THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

January 11, 2010

Mr. Kevin Kennedy, Ph.D.
Assistant Executive Officer
Office of Climate Change
California Air Resources Board
1001 I Street, P.O. Box 2815
Sacramento California 95812

Dear Mr. Kennedy:

<u>Comments Regarding CARB's Preliminary Draft Regulation for California Cap-and-Trade Program for Greenhouse Gas Emissions</u>

The Metropolitan Water District of Southern California (Metropolitan) appreciates the opportunity to comment on the Preliminary Draft Regulation for a Cap-and-Trade Program for Greenhouse Gas Emissions (PDR) prepared by the California Air Resources Board (CARB) and recognizes the hard work and accomplishment in preparing the detailed PDR. Metropolitan shares vital concerns with other western water agencies regarding the climate change impacts resulting from increases in atmospheric greenhouse gas (GHG) emissions and their impacts on water supplies and demands. Because of these impacts and the inevitable increase in electricity costs and water rates that will result from implementation of California Assembly Bill (AB) 32, Metropolitan remains committed to participating in CARB's efforts to develop the measures, including creation of a Cap-and-Trade-Program, as outlined in the Scoping Plan.

As the nation's largest provider of drinking water, Metropolitan distributes water from the Colorado River and Northern California to 26 member agencies (cities and water districts) and supplies more than one-half of the water used by nearly 19 million people in the 5200 square mile coastal plan (Los Angeles, Orange, San Diego, Riverside, San Bernardino, and Ventura counties) of Southern California. Metropolitan's regional water supply and distribution system includes five of the largest pumping plants and water treatment facilities in the United States. Metropolitan's mission is to provide its member agencies with adequate and reliable supplies of high quality water to meet present and future needs in an environmentally and economically responsible way.

Metropolitan recognizes that climate change will have significant adverse impacts on many aspects of water resources management, including hydrology, water storage, water supplies, water demands, and water conveyance systems, and will further challenge the water sector in its mission to economically provide a reliable high quality supply of water. Metropolitan has developed adaptation strategies to accommodate the expected effects of climate change, and has also undertaken mitigation strategies to improve the efficiency of its energy use and thus contribute to the stabilization of the amount of carbon entering the atmosphere. To this end, Metropolitan has made several efforts to reduce its GHG footprint, including moving away from contracts for coal-fired electrical supplies used to meet a portion of the Colorado River Aqueduct energy requirement in the early 1990s,

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and the recent completion of Metropolitan's first large scale solar facility. Metropolitan's GHG emissions are currently below 1990 levels, and Metropolitan will continue to invest in renewable energy sources to achieve further reductions in GHG emissions.

Metropolitan is a member of the California Climate Action Registry (CCAR) and reports its GHG emissions inventory in accordance with CCAR protocols. In June 2009, following the process laid out in the GHG Mandatory Reporting Rule (MRR) for the electricity marketing sector, Metropolitan provided information to CARB on our 2008 imported electricity from unspecified, non-hydroelectric sources which totaled 94,498 megawatt hours (MWh) for that year. This imported power is utilized by Metropolitan to power our five pumping plants to bring Colorado River water to Southern California. The direct emissions from each of our facilities, such as treatment plants, are well below the reporting threshold of 25,000 metric tons of CO2e per year, and as such there was no reporting obligation for those emissions under the MRR.

Given Metropolitan's special state and federal historic considerations and its unique wholesale power operations, it does not believe it is covered under the proposed Cap-and-Trade regulations. Metropolitan directly imports wholesale energy from out-of-state sources to serve exclusively the electrical pumping requirements of its Colorado River Aqueduct (CRA). This wholesale energy is used only by Metropolitan; it is not marketed or resold to other utilities, Metropolitan's Member Agencies and does not serve any type of retail load. Metropolitan provides no electrical service to any load other than its CRA pumping plants. The CRA electrical load is tied directly to Metropolitan's own high-voltage transmission system that connects to the Western Area Power Administration's electrical grid at locations near Hoover Dam in Nevada and Parker Dam on the border of California and Arizona. It is on these lines that Metropolitan transports its contractual energy from the Hoover and Parker Dams on the Colorado and unspecified wholesale energy from suppliers in the southwest. Metropolitan's transmission system is within the CAISO control system but is not part of the ISO grid.

