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LEG 2011-0544

September 27, 2011

Clerk of the Board
California Air Resources Board
1001 I Street
P.O. Box 2815
Sacramento, CA 95812

Re: Sacramento Municipal Utility District's Comments on Proposed Second 15-Day Modifications to California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation

Clerk of the Board,

SMUD appreciates the opportunity to comment on the second 15-day modifications to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation.

SMUD believes that several significant beneficial changes have been made in the second 15-day language package. In particular, SMUD is appreciative of changes that:

- Help to conform the RPS and the Cap and Trade regulations by allowing "renewable" GHG treatment for substitute energy used to help deliver the renewable benefits to California ratepayers. However, entities still may use "unbundled" RECs to achieve RPS compliance and yet receive no GHG benefit, and SMUD urges continued attention to resolving this lack of regulatory conformance as the Cap and Trade program is implemented.

- Remove much of the "market-disruptive" effects or the previous overly-broad definition of resource shuffling. SMUD expects further discussion as the Cap and Trade program is implemented to determine whether any additional provisions regarding resource shuffling concerns are necessary.

- Add a 45-day penalty "accrual period," after the provisions for untimely surrender are followed, for the multiplication of penalties when a regulated party remains short of compliance instruments. SMUD still believes that there may be a disconnect between the potential penalties for a specific violation under the Health and Safety code and the market cost or value of a compliance instrument,

and there is some remaining concern about the market impacts of these potential penalties.

- Return unsold allowances in each auction back to the Auction Account, with reasonable conditions. SMUD believes that this change will help make the quarterly auctions – a key element of the Cap and Trade program – more cost-effective and successful.

- Allow use of offsets, up to the offset limit, to satisfy up to one fourth of one's untimely surrender obligation. This provision will help ensure that cost-effective offsets can be used up to the limit allowed for compliance.

The process continues to be a good process and the proposed changes to the regulation continue to significantly improve the prospects that good and lasting regulations will be in place for California's historic Cap and Trade program. SMUD has a few additional comments on the proposed regulations, in the interest of further improvement, as described in the sections below.

A) Biomass-Derived Fuel Restrictions In Section 95852.2(a) and 95852.1.1 Should Be Further Revised.

Section 95852.2(a) describes emissions for which there is no compliance obligation, from combustion of bio-derived fuels, and Section 95852.1.1 describes eligibility requirements for biomethane fuels. SMUD recognizes that procurement of existing out-of-state biomethane requires some consideration to avoid a form of "resource shuffling," allowing zero-GHG treatment of this biomethane when there has been no real reduction in GHG emissions out of state or overall. This occurs when a Cap and Trade regulated party receives zero-GHG treatment for biomethane that was already being produced and put to useful purpose outside of California, so that the California party's contract for that biomethane merely "shifts" its use into the state.

It is clear that ARB staff have thought carefully about the biomethane question in order to prevent such "resource shuffling." First, the restrictions in the current 15-day draft of the regulations only allow existing contracts (up to 1/1/2012) to be eligible for this treatment if the biomethane starts being delivered relatively soon after the contract signing (there are three possible conditions in the regulations), preventing regulated parties from simply signing up existing sources of biomethane delivery far in the future. Second, any contracts signed after the beginning of next year must access new or expanded sources of biomethane, or sources that were previously being vented or flared, ensuring that in the future existing biomethane resources are not simply "redirected" to California use.

However, SMUD still believes that the ARB is being slightly too cautious here. SMUD has two specific suggestions for regulation revisions that would reward early action with regard to biomass-derived fuels without adding to concerns about resource shuffling.

First, there should be a little additional room for contracts for biomass-derived fuels signed prior to 1/1/2012. In this regard, SMUD sees nothing wrong with contracting for a source of biomethane prior to1/1/2012 when that biomethane is a new or expanded source or a source which was previously being vented or flared, as these examples still reflect real GHG reductions. In many instances, these resources require some development time, so one cannot simply contract with them today and have gas flowing under the contract within 90 days (one of the acceptable criteria for contracts signed prior to 1/1/2012).

