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SMUD Comments on Potential Post AB 398 Cap-and-Trade Amendments

Thank you for the opportunity to submit comments concerning amending the Cap and Trade regulations, in response to the April 26, 2018 workshop. SMUD supported AB 398 and was active in the stakeholder discussions leading up to its adoption. SMUD has long supported an extension of the Cap and Trade Program beyond 2020.

SMUD has the following comments on the topics that were the focus of the April 26, workshop:

- **Use of Allowance Value:** SMUD continues to support flexibility in POU use of allowance value, including the ability to procure allowances for compliance with auction proceeds, as well as fund a broad range of GHG programs.
- **Electrification-Related Load Growth:** SMUD supports providing additional allowances to EDUs to address the ratepayer costs of associated additional emissions from electrification-related load growth, but does not support verification methods for that load growth that are infeasible and costly, acting as a barrier to utility electrification programs.
- **Cost Containment Design Features:** SMUD continues to support a price ceiling that is near the current APCR price, in order to foster program continuity if the price ceiling is triggered. SMUD also continues to support price containment points that act early, act twice, and are well funded with enough allowances that the market is provided a significant plateau in which to consider GHG emission reduction measures. SMUD supports continued environmental integrity by using the additional revenue at the price ceiling to reduce GHG emissions on at least a one-to-one basis. Finally, SMUD continues to support additional cost-containment actions.
- **“Over-allocation”:** SMUD does not support further adjustments to the current program caps because there is time to make future adjustments if those are needed.

- **Allowance Allocation:** SMUD continues to support moving to 100% assistance factors in the 2018 – 2020 compliance period in order to smooth the market transition to the post-2020 program.
- **Offsets and Direct Environmental Benefits:** SMUD supports a broad definition of “Direct Environmental Benefits, that includes clearly designated categories of offsets that meet the criteria and the opportunity for a “case-by-case” treatment of projects that need some analysis to determine whether they meet the criteria.
- **Energy Imbalance Market:** SMUD supports continued use of CARB’s “bridge solution” in this rulemaking.

SMUD’s earlier comments on the March 2nd workshop remain relevant for many of these issues. SMUD expands on some of these positions in detailed comments below.

A. Use of Allowance Proceeds

First, SMUD believes that the consignment-choice provision of the current Cap and Trade regulations has been working well and should continue. The current discussion of uses of allowance proceeds for those allowances that are sold at auction is somewhat independent of the consignment-choice provision, applying only to the portion of allowances designated for auction. CARB should clarify that the consignment-choice question has been considered, and such choice should remain in the post-2020 Cap and Trade program.

Per our comments on the March 2 workshop, SMUD supports a degree of clarification in the regulations about the allowed uses of allowance value and allowance proceeds, but has significant concerns with the proposed language in the Discussion Draft or “February concept paper”. That concept paper omitted a variety of proceeds uses that are consistent with the purposes of AB 32 (and SB 32) and that would benefit ratepayers. SMUD’s recommends retaining the language in the current regulation (Section 95892(d)(3)), stating that allowance proceeds “... shall be used exclusively for the benefit of retail ratepayers of each electrical distribution utility, consistent with the goals of AB 32, and may not be used for the benefit of entities or persons other than such ratepayers,” with minimal additional clarification language, such as:

“Proceeds must be used for direct program compliance costs such as the procurement of allowances for compliance or programs aimed at reducing GHG emissions, included but not limited to:

1. Energy efficiency programs;
2. Renewable Energy programs;

3. Electrification activities, including promoting and incenting electric transportation and building electrification, and funding infrastructure investments related to these activities;
4. Marketing and public outreach programs focusing on climate change, renewable energy, etc, including funding institutions that provide an opportunity to educate constituents and ratepayers about these topics;
5. Efforts to incent or promote use of zero or low-GHG applications, such as refrigerants and SF6 alternatives that may lower GHG but do not necessarily save energy.
6. Research and Development projects in areas that act to reduce GHG emissions.
7. Above market costs of low-GHG procurement, such as from Asset Controlling Suppliers.
8. Explicit monetary return to ratepayers, if returned non-volumetrically.

SMUD understands that CARB desires that any explicit monetary return of proceeds to ratepayers be non-volumetric, but reiterates that CARB does not have the authority to determine how POU's set their rates -- ratemaking authority rests solely with POU Governing Boards. SMUD's inclusion of explicit monetary return as an example in the list clarifies that CARB is not discussing ratemaking authority here, but rather permissible use of allowance proceeds. SMUD contends that the significant market signals to reduce GHG emissions in the electricity sector are in the wholesale market -- by including a GHG cost adder in dispatch and procurement decisions -- and not the retail market, where customers see monthly bills comprised of electricity purchased at a variety of different rates each month (including fixed charges, tiered rates, time of day rates, etc.). SMUD notes that any funds returned explicitly to ratepayers, either volumetrically or non-volumetrically, are likely to imply an increase in GHG as consumers use the money provided through reduced electricity costs, either via volumetric or non-volumetric fashion, on a variety of consumer activities.

