August 11, 2011

Mary Nichols, Chairwoman
California Air Resources Board
1001 "I" Street
Post Office Box 2815
Sacramento, California 95812

Subject: Treatment of Electricity Use for Energy Intensive Trade Exposed Entities in Greenhouse Gas Cap-and-Trade Market

Dear Chairwoman Nichols:

The California Large Energy Consumers Association ("CLECA") hereby submits its Comments on the CARB's proposed regulations implementing its Cap & Trade scheme under AB 32. CLECA's focus is on the regulations' approach to indirect costs associated with electric usage in large industrial facilities.

Introduction

CLECA is an organization of large, electricity-intensive industrial firms that are customers of either Pacific Gas & Electric Company ("PG&E"), Southern California Edison Company ("Edison") or San Diego Gas & Electric Company ("SDG&E"). The members of CLECA use very large quantities of electricity in their California manufacturing facilities, they typically operate in a manner that creates high load factors for electric use, and they take power at transmission or sub-transmission voltages. In short, they are among the very largest customers of the three investor-owned electric utilities. In the aggregate, CLECA member companies spend more than $200 million annually for purchased electricity; during more robust economic conditions they spent roughly $300 million annually. Some of these member companies self-generate a portion of their electric requirements on site and others are actively considering the installation of combined heat and power ("CHP") and/or renewable generation at their facilities.

These companies are unique in the sense that electricity comprises a very large percentage of their overall cost of production, from 20% to as much as 60% of production costs for some members, and thus electricity cost increases have a much larger impact on their competitiveness in the marketplace than is the case for other customers of the utilities. In short, they are "electricity intensive" customers. CLECA members pay large electric bills each month and they are likely to face significant adverse economic impacts from the anticipated increase in electricity costs which will come with implementation of AB 32's GHG reduction scheme, and specifically the CARB's Cap & Trade regulation of the electric industry.

Some CLECA member companies are in those industries which the CARB has designated as "energy intensive, trade exposed" ("EITE"). These include cement manufacturers, steel manufacturers, certain industrial gas manufacturers (specifically makers of hydrogen), certain mineral extraction operations and certain beverage manufacturers. Other CLECA member companies have very electricity-intensive operations, but have not been deemed to be "trade exposed". Examples include certain manufacturers of industrial gases. The treatment of both the increased wholesale electric costs anticipated to result from implementation of Cap & Trade, and of auction revenues derived from free allowances given to electric utilities will each have a substantial impact on the ability of these firms to compete in the market place and to continue to provide good jobs for California residents.

CARB Has The Responsibility to Minimize Leakage - It Must Assure That Any Delegation of Its Responsibility to the CPUC Accomplishes That Goal

AB 32 explicitly recognizes the importance of preventing negative consequences to certain industries caused by the implementation of a GHG reduction program, including both in relation to the direct emissions of carbon in their manufacturing processes and to the indirect emissions of carbon associated with the electricity they must purchase in order to manufacture their products. It places on the CARB the responsibility to "minimize leakage". (Health and Safety Code, Sections 38562(a) and (b).) CARB has an obligation to ensure that all of the AB 32 goals, including the goal of minimizing leakage, are carried through in the implementation of the Cap & Trade program.

CARB has generally recognized its responsibility with respect to "minimizing leakage". Resolution 10-42 and the accompanying appendices set forth in detail the considerations that the CARB included in developing its policy as well as more detail as to how CARB expects AB 32 implementation to proceed. In stating its policy for allocation of allowances, contained in Appendix J - "Allowance Allocation", CARB provides a further discussion of its concerns about industries with leakage risk. There, CARB states that “[f]ree allocation needed to minimize leakage will be maintained until adoption of equivalent carbon-pricing policies by other jurisdictions eliminates the leakage risk or it is determined that such a level of free allocation is not required to shield entities from leakage risk”. (App. J., p. J-19.)

