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Clerk of the Board
California Air Resources Board
1001 I Street
PO Box 2815
Sacramento, CA 95812

Re: Pacific Gas and Electric Company's Comments on the Air Resources Board's September 12, 2011 Proposed Modifications to the AB 32 Cap-And-Trade Regulation

Clerk of the Board:

Pacific Gas and Electric Company ("PG&E") is pleased to submit these comments on the Air Resources Board's ("ARB") proposed modifications to the regulation entitled "California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms" and accompanying materials, released September 12, 2011, under Assembly Bill 32 ("AB 32"). PG&E is submitting comments on the proposed modifications to the Mandatory Reporting Regulation ("MRR") under separate cover.

PG&E believes a well-designed, multi-sector cap-and-trade program – linked with emerging regional, national, and international programs – will allow California to meet its greenhouse gas ("GHG") emission reduction goals in a cost-effective manner as required by AB 32 (Cal. Health & Safety Code, § 38560). We appreciate a number of the modifications reflected in the latest version of the proposed regulation, to include: accounting for the greenhouse gas reduction value of out-of-state Renewable Portfolio Standard ("RPS") eligible resources; providing increased flexibility for the surrender of allowances within a compliance period; and deferring to the California Public Utilities Commission to determine the manner in which consignment auction proceeds are returned to investor-owned utility customers. PG&E would also like to thank ARB for continuing to recognize the need to design allowance allocation and the use of auction proceeds for the benefit of utility customers. Finally, PG&E supports ARB's decision to defer the start of the cap-and-trade compliance obligation until 2013 to allow necessary market simulations and testing of auction systems, design and protocols in the first half of 2012.

While ARB has made significant progress in the design of the cap-and-trade program, PG&E believes there are several important remaining issues that should be addressed in a supplemental

rulemaking in 2012. As discussed more fully below, we believe the planned market simulations will provide valuable insights with respect to market design and will allow ARB to make necessary modifications to the regulation prior to commercial and financial commitments being made in the first two auctions in 2012. To this end, we offer the following comments and will work constructively with ARB and all concerned stakeholders to ensure sustained GHG emission reductions, manage costs for our customers, and create a program that can serve as a model for others to follow.

I. INTRODUCTION.

PG&E's detailed comments on the proposed modifications to the regulation are set forth in Section II below. At the outset, however, the following summarizes issues which we believe are of critical importance to the successful implementation of AB 32's cap-and-trade program:

A. PG&E Strongly Recommends That ARB Establish A Contingency Plan In The Regulation To Address Potential Depletion Of The Allowance Price Containment Reserve ("APCR" or "Reserve"). (Section 95913)

- ARB should amend the regulation to establish a procedure to replenish the APCR in the event that the Reserve is depleted. With language in the regulation identifying the triggering event and actions ARB will take, the market will have assurance that a timely remedy will be in place.

B. An Adequate Supply Of Offsets Is Necessary To Ensure That The Goals Of AB 32 Are Achieved In A Cost-Effective Manner. (Sections 95854, 95985, 95990, and Forest Project Protocol)

- Because PG&E projects that the supply of offsets is likely to be inadequate to cover 8% of emissions in the early years of the program, PG&E recommends the ARB to allow complying entities the flexibility to use offsets up to the 8% limit over the entire cap-and-trade program.

- PG&E is concerned that reducing the percentage of sector-based offsets from 50% to 25% in the second compliance period will restrict supply at a critical stage of the program.

- The requirement for a project to meet all its legal and contractual requirements and terminate its relationship with a voluntary offset program before being listed by ARB is confusing and could restrict offset supply.

C. ARB Should Provide Sufficient Flexibility To Electrical Distribution Utilities To Procure Compliance Instruments For Their Contractual Obligations. (Sections 95834 and 95920)

- ARB should revisit the holding limit or beneficial holdings language in advance of the first auction to allow an electrical distribution utility to hold enough compliance instruments to cover its obligations to counterparties with which it has contracts for the delivery of electricity, and sufficiently hedge future obligations.

