BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.	Rulemaking 06-04-009 (Filed April 13, 2006)

SACRAMENTO MUNICIPAL UTILITY DISTRICT'S REPLY COMMENTS TO OTHER PARTIES' COMMENTS ON ADMINISTRATIVE LAW JUDGE'S RULING REQUESTING COMMENTS ON EMISSION ALLOWANCE ALLOCATION, COMBINED HEAT AND POWER, AND FLEXIBLE COMPLIANCE POLICIES

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The Sacramento Municipal Utility District ("SMUD") hereby files its reply to comments on the Administrative Law Judges' Ruling Updating Proceeding Schedule and Requesting Comments on Emission Allowance Allocation Policies and Other Issues (April 16, 2008 ("Allocation Ruling")).

Specifically, SMUD offers these additional comments pertaining to SMUD's preferred fuel-differentiated, output-based allocation method, which SMUD described in its June 2, 2008 comments on the Allocation Ruling. SMUD's preferred allocation method would allocate allowances on an annual updating, output basis with allowance allocation further differentiated by coal and non-coal resources. New eligible renewable resources would be allocated allowances, and consumer energy efficiency savings would receive due credit. Non-carbon emitting resources existing before passage of AB32 would receive no allowances.

In addition, SMUD disagrees with concerns expressed by independent power producers ("IPPs") that Staff's proposed options for returning auction revenues to retail providers raise competitiveness concerns because Staff proposes that allowance value be returned to LSEs in proportion to retail activity.

I. **<u>Fuel-Differentiated, Output-Based Allocation Can Resolve Reliability and Inequity Issues.</u>**

In recommending an output-based method for allocating the value of allowances, SMUD was in agreement with many parties in recognizing the positive inherent policy incentives for use and deployment of low and zero carbon resources (e.g., PG&E, p.20; REMA, p.10; Calpine, p.1; Sempra Electric Utilities, p.2; Solar Alliance, p.4; and others). However, simple application of the output-based allocation principle will lead to unacceptable grid reliability issues and politically unacceptable disparate impacts to ratepayers, as noted by multiple parties. (SCPPA p.37; LADWP, p.22; PacifiCorp, p.4).

Throughout the discussion of allowance allocation issues in this proceeding, SMUD has advocated policy that would not only be fair to its own bill paying customers, but would also treat customers across all of California fairly and in a manner that preserves local revenue for each retail provider to fight climate change through local measures. For this reason, throughout this Joint Commissions' process, SMUD has voiced a preference for allocating allowance value to electric resource providers on a hybrid basis, by combining an initial emissions-based allocation method with an output-based method. Analysis conducted through workshops and the E3 model has led SMUD to adopt a simpler output-based allocation methodology from the start, albeit one needing fine tuning to equitably address fuel-differentiated allocation value.

II. **<u>The Fuel-Differentiated, Output-Based Method Provides Lower Costs Without Creating Inter-Regional Wealth Transfer</u>**

Using the E3 model and noting both the Joint Commission Staff's identified output-based MCP Effect on bidding (Staff Whitepaper, p.27), and the value of fuel-differentiated allocation values in equalizing initial resource mix issues, SMUD selected its preferred allocation method due to its simplicity and lower overall cost to California's consumers. Further evaluation and public discussion of fuel-differentiated allocation methods will be needed to find an optimum value. Without fuel-differentiation, several parties (LADWP, SCPPA, Calpine) and the Staff Whitepaper correctly note that large compliance costs could be placed upon customers of high-carbon utilities under a pure output-based approach. SMUD asserts that, contrary to the position espoused by Calpine, fuel-differentiated valuation is an essential attribute for an output-based approach to minimize disparate impacts of reducing statewide emissions between electric customers.

III. **The Fuel-Differentiated, Output-Based Method Provides Grid Reliability**

SMUD also asserts *that it is vitally important to any GhG cap and trade program that includes the electricity sector that the issue of coal versus natural gas fueled generation be examined to avoid unintended consequences*. Operating costs for the current fleet of carbon-laden coal-fired generation are far lower than cleaner, newer fossil-fired resources. The Plexos modeled resource mix for 2020 and the E3 model upon which it is based, paint a plausible, economically viable scenario, but one which presumes intelligent master control of GhG emitting resources; a reasoned possibility under LSE-controlled purchasing and dispatch decisions. However, left to survival mode instincts of individual generators, the low-cost, high-carbon plants can consistently underbid cleaner generators and use more of the limited pool of allowances than is compatible with the Plexos' optimistic outcome.

The reliability issue is highlighted by both Dynegy and NCPA. Each, in their own way, raises concerns about scenarios in which allowances become scarce and, as a result, force generators to curtail output. In yet another instance, this time in GPI's comments, specific operating cost differentials between coal and natural gas generators illustrate an example that could well create unintended allowance shortages. The comments by Dynegy highlight the difficulty generators face as the point of regulation; "LSE's are more likely to have more options for achieving carbon reductions than are generators. As there are no proven technologies for removing carbon from fossil fuel emissions*, a generator's only option for reducing carbon emissions is to generate less*. LSE's however can reduce emissions by shifting purchases to less carbon intensive producers, demand reduction and efficiency programs." (Dynegy, p.4) (emphasis added). NCPA describes the reliability issue in greater detail (NCPA, pp. 9-11) and GPI offers some fuel-differentiated operating cost margin examples (GPI, p.11) that describe how low-cost, coal-fired facilities, acting in reasonable self interest, could purchase allocations that other, lower emitting fossil-fuel generation would need to remain available throughout the compliance period. As Dynegy notes, it is the role of LSEs, not the generators, to plan for a reliable grid resource mix. Generators can only purchase what they can afford, and as the GPI analysis shows, coal-fired facilities can afford to purchase more.

