

December 14, 2010 ***Electronic Filing***

The Honorable Mary Nichols, Chairman

Mr. James Goldstene, Executive Officer

California Air Resources Board

1001 I Street

Sacramento, California 95812

Comments of the State Water Contractors (“SWC”) on the California Air Resources Board’s (“ARB”) October 28, 2010 Proposed Regulation to Implement a California Cap-and-Trade Program

1. **Introduction**

The SWC is a non-profit, mutual benefit corporation organized under the laws of the State of California, comprised of 27 public agencies holding contracts to purchase water delivered by the State Water Resources Development System, otherwise known as the State Water Project (“SWP”), which is owned and operated by the California Department of Water Resources (“DWR”). SWC’s public agency members are the beneficial users of the SWP, providing water for drinking, commercial, industrial, and agricultural purposes to a population of more than 20 million people and to over 750,000 acres of farmland throughout the San Francisco Bay Area, the Central Valley of California, and Southern California. The primary purpose of the SWP is to store and deliver water to the SWP Contractors, who pay all of its costs. Thus, the SWC has a vested interest in the ongoing development of regulations for implementing AB 32. By imposing significant costs on the importation of electric energy, the final regulations will dramatically affect the costs of SWP’s delivery of water throughout the state and the rates imposed on end-use water customers. Delivery of this water is vital to the health, welfare, and productivity of the State of California.

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The SWC members are: Alameda County Flood Control & Water Conservation District, Zone 7; Alameda County Water District; Antelope Valley-East Kern Water Agency; Casitas Municipal Water District on behalf of the Ventura County Flood Control District; Castaic Lake Water Agency; Central Coast Water Authority on behalf of the Santa Barbara County Flood Control & Water Conservation District; City of Yuba City; Coachella Valley Water District; County of Kings; Crestline-Lake Arrowhead Water Agency; Desert Water Agency; Dudley Ridge Water District; Empire-West Side Irrigation District; Kern County Water Agency; Littlerock Creek Irrigation District; The Metropolitan Water District of Southern California; Mojave Water Agency; Napa County Flood Control & Water Conservation District; Oak Flat Water District; Palmdale Water District; San Bernardino Valley Municipal Water District; San Gabriel Valley Municipal Water District; San Gorgonio Pass Water Agency; San Luis Obispo Co. Flood Control & Water Conservation District; Santa Clara Valley Water District; Solano County Water Agency; and Tulare Lake Basin Water Storage District.

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Central Coast Water Authority

### General Manager

Terry Erlewine

**Summary of the SWC’s Recommendation**

To the extent that DWR is required to participate in the cap-and-trade program, it should receive a direct allocation of allowances according to the same formula used for Electric Distribution Utilities (“EDUs”). Since DWR, like the publicly-owned EDUs, is a publicly-owned utility providing an essential public service, there is no rational basis for treating it differently from EDUs with respect to allowance allocations. If DWR does not receive free allowances under the program for the benefit of end-use water customers, it should not be considered a “Covered Entity.”

1. **Comments on Relevant Components of the Proposed Cap-and-Trade Program**
	1. As defined in the Proposed Regulation, DWR is a First deliverer of electricity because it is expressly deemed an Electricity importer.[[1]](#footnote-1) DWR has complied with the Mandatory Reporting Regulation and has reported in prior years to the same extent as a retail electricity provider.[[2]](#footnote-2) The associated emissions from DWR’s imported electricity from specified sources exceed the threshold of 25,000 metric tons CO2 per year.[[3]](#footnote-3)

**Recommendation: DWR is considered a Covered Entity by virtue of its activities in the electricity sector.[[4]](#footnote-4) DWR is more comparable to an EDU than a generator or marketer, since the costs of the allowances it will be required to surrender will ultimately be passed to end-use consumers. Therefore, DWR should receive a direct allocation of allowances pursuant to regulations that are applicable to the electricity sector. Alternately, DWR should not be considered a Covered Entity under the regulations.**

