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Re: Sacramento Municipal Utility District's Comments on Compliance and Information Requirements and Cost Containment Options in California's Cap-and-Trade Program

SMUD appreciates the opportunity to comment on the topics discussed at the June 25th workshops regarding compliance and information requirements and cost containment options in California's Cap-and-Trade program. SMUD has no comments at this time regarding the proposed addition of "true-up" accounts or the order of compliance instrument retirement as presented at the June 25th workshop. SMUD's main comments here relate to the two remaining parts of the morning half of the June 25th workshop: 1) the proposal to alter reporting, verification, and other dates to allow access to a price reserve auction prior to the surrender due date; and 2) the proposal for public information sharing and reporting requirements. In addition, SMUD has comments on the afternoon part of the workshop regarding cost containment options in the Cap and Trade program.

I. ARB Should Carefully Consider Any Proposed Changes to Reporting, Verification, and Compliance Timelines.

SMUD understands the reason that ARB staff is considering altering the verification, reporting, and compliance timelines, at least at the end of a compliance period, in order to allow covered entities an opportunity to participate in an Allowance Price Containment Reserve (APCR) auction after their final compliance obligation is

determined. SMUD acknowledges that ARB is contemplating moving reporting and verification deadlines approximately two weeks earlier, while moving the third APCR auction approximately two weeks later, so that an entity's final compliance obligation is known prior to the closing of the application window for participation in the third APCR auction for the year.

However, SMUD currently does not favor moving the reporting and verification dates forward by two weeks for reasons explained in greater detail in SMUD's comments on the proposed changes to the Mandatory Reporting Regulations (these appear to be coordinated changes). Basically, the proposed earlier reporting dates would conflict with Federal GHG reporting tasks, which would strain entity resources, and since information from the Federal GHG reporting must be complete in order to fill out the ARB GHG reporting, would cause an unintended change in how entities perform their Federal reporting requirements. In addition, SMUD's experience with verification of our GHG reports indicates that losing two weeks of verification time is problematic.

SMUD encourages the ARB to consider other changes, to compliance timelines or other regulation aspects, to accomplish the intended goal, rather than moving the reporting and verification dates forward. For example, perhaps the third APCR reserve sale could be moved a little later than contemplated, and the two and one-half weeks between the closing of the application window and the sale could be shortened somewhat. Or, perhaps the final APCR auction of the year in December could be moved forward approximately two weeks, and the surrender date moved later by approximately two weeks, allowing access to this fourth APCR prior to the surrender date (with the added advantage of additional time to procure appropriate compliance instruments in the secondary market).

II. The Cap-And-Trade Regulations Do Not Require Release of Entity-Specific Compliance Account Balances, and ARB Should Only Release Aggregate Compliance Account Data.

With regard to information disclosure, SMUD points to our comments for the initial information disclosure workshop on January 25, 2013. As explained in those comments, SMUD understands the need for a balance between transparency and protection of market sensitive information in the Cap-and-Trade program, to make the market work more efficiently and prevent undue influence from entities that have information not available generally, while protecting from release information about entity positions that can affect trades and prices adversely for those entities, thus harming the market in general. SMUD's basic position is that transparency in markets generally involves the availability of basic, aggregated, trade and price data, while entity-specific information, such as account balances, is kept confidential to allow for robust and fair participation in the market. SMUD believes that ARB wants the Cap-

and-Trade market to function as efficiently and robustly as possible, which is only possible if market participants can make trades and transactions secure in the knowledge that their trading strategies and prospects have not been adversely influenced by information that reveals their market positions to potential trading counterparties.

