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The Honorable Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
California Air Resources Board
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Sacramento, California 95812

Comments of the State Water Contractors (“SWC”) on the California Air Resources Board’s (“ARB”)’s September 2011 Modified Proposed Regulation to Implement a California Cap-and-Trade Program

1. Overview

In its December 16, 2010 Board meeting, the Board emphasized that an important goal of these regulations was economic neutrality.¹ At the same Board meeting Assistant Executive Officer Kennedy stated that, while staff had included the emissions related to the State Water Project (SWP) and Metropolitan Water District (Metropolitan) operations into those covered by the regulation, they had realized late in the day that they had not provided allowances to the consumers of those organizations and had not investigated the cost structure of those organizations. The Board directed, and Mr. Kennedy undertook, to investigate an appropriate solution for this oversight.² *This has not been achieved.*

ARB should be concerned that it appears to have developed justification for not granting allowances to the benefit of our customers after it had made its decision. The Initial 15-day comment period set forth criteria for use of revenues from the sale of the allowances. ARB then claimed the SWP member-agencies could not meet the criteria as the justification to refuse allowances to the SWP. This is despite presentations by SWC, in meetings with Staff and in its previous comments, stressing the similarity of their organizational structure to those of the Publicly Owned Utilities (POUs), and thus their ability to adopt similar practices as those adopted by the POU.

In the changes made to Section 95892 and in the notice documents released for the second 15-day comment period, the staff has acknowledged that it does not have the authority to specify what utilities would do with the revenues from the sale of allowances. Logic dictates that once ARB acknowledged it lacks the authority to impose these criteria it has no basis for refusing to grant allowances to SWP. As a result the ARB staff lacks justification for its decision that will produce wealth transfers that are contrary to established Board policy.

¹Transcript, at 139.
²Transcript, at 137.

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2. Introduction

The SWC is a non-profit, mutual benefit corporation organized under the laws of the State of California, comprised of 27 public agencies³ 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 Contractors⁴, who pay all of its costs.

The SWP owns large hydroelectric generation and purchases supplemental 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 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 to deliver water to each agency’s location. As pointed out in our comments filed for the previous 15-day comment period, the proposed regulations are inequitable to SWP’s customers and will result in:

- i. an unmitigated rate shock to retail customers of SWC agencies;
- ii. a transfer of income from southern to northern California ;
- iii. impairment of the ability of SWP water users to compete with those in similar industries;
- iv. “leakage” of carbon emissions from California industries to those competitors outside the state; and,
- v. Lack of protection for SWP water users in the event of market failure.

Thus, the SWC has a vested interest in the ongoing development of regulations for implementing AB 32.

³ 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.

⁴ Where “Contractor” is capitalized in this comment letter, it refers to the individual agencies that have water supply contracts with the State Water Project.

3. SWC Comments on the Proposed Changes

SWC has comments related to one section of the September, 2011 public release for 15 –day comment.

Section 95892. Allocation to Electrical Distribution Utilities for Protection of Electricity Ratepayers

There are two proposed changes to this section that SWC wishes to address: the modifications to Section 95892(d)(3)(B and C) related to rebates of allowance value; and the changes made to Table 9-3.

Modifications to Section 95892(d)(3)(B and C)

In the *Second Notice of Public Availability*, staff noted that language was removed from these areas that had indicated particular requirements for use of auction proceeds from the sale of free allowances. Staff noted that ARB does not have authority to appropriate funds, and that the use of revenue obtained from consignment of allowances is the responsibility of the PUC for investor owned utilities and the governing Boards of publically owned utilities.⁵