- An entity's holding limit should be the larger of the number given by the current formula or an entity's annual allocation of allowances. Alternatively, a beneficial holding agent should be allowed to (1) specify the timeframe for transfer to the principal, and (2) amend its request to transfer compliance instruments to the principal should the contractual obligation to transfer end up being less than stated in the original transfer request.

D. A Market Monitor Is Critical To The Success Of Cap-And-Trade And Should Be Included In The Regulation.

- The regulation should specify the authority and duties of the market monitor to include the responsibility of certifying auctions in a timely manner.

II. DISCUSSION.

To assist Staff in its review of our comments, the following detailed discussion is set forth on a section-by-section basis. Where appropriate, we have also provided suggested revisions to regulatory language.

Section 95802. <u>Definitions</u>.

Section 95802 (279). The defined terms of "Unspecified Source of Electricity" or "Unspecified Source" appear in both the MRR and Cap-and-Trade regulations in Section 95102(a)(399) and Section 95802(a)(279), respectively, and are used throughout each regulation. Because the two sets of regulations together form the requirements of the reporting entities, the defined terms in the respective regulations need to be identical for reporting entities to consistently comply with the regulations. In addition, PG&E has revised the definition to further clarify that an unspecified source will have no reference to any specific generation facility or unit in the transaction and that the treatment of electricity as unspecified cannot be contradicted by subsequent information. PG&E's proposed revision is as follows:

> "Unspecified source of electricity" or "unspecified source" means electricity procured and delivered without ~~limitation~~ reference ~~at the time of transaction~~ to a specific facility's or unit's generation at the time of transaction, regardless of the specification in the corresponding NERC E-Tag, settlements data, or any other applicable information. Unspecified sources contribute to the bulk system power pool and typically are dispatchable, marginal resources that do not serve baseload.

Sections 95834 and 95920. The Proposed Beneficial Holding Limit Does Not Provide Sufficient Flexibility To Electrical Distribution Utilities To Procure Compliance Instruments For Their Contractual Obligations.

PG&E remains concerned that the current proposed holding limit will not enable it to procure sufficient compliance instruments on behalf of certain counterparties with which it has contracts for the delivery of electricity. Further, the proposed holding limit prevents entities with a large compliance obligation from being able to sufficiently hedge future obligations. PG&E believes that there are two relevant sections in the regulation, either of which could be amended to resolve these concerns. PG&E urges ARB to consider amending one or both of these sections in advance of the first auction.

PG&E recommends that ARB revisit the holding limit established in Section 95920 and that it be established as the larger of the number given by the current formula or an entity's annual allocation of allowances. This will allow electrical distribution utilities that have contractual obligations the flexibility needed to procure enough compliance instruments to meet both their contractual and compliance obligations. Further, PG&E recommends that all allowances transferred to an entity's compliance account be exempt from the holding limit. This will better allow compliance entities to physically hedge future obligations.

While the beneficial holdings language of Section 95834 allows for the compliance instruments held by an agent to count against the holding limit of the principal, compliance instruments must be transferred to the principal within one year after the agent acquired them. This prevents the agent from acquiring compliance instruments on behalf of the principal more than one year in advance. Further, the agent is acquiring compliance instruments before it has knowledge of the principal's actual annual compliance obligation. This could result in the agent being obliged by the regulation to transfer more compliance instruments to the principal than its contract for the delivery of electricity requires.

To resolve this concern, PG&E proposes that ARB remove the one-year limitation and instead allow the agent to specify at the time it submits a transfer request the time period for the transfer to the principal. Further, should the agent's obligation to transfer compliance instruments to the principal end up being less than stated in the original transfer request, the agent should be permitted to amend its transfer request accordingly. At the time the transfer request is amended,

any compliance instruments that were previously counted against the principal's holding limit but will no longer be transferred to the principal on account of the amendment should count against the agent's holding limit.