Given that, the presentation provided by ARB staff at the June 25th workshop proposed that entity-specific compliance account balances be released four times a year -- on the last business day of each quarter. ARB staff also indicated that "alternatives to releasing individual account" information is being considered, as well as adjustments to the frequency of the information release. ARB staff asked when the release of individual account balances would reveal if an entity is "going long" or short, and more importantly whether such release exposes covered entities to manipulation, or in contrast, would prevent action by someone intending to manipulate the market. Implicit in the discussion was 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 assert that the Cap-and-Trade regulations do not require release of entity-specific compliance account data in the first place, as explained below. SMUD also continues to believe that aggregate release of compliance account data would be useful market information – as it informs stakeholders about how many allowances have been, in effect, "removed from circulation" – and hence no longer available for trading. However, SMUD asserts that any release of individual account balance information is not needed for this market purpose, would tend to expose covered entities to some manipulation, and would be unlikely to prevent what would appear to be a rare event – an attempt by some compliance entity to manipulate the market by the bizarre strategy of placing compliance instruments they hold in an account where their use is significantly constrained.

As SMUD explained in our comments on the January 25th workshop, Section 95921(e) is the part of the Cap-and-Trade regulations that discuss the release of compliance account information. The title of this section is, "Protection of Confidential Information," and the section generally requires the Executive Officer to "…protect confidential information to the extent permitted by law…." Subparagraph (4) suggests that the accounts administrator will release "…information about the quantity and serial numbers of compliance instruments contained in compliance accounts in a timely manner." Note that this subparagraph does not state or indicate clearly that individual account information shall be released. Release of entity-specific information is not explicitly discussed anywhere in this section of the regulations, and so SMUD continues to assert that the regulations allow aggregation prior to release.

The FSOR for the Cap-and-Trade (*2011 FSOR, page 1658*) asserts that the number of allowances in compliance accounts is important information to the market because it informs about the remainder of allowances – those not in compliance accounts – that remain available for trading. For this market purpose, aggregated compliance account information is clearly useful, while disaggregate compliance account data may be distracting to the market, but is potentially harmful to individual entities.

Second, the FSOR asserts that information on an entity's compliance with the requirements of an environmental regulation benefits the public interest. As a matter of general course, SMUD disagrees that release of this entity-specific information is in the public interest. The Cap-and-Trade program has been structured by ARB with multi-year compliance periods, the ability to bank compliance instruments for the next compliance period, and partial annual surrender of compliance instruments. Compliance itself is not determined by compliance account holdings on a quarterly basis, but by sufficient compliance instruments *surrendered by the end* of a compliance period (in addition to the annual partial surrender requirements). SMUD believes that making individual compliance account balances public prior to surrender will undermine the flexibility designed into the Cap-and-Trade with banking and multi-year compliance periods.

For example, it is a viable and flexible market strategy, allowed by the Cap-and-Trade regulations, to hold most of a covered entity's compliance instruments in a holding account, rather than one's compliance account, and to place only those instruments needed for annual surrender, or compliance period surrender, into those accounts *only when it is necessary to do so*. The regulatory requirement for transferring allowances into compliance accounts is related directly to the November 1st (of the following year) surrender date – the transaction must be made by this date in sufficient quantity to meet surrender requirements. Hence, for the 2013 annual surrender, a covered entity could hold zero allowances in their compliance account throughout 2013 and for the first three quarters of 2014. Such a strategy, in addition to preserving flexibility for the specific covered entity, has a general market benefit of preserving liquidity in the Cap-and-Trade market by keeping compliance instruments "tradable" for the longest time. However, this viable strategy is likely to be constrained somewhat if there is release of entity-specific compliance account balances on a quarterly basis. Release of what amounts to partial compliance information exposes a covered entity to unfounded accusations of "non-compliance." Not only will this likely increase entity costs – to respond to such misdirected questions about compliance – it also favors a practice of placing allowances in compliance accounts in greater numbers and earlier than really necessary under the Cap-and-Trade regulations. Therefore, it would have the unfortunate effect of reducing allowances available for trading, potentially driving up allowance prices.

On the other hand, there is also a viable strategy to place more allowances into one's compliance account than needed for annual or compliance period surrender, intending

to bank those instruments for future compliance. There is nothing inherently nefarious about this, despite ARB staff's concern that such "going long" strategies could be thought of as an attempt to "manipulate the market." In the first place, the most likely reason for placing significant allowances in compliance accounts is simply a conservative approach to compliance, intending to ensure that compliance instruments are held for compliance well prior to when needed, including banking for future compliance periods. However, releasing entity-specific compliance account balance information opens up covered entities following this viable strategy up to questions about their intent to "manipulate the market."

