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April 21, 2011
LEG 2011-0208

The Honorable Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
Mr. James R. Ryden, Chief, Enforcement Branch
Mr. Kirk Oliver
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: ARB's Proposed Enforcement Penalty Policy

Dear Ms. Nichols, Mr. Goldstene, Mr. Ryden, and Mr. Oliver;

Thank you for the opportunity to submit these comments on the Air Resources Board's (ARB) Proposed Enforcement Penalty Policy (PEPP), released for public comment on February 25th, 2011. The Sacramento Municipal Utility District (SMUD) appreciates the work of the Air Resources Board (ARB) enforcement staff. SMUD believes that ARB adoption of a written penalty policy is an important step forward in transparent and fair enforcement of its regulations.

SMUD has three significant areas of comment:

- First, SMUD supports ARB's inclusion in the PEPP of AB 32 related enforcement and penalty issues. However, SMUD believes that the PEPP must be modified to promote reasonable enforcement policies for the regulations and procurement rules essential to the success of AB 32.

- Second, SMUD acknowledges case law justifying the practice of starting penalty determinations at or near the Health and Safety Code maximums. However, it is our view that this practice will not lead to better compliance with AB 32 requirements. Instead, it is likely to simply lead to over-procurement and thus undermine AB 32's mandate of cost-effective control measures. SMUD sees no reason to rely solely on the maximums in development of a written penalty policy.

- Third, SMUD believes that the PEPP would be improved by laying out a structure or methods for how ARB proposes to apply the factors of AB 1402. Not providing this roadmap in a quantitative or qualitative way leaves regulated parties with only the statutory maximums upon which to base potential risks, which distorts the cost of compliance.

SMUD expands upon these principal points, and related matters, in the following detailed comments.

A. AB 32 Related Penalty Assessments

SMUD understands that Senate Bill 1402 required the development and adoption of a written enforcement policy focused on mobile source enforcement and penalty issues. Nevertheless, SMUD appreciates the inclusion by ARB staff of AB 32 related enforcement and penalty issues in the PEPP. Unfortunately, SMUD believes that there has not been sufficient attention to the striking structural differences in AB 32 related regulations when compared with traditional Clear Air Act emission limits. In short, SMUD believes that the PEPP should adapt the daily penalty authority in the Health and Safety Code to the new regulatory structures derived from AB 32 and focused on annual or greater timeframes for compliance and violations.

SMUD and other electric utilities have previously commented in the AB 32 rulemakings for the Renewable Energy Standard (RES) and Sulfur Hexaflouride (SF_6) that the daily penalty provisions of Parts 4 and 5 of Chapter 26 of the Health and Safety Code are ill-suited to those programs, arguing that daily penalties are inappropriate for annual or triennial compliance periods. Daily penalties under the Clean Air Act were designed for and work very well at promoting compliance with limits on emissions measured instantaneously, hourly or even daily. But daily penalties can be applied punitively to the emissions limits associated with longer compliance periods in the RES and SF6 regulations. The key point here is that what is meant by a violation under these longer timeframe rules must be carefully considered to avoid excessive and arbitrary reliance on the penalty-reduction flexibility implicitly allowed in the Health and Safety Code. If this does not happen, then additional specificity is needed in the PEPP to allow stakeholders to understand better how the penalty structures will be applied in circumstances where the manner in which violations are specified in regulations will lead to potentially egregious penalties and/or a too broad range of possible penalties.

As one example of the difficulty of applying daily penalties to multi-year compliance periods, the adopted RES regulation[1] establishes a separate violation per day for each MWh a Regulated Party falls short of its RES Obligation. In 2010, SMUD generated about 2.5 million MWhs of renewable energy, and over the first three-year compliance period of the RES, 2012-1014, would be expected to generate about 7.5 million MWhs for compliance. However, if we were only a 1,000 MWHs short – a mere 0.01% short of our goal -- the RES regulation would declare that to be 1,000 violations per day. Under Health and Safety Code Sec. 42400.2, if we knew of the emission but fail to take corrective action, the maximum penalty is $40,000 per violation per day, which translates into a potential daily penalty of $40,000,000 per day for a relatively minor violation -- missing our target by .01%. Under the current draft of the PEPP, the burden would fall

