirement.
- MidAmerican is only responsible for its share of emissions from jointly-owned units.

Using these high-level assumptions, MidAmerican's calculated baseline emissions for Iowa and South Dakota would be 18,265,401 U.S. tons, or 16,574,774 metric tons. This is equivalent to the actual emissions attributable to those retail customers in 2005 (from both retail and wholesale sales). As a result, under these assumptions, the targeted emissions cap to serve customers in these states would be:

2005 Baseline:	18,265,401 U.S. Tons
2020 Cap:	15,160,283 U.S. Tons (17% reduction)
2030 Cap:	10,593,933 U.S. Tons (42% reduction)
2050 Cap:	3,105,118 U.S. Tons (83% reduction)

Alternatively, if Illinois decided to pursue the cap and trade approach, it is projected that MidAmerican would receive approximately 62% of the allowances it would need in 2012 to serve Illinois customers, and the free allocation would reduce each year until zero are received in 2030.

For clarity, all emissions from both retail and wholesale sales from MidAmerican's generation are covered under the alternative compliance mechanism (meet hard cap) and the cap-and-trade approach (hold sufficient allowances or offsets). Conversely, emissions associated with purchased generation would not accrue against the hard cap, or require emission allowances.

VI. TEXT OF ALTERNATIVE COMPLIANCE MECHANISM LEGISLATIVE AMENDMENT:

"(X) ALTERNATIVE COMPLIANCE MECHANISM FOR ELECTRIC UTILITIES

"(1) DEFINITIONS.— For purposes of this subsection, the term "covered electric utility" means an electric utility—

"(A) that is an investor-owned utility, municipal utility, electric cooperative or public utility district; and

"(B) that has a legal, regulatory, or contractual obligation to deliver electricity directly to retail consumers in one or more States; and

"(C) that is subject to the greenhouse gas emissions restrictions and prohibitions of section XX [provision comparable to H.R. 2454 section 722]; and

"(D) that is subject to oversight by a State regulatory authority, governing board or supervising State or political subdivision (or an agency or instrumentality of, or corporation wholly owned by, either of the foregoing) having the ability to (i) consider the interests of retail electric consumers served by the covered electric utility and (ii) require the covered electric utility to satisfy the emissions reduction goals and restrictions.

"(2) STATE CERTIFICATION OF COMPLIANCE METHOD.—

"(A) Not later than 1 year after the date of enactment of this Act, each State shall certify to the Administrator of the Environmental Protection Agency, by legislative act effective upon signature of the governor, which covered electric utilities providing retail electric service within that State will satisfy the emissions reduction goals of section XX [provision comparable to H.R. 2454 section 703] by holding emission allowances or offset credits equal to its emissions levels as provided in subsection XX [provision comparable to H.R. 2454 section 722(b)], and which will satisfy the emissions reduction goals through a state alternative compliance plan developed under this subsection.

"(B) If a State certifies that one or more of the covered electric utilities providing retail electric service within that State will be subject to an alternative compliance plan under this subsection, the State must also certify that the State

regulatory authority, governing board or supervising State or political subdivision that oversees the covered electric utility has the ability to (i) consider the interests of retail electric consumers served by the covered electric utility and (ii) require the covered electric utility to satisfy the emissions reduction goals and restrictions. Upon filing the certifications, the State is authorized to implement and enforce the requirements of this section and Title XX of this Act through a state alternative compliance plan developed under this subsection.

"(C) A covered electric utility that complies with a State's alternative compliance plan developed under this subsection shall be deemed to be in compliance with any requirements under Title XX of this Act, excluding any reporting requirements under sections XX [provision comparable to H.R. 2454 sections 711 through 713].

"(3) PENALTIES FOR NON-COMPLIANCE.— The penalty for noncompliance described in section XX [provision comparable to H.R. 2454 section 723] shall apply to a State's failure to comply with its alternative compliance plan; provided that a certifying State may seek to recover the costs of the penalty for non-compliance from the covered electric utility which is subject to the alternative compliance plan if the certifying State determines that the cause of non-compliance was the direct result of an action or inaction by such covered electric utility.

"(4) REQUIREMENTS.—Within 1 year after the date of submitting the certification under paragraph (2), the State regulatory authority, governing board or supervising State or political subdivision that oversees a covered electric utility shall adopt an alternative compliance plan for each covered electric utility that has been certified as being subject to an alternative compliance plan. The State shall promulgate any laws or regulations necessary to provide for the implementation, maintenance, and enforcement of the requirements described in this section.

"(5) CONTENTS OF ALTERNATIVE COMPLIANCE PLANS.— Each alternative compliance plan of a State shall—

"(A) identify the covered electric utility providing retail electric service within that State that will be subject to the alternative compliance plan;

"(B) determine the quantity of greenhouse gas emissions attributable to the retail electric service provided within the State by the covered electric utility during the base period;

"(C) require that, if the covered electric utility owns or operates a covered EGU within the State as defined in section XX [provision comparable to H.R. 2454 section 116 of Title I] of this Act, the covered EGU must meet the performance standards established by that section; and

"(D) set forth in detail the measures that will be required to be undertaken by the covered electric utility to satisfy the emissions reduction goals of section XX [provision comparable to H.R. 2454 section 703] for the proportion of its total emissions that are attributable to the State adopting the alternative compliance plan.

"(6) REGIONAL CAP AND TRADE PROGRAMS PROHIBITED -- Participation in a regional cap and trade program or comparable program shall not be deemed a permissible measure for an alternative compliance plan under subsection (5). However, the state regulatory authority, governing board or supervising state or political subdivision that oversees a utility that is subject to an alternative compliance plan is not precluded from permitting the utility to use domestic offset credits as one means of reducing emissions.

"(7) UPDATES TO PLANS.-- Alternative compliance plans shall be updated by the State at least every four years.

"(8) FILING OF PLANS.--

"(A) Within thirty days after adoption by the State regulatory authority, governing board or supervising state or political subdivision, an alternative compliance plan or update shall be filed with the State environmental agency delegated enforcement authority of U.S. Code Title 42, Chapter 85.

"(B) The State environmental agency delegated enforcement authority of U.S. Code Title 42, Section 7410 shall file the alternative compliance plan or update with Administrator of the Environmental Protection Agency as a State Implementation Plan control measure.

“(9) NO ALLOCATION OF ALLOWANCES— A covered electric utility that is subject to a state alternative compliance plan under this subsection shall not receive a distribution of allowances under subsection XX [provision comparable to H.R. 2454 section 783(b)] for the proportion of the distribution attributable to the emissions in the State adopting the alternative compliance plan. Such allowances shall be permanently retired. Except as provided in this subsection, a covered electric utility that is subject to an adopted alternative compliance plan shall not be subject to the provisions and rules of section XX [provision comparable to H.R. 2454 section783].

“(10) PUBLIC-PRIVATE COLLABORATION.— A covered electric utility that has been certified to be subject to a State alternative compliance plan under this subsection shall collaborate with the State regulatory authority, governing board or supervising State or political subdivision that oversees the covered electric utility to develop the alternative compliance plan and updates.

"(11) APPLICABILITY OF CLEAN AIR ACT PROVISIONS --

"(A) A covered electric utility that is subject to a State alternative compliance plan under this section shall not be subject to the following provisions of the U.S. Code as long as the plants remain in compliance with the state's alternative compliance plan: Title 42, Sections 7411, 7412, 7413, and 7470 through 7479.

"(B) The exemptions in Part XX [provision comparable to H.R. 2454 Part C of Title VIII] of this Act shall apply to a covered electric utility that is subject to a State alternative compliance plan under this section.