SMUD believes that ARB staff's concern about the "going long" manipulation is overwrought. This is essentially a concern about market manipulation through excessive compliance, which is not a common strategy. Only compliance entities have compliance accounts, removing the potential that speculators and traders that are not also compliance entities could use such a strategy. In order to achieve the questionable market manipulation, the covered entity must contemplate procuring instruments in the market well beyond any administratively provided allowances they have received, and then *restricting their own use of the value* of these allowances by placing them in their compliance accounts. This does not seem like a sensible strategy in most cases, and it decreases in likelihood of success with size – most covered entities are simply not large enough that any conceivable "going long" in compliance accounts could have the market manipulative effect of concern. In other words, it is possible to conceptually posit such a strategy, but, in reality, it requires a large covered entity that procures a significant amount of compliance instruments in the market and then places a significant amount of this procured value in an account where they are constrained from taking advantage of this value except for actual compliance. In addition to the unlikely economic benefit of such a strategy, these entities are constrained by purchase and holding limits, and by the fact that those that are utilities would not be allowed to follow such a strategy.

In summary, ARB's proposal to have quarterly release of entity-specific compliance account balances: 1) may negatively impact the market, tending to reduce liquidity by inducing covered entities to favor placing compliance instruments in their compliance accounts earlier than necessary; and 2) is not well-targeted toward preventing the small potential for market manipulation. In SMUD's view, the negative impact strongly outweighs the small possibility of a positive effect of avoiding potential market manipulation.

III. ARB Should Adopt Measures to Achieve Further Cost Containment in the Cap-and-Trade Program.

SMUD has long supported the Cap-and-Trade program and appreciates the cost-containment provisions already included in the program, including multiple-year compliance periods, allowing a significant but limited amount of offsets in the program, and the APCR. SMUD is committed to compliance with the Cap-and-Trade program and our own internal long range GHG goals, and desires to achieve that compliance at the lowest possible cost to our customer-owners.

SMUD welcomed the Air 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 third 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. And, the third part of the resolution implies that ARB should act during the 2013 Cap-and-Trade update rulemaking to enact further cost containment measures.

SMUD supports the cost containment proposal of the Joint Utilities provided to ARB in late June, and provided here as an Appendix. That proposal laid out three separate categories of measures that the ARB should consider adopting (ARB could adopt all of the example measures), as follows:

1) Measures that act gradually to reduce the likelihood of prices rising above the APCR in the future, altering the long-run supply/demand balance for allowances by:

    a) Reducing demand for compliance instruments;
    b) Increasing the supply of compliance instruments while ensuring commensurate emission reductions; and
    c) Ensuring that compliance instruments are accessible in the marketplace.

    For example, a measure that fostered greater electrification would reduce demand for allowances because the reduction in emissions on the fuel side would be greater than the increase in emissions on the electricity side. A measure that exempted California-sited offset projects from the 8% offset limit would increase the supply of compliance instruments while ensuring commensurate emission reductions from the offset project site. Also, approving

additional offset protocols would help ensure that the 8% limit on offset use could be fully accessed by the marketplace.

2) Measures that, when triggered, would quickly alter compliance instrument demand/supply dynamics and constrain upward pressure on market prices for a period of time. For example, the ARB could adopt a provision that when 40% of the allowances in the APCR have been purchased, entities are allowed to borrow allowances from the next vintage year. An extra year's worth of eligible compliance instruments 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.

3) 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. The trigger for this category of measures is clearly tied to near depletion of the APCR, and the presumptive example is to keep selling allowances to the market, upon depletion of the current allocation, at the APCR third tier price, while using the proceeds to achieve commensurate emission reductions elsewhere. This is the "capstone" or backstop measure that ensures the Air Board's resolution goal – to keep allowance prices from rising above the third tier APCR price, while preserving environmental integrity. The exact mechanism for this to occur must be determined by ARB.