CLECA agrees with these sentiments. Our concern with the proposed regulations is that the CARB has not provided a mechanism to assure full protection from leakage that occurs as a result of significant increased costs to EITE industrial firms resulting from higher electric costs caused by implementation of its Cap & Trade scheme. It really is not clear how CARB intends to ensure full achievement of its obligation to minimize leakage through the electric utility allowance allocation process. Neither the regulation nor Resolution 10-42 expressly direct the CPUC to ensure that the allowance allocation methodology fully protects EITE customers and thereby minimizes leakage.

The risk we perceive is that once those free allowances are monetized and the revenues are placed under the control of the utilities and their regulator, the CPUC, the CARB's ability to specify and dictate uses for such funds may be compromised. While the CPUC's role is the regulation of electric utilities' costs and service, the CARB is the agency charged with the task of assuring that leakage is minimized. Clearly, the CARB has offered its "instructions" for disposition of such allowance auction proceeds.

> Proceeds from sale of allowances at auction will generate a new revenue stream for a distribution utility. This revenue stream will need to be accounted for along with all other revenues and costs in the ratemaking actions of the PUC and the governing bodies of the POUs. The statutory goals of AB 32 will apply to all utility proceeds raised through auctioned allowances and all proceeds must be used to the benefit of ratepayers rather than for the benefit of shareholders (or any other entities). Distribution utilities will be required to report to ARB on how they use proceeds generated from the sale of allowances at auction. (App. J, at pp. 60-61.)

Unfortunately, the CARB's "instructions" regarding the disposition of allowance auction revenues are not sufficiently specific with respect to EITE customers and leakage and further, they may carry the weight of mere "suggestions" in the context of CPUC ratemaking. It is the CPUC, not the CARB, which has exclusive jurisdiction over investor-owned electric utilities with respect to ratemaking. (CA Pub. Util. Code, sections 454, 701, 702, 728; CA Const., Art. 12; *City of Vernon v. Southern Cal. Edison Co*., 191 Cal. Rptr.2nd 378.) If the CPUC determines that a substantial portion of the allowance auction proceeds should be spent on purposes other than "minimizing leakage", perhaps simply because it has not been specifically charged with that responsibility, the CARB could find that its task has been compromised.

The initial proceedings at the CPUC in R.11-03-012, its rulemaking proceeding to assess how to treat both anticipated higher wholesale electric costs and allowance auction proceeds resulting from implementation of Cap & Trade, suggest that some parties will strongly urge the CPUC to direct the electric utilities to spend such allowance auction proceeds for purposes other than minimizing leakage, indeed for purposes other than benefiting ratepayers. Yes, the CARB, once informed of such actions by the CPUC and/or the utilities, might engage in the very cumbersome and time consuming process of modifying its regulations to change the way in which it grants free allowances to utilities, but that approach would prove highly unsatisfactory given the amount of dollars at stake with respect to each year's allowances.

CLECA sees two potential solutions. One is for the CARB to include such indirect electric costs in its determination of the benchmark for each EITE industry and to distribute allowances to such EITE entities sufficient to cover such costs, along with direct costs. This would, of course, require that allowances which were to be provided to the electric utilities to cover the usage of EITE customers are instead provided to the EITE pool. CLECA urges CARB to reconsider this aspect of its regulations, specifically sections 95891 and 95892. Specifically, the CARB should add a term to the Product Output-Based Allocation Calculation Methodology set forth in Section 95891(b) as follows:

kWh purchased from the utility x utility emission factor/kWh.

CLECA believes that full protection of EITE customers requires that the allowances to be provided to them must include both direct and indirect costs and that the benchmarks can be set to accomplish that task. If indirect costs for EITE customers are covered in their allowances, such allowances would be deducted from those provided to the electric utilities and the utilities would be instructed not to give EITE customers any portion of the utilities allowance auction proceeds so as to avoid a double recovery.