SMUD also maintains that general utility contracting and planning processes involve planning ahead to meet resource needs. Hence, a utility could have signed a contract a year or more ago, prior to publication of the initial Cap and Trade proposed regulations, for biomethane that is to be delivered well in the future, either when the resource is developed or when the resource is needed by the utility. If the resource is yet to be developed, such a contract would NOT receive zero-GHG treatment under the current 15-day regulatory language, while a contract that simply redirects an existing source of biomethane that is being productively used out of state to California use would, as long as the contract is signed prior to 1/1/2012. Even if the resource involves an existing productive use of the biomass-derived fuel, signing such a contract a year or more ago, prior to publication of the initial Cap and Trade proposed regulations, should not raise concerns about resource shuffling, as the contract clearly would predate the Cap and Trade program. Such early action should be rewarded because it arguably creates some beneficial market transformation and is now potentially constrained by a regulation that could not have been contemplated at the time the contract was approved.

These are not simply theoretical arguments, but rather reflect a situation that exists with SMUD contracts. SMUD's Board approved a biomethane contract in 2010 that was expected to begin delivery of biomethane beginning in 2014 to meet our renewable resource demand.

SMUD suggests that the regulations be changed so that signing a contract for biomethane that will be new, or first put to a productive use is allowed zero GHG treatment regardless of the date on which the contract is signed. SMUD also suggests that the regulations reflect the "early action" benefits of contracts signed prior to January

1, 2011, and avoid the market disruptions of potentially voiding these contracts. The proposed regulations should be changed as follows:

> 95852.1.1(a)(1) The contract for purchasing any biomass-derived fuel that does not reflect an increase in the biomass-derived fuel production capacity at the site or recovery of fuel that was previously vented or destroyed without producing useful energy transfer must be executed ~~in effect~~ prior to January 1, 2012 and remain in effect or have been renegotiated with the same California operator within one year of contract expiration. …

And by adding a new (D) to 95852.1.1(a):

> 95852.1.1(a)(1)(D) The date established in the contract, if the biomass-derived fuel contract was approved by the PUC or POU governing Board prior to January 1st, 2011.

Note that as this regulatory change references a historical date for eligibility under the clause, it does not open a door to widespread use or abuse of this provision.

Second, there is a circumstance whereby biomass-derived fuel that is eligible to avoid a compliance obligation may inadvertently and inappropriately acquire such an obligation. Section 95952.1.1(a)(5) currently establishes that biomass-derived fuel that is used at the site of production does not have a compliance obligation if it is an existing resource in California, or if it previously was not used to produce useful energy transfer (here, regardless of in-state or out-of-state location, the resource is newly developed, and even imported electricity derived from the resource has no compliance obligation, as there is no sense of "resource shuffling"). Section 95852.1.1.(a)(3) allows entities to contract with resources that already have qualified to not have a compliance obligation pursuant to sections 95852.1.1(a)(1) or (2), and SMUD agrees that these provisions are reasonable. However, SMUD believes that this practice should be expanded slightly to cover "new uses" of biomass-derived fuel previously covered under Section 95952.1.1(a)(5). Here, an entity may desire to shift from onsite productive use of biomass-derived fuel to a new contractual situation that sends that fuel through a pipeline for productive use elsewhere in California. There appears to be no reason why a biomass-derived fuel currently afforded treatment where there is no compliance obligation should lose this treatment when its use is shifted within California. In fact, such a shift would be contemplated in situations where there would be more efficient and cleaner productive use of the biomass-derived fuel.

Again, this is not simply a theoretical argument. SMUD has a current contract with a unit that meets the requirements of 95952.1.1(a)(5), in that the biomass-derived fuel has been combusted at the site of production, in California, prior to January 1, 2012. SMUD has an opportunity to produce more electricity from this fuel, with fewer criteria pollutants, by simply putting the fuel into a SMUD-owned, dedicated, gas pipeline and

deliver it directly to an efficient combined cycle power plant. This environmentally improving opportunity should be allowed by the regulations. A simple change to allow this type of shift in the location of the resource is as follows:

> 95852.1.1(a)(3) The fuel being provided under a contract ~~dated after January 1, 2012~~ is for a fuel that was previously eligible under sections 95852.1.1(a)(1), ~~or~~ (2), or (5), and the verifier is able to track the fuel to the previously eligible contract or project; or;

