



July 5, 2018
LEG 2018-0362

Ms. Rajinder Sahota
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: 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 June 21, 2018 workshop. SMUD appreciates the changes in the June 2018 Preliminary Discussion Draft (June Draft) that increased flexibility in use of allowance value, but proposes additional changes below. SMUD also appreciates and supports ARB staff's analysis regarding the issue of "oversupply", indicating that there is no need to address this question at present with removal of allowances from the market. In these comments SMUD summarizes our positions on many issues that were not included as changed text in the June Draft, but were raised in the June workshop with ARB request for further comment. Specifically, SMUD has the following comments:

- **Use of Allowance Value:** SMUD supports added flexibility in POU use of allowance value, including the ability to procure allowances for compliance with auction proceeds, as well as to fund a broad range of GHG programs where emissions reductions may not be readily quantifiable, and proposes additional changes in this area.
- **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 politically feasible, allowing for program continuity if the price ceiling is triggered. SMUD also continues to support price containment points that act in time to make a difference, act twice, and are well funded with enough allowances that the market is provided significant plateaus in which to consider GHG emission reduction investments and actions.
- **Banking and Oversupply:** SMUD appreciates the continued ARB staff position that there is no need to make further adjustments to the current

program caps at this time. As SMUD has commented previously, there is time to make adjustments after more market experience and direction.

- **Energy Imbalance Market:** SMUD opposes the EIM Purchaser proposal with respect to EIM secondary emissions, and rather supports continued use of ARB's "bridge solution" in this rulemaking.

A. Use of Allowance Proceeds

SMUD appreciates the support that ARB staff indicated at the June 21 workshop for continuation of the publicly owned utility (POU) consignment choice provision in the current regulations, due to information provided by POUs that a carbon price was included in dispatch decisions in electricity markets. SMUD believes that the consignment-choice provision of the current Cap and Trade regulations has been working well and should continue. SMUD supports the concept that a wholesale market price signal – by including a GHG cost adder in dispatch and procurement decisions – is the more important carbon price signal to send in electricity markets. In 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.), such price signals are easily lost in the clutter.

SMUD also appreciates the inclusion of additional flexibility for allowance proceeds use, and in particular the addition of Section 95892(d)(3)(C), allowing use for "Other GHG Emission Reduction Activities" (and the specific example of programs to reduce emissions of sulfur hexafluoride). This is the kind of "catch all" language or "including but not limited to" language that SMUD has advocated in our previous comments. However, SMUD still has significant reservations about the proposed proceeds use language, and provides discussion and proposed language in the sections below.

Demonstrating Quantifiable GHG reductions: The new Section 95892(d)(3)(C) covering GHG reduction activities other than efficiency program and renewable funding includes the language: "... for which the electrical distribution utility can demonstrate quantifiable GHG emission reductions per section 95892(d)(4)." Section 95892(d)(4) in turn refers to demonstrating quantifiable GHG emissions reductions "... as described in section 95892(e)(4)(B)." Section 95892(e) contains the requirements for reporting on use of allowance value and allowance proceeds, and part (4)(B) requires that the report includes: "Estimating the GHG emission reductions from each use of allocated allowance proceeds ..." (emphasis added). The term "estimating" here replaces the term "quantifying" from the earlier Preliminary Discussion Draft. SMUD supports this move to reasonable estimation of GHG reductions for these programs, but believes that the use of the term "demonstrate quantifiable" in the previous two sections cited has caused some confusion.

SMUD suggests that the "demonstrating quantifiable" GHG emissions language in Sections 95892(d)(3)(C) and 95892(d)(4) be changed to be consistent with Section

95892(e)(4)(B), and refer to “estimated” or “projected” GHG emission reductions. Continuing to use the term “demonstrating quantifiable” GHG emission reductions is not only confusing, given the later “estimating” language, but it is likely to be a significant barrier to EDU program spending on energy efficiency, public education and outreach, renewables and other programs intended to reduce GHG emissions for which the EDU and its customers are responsible.