Metropolitan's primary concerns with the Cap-and-Trade PDR are grounded in the disastrous experience following the passage and implementation of AB1890 in the mid-1990s. This failed attempt to de-regulate the electrical sector, largely through market mechanisms, was costly to all sectors of California's economy and set investment in the reliability of the California electrical sector back decades. While market mechanisms, such as cap-and-trade can be a practical means of allocating resources and driving desired behavior, without careful and thoughtful development, including thorough input and understanding from all stakeholders, a poorly structured, overly complex cap-and-trade strategy for GHG allowances may result in significant unintended and adverse consequences.

To successfully employ a cap-and-trade market strategy for GHG emissions in California, Metropolitan strongly encourages CARB to consider the following:

- Keep California rate payer money in California to fund emission reduction efforts in California until such time as broader national and global efforts and markets catch up. As a result of AB1890, a tremendous amount of rate payer capital that could have flowed into electrical generation and transmission upgrades to support California's long-term economic viability left California through private entities like Enron.

- Ensure that any revenues generated through auctions or otherwise are returned to the entities from which they were generated to fund direct GHG reduction efforts.

- Do not transfer funds generated from GHG allowance auctions to other State agencies or Funds for the purpose of addressing any shortfall in revenue in the State's budget.

- Start with a simple, transparent market structure with low transaction costs. A market needs time to mature and develop and should be guided in this direction by clear, well understood boundaries on prices and transactions. In the aftermath of AB1890, much was learned about the true nature of many of the transactions. This was shocking evidence of how well intended but poorly formed public policy can lead to adverse and unintended consequences. In 2001 alone, Metropolitan paid over $100 million in excess of normal power costs to meet the Colorado River Aqueduct energy requirement. It has been documented that over $5 billion left the State following the adoption of AB1890.

- Develop a market structure that can be relied upon over the long-term to reduce uncertainty. By their nature, investments in energy efficiency and renewable resources required to reduce GHG emissions are capital intensive. Thus, a market intended to encourage such investments should guarantee a sufficient return on the capital investment for those required to reduce their emissions.

- Allocate free allowances to cover non-profit public entities that provide essential public services. Rather than collecting auction proceeds from these public entities, and later redistributing them to fund third-party renewable energy projects or meet other state goals not related to GHG emission reductions, CARB should allocate allowances to such entities based upon their reported GHG emissions and let the allowance price drive investments in renewable energy.

- Build market liquidity through auctions of a portion of the allowances.

- Avoid complicated and burdensome processes and minimize the creation of new bureaucracies for the allocation of allowances, collection of funds, and the distribution of auction proceeds.

- Any back office systems and processes required to support allowance allocations, auctions, further trading and the return of funds generated from allowance auctions for the development of projects that reduce GHG emissions should be designed to minimize transaction costs.

- Stage the introduction of entrants to the market to best coordinate with other climate change initiatives like the Western Climate Initiative (WCI) that seeks a broader regional approach, and will not put California's already struggling economy at a competitive disadvantage in comparison to other states.

- Ensure that to the extent they are allocated to utilities, free allowances be allocated to all covered Load-Serving Entities (LSEs) including those that only serve electrical load at the wholesale level.

As stated above, Metropolitan does not believe it is covered under the proposed Cap-and-Trade regulations. However, Metropolitan does have specific comments on the PDR that focus on issues applicable to the inclusion of imported electricity in a California only Cap-and-Trade market and they are included in this letter and its enclosure.

Our specific comments are provided as an attachment to this letter and are broken down into the following six categories:

1. Sub-article 2 "Purpose and Definitions" – There is a lack of consistency between the MRR and the PDR, and clarification relative to use of such terms as "electricity deliverer," "marketer," and "first jurisdictional importing deliverer" is needed. The definitions are not consistent within the PDR itself, and words such as "surrender" and "retire" that are not intuitive are used differently in the PDR.

2. Sub-article 3 "Applicability" – Our comments focus on the appropriateness and legality of applying a California Cap-and-Trade Program to electricity generated in other states.

3. Sub-article 7 "Surrender Requirements for Covered Entities" and Sub-article 13 "Offset Credits" – The compliance cycle that is outlined is overly complex and the allowable percentage of offset credits is too low to be of much value.

4. Sub-articles 8 & 10 "Distribution of Allowance Value and Free Allowance Mechanisms" – Several CARB staff reports on allocation are still in progress or in draft form, so there are critical gaps and limited specifics on the mechanisms for distribution of allowances to covered entities which make it difficult to provide substantive comments on the PDR.

5. Sub-article 12 "Linkage to External Trading or Offset Crediting Systems" – There is a lack of detail in the PDR that describes how the CARB Cap-and-Trade system will work on a regional basis, and mesh with the WCI program and a federal proposed program.