B) Regulations Should Be Changed To Not Dis-incentivize Cogeneration Facilities That Also Supply Steam To Nearby Industrial Customers

SMUD invested in three cogeneration facilities in the 1990's to provide clean, efficient power for our ratepayers while encouraging low-emissions industrial facilities in our service area. Unlike typical cogeneration facilities, which supply electricity and steam to an industrial facility and sell any excess electricity to the grid, these cogeneration plants provide electricity only to the grid and supply steam which is sold over-the-fence to industrial facilities nearby. The contracts for steam sales to these industrial facilities allow no flexibility for pass through of the carbon allowance costs. Nor were the emissions from providing this steam recognized in the ARB methodology for allocating allowances to electrical distribution utilities, as this was based upon retail load projections alone, ignoring steam sales. Hence, SMUD and SMUD's ratepayers have the obligation of compliance for the emissions associated with the steam sales, but the Cap and Trade program does not recognize this obligation. The proposed 15-day language for the Cap and Trade program imposes an allowance obligation on the extra emissions needed to produce process steam that is delivered to industrial customers near the plant, but not used to cover SMUD's retail load.

A remedy for this apparently uncommon cogeneration arrangement would be to allocate to the steam provider a requisite portion of allowances from the industrial sector to cover emissions associated with provision of steam to the industrial customers. This would partially remove the burden to SMUD ratepayers and the otherwise illogical problem of a combined cycle generation facility with what appears to be a higher heat rate than normal. To acknowledge this situation and accommodate others that may potentially fall in this category, SMUD recommends that under this alternative the following section be added to the regulation:

> § 95891. (c)(5) Wholesale Steam Sales. For covered entities who are under Long-term Steam Contracts to supply steam to an industrial facility that does not contain a clause to pass through the cost of compliance, allowances will be provided to the steam provider in the amount equivalent to what the industrial facility would have received if its emissions were covered in the industrial sector.

In addition to this added section, SMUD recommends splitting the definition of "Long Term Contract" into two terms – reflecting Electricity and Steam Contracts, as follows:

156)"Long-Term Electricity Contract" means a contract for the delivery of electricity entered into before January 1, 2006 for the term of five years or more.

157)"Long-Term Steam Contract" means a contract for the delivery of steam entered into before January 1, 2006 for the term of five years or more.

C) Section 95892(b)(2) Should Recognize Compliance Accounts For Electricity Imports.

Section 95892 describes the method used by the Executive Officer to distribute allowances allocated to a POU or Co-op. In the second set of 15-day language, this section was revised in such a way that a "general" compliance account for POUs, covering compliance accounts as an electricity importer was inadvertently not included. Since many POU's are electricity importers of electricity into California they may well have a compliance account for those imports as well as compliance account(s) for in-state electrical generation they own or control. For this reason wording in section 95892(b)(2)(A) [p. A-141 of the 2nd 15-Day language] should be changed as shown below:

§95892(b)(2)(A): In the compliance account of a publicly owned utility or electrical cooperative, an electrical generating facility operated by a publicly owned electric utility~~'s or E~~ or an electrical ~~C~~cooperative~~'s compliance account,~~ or ~~the compliance account of~~ a Joint Powers Agency in which the electrical distribution utility or electrical cooperative is a member and with which it has a power purchase agreement; or

D) Additional Compliance Flexibility Is Reasonable When The Allowance Price Reserve Is Significantly Accessed.

SMUD does not support, in general, allowing borrowing between compliance periods, as we believe this may result in a lack of balance between the amount of compliance instruments available in early years and the amount needed for compliance, in effect causing delays in investments that may be needed to achieve compliance by 2020. However, adverse circumstances, such as a two or three year sequence of low hydro years combined with more rapid than expected economic growth, could cause allowance prices to spike in the last year of a compliance period, and then fall as a new compliance period affords additional flexibility. This kind of price volatility will also cause delays and uncertainty in needed investments.

