THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

September 27, 2011

Clerk of the Board
Mr. James Goldstene, Executive Officer
Ms. Mary Nichols, Chair
California Air Resources Board
1001 I Street
Sacramento, California 95814

Comments Regarding ARB's Second 15-Day Modifications to the Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms

Dear Mr. Goldstene and Ms. Nichols:

The Metropolitan Water District of Southern California (Metropolitan) has reviewed the Air Resources Board's (ARB's) Second 15-Day Modifications to the Regulation for the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms (Second Modifications), released on September 12, 2011, and provides the following comments for your consideration. Although the Second Modifications do not contain any changes to the cap-and-trade regulations requested by Metropolitan in any of our prior comments, the substance of the regulations and the manner in which they were adopted raise serious policy and legal concerns for Metropolitan, our member agencies, and our customers. Therefore, Metropolitan reiterates the strong objections to the deficiencies and inequities we have previously identified in these regulations.

Background

As the nation's largest provider of drinking water, Metropolitan distributes water from the Colorado River and Northern California to 26 member agencies (cities and water districts), and supplies more than one-half of the water used by nearly 19 million people in the 5200 square-mile coastal plain of Southern California. Metropolitan's regional water supply and distribution system includes some of the largest pumping plants and water treatment facilities in the United States. In order to bring Colorado River water to Southern California, Metropolitan often imports wholesale energy into California exclusively to serve the electrical pumping requirements of the Colorado River Aqueduct (CRA). This wholesale energy is not marketed or resold to other entities in California; it is used only by Metropolitan to bring water into Southern California, and does not serve any type of retail load.

Metropolitan has actively participated in the AB 32 rulemaking process, including the submittal of detailed written comments on the Cap-and-Trade Proposed Draft Regulation on January 11, 2010, on the Proposed Regulation to Implement the California Cap-and-Trade Program on December 14, 2010, and on the Initial Modifications on August 11, 2011. Metropolitan also provided comments on the AB 32 Scoping Plan in 2008, as well as on the ARB's Supplement to the AB 32 Scoping Plan Functional Equivalent Document on June 13, 2011.

As reflected at page 136 of the meeting transcript and as previously cited in our comments, ARB senior staff recognized at the December 2010 Board meeting that, with respect to the water sector, staff "sort of missed an important category of customers where we need to address the cost" and was "prepared to talk to them about that." In response to this, Metropolitan staff has engaged in numerous meetings with ARB staff to articulate our concerns and propose potential solutions for Metropolitan and our customers. ARB staff has not given those concerns serious consideration, as evidenced by the fact that Metropolitan's concerns have not been addressed in either the Initial Modifications or the Second Modifications.

Metropolitan's Prior Comments

As noted above, Metropolitan has previously submitted comments that detail our major concerns regarding the draft regulations and our proposed recommendations for addressing them. Those comments and concerns are summarized below.

1. <u>Exempting Metropolitan from the list of "covered entities" is the best public policy option.</u>

After careful internal review and discussions, Metropolitan concluded that the cap-and-trade regulatory scheme developed by ARB is simply not viable or feasible for a public water supply agency. As ARB staff has recognized, Metropolitan does not provide electrical service to any load other than the CRA pumping plants and is therefore not an electric utility. However, contrary to the classification to which we have been assigned in the cap-and-trade regulations, Metropolitan is also not a marketer of electricity. To demonstrate our unique status in the California energy markets and support our argument for an exemption from the cap-and-trade regulations, Metropolitan asserted the following in our August 11th comments:

- Metropolitan is not a marketer of electricity, although it is classified as such under the Mandatory Reporting Regulation and Cap-and-Trade Program.
- Metropolitan does not purchase power for the purpose of resale.
- As a public agency, Metropolitan is legally required to pass all of its costs to ratepayers.
- Unlike retail electricity providers, including electric publicly-owned utilities, Metropolitan (based on ARB's decision) will receive no cost mitigation for its member agencies and ratepayers.

- As a public agency, Metropolitan should not be compelled to participate in the carbon market against for-profit market participants, including opt-in entities.
- Metropolitan's role, specifically the purchase of imported power to deliver water, is as a consumer of electricity, not a marketer, retail provider, or generator.
- The compliance obligation to acquire and surrender allowances will result in highly volatile costs to Metropolitan because of the variability of Metropolitan's energy imports for the CRA and the anticipated increase in the auction price of allowances. (For example, from 2005-2010 Metropolitan's historical imported electricity has ranged from 0 to 750,000 megawatt-hours.)
- The emissions assigned to Metropolitan's imported electricity are already below its 1990 levels when Metropolitan had an agreement for coal energy from the Navajo Power Plant.

