SMUD
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June 7, 2010

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 Allowance Allocation in a California Cap-and-Trade Program

Dear Ms. Van Ommering:

The Sacramento Municipal Utility District ("SMUD") appreciates the opportunity to offer our recommendations to ARB staff related to the allocation of allowances under the proposed Cap-and-Trade Program. We recognize the difficult nature of this design element and its paramount importance to the success of the program. Fundamentally, SMUD believes that an effective program will not only put a price on carbon, but it will leverage the value generated to reduce the costs of zero- and low-emitting alternatives. This design element can be built into any sector allocation approach, and will ensure not only that the State meets its reduction goals, but that it does so in a way that shows leadership in growing a sustainable economy for the 21st century.

For the electricity sector allocations, SMUD has offered comments previously on the importance of allocating allowances to the benefit of ratepayers in a way that ensures that the value is directed toward measures which reduce emissions. The most effective way to ensure that happens in the electricity sector is through the regulated Local Distribution Company (LDC). It is the LDC that makes resource decisions, builds and administers efficiency programs, reduces disproportionate burden on low income households, and more. Note that the LDC is unable to use the value for purposes other than those directed by its regulators. The State of California has long-recognized the value in driving innovation and protecting the environment through the regulated utilities. Allocating allowances to regulated LDC's, and requiring that the value be spent on measures that reduce emissions (such as the RPS) is consistent with this long-standing policy.

The ARB should put the responsibility of determining the best use of that value with the responsible regulator – the California Public Utilities Commission (CPUC) for the investor-owned utilities (IOUs), and the governing boards of the publicly-owned utilities (POUs). By doing so, the ARB will enable informed regulators to make decisions that provide cost-effective emission reductions. Determination of value use should not be made centrally, through set percentages, but rather locally, based on climatic conditions, resource availability, customer types, and other factors that vary widely across California.

While ARB staff suggested allocations to cover only the cost of implementing the RPS/RES, it is important to recognize that there are other mandates on utilities, that in combination will put the sector below its share of the State's 2020 emissions target. These costs will put upward pressure on electricity rates. It is in this context that we recommend that the ARB allocate allowances equivalent to the full historic emissions level of the electricity sector among the LDC's. A smaller allowance allocation to LDC's to accommodate other requests amounts to an unfair burden being placed on the State's electricity consumers. The electricity sector represents 23% of the State's emissions, and offers a pathway toward steep reductions through fuel-switching. But layering on substantial rate increases at the outset of this program will ultimately hamper that long-term potential by restricting the ability of LDC's to pay for needed infrastructure to support the addition of substantial transportation loads.

Within the electricity sector, considerations must be made for allowance allocations among LDC's to ensure that there is fairness across diverse LDC customer bases. Fairness can be evaluated from a variety of different standpoints. Historic LDC resources, climate, costs of early action, access to renewables, efficiency and CHP opportunities, exposure to climate change impacts, customer demographics, and other factors all contribute to developing a determination of a fair allocation. Therefore, it is necessary to develop a solution that provides a compromise between mitigating near-term rate impacts as the program phases in, and ensuring a level, consistent signal to all parties to reduce emissions as the program reaches maturity. This transition element in the electricity sector is best represented by an approach which initially favors a majority of the emissions allowances being distributed on a historic emissions basis, but transitions to a majority of the emissions allowances being distributed based on retail electricity sales.

Of the portion of allowances provided to electricity LDC's, it is reasonable to expect that some portion should be directed to expenditures related to community benefit funds. While there are clearly a broad range of measures which disadvantaged communities desperately need, directing this allowance value to measures that reduce emissions and reduce energy use is most germane to the declarations and intent of the Legislature in

passing AB 32.[1] Energy efficiency is one of the most cost-effective measures available to reduce emissions. More can and should be done to ensure that our disadvantaged communities are among the most efficient in the use of energy in California, so that those who can least afford rate increases are protected by reducing the amount of electricity they need to purchase. Electricity LDC's are the best at providing energy efficiency solutions, and some portion of the allowance value provided to LDC's should be directed to expanding energy efficiency programs within disadvantaged communities.