Section 95852(a)(1)and (h). Emission Categories Used To Calculate Compliance Obligations Should Be Clarified.

This section describes the operators of facilities that have cap-and-trade compliance obligations and includes references to Petroleum and Natural Gas Systems. Section 95852(h) describes certain requirements for obligations from this sector, but also contains the language "except as specified in section 95852.2." In describing the compliance obligation for Petroleum and Natural Gas Systems in section 95852(a)(1), there is not provision or reference to section 95852.2. The same exception should also be included in section 95852(a)(1) to make it clear that compliance obligations are required, except as provided in 95852.2. We therefore recommend that the first sentence of section 95852(a)(1) be amended to include the phrase "except as specified in section 95852.2" at the end of the sentence.

Section 95852(b). ARB Should Re-Assess Recognition Of Out-Of-State RPS-Eligible Resources At The Time Of Program Linkage.

PG&E appreciates the modifications to Section 95852 that establish a mechanism to account for the GHG reductions associated with out of state RPS eligible resources. We believe a mechanism like this is crucial to ensure that California is able to account for the full GHG reduction benefits of the State's renewable programs. We remain concerned however with Section 95852(b)(4)(E) that states that the RPS adjustment would not be allowed if a renewable resource is located in a jurisdiction which links with California's cap-and-trade program in the future.

We understand ARB's intent to prevent double counting the GHG attributes of the renewable facility, however this prescriptive approach would prevent Californians from receiving credit for renewable investments in which the environmental attributes were conveyed to them contractually, solely to the fact that the state opted to develop a cap-and-trade program. As ARB has yet to determine whether and to what extent it will link with other jurisdictions and the rules under which linkage may occur, PG&E believes it is premature to disqualify out-of-state RPS-eligible projects from such jurisdictions at this time. Accordingly, we recommend deleting the current language and inserting the following:

> (E) ARB will re-assess the subject of RPS adjustment if the underlying renewable resource becomes part of a linked jurisdiction in the future.

Section 95911. ARB Should Ensure The Auction Settlement Price Equals The Auction Reserve Price When There Are Unsold Allowances.

PG&E supports the modifications to the regulation which make allowances unsold at auction eligible for re-auction at a later time instead of being redirected to the Allowance Price Containment Reserve. This change will prevent situations that could have otherwise led to artificial shortages in later periods.

PG&E understands the intent of the auction format is for the price to be set at the Auction Reserve Price when there are unsold allowances. However, the current text in Section 95911(d)(4) does not ensure this outcome. Further, Section 95911(b)(3), which describes the process for returning unsold allowances, is predicated on there being unsold allowances only when the Auction Settlement Price equals the Auction Reserve Price. This may not always be the case.

PG&E offers the following hypothetical example to highlight this concern. Assume there are 4 allowances consigned and there is a single bid for 3 allowances at $15/allowance. In accordance with (d)(4), the regulation does not specify what the Auction Settlement Price would be because there is no additional bid below the Auction Reserve Price of $10/allowance. Further, even if the example included an additional bid for 2 allowances at $5/allowance, the current regulation suggests that the Auction Settlement Price would be the "current price" of $15/allowance instead of the Auction Reserve Price of $10/allowance as intended. PG&E recommends the following changes to Section 95911(d)(4)(A) to address both these possibilities and ensure the auction operates as intended.

> (4) Beginning with the highest bid price, bids will be considered in declining order by price and entities submitting bids at that price will be sold allowances until either:
>
> (A) The next lower bid price is less than the ~~a~~Auction ~~r~~Reserve ~~p~~Price or there are no additional bids, in which case the ~~current price~~ Auction Reserve Price becomes the ~~a~~Auction ~~s~~Settlement ~~p~~Price; or

Section 95913. PG&E Strongly Recommends That ARB Establish A Contingency Plan In The Event The Allowance Price Containment Reserve Is Significantly Depleted.

