

LEG 2009-0359

August 21, 2009

Ms. Lucille Van Ommering
Cap-and-Trade Section
Office of Climate Change
California Air Resources Board
1001 I Street
P.O. Box 2815
Sacramento, CA 95812

Re: Sacramento Municipal Utility District's Comments on Linking California's Cap-and-Trade Program to Other Greenhouse Gas Trading Programs

Dear Ms. Van Ommering:

Thank you for the opportunity to provide comments on the topic of linking California's cap-and-trade program to other greenhouse gas (GHG) trading programs. Generally, SMUD agrees that linkage, if properly structured, is a potential cost containment mechanism to include in California's cap-and-trade design, thereby fulfilling the legislative intent of AB 32 to secure cost-effective reductions in GHG emissions. Linkage would also extend the influence of California Climate Change policies beyond its borders, which would realize another important legislative goal of AB 32.

More specifically, by linking a California-only or Western cap-and-trade market to compatible trading schemes, the ARB would widen and deepen the market for emission allowances, and thus tend to foster liquidity and price stability. Linkage would also provide an opportunity for more cost-effective emission reductions, by affording compliance entities access to additional, low cost GHG reduction options that could mitigate the cost and accelerate achievement of California's GHG goals. Not only does linkage present the prospect of more bang for the buck for California businesses, but it could enable more inflows of capital into California to reduce the cost of carbon reduction projects. These economic benefits, and potential extra-territorial environmental benefits, support linkage as an effective tool to accomplish our shared goals in an efficient manner. In the following comments, SMUD will identify certain economic and environmental co-benefit issues that must be addressed in linking with other carbon trading schemes.

Linkage to Other GHG Trading Systems

SMUD supports bilateral linkage to other GHG trading systems with similar stringency and trading rules, such as the European Union Emission Trading Scheme (EU ETS). Linking to compatible systems can result in local benefits, including cost savings in reducing emissions, fostering a world price for carbon that places California (and American) firms on a level playing field with their international rivals, and improving the function of our carbon allowance market. However, linking also has complexities. For example, California needs an efficient process for approving international credits before they should be counted for AB 32 compliance. We need rules to avoid double-counting of international credits. And, we need a minimum symmetry in structure between systems to ensure integrity, such as comparably stringent compliance targets, and reliable monitoring, verification and enforcement mechanisms. In addition, California should not link with systems that include a "safety-valve", loose offset rules, or excessive borrowing from future obligations, as well as with systems that are themselves linked to other systems with dissimilar stringency and trading rules. SMUD believes that these structures can not only act to challenge attainment of California's GHG reduction goals, but present undue risk to market participants that may become overly reliant on cheaper allocations from these linked sources, only to find that discount rug pulled out from under them when rules change to reject these sources in order to maintain California's goals. With respect to loose offset rules, SMUD believes that systems where linkage is being considered should allow compliance with offsets similarly to that proposed in California – where a majority of the reductions from covered entities must be achieved through in-system mitigation choices, not offsets.

The EU ETS represents a suitable trading system to link with California. It's monitoring and reporting standards are high, and emissions data is now reported more frequently and transparently than in Phase 1. Phase 2 also has a more effective compliance regime than before. The Phase 3 emissions cap, which begins in 2013, will require substantial reductions. It holds allowances in fast and secure electronic registries, and uses an international communications protocol developed under the Kyoto Protocol. It embraces a free market approach, with no price controls. And it allows banking and limited borrowing. If AB 32's allowance market can be designed so that it is compatible with the EU ETS, then California and Europe would encourage the inclusion of emerging economies, particularly those of China and India, to address Climate Change more forcefully. On the other hand, SMUD believes that the Regional Greenhouse Gas Initiative (RGGI) system currently does not have comparably stringent compliance targets to California, and linkage to this system should be avoided, at this time.

One specific complexity that the State must consider in linking to other systems involves the comparability of the points of regulation between or among systems. In California, the 'first-deliverer' approach includes regulating emissions from electricity imports to the State, and these emissions often must be estimated, as they cannot be traced to a specific source. The EU ETS, which is source-based, may have concerns with our allowances because California will have to use default emission factors to calculate imports. However, so long as our accounting methods are consistent and constant,

SMUD believes that a different point of regulation is not a fundamental impediment to linking the two systems.