A second approach would be for the CARB to much more explicitly condition its grant of free allowances to electric utilities. CARB is fully within its jurisdiction to condition its provision of allowances to the utilities on treatment of EITE ratepayers in a way that will minimize leakage. In other words, the CARB would make conditional its grant of free allowances to the utilities on their assuring that auction proceeds are used, in part, to fully cover the indirect costs of EITE customers. If the funds needed to cover EITE indirect costs were used for other purposes, the grant of allowances to the utilities would be adjusted downward and instead would be allocated by CARB directly to EITE customers. This could be accomplished by adding to Section 95892(d)(3) a subsection (D) as follows:

> (D) Investor owned utilities shall use a portion of the auction proceeds to fully offset the greenhouse gas compliance costs reflected in the electricity rates charged to energy-intensive, trade-exposed customers consistent with the goal of AB 32 to limit emission leakage.

AB 32 places the responsibility to "minimize leakage" on the CARB and the CARB must adopt regulations which will effectively carry out that mandate.

The CARB's "Restrictions" on the Use of Allowance Auction Proceeds by Electric Utilities Are Misdirected.

CLECA wholeheartedly agrees with the CARB's statement that utility allowance auction proceeds must be used exclusively for the benefit of ratepayers. (Section 95892(a).) We agree with the CARB's statement in Appendix J that auction proceeds should be used to reduce the cost impact of Cap & Trade on ratepayers:

> Allowances will be freely allocated to the electrical distribution utilities that distribute electricity to Californian ratepayers. These utilities are receiving these allowances on behalf of these customers. ***Utilities must use this allowance value to reduce the costs of AB 32 policies on their ratepayers.*** (App. J, at p. J-15, emphasis added.)

We also agree with the CARB's direction that utilities shall assure that proceeds are used in a manner which provides equal treatment of bundled and direct access customers. CLECA includes firms that utilize bundled service and firms that take service from energy service providers under direct access. (Section 95892(d)(3)(A).)

However, CLECA believes that the CARB's instruction that the use of such proceeds to provide a rate reduction or rebate to utility customers should only apply to the fixed portion of the customer bill and should not be based on usage for any period after January 1, 2012 is misguided. (Section 95892(d)(3)(B) and (C).) Not only do these restrictions make the pass-through of allowance auction proceeds to customers cumbersome to implement, and risk the possibility that some customers will receive a disproportionate share of proceeds in relation to their exposure to higher electric costs, whether higher or lower, they fail to acknowledge the fact that the rates paid by California investor-owned electric utilities currently reflect a very significant "carbon premium".

Clearly, the CARB's attempt to divorce any allowance auction proceeds rebates from the ongoing energy rates paid by utility customers has to do with its belief that a "carbon price signal" should be reflected in retail electric rates. The implementation of Cap & Trade will cause wholesale electric rates to increase over time. While we cannot know the extent of this increase, it is clear that it will be passed through by the utilities in their retail rates. The question is whether allowance auction proceeds should be used to soften the blow of such retail rate increases and whether the purposes of AB 32 can be accomplished in a more economical manner and without subjecting electric ratepayers to huge rate increases. CLECA submits that the proceeds should be used to soften the blow of Cap & Trade and they should be used in a way that addresses the fact that different customers will face different levels of cost increase as a result of AB 32.

California electric rates currently reflect a very significant "carbon price signal". Such rates are among the very highest in the nation; the system average rates of the three big investor-owned electric utilities are approximately 50% higher than the national average. The rates are higher because of specific policy initiatives of the California Legislature and/or the CPUC over the past ten years aimed at changing the make-up of the utilities' resource mix to reduce carbon intensity and thus reflect the cost of carbon. The CPUC has specifically mandated that the utilities rid their portfolios of coal-based generation, despite the fact that such generation is among the least expensive sources. California ratepayers currently pay well in excess of $1 billion dollars each *year* for energy efficiency programs designed to reduce their usage and thus the amount of generation, largely fossil-fuel based, required to serve them. Their rates includes several hundred millions dollars of subsidies each year for distributed solar PV installations under the California Solar Initiative and for other distributed, clean generation. Finally, the 20% RPS mandate and now the 33% RPS mandate mean that California electric ratepayers must pay rates that include the significantly higher costs of purchasing or building renewable power. In the aggregate, these programs add literally billions of dollars to the annual cost of utility service from the big three investor-owned utilities. It is simply wrong to suggest that such rates do not reflect the cost of avoided carbon.