SMUD believes that one indicator of such inter-compliance-period volatility is a significant price increase so that obligated entities substantially purchase allowances from the Allowance Price Containment Reserve. SMUD believes that a mechanism to react to this potential circumstance, and act to smooth long-term allowance prices in the transition between compliance periods would be beneficial to the market. Addressing this will also delay or prevent an unfortunate "run" on purchasing allowances from the Reserve, but making additional supply available in limited circumstances as suggested. To accomplish this, SMUD suggests the following changes to Section 95856(b)(2):

(2) To fulfill any compliance obligation, a compliance instrument must be issued from an allowance budget year within or before the year ~~during~~ for which an annual ~~the~~ compliance obligation is calculated, or the last year of a compliance period for which a triennial obligation is calculated, unless:

(A) T~~t~~he allowance was purchased from the Allowance Price Containment Reserve pursuant to section 95913; ~~or~~

(B) T~~t~~he allowance is used to satisfy an excess emissions obligation~~.~~; or

(C) The compliance instrument is from the allowance budget year following a triennial compliance period and 40% of the allowances in the Allowance Price Containment Reserve have been purchased for compliance during the compliance period.

E) Penalty Structures For The Cap and Trade Program Should Be Further Modified To Provide Penalties Commensurate With Violations

SMUD appreciates the changes to the proposed penalty structures for the Cap and Trade program that are captured in the initial and second set of 15-day regulatory changes published by ARB. In particular, allowing an effective "grace period" while the untimely surrender process is dealing with a shortfall of surrendered emissions, prior to establishing penalties for each compliance instrument remaining short, and allowing a "45-day accrual period" limiting the daily multiplication of violations, helps to ensure a reasonable and effective penalty structure for the Cap and Trade program. However, one additional change is necessary to ensure reasonable penalties, while maintaining the necessary deterrent effect of a penalty structure to ensure maximum compliance.

SMUD continues to believe that with a basic penalty amount per violation under Health and Safety Code § 40402(b) of "up to $10,000." the potential penalties when each ton is a violation remain egregious at 1000 times higher than the Reserve Price for initial auctions at the beginning of the program and approximately 200 times prices established for allowances from the Allowance Price Reserve. There is no need for such extreme penalties, but the prospect of them has market impacts. Changing the regulations so that each ***10*** instruments short represents a violation is a way to limit the number of violations, yet still yield penalties that can be up to 100 times above the Reserve Price and approximately 20 times the higher prices in the Allowance Price

Reserve. Even under the interpretation that maximum penalties in the Health and Safety Code are limited to "up to $1,000" per violation, which SMUD does not believe is the correct interpretation, the proposed change yields penalties that can be 10 times above the initial Reserve Price and approximately twice the higher prices in the Allowance Price Reserve. These penalties should be sufficient to clearly induce compliance on top of the 4-1 excess surrender requirement established in Section 95857, while simultaneously significantly reducing marketplace borrowing and investment concerns about potential penalty liability.

In addition, the second set of 15-day changes add the term "Untimely Surrender Period" to 96104(b), while substituting the recommended "..and the procedures in 95857(c) have been exhausted" in 96104(a). The untimely surrender period term is still undefined, and SMUD recommends using the language that was inserted in 96104(a).

To accomplish these changes, parts (a) and (b) of Section 96014 should read:

96104(a) If an ~~covered~~ entity fails to surrender a sufficient number of compliance instruments to meet its compliance obligation as specified in sections 95856 or 95857, and the procedures in 95857(c) have been exhausted, there is a separate violation of this article for each 10 required compliance instruments, or portion thereof, that have~~s~~ not been surrendered, or otherwise obtained by the Executive Officer under 95857(c).

(b) ~~There is a separate violation for each day or portion thereof after the compliance date that each required compliance instrument has not been surrendered. There is a spearte violation for each day or portion thereof after the end of the Untimely Surrender Period that each required compliance instrument has not been surrendered.~~ A separate violation accrues every 45 days after the procedures in 95857(c) have been exhausted ~~end of the Untimely Surrender Period~~ for each required 10 compliance instruments, or portion thereof, that have~~s~~ not been surrendered.

F) Voluntary Renewable Energy Provisions Should Also Recognize Out-of-State Renewable Purchases.

