

August 11, 2011

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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”)’s July 2011 Modified Proposed Regulation to Implement a California Cap-and-Trade Program

**Introduction**

The SWC is a non-profit, mutual benefit corporation organized under the laws of the State of California, comprised of 27 public agencies<sup>1</sup> 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.

The SWP owns large hydroelectric generation and purchases power to operate its water pumping plants. It buys and sells power through the CAISO to shape its generation to meet its load, and to provide load-following services and peaking power to the benefit of the people of California as a whole. The SWP pumping load uses slightly less than 5 percent of the energy on provided through the ISO, and comprises the single largest end-user whose demands are met through that market. The variable cost of meeting this load is billed on a per acre-foot (AF) basis to the member agencies, based on the amount of pumping required

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<sup>1</sup>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 Geronio 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.

to deliver water to each agency's location. Because of the structure of the SWP, agencies in southern California pay considerably more for energy costs per AF than agencies in northern California. Thus, the SWC has a vested interest in the ongoing development of regulations for implementing AB 32.

By imposing significant additional costs on the electric energy used to move SWP water, the final regulations will dramatically affect the costs of SWP's delivery of water throughout the state and the rates imposed on its end-use water customers. As currently proposed, the regulations are inequitable to SWP's customers, and will result in an unmitigated rate shock, a transfer of wealth from southern to northern California, impairment of the ability of SWP water users to compete with those in similar industries, "leakage" of carbon emissions from California industries to those competitors outside the state, and unmitigated risk to SWP water users in the event of market failure.

### **Summary of the SWC's Recommendation**

To the extent that SWP is required to participate in the cap-and-trade program, its customers should receive the same protection from rate shock and the risk of market failure as the customers of the electric distribution utilities. The current staff proposal is inequitable, results in a south-to north wealth transfer, risks leakage from disadvantaged industries and further disadvantages areas of the state that are already in economic distress. It also leaves SWP water users particularly exposed to risk of market failure. There are alternative regulatory structures that would meet the requirements of the regulation while ameliorating these concerns.

Staff appears to have decided that the "end-users" associated with SWP loads are not the SWP pumps, but rather the water "end-users". If the Board upholds this interpretation, the water distribution agencies (WDAs) should receive a direct allocation of allowances associated with the SWP load according to the same formula used for Electric Distribution Utilities ("EDUs"). Alternatively, if the Board decides that the appropriate "end-users" are the SWP water pumps, then the direct allocation of allowances should be provided to the SWP.

### **Comments on Relevant Components of the Proposed Cap-and-Trade Program**

#### **a. DWR a covered entity**

As defined in the Proposed Regulation, DWR is a First deliverer of electricity because it is expressly deemed an Electricity importer.<sup>2</sup> DWR has complied with the Mandatory Reporting Regulation and has reported in prior years to the same extent as a retail electricity provider.<sup>3</sup> The associated emissions from DWR's imported electricity from specified sources exceed the threshold of 25,000 metric tons CO<sub>2</sub> per year.<sup>4</sup> DWR also purchases power on the CAISO market and its operating costs will be impacted by the carbon cost associated with those purchases. Question has been raised as to whether CARB has jurisdiction over DWR as a state agency, but this comment letter does not take a position on that issue.

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<sup>2</sup> Proposed Regulation ("PR") § 95802(a) (84), (a) (97).

<sup>3</sup> PR § 95850(a).

<sup>4</sup> PR §§ 95811(a)-(b), 95812(b) (2).

**Recommendation:** DWR is considered a Covered Entity by virtue of its activities in the electricity sector.<sup>5</sup> Because of its integration in the electric market, if CARB has the appropriate authority it is difficult to see how DWR could be excluded from regulations covering the electric sector.