6. Emissions Calculations - No final methodology has been released for calculation of emissions from unspecified imports which affects our ability to determine "Applicability" in Sub-article 3.

Metropolitan appreciates the opportunity to provide comments on the PDR which is in essence the cornerstone of the AB 32 Scoping Plan, and we look forward to providing further input as the process moves forward. Because of the potential significance of a Cap-and-Trade program on all electricity imports and on water supply costs in California, we are interested in meeting with you and your staff to initiate a dialogue on this important issue to discuss our comments and concerns, and to gain clarification and mutual agreement on specific issues. We also request that CARB staff continue to work with all affected stakeholders to complete and solicit stakeholder input on pertinent staff analyses and reports, including the critical economic analyses, before moving towards consideration and adoption of a Cap-and-Trade regulation in October 2010, as proposed by CARB staff.

If you have any questions on our comments, please contact Janet Bell at (213) 217-5516 or via e-mail at jbell@mwdh2o.com, or Jon Lambeck at (213) 217-7381 or via e-mail at jlambeck@mwdh2o.com.

Sincerely,

Debra C. Man
Assistant General Manager and Chief Operating Officer

JB:mm
o:\opsexec\adminsupportfiles\corresp\DM_Carb letter

Enclosure

cc: J. J. Bell
S.O. Chapman
J. Kightlinger
B. Koch
J. C. Lambeck
D.C. Man
M. L. Parsons
B.G. Thomas

Attachment

Metropolitan Water District Comments on CARB PDR

1. Sub-article 2 "Purpose and Definitions" – There is a lack of consistency between the Mandatory Reporting Rule (MRR) and the Cap and Trade PDR, and clarification relative to use of such terms as "electricity deliverer," "marketer," and "first jurisdictional importing deliverer" is needed.

    - Section 95802 – "Definitions" – There are contradictions and inconsistencies in the definitions that apply to electricity importers. The definitions for "Electricity Deliverer", "Electricity Importer", and "Importer" are largely consistent. However, these defined terms are inconsistent with use of the term "Electricity Deliverer" in Section 95820(b) and, more particularly, the use of the terms "Marketer" and "First Jurisdictional Importing Deliverer" in Attachment 6. It is unclear whether marketers and importers are intended to be treated the same under the PDR provisions. Essential public services, such as Metropolitan and other wholesale water purveyors that import electricity to directly serve their own water pumping load should be treated differently from entities that merely market power as a part of their for profit business ventures. Although Metropolitan did provide information as described in the MRR, the definitions in the PDR are different from the MRR, and are not designed to cover Metropolitan's wholesale electric activities for the Colorado River Aqueduct.
    - We also request clarification of the definition of "Importer" in this section as the "majority owner" of a product when it first enters California. With respect to joint projects, it is unclear under this definition if the importer would be the majority owner of all the power being imported or the majority owner of each project participant's share. If it is the former, the majority owner would be unfairly saddled with the compliance obligation for all project participants. If it is the latter, the definition would not appear to apply to projects where the "majority owner" of each share would always be one party. Since the "Importer" is the entity with the compliance requirement, this is an important substantive issue that needs to be clarified.

2. Sub-article 3 "Applicability" - Our comments focus on the appropriateness and legality of applying a California cap and trade program to electricity generated in other states.

    - Section 95820 – "Covered Entities" – Metropolitan requests concurrence from CARB that Metropolitan is not considered a covered entity under the PDR, and if CARB does consider Metropolitan a covered entity, the justification for such inclusion and which categories and circumstances are applicable. If CARB considers Metropolitan to be a deliverer, we would like to know the rationale behind this inclusion since the importer and marketer definitions do not appear to fit our circumstances. Also, it is unclear what is specifically meant by deliveries to the California Energy Transmission and Distribution System. Does the system include Colorado River

Aqueduct Transmission System (CRATS) which is not part of the California Independent System Operator (CAISO) control grid, or does it apply to the next downstream connection to Southern California Edison?