In light of Metropolitan's clear differences with both electric utilities and for-profit marketers, Metropolitan urged the ARB to adopt specific language that would create a new reporting category and definition under the regulations. Under this proposal, Metropolitan would continue to report our imported electricity annually, would continue to maintain the required records and verifications, and would continue to pay the annual Cost of Implementation Fee for our imports. Metropolitan would also agree to certify that, if we alter our market behavior in a manner that would make us a true marketer of electricity, we would become subject to all of the requirements imposed upon covered entities. However, since Metropolitan would not be classified as an electricity marketer or an Electric Distribution Utility (EDU), we would not have a compliance obligation under the cap-and-trade program.

2. <u>The development of a water sector-specific cap-and-trade compliance program and/or a deferral of the regulations for the water sector until such regulations are developed is appropriate.</u>

Metropolitan also proposed the creation of a compliance program to integrate water sector measures for energy efficiency and renewable energy projects, as specified in ARB's AB 32 Scoping Plan. This proposal is in fact consistent with the water sector measures that ARB proposed in the "Recommended Actions" section of the Scoping Plan for water. Metropolitan proposed to work with ARB along with other water agencies to develop the program and work towards implementation starting in 2014-2015. Deferring actual implementation of water sector regulations would allow ARB staff to concentrate priorities and resources on implementing the cap-and-trade program for the electric and industrial sector in 2012-2013 and would avoid imposing unnecessary and inequitable costs, potentially through duplicative regulations, on the water sector. To that end, Metropolitan proposed the following:

- Develop a compliance strategy or memorandum of understanding for Metropolitan as a consumer of wholesale electricity that integrates the imported energy issue into a comprehensive water sector program that includes measures identified in the AB 32 Scoping Plan, such as energy efficiency and renewable energy projects; and

- Defer Metropolitan/water sector measures until 2014 or 2015, after the cap-and-trade program is implemented.

3. In the absence of an exemption or deferral, the only equitable alternative is to provide Metropolitan with free allowances.

If ARB does not make these changes to exclude Metropolitan from the cap-and-trade program, or defer our compliance until comprehensive water sector specific measures are adopted, the only equitable alternative is to allocate free allowances to Metropolitan as a wholesale water utility. Wholesale water utilities are essential public services, and like the retail electric utilities they serve a critical public purpose. Metropolitan believes that it is inappropriate for ARB to deny the publicly-owned providers of a critical public resource the same price relief for their customers that the electric sector will enjoy.

ARB Staff Reaction to Metropolitan Concerns and Recommendations

The Initial Modifications, in Appendix A, focused exclusively on the alleged obstacles to providing free allowances to the water sector and did not address Metropolitan's exemption and deferral proposals. In our August 11th comments and in numerous meetings with ARB staffers, Metropolitan consistently and vigorously pressed the point that, as a public agency that provides water to much of Southern California, we should not be both treated as a for-profit marketer for purposes of regulation and denied the price mitigation provided to the public agencies that provide electricity to Southern Californians. Not only did ARB staff not provide Metropolitan with any of the revisions to the cap-and-trade regulations that we requested, it did not even address Metropolitan's arguments in the Second Modifications, notwithstanding the fact that the Second Modifications will likely be staff's final opportunity to address the comments of stakeholders prior to ARB's planned submission of the cap-and-trade regulations to the Office of Administrative Law (OAL) in October.

Metropolitan's Detailed Comments on the Second Modifications

1. The proposed regulations are fundamentally inequitable to Metropolitan and our ratepayers.

A consistent theme in the comments submitted by the wholesale water providers has been the inequity inherent in imposing increased costs on both electric and water customers, yet only providing offsetting price mitigation to electric customers. On page 16 of Appendix A to the Initial Modifications, ARB concluded that the publicly-owned water utilities are akin to electricity marketers, not distribution utilities, and that providing free allowances to the water agencies is inappropriate since the wholesale water utilities do not "maintain direct relationships" with their end-use customers and, thus, allocating allowances to these utilities might result in "the deterioration of the emissions price signals in the water sector."

This analysis is notable for its flawed assumptions and the facts that it omits or concedes. ARB's analysis does not deny that end-use water customers, like end-use electric customers, will be impacted by cap-and-trade-related cost increases; it does not propose to protect water customers by providing price mitigation to retail water providers; and it does not explain why "price signals" are more important than equity.

