June 12, 2009

Mr. Kevin Kennedy, Chief
Office of Climate Change
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Comments from Pacific Gas and Electric Company, Southern California Edison Company, and Sempra Energy on the Use of Allowance Set Asides in a Cap-and-Trade Program

Dear Mr. Kennedy:

Pacific Gas and Electric Company, Southern California Edison Company, and Sempra Energy (collectively referred to herein as "Utilities") welcome the opportunity to provide these preliminary comments in response to the California Air Resources Board ("ARB") Staff's May 18, 2009 workshop on the "Use of Allowance Set Asides in a Cap-and-Trade Program." We appreciate the ARB's efforts to consider a set aside component of a cap-and-trade market.

A. POSITION ON USE OF ALLOWANCE VALUE

In determining the use of cap-and-trade allowances to support the California Global Warming Solutions Act of 2006 ("AB 32"), the ARB should be guided by environmental integrity and customer cost criteria. First, the objective of any proposal for the use of allowances should be to accelerate emission reductions and help transition Califonia's economy to low-carbon technologies. Second, because the ultimate costs of meeting sustained greenhouse gas ("GHG") reduction goals in the electric sector will flow through commodity markets to utility customers, allowances or revenue from allowance auctions should be used to mitigate those increased customer costs. The Utilities believe that the discussion of set asides cannot be divorced from a discussion of the use of allowance value under AB 32 to mitigate costs to customers. Like the ARB's other GHG reduction measures, set asides of allowance value should be available only if they result in real, permanent, verifiable, quantifiable, enforceable, and additional GHG reductions.

B. DEFINITION OF ALLOWANCE SET ASIDES

In the context of the ARB's May 18, 2009 workshop and presentation on the "Use of Allowance Set Asides in a Cap-and-Trade Program," "set asides" refer to either a given amount of allowances, or allowance value removed from the total pool of

allowances or auction revenue, and distributed to entities implementing voluntary emission reduction projects in support of AB 32 reduction goals. The Utilities assume that set asides would be available only to voluntary emission reduction projects in capped sectors that achieve reductions after January 1, 2012.[1] These assumptions underlie the Utilities' discussion of set asides below.

C. SET ASIDES FOR VOLUNTARY REDUCTIONS

a. The Use of Set Asides Should Achieve a Public Purpose

Any proposal for the use of set asides should achieve a public purpose in support of AB 32 objectives that represents the best use of allowance value. Any allowances used for set asides would no longer be available to California utility customers, and any mechanism that removes allowances from the market has the potential to increase allowance prices and compliance costs. Therefore, any allowance value that is not returned directly to customers must achieve additional, cost-effective emission reductions on behalf of customers, or otherwise meet the statutory objectives of AB 32 as it relates to sectors covered by the cap-and-trade program.

To ensure that a set aside program represents the best use of allowance value, the ARB should not support projects that create reductions achievable through other existing or proposed programs or incentives. Examples of existing or proposed programs to achieve emission reductions include, but are not limited to: a cap-and-trade mechanism, utility customer energy efficiency programs, the federal stimulus package, state incentive mechanisms, tax credits, and private equity. In particular, potential for voluntary energy efficiency projects duplicating energy efficiency savings funded through California Public Utilities Commission-mandated energy efficiency programs could be substantial in the electric and small natural gas customer segments.

b. The ARB Should Define Objectives and Criteria for the Use of Set Asides

The Utilities recognize that AB 32 stakeholders have many innovative ideas for reducing emissions in support of AB 32 goals and that research and demonstration is critical to developing long-term emission reduction technologies and projects. For projects whose purpose is to reduce emissions, the ARB should carefully define its expectations for GHG emission reductions or other goals achieved through set aside funding to ensure that proposed projects meet AB 32 objectives. The ARB should only set aside allowances after projects applying for the set asides can show that they are able to achieve GHG reductions at a lower cost per ton reduced than the cost per ton of direct reductions through cap-and-trade or other specific measures that the ARB might adopt.