There is also a clear timing problem – an EDU must commit funding to a program up front, but demonstration of “quantifiable” GHG emission reductions implies an ex-post analysis of the impact of a program that has already been implemented.

To resolve these two issues SMUD suggests language that reads:

95892(d)(3)(C): Other GHG Emission Reduction Activities: Programs or activities other than renewable energy, integration of renewable energy, energy efficiency, or fuel-switching, for which the electrical distribution utility can demonstrate *a reasonable estimate of* quantifiable GHG emission reductions per section 95892(d)(4), *if appropriate*. This includes funding:

95892(d)(4)(~~E~~): Electrical distribution utilities must demonstrate *a reasonable estimate of* quantifiable GHG emissions reductions for each use of allocated allowance auction proceeds authorized undertaken under sections 95892(d)(3)(A)-(C) and (B), *if appropriate*, ~~must demonstrate quantifiable GHG emissions reductions, as described in section 95892(e)(4)(B).~~

Grandfathering: As we mentioned in the June workshop, SMUD has committed to using some AB 32 proceeds funds for a specific energy educational activity in Sacramento – development of the *Powerhouse Science Center*. SMUD expects that programs at the Center will lead to increased public awareness of the need to reduce greenhouse gases and subsequent public citizen actions to address climate change, ranging from engaging in additional energy efficiency and voluntary renewable actions to support for regulatory and political actions taken to address climate change. Hence, should the ARB make the change suggested above, allowing funding for programs amenable to estimating quantifiable emission reductions, this prior commitment of funding will be acceptable.

However, should the above change not be made, or should any criteria for a reasonable estimate of GHG emission reductions not cover a current funding commitment such as the *Powerhouse Science Center*, SMUD suggests that language be included that clearly “grandfather” funding commitments that were made under the current rules. It would be unfair if a change in rules prevents execution of a funding commitment made in good faith under current rules. SMUD suggests the addition of language such as:

95892(d)(3): ~~Auction proceeds and~~ Allowance value, including any allocated allowance auction proceeds, obtained by an electrical distribution utility shall be used exclusively for the primary benefit of retail electricity ratepayers of each electrical distribution utility, consistent with the goals of AB 32, and may not be used for the primary benefit of entities or persons other than such ratepayers. Allocated allowance auction proceeds ~~may~~ must be used to reduce greenhouse gas emissions or returned to ratepayers, using one or more of the following approaches: *Electrical Distribution Utility funding commitments made publicly prior to June, 2018 shall be evaluated under the rules in place at the time the commitment was made.* ~~Any allocated allowance auction proceeds returned to ratepayers must be returned in a non-volumetric manner.~~

Use for procuring allowances for Compliance: At the June 21st workshop, ARB staff requested a specific proposal for "...Role and oversight of using proceeds to purchase allowances." (Slide 7) SMUD strongly supports the continued ability to use allowance proceeds to purchase allowances. Use of allowance proceeds to procure allowances for compliance is fully consistent with goals of AB 32. The proceeds come from the sale of allowances that could be used for compliance (through POU consignment) so it's logical that the proceeds be available to also establish compliance through the procurement of allowances. Such use benefits ratepayers, as it allows the option of exchanging the allocated allowances for allowances that can be placed in entity holding accounts, and traded if beneficial to the ratepayers, or used for compliance if beneficial to ratepayers. Such flexibility also creates additional liquidity for the secondary allowance market. There is no legislative directive in AB 398 nor in AB 32 that suggests a policy by the Legislature to prohibit this use.

SMUD believes that this proposed prohibition could have significant negative consequences, including unnecessary rate increases, hoarding of allowances and allowance price volatility. Rate increases could result because the proposal could force POU's to seek other funding for needed allowance procurement. The proposal also could reduce liquidity in the cap and trade market, causing POU's to designate additional allowances directly for compliance rather than having them available for trading. A plausible scenario could then be that entities who need additional allowances will be unable to find them, causing unnecessary volatility, price spikes, and uncertainty in the market. Such results would run counter to the goal of a cap and trade regulation that is designed to cost effectively achieve carbon reductions by allowing trading under the cap – restricting trade will restrict cost-effectiveness of the market.