ARB's decision to sacrifice equitable treatment of all stakeholders in order to promote the vague economic concept of price signals is indisputably inconsistent with what AB 32 requires. Section 38562(b) of the statute provides that, "to the extent feasible," ARB must "[d]esign the regulations, including the distribution of emissions allowances, in a manner that is equitable." As the court found in a case involving a public agency's elimination of medical services, Morris v. Williams, 67 Cal.2d 733, 757 (1967), the language "to the extent feasible" means that an administrative agency must use every "feasible" effort to accomplish the directive. The court concluded that an administrative agency's discretion in the rulemaking process is circumscribed by the express requirements on the statute and that "'feasible,' in short, means capable of being done." Id. Thus, ARB can develop regulations that promote price signals, but it does not have the discretion to elevate this goal above the equitable treatment of all entities. Since equitable treatment of all public agencies is feasible, it trumps ARB's price signal goal.

Throughout the rulemaking process, ARB staff has expressed the concern that exempting Metropolitan from the coverage of the cap-and-trade regulations will create a gap in the regulations, since all emissions associated with imported energy will not be accounted for. In a conference call between Metropolitan and ARB staff, one ARB staffer indicated that exemptions would undermine the "purity" of the cap-and-trade program. ARB's concerns are unfounded. Section 38505(m) of AB 32 does specify that "statewide greenhouse gas emissions" include electricity that is either generated in state or imported. However, the statute does not require that all imported electricity be covered by a cap-and-trade program. The statute merely requires that all greenhouse gas emissions be reported and that these emission levels be reduced to 1990 levels by 2020. Section 38570 permits the ARB to include "market-based compliance measures" in the regulations, provided that the measures consider cumulative impacts, prevent increases in air pollutants, and maximize economic benefits. Ensuring that all emissions are captured within the market-based mechanism is not a requirement. Therefore, the ARB is not prohibited from exempting from cap-and-trade coverage emissions associated with an entity's imports, and it should do so where, as in this instance, including these emissions would result in inequitable treatment.

2. The proposed regulations will likely result in duplicative regulation of the water sector.

ARB has consistently minimized the cost impact of the cap-and-trade regulations on the water sector; it is clear, however, that water customers will be burdened with significant overall cost increases as a result of the regulations. In our December 14, 2010 comments, Metropolitan estimated that the annual cost of purchasing allowances to cover our imported energy needs would be between $11 million and $22 million, depending on auction prices. The decision by ARB to neither exempt Metropolitan from the cap-and-trade regulations nor defer the

applicability of those regulations raises the specter of even greater inequities. Specifically, Metropolitan, our customers, and other water agencies will be forced to bear the cost burden of cumulative regulations when the water sector-specific regulations are implemented.

In Section 17 of its Scoping Plan, ARB "recommends a public goods charge for funding investments in water management actions that improve water and energy efficiency and reduce GHG emissions." ARB anticipates that such a charge "could generate $100 million to $500 million." Given that energy efficiency measures will undoubtedly involve reducing GHGs associated with energy consumption, these measures will require Metropolitan to pay a significant amount of money for renewable energy at the same time that we are buying allowances for our imported energy. The likelihood of this additional cost burden is acknowledged in the Scoping Plan, which recommends a "mechanism to make allowances available in a cap-and-trade program" to, among others, "water suppliers," and concludes that an "allowance set-aside will be evaluated during the rulemaking for the cap-and-trade program." Other than the cursory, one-paragraph discussion in Appendix A to the Initial Modifications, no such evaluation has been done.

Similarly, the July 12, 2010 study "Implementing a Public Goods Charge for Water" (PGC Study), authored by three U.C. Berkeley economists on behalf of the Public Utilities Commission and the Water Energy Team of the Climate Action Team (WetCat), estimates that "approximately 20% of all electricity consumed in the state" is used for "water delivery, treatment, and use." (PGC Study at 5). The study characterizes the "[g]reenhouse gas emissions from pumping, treating, and heating water" as a "negative externality" that must be taxed in order to accomplish the goals of AB 32. Id. at 6. With respect to the ultimate cost to water consumers, the study concludes that a $680 million dollar per year public goods charge is necessary because, while publicly-owned water utilities have the ability to raise rates to fund GHG-reduction measures, "they are often reluctant to do so." Id. at 4, 10.

Thus, ARB's own Scoping Plan, as well as the study commissioned to implement it, have concluded that the water sector should be heavily taxed to fund GHG emissions-reducing measures. By determining in the cap-and-trade regulations that publicly-owned water utilities must incur costs to cover the emissions associated with moving water without providing any indication as to types and magnitude of additional costs that those utilities will incur as a result of to-be-developed water sector measures is grossly unfair. This is particularly true given the strong indications that Metropolitan will be required to mitigate emissions costs associated with our energy imports through both the cap-and-trade regulations and the water sector measures.

