

LEG 2010-0013

January 11, 2010

**The Honorable Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
Dr. Kevin Kennedy
Ms. Lucille Van-Ommering
California Air Resources Board
1001 I Street
Sacramento, CA 95814**

Re: AB 32 Cap-and-Trade Program Preliminary Draft Regulation (November 24, 2009)

Dear Ms. Nichols, Mr. Goldstene, Mr. Kennedy, and Ms. Van Ommering:

The Sacramento Municipal Utility District (SMUD) appreciates the opportunity to offer these comments on the ARB's Preliminary Draft Regulation (PDR). We commend the ARB staff for its transparent and inclusive process to develop this PDR. SMUD strongly supports much of its content.

Regarding the content of the PDR, SMUD continues to support the principle of including all major emitting sectors in an economy-wide Cap-and-Trade from the outset of the program. We encourage the ARB to review the strong work done by the Joint Commissions alongside current recommendations the ARB is receiving from the EAAC on allowance allocations. We continue to support strong voluntary mechanisms for emissions reductions, including the voluntary renewable energy set-asides contemplated in the PDR. We encourage the ARB to more explicitly acknowledge the role of and the need to account for the use of biogas in interstate natural gas pipelines to meet demand for natural gas in California power plants. Finally, we support both the notions of early submittal of a portion of an emitters' obligation, as well as the use of price collars which do not compromise the environmental integrity of the program, as sound mechanisms to ensure price stability in the market. The comments that follow will discuss these areas in more detail.

A. Include Fuel Deliverers, Including Transportation Fuels in the Cap-and-Trade Program in 2012

Section 95940 of the PDR seeks stakeholder comment on the inclusion of fuel deliverers, including those for transportation fuels, from the onset of the Cap-and-Trade Program in 2012. SMUD has consistently argued for the inclusion of transportation

fuels and other fuels within the scope of the cap from the beginning of program, and continues to urge the ARB to establish a broad initial market for the program. Over the next 10 years, emissions from transportation are expected to grow by 25% under a business as usual scenario.¹ While complementary programs such as the LCFS and vehicle tailpipe standards will result in emissions reductions relative to business as usual (BAU), these programs are most likely to see the majority of their reductions in the latter compliance periods, between 2015 and 2020. As a result, BAU growth in these sectors will, in effect, eliminate gains made by the electricity and industrial sectors in the first compliance period. There has been no compelling reason offered to date for excluding these sectors from the Cap-and-Trade program in the first compliance period. If the ARB wishes to ensure the environmental effectiveness of the cap all major emitting sectors should be included from the outset.

Inclusion of the transportation and natural gas sectors from the outset establishes a broader initial market and an early carbon price signal for transportation fuels, as described in the Recommendations of the Market Advisory Committee (MAC) to the California Air Resources Board.² The MAC Final Report provides in pertinent part:

Some observers have suggested that this [expectation that a trading program alone would not produce major emission reductions] is a good reason to delay including the transportation sector in the Cap-and-Trade program, even in light of the principle favoring broad-based coverage, because the effect on emission reductions would be relatively small — at least until program stringency and resulting allowance prices reach higher levels in the future. However, the Committee believes that, in the long run, including the transportation sector is critical to providing a consistent price signal across all sectors to promote economy-wide reductions in GHG emissions. Failing to provide this consistent signal would lead to distortions in automobile supply and purchase decisions. In addition, if Cap-and-Trade were applied to the transportation sector it would help reduce distortions relating to decisions as to how much to drive. Specifically, by incorporating the carbon price in the price of gasoline, it would encourage owners of conventional fuel cars to make more socially efficient decisions as to how much to drive. If the state chooses to embrace the fundamental principle of comprehensive coverage, it should strive to incorporate that principle from the outset, when the cost of doing so is relatively low. This would reduce uncertainties about whether this sector will ever be included, and establish an efficient architecture for the Cap-and-Trade program to grow in stringency over time.

Nor should inclusion of the transportation sector be delayed because of implementation issues. The PDR identifies the points of regulation as refiners and importers of gasoline and diesel fuels and there are a limited number of these distribution points state-wide. These sources will already have to report the carbon content of transportation fuels

¹ Scoping Plan, p. 12.

² *Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California*. June 30, 2007. p. 36-37. http://www.climatechange.ca.gov/publications/market_advisory_committee/2007-06-29_MAC_FINAL_REPORT.PDF (“MAC Final Report”)

under the LCFS, so the carbon content for purposes of a Cap-and-Trade program can be calculated from the same data.³ Moreover, no delay is required to establish the regulatory roles for transportation sector emissions because those responsibilities are established at the ARB.