[1] With the passage of SBX1 2, SMUD understands that the RES regulation may be moot (as ARB may not work toward final approval of the regulations), but believes that the arguments raised and discussion with staff regarding enforcement and penalties is still relevant here.

on us to explain how and why ARB shouldn't penalize us $40,000,000 per day. A $40,000,000 per day penalty would be more likely to lead to over-procurement rather than cost-effective compliance. In this case, as well as in the Cap and Trade regulation adopted in December, 2010, curing noncompliance can depend upon market transactions, and the potential for high daily penalties gives market power to entities that regulated parties must transact with for the instruments needed for compliance.

As the RES regulation was adopted, the Board and staff recognized that the standard penalty structure would lead to potentially egregious penalties, and staff was directed to continue discussing enforcement issues with regulated parties and other stakeholders. The Board resolution for the RES directed the Executive Officer to include in the final regulation: "…the suggested modifications set forth in Attachment A and …" The "Attachment A" in this reference included the following proposal from staff: "… [additional] language that will provide specificity on how violations of the proposed RES regulation will be assessed. … Potential options that may be considered include, but are not limited to, removing language in the proposed regulation establishing a separate violation for each day, establishing a not to exceed penalty cap for strict liability of negligence, and establishing an alternate metric for determining penalty amounts."

In the resulting stakeholder discussion with ARB staff, it is our understanding that the one penalty modification that would be proposed in 15-day language was that any shortfall in complying with the minimum renewable amounts in the RES would be considered separate violations ***every six months***, rather than ***every day*** as in the original regulations. In the example above, rather than a potential $40 million dollars of penalties each day, the potential would be $40 million each six months – equivalent to just over $200,000 per day. While still significant, this penalty level would be more conducive to cost-effective compliance rather than expensive over-procurement.

Note that the length of the compliance period combined with the common measure of renewable standards – a MWh – leads to the potentially disproportionate penalties. In a typical violation of a concentration limit under the Clean Air Act, the only penalty multiplier is time – the number of days of non-compliance – intended to bring compliance sooner. However, under the RES, a minute degree of violation (e.g., a MWh) is another multiplier, and compliance is for a historical period and dependent upon market transactions to make whole. When these factors are simply multiplied together, the penalty rapidly escalates and becomes disproportionate. Yet, the basic daily penalty structure is identical in both cases in the PEPP, not reflecting differences in the nature of the violations.

ARB staff has assured stakeholders in the past that the enforcement staff will be reasonable with AB 32 related penalties. SMUD's problem with this position is that with such a large range of penalties -- $40 million per day down to zero in the above example -- it is difficult to determine what is reasonable. How are we supposed to make the case that some number between $40,000,000 and $0 is reasonable? SMUD believes that assuming a starting point at the statutory maximum is unreasonable, and without a different method for applying daily penalties to AB 32 reduction measures stakeholders

will have no assurance that the ARB will not act arbitrarily in administering these programs.

SMUD believes that the Legislature added § 38580(b)(3) to deal with the potential incongruity between the basic daily penalty authority in the Health and Safety Code and the expected longer compliance timeframes from a variety of AB 32 regulations. That provision says that ARB may "develop a method to convert a violation of any rule, etc. into the number of days of violation if appropriate." SMUD sees this as providing authority for ARB to not only translate violations that are inherently non-daily into a daily structure, but to establish a reasonable daily structure in each case – one that allows for proportionate and reasonable penalties from the start, avoiding reliance on ARB negotiations in nearly all AB 32 cases to not start out with potentially egregious penalties that may result from blind application of the 'daily paradigm'. As mentioned earlier, the draft PEPP should include explicit discussion of criteria and issues for establishing appropriate penalties for AB 32 related regulations under the basic authority of the Health and Safety Code.

There is a somewhat different, but still problematic, situation with the adopted SF_6 regulation. With that regulation, we may not even know whether there is a violation of the annual emission limit until the compliance period is over, but that potential violation, regardless of severity, will be automatically converted into 365 days of violation. As ARB staff has realized, in this case, compliance or noncompliance has already happened and is past once the year is up, and any kind of subsequent daily penalty will not serve the goal of faster compliance. The problem with this penalty structure is that should an SF_6 leak occur that leads to noncompliance, the standard penalty amount is already determined, and entities have no incentive to then reduce the leakage within the compliance period. Again, regulated entities must rely on ARB flexibility and negotiations to achieve reasonable and proportionate penalties.