**b. Proposed Allocation of Emissions Allowances Inequitable**

The ISOR recommends that a set number of allowances are set aside each year for the electricity sector, starting with the 2012 allocation at 90% of 2008 electricity sector emissions and declining linearly to 85% of that value by 2020. Thus the initial expectation appeared to be that the allowances available for use by the electric utilities would be less than they would otherwise need, to ensure that the emissions would be reduced each year to the levels specified by the regulation. Since these levels were set, two events have occurred that allow the free allocations to the Electric Distribution Utilities (EDUs) to exceed those needed by those EDUs: (1) the recession has reduced the demand for electricity (and water), leading to at least a temporary decrease in emissions; and (2) the ARB staff have allocated the allocations associated with SWP load (and loads of others) to the EDUs, ensuring that the electric utility consumers will receive a net short-run benefit from the imposition of the cap-and-trade program, while water consumers associated with the SWP will receive no mitigation from rate shock.<sup>6</sup>

This is inequitable. The staff suggested in the July 25 workshop that they believed that allocating the emission allowances associated with the SWP's load to the electric utilities would be "approximately equitable."<sup>7</sup> This appeared to be based on the reasonable assumption that all electricity users are also water users. The staff appears to assume that while water users would get no rate shock mitigation from their water utilities, they would get excess mitigation from their electric utilities, and so the two inequities would cancel out. This is far too simplistic.

***Some water agencies do gain benefit from free allocations***

Many water agencies not associated with the SWP are gaining rate shock mitigation from their electric utilities. Water utilities that rely on groundwater pumping and purchase electricity at retail will obtain rate shock mitigation from their EDUs. Utilities such as East Bay Municipal Utility District -- where the pumping load is part of PG&E's service area load -- will receive mitigation from PG&E. They will also receive additional mitigation above their costs because of the share of SWP allowances allocated to PG&E. Thus some water utilities will receive mitigation above the level of rate shock they are expected to experience. SWP is different from these utilities only because of its size and because it purchases power at wholesale, rather than retail. Neither of these is an appropriate reason to withhold rate shock mitigation from SWP's end-use consumers.

***Allocation allowances and SWP cost impacts are spread differentially across the state***

The allowance allocations are not spread equally across the state's electric utilities. In Appendix A, staff reports that the allowance allocation to EDUs is based on cost burden, projected cumulative

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<sup>5</sup> PR § 95802(a) (61).

<sup>6</sup>California Air Resources Board, Appendix A: Staff Proposal for Allocating Allowances to the Electric Sector. Staff acknowledges in Appendix A that the emissions associated with operation of the SWP is included in the pool of allowances set aside for the electric sector (Appendix A at 16.)

<sup>7</sup> Response by Steve Cliff, ARB to question asked by Timothy Haines (SWC) at the July 23 workshop.

energy efficiency, and early investment in renewables.<sup>8</sup> Thus the allocation between utilities is not an even dollar amount per kWh, or an even percentage of end-user power costs.<sup>9</sup> Even if the costs associated with SWP emissions were spread evenly across the state, the fact that the allocation to the electric industry is not spread evenly would suggest that this “rough equity” might be problematic.

However, the SWP costs are *not* spread evenly across the state. As the water from the project is pumped further uphill and to the south, the associated electric costs (and therefore, cap-and-trade costs) increase. Thus the ARB staff’s “rough equity” results in a wealth transfer from southern California to northern California that we have conservatively estimated to be between \$40 and \$260 million. This is exacerbated when it is realized that the southern California consumers are further disadvantaged by the staff’s decision not to allocate allowances to Metropolitan Water District of Southern California (MWDSC). When this is factored in, the inequity becomes much greater.

