

LEG 2009-0183
May 4, 2009

Via E-mail

Mr. Kevin Kennedy, Chief
Program Evaluation Branch
Office of Climate Change
California Air Resources Board
1001 I Street
P. O. Box 2815
Sacramento, CA 95814

Re: SMUD Comments on Cap and Trade Auction Design

Dear Mr. Kennedy:

SMUD appreciates this opportunity to comment on auction design elements under the ARB's proposed cap and trade system.

As a customer-owned utility, our first priority is to provide reliable electric service in full compliance with applicable laws at the lowest possible cost to our customers. This priority is compatible with the ARB's mandate to develop cost-effective measures to meet aggressive AB 32 goals. For any allowance auction to be cost-effective, it should promote needed carbon reductions in an economically efficient manner for California as a whole, should contribute to price stability, and it should be designed to minimize the cost to California ratepayers. The cap and trade measure, as envisioned by the Scoping Plan, is a flexibility mechanism that will not serve as the primary driver of emissions reductions in the State. The vast majority (80%) of the reductions will come from mandatory measures. Thus, cap and trade should provide a complementary mechanism to compliance entities to obtain a portion of the required reductions at a lower cost, and more efficiently for the economy as a whole, than through mandatory means alone. To achieve this function, an auction should not be viewed as a revenue source for the State, but rather as one component of a regulated market where entities can buy or sell allowances at an average cost that is lower than the cost of implementing reductions through additional direct regulation. Auctioning allowances will add to the direct expense of compliance and, even with the noblest *intent* to return revenue efficiently, will add cost to ratepayers and to the economy as a whole. These increased revenue streams are not necessary for a market under cap and trade to function efficiently and, thus, would add unnecessary costs to the overall AB 32 program. Accordingly, ARB should focus its design efforts on minimizing pricing volatility, minimizing administrative and transaction costs, promoting liquidity, and revealing market valuations of allowances, in particular allowance prices for future years.

SMUD believes that the objective of minimizing pricing volatility can be achieved through quarterly auctions in the compliance year, and by auctioning portions of future year allowances with enough time to provide appropriate price signals for infrastructure investment. Providing predictable and transparent information about emissions levels, and factors that drive emissions levels, should also help to minimize volatility. One difficulty in creating a viable forward market may be the question of eventual federal pre-emption, so this element should be closely tied to federal progress on a cap and trade program. Additionally, ARB should limit the allowances that any one entity can purchase in a given auction, require close market oversight, and provide the regulator with sufficient authority to intervene to prevent hoarding of allowances or other market manipulation. Finally, the preliminary structure of the cap and trade program is such that the amount of emissions subject to the cap effectively doubles in 2015, when the transportation and natural gas sectors are brought in. These sectors will have both different price points for triggering carbon reductions, and different demand elasticities. Such a change will inevitably result in substantial market volatility, speculation, and disruption. To prevent this, the ARB should institute a pre-cap carbon fee on these sectors, equivalent in price to the cost of carbon under the cap and trade, to ensure that the effect of the carbon price is felt on these sectors prior to their introduction in the cap and trade. The fee revenue could be directed back to carbon reduction efforts in these sectors to ensure they are contributing their fair share to meeting the statewide targets. These design elements should minimize volatility.

With respect to minimizing administrative costs and promoting liquidity, a sealed bid, single round, single price auction should be most effective. A single price auction may also promote liquidity by reducing risks during bidding and by its relative simplicity, which would tend to encourage broader participation. By contrast, additional complexity in the auction process would likely limit participation by many parties, raise administrative costs, and possibly raise transaction costs by requiring participating firms to hire experts to advise them on bidding strategies and minimum clearing price speculation. It would also tend to shrink the number of successful bidders to those with greater expertise to properly judge the market demand for allowances.

The price discovery purpose of an auction is most important with regard to allowing discovery of the value of future year allowances. This function enables the present value of long-term infrastructure investments to be weighed against the present value of future carbon allowances, thereby helping to meet the overall cap with maximum efficiency. One key difficulty in forward selling of allowances as a means of price discovery lies in the uncertainty created by the large changes that are built into the cap and trade mechanism and the potential for federal pre-emption. Specifically, with regard to the cap and trade structural changes, the omission of the transportation and natural gas sectors until 2015 creates a large price uncertainty around any allowances sold for post-2015 compliance. Without the price impacts from integrating the transportation and natural gas sectors, it is difficult to know the demand responsiveness of these sectors to carbon regulations, and, as a result, there is less assurance that 2015 allowance prices will be adequately reflected by prices paid for those allowances in forward auctions. When considering the very real possibility of federal pre-emption in the post-2013 or 2014 timeframe, price uncertainty becomes compounded because pre-emption with a different cap trajectory for a federal cap and trade will substantially impact the value of allowances for California's system. Because of these factors, the ARB should develop rules to preserve the value of forward markets in providing price certainty upon which to make large infrastructure investments.

Finally, SMUD believes that the risks of making an error in auction design can be minimized by keeping the auction size small. While we recognize that there are many demands on the ARB for worthy uses of auction revenues, the risks associated with putting in place a system that adds unnecessary costs to California consumers should be thoroughly considered. Moreover, because a federal program is likely and federal pre-emption is a substantial risk, establishment of State-funded programs using large amounts of auction revenue would create considerable political difficulties if pre-emption also involves the transfer of auction revenue disbursement to the federal EPA.

SMUD appreciates the opportunity to provide comments on this topic, and looks forward to continuing to work with the ARB to make sure that AB 32 accomplishes our joint environmental objectives without sacrificing the reliability or affordability of electricity in California.

Sincerely,

/s/

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cc: Sam Wade
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