3. The development of the cap-and-trade regulations did not occur through an open process.

Metropolitan has provided comments to the Board in response to every iteration of the cap-and-trade regulations, including comments submitted to Assistant Executive Officer Kevin Kennedy on January 11, 2010 articulating most of the concerns that Metropolitan is still expressing today. Notwithstanding Metropolitan's communications to him, Mr. Kennedy, as noted above, stated at the December 2010 Board meeting adopting the cap-and-trade regulations that, with respect to

the wholesale water utilities, ARB staff had "missed an important category of customers" and indicated a willingness to talk to wholesale water agencies. Metropolitan began meeting with ARB staffers following the Board adoption of the regulations and has since met with them several times to discuss Metropolitan's concerns and to advocate specific proposals for addressing those concerns. At some of these meetings, ARB staff indicated that they were reluctant to make changes to the regulations that would be unpalatable to the EDUs, including the publicly-owned utilities, the investor owned utilities, and the Joint Utilities Group (JUG). Ultimately, ARB staff did not adopt any of the recommendations made by Metropolitan.

Metropolitan is very concerned that, in working directly with the JUG to craft price mitigation measures for their members, ARB staff may have impermissibly made decisions without engaging non-JUG members. The Public Meetings Act, as contained in Section 11120 of the Administrative Procedure Act (APA), provides that it is the intent of that law "that actions of state agencies be taken openly and that their deliberation be conducted openly." AB 32 itself reinforces this directive by requiring that the ARB "adopt rules and regulations in an open public process." The sequence of events leading to ARB's determination that free allowances would only be given to Local Distribution Companies (LDCs) gives rise to the concern that stakeholders such as Metropolitan did not have an adequate opportunity to advocate their positions prior to a de facto decision made by ARB staff.

Following the issuance of a recommendation by the ARB's Economic and Allocation Advisory Committee on January 2, 2010, the JUG, representing all of the major LDCs in California, began meeting with ARB staffers on a regular basis to discuss the allocation of free allowances. According to information made available to Metropolitan, the JUG met with ARB staffers on numerous occasions prior to the release of the draft cap-and-trade regulations in October of 2010. In a February 11, 2010 meeting, held seven days prior to the public Ad Hoc Committee meeting to discuss allowance allocation, the JUG provided ARB staff with a recommendation that largely tracks the draft cap-and-trade regulations with respect to free allowances. At an August 16, 2010 meeting, Mr. Kennedy indicated that ARB staff was hopeful that they could build on the agreement reached by the utilities. In advance of the spring 2011 workshops at which allowance allocation was publicly discussed, Metropolitan received information from a member agency indicating that ARB planned to meet with a subgroup of utilities prior to the public meetings to discuss allowance allocation.

One consequence of the failure to include the water sector in this process is that allowances associated with the emissions of the wholesale water utilities were allocated to other entities. ARB has in fact acknowledged this inequity in Appendix A to the Initial Modifications, where, in reference to the water utilities, it states that "each of these entities use electricity to transport water into and around California, and the emissions associated with this activity are included in the pool of allowances set aside for the electric sector." This strongly suggests that the EDUs who participated in the emissions allocations discussions obtained not only the free allowances associated with their own electricity usage, but also a pro rata share of the allowances associated with the electricity use of the water utilities.

Metropolitan does not raise the issue of transparency in order to cast aspersions on either ARB staffers or JUG members. Metropolitan assumes that the representatives from ARB and the JUG were attempting to resolve issues pertinent to the retail electric utilities in a time-constrained environment in advance of the October 2010 issuance of the proposed cap-and-trade regulations. However, an unintended consequence of these closed meetings was that stakeholders, such as Metropolitan, which were not included in meeting announcements, were unable to voice their concerns and assert their interests in a process that led to the formulation of regulations with a profound impact on many entities outside of the JUG. While staff and the Board made the ultimate decision with respect to the regulations, they did so without the input of many affected parties.

4. Contrary to the requirements of the APA, ARB did not respond to Metropolitan's comments.

In addition to requiring open meetings, the APA requires that public agencies be responsive to public input. As the court articulated in Morning Star Co. v. State Board of Equalization, 38 Cal.4th 324, 333 (2006) (citing Gov. Code § 11346), "[i]f a rule constitutes a 'regulation' within the meaning of the APA it may not be adopted, amended, or repealed except in conformity with 'basic procedural requirements' that are exacting." The court notes that one of those exacting requirements is that the public agency must "respond in writing to public comments," and cautions that "[a]ny regulation or order of repeal that substantially fails to comply with these requirements may be judicially declared invalid." Id. at 333.

