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Re: Sacramento Municipal Utility District's Supplemental Comments on Proposed Regulation Order -- July 2013 Amendments to California's Cap-and-Trade Program

SMUD appreciates the opportunity to comment on the Proposed Regulation Order (Appendix E of the 2013 Cap-and-Trade Rulemaking) detailing proposed amendments to California's Cap-and-Trade program. SMUD supports the concept of 'fine-tuning' the Cap-and-Trade regulations at this time and believes that most of the proposed changes to the regulations are well founded. SMUD's comments below include a variety of additional recommended alterations that will help make the Cap-and-Trade program work better. SMUD believes that all of our proposed changes are within the scope of the current rulemaking.

I. ARB Should Include Amendments To The Cap-and-Trade Regulations That Allow Flexibility In CITSS Account Participation

Currently under the Cap-And-Trade regulations, Primary and Alternative Account Representatives register in CITSS and have the authority to transfer allowances among accounts as a "settlement" function per the definitions of these roles in §§ 95802(9) and (206), along with the registration structure established in § 95832. These CITSS participants are also allowed to participate in the quarterly auctions per § 95912 – in fact, a PAR or AAR CITSS registration is required to participate in these auctions (as well as the APCR auctions, when held).

However, in SMUD, and in many other companies, the "settlement" function is strictly and explicitly separated from the "trading" or auction participation function for transaction integrity reasons. Thus, the broad authority provided to PARs and AARs in CITSS is

problematic. SMUD understands that a solution to this problem can be implemented in the CITSS structure when there is time and resources to do so, but that first the Cap-and-Trade regulations must be modified to allow the CITSS solution to be a possibility. Hence, SMUD believes that the Cap-and-Trade regulations should be modified to allow an eventual CITSS solution by providing participating entities the flexibility to designate the proper roles in CITSS for entity personnel. This can be accomplished by simply adding the phrase ***"… as specified by the entity***" to the definitions for PARs and AARs in §§ 95802(12) and (269). These definitions would now read:

> 95802(12) "Alternate Account Representative" means an individual designated pursuant to section 95832 to take actions on an entity's accounts, as specified by the entity.
>
> 95802(269) "Primary Account Representative" means an individual designated pursuant to section 95832 to take actions on an entity's accounts, as specified by the entity.

These simple changes are all that SMUD believes is required in the Cap-and-Trade regulations in order to enable auction participants such as SMUD to preserve internal trading guidelines. SMUD believes that this change is within the scope of 15-day changes because § 95802 includes many modifications, including renumbering of the specific subsections for AAR and PAR. In addition, SMUD believes that the change will be useful for a variety of market participants in addition to SMUD, and that the proposed change is noncontroversial and uncomplicated.

II. SMUD Believes That Voluntary Renewable Energy Provisions Should Be Further Modified

Under the RPS, a covered entity can reduce its reported emissions and hence compliance obligation either by procuring directly delivered renewables, which come with zero or near zero specific source GHG emission factors, or by procuring firmed and shaped renewables along with substitute energy delivered to the state, thus taking advantage of the "RPS adjustment" to reduce the emissions associated with the substitute energy. Both instances reduce the covered entity's reported emissions and allow commensurate emissions elsewhere under the cap. ARB's voluntary renewable energy (VRE) set-aside provisions recognize that the Cap acts to reduce the incentive to procure renewables for a voluntary program (as GHG emissions are not altered under the Cap), and therefore sets aside some allowances that can be retired to ensure that GHG reductions actually occur with these voluntary programs, despite the existence of the Cap.

However, the Cap-and-Trade regulations currently reserve use of the VRE program for only directly delivered renewables, not covering the "RPS adjustment" pathway. SMUD continues to recommend that the Cap-and-Trade regulations allow use of the VRE

provisions for renewable procurement that *could* take advantage of the RPS Adjustment *if* the procurement is associated with an entity's RPS obligation, rather than part of a VRE procurement. This will provide equal treatment for RPS procurement and VRE procurement.