* 1. The cap-and-trade program emission cap determines the number of allowances issued by ARB and the Initial Statement of Reasons (“ISOR”) acknowledges that the emission cap must be set to achieve the proper price for allowances. These allowances, plus the permitted quantity of offset credits, “determine the total limit on emissions from *all* of the covered entities” in the cap-and-trade program.[[5]](#footnote-5) The Proposed Regulation calculates a cumulative emissions cap for the years 2012-2020 and divides this quantity into annual budgets. The Proposed Regulation sets the “starting allowance budget levels equal to the expected emissions for the year that a category of covered sources enters the program” which will “enable emissions to continue as expected under business-as-usual (BAU) conditions in the first year of a sector’s inclusion in the program.”[[6]](#footnote-6) The initial year’s allowance budget equals the projected 2012 emission level of the narrow scope sources which includes sources in the electricity and industrial sectors. The Proposed Regulation will freely allocate 97.7 million allowances in 2012.[[7]](#footnote-7)

**Recommendation: The ISOR states that “accuracy in emissions estimates from covered entities is a key component of ensuring that the desired level of cap stringency is implemented.”[[8]](#footnote-8)** **The Mandatory Reporting Regulations required DWR to report its GHG emissions according to the same rules that applied to retail electricity providers. Pursuant to a conversation with ARB GHG Inventory staff, the SWC understands that the emissions associated with DWR’s imported electricity were included by ARB staff when the starting allowance budget level of 97.7 MMT was set. Because DWR’s reported emissions from its electricity operations are included in the graph, DWR will be responsible for incurring abatement costs tied to its emissions without the benefit of receiving that allowance value. The allowances to which DWR would otherwise be entitled will be distributed to EDUs who will not be responsible for any abatement costs associated with these emissions. Therefore, in order to ensure equitable treatment, DWR should be included in the list of Covered Entities that receive direct allowance allocations.**

* 1. The ISOR acknowledges that the cap-and-trade program must be designed so the covered entities that need allowances may acquire them. A fundamental aspect of program design concerns determining “how best to allocate the value embodied in the allowances.”[[9]](#footnote-9) In ISOR Appendix J, the Figure J-1 is offered as a stylized representation of California’s emissions market. I t graphically indicates the total abatement costs required to reach a chosen emissions cap, as well as the total allowance value at a selected market price. The text notes that “if covered entities were required to purchase *all* allowances at auction, a significant cost would be imposed”[[10]](#footnote-10) because the “covered entities would be required to pay both the total abatement cost to reduce emissions and an amount equivalent to total allowance value to acquire allowances.”[[11]](#footnote-11)

**Recommendation: DWR will be required to pay the total allowance costs for its emissions if it does not receive a direct allocation of allowances. Under the proposed regulations, water wholesalers such as DWR are the only utilities whose downstream customers receive no relief from increased rates associated with AB 32 compliance. Water is an important commodity no less essential than electricity and water ratepayers cannot forego its consumption. ARB should be as mindful of the impacts on water ratepayers as they are of electricity ratepayers. Therefore, DWR should receive a direct allocation of allowances for the same *purposes* as EDUs, i.e., the protection of water customers.**

* 1. The ISOR uses the term “incidence . . . to describe who bears the burden of a levy or fee.”[[12]](#footnote-12) The ISOR states that, “[i]n general, the incidence of a regulation will fall on consumers if the producer has full cost pass-through ability and will fall on the producer if the producer has no cost pass-through ability.[[13]](#footnote-13) The ISOR uses Table J-1 to show the “expected incidence of carbon costs by sector assuming no return of allowance value.”[[14]](#footnote-14) The Table shows that it is “certain” for the Deliverers of Electricity that the carbon price incidence is on the retail consumers of electricity.[[15]](#footnote-15) For this reason, the Proposed Regulation will allocate free allowances to utilities that provide electricity to California ratepayers.[[16]](#footnote-16)

**Recommendation: DWR passes through all SWP power costs to the SWC agencies and, ultimately, to end-use water consumers. Thus, water ratepayers are in precisely the same situation as the retail electricity ratepayers as the incidence of the cap-and-trade program falls directly on them. Therefore, DWR should receive a direct allocation of allowances for the same reason that allowances are being given to EDUs.**