For this reason, as well as to mitigate regional resource mix issues, SMUD believes strongly that, with the Deliverer as the Point of Regulation, a fuel-differentiated allocation method is a necessity. The imposition of separate caps for coal and non-coal fired resources might be an alternative, but the current record in this process offers no discussion of that concept.

IV. **A Fuel-Differentiated, Output-Based Allocation Approach Can Minimize Cost Effects of a Cap and Trade on the Electricity Market**

Several parties (WPTF, p.29; SCE, p.9; GPI, p.13; SCPPA, p.39; IEP, p.14) made reference to the Market Clearing Price ("MCP") effect and its appropriateness for use in evaluating the different scenarios. SMUD finds the Staff Whitepaper and referenced papers (Burtraw et al. 2001, 2005; Fisher and Fox 2004) to be compelling in their discussion of the significantly reduced price increases associated with the output-based approach as compared to either emissions-based allocation or auctioning of allowances. As a result, SMUD disagrees with the recommendation of the WPTF that this effect should be disregarded, and finds WPTF's justification only applicable to an auction-based approach. We also disagree with SCE's assertion (SCE, p.10) that a fuel-differentiated output-based allocation is essentially the same as an emissions-based allocation. We see the significant reduction in the MCP effect as the critically important difference. We agree with SCPPA (SCPPA, p.39) that Staff should pursue modeling to better quantify this effect.

V. **Competitiveness Issues Are Not a Concern in the Staff's Proposed Options**

Much was made in the IPPs' opening comments regarding the potential for anti-competitive allowance distribution in California's hybrid market. (IEP, Summary, pp.9-10, and Attachment A, p.12; Dynegy, pp.10-11; Calpine, p.12). In particular, Dynegy speculates, but does not demonstrate, that the allocation of allowance value to LSEs with generation would act as an incentive for those LSEs to build more of their own generation rather than to seek it through competitive solicitations. (Dynegy, p.11). SMUD disagrees with this assertion and points to the Staff Whitepaper's description of the auction revenue return mechanisms (Staff Whitepaper, p.38) as clear evidence that this would not be an outcome.

In the Staff Whitepaper, Staff described several ways that auction revenues could be returned to retail providers. (Staff Whitepaper, pp.33-34). SMUD has repeatedly stated that this additional revenue should be used solely for rate relief or to support GhG reductions through enhanced energy efficiency programs or new renewable energy procurement. If designated for rate relief, then these funds would be returned to customers and the funds could not be used by LSEs to out-compete IPPs in California's hybrid market. For those monies not designated for rate relief, LSEs would bear the same or similar costs to build new generation as they would to procure it from third parties. In fact, IEP points out (IEP, p.14) that LSEs could use the auction revenues for power purchase agreements with IPPs for new renewables.

The question raised by Dynegy of whether allowance value given to LSEs might provide LSEs an unfair competitive advantage over IPPs misinterprets the basis upon which the Staff Whitepaper proposes to distribute allowance value. The allowance value distribution from an auction (described in the Staff Whitepaper at p.38) is to be based upon either *retail* sales or emissions associated with *retail* sales. In neither case does the Staff refer to ownership of the underlying generation resources. The decision by an LSE to construct versus purchase new generation is not one that would be influenced by the potential for additional free allowances. LSEs would receive the same allowance value under the proposed options, irrespective of their decision to purchase or own new generation, because Staff proposes that allowance value be returned in proportion to retail activity.

VI. **<u>Allocation of Allowances to New Renewables is Appropriate</u>**

SMUD agrees with the proposal in REMA's comments (REMA, p.9) regarding the allocation of allowances to new renewables as a means to encourage voluntary renewable energy purchases. Such an allocation would allow voluntary renewable energy programs to continue to be an effective way to reduce statewide emissions and encourage the development of more renewable energy. Further, such allocation would provide incentives for faster development of new renewables for meeting RPS obligations. We also note the comments made by the Solar Alliance support this approach. (Solar Alliance, p.4).

VII. **Summary**

In summary, SMUD continues to urge the Commissions to incorporate the flexibility of a fuel-differentiated output-based allocation, in order to minimize costs and incent the right actions within the electric sector to move quickly towards reducing emissions. We appreciate the opportunity to provide these reply comments, and look forward to helping the Commissions craft recommendations that are in the best interest of the environment and of all of California's electricity customers.

Dated: June 16, 2008

Respectfully submitted,

DOWNEY, BRAND, LLP

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933186.2

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the attached:

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on all known parties to R. 06-04-009 and CEC Docket No. 07-OIIP-01 by transmitting an e-mail message with the document attached to each party named in the official service list. I served a copy of the document on those without e-mail addresses by mailing the document by first-class mail addressed as follows:

See attached service list

Executed this 16th day of June, 2008, at Sacramento, California.

/s/
Lois Navarrot

Service List R. 06-04-009, as of June 16, 2008

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Re: Docket No. 07-OIIP-01
1516 Ninth Street
Sacramento, CA 95814-55