a. Inconsistency of Staff Positions

SWC agrees with staff⁷ position on this language, and points out that removal of this language, while appropriate, is inconsistent with unrevised language from the last 15-day comment documents. In the first set of 15-day documents, staff developed a set of criteria that required that the revenue from the sale of allowances should be used to mitigate rate shock to end-use consumers, without diluting the price signal.⁶ Despite SWC statements to the contrary, staff decided that the State Water Contractor agencies were not able to meet these criteria, and so should not receive an allocation of allowances. In changing the language in Section 95892 to recognize these limits on ARB’s authority, staff does not appear to have realized that the criteria developed for the refusal is contrary to these limits. Thus, when changing the language in Section 95892 to reflect ARB’s lack of authority to direct treatment of revenues, staff should also have changed the language of the criteria developed in the last comment period to be consistent with this limitation. If staff cannot require particular treatment of these revenues, then it is inconsistent to refuse to provide an allocation based on a mistaken belief about the likely treatment of those revenues.

In particular, in Appendix A of the Draft Regulation released for comment in July, 2011, staff argued against an allocation of free allowances to the SWP and to the Metropolitan Water District of Southern California (Metropolitan) because of their concern as to how these agencies would use the proceeds of any free allocation. In that document, staff say that “allocating (free allowances) directly to these entities 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 end-users.”⁷

⁵ State of California, Air Resources Board, *Second Notice of Public Availability of Modified Text and Availability of Additional Documents and Information*, (September 2011) at 19.

⁶ State of California, Air Resources Board, *Appendix A: Staff Proposal for Allocating Allowances to the Electric Sector* (July 2011) at 16.

⁷Appendix A at 16.

As SWC explained in its previously-filed comments, it was initially unclear to the water agencies who ARB staff considered to be the end-users of the SWP that would be considered for protection. If staff considered that the SWP pumps were the appropriate end-users, then free allowances should be allocated to DWR. This would also be the most administratively-efficient option. However, it now appears apparent that ARB staff considers the consumers of SWP-supplied water to be the appropriate end-users to be protected. In this case, the free allowances should be allocated to the appropriate water agencies that obtain water from the SWP. As the language in the *Second Notice of Public Availability* states in regard to the POU's, the disposition of revenues from allocations of free allowances is not something for ARB staff to decide, but, in the case of publicly –owned utilities, is the responsibility of the appropriate governing Boards, which have been given responsibility for finances and ratemaking for those utilities. The contracting agencies of the SWP each have such governing boards, with the appropriate ratemaking authority. Given that ARB staff has recognized that these are the appropriate bodies (rather than the ARB staff) to make decisions regarding the disposition of revenues, it is inconsistent for the ARB staff to continue in its decision not to allocate free allowances to the SWP contractors because staff is concerned that the responsible boards potentially *might* make decisions that staff might not approve.

b. Revising for Consistency Solves Serious Inequities

Revising the past decision to conform to the most recently revised language reflecting ARB staff's recent recognition of the financial responsibilities of public utility boards is not only appropriate and consistent, but it also removes a serious inequity and allows the regulation to meet the Board's adopted policy of being economically neutral. As the proposed regulations currently stand, water pumping by the SWP is the only water source that has not received the appropriate allocation of free allowances, and thus does not have the benefit of mitigation from rate shock and protection in the case of market failure. In particular, as the regulations now stand, the lack of provision of allowances to SWC agencies will have the following outcomes which are contrary to Board policy.

i. *An Unmitigated Rate Shock To Retail Customers Of SWC Agencies*

In the initial documents discussing allocation of allowances, an important purpose of the allocation of free allowances was the protection of utility customers.⁸ Further, in the documents released in the previous 15-day comment period, staff stated the following:

*As a matter of policy the approach to allocating allowances to the electric sector has been to ensure that each utilities allocation is at least equal to their customers' total expected cost burden in each year.*⁹

Thus it has been clear Board policy to allocate free allowances in such a manner as to protect the end-use customers from rate shock associated with the imposition of costs for carbon emissions, providing them with time and economic means to adjust to this change in the market place. Although the SWP will be required to pay for the emissions associated with its operations, the consumer protection that is clearly Board policy has been withheld from the end-use consumers of SWP water.

ii. *A Transfer Of Income From Southern To Northern California*

Contrary to Board policy, the regulation as currently proposed will result in a shifting of wealth from southern to northern California. This results inevitably from the structure of SWP pumping costs; an estimated 90 percent of electricity costs related to pumping SWP water are paid by SWP contractors

⁸State of California, Air Resources Board, *Draft Resolution* December 16, 2010 Appendix J at J-11.