B. Electrification Related Load Growth

Board Resolution 17-21 directed the Executive Officer to "... evaluate appropriate quantification methodologies for additional electric distribution allocation that would provide ratepayer benefit for the Cap-and-Trade program cost burden to EDUs associated with transportation electrification load growth (in recognition of the requirements of SB 350)." At the workshop, CARB staff requested additional feedback on: "Methods to quantify transportation-related load growth emissions (quantifiable and verifiable to allocation standards)." (see last bullet on slide 15). When asked what was meant by "allocation standards", CARB staff indicated that meant to the same level of demonstration as for industrial sector allocations, which

are provided retroactively based on tracked and reported historical data (either product or energy).

SMUD strongly suggests that CARB staff look to the allocation protocols for the electric sector rather than the industrial sector for quantifying transportation-electrification (and building electrification) load and emission growth. Electric sector allocations are forward looking, based on historical projections of loads and resources out to 2030, providing allocations to address the “cost-burden” to ratepayers of the Cap-and-Trade program, in recognition of the significant costs that ratepayers already incur for complementary measures to reduce GHG. CARB should follow this path because metering quality data is likely to be unavailable, making the “allocation standards” metric CARB is suggesting infeasible for most transportation electrification and likely all building electrification loads. The path CARB proposed at the workshop will almost certainly not provide additional allowances to EDUs sufficient to cover the increased emissions from electrification.

When the electric sector allocation protocols were suggested at the workshop, CARB staff indicated that the base EDU allowances were for ratepayer protection, and that any additional allowances should be held to a higher standard of verification. This is inconsistent with Board Resolution 17-21, which explicitly suggests additional allowances to “... provide ratepayer benefit for the Cap-and-Trade program cost burden to EDUs associated with transportation electrification.” In fact, the additional emissions associated with electrification present exactly the same cost-burden to ratepayers as in the initial allocations – there is no difference in expected burden. While some electrification was included in the load forecasts underlying the initial allocations, those EDUs with higher rates of electrification than forecasted in 2016 (hopefully all EDUs, given the Governor’s subsequently announced EV goals) will certainly see increased load, generation and emissions, and consistent with the initial allocation methodology, this represents the very “cost-burden” that Board Resolution 17-21 directed be addressed by the transportation electrification quantification methodology.

While it is true that other changes in resources or loads can result in emissions and cost-burden that differs from that established in the initial 2016 load and resource forecasts, the Board has not directed staff to do anything with regard to these changes. It is only for transportation electrification that the Board directed staff to consider quantifying additional emissions and providing additional allowances. SMUD believes that the Board provided this singular direction because transportation electrification is likely to significantly contribute to the State policy goals of AB 32, SB 32, and AB 398. Not covering the additional cost-burden to EDUs does act as a barrier to additional EDU investment in transportation

electrification, which will tend to reduce the contribution of this critical component of the State's policies.

When it was pointed out at the workshop that the Low Carbon Fuel Standard (LCFS) program allows reasonable "estimation" of LCFS credits for electricity as a transportation fuel, CARB staff suggested that the Cap and Trade market was "different" because LCFS credits were "unlimited" – there is no cap on the credits market entities are allowed to create, while the Cap and Trade program operated under an overall cap, so that providing allowances to one entity inherently took them away from another or from the general Cap and Trade marketplace leading to increased prices for other participants. This logic applies poorly to industrial allocations, and is actually backwards when considering allocations for transportation electrification.

In the industrial sector, providing additional allowances to an entity to reflect increased production or energy use does not remove allowances from any other industrial allocation or from the EDU allocations – these are independent. While fewer allowances would be available for the general market, the price implications are not clearly pointing toward higher prices. Supply of allowances overall has not changed, it is only the allocation of that supply that has changed. The entity that has been provided additional allowances presumably has additional demand due their documented increased production or energy use, but that increased demand would be present in the market whether or not the allowances are allocated to the entity – they would have to procure the allowances if not provided administratively. By providing allowances administratively, CARB has really not clearly changed the demand and supply conditions in the market, so there is no clear impact on market prices.

The logic is not helped if the entity with increased production receives administrative allowances above their actual change in emission burden (for example -- if the increased production is the result of increased efficiency). In this case, the industrial entity receives additional allowances and has the ability to put those back into the secondary market if not needed internally, thereby again providing equivalency between market demand and supply prior to and after the additional allocation.