Note that SMUD is not recommending application of the VRE to renewables that are not eligible for the RPS – SMUD agrees with the ARB policy of reserving the VRE adjustment for only those renewables that are RPS-eligible. Rather, SMUD is requesting greater equivalency between the VRE provisions and the RPS, allowing both directly delivered *and* RPS adjustment provisions in the VRE context to lead to GHG reductions through allowance retirement from the VRE, just as both of these pathways are accepted in the RPS.

SMUD also understands that the ARB established a direct delivery requirement for the VRE in order to implement a VRE that is based on the location of the renewable generator rather than the location of the VRE purchaser. With this structure, even a non-obligated entity under the Cap-and-Trade program – for example, someone that sells unbundled RECs to customers outside of California -- can ensure GHG reductions for the purchasers of this voluntary renewable product – even for those renewable generators located here in California and thus under the GHG cap in place in the state (and linked jurisdictions).

SMUD contends that it is not just the location of the renewable generator that is important but also the context of the renewable procurement. We recommend including "RPS-Adjustment renewables" in the VRE structure, although these RPS-eligible facilities are typically located outside of California, because, as with directly delivered renewables, RPS procurement of renewables via the RPS Adjustment yields a GHG benefit to the procuring entity in California. Such procurement provides a reduction of their GHG obligation, but other obligated entities in the capped jurisdiction (California) can then emit more GHG. Hence, just like a voluntary procurement of directly delivered renewables by an obligated entity, a voluntary procurement of RPS Adjustment eligible renewables by an obligated entity would yield no change in overall GHG emissions unless covered by the VRE structure. Both types of transactions should be covered by the VRE when procurement is by a Cap-and-Trade obligated entity, to allow full use of renewable options while ensuring that the voluntary procurement leads to GHG reductions. Only directly-delivered renewables should be covered by the VRE when procurement is by a non-obligated entity because there is no GHG obligation change for the procuring entity, and the important concept for ensuring GHG reduction is limited to the impact on the actual electricity grid implied by directly delivered renewables.

In the FSOR for the Cap-and-Trade regulations, ARB staff suggested that: " … If electricity under SMUD's green pricing program meets the established [CEC] RPS requirements, then it will be allowed to take the RPS adjustment." (FSOR, page 2132.) However, the regulations as drafted would limit the RPS Adjustment to situations of actual RPS compliance, thereby constraining its use for green pricing programs that are

not subject to RPS compliance. The following changes would allow resources that would normally count for the state's RPS to also be fully viable for voluntary program procurement by a covered Cap-and-Trade entity, without incurring a compliance obligation or challenging the GHG benefits expected from voluntary renewable procurement.

> 95841.1(a) Program Requirements: The end-user, or VRE participant acting on behalf of the end-user, must meet the requirements of this section. Generation must be new and not have served load prior to July 1, 2005. Allowance retirement for purposes of voluntary renewable electricity will begin in 2014 for 2013 generation. Voluntary renewable electricity must be directly delivered to California, or associated with a transaction that uses the RPS adjustment. RECs, if created, must be retired within the year for which VRE retirements are requested.

> 95852(b)(4)(B) The RECs associated with the electricity claimed for the RPS adjustment must be placed in a ~~the~~ retirement subaccount of the entity party to the contract in 95852(b)(4)(A), in the accounting system established by the CEC pursuant to PUC 399.25 and either designated as retired for the purpose of compliance with the California RPS program; or designated as retired for purposes of a voluntary green pricing program operated by a covered entity ~~used to comply with California RPS requirements~~ during the same year ~~in~~ for which the RPS adjustment is claimed.