⁹ Appendix A at 11.

in southern California.¹⁰ ARB staff has included the emissions resulting from SWP pumping into the general pool of emissions from electricity pumping¹¹, which has the effect of providing a windfall profit to electric distributors across the state in rough proportion to the level of expected emissions of GHG from those generators.¹² It does not seem likely that the ARB Board intended to provide such a windfall profit, and certainly not in proportion to future emissions expected for load.¹³ In any event, this certainly does not provide an approximate match to the pattern of the cost burden from SWP emissions.

Despite the localized impact of the cost of SWP pumping, ARB staff has suggested that pooling the SWP emissions with those of the electric utilities, and spreading the free allocation of permits across the state’s electric distribution utilities will result in “approximately” equal protection for SWP water consumers.”¹⁴ This appeared to be based on the apparently 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.

While this is far too simplistic, the negative is difficult to prove. SWC has identified only a few areas where the incidence of the SWP pumping costs can be compared with the mitigation provided to electric utilities. To demonstrate the lack of equity, it is necessary to find electric and water service areas that have approximately overlying boundaries. All of the examples below have been developed in ways that *under-estimate* the inequity involved. It is hard to see how this can be judged as approximately equitable.

Comparison of Proposed SWP Allowance Allocation and Emission Cost Burden

Region	Emissions Allocated	Costs to be Incurred
Northern California	38%	10%
Southern California	62%	90%
San Diego County	7%	18%
Kern County	2%	5%

We have estimated that the current proposal will result in a wealth transfer from southern to northern California of between \$33 and \$250 million dollars, depending on the auction price for permits.

It should be noted that approximately 40 percent of this total will be taken from San Diego County. 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, for example, Oakland, where the water supplier will receive mitigation from PG&E. Those San Diego industries will also be disadvantaged compared to competitors outside California. Farmers using SWP water will be competitively disadvantaged when compared to other farmers both inside and outside California.

The situation in Kern County is also disturbing. The region is home to a hard-pressed agricultural economy, where the unemployment rate is reported to be 15%. The incomplete mitigation

¹⁰ Estimated from the average share of electric costs paid in 2000-2009, from Department of Water Resources preliminary Table B16-B, prepared for inclusion in Bulletin 132-2011.

¹¹ Appendix A at 16.

¹² Appendix A at 16

¹³ Staff states that under the proposed allocation nearly 94% of allowances are allocated to defray expected costs. Appendix A at 5.

¹⁴ Response by Steve Cliff, ARB to question asked by Timothy Haines (SWC) at the July 23 workshop.

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. While we have not been able to assemble appropriate data for analysis, we are concerned that similar levels of inequity will be experienced by households and businesses in the High Desert area of southern California, which is also an area with high levels of unemployment.

We have provided staff with the spreadsheets used to develop these estimates. Staff has replied that they have developed additional analyses which support the approximate equity that they expect, but have not yet provided us with their spreadsheets, despite our requests. In an attempt to understand their perspective, we have analyzed the case of San Diego County to attempt to justify the staff's statements. We reviewed the Table which begins on page 12 of the Appendix A in the July 25 release of documents.¹⁵ This shows that SDG&E was allocated a proportion of emission allowances in excess of its expected cost burden. Lacking any further information, we have assumed that staff has decided that this excess is sufficient to provide rough equity,

However, the language describing this table states:

“As a matter of policy the approach to allocating allowances to the electric sector has been to ensure that each utilities allocation is at least equal to their customers’ total expected cost burden in each year. Below is a table that reports allocation to each utility by year as a percentage of expected customer cost burden. As is easily verified, each utility is expected to receive allocation in excess of their total annual expected cost burden. This is because each utility not only receives an initial allocation of allowances equal to their expected cost burden, but each utility also receives a share of allowances awarded on the basis of projected cumulative energy efficiency and early action.”¹⁶

Thus, if ARB staff is relying on this excess to afford the equity in cost and risk mitigation, they are using the allowances that, under the adopted policy, should have been awarded to SDG&E because of its early actions and expected energy efficiency. Changing the justification for the limited allowances allocated does not change the inequity inherent in staff's current approach. In addition, a simple estimation shows that when the SWP emissions are included in the cost burden, this approach further breaches the policy that requires that each utility's allocation is at least equal to its cost burden in each year. As the following table shows, when estimated SWP emissions are taken into account, San Diego County has not been allocated sufficient allowances to cover the county's expected cost burden in 2015 and 2016. This is counter to the described policy. It should also be noted that this is *before* the effect of no allocation being provided to Metropolitan, which will increase the cost burden to San Diego. We can see no way that even “rough” equity can be achieved without allocation of allowances to the SWP consumers.

¹⁵ The counterpart to this table has not been released in the latest round of documents, and without provision of the requested spreadsheets SWC cannot provide an updated version.

¹⁶ Appendix A at 11.

	2013	2014	2015	2016	2017	2018	2019	2020
SDGE Allocation	6913.19	6542.724	6419.942	6399.658	6452.767	6280.3	6171.852	6127.326
Excess above costs	6.91%	5.65%	2.82%	4.07%	6.36%	7.83%	8.05%	11.11%
Est. Cost Burden	6466.41	6192.55	6243.57	6149.11	6067.00	5824.31	5712.03	5514.64
Est above costs	446.78	350.18	176.37	250.55	385.77	455.99	459.82	612.68
Est. SWP emissions to SDCWA	349.48	267.31	257.03	257.03	257.03	257.03	257.03	257.03
Remaining SDGE Reward	97.31	82.87	-80.66	-6.48	128.74	198.97	202.80	355.66
% above cost	1.50%	1.34%	-1.29%	-0.11%	2.12%	3.42%	3.55%	6.45%

iii. Impairment of The Ability Of SWP Water Users to Compete With Those in Similar Industries

Water utilities and farmers 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. In contrast, the current regulation will provide no mitigation for consumers of water supplied by SWC agencies. This inequity poses an unfair competitive disadvantage for industries and agriculture dependent on SWP water supplies. The proposed regulation would place manufacturers in SWP service areas at a competitive disadvantage with other similar manufacturers in California and across the world. With the regulation as it is currently proposed, farmers served by SWP water will be placed at an immediate competitive disadvantage to their neighbors who use groundwater pumped by electricity. As noted in the Legislative Analyst’s report, it is ARB’s stated desire to reduce the potential for economic activity to leave the state as the result of the proposed program.¹⁷ Placing SWP consumers at unnecessary economic disadvantage is counter to this goal.

iv. “Leakage” Of Carbon Emissions From California Industries To Those Competitors Outside The State

Where those industries and agriculture compete with entities from outside the state, the result will likely be “leakage” of carbon emissions to sources outside the state. “leakage” refers to the potential for the unmitigated costs of proposed regulation to move production outside of California, thus merely moving the source of the GHG, not reducing them. This is contrary to Board policy. Farmers that rely on water from the SWP sell their produce across the world, and compete in world markets against other farmers that are not subject to a cap and trade regulation, as well as to farmers within California that are receiving mitigation from rate shock under the present regulation.