It is unclear to SMUD exactly why ARB is concerned about this use of allowance proceeds, which makes it difficult to comment on the proper role and oversight of the use. If the concern is that allowance proceeds may be used to purchase allowances that could then be used for compliance related to wholesale sales – a use prohibited for

the original allowance prior to consignment, SMUD agrees that some additional clarification here may be useful, as follows:

- 95892(d) ~~(5)~~(6) Prohibited Use of Allocated Allowance Value. Use of the value of any allowance allocated to an electrical distribution utility other than for the primary benefit of retail electricity ratepayers consistent with the goals of AB 32 is prohibited, including:
- (A) Use of such allowances *or allowance value* to meet compliance obligations for electricity sold into the California Independent System Operator markets *or other wholesale markets in which a carbon price is included in the sale.*
 - (B) Use of such allowances or allowance value to meet compliance obligations related to sale of useful thermal energy.
 - (C) Use of allocated allowance auction proceeds to pay for the administrative costs of complying with MRR, ~~or the AB 32 Cost of Implementation Fee Regulation (California Code of Regulations, sections 95200-95207), or the Cap-and-Trade Regulation~~ is prohibited, except for the costs allowable pursuant to section 95892(d)(3)(DE).
 - (D) Use of allocated allowance auction proceeds to pay for costs of lobbying, advocacy, employee bonuses, or shareholder dividends is prohibited.
 - (E) Returning allocated allowance auction proceeds directly to ratepayers in a volumetric manner is prohibited.

In addition, the proposed language in 95892(d)(3), which changes the word “may” to “must” in the phrase reading “... allowance auction proceeds ~~may~~ must be used to reduce greenhouse gas emissions or returned to ratepayers ...”, acts to implicitly prevent use of allowance proceeds to procure allowances for compliance. SMUD suggests that ARB change this language as follows (note that the language below repeats a proposed change discussed above, since it is in the same section):

95892(d)(3): ~~Auction proceeds and~~ Allowance value, including any allocated allowance auction proceeds, obtained by an electrical distribution utility shall be used exclusively for the primary benefit of retail electricity ratepayers of each electrical distribution utility, consistent with the goals of AB 32, and may not be used for the primary benefit of entities or persons other than such ratepayers. Allocated allowance auction proceeds ~~may~~ must be used to reduce greenhouse gas emissions, to procure allowances (except for uses prohibited in Section 95892(d)(6)), or returned to ratepayers, using one or more of the following approaches: Changes to these requirements adopted in 2018 shall not apply to Electrical Distribution Utility funding commitments made publicly prior to June, 2018. ~~Any allocated allowance auction proceeds returned to ratepayers must be returned in a non-volumetric manner.~~

Alternatively, ARB could include an explicit subsection under Section 95892(d)(3) that addresses the allowed use of proceeds to procure allowances for compliance, subject to the requirements and restrictions ARB desires.

Designation to Federal Power Authority Accounts: SMUD appreciated the additional flexibility included in the initial preliminary discussion draft of being able to designate some allowances received administratively to be placed directly in the compliance account of a federal power authority, such as the Western Area Power Authority (WAPA). SMUD has advocated for that flexibility in previous comments, because direct designation is a simple way of covering the obligation from WAPA power imports on behalf of SMUD ratepayers.