SMUD believes that considering each day of a compliance period to be a separate violation when compliance is based on an average annual emission rate is not an accurate reflection of actual violation. For the SF_6 Regulation, for example, if an entity exceeds the average annual emissions rate, in most cases there would not be a daily violation if each day's emissions rate is considered separately, therefore each day of the compliance period should not be considered a violation. It is the summation of SF_6 leakage over many days that may result in a violation of the annual limit. Suggesting that each day of the compliance period is a violation when the annual limit is broached is akin to suggesting that each hour of a day is a violation when a daily emission limit is violated. This daily penalty structure applied retroactively does not serve the purpose for which it was intended – to inform the emitter it is in violation on a given day, and that it should return to compliance the next day or face another stiff fine.

SMUD submits that Section 38580(c) provides significant flexibility for ARB to develop a much better penalty structure – one that allows penalties that are clearly proportionate to violation severity and that reduces the uncertainty that is inherent in the current structure, while yet providing sufficient penalty authority for egregious violations.

Again, stakeholders raised these penalty issues before the Board in the SF_6 rulemaking during adoption of the basic regulations, and in response, the Board directed Staff to reconsider the appropriateness of daily penalties. Unfortunately, the staff did not reconsider the daily penalty structure established for SF_6, and there is no discussion in the PEPP about the appropriateness of using daily penalties to enforce yearly procurement goals or about any methods for converting daily penalty provisions of the H&S Code to annual limits. Stakeholder comments in the SF6 proceeding provided two examples of penalty structures that would better reflect the severity of a violation in a 'daily' penalty structure.

So, how should the PEPP be changed to resolve these issues? The PEPP needs to explicitly explain how the penalty factors will be developed and applied, particularly in the case of AB 32 related regulations. Simply listing or explaining the factors that are expected to be taken into account allows ARB staff unlimited flexibility in changing how they are applied from one case to the next. At some point unlimited flexibility allows for arbitrariness. Unlimited flexibility also wreaks havoc on business decisions that must take into account financial exposure of various procurement decisions. ARB should develop general structures to describe how annual and longer compliance periods are to be turned into 'daily penalties' and should also assign relative importance to all factors used to assess penalties.

B. Emphasis on Starting With Maximum Penalty Amounts

ARB should seriously consider quantitative criteria for assessing penalties that calculate penalties from "0", or a minimum value, rather than from the statutory maximums. Since the statutory maximums are so high, and since ARB has interpreted the Health & Safety Code so broadly in defining daily violations, regulated entities can easily face potentially astronomical penalties for substantive and technical violations alike. This makes it difficult for those entities to judge risk. This also burdens the financial markets ability to judge risk for the purposes of extending credit. This hurts business and the economy but does little to promote compliance with the law.

C. The PEPP should explain how the 8 factors of SB 1402 are to be Applied to Reach a penalty.

It is not enough for an agency to merely list the qualitative factors to be considered when calculating a quantitative penalty. For those factors to be meaningful to the regulated community, ARB needs to assign a weight or relative importance to them, or somehow provide guidance about how they will be applied to deliver:

- a pertinent, clear, and reasonable penalty structure that reflects the severity of potential violations in the regulation itself, without implying a clear risk for egregious and out-of-proportion penalties;

- regulatory certainty about the enforcement process and a meaningful guide to understanding how potential violations will be enforced; and

- induces compliance through a set of consistent enforcement mechanisms on which current and future ARB staff can rely.

To do less is to invite arbitrariness for ARB staff to use any factor to justify a penalty up to the statutory maximum or perpetuate an unjust penalty in a prior case out of "fairness" or consistency. This leaves the regulated community relatively powerless to persuade the agency of the merits of its point of view because there are no clear rules for how the factors are to be applied from one case to another. There are enforcement paradigms that ARB could and should draw upon. SMUD would like to see ARB hold another workshop to discuss them.

Respectfully submitted,

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