SMUD believes that commensurate emission reductions to cover the extra allowances sold in the "capstone" measure set may be difficult to come by in a timely fashion. Hence, SMUD believes that the best course of action is to do everything possible to avoid having to exercise this option, by enacting regulatory changes from the first two categories above. However, SMUD believes that this third category of measure is essential to ensure that the Air Board's resolution is fully achieved. Adoption of a measure ensuring that prices will go no higher than the APCR third tier price acts to reduce speculation and hoarding if prices rise to near that level, as parties can be assured that they can get allowances at that APCR price and will not have to buy now to avoid spending more later.

Comments on ARB Cost Containment White Paper

ARB Staff posted a cost containment "policy options" paper for the June 25th workshop. That paper described: 1) existing Cap-and-Trade cost containment features; 2) circumstances that could lead to higher than expected allowance prices; and 3) the 12-51 Air Board Resolution on cost containment. The paper went on to discuss four potential policy approaches to contain Cap-and-Trade costs, in addition to the "do

nothing" option, and four possible measures that would help to ensure the environmental integrity of the program as cost containment is enacted.

SMUD believes that the ARB white paper provides a valuable contribution to the cost containment discussion. Of the five cost containment policy options, SMUD believes that only the first two: 1) increasing the availability of allowances for sale at the highest price tier of the reserve; and 2) providing for a fixed price per ton "compliance" payment at the highest price tier of the reserve; achieve the goal of Resolution 12-51 to provide certain cost containment, when combined with measures to provide commensurate emission reductions. These options, and particularly the first option, are similar, if not identical, to the third element in the Joint Utilities' proposal for ensuring cost containment.

The third option in the white paper – delaying compliance obligations – suffers from a lack of certainty regarding cost containment – it may be insufficient to achieve the goal of prices no higher than the third tier of the reserve. However, it is similar to measures recommended in the second element of the Joint Utilities' proposal for cost containment. The ARB white paper acknowledges that this measure would be "triggered" by some event, such as depletion of the first two tiers of the APCR. The white paper also acknowledges that the proposal essentially amounts to limited "borrowing" from future vintage allowances. SMUD prefers that this borrowing be acknowledged explicitly, and allowed to ensure timely compliance, rather than describing the process as "compliance delay."

SMUD cannot support the fourth option – cancelling compliance obligations. While ostensibly this option would prevent prices from escalating beyond the third tier of the APCR level, SMUD sees no way in which the environmental integrity of the Cap-and-Trade structure can be easily assured under this option. In essence, cancelling compliance obligations implies that the environmental goals of the cap are also cancelled.

SMUD also cannot support the fifth option – making no program changes at this time. While SMUD agrees that the likelihood of allowance prices reaching the level of the third APCR tier is small under most reasonable scenarios, that small probability should not lead to the conclusion that nothing need be done. Though the probability of occurrence may be small, the consequences of occurrence are large, hence it is a potential event worth action to avoid.

SMUD believes that a complete 2013 package to address further cost containment should draw from all of the three program elements mentioned in the Joint Utilities' white paper. It is necessary but not sufficient, in SMUD's view, to establish measures that are triggered when prices get high or the APCR is substantially depleted. In addition to these necessary actions, the ARB should consider measures from the first

element of the Joint Utilities' white paper – measures to avoid prices in the Cap-and-Trade market rising to these trigger levels.

SMUD again appreciates the opportunity to comment on the proposed protocols for public information sharing from the Cap-and-Trade Program.

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Enclosure
cc: Corporate Files

Appendix

Joint Utilities Cap and Trade Cost Containment Proposals

The following recommendations constitute essential components of a robust cost containment structure that should be adopted as a single package. The recommendations fall into three categories, described below. It is important to implement multiple (if not all) measures from each category in the 2013 amendments to the Cap and Trade Regulation. Doing so will provide needed certainty to the regulated community and the market that there are mechanisms in place to ensure prices do not exceed the third tier of the allowance price containment reserve (APCR).