However, the proposed changes in the June Draft sharply limit if not completely zero out the benefit of that change to SMUD. The June Draft changes the phrase "... that is importing electricity on behalf of the electrical distribution utility." to "... with which the publicly owned utility or electrical cooperative has a power purchase agreement." In SMUD's case, the Western Area Power Administration (WAPA) imports power on behalf of SMUD's customers, but never takes ownership of the power. Hence, SMUD does not explicitly have a "power purchase agreement" with WAPA, but rather an import agreement. SMUD is unclear why the proposed change was included in the June Draft, but in order to give weight to that purpose and return flexibility to SMUD, we suggest the following wording:

(B)2- Operated by a federal power authority, ~~that is importing electricity on behalf of the electrical distribution utility~~ *that is importing electricity on behalf of the electrical distribution utility or* with which the publicly owned utility or electrical cooperative has a power purchase agreement.

B. Electrification Related Load Growth

At the June 21st workshop, ARB staff also asked for specific proposals regarding "... methods to quantify transportation-related load growth emissions (quantifiable and verifiable to allocation standards)." At a previous workshop, when asked what was meant by "allocation standards", CARB staff indicated that the concept was meant to indicate 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 reiterates from previous comments that such a "metered data or its equivalent" requirement for the cost burden from electrification is not feasible or cost-effective for much of the potential transportation electrification load, or for the potential building electrification load that is desired in state policy.

SMUD believes that conservative estimation methods are most appropriate, and that these methods are consistent with the "allocation standards" that have been used here to date to provide allowances in the electricity sector. SMUD again notes that 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).” In short, the Board Resolution uses the same term that is used for providing allowances for the overall electric sector allocation.

The following summarizes the rationale and logic from our previous comments on this issue:

- Allocation protocols for the electric sector, rather than the industrial sector, should be the model for electrification-associated additional allowances. The base electric sector allowances are to address “cost burden”, do not require metered data, and are based on forecasts (estimation).
- Metering quality data, as in the industrial sector, is prohibitively expensive on a per vehicle basis and so is likely to be unavailable, making the “allocation standards” metric CARB is suggesting infeasible for most transportation electrification and likely all building electrification loads.
- SMUD believes that the Board directed action on additional allowances for transportation electrification because of the significant nexus to the State policy goals of AB 32, SB 32, and AB 398. An “uncovered” additional Cap and Trade cost-burden to EDUs is a barrier to additional EDU investment in transportation electrification, reducing the contribution of this critical component of the State’s policies.
- ARB uses estimation for Low Carbon Fuel Standard credits given to utilities, and should utilize that work for Cap and Trade allowances, despite the differences between the two programs.
- Providing allowances for electrification induces additional amounts of electrification by removing the cost barrier, thus improving supply/demand conditions in the capped market, since transportation sector emission reductions more than offset the increases in the electric sector.
- Providing allowances for electrification will not raise prices in the Cap and Trade market nor “take” allowances away from the pot available for other actors in the market. On the contrary, it is likely to reduce prices and free up allowances for use by others.

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 believes that the barrier to productive dialogue on this is CARB staff’s continued fealty to industrial sector “allocation standards,” and there is no clear specific proposal to present to CARB as requested as long as this requirement remains interpreted as it has been. SMUD would be pleased to consider and develop methods of estimation that take into account baseline electrification already included in allocations, expectations of emission increases from additional load above baseline as resources change, use of advanced metering data to improve estimation of load, etc. It

is difficult to put in the time and effort to develop such a method, as requested by CARB, if it will not be considered because it is not consistent with industrial sector “allocation standards.”