SMUD appreciates the recognition of the need to align the Cap and Trade program with the state's ambitious RPS program. However, we feel it is also important to ensure that resources recognized for RPS compliance are also eligible for green pricing programs that may be offered to customers who would like to purchase renewable energy outside the RPS. While the ARB has included provisions to handle the GHG treatment for purchasing in-state renewable energy for use in voluntary programs, SMUD believes that it is important to ensure harmony where possible with RPS rules that recognize the

benefits of out-of-state renewable energy. The following change would allow resources that would normally count for the state's RPS to also be fully viable for voluntary program customer needs without incurring a compliance obligation or challenging the GHG benefits expected from voluntary renewable procurement.

95852(b)(4) RenewableRPS Energy adjustment. Electricity imported or procured by an electricity importer from an eligible renewable energy resource reported pursuant to MRR must meet the following conditions to be included in the calculation of the RPSRenewable Energy adjustment: Replacement electricity that substitutes for electricity from a variable renewable resource qualifies for the ARB facility specific emission factor specified pursuant to MRR section 95111 of the variable renewable resource under the following conditions:

(A) First deliverersThe electricity importer of replacement energy must have either:have a contract, or ownership relationship with the supplier of the replacement electricity, in addition to a contract with the variable renewable resource; and

1. Ownership or contract rights to procure the electricity generated by have a contract, or ownership relationship, with the supplier fo the replacement electricity, in addition to a contract with the eligiblevariable renewable energy resource, orand
2. Have a contract to import electricity on behalf of a California entity that has ownership or contract rights to the electricity generated by the eligible renewable energy resource, as verified under MRR.

(B) The RECs associated with the electricity claimed for the RPS Renewable Energy adjustment must be deposited prior to verification in a WREGIS account that can only be used:

1. To comply with California RPS requirements during the same year in which the RPS is claimed, or
2. To supply a green pricing program.

(C) The quantity of emissions included in the RPSRenewable Energy adjustment is calculated as the product of the default emission factor for unspecified sources, pursuant to MRR, and the reported electricity generated (MWh) that meets the requirements of this section, 95852(b)(4). Replacement electricity with an emission factor greater than the default emission factor for unspecified electricity specfieid pursuant to MRR section 95111 is not eligible to receive an emission factor of zero metric tons CO2e/MWh. For contracts that use replacement electricity for which the emission factor is greater than the default emission factor for unspecified electricity, the difference between the emission factor from the

~~replacement electricity and the default emission factor for unspecified electricity will be used to calculate emissions with a compliance obligation~~.

(D) No ~~RPS~~Renewable Energy adjustment may be claimed for an eligible renewable energy resource when its electricity is directly delivered.

(E) No ~~RPS~~Renewable Energy adjustment may be claimed for electricity generated by an eligible renewable energy resource in a jurisdiction where a GHG emissions trading system has been approved for linkage by the Board pursuant to subarticle 12.

G) 2012 Allowance Allocation To Industrial Facilities Should Be Expedited.

Section 95870(e) covers disposition of allowances to industrial entities. In 2012, these entities get their 2013 allowances on or before November 1, 2012. However, electrical distribution utilities get their allowances this year on July 15, 2012, in preparation for the two advance auctions that will be held in 2012. These first two auctions are, in part, a way to test the operation of the auction system for the Cap and Trade program. In order for these auctions to reflect 2013 and 2014 market circumstances as much as possible, the ARB should strive to allocate allowances to industrial customers prior to the auctions, or at least prior to the second auction, so that industrial sector participation in the auctions is based on good knowledge of what allowances have been allocated to them.

H) Recommend Additional Sentence And Fixing Incorrect Reference In Section 95831(b)(2).

Section 95831(b)(2) contains an errant reference in subpart (D). The reference should be to section 95857(d)(1)(A), not 95857(d)(a)(A). Also, there should also be a subpart (E), as follows:

(E) The allowances consigned to Auction by the Executive Officer pursuant to 95831(D).

Closing

SMUD again appreciates the opportunity to comment on the second 15-day modifications to the California Cap on Greenhouse Gas Emissions and Market-Based

Compliance Mechanisms Regulation, and urges consideration of the comments described above.

Respectfully submitted,

/s/

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cc: Corporate Files