* 1. The “cap-and-trade program is intended to embed a carbon price in both retail and wholesale rates of electricity.”[[17]](#footnote-17) Electricity generators will not be given any allowances because they generally can fully pass the cost into the wholesale market. This cost will also be passed on to the end-user in a subsequent retail transaction. This increased cost will provide a signal to the consumer, but “staff is mindful of the need to protect ratepayers from increased expenditures on electricity.”[[18]](#footnote-18) Therefore, EDUs “will receive free allowances, and the value of the allowances must be used to mitigate the bill impacts of AB 32 programs on their distribution customers.”[[19]](#footnote-19) The EDUs will be required to use the allowance value “for protection of electricity customers and for other AB 32 purposes.”[[20]](#footnote-20) At this point, the actual allocation method is undecided but it “must further the cap-and-trade emissions reduction objectives, including providing incentives to reduce emissions cost effectively.”[[21]](#footnote-21) The allocation must also enable “all the *utilities* to serve their customers reliably and affordably.”[[22]](#footnote-22)

**Recommendation: As described in paragraph d, the cost of carbon directly incurred by DWR through the SWP’s electricity-related emissions will be passed through to water consumers. There are important differences between water utilities and electric utilities in terms of how wholesale electric costs are ultimately allocated, but these differences should not result in inequitable treatment of the water sector with respect to “protect[ing] ratepayers from increased expenditures on electricity.” In the electric sector, IOUs and POUs purchase wholesale power and resell it to retail electric customers. Thus, providing these EDUs with free allowances enables them to directly offset AB 32 compliance costs imposed on their retail customers. In the water sector, by contrast, DWR purchases wholesale power for its own operations. Since DWR does not have retail water customers, it passes all wholesale power costs, including any costs associated with AB 32 compliance, along to the State Water Project Contractors, who then pass the costs along to retail water customers, either directly or through member agencies. Because it is not practical to provide free allowances to retail water utilities, the only way that end-use water customers can be protected from the allowance-related costs associated with AB 32 compliance is to allocate free allowances to the wholesale water providers, such as DWR, that incur these direct compliance costs. In sum, if DWR does not receive free allowances for imported energy purchased to power the SWP, no other entity will be able to mitigate allowance-related costs to water consumers, defeating ARB’s intent to protect end-use utility customers from exorbitant price increases. If ARB determines that providing free allowances directly to DWR is inconsistent with the requirements and goals of AB 32, it should work with the SWC to fashion a methodology to ensure that retail water utilities are treated in the same manner as retail electric utilities with respect to the mitigation of cost increases.**

* 1. The local regulatory authority of a publicly-owned electric utility (“POU”) will review all costs and set electricity rates. Most POUs own and operate their own generation and do not compete with independent generators. Therefore, the Proposed Regulations permit POUs to either use the freely gained allowances either directly for compliance or to monetize the allowance value by sale into the auction and then use the value for their customers.[[23]](#footnote-23)

**Recommendation: DWR is analogous to a POU in its provision of service, the necessity of passing through costs, and its obligations to reduce GHG emissions through what are akin to complementary measures.Like POUs, DWR is vertically integrated to some degree and owns generation facilities, procures electricity on the open market, operates distribution systems, and engages in power sales.[[24]](#footnote-24) Its similarity is graphically demonstrated in Appendix J by Table J-8. Also like a POU, DWR has obligations to procure additional renewable resources and to facilitate energy efficiencies. In accordance with Health & Safety Code § 38592(a), all state agencies shall consider and implement strategies to reduce their GHG emissions. DWR, as a state agency, has an independent duty to consider and implement strategies to reduce its GHG emissions for the purpose of mitigating climate change. DWR is currently pursuing this mandate through the implementation of its Sustainability Plan. DWR has incorporated significant mitigation strategies into its Sustainability Plan including pursuing efficiency in water and energy use at every opportunity. The Plan also incorporates a progressively increasing procurement of renewable resources to achieve the state’s GHG targets of reaching 1990 levels by 2020 and 80% below 1990 levels by 2050 as described in Executive Order S-3-05.[[25]](#footnote-25) For example, DWR issued a competitive request for wind power on November 12, 2010 with proposals due on January 27, 2011. DWR’s commitment to mitigating the impacts of climate change—independent from its statutory and regulatory obligations—is evidenced by the fact that it initiated a sustainability plan in the 1980’s long before it had any legal obligation to do so. The Sustainability Plan represents an AB 32-consistent emission reduction plan in which DWR can invest its allowance value, and DWR should receive free allowances on the same basis as a publicly-owned electric distribution utility. DWR’s commitment to reducing GHG emissions is well-established by its current and prior actions.**

1. **Recommended Amendment to the Proposed C&T Program Regulation**

In order to implement the recommendations discussed above, the SWC proposes adding section 95890(d) as shown here.