III. SMUD Supports The Proposed Modifications To The Eligibility Requirements for Biomass-Derived Fuels In Section 95852.1.1

SMUD appreciates the proposed modifications to the provisions in the section describing eligibility requirements for biomass-derived fuels. Fuels that meet the requirements in this sector do not incur a compliance obligation under the Cap-and-Trade Program. SMUD believes that the proposed changes continue to prevent "resource shuffling" with respect to biomass-derived fuels while clarifying that new sources of these fuels, and those sources that were previously delivered to California, do not have compliance obligation.

IV. The ARB Should Include Additional Modifications To Address Cost Containment Pursuant To Board Resolution 12-51

SMUD welcomed Board Resolution 12-51 asking ARB staff to develop proposals to prevent allowance prices in the Cap-and-Trade program from rising above the price in the 3rd tier of the APCR, while preserving the environmental integrity of the Cap-and-Trade structure, and being reasonably available in 2013-2020. To SMUD, this second part of the resolution is as important if not more important than the first part – we desire costs to be as low as possible, but more importantly, we want to achieve our GHG reduction goals. SMUD believes that the third part of the Resolution implies that ARB should act during the 2013 Cap-and-Trade update rulemaking, or very soon thereafter, to enact further cost containment measures.

The proposed modifications in the Proposed Regulation Order are not sufficient, in SMUD's opinion, to address the goals of the Board's resolution. The Proposed Regulation Order primarily includes a provision to "borrow" a finite number of allowances from future vintages and make these available at the highest price tier of the APCR, and only at limited times (there is also a provision to ensure that offsets procured and retired are not inadvertently "lost" and an additional offset protocol being proposed). Should this provision for a limited amount of additional allowances in the APCR be insufficient at any time, or should high prices ensue during an auction other than the "end of a compliance period" auctions identified in the Proposed Regulation Order, then the Cap- and-Trade Program regulations would "ration" procurement from the APCR, leading to market prices rising above the level suggested in Board Resolution 12-51. In addition, should the envisioned borrowing of allowances from future vintages be pervasive or occur multiple times, it is clear that fewer and fewer allowances will be made available to moderate prices, meaning that this provision clearly does not achieve the Board Resolution goals in cases where there is a long-term change in demand/supply characteristics of the Cap-and-Trade market.

ARB staff may feel that the proposed limited borrowing is sufficient to address the Board's Resolution because the scenarios in which demand/supply conditions lead to 3rd Tier APCR prices are unlikely. However, staff acknowledges in the Initial Statement of Reasons that accompanied the 45-day language that unanticipated conditions might "… create a long-term and persistent increase in the demand for allowances … [in which case] … the proposal would ***not*** ensure that allowance prices do not exceed the Reserve top tier price." (Page 43 of ARB 2013 Initial Statement of Reasons, emphasis added.) This statement is consistent with the EMAC analysis found in the paper: "*Forecasting Supply and Demand Balance in California's Greenhouse Gas Cap-and-Trade Market, March 12, 2013."* This analysis states that there is a "non-trivial possibility" that auction prices could reach unacceptably high levels due to a systemic imbalance in market fundamentals.

In addition, SMUD points out that there was a bill being seriously considered in the 2012-2013 California legislative session that would significantly limit the supply of carbon offsets in the Cap-and-Trade program if it had been enacted. SMUD understands that this bill will likely be considered by the legislature again in the next legislative session, and that there are constituencies in California that will continue to attempt to limit the use of offsets in the Cap-and-Trade program. Market analysis of such limits points to significantly higher prices in the Cap-and-Trade market – in some cases well above the APCR 3rd Tier price. Since offset supply is limited to 8% of the total compliance instrument supply, the market analysis here suggests that a reduction in total supply of less than 8% from that expected can have significant market and pricing impacts. SMUD can easily imagine scenarios where either supply (as indicated above) or demand, or a combination of the two, yields a demand/supply situation that is 5-10% "tighter" than expected, potentially leading to prices that would be inconsistent with the intent of Resolution 12-51.