In contrast to industrial allocations, providing additional allocations to EDUs for transportation electrification is likely to reduce overall market demand for allowances and hence reduce market prices for all. In the industrial allocation case, increased production or energy use at one entity is for the most part independent of changes in emissions elsewhere in the Cap and Trade market. Increased or decreased production or energy use of one covered industrial entity is not directly associated with decreased or increased production or energy use in other covered industrial

entities. However, with electrification, and particularly transportation electrification, there is a clear link between increased emissions from the generation of electricity and reduced emissions from combustion of transportation fuels. Providing additional allowances to EDUs for transportation electrification reduces the supply of allowances available to the general Cap and Trade market, but electrification reduces the demand for allowances in that general market as transportation sector emissions decrease. By acting to cover the increased cost-burden from transportation electrification, CARB provides an incentive to increase EDU investment in this activity, without increasing the overall demand for allowances and Cap and Trade market prices.

SMUD still hopes to work with CARB staff to avoid a regulatory scheme that would require expensive and infeasible metering or similar documentation of electrification load growth in order to receive additional allowances for increased electrification. SMUD is concerned that the path CARB describes of quantifying the need for additional EDU allowances using industrial sector “allocation standards” would cause the State to lose or have delayed desired transportation sector GHG reductions, making achieving the 40% reduction goal in SB 32 and AB 398 more difficult and expensive.

C. Cost Containment Design Features

SMUD reiterates our previous comments on cost-containment pursuant to the earlier March 2 workshop. To summarize, SMUD believes that:

- **Level of Price Ceiling:** ARB should establish a price ceiling that is not so high that it significantly increases the potential for economic and emission leakage, or that it creates a risk of political reconsideration of the Cap and Trade program. The current APCR is a good proxy for those criteria, leading to a recommended price ceiling in the range of \$70/ton in 2021. SMUD opposes any price ceiling structure higher than the above path.
- **Price Containment Point Price Levels:** SMUD recommends price containment point levels that are spread out from each other and from the floor and ceiling prices, such as at 1/3 and 2/3 of the way between the established floor price and the new ceiling price.
- **Price Containment Point Supply Amounts:** SMUD does not think that the level of initial supply established by AB 398, approximately 40 million allowances each, is sufficient to have the intended market impact of slowing a rapid price run-up long enough for market actors to make investment decisions and have appropriate abatement actions implemented. SMUD

suggests that ARB transfer the vintage borrowing concept to the price containment points, establishing that at each of these points supply can continue to be injected by borrowing up to 5% of future vintages or allowance budgets. Doing so will imply sufficient supply available to promote the price stabilization envisioned by the containment point concept. At the same time, if the price containment points are not triggered, the allowances remain available in the original vintage years.

- **Use of Revenue from Printed Compliance Instruments.** If prices in the market do rise to the price ceiling, SMUD strongly supports the environmental integrity provisions included in AB 398, which require ARB to use the revenues from selling “additional” allowances in the market to achieve at least one-to-one reductions in GHG emissions. SMUD supports:
 - Going beyond one-to-one reductions where feasible to insure integrity;
 - Inclusion of ready to implement offset projects such as REDD projects;
 - Procuring and retiring compliance instruments from other jurisdictions where appropriate and feasible; and
 - Early consideration of policies to develop and establish options and projects, so that emission reductions can be readily and quickly accessed if the price ceiling is reached.
- **Additional Cost Containment Actions:** SMUD reiterates recommendations that CARB should continue to develop and consider policies that decrease the demand for allowances, such as electrification, and policies that provide supply flexibility when needed in order to foster stable market prices at levels below the price ceiling. The best market structure is one where the price ceiling influences the market but is never reached. SMUD suggests that it is appropriate for CARB to consider structural changes including:
 - Additional electrification measures to reduce demand for allowances;
 - Policies that ensure that the amount of offsets allowed under the lowered and constrained offset limit can be fully utilized in the market, such as offset banks, offset limit trading or spreading, etc.; and
 - A limited amount of banking to smooth the transition between compliance periods.

In addition, on Slide 21 from the Staff presentation at the April 26th workshop, CARB Staff indicates that too many allowances at low prices could mute that carbon price signal and may undermine the incentives for necessary GHG reductions, risking existing and future linkages. Staff also suggested that with prices that are too low, the Cap and Trade program functions like a lower cost carbon tax.

SMUD understands Staff and stakeholder concerns about market prices being too low, but believes these concerns are hypothetical and not borne out by evidence in Cap and Trade markets. SMUD believes that the strong price floor and floor price escalation in California's Cap and Trade marketplace is sufficient to drive initial Cap and Trade investments. California prices have hovered around or just above the floor prices to date, but are significantly above the prices found in the Regional Greenhouse Gas Initiative (RGGI) carbon market in the Northeast. In both programs, market prices and strong complementary state policies have driven emissions, particularly in the electricity sector, well below expected levels. As supply decreases under California's cap, SMUD understands that analyses indicate that higher prices are on the horizon.

