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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 October 12, 2017 workshop. SMUD was active in the process that led to the adoption of Assembly Bill 398 and subsequent ARB adoption of the 2016 Cap-and-Trade Amendments in July 2017. SMUD has long supported an extension of the Cap-and-Trade Program beyond 2020.

As noted in the October 12th presentation, AB 398 requires consideration of certain changes in the Cap-and-Trade structure. In particular, AB 398 requires ARB to develop and/or implement:

- A firm Cap-and-Trade price ceiling, taking into account several factors;
- A mechanism to sell additional compliance instruments to enforce the price ceiling, with the proceeds used for at least one-to-one GHG emission reductions;
- Two price containment points, or “speed bumps”, between the annual reserve price and the new price ceiling;
- Reduced offset credit compliance limits and requirements that half of these provide “direct environmental benefits in CA”; and
- Potential new banking rules to discourage speculation and avoid financial windfalls, and consider the impact on compliance entities and price volatility.

In addition, AB 398 requires ARB to evaluate and address concerns about over-allocation, meaning concerns about the total number of compliance instruments available being higher than covered emissions, historically and going forward.

The adoption of the 2016 Cap-and-Trade amendments included defined electricity distribution utility (EDU) allowance allocations based on cost-burden. SMUD actively supported that methodology and the resulting allocations. Board Resolution 17-21, which accompanied the adoption, required efforts to:

- Evaluate methods to provide additional EDU allowances associated with transportation electrification load growth; and
- Consider requiring all EDUs to consign all allowances to auction and use auction proceeds to further the goals of AB 32 and SB32.

SMUD addresses each of these questions in the following comments.

A. 2021 to 2030 Price Ceiling

SMUD recommends that ARB 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. At the same time, the price ceiling must be high enough to allow room for the two price containment points that AB 398 requires, as well as to avoid any conflicts with policies in linked jurisdictions. In general, SMUD recommends a lower price ceiling to keep these risks low. SMUD recommends a price ceiling no higher than \$70/ton in 2021 (in the same ballpark as the expected Allowance Price Containment Reserve (APCR) pricing in that timeframe).

The price ceiling provides certainty that allowance costs will not rise above a certain point in the auctions, which should stabilize prices in the secondary markets, thus making the program more stable. Consequently, market participants will be able to rely on price controls within the program structure rather than through some uncertain political solution to change the State's policies if prices go significantly higher. At the same time, the ARB 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 hopefully much lower than the price ceiling. The best market structure is one where the price ceiling influences the market but is never reached.

In the past SMUD has recommended a variety of demand reducing and supply stabilizing policies, some of which have not been adopted by ARB. At this juncture, where the Cap-and-Trade program has been stabilized by court rulings and legislative action and is doubling in lifetime, SMUD suggests that it is appropriate for the ARB to consider structural changes that may have been difficult to include in the initial Cap and Rulemakings. These include:

- 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.

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 a one-to-one reduction in GHG emissions. SMUD supports:

- Ensuring environmental integrity by going beyond one-to-one reductions where feasible;
- Inclusion of well-developed, ready to implement, offset projects such as REDD projects;
- Using the new one-way linkage option in the Cap-and-Trade regulations to procure and retire compliance instruments from other jurisdictions where appropriate and feasible; and
- Early consideration of policies to develop and establish options and projects well before the price ceiling is reached, so that emission reductions can be readily and quickly accessed at that point.

B. Price Containment Points

SMUD supports robust price containment points, or “speed bumps”, that will act to inject supply quickly into the market to constrain for a time a rapid rise in allowance prices. AB 398 directs that one third of the allowances in the APCR as of the end of 2017 be used to initially fund the required price containment points. ARB has determined that this will amount to just over 40 million allowances in each speed bump. This represents about a 10-15% injection above the annual allowance budgets of approximately 300-350 million over the next few years. While a good start, SMUD is concerned that this amount of injected supply may be insufficient to act as intended – to stabilize the price curve and allow the market time to get demand back in balance with supply.