In addition, the transportation sector should not be excluded from the initial program on the grounds that the Cap-and-Trade program should be 'phased-in', so that entities covered in later periods can benefit from the initial 'testing' of the structure. In order to most effectively establish a Cap-and-Trade market, all sectors intended to be covered should participate and learn from the beginning, with no sector receiving a grace period for observation and preparation. Many sectors may wish to take advantage of such an opportunity – none should be allowed. Nor does such 'phasing' benefit the Cap-and-Trade implementation – the infusion of such a significant additional set of emissions in a later compliance period is a market disruption akin to starting the Cap-and-Trade program anew.

The ARB should not delay utilization of one of the only effective measures in the near term for controlling GHG emissions from the transportation and natural gas sectors. While policies such as the LCFS, tailpipe emission standards and land use policies will make a difference in the long run, none will have the same kind of near term effect as the Cap-and-Trade program. The transportation sector is too large and important a source of GHG emissions to delay emission reduction measures. A broad initial Cap-and-Trade market treats all sectors equally, provides for the greatest opportunities for trading to achieve compliance flexibility and cost-effectiveness, and moves California most quickly toward the low-carbon goals of AB 32.

B. Emission Categories For Calculating Surrender Obligations

Section 95950 of the PDR describes the proposed surrender obligations of covered entities. SMUD supports the basic structure of a surrender obligation for every metric ton of CO₂e of GHG emissions, and has the following comments. First, SMUD suggests that the PDR explicitly state that emissions from the combustion of pipeline biogas, 'nominated' for use in a specific generator, will be excluded from a surrender obligation as in 95950 (b)(2).

Second, SMUD believes that the ARB should consider excluding emissions from the importation of electricity as part of an electricity exchange or through-state transfer from a surrender obligation. These imports/transfers do not reflect in-state use of electricity and should not have a surrender obligation.

Finally, SMUD supports Option 1 for the surrender obligation of the transportation fuel deliverer, which would require surrender of allowances for the CO₂ associated with fossil fuel sold in California. No allowances would be required to be surrendered for biofuels sold in the state. The Low Carbon Fuel Standard appropriately accounts for the lifecycle impacts of transportation fuels, and there is no need to duplicate this accounting as part of the Cap-and-Trade program. Calculating transportation fuel

³ Final MAC Report, p. 30.

surrender obligations with one of the other three options identified would be inconsistent with the treatment in other covered sectors of both fossil and biomass fuels. Any use of lifecycle assessment in the Cap-and-Trade program would open the door to full lifecycle assessment for all fuels, introducing significant uncertainties into the Cap-and-Trade program at this time and raising the potential for double counting in multiple sectors (as a lifecycle surrender obligation could be calculated as part of the fuel and for the stationary sources involved upstream of the fuel). Use of Option 1 will likely be most consistent with treatment of surrender obligations in other Cap-and-Trade programs to which California may be linked. For these reasons, Option 1 is the best option to allow participation of transportation fuels in a multi-sector Cap-and-Trade.

C. ARB Should Consider the Joint Commissions Recommendations on Allocation alongside the EAAC's Recommendations

Although the PDR does not have specific regulations addressing allowance allocation at this point in time, it does refer to the Economic and Allocation Advisory Committee (EAAC) and the forthcoming allocation recommendations expected from that committee. SMUD has been participating actively in the EAAC process, and we do not feel that the substantial comments made by the electricity sector have been adequately considered and addressed in its recommendations. We are very concerned that adoption of EAAC recommendations would result in excessive burdens being placed on the electricity sector for meeting the state's AB 32 goals. The joint proceeding of the CPUC and CEC, which was charged with making recommendations to the ARB for treatment of the electricity sector, clearly acknowledged the significant contributions and associated costs that the state's utilities are undertaking via the RPS and EE policies. The joint Commissions also acknowledged that these policies would be enough to accomplish the electric sector's fair share of statewide reductions. As a result, they recommended that allowance value proportional to the electric sector's total emissions be returned to the sector for use in accomplishing these nation-leading policies. The EAAC has thus far rejected this argument, and instead has recommended an approach that would potentially result in electricity customers paying for not only their own reductions via the EE and RPS programs, but also for the reductions associated with other sectors that do not face the same, stringent complementary policies.