SMUD does not understand why low prices (at the floor?) imply a program that functions like a lower-cost carbon tax. The Cap and Trade program is functioning well at prices just at or above the floor prices to date. Trading of compliance instruments still occurs, and there are still investments that are cost-effective or otherwise induced that imply emission reductions and allowances available to trade. It is unclear that there is a problem with such a Cap and Trade market.

D. Banking and Oversupply

SMUD supports CARB Staff's position of avoiding taking actions, such as taking away or devaluing entity-banked emissions, which would act to penalize covered entities and incentivize only minimum levels of emission reductions. SMUD also supports avoiding actions that would introduce future allowance scarcity in the market, raising current prices for compliance and customers (and increasing "windfall" concerns). SMUD reiterates our suggestion from our March 2 workshop comments that no action is currently necessary to address perceived oversupply concerns beyond actions and policies that ARB has already taken – such as establishing holding limits, moving unsold allowances to the APCR after some time, and placing 52 million allowances into the APCR structure.

SMUD believes that CARB Staff has provided a reasonable analysis as part of the April 26 workshop that shows the current "bank" of allowances likely being needed and used prior to 2030, hence presenting no danger to the specific GHG target in that year. SMUD agrees that significant sources of uncertainty remain that imply that further action to address oversupply may be counterproductive. To the list of uncertainties identified by Staff, SMUD would add the potential for reduced hydroelectric generation and increased electricity demand in future years, due in part to the impacts of Climate Change itself on California weather.

SMUD reiterates points from our March 2nd comments that suggested reasons why CARB should not be overly concerned today about a "bank" of allowances threatening the achievement of the 2030 target of GHG emissions 40% below 1990 levels, such as:

- Increases or decreases in emissions over time are based on the price of allowances versus the cost of abatement and on complementary program actions, not the existence or size of a “bank”.
- The expectation that the Cap and Trade program will extend beyond 2030, meaning that held allowances have long term value, rather than having a 2030 “use it or lose it” aspect.

In addition, as noted by Staff, the impacts of GHG emissions are related to the cumulative amount of CO₂e in the atmosphere, rather than the specific amount released in 2030. Lower emissions in the years leading up to 2030 are better because cumulative emissions have been reduced more, even if these lower emissions prior to 2030 result in an available “bank” in that year. Flexible banking rules encourage such early reductions.

E. Industry Assistance Factors

SMUD supports CARB Staff’s conservative position on industry assistance factors for the 2018-2020 compliance period. SMUD agrees that keeping assistance factors at 100% for these years, as they were in 2017 and will be again per AB 398 in 2021, avoids potential market disruption. Moving down to the 75% and 50% assistance factors put in place for this period prior to passage of AB 398 makes little sense, and brings the unnecessary risk of emissions and economic leakage. SMUD supports our industrial customers, and prefers that they stay in the Sacramento area.

F. Offsets and Direct Environmental Benefits

Offsets remain a critical cost-containment option for the Cap and Trade program, and provide an important link to sectors not covered by the program, both in and outside of California, inducing GHG reductions and attention to the issue of global climate change in those sectors and other jurisdictions. SMUD supports a broad definition of “Direct Environmental Benefits” so that a sufficient quantity and variety of offsets are available to fill the direct environmental benefit “buckets” established by AB 398. CARB should develop a broad set of clearly designated categories of offset projects that meet the DEB criteria and then establish a policy of “case-by-case” treatment of projects are not within the designated categories to determine whether they also can be included. SMUD also believes that it would be unfair to apply the DEB criteria to offsets issued from existing projects, which were developed in good faith under the previous offset rules.

G. Energy Imbalance Market

SMUD supports continued use of CARB’s current “bridge solution” for purposes of this Cap and Trade rulemaking. A California Independent State Operator (CAISO) process for dealing with secondary GHG emissions in the EIM marketplace is not final, and CARB can wait to consider changes to the Cap and Trade rules until that

decision is made, using the current solution of retiring allowances commensurate with the estimated or identified emissions.

SMUD understands that CARB Staff feels that the policy of retiring allowances generally does not provide EIM participants the incentives to address the secondary EIM emissions. SMUD opposes, however, the "EIM Purchaser" option under potential reconsideration. This option does not solve the "incentive" issue that concerns ARB Staff. Rather, the option imposes additional costs on EIM participants simply for being part of the market, not in any manner proportionate to conscious procurement of GHG emitting resources. It is unclear how EIM participants can change their market practices to reduce their imposed obligation. The option creates potential Cap and Trade obligations for entities that currently have none, and that are not consciously procuring power that has a GHG emissions signature. This option is likely to simply reduce participation in the EIM market, contrary to the State's goals.

/s/

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