SMUD recommends adjusting the “vintage borrowing” provision in the Cap-and-Trade regulations to ensure robust price containment points. Currently the Cap-and-Trade regulations allow ARB to continue selling allowances at the highest APCR Tier price (now the singular APCR price), by borrowing 10% of the allowance budget from future vintages or budget years (starting with vintages farthest out in time). However, with the new price ceiling mechanism required by AB 398, this vintage borrowing, at the ceiling, is superfluous, since AB 398 makes additional compliance instruments available at the ceiling price. 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. This will promote the price stabilization envisioned by the containment point concept.

C. New Offset Limits and Constraints

AB 398 lowered offset limits and required that one half of offsets used must come from projects with “direct environmental benefits” in California. SMUD has no input at this time about what is meant by “direct environmental benefits”. SMUD does support the ARB position as described in the October 12th workshop – that the law essentially divides the offset market into two separate and independent categories. Hence, an obligated entity is perfectly free to surrender offsets that do not provide “direct environmental benefits” up to the 2% limit established for the years 2020-2025 and the 3% limit for years 2026 through 2030, independently of the amount of offsets retired that do have “direct environmental benefits”. In addition, SMUD supports the ARB proposal to apply the 6% limit to the entire required “surrender” in 2026 – the third year of a compliance period.

D. Banking Rules

AB 398 requires ARB consideration of revised banking rules with the intent of discouraging speculation, avoiding financial windfalls, as well as ensuring compliance flexibility and avoiding price volatility. As an electric utility subject to significant swings in zero-emission hydroelectric generation between “wet” and “dry” years, SMUD places great importance on flexible banking rules. SMUD strongly prefers the current banking structure in the Cap-and-Trade program, whereby an allowance of one vintage can be used in any subsequent vintage year – unlimited banking. This provides the flexibility needed to ensure compliance as hydroelectric generation varies from year to year while at the same time protecting against the risk that compliance assets – allowances – are not stripped of value in the market. As banking revisions are considered, SMUD suggests that compliance entities be grandfathered under current rules.

E. Question of “Over-allocation”

AB 398 requires ARB to evaluate and address concerns about over-allocation in the number of available allowances for the years 2021 to 2030. SMUD believes that ARB should make clear that this evaluation is addressing concerns about the total available compliance instruments in the market, not the EDU allocations recently adopted nor the industrial allocations that depend on assistance factors. SMUD will strongly oppose any re-evaluation or reconsideration of the EDU allocation structure adopted in July, 2017.

With respect to the total number of allowances in the 2021 through 2030 budgets, SMUD suggests that at this time ARB can afford to take a “wait and see” approach. While it is widely recognized that there is a substantial amount of unsold and/or unused allowances in the market today, there is no need to make an early and significant correction to the provided allowances going forward. It remains speculative that there will be too many allowances available in 2030, since over the next 13 years there are many factors that will play out to affect demand for allowances versus the current supply, including but not limited to:

- Strong economic growth – the 2009 recession was one reason for lower than expected allowance demand at the beginning of the Cap-and-Trade program, but today California’s economy is expanding rapidly;
- Linkage with Ontario – the planned linkage with Ontario in 2018 is expected to increase demand for allowances in comparison to supply – as acknowledged by the Ontario representative at the October 12th workshop;
- Potential linkage with other jurisdictions – there is speculation that some other Western states may consider joining the Cap-and-Trade program, and it is not clear what the demand/supply impacts of the increased market scope would be at this time;
- Potential triggering of the new “one-way” linkage option – even without a full linkage to the California/Quebec/Ontario market, other jurisdictions may begin to procure and retire California allowances through the new “one-way” linkage established in the adopted July regulations;
- Placing of allowances into the APCR – AB 398 and the adopted July regulations require that allowances that remain unsold for more than 24 months be transferred to the APCR, where they will be unavailable to the Cap-and-Trade market until and unless market prices bust through the pending price containment points and reach (or at least approach) the price ceiling; and
- The potential for reduced hydroelectric generation in future years, due in part to the impacts of climate change itself on California weather.

Given all these factors, SMUD does not see a present need to “adjust” the amount of allowances provided to supply the Cap-and-Trade market, beyond the adjustment already adopted by CARB in the July amendments to transfer an additional 52.6 million allowances into the APCR from 2021-2030. It would be a mistake to significantly reduce future allowance budgets today only to find out in 10 years that demand is then exceeding the reduced supply and the market is pushing the price ceiling.