SMUD believes that to achieve the goals of the Board Resolution, the ARB should include additional cost limitation provisions in the 2013 Cap-and-Trade update. In addressing the Board Resolution, ARB staff has focused only on a measure that would be triggered once a price crisis is already happening. A broader reading of the Board's Resolution would embrace provisions that would help to prevent the price crisis from happening in the first place. The ARB should add provisions in 15-day language adjustments to the Proposed Regulation Order to further address cost containment, drawing from all three program elements mentioned in the Joint Utilities' white paper provided as part of the cost-containment workshop. The proposed limited borrowing from future vintages at the highest price APCR level, in limited circumstances, is not sufficient, in SMUD's view, to achieve the Board's goals.

Hence, SMUD suggests that ARB revisit the basic structure of the Joint Utilities proposal, with the three main categories of cost containment measures, and include additional Cap-and-Trade modifications from these categories:

A) Measures that take effect now and gradually over time to reduce the likelihood of prices rising above the APCR in the future by: 1) reducing demand for compliance instruments; 2) increasing the supply of compliance instruments; and 3) ensuring that compliance instruments are accessible in the marketplace.

B) Measures that, when triggered, would quickly alter compliance instrument demand/supply dynamics and constrain upward pressure on market prices for a period of time. An example trigger is a percentage level of depletion of the APCR.

C) Measures that, when triggered, would keep allowance prices at the third tier of the APCR regardless of current demand, while preserving the environmental integrity of the Cap-and-Trade Program over time.

SMUD contends that the limited borrowing measure in the Proposed Regulation Order is essentially from Category B above – it would quickly alter compliance instrument supply and demand dynamics for a period of time, and is triggered when the APCR is essentially 100% depleted. While ARB staff's proposed cost-containment changes include a couple of minor measures from Category A, they do not at all include a measure that is from Category C. SMUD believes that a Category C measure is necessary to truly ensure the price cap that is envisioned in the Board's resolution.

SMUD recommends that ARB include additional Category A and B measures in the 2013 Cap-and-Trade amendments, while signaling that a Category C measure that would fully meet the intent of the Board's resolution is being further examined. The Category C signal would come from the Board directing staff in a resolution to undertake a specific analysis that would:

1) Define a maximum demand/minimum supply scenario that assumes robust economic growth, reduced efficacy of GHG reduction measures in place; and sharp limits on the amounts of offsets available to the market;

2) Estimate how many additional allowances would be necessary in that scenario to ensure, per Resolution 12-51, that allowance prices "…will not exceed the highest price Tier of the Allowance Price Containment Reserve…"; and

3) Identify and confirm the existence of sufficient emission reductions outside the Cap that would be available to fully offset that estimated amount of additional allowances, along with describing viable mechanisms for quickly accessing these commensurate emission reductions.

With respect to additional Category A and B measures, SMUD suggests that the ARB include, but not limit consideration to, the following additional measures:

1) Measures to ensure that the allowed 8% of compliance from offsets is fully available to the market, by:

    - Avoiding the loss of this potential if entities do not use their full offset allocation, allowing carryover of the offset limit on an entity-specific basis or by spreading unused amounts over the broader market.
    - Quickly pursuing and adopting new, rigorous offset protocols, and expanding the geographic scope of existing protocols. SMUD has seen market analysis indicating that even with eventual adoption of the proposed new protocol for mine methane capture, and future consideration of adoption of a protocol related to rice cultivation, offset supply (given the current geographic scope of the offset protocols in place) will not be sufficient to provide the full "room" under the 8% offset limit. SMUD encourages the quick adoption of the proposed coal mine methane protocol and refocused effort on developing and adopting additional

protocols; including REDD+ protocols. SMUD also recommends consideration of expanding existing protocols to all of North America and beyond if feasible (SMUD notes that geographic expansion to North America is allowed under the Cap-and-Trade regulations without a new rulemaking).