- Section 95820(b) – "Covered Entities" – Electricity Deliverer" is already defined in Section 95802, yet there is a slightly different definition in this section.
- With regard to applicability, Metropolitan questions whether California can legally regulate electricity generated in other states under a state Cap-and-Trade regulation, particularly when there is no regional or federal cap and trade program in place. The PDR appears to violate the federal Commerce Clause issue by indirectly regulating out-of-state entities. More specifically, the proposed regulations would "unduly burden" interstate commerce by substantially affecting the cost of electricity generated in other states. Such regulations could also conflict with and possibly duplicate other regional and federal Cap-and-Trade systems that are currently being developed or could be implemented in the future. This could impact the financial and electrical reliability in California if neighboring states or individual out-of-state generators implement added GHG emission reduction measures that increase power costs which are further increased when the power is delivered to California. The most prudent approach would be to exclude electricity imports from the CARB Cap-and-Trade provisions until the linkages with the regional Western Climate Initiative are in place
- Section 95830 – "Inclusion Thresholds for Covered Entities" – Covered entities are those that emit at or above the 25,000 metric ton threshold for the 2008 data year, rather than the most recent reporting year. It is unclear why 2008 is referred to as the base year when the first compliance period is not until January 1, 2012. If considered an importer, Metropolitan is not directly generating or emitting the CO2 emissions, and should not be captured within this inclusion threshold.
- The language in the Overview to the PDR is not correct with regard to "covered entities" in the 2015 compliance period. The text on page 5 of the Overview indicates that "industrial fuel combustion" at facilities with emissions below 25,000 MTCO2e…" is captured in 2015. This implies that all facilities with any quantity of fuel combustion will be covered. This is not the intent of AB 32, and the Scoping Plan indicates that "upstream treatment of industrial fuel combustion at facilities with emissions at or below 25,000 MTCO2e…" is included. The word "upstream" is a key point and is meant to refer to natural gas processors, pipeline transporters, and producers, as well as refiners and deliverers of petroleum products. It should not encompass de minimis combustion sources.
- Section 95840 describes "Opt-In Participants" to the Cap-and-Trade system. Opt-In participants are non-covered entities and their motive to participate in the emissions allowance Cap-and-Trade market would not be to acquire allocations necessary to reduce GHG emissions in California nor to minimize the economic burden of the program on consumers and rate payers. Opt-In participants could adversely affect allowance cost volatility to covered entities and increase opportunities for market manipulation.
- Metropolitan and all of California experienced directly the result of a complicated and poorly regulated market during the energy crisis of 2000-01. When entities not involved in the delivery of critical utility services to the citizens and businesses of California can acquire the assets or resources necessary for such deliveries, the results can be disastrous. The focus of such entities to maximize profits, achieve market

dominance or promote a social objective. This can lead to abusive market practices, such as the withholding of resources, market manipulation or advantageous insider business transactions. Metropolitan recommends that CARB reconsider and refrain from allowing non-covered entities to participate in the Cap-and-Trade system. If CARB does allow entities to "opt-in" to the system, it must establish more rigorous regulations in order to prevent price-gouging and anti-competitive behavior. In either event, the issue requires much more discussion than the scant analysis provided in the PDA.

3. Sub-article 7 "Surrender Requirements for Covered Entities" and Sub-article 13 "Offset Credits" – The compliance cycle that is outlined is overly complex and the allowable percentage of offset credits is too low to be of much value.

    - Pages 34-36 – The compliance cycle that is laid out and described seems overly complicated, difficult to implement, and almost unworkable in practice. We recommend streamlining and simplifying the cycle to make it easier for the regulated entities to understand and to follow. There are benefits to both one year and three year cycles, however a three year timeframe allows the regulated entities additional flexibility towards compliance and emissions reductions.
    - It is unclear as to the quantity of allowances or compliance instruments that must be acquired and surrendered each compliance period and how this is proposed to work with respect to electricity imports where the importer and the generator are not the same. Our understanding is that the allowances would be a one-time acquisition by auction or free allocation and as the cap declines over time, either a portion of the allowances must be surrendered, or only the increased differential to continue to meet electricity needs must be obtained through additional allowances and/or offsets. Since this concept has a dramatic effect on initial and recurring costs, clarification is requested.
    - Pages 42-43 – The allowable percentage of offset credits is proposed to be no more than 4%. For offsets to provide sufficient value in mitigating CO_2 emissions, we recommend that a higher percentage of at least 15% be utilized. It is our understanding that the AB 32 Scoping Plan, the WCI Cap-and-Trade design recommendations, and the federal Lieberman-Warner Cap-and-Trade Bill, S 2191, would allow a higher percentage of allowance surrender requirements to be achieved through carbon offsets.

4. Sub-articles 8 & 10 "Distribution of Allowance Value and Free Allowance Mechanisms" – Several CARB staff reports on allocation are still in progress or in draft form, so there are critical gaps and limited specifics on the mechanisms for distribution of allowances to covered entities which make it difficult to provide substantive comments on the PDR.