### ***Examples of Inequity***

One of the areas most hard-hit by this inequity is San Diego County. It is at the southern end of the SWP system, and so will receive a large portion of the burden of SWP emissions costs. Yet the excess allocation to SDG&E is only 7 percent of the SWP emissions (the share of the state’s total allocations awarded to SDG&E). In contrast, very little of the SWP emission costs will fall on consumers in the north of the state, yet PG&E is awarded 26 percent of SWP’s emission allocations.<sup>10</sup> It should be noted that PG&E also has been awarded with 26 percent of MWDSC’s free allocation, even though it serves no load in MWDSC’s service territory. Finally, the situation in Kern County is another example of inequitable treatment. Situated at the southern (uphill) end of the San Joaquin Valley, it has been estimated that the County will experience approximately 5 percent of SWP’s costs associated with cap-and-trade, but be provided with only 2 percent of the SWP allocation from PG&E.<sup>11</sup> Kern County is a hard-pressed agricultural economy, where the unemployment rate is reported to be 15%. The incomplete mitigation of the rate shock associated with SWP supplies will fall hard on impoverished and unemployed workers in the county. It will also likely add to the economic hardship as farmers who are reliant on SWP water have to compete with farmers who use groundwater, and thus are receiving some of the rate shock mitigation that should rightfully go to the SWP farmers.

Thus, households in San Diego County will receive inadequate protection from rate shock, whereas households in Oakland will be more than compensated. Water-intensive industries in San Diego will be competitively disadvantaged when compared to those same industries in Oakland, or outside California. Farmers using SWP water will be competitively disadvantaged when compared to other farmers both inside and outside California. To the extent that output from disadvantaged industry and agriculture is displaced by competitors outside the state there will be leakage, as the emissions related to those customers are relocated outside the state rather than being reduced.

**Recommendation: The allocation of free emission allowances should be provided in such a way as to protect consumers of SWP water from rate shock. Under ARB Staff’s current proposal, the allowances to which SWP users would otherwise be entitled will be distributed to EDUs who will use those benefits for mitigation of costs to their customers, not the customers of the**

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<sup>8</sup>California Air Resources Board, Appendix A, at 4 and 5.

<sup>9</sup>See, for example in Appendix A, the table beginning at 12.

<sup>10</sup>PR Table 9-3, at A-124.

<sup>11</sup> According to workpapers filed by PG&E in its recent rate case, the Kern Division was responsible for 0.7 percent of PG&E’s load in 2007, and so would get approximately 0.7% of PG&E’s 26% free allocation of SWP allowances.

**SWP. These households and businesses will be negatively affected by the cost of the regulation, and, in particular, businesses and agriculture that use SWP-supplied water will be placed at an economic disadvantage. This is inherently inequitable and would likely lead to leakage.**

**c. Proposed Allocation of Emission Allowances Exposes SWP Consumers to Risk of “Market Meltdown”**

In addition to the Staff’s stated goal of providing free emissions to mitigate rate shock, the provision of free emissions will provide partial consumer protection in the event of “market meltdown”. The Legislative Analyst’s office has expressed concern that this new market might have insufficient “fail-safe” aspects, and so could result in wide swings in prices that could destabilize the California economy.<sup>12</sup> Californians remember the experience of market failure when its precedent-setting electric market resulted in soaring electric rates and utilities threatened with bankruptcy. One aspect of the allocation of free emissions will be to protect consumers in the event of such a market failure occurring in California’s precedent setting carbon market. If prices on that market do soar, consumers will have the protection of being both payers for and sellers of emission allowances.

SWC wants that benefit for its consumers. It is inequitable that consumers of SWP water be unnecessarily exposed to the risk of market failure without the benefit of the insurance policy of free allocations that is provided to most other parties to be affected by the market. SWC finds it particularly disturbing that San Diego County, which was particularly exposed to the electric market failure, will, under the Staff’s proposal, be once again particularly exposed in case of market failure.