The implementation of Cap & Trade will increase wholesale electric costs. But, the overarching goal of reduced GHG emissions can be achieved without having to pass through in retail rates the full impact of such costs. Indeed, the benefit of Cap & Trade over a simple carbon tax is the possibility that we will be able to achieve reduced levels of GHG emissions in a more economical way, thereby benefitting the economy and each of us as residents of the State. Given the likely impact of implementation of AB 32 on the already high cost of electric generation, and the adverse impact on rates which will certainly result from implementation of 33% RPS, CLECA submits that ratepayers will "benefit" most from a return of 100% of the free allowance auction proceeds through some form of rate reduction or offset to rate increases. Further, those proceeds should be passed through to ratepayers in a manner that reflects the extent of their exposure to higher electric costs. It should reflect their current usage and it should reflect the degree to which their rates are exposed to price increases resulting from Cap & Trade. Some ratepayers are currently protected from rate increases, or the full effect of rate increases, through programs such as CARE for low-income customers, or the residential inverted tier rate structure which subsidizes rates for initial volumes of usage through excess charges on higher volumes of usage. CARE customers and low usage non-CARE residential customers will not feel the full effects of Cap & Trade on their electric rates and they should not receive a full share of allowance auction proceeds through "per capita" or "per ratepayer" rebates.

Further, the instructions on the use of allowance auction proceeds contained in section 95892(d)(3)(B) and (C) go directly to the CPUC's regulatory discretion to set electric rates. The CARB has no authority to direct the CPUC to make rates in any particular manner and it should not attempt to do so here. CLECA therefore urges the CARB to remove subsections (B) and (C).

CARB's Failure to Reflect Indirect Emissions in the Product Benchmark Will Discourage CHP -

The CARB's revised regulations fail to include indirect emissions associated with the use of electricity used in a manufacturing operation from the calculation of the Product Benchmark. (See Appendix B to the July 25, 2011 revised regulations.) In addition to CLECA's concerns that such failure will risk causing EITE customers not to have full coverage of their new Cap & Trade costs, this approach unnecessarily and improperly sends a very discouraging signal to customer who might be interested in new CHP in California. The CARB's logic is that indirect costs associated with electricity use will somehow be compensated by the utilities using their allowance auction proceeds. As we have discussed, the CPUC may have different ideas about the disposition of such proceeds. But, even if the auction proceeds were used to provide rebates or bill reductions to customers in relation to their electric use, this approach fails to acknowledge that some customers currently self-provide or would like to self-provide all or a portion of their electrical requirements through CHP or other renewable technologies.

Consider a situation in which an industrial customer, whether EITE or not, is currently a full bundled utility customer but would like to install CHP or a renewable technology to meet 50% of its electric requirements two years hence. Assuming that the allowance auction proceeds are actually used to provide bill reductions to the customer based on its utility electric purchases, a decision to install CHP or a renewable technology to meet 50% of its requirements would mean a loss of 50% of the auction proceeds. This will create a powerful disincentive to the installation of new CHP or renewable power and it will run directly counter to the CARB's own endorsement of the goal of achieving nearly 7 million tons of GHG reductions through the increased use of CHP. While the CARB, in Resolution 10-42, calls for incentives to encourage CHP, its regulations will act to discourage CHP.

This can be readily solved by the CARB including indirect emissions in the product output benchmark for each industry. CLECA strongly urges the CARB to make this change.

CLECA would be pleased to respond to any questions the CARB may have regarding these comments.

Respectfully submitted,

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cc: Sam Wade