With regard to the logistics of linking, SMUD believes that market disruption will be minimized if linkage decisions are transparent, gradual, and mutual. California stakeholders must have advance knowledge of potential linking or de-linking decisions, in order to estimate and prepare for the market changes that will inevitably result from those decisions. SMUD believes that linkage structures should be effective at least a year after a linkage agreement is reached, and that consideration should be given to phasing in access to allowances in the linked markets over a period of two to three years to allow for orderly market transition. Similarly, SMUD believes that decisions to de-link from another system due to changes in that system's structure that make the environmental integrity unacceptable should happen with sufficient advance knowledge (approximately one year) that market participants are able to reasonably alter their positions in the market. De-linking should be phased, if possible, to minimize market volatility.

Finally, linking to another cap-and-trade system is not a unilateral decision, but requires joint agreement with that system. These joint agreements should be established with transparency to market stakeholders with ability to comment, and should include up-front procedures that identify the phasing of the linkage action as well as the protocols for de-linking due to changes in one system or another. A de-linking decision should be allowed by either party as a unilateral decision, not requiring joint agreement, but the conditions under which such decisions may be triggered can be laid out to the extent possible in the original linkage agreement. One obvious concern with any agreement is the U.S. Constitution's prohibition on states from entering into treaties with foreign nations. Some kind of mutual recognition without a treaty would be required.

Linkage to Credit Reduction Systems

SMUD supports unilateral linkage to allow California's cap-and-trade system to accept credits from, but not trade allowances into, viable credit reduction mechanisms such as the Low Carbon Fuel Standard (LCFS) system in the state. Such a linkage will help to reduce California's GHG reduction costs, reduce emissions from California's largest emitting sector, promote electrification of the transportation sector, and integrate these two flagship California climate programs. There have been some indications that LCFS credits created through transportation electrification may be faced with informal trading restrictions in the LCFS market, so a viable outlet for these credits should be established by a unilateral link allowing one-way sales of LCFS credits into the cap-and-trade market. The GHG reduction burden of the electricity sector is complicated by load growth from electrified transportation – essentially a transfer of reduction obligation from the transportation sector to the electricity sector. SMUD believes that the State's carbon policy should embrace this strategy and act to mitigate the effects on the electricity sector's reduction burden by, among other things, accepting LCFS credits into the State's cap-and-trade system, at least until the transportation sector is brought under the cap. Once under the cap, an LCFS credit would no longer have a carbon

value and thus would not be tradable into the larger AB32 market. In this case it may be more appropriate to adjust allowance allocations between the transportation and electricity sectors to continue to incent the introduction of electric vehicles into the transportation sector.

In addition to the Low Carbon Fuel Standard, SMUD supports the use of State-approved international credits (such as certified emission reductions or “CERs”) through the Clean Development Mechanism (CDM) under Kyoto or another framework for measuring and certifying GHG reductions. Approving CERs would require evaluation of the issuer’s process to ensure that the reductions are real, verifiable, additional and possess other attributes required under AB 32. This is true whether the CERs are created through a project-based approach or a sectoral approach. SMUD sees benefits to either approach for offset creation, and encourages the ARB to explore the creation of sectoral approaches to encourage creation of high quality offset projects, both at home and abroad.

Limits on Linkage

While SMUD supports linkage with other appropriate GHG trading systems and CERs mechanisms as mentioned above, SMUD also believes that the State should reasonably limit the use of these reductions in order to ensure that over time real reductions are occurring within California. While California’s renewables portfolio standard (RPS) and energy efficiency programs will also act to ensure GHG reductions in the State, ensuring that a portion of reductions come from within the State will enhance co-benefits associated with climate policy by driving economic investment, reducing environmental copollutants, and preparing California’s economy for a low-carbon future. Balancing these objectives is important for a policy with such far-reaching implications as this one.

State-approved CERs are, at times, indistinguishable in character from offsets. These credits represent reductions from uncapped sectors or regions that have been made available through a certified credit protocol, such as the CDM, for use in cap-and-trade systems and other structures according to the rules of those programs. SMUD believes that these credits are similar enough to offsets in general that they should fall under the offset limit being contemplated by ARB – no more than 49% of reductions can come from offsets *and credits from credit reduction mechanisms*. SMUD recommends that this restriction, however, should not apply to LCFS credits, as these credits represent actions that reduce emissions and provide economic benefits within the state.

SMUD has no recommendation for a limiting allowances resulting from bilateral linkages between reasonably similar cap-and-trade systems at this time, but recommends that these allowances be carefully tracked in order to allow quick consideration and adoption of appropriate limits if it is determined that these linkages are acting to undermine California’s climate change goals. Since trade here can go in either direction, such linkages may result in additional reductions within California, or vice-versa, but in any

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regard should reduce costs and achieve valuable GHG emission reductions commensurate with California's goals.

Thank you for the opportunity to comment.

Respectfully submitted,

/s/

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cc: Corporate Files