2) Measures that will act to reduce demand for compliance instruments over the long term. For example, the ARB could pursue measures that fostered greater electrification of energy uses currently associated with distributed fuel use in California. Such electrification, if expanded beyond a baseline amount, would act to reduce demand for allowances because the reduction in emissions on the distributed fuel side would be greater than the increase in emissions on the electricity side. This electrification requires investments in infrastructure, outreach to consumers, and potential changes in policies to recognize the energy and GHG benefits fully. The ARB should consider how the Cap-and-Trade structure can be modified to reflect the long-term reduction in compliance instrument demand that come with greater electrification of distributed fuel sources. Presently, the Cap-and-Trade structure acts as a disincentive for this path, as electrification means an additional compliance obligation for the electric utility obligated entity, with nothing in place to reflect the reduced Cap-and-Trade obligation of a distributed fuel provider, or to reflect the overall decrease in compliance instrument demand.

3) Measures that would act to increase supply of compliance instruments over the long term. For example, the ARB could exempt from the offset limit any offsets that provide in-state ancillary environmental benefits similar to actual reductions at capped sector facilities. One way to structure this would be to exempt offsets from the 8% limit if they could prove one or more of the following:

   - a direct reduction or avoidance of any criteria air pollutant in California;
   - a direct reduction or avoidance any impacts on water quality in California;
   - a direct alleviation of a local nuisance within California associated with the emission of odors;
   - direct environmental improvements to land uses and practices in California's agricultural sector;
   - direct environmental improvements to California's natural forest resources and other natural resources;
   - a direct reduction of the need for mitigation of the impacts within California of rising global greenhouse gas emissions.

4) Additional limited borrowing, but triggered earlier than that proposed in the Proposed Regulation Order, where the sole cost-containment measure is triggered when the APCR is essentially fully depleted. SMUD contends that the ARB should include measures that are triggered earlier than the full depletion of

the APCR, in order to gain time to avoid the more severe price crisis. The "door" to consideration of limited borrowing has been cracked ajar by the ARB's proposed cost-containment measure in the Proposed Regulation Order. SMUD reiterates that the ARB should adopt a provision that when 40% of the allowances in the APCR have been purchased, entities are allowed to use allowances for compliance from the next vintage year. An extra year's worth of eligible compliance instruments in the market pulls supply of allowances temporarily back into a better balance with demand, providing time for technology or other measures to reduce demand in the following year and beyond.

V. SMUD Supports The Provision Of Allowances To University Sources and Legacy Contracts

SMUD supports the modification proposed in the Proposed Regulation Order to provide allowances to public and private university covered parties. SMUD believes that the provision will reduce the incentives of such entities to forego their combined heat and power systems in order to reduce their compliance obligations or even avoid being a covered entity altogether.

SMUD also appreciates the proposed changes that will provide 2015 allowances to cover 2013 and 2014 emissions associated with "legacy contracts" – electricity or qualified thermal output contracts that were signed prior to the Cap-and-Trade program and that have not been able to be altered to include compensation for the compliance instrument costs associated with the contracts.

SMUD supports these changes being adopted as part of the Cap-and-Trade structure.

VI. The ARB Should Slightly Expand Ability Of POUs To Place Allowances In Other Compliance Accounts To Cover Retail Sales Obligations

The current Cap-and-Trade regulation allows a POU to designate what amounts of administratively provided allowances that the Executive Director should place in the POU's limited use holding account or in the compliance accounts of: 1) an electrical generating facility operated by the POU; 2) an electrical cooperative; or 3) a JPA in which the POU is a member and with which it has a power purchase agreement.