**Recommendation: SWP consumers should be provided with the protection against market failure that has been provided to other consumers in California, by the allocation of free emission allowances.**

**d. A Free Allocation of Emission Allowances to SWP Can Meet the Goals of the ARB Regulation**

Under its discussion of the criteria for receiving allowances as part of the Electricity Sector Allocation, the ARB staff states:

Generators, marketers, and other providers of electricity that do not have a transactional relationship to end-use customers are not eligible for allowance allocation. This requirement is essential to correctly incorporating the emissions price signal in electricity markets and appropriately compensating electric customers for the costs of the program. If entities without a transactional relationship to consumers are allocated allowances for the benefit of end-use customers their only means of directly defraying the programmatic costs would be reduce prices. This outcome is explicitly NOT the goal of cap and trade.<sup>13</sup>

Furthermore, the staff uses this argument to justify not allocating free emissions to SWP because such an action “could result in either the deterioration of the emissions price signal in the water sector, if they used the value to reduce prices, or lost value for end-use customers, if they used the allowance value for something other than direct compensation, which they are not well positioned to provide to

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<sup>12</sup>Legislative Analyst’s Office, *Cap and Trade Market Issues*, Presented to the Senate Select Committee on the Environment, the Economy, and Climate Change, June 29, 2011.

<sup>13</sup>Appendix A at 16.



end-users.”<sup>14</sup> While the staff’s goals may be laudable, the analysis of the situation with regard to the SWP is not.

***SWP energy costs are charged on a per-unit basis to its members***

The SWP passes along its energy costs to its contractors on a per AF basis based on the kWh required to deliver water to each agency’s location. In turn, these contractors, many of whom have “transactional relationships with consumers” pass the energy charge on to their consumers. The price signal imposed by the cap-and-trade regulation *will* be passed to the end-use consumers. The only remaining questions are: (1) will those end-use consumers receive the same rate-shock mitigation and market insurance that other consumers have been awarded; and (2) if so, how?

***No electric utilities have determined how to use revenues from sale of the free allocations***

Initially, SWP was under the impression that ARB staff was focused on electricity end-use, and use of the revenues from the sale of the free allocations “for protection of electricity customers and for other AB 32 purposes.”<sup>15</sup> Because of this, SWP’s initial proposals focused on the SWP pumps (the electricity end-users) and use of the revenues for “other AB 32 purposes”, specifically the use of those revenues to increase pumping efficiency, use of renewable energy, and promote conservation.

However, in its most recent release ARB staff have clarified that it is interested in the effect on the retail end-user, whether that end-user is a user of electricity or water. They have further clarified that it is ARB’s intent that auction proceeds from consigned allowances to be used only for ratepayer relief. However, the regulation is not clear how this is to be achieved. Indeed, the California Public Utilities Commission (CPUC) is currently exploring how to implement this part of the regulation.<sup>16</sup>

A recent prehearing conference in that proceeding directed the participants to provide input on the following questions: (1) How should the electric utilities under Commission jurisdiction allocate the revenues from the auction of GHG emission allowances received from ARB? (2) What portion, if any, of revenues should be returned directly to customers to offset GHG compliance costs versus held for use for other purposes, e.g., energy efficiency programs and renewable energy procurement?<sup>17</sup> It should be noted that the energy utilities’ initial filing in this proceeding recommended that the revenue be returned by reducing the cost of energy.<sup>18</sup> This is counter to the ARB staff goals. *Fear that SWP might do this* was sufficient for ARB staff to refuse an allocation of free allowances, yet ARB has not suggested that the electric utilities’ requests to do exactly that should disqualify them from receiving their free allocations. We would like to stress that this emphasizes that SWP is being held to a different standard than the electric utilities. *While the other utilities are still deciding what to do with the revenues obtained from auctioning the free allocation, ARB is refusing to provide SWP with free allowances because it is concerned that SWP might do something ARB would not like, and SWP has not yet proven that this will not be the case.*

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<sup>14</sup>Appendix A, at 16.

<sup>15</sup> ISOR Appendix J at 11, 15.

<sup>16</sup>In Proceeding number R-11-03-012

<sup>17</sup>Prehearing Conference Agenda, Rulemaking 11-03-012, August 1, 2011, 10:00 am

<sup>18</sup>Joint Motion Of Pacific Gas And Electric Company (U 39 E), Southern California Edison Company (U 338 E), And San Diego Gas & Electric Company (U 902 E) For Interim Decision to Authorize Use of Greenhouse Gas Allowance Revenues for 2012 Electricity Rates, filed May 11, 2011 in R 11-03-012.