    - The mechanisms for distribution of allowances are very important from a cost standpoint, but there are no regulatory proposals in the current PDR. There is only a concept discussion and placeholder on allowance allocation and free allocation mechanisms. The forthcoming January 2010 Economic and Allocation Advisory Committee (EAAC) report and recommendations are referenced in this section. Since the distribution of allowances is critical to a Cap-and-Trade program, the PDR is premature, and should not be acted

upon until the EAAC reports are available for public comment, finalized, and integrated into the PDR language.

- With respect to free allocations versus auction, we recommend that auctioning be kept to a minimum. Extensive use of auctions will potentially result in gaming of the system, wealth transfers, and contentious debates over how to divide the proceeds. Additionally, unless the proceeds are returned to the entities emitting the greenhouse gases, they are not likely to be used to actually reduce emissions. If CARB decides to freely allocate allowances to all utilities, it is important that these allowances are distributed to all regulated LSEs. If allowances are freely allocated to Local Distribution Companies (LDCs), the LDCs can sell these allowances to generators and energy marketers, and then use the funds to offset compliance costs (e.g. the costs that the generators and marketers will charge to cover the allowances). Finally, if allowances will be freely distributed to generators and marketers, CARB needs to ensure that the allowance distribution is based on historic emissions, and that baseline years with lower emissions are not utilized.
- These sub-articles discuss three "potential claims on the allowance value" with only the third one appearing to be appropriate. Any funds generated from allowance allocation or auctions should be used strictly for program costs or projects that will result in direct emissions reductions. The rationale for allocating allowance value based on disproportionate impacts and the general public benefit is difficult to justify, and begs the questions of how to calculate the value and to whom will it be directed. We recommend that AB 32 not be used as a means to transfer money from regulated entities into the state coffers or general fund.

5. Sub-article 12 "Linkage to External Trading or Offset Crediting Systems" – There is a lack of detail in the PDR that describes how the CARB cap and trade system will work on a regional basis, and mesh with the WCI program and a federal proposed program.

   - There is no concept discussion of how the Cap-and-Trade program would work if a federal program is adopted, nor a description of the linkages to a regional program, such as WCI. Metropolitan understands that this is out of California's control, since the federal program may choose to preempt a California program. The adopted CARB regulations should only remain in effect until there is a federal program in place. Reduction of greenhouse gases is a regional and global issue; it is illogical for California to act independently on this issue.
   - There is a potential issue with regard to "GHG Offset Crediting Systems." Metropolitan understands that under the PDR provisions, parties could use credits obtained from entities regulated in other states and from offset projects potentially located throughout the world, provided that the other states' programs or regional programs are authorized by CARB. It is not clear how this would work with overlapping federal and state regulations. Metropolitan recommends that CARB establish an offset crediting program with no geographic restrictions and with criteria sufficient to ensure environmental integrity.

6. Emissions Calculations - No final methodology has been released for calculation of emissions from unspecified imports which affects the determination of "Applicability" in Sub-article 3.

- It is our understanding that the default emissions factor of 1100 lbs/MWh for unspecified power is still only a recommendation from the California Public Utility Commission (CPUC), the California Energy Commission (CEC), and in the latest draft of the AB 32 Administrative Fee regulations; and has not been formalized into a final number. CARB needs to address carbon attributions for unspecified imported electricity. Metropolitan recommends that a regional approach based on rational analysis be used in lieu of a single unsupported factor, and that double counting needs to be avoided in development of this emissions factor.
- At CARB's June 2009 public meeting on "Including Imported Electricity in a California Cap and Trade Program" staff's presentation included a slide on next steps which referenced two staff concept papers. One of the papers provided a discussion of alternative methods for calculating default emission factors for unspecified power, and was slated for October 2009 release for review. Our understanding from CARB staff is that this report has been delayed, and will not be issued until sometime in 2010. It seems premature to include imported electricity in the Cap-and-Trade PDR without completion of this staff report, as well as the concept paper on preliminary thinking on identifying obligated entity, sources of imported power, and the methodology for tracking imported power. A concept document on this topic was scheduled for release in August 2009, and has also been delayed.
- CARB's June 2009 public meeting on "Including Imported Electricity in a California Cap and Trade Program" also referred to a CPUC/CEC recommendation to replace the default emission rate of 1,100 lbs CO_2e/MWh for unspecified sources with "values derived from a common set of rules that will be developed by WCI." Although the PDR discusses potential linkage to WCI or other emissions trading systems, it does not refer to the adoption of WCI-derived emission rate setting rules.