SMUD suggests adding a fourth component to the allowable compliance accounts that can be designated, as follows:

95892(b)(2)(A): In the compliance account of an electrical generating facility operated by a publicly owned electric utility, an electrical cooperative, or 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 a federal power authority that is importing electricity products on the behalf of the electric distribution utility; or

The Proposed Regulation Order recognizes the instances where a federal power authority imports power on the behalf of retail customers of POUs, by explicitly allowing the entry of a zero price in a CITSS transfer agreement if "… the proposed transfer is from a public utility to a federal power authority to cover emissions associated with imported power." (Proposed Regulation Order, § 95921(b)(6)(D), page 199.) SMUD would prefer the convenience and flexibility of an option to simply place allowances in the federal power authority's compliance account in these cases. SMUD believes that the added language referring to such transfers in § 95921 imply that a conforming or related change in § 95892, as indicated above, is within the scope of the rulemaking and open for 15-day changes.

VII. The Cap-And-Trade Regulations Should Be Modified To Clarify That Release of Entity-Specific Compliance Account Balances Is Not Required, and ARB Should Only Release Aggregate Compliance Account Data

SMUD has weighed in on the issue of compliance account balance disclosures twice in the past year, in comments for the initial information disclosure workshop on January 25, 2013, and comments on the June 25, 2013 workshop. SMUD understands the need for a balance between transparency and protection of market sensitive information in the Cap-and-Trade program. SMUD believes that a proper balance here is achieved without revealing entity-specific compliance account balances. Implicit in the ARB staff discussion of this issue is a continued assertion that entity-specific compliance account information is required to be released publicly by the current Cap-and-Trade regulations. SMUD continues to believe that the Cap-and-Trade regulations do not require release of entity-specific compliance account data in the first place, for reasons explained in our June 25th workshop comments. Accordingly, SMUD recommends that § 95921(e)(4) be modified as follows:

(4) Releases information on the aggregated quantity ~~and serial numbers~~ of compliance instruments contained in compliance accounts in a timely manner.

There are significant changes proposed to § 95921, implying that the section is open for the potential change as described above to be within scope for 15-day language.

VIII. The Proposed Regulation Order Proposed Modification To Bid Guarantees That Are Not Cash Should Be Altered

The Proposed Regulation Order includes a new provision on page 175 that states that any bid guarantee that is not provided in the form of cash must be payable within one business day of a payment request. While SMUD understands that the ARB desires swift payment protocols in order to facilitate settlements, one business day is restrictive for many forms of bid guarantee still allowed by the Cap-and-Trade regulations. For example, a certified letter of credit is normally payable in two business days, and at times it may take three business days to complete the transaction. It is unclear to SMUD why settlements from a quarterly auction must be finalized as quickly as the modification in the Proposed Regulation Order suggests. SMUD recommends that the time period allowed for this be modified as follows:

95912(j)(3): A bid guarantee submitted in any form other than cash must be payable within three ~~one~~ business days of payment request.

IX. The Cap-and-Trade Regulations Should Be Modified To Explicitly Include Option 2 As A Viable Method Of Meeting the Know Your Customer Requirements

As the ARB began implementation of the Cap-and-Trade Program last summer, the Know Your Customer requirements raised significant concerns among covered entities. ARB responded at that time with guidance providing a second option for meeting the KYC requirements, involving much of the sensitive information being held by the covered entities themselves, and available for ARB inspection as required. The CITSS User Guide, Volume 1 describes these options and provides for compliance documentation with a covered entity attestation form (where the covered entity holds the KYC information in-house and files an attestation that it has the required information) or an individual attestation form (where the documentation would be sent to ARB for each individual).

SMUD appreciated the guidance provided at that time and understands that this guidance continues to be in place. Nevertheless, SMUD was under the impression that eventually changes would be made to the Cap-and-Trade regulations to clarify that the compliance entity attestation option was an explicit choice for the KYC requirements. SMUD urges the ARB to modify the language in the Proposed Regulation Order to address this issue as follows:

Section 95834 (b): The individual must provide, either directly or by covered entity attestation, documentation of the following: ….

SMUD again appreciates the opportunity to comment on the Proposed Regulation Order modifications to the Cap-and-Trade Program.

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cc: Corporate Files