### *Processes can be developed to meet the goals of the regulation*

Despite ARB staffs' fears about the distance between SWP and the water end-use customers, mechanisms exist to ensure that ARB staff's goals can be met by procedures within the SWP system. SWC would like to emphasize the following points:

1. SWP provides water to the State Water Contractors, many of whom have the required "transactional relationship with end-use customers".
2. Even in cases where the Contractor<sup>19</sup> sells at wholesale to retail agencies, the wholesale agency maintains planning and operational contacts with the retail agency, and some maintain a "transactional relationship" with some end-use customers through Contractor-operated conservation programs and other planning programs.
3. Anything an Electric Distribution Utility can undertake to return value to its retail end-users will have an analogue in the water industry, and the appropriate parallel action could be taken by DWR, a Contractor, or a Water Distribution Utility.

SWC proposes that ARB should allocate the free emission allowances associated with SWP loads to the individual state water contractors, in proportion to their responsibility for SWP energy costs. Where the Contractor is a Water Distribution Utility (such as Alameda County Water District), that district should be treated by ARB in the same way that ARB is treating the POU – that is, allowing the District to choose between providing DWR with the emission allowances needed for surrender, or selling the allowances at auction. ARB should provide the same general guidelines and reporting requirements to these WDUs as it is providing to the EDUs.

Where the contractor is an intermediate wholesaler, or even a mixed utility (part WDU, part wholesaler) SWC proposes that ARB chooses between the following two alternatives.

1. ARB does not provide the free allocation to the Contractor, but to the WDUs that are served by the contractor. It should then treat these WDUs as outlined for the Contractor WDUs above. This exactly matches the situation with the electric utilities, and ARB's stated preference. However, it is administratively difficult for ARB because of the large number of small WDUs, and for the small WDUs because of their small staff and limited financial experience.
2. ARB provides the free allocation to the Contractor, with the requirement that the Contractor assist its member WDUs to return the value associated with the allocation of the revenues to their end-use customers. Other than the allowances are held in trust for the member WDUs, these Contractors should be treated as the Contractor WDUs and the POU EDUs are treated, as outlined above. This has the advantage of somewhat greater administrative simplicity. It also does not place an extra burden on the Contractors, because they would be required to assist their smaller WDUs under either scenario.

**Recommendation: ARB's goal of providing carbon price signals to the end-user will be met by the SWP. However, ARB's goal of mitigating for price increases cannot be met under ARB's current plan to provide the free allocations associated with SWP load to electric distribution utilities. This goal can be met by providing those free allocations to the State Water Contractors in proportion to their energy charges from the SWP. This approach will meet ARB's goals and provide equity and protection to SWP water users.**

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<sup>19</sup> Where "Contractor" is capitalized in this comment letter, it refers to the individual agencies that have water supply contracts with the State Water Project.

## **Recommended Amendment to the Proposed C&T Program Regulation**

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

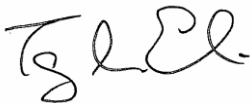
### **§ 95890. General Provisions for Direct Allocations**

*(c) All provisions of this Article applicable to a publicly-owned Electric Distribution Utility shall be applicable to the Contractors of the State Water Project pumping load reported under article 2, section 95111(e), title 17, Greenhouse Gas Emissions Data Report. Where these Contractors are not Water Distribution Utilities, the Allocation provided to the individual Contractor shall be held in trust for its member water distribution utilities.*

### **Conclusion**

The regulation as currently proposed by ARB staff is inequitable to SWP water consumers, and fails to meet ARB's goals of mitigating rate shock to the end-user. It also raises concern over the SWP consumers' particular exposure to the risk of market failure. Equity can be achieved, along with ARB's goals for the regulation, by allocating free emissions allowances to the SWC contractors, as described above.

Sincerely,



Terry Erlewine  
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