Further, the expected recommendations from the EAAC do not reflect the legal and practical constraints under which CARB operates, and we are concerned that the recommended approach could allow the value raised from allowance auctions to be diverted from programs relevant to AB 32 to programs that they view to be in the public interest such as general deficit contributions, but that become further and further detached from reducing emissions as time goes on. Such a mechanism is unacceptable considering the seriousness of the task at hand and the real need for financing the fundamental changes to our state's energy infrastructure that will be necessary.

D. ARB Should Adopt Voluntary Renewable Set-Asides

SMUD supports adjustments to base budgets to account for voluntary renewable purchases, as described in Section 95910, and believes that the conceptual discussion

in the PDR as to how these adjustments would work describes a reasonable process. In SMUD's case, our award-winning Greenergy voluntary renewable energy program has been in existence for nearly 12 years and has approximately 10% participation amongst our residential customers. In the Scoping Plan, the ARB identified the need to engage the public in reducing emissions. Voluntary purchases of renewable energy, such as SMUD's Greenergy program, are one of the easiest ways to enable public participation in achievement of the objectives of AB 32. Without an adjustment of base allowance budgets to account for these voluntary purchases, as many as a million or more Californians will in effect be told that their voluntary efforts do not matter for purposes of affecting climate change (as their efforts would then not change the total amount of CO₂e that is emitted in California). Inclusion of a base budget adjustment to reflect voluntary renewable purchases will not have a negative impact on participants in a Cap-and-Trade program because for each allowance retired as a result, a voluntary investment in emissions reduction will also have occurred, reducing the demand for allowances in the market and thereby minimizing any price effect in the market. These base budget adjustments should be for new renewable energy in California that is serving the voluntary market, and the ARB should encourage other WCI jurisdictions to adopt the same rules.

E. Pipeline Biogas Must be Acknowledged Explicitly in Mandatory Reporting Regulations

Pipeline biogas offers an opportunity to construct renewable energy facilities remotely from the load they serve without increasing the burden on our transmission system. It provides an opportunity to burn biogas in a cleaner, more efficient manner than onsite combustion. These contracts connect bio-digesters in otherwise emissions constrained areas with existing clean burning combined cycle power plants, displacing natural gas demand here in California. These types of contracts should be encouraged by the ARB as a way to reduce California's reliance on natural gas. The ARB should explicitly state in its mandatory reporting regulations that any facility that has been nominated to burn biogas should subtract the amount of biogas purchased from the natural gas combusted at that site for the purposes of reporting and compliance. Separate reporting of the biogas is not enough to ensure that entities making these investments will receive appropriate credit.

F. RPS Achievement Should be Considered for Early Action Credit

The PDR points to the EAAC process for recommendations on Early Action Credit, however thus far, SMUD has not seen this issue in the draft EAAC recommendations. Without some clear direction here, investments by covered entities prior to implementation of the Cap-and-Trade may be delayed. In addition, depending upon how allowance allocation is established, entities that have made these early investments rather than delaying them may be disadvantaged. One example of such early actions involves actions pursuant to California's Renewable Portfolio Standard (RPS). SMUD adopted an RPS in 2001 of 20% renewables by 2011 and accelerated its goal in 2008 to be consistent with the state's accelerated targets of 20% by 2010. SMUD is achieving those targets through significant financial investments. SMUD will have to raise rates to pay for these investments. SMUD could have been less

aggressive in our pursuit of renewable energy and fallen short of those goals, thereby incurring less cost to our customers. However, we have been pushing very strongly since 2004 to increase our RPS levels. In 2003, SMUD was at 6% renewables, and through focused investment SMUD has raised our percentage of resources from renewable sources to 12% by 2006 and 21% by 2009 (including 3% dedicated to Greenergy rather than RPS). While this is consistent with SMUD and state policy, few other utilities have been able to follow suit. ARB should compensate SMUD's customers with early action credit for this aggressive and successful achievement. This could be done by measuring against a benchmark of the other utilities and crediting SMUD for RPS levels that have gone beyond this benchmark. While we acknowledge that this effort was made in response to SMUD Board policy, we would point out that it is unlikely that this disproportionate investment will be explicitly recognized in allowance allocation schemes that have been proposed thus far.

Partial Submittal of Compliance Obligation Annually

SMUD supports the underlying flexibility that is inherent in a three-year compliance period as proposed in Section 95930, and at this time supports the concept of partial submittal of compliance obligation as described in Section 95960. SMUD believes that such partial surrender will help ensure that prices remain stable in the cap and trade program, in addition to protecting the Cap-and-Trade structure from intentional or unintentional avoidance of obligations through bankruptcy or similar business decisions. SMUD also believes that partial surrender can help protect regulated entities such as ourselves, which are unlikely to declare bankruptcy or otherwise avoid a compliance obligation, from the risk of shouldering additional burden under the Cap-and-Trade structure due to unregulated entities following these practices.