v. Lack of Protection for SWP Water Users in the Event of Market Failure

In its report to the Senate Select Committee, the Legislative Analyst’s Office noted that the proposed Cap-and-Trade Program will give rise to multiple carbon markets. They further stated that this complexity will make it challenging to regulate, and that such regulation will largely be the responsibility of ARB, a body that the report notes has no experience in such an undertaking. The report warns that under such conditions the chance for market manipulation is increased.¹⁸ California has already experienced the effect of market manipulation with the early years of electricity deregulation. At that time, San Diego consumers were particularly hard-hit. With the provision of free allowances,

¹⁷ Legislative Analyst’s Office, *Cap-and-Trade Market Issues*, Presented to Senate Select Committee on the Environment, the Economy, and Climate Change, June 29, 2011 at 4.

¹⁸ Legislative Analyst’s Office at 4.

ARB has provided consumers with an insurance policy against market meltdown, because any skyrocketing costs will be more than matched with high revenues from the sale of the allowances. However, by not providing SWP consumers with an appropriate allocation of allowances, ARB has also refused to provide SWP consumers with the same insurance policy. Unfortunately, San Diego consumers appear once more to be at particular risk if the market is manipulated.

Recommendation: The currently-proposed language changes reflect appropriate recognition by ARB staff of the organizations that bear the responsibility for determining suitable treatment of emission allowance revenues. However, these changes are inconsistent with ARB’s previous decision to withhold free allocations of allowances from SWP water users. To correct this inconsistency, to provide equitable rate shock mitigation to SWP water users, and to meet Board policy objectives, allocations of allowances should be provided to SWP water users.

Modifications to Table 9-3

In documents released for both the first and second 15 day comment periods, Table 9-3 has been updated to revise the apportionment of allowance values has been changed. These changes resulted from new information provided by WAPA and Lassen utility districts, and to correct errors in the initial spreadsheet. The State Water Contractors were surprised to see these revisions. In private conversations with staff, a major reason given for refusing to allocate allowances to SWP has been that the allocation has been set in concrete, and cannot be changed. SWC supports ARB staff’s decision to revise the allocation based on additional information, and urges that further revisions be undertaken to include the allocation of allowances to SWC agencies based on SWP-related emissions. While SWP is a large load on the CAISO system, the majority of its resources are hydroelectric, and so do not require allowances. In addition, SWP is only asking for emissions associated with its *net* purchases of non-hydro power. Both of these factors serve to make the adjustment needed to include an allocation to SWP consumers result in a minor redistribution of allowance value for all utilities.

Recommendation: It is appropriate that Table 9-3 be updated to reflect further information and corrections. SWC urges that Table 9-3 be further updated to reflect allocations of allowances to SWP water consumers.

4. Processes Developed for Electric Utilities Can Be Adapted to Water Utilities

The organization of water and electric utilities share many parallels, as well as differences. 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 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. 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.

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

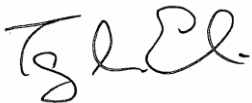
(c) All provisions of this Article applicable to a publicly-owned Electric Distribution Utility shall be applicable to the Contractors of the State Water Project pumping load reported under article 2, section 95111(e), title 17, Greenhouse Gas Emissions Data Report. Where these Contractors are not Water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

SWC further proposes the revision of Table 9-3 to include the allocation of allowances to the SWP water consumers.

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. ARB staff justification for this refusal is based on an apparent misunderstanding of ARB’s authority that has now been corrected in other parts of the regulation. Disturbingly, while SWC has provided examples detailing the inequities, ARB staff has maintained that such inequities do not exist or are immaterial, while failing to provide SWC with any analysis that supports this position. But perhaps more disturbing is that through its initial and second 15-day comment period documents, ARB staff has created and then repudiated any justification for refusing to grant allowances to the SWP. The result is it has no basis for the wealth transfer its decision produces. That is unfortunate because equity can be achieved, along with ARB’s goals for the regulation, by allocating free emissions allowances to the benefit of the customers of the State Water Project.

Sincerely,



Terry Erlewine
General Manager
State Water Contractors