ARB staff is considering two tiers for use of allowance value, with 'senior uses' in a 1st Tier and 'subordinate uses' in a 2nd Tier. This structure may have made sense in the context of the EAAC allocation recommendations, where a small amount of allowance value reserved for important senior uses, but it loses value in the context of the ARB staff's proposed allowance allocation policy. In effect, the structure has all or nearly all of the industrial sector allowances initially in the 1st Tier of senior uses, while all or nearly all of the electricity sector allowances are in the 2nd Tier of subordinate uses. SMUD thinks that this is inappropriate for two reasons. First, the structure implies that allocation of allowances to the electric sector, and targeted public investment with that allowance value, is subordinate in importance to allocation of allowances to the industrial sector, and use of that allowance value for leakage prevention. SMUD believes that the public investments in AB 32 related programs in the electric sector should at least be placed on a par with industrial sector leakage protection. Second, while the ARB has indicated that leakage protection in the electric sector is handled through the First Jurisdictional border adjustment, this practice only addresses the primary leakage of electric generation from in-state to out-of-state. It does not address the secondary leakage that may occur from commercial businesses shifting activity outside the state due to higher in-state electric prices caused by allowance costs. Hence, the proposed and commendable policy of providing allowances to the electric sector for targeted public investment also has a leakage prevention purpose, similar to the 1st Tier placement of industrial sector allowance policies.

SMUD recommends that the ARB adopt one of three alternatives to the Tier structure. First, the ARB could avoid use of a Tier structure altogether, as the structure does not seem to provide significant value to consideration of the proposed allowance allocation policy. Second, if the ARB believes that there is conceptual value in consideration of a Tier structure, the ARB could establish a three Tier structure, where: (1) the first Tier included small amounts of allowance value for purposes such as an allowance reserve (though SMUD believes that a reserve should not be funded from within the current pool of allowances); (2) a second Tier included the allowances allocated to the industrial and electric sectors for leakage prevention and targeted investments; and (3) a third Tier signals the intent to eventually include or phase in a consumer rebate program. Finally,

[1] *See* Health & Safety Code, § 38501.

ARB could simply move the electric sector allowances and use for targeted public investment up to be part of the 1st Tier of senior uses, on par with industrial sector allowances and use for leakage prevention.

The Staff presentation touched briefly and at high level on use of an “Allowance Reserve for Price Mitigation”, slide 28. Without additional detail on a number of specifics, it is really not possible to determine the Staff’s proposed Reserve architecture. However, to the extent staff proposes use of a reserve, SMUD suggests that Reserve Allowances not be drawn from the current compliance period allotment. Instead, the ARB should consider the use of the difference between pre-recession and post-recession business-as-usual trajectories to fund the reserve. Such a funding mechanism accounts for the natural economic variability that a reserve is intended to account for, while not compromising attainment of the 2020 goal.

To the extent that a reserve is funded by drawing from future vintages, this should not include assessment of additional allowances in the form of assessed interest or fees. Any such interest or fees should be financial, and not further reduce availability of allowances under the cap. For instance, use of a future allowance (as from a Reserve or other forward usage scheme such as the Discussion Draft Federal American Power Act, sec.723(c)(2), Borrowing with Interest, p.346) should not result in more allowances being retired than the emission face value of the allowances; any fee or interest amount assessed should be financial, not calculated in allowances. This should apply as well to fines for non-compliance, since levying fines as a percentage of allowances, beyond the amount needed for compliance, could tend to raise costs for all market participants not just those that are noncompliant .

Finally, to the extent that the ARB intends to maintain allowance value within economic sectors, SMUD encourages the ARB to consider the important effects that fuel switching will have as an emissions reduction measure, and to adjust sectoral allocations accordingly. Electrification of the transportation sector, CHP, heat pumps, and agricultural electrification all represent potentially significant opportunities for reducing emissions via fuel-switching; however, these opportunities may be hampered if allowance allocation policy does not recognize and encourage these types of measures. The ARB should consider transferring the allowance value of, at a minimum, the new emissions that result from the fuel switching. Such allocation policy will at a minimum hold the sector accepting the new emitting activity harmless, and potentially offer a significant incentive for entities in the new sector to encourage such fuel switching as a means to help the state reduce emissions. Allowance allocation should not only be looked at as a way to minimize pain to different economic sectors within the State, but should truly be looked at as an opportunity to create the benefits that were envisioned when the State embarked on this initiative. The value should be dedicated to building the new economy by making new capital available to invest in cost-effective emission

reduction measures, and allocated in a way that encourages greater efficiency and economic growth.

Respectfully submitted,

/s/

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WW:dm

cc: Kevin Kennedy
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Corporate Files