**§ 95890. General Provisions for Direct Allocations**

***(d) All provisions of this Article applicable to a publicly-owned Electric Distribution Utility shall be applicable to the California Department of Water Resources for the State Water Project pumping load reported under article 2, section 95111(e), title 17, Greenhouse Gas Emissions Data Report.***

1. **Conclusion**

ARB recognizes that EDUs are “best situated to use allowance value for their ratepayers” and that EDUs are making large investments in order to achieve emission reductions.[[26]](#footnote-26) The proposed regulations therefore recommend that allowances be freely distributed to EDUs to: (1) support policies and programs for “reducing GHG emissions from the electricity sector” and (2) ensure that ratepayers “do not experience sudden increases” in their bills “associated with the pricing of carbon emissions in a cap-and-trade program.”[[27]](#footnote-27) As stated above, DWR is best situated to use allowance value for the benefit of water ratepayers who will be incurring the cost of carbon from DWR’s “electricity sector” emissions. Like EDUs, DWR will use this value to: (1) reduce emissions through its Sustainability Plan and (2) reduce the costs experienced by ratepayers associated with the cap-and-trade program. The same logic and policy for distributing allowances to EDUs also applies to DWR and the SWP.

**Therefore, DWR should be allocated free allowances for the benefit of the SWP. If DWR does not receive the allowances, equitable treatment can only be ensured by excluding DWR from the list of Covered Entities.**

Sincerely,



Terry Erlewine

General Manager

State Water Contractors

1. Proposed Regulation (“PR”) § 95802(a)(59), (a)(71). [↑](#footnote-ref-1)
2. PR § (95850(a). [↑](#footnote-ref-2)
3. PR §§ 95811(a)-(b), 95812(b)(2). [↑](#footnote-ref-3)
4. PR § 95802(a)(44). [↑](#footnote-ref-4)
5. ISOR, Appx E at 5 (emphasis added). [↑](#footnote-ref-5)
6. ISOR, Appx E at 5, 6. [↑](#footnote-ref-6)
7. Electricity Sector Allowance Allocation Recommendation Paper for Conference with Chair Nichols, November 30, 2010 (“Recommendation Paper”). [↑](#footnote-ref-7)
8. ISOR Appx E at 7. [↑](#footnote-ref-8)
9. ISOR Appx J at 6. [↑](#footnote-ref-9)
10. ISOR Appx J at 7 (emphasis added). [↑](#footnote-ref-10)
11. ISOR Appx J at 7. [↑](#footnote-ref-11)
12. ISOR Appx J at 9. [↑](#footnote-ref-12)
13. ISOR Appx J at 7. [↑](#footnote-ref-13)
14. ISOR Appx J at 10. [↑](#footnote-ref-14)
15. ISOR Appx J at 10. [↑](#footnote-ref-15)
16. PR § 95870(c)(1); ISOR Appx J at 11, 15, 55-61. [↑](#footnote-ref-16)
17. ISOR Appx J at 15. [↑](#footnote-ref-17)
18. ISOR Appx J at 16. [↑](#footnote-ref-18)
19. PR § 95890(b); ISOR Appx J at 16. [↑](#footnote-ref-19)
20. ISOR Appx J at 11, 15. [↑](#footnote-ref-20)
21. ISOR Appx J at 17. [↑](#footnote-ref-21)
22. PR § 95892; ISOR Appx J at 17 (emphasis added). [↑](#footnote-ref-22)
23. PR § 95892(d); ISOR Appx J at 17, 18. [↑](#footnote-ref-23)
24. ISOR Appx J at 55. [↑](#footnote-ref-24)
25. DWR has other statutory obligations for reducing emissions besides those listed in AB 32. California Water Code § 142(a) states that “[i]In order to reduce greenhouse gas emissions associated with water and energy usage, on and after January 1, 2008, the department shall do all of the following: . . . (2) Use reasonable, feasible, and cost-effective efforts to use energy efficiently, and to increase use of renewable energy in the department's water operations . . . .” [↑](#footnote-ref-25)
26. Recommendation Paper at 2. [↑](#footnote-ref-26)
27. *Id.* [↑](#footnote-ref-27)