Save for the one-paragraph discussion in Appendix A to the Initial Modifications regarding the propriety of allocating free allowances to water utilities, the ARB has not addressed the arguments repeatedly proffered by Metropolitan with respect to cap-and-trade. Although, as discussed below, allocating free allowances to wholesale water utilities provides a bare minimum of protection for water customers against rising costs, Metropolitan's primary arguments regarding exemption and deferral have been completely ignored in the numerous iterations of the cap-and-trade regulations that the ARB has released in the last year. While the AB 32 implementation proceedings are governed by the APA, ARB's blatant disregard for public input and administrative dictates in its development of the cap-and-trade regulations is highly analogous to ARB's violation of CEQA in its approval of the Scoping Plan, as found by a court in Association of Irritated Residents v. ARB, Statement of Decision, Case No. CPF-09-509562, Superior Court of California, County of San Francisco (March 18, 2011). There, as here, the ARB failed to adequately respond to public comments prior to making a determination. ARB's repeated failure to address Metropolitan's comments on the cap-and-trade regulations makes it susceptible to the same type of legal challenge.

5. In the absence of an exemption or deferral, providing free allowances to Metropolitan is the only equitable alternative.

In the absence of a decision to exclude Metropolitan from the category of "covered entities" or to defer our compliance obligations until water sector-specific measures are formulated, the only

equitable alternative is an allocation of free allowances. Metropolitan agrees with the ARB's apparent conclusion that we are distinct from the EDUs in important respects. However, it is fundamentally unfair for ARB to treat publicly-owned providers of a critical public resource in the exact same manner as for-profit marketers and, thereby, deny these providers and their customers any sort of price relief. In other words, if the ARB decides to impose the same compliance obligation on Metropolitan that it imposes on energy marketers and EDUs that import energy, it should protect Metropolitan's customers in the same manner that it protects the customers of the EDUs.

The inequity inherent in ARB's free allowance allocation approach is evident in a comparison with Metropolitan's member agencies that serve retail electric load. Many of these agencies have entitlements to energy resources outside of California. As importers, they will be required to acquire allowances to cover the emissions associated with this energy. This activity does not, however, result in these EDUs being characterized as "marketers," which are not entitled to receive free allowances. In addition, although these retail electric utilities will be able to use the free allowances they receive as EDUs to offset costs to their retail electric customers, as purchasers of Metropolitan water they will be unable to mitigate prices increases to their retail water customers resulting from higher power prices at the wholesale water level.

Finally, ARB's articulation of the reasons that wholesale water utilities are ineligible to receive free allowances (*i.e.* no direct end-use customer relationship and thus no price signal) is inconsistent with the rationale provided for the regulations that have been developed. POU retail electric providers will be permitted to retire their free allowances in order to meet their compliance obligations as importers or generators, resulting in no price signals at the retail level. Although the ARB apparently intends for the POUs to use the value of the free allowances to offset rate shock associated with rate increases, there is nothing in the statute that compels this result, and few public agencies will increase rates unless they are required to do so. Thus, not only has ARB created a price signal metric for measuring the need for free allowances that is not found in the statute, but it has also applied that metric in an arbitrary, inequitable manner.

Conclusion

Metropolitan is sensitive to the ARB's statutory deadlines and cognizant of ARB's desire for purity in the design of the cap-and-trade regime. However, we have repeatedly requested, since January of 2010, that ARB address the inequities inherent in its proposed regulations and suggested numerous approaches to resolving these inequities. In response, the ARB has made decisions that negatively affect Metropolitan in a process in which Metropolitan was not invited to participate and without considering our comments on the inequitable results of that process.

In order to ensure that Metropolitan's ratepayers are not unfairly disadvantaged and subjected to cumulative cost impacts as a result of the cap-and-trade regulations, and to assure that the regulations are not susceptible to legal challenge, Metropolitan strongly urges the ARB to further modify its cap-and-trade regulations to address Metropolitan's concerns prior to the ARB's October submission of the regulations to the OAL. If such modifications are not made,

Metropolitan will take whatever actions are necessary to protect the millions of Southern Californians who rely on Metropolitan's water from the adverse impacts of the ARB's regulations.

If you have any questions on our comments, please contact Mark Parsons in our Legal Department or Janet Bell in our Safety and Environmental Services Section.

Sincerely,

Jeffrey Kightlinger
General Manager