A) Measures which take effect now and gradually over time 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.

A) Potential measures that could be implemented now to reduce the likelihood of prices rising above the APCR in the future:

1. Approve more offset protocols to increase the supply of offsets.
2. Exempt offsets from projects within California from the 8% offset limit.
3. Allow each covered entity to carry over any unused portion of its 8% offset limit, to use for future compliance.
4. Address constraints imposed by the current holding limit.
5. Hold an additional auction after the end of each compliance period:
   - Redistribute allowances between auctions to allow for one additional auction per compliance period, and/or acquire allowances for auction per B2 below.
   - This auction should be held between September 1 of the year following the end of a compliance period, when verification statements for prior-year emissions are due (section 95103(f) of the MRR), and November 1, when compliance entities are required to demonstrate compliance (section 95856(f)(1) of the Cap and Trade Regulation).
6. Provide allowances to electrical distribution utilities to cover emissions from electrification of transportation and distributed fuel uses in California.
   - Each allowance provided to EDUs for electrification represents significantly greater reduction in transportation and distributed fuel sector demand for compliance instruments, lowering demand in comparison to supply.
   - This proposal would be limited to electrification that is incremental from the date this measure is adopted and can be reliably measured.

B) Potential measures that would take effect when a specified trigger is reached (e.g. the APCR is 40% depleted) to quickly alter compliance instrument demand/supply dynamics and constrain upward pressure on market prices for a period of time:

1. Unused offset proposal:
   - ARB would track the number of offsets used for compliance (cumulatively) compared to the number of offsets that would have been used if every covered entity exhausted its 8% limit.
   - The difference between the two numbers would be the "8% offset shortfall."
   - When the trigger is reached, ARB will announce an increase in the maximum level of each entity's offset usage for the current compliance period. The increase will be calculated to ensure that, if all covered entities surrender offsets up to the new higher level, the 8% offset shortfall will be used up but not exceeded.
   - If the 8% offset shortfall is not used up in that compliance period, a new offset level will be calculated for the next compliance period.
2. Compliance account proposal:
   - When the trigger is reached, allow covered entities the flexibility to transfer surplus allowances from their compliance account to their limited use holding account.
   - This allows entities that have built up a bank of allowances in excess of their compliance needs to re-inject those allowances into the market.
3. Limited borrowing proposal:
   - When the trigger is reached, allow covered entities to surrender for compliance allowances with vintages of the current year and the following year (not applicable post-2020).
4. Offset geographic scope proposal:
   - When the trigger is reached, increase the number of compliance-grade offsets by expanding the geographic scope of the approved offset protocols to North America.
5. Offset project start date proposal:
   - When the trigger is reached, increase the number of compliance-grade offsets by changing the Offset Project Commencement date in sections 95973(a)(2)(B) and (c) of the Cap and Trade Regulation to an earlier date.

C) Potential measure that would be triggered only if and when the third tier of the APCR is depleted, to keep prices at the third tier level, while preserving environmental integrity:

Allowance-offset proposal: Upon depletion of the highest tier of the APCR, the Executive Officer will make available (through the APCR sale mechanism) additional allowances, in excess of the cap, necessary to satisfy the demand of compliance or opt-in compliance entities at the price set for the highest tier of the APCR in the relevant year. The Executive Officer will use the funds raised by the sale of additional allowances to reduce GHG emissions, with the intent that emissions reductions will be equal to or larger than the number of additional allowances sold. The options available to the Executive Officer for reducing GHG emissions include, but are not limited to, one or more of the following:

- Commission a third party to obtain and retire high-quality offsets not otherwise eligible to satisfy the compliance obligations of compliance entities.
- Commission a third party to purchase and retire allowances from emissions trading programs outside of California and linked jurisdictions.
- Commission a third party to invest funds in emission reduction projects outside the capped sectors.
- Mandate emission reductions in sectors not covered by the Cap and Trade Regulation.