Before distributing any set aside of allowance value, the ARB should establish a set of objective and transparent GHG emissions abatement cost-effectiveness criteria to

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[1] In this letter, we do not address early action credits or reductions made in capped sectors prior to 2012; nor do we address offset credits for reductions made outside the capped sectors as these issues are being addressed in other ARB workshops.

ensure that set aside projects represent the best use of allowance value from a customer perspective. These criteria should be used to systematically compare projects applying for set aside funding against each other through a transparent process that indicates how potential projects will achieve AB 32 GHG emission reduction goals. In addition, ARB should consider performance metrics or accountability criteria, including verification of emission reductions, for projects that receive customer funding through set asides of allowance value. Poor project performance could affect the overall success of a cap-and-trade program, and ARB must ensure that projects perform according to the pre-determined criteria.

c. The Method for Distributing Allowance Set Asides Should Not Remove Allowances from the Cap-and-Trade Market

The best approach for distributing allowance value for voluntary emission reduction projects that achieve reductions starting in 2012 is through direct transfer of auction revenues. This approach would most effectively correlate funds distributed with funds needed to achieve emission reductions, and would preserve allowances in the market for complying entities.

One proposed distribution methodology would transfer allowances directly to entities implementing voluntary emission reduction projects. This approach creates considerable uncertainty about the amount of funding available for project implementation. Assigning a set number of allowances with an unknown future value to an emission reduction project may not yield cost effective reductions equivalent to the funding required to achieve reductions. On the other hand, depending on future market prices, the value of such allowances could be much larger than the amount needed to finance the project. Emission reduction projects should receive no more and no less funding than is necessary and effective.

The Utilities understand that the ARB is considering allowing entities that receive allowance set asides to retire those allowances. If set aside allowances were retired, unless the project performed as anticipated and the estimated emissions reductions were equal to the quantity of allowances set aside for that project, increased scarcity and higher prices would result. Higher allowance prices increase compliance costs. The Utilities are concerned about any proposal that could increase compliance costs for California businesses and consumers and for our customers.

However, if the ARB nevertheless decides to retire set aside allowances, it must ensure that the reductions associated with those allowances meet the same performance obligations and standards as any other mandatory reduction in a cap-and-trade program. In that case, reductions must be verified and accounted for under California's cap-and-trade program.

D. COMMENTS ON ISSUES RAISED IN THE ARB WORKSHOP

a. Set Asides as a Mechanism for Meeting AB 32 Policy Goals

AB 32 policy mechanisms should transition California's economy to low-carbon technologies in a cost-effective manner. A cap-and-trade market serves those objectives through a carbon price signal that provides economic incentives for reduction opportunities. In some specific instances, this price signal to capped sector entities may fail. In those limited cases, set asides of allowance value may be an appropriate mechanism for meeting AB 32 statutory goals. The Utilities strongly prefer direct funding through the revenues from an auction to better match funding to program needs. However, for those limited cases, other funding or incentive mechanisms, such as tax credits, rebates or direct incentives to energy users, may be more cost-effective or administratively simple to administer than set asides of allowance value.

b. Mechanisms that Provide Incentives for Emission Reductions

A cap-and-trade market creates an economic incentive for low-carbon technologies and projects by creating a carbon price signal.

c. Set Aside Distribution

As stated above, any set asides of allowance value should be distributed through a transparent, criteria-based process that ensures that the use of allowance value meets AB 32 objectives and avoids duplication with existing programs, incentives, or funding. The Utilities' preferred methodology for distribution would ensure that set asides of allowance value remain in the cap-and-trade market, available in an allowance auction to entities that must comply with AB 32.

d. Program Limits

A limit on the use of set asides should be decided as part of a larger discussion of the use of allowance value. Because allowance set asides represent a subset of the total allowance pool in a cap-and-trade program, the question of how to use these allowances cannot be decided in isolation. The Utilities encourage the ARB to consider the larger context of allocation of allowance value before making any decisions about whether or how to distribute set asides of allowance value.

Thank you for the opportunity to provide these preliminary comments, in response to the ARB Staff's May 18, 2009 workshop on the "Use of Allowance Set Asides in a Cap-and-Trade Program." Please do not hesitate to contact us if you have any questions regarding these comments.

Very truly yours,

John Busterud
(Cathy Karlstad for John Busterud)

Michael M. Hertel

John W. Busterud
Director and Counsel
Environmental Affairs
Pacific Gas and Electric Company

Michael M. Hertel
Director
Corporate Environmental Policy
Southern California Edison Company

Michael Murray
Regional Vice President
State Government Affairs
Sempra Energy

cc: Ms. Claudia Orlando