SMUD remains concerned that the path CARB describes of quantifying the need for additional EDU allowances using industrial sector “allocation standards” is akin to making the perfect the enemy of the good, and would cause the State to lose or have delayed vital 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:** The whole point of a hard price ceiling, in SMUD’s view, is to provide market stakeholders with additional certainty about the longevity of the Cap and Trade program so that abatement investments are clearly worthwhile. If the price ceiling is set so high that market stakeholders believe policymakers will step in to suspend the program well before it is reached, it is pointless. A high price ceiling will likely reduce, rather than drive, investment in abatement technologies and actions. The price ceiling should not be set in relation to perceptions of current abatement costs, as those will change and tend to decline. SMUD continues to oppose a price ceiling significantly above the current APCR level expected in 2021. The Ontario provincial election reinforces the importance of politically defensible price containment.
- **Price Containment Point Price Levels:** SMUD recommends price containment point levels that are spread out from each other so that they act to brake market prices twice, such as at 1/3 and 2/3 of the way between the established floor price and the new ceiling price. If the ceiling price is set too high, the price containment points should be lower. Again, the chief danger is not lack of abatement investment due to prices that are too low – the floor price protects against that. The chief danger is lack of abatement investment due to stakeholder concerns that too high prices will lead to political intervention.
- **Price Containment Point Supply Amounts:** SMUD does not think that the level of initial supply established by AB 398 is sufficient to have the intended market impact of slowing a rapid price run-up long enough for market actors to invest in and implement abatement actions. SMUD suggests that ARB split the current 10% vintage borrowing concept for the APCR into two 5% tranches, one for each price containment point (ARB staff misreads SMUD’s previous comments about cutting the 10% borrowing concept to only 5%).
- **Use of Revenue from Printed Compliance Instruments.** SMUD would not have supported the hard price ceiling concept without 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 by providing political certainty and driving abatement, 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.

D. Banking and Oversupply

SMUD continues to support the CARB Staff position that there is no current need to take actions, such as taking away or devaluing entity-banked emissions, that would penalize covered entities while exacerbating market uncertainties. SMUD believes that any action to remove allowances from the market today would introduce the potential for future allowance scarcity in the market, which would raise current compliance prices for our customers and increase concerns about unearned benefits to entities currently holding allowances in good faith. No regulatory action is currently necessary to address perceived oversupply concerns beyond those 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.

CARB Staff admirably defended their reasonable analysis of the potential for oversupply in the June 21st workshop. This analysis confirms that the current “bank” of allowances will very likely be needed and used prior to 2030, hence presenting no danger to the specific GHG target in that year. SMUD also 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 advocates a “wait and see” approach to the question of changes to market supply (the caps) given significant uncertainty in market demand going forward over the next decade and beyond. If the current bank persists over the next five years or so, that means that emission levels are following the Cap trajectory downward, and there is no clear reason why they would not continue to do so – that’s a good thing. If the bank is declining over time, that means that emission levels are not declining with the cap, but it also means that the bank is useful and that prices in the market will rise to reflect the changing conditions and increasing abatement in the future. There is not an economic rationale that supports the position that simply because there is a “bank” of allowances, market entities will ignore cost-effective abatement opportunities in favor of dipping into the bank. In short, 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 for many reasons, including but not limited to:

- 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 market 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.

While some may suggest that the politically driven departure of Ontario from the linked Cap and Trade structure raises the importance of addressing perceived oversupply, SMUD asserts the opposite. The experience with Ontario reinforces the importance of keeping a stable structure, including supply of and pricing of allowances, to avoid the potential for political abandonment of carbon policy overall. A stable and predictable increase in carbon prices as caps decrease, supported by a gradual increase in the price floor, will best avoid politically driven abandonment of the program, and increase the potential for additional linkage to replace or re-include Ontario.

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. Energy Imbalance Market

SMUD continues to support use of CARB's current "bridge solution" for dealing with potential secondary dispatch emissions in the Energy Imbalance Market (EIM), rather than developing an alternative policy in this rulemaking. The current California Independent System Operator (CAISO) process for dealing with secondary GHG emissions in the EIM marketplace is not final, but we understand that CAISO management plans to take their proposal to the CAISO board and the EIM board in the coming months. Therefore, CARB can wait to consider changes to the Cap and Trade rules until those board actions, while continuing to use 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 proposed by CARB staff. This option does not solve the "incentive" issue that concerns ARB Staff, and seems likely to impose additional costs on California ratepayers. Rather, the CARB Staff's option imposes additional rules 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 to SMUD how EIM participants would be able to 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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cc: Corporate Files (LEG 2018-0362)