SMUD understands that one reason for the requirement in AB 398 to analyze over allocation was concern that a lingering amount of excess supply would be available in 2030 and use of that “bank” in that year would challenge achievement of the 2030 target of GHG emissions 40% below 1990 levels. ARB should not be overly concerned about this possibility, for the following reasons:

- Compliance entities will not increase emissions in 2030 simply because banked allowances are available. Increases or decreases in emissions over time are based on the price of allowances versus the cost of abatement, not the existence or size of a “bank”;

- Compliance entities will expect the Cap-and-Trade program to extend beyond 2030, and see any bank they have as ensuring the ability to comply in the long run, rather than having a 2030 “use it or lose it” aspect; and
- The impacts of GHG emissions are related to cumulative amount of CO_{2e} in the atmosphere, rather than the specific amount released in 2030. If lower emissions in the years leading up to 2030 result in an available “bank” in that year, that’s a good thing because emissions have been reduced sooner. Flexible banking rules encourage such early reductions.

F. EDU Allowance Allocation – Electrification

Board Resolution 17-21 directed the Executive Officer to continue to evaluate appropriate quantification methodologies for additional EDU allowance allocation to reflect the increased “cost burden” to EDUs associated with transportation electrification load growth. SMUD supports consideration of additional allowances for transportation electrification, and believes that ARB staff should also consider additional EDU allocations to cover additional load and emissions from *non*-transportation electrification (as required by SB 350).

Broad substitution of electricity for combustion of fossil fuels is an essential measure for achievement of Governor Brown’s goal of a 50% reduction in petroleum use in vehicles by 2030. Electrification of the transportation sector will reduce GHG emissions overall because on a miles travelled per ton of CO_{2e} emitted basis, there are substantially greater decreases in emissions from the transportation sector than there are increases in emissions from the electric sector (approximately 4 tons decreased in transportation for every ton increase in the electric sector). Despite this favorable trade-off, the EDU sees an emission increase and the additional compliance cost, as well as the cost of additional infrastructure. These EDU “costs”, if not offset, act as a drag on EDU investment in electrification.

SMUD is concerned that ARB staff will require expensive and infeasible documentation of electrification load growth in order to receive any additional allowances for increased electrification. Slide 13 from the October 12th Cap-and-Trade workshop suggests that Staff will emphasize “... large, quantifiable, and verifiable (to allocation standards) growth”. An emphasis on large impacts makes some sense, but broad electrification, including electrification of gas end uses in buildings is needed and should be supported. Verification requirements for load growth due to electrification should be established with consideration whether the requirements can be cost-effectively implemented so as to allow the emission reductions with reasonable certainty. While the term “allocation standards” is not defined, SMUD is concerned that there is a view by Staff that the additional load from electrification must be metered incrementally, or verified through some equivalent demonstration of this load, no matter how small the load or what the costs of this demonstration are.

For example, most electric vehicles are currently charged at home, using a dedicated circuit or a simple normal outlet, neither of which is typically metered separately from

the house as a whole. Requiring a separate meter for demonstration of the additional load would be an unnecessary expense. Electrification of other end-uses, such as water heating, space heating, etc., are currently less significant in magnitude than transportation electrification, and are even less amenable to verification methodologies such as separate meters.

Requiring load growth from transportation electrification to be precisely measured seems to simply ignore the dramatic reduction in overall emissions – as if the electric sector emission increases are independent of the transportation sector decreases. In point of fact, if overly strict requirements for documenting electric load growth are implemented, the State could lose some of the dramatic transportation sector reductions. The situation is completely different than allocations to industrial entities which are based on documented production from a facility, but with no commensurate 4-1 emission reduction in another sector.

G. EDU Allowance Allocation – Consignment

Board Resolution 17-21 also directed the Executive Officer to consider requiring all EDUs to consign all allowances to auction and use auction proceeds to further the goals of AB 32 and SB 32. SMUD is opposed to requiring POUs to consign all of their EDU allowances to auction. SMUD believes that the consignment-choice provision of the current Cap-and-Trade regulations has been working well for five years now, and sees no reason to make this change. A recognized and reasonable acceptable use of administrative allowances is to simply place them in compliance accounts, rather than force the risk of market participation in order to procure allowances for compliance.

Thank you for the opportunity to comment.

/s/

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