Clearly, 100% surrender is equivalent to annual compliance, which is problematic from a flexibility consideration, and we encourage the ARB to consider flexibility criteria including hydro-variability, market uncertainty, offset development ramp-up and others to determine an appropriate partial surrender level that does not overly constrain compliance flexibility. SMUD feels that a partial submittal level of approximately 70% would be appropriate; setting a level much higher than this would seem to limit the value of having a 3-year compliance period from a flexibility standpoint.

In addition, SMUD notes that with annual reporting requirements in place, partial surrender administratively becomes very similar to annual compliance. The protocols for this partial surrender are presumably similar to annual compliance protocols, though the combination of partial surrender with a three-year compliance period preserves flexibility in comparison to strict annual compliance. However, SMUD believes that a three-year compliance period may not provide sufficient flexibility in certain circumstances, such as the electricity industry finding itself in a difficult position due to a poor hydro year that corresponds with the final year of a compliance period, where presumably 100% of that year's needed allowances must be surrendered in addition to the remaining percentages of previous year's allowances that were not covered by any partial surrender. SMUD believes that some sort of 'rolling compliance' may be another useful strategy for the ARB to consider to provide flexibility.

For example, the ARB may wish to establish a system where an entity surrenders 50% of their obligation in the year in which the obligation happens, 25% the following year, and 25% in the third year. This system could provide similar or better flexibility to a three-year compliance period while protecting against price volatility and bankruptcy similarly to partial surrender or strict annual compliance. After the second year of the Cap-and-Trade, covered entities would annually be surrendering obligations related to three individual years, and would fully cover any year's obligation within three years, ensuring environmental integrity while providing some flexibility to account for hydro variability and other uncertainties.

Concepts for a Price Collar

The first two concepts, either an allowance reserve or allowing more offsets to be used, are both appropriate mechanisms for maintaining a stable upper end of a price collar. The latter two concepts examined in the PDR are not acceptable, as they are likely to compromise the environmental integrity of the cap. The first two mechanisms, if used in conjunction with one another may create a much more reliable price collar than if either mechanism were used on its own. By allowing additional use of offsets after a strategic reserve is used up, the price collar would be more likely to constrain prices to within an acceptable range without sacrificing the environmental integrity of the cap. SMUD encourages the ARB to consider using both mechanisms to ensure that the costs of the Cap-and-Trade program remain reasonable and stable enough to provide a clear price signal to investors in carbon reduction measures. In addition to stabilizing the upper end of prices, SMUD feels a price floor, escalating at no more than the rate of inflation, would help provide investment certainty for the market. Failure to utilize some kind of price stabilizing mechanism would likely introduce uncertainties for investment in low carbon opportunities.

Conclusion

SMUD supports the impressive first draft of the proposed Cap-and-Trade regulation issued by ARB staff on November 24, 2009, and is generally in agreement with the preliminary thinking of ARB staff expressed in the PDR. Thus, we have limited our comments to emphasize a short list of issues where significant work remains to be done. Of these, perhaps the most critical is our concern over the expected recommendations of the EAAC to require the electricity sector to make emission reductions beyond our fair share in order to pay for reductions needed from other sectors. This would place an excessive burden on our sector and frustrate the expectations of our customers, with potentially troubling effects.

Our other comments merit your serious consideration as well. If the ARB wishes to ensure the environmental effectiveness of the cap, ALL major emitting sectors should participate from the outset. The transportation sector is too large and important a source of GHG emissions to wait for substantial reductions from the LCFS program and the Pavley standards. SMUD also believes that it is critical for ARB to offer the concerned public a direct means to reduce emissions by providing voluntary renewable set-asides in any Cap-and-Trade program. In addition, explicitly recognizing the greenhouse gas benefits of pipeline biogas enables the use of existing pipeline

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infrastructure to both reduce California's greenhouse gas emissions and our dependence on natural gas. While SMUD recognizes the RPS is required by law, most utilities in the state will not meet the 2010 targets, as a result, achievement of these targets could and should be considered a creditable early action. SMUD also supports an annual partial compliance obligation, and believes that such a mechanism, in combination with an environmentally effective price collar mechanism should ensure the price stability that is crucial for long-term investment decisions in lower carbon emitting energy supplies.

SMUD looks forward in the coming year to continuing the fruitful dialog that ARB staff has created on this vitally important mechanism for controlling the State's GHG emissions.

Respectfully submitted,

/s/

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