As PG&E discussed in its August 11, 2011 comments, we strongly recommend that ARB establish a procedure to replenish the Reserve if it is significantly depleted, and that the ARB include these actions in its regulation prior to the first auctions in 2012. Otherwise, in PG&E's view, and based on its own experience in the California energy crisis, the likelihood of timely and effective action if this situation did occur would be diminished. We believe the market simulations planned in 2012 could help inform and shape the specific contingency measures included in the regulation.

The absence of regulatory language addressing a contingency plan is noted in a recent UCLA paper addressing market manipulation. While the paper is generally supportive of the ARB's cap-and-trade program design, it does express the following concerns, and draws from the crises in the energy and RECLAIM markets.

> *"Beyond the allowance reserve, banking, and offsets, CARB has not set forth any guidance on steps it would take in the event of extended high allowance prices. At the same time, market players will likely infer that CARB views the reserve price limits as a price ceiling. Extended high prices after the depletion of the reserve may paradoxically not concern covered entities who may anticipate political intervention in that scenario.*
>
> *Comparison to the RECLAIM price spike is instructive. In 2000-2001, allowance prices spiked dramatically. That spike was due in part to a decreasing cap that resulted in constrained allowance availability for the first time. Lack of banking and the California energy crisis were strong contributing factors to the price spike. In response to the price spike, SCAQMD removed power utilities from the program and significantly revamped RECLAIM rules".* (Source: "Rules of the Game: Examining Market Manipulation, Gaming and Enforcement in California's Cap-and-Trade Program" Emmett Center on Climate Change and the Environment, August 2011, UCLA School of Law, p.41.)

PG&E observes that in the California energy crisis, political intervention was neither timely nor effective. In the unfortunate event that unsustainably high allowance prices were experienced in this market, market participants would not have assurance that a remedy will be in place, which could result in substantial harm to both the cap-and-trade and electricity markets.

The absence of regulatory language demonstrating ARB's intent to intervene was also noted in the UCLA report.

> *"It is also unclear if CARB is willing to assert regulatory authority to implement changes to the program, to the extent necessary. Being upfront about the possibility of such regulatory changes is preferable to disrupting the market later with major changes." (Source: Id., pg. 43.)*

PG&E strongly recommends the ARB articulate and establish a procedure in the cap-and-trade regulation to replenish the reserve in the event the reserve is depleted. This action will position the cap-and-trade portion of AB 32 to function smoothly under a wide range of market conditions, and will avoid adverse impacts in related markets. Most important, well crafted regulatory language will protect California businesses and consumers, enhancing the prospects for successful program implementation.

Section 95854. Flexibility In The Use Of Offsets Is Necessary To Ensure That The Goals Of AB 32 Are Achieved In A Cost-Effective Manner.

Because the supply of offsets is likely to be inadequate to cover 8% of emissions, especially in the early years of the program, PG&E recommends that the ARB allow complying entities the flexibility to use offsets up to the 8% limit over the entire cap-and-trade program. As stated in our August 11, 2011 comments, PG&E requests that the quantitative usage limit apply to a complying entity's total compliance obligation from January 1, 2013 through the current compliance year. Revisions to the regulations can be found in the aforementioned comments.

PG&E is also concerned about reducing the percentage of sector-based credits allowed in the second compliance period. Reducing the use of sector-based offsets from 50% to 25% will put strain on an already limited market. PG&E's analysis shows that supply will only be approximately 60% of the allowed supply in the first compliance period, even if the pneumatic controllers, rice cultivation, and fertilizer management protocols are adopted early next year. PG&E expects more significant shortfalls in the second and third compliance periods, absent adoption of additional protocols.

Section 95990. PG&E Supports Early Action Offset Credits.

PG&E supports the modifications to the regulation addressing early action offset credits. PG&E appreciates the modification of the desk review which states that a verification body must conclude with "reasonable assurance that they concur that a positive verification statement should have been issued." This will leverage the work performed by the original verifier while ensuring that these credits meet the requirements to be real, additional, verifiable, and permanent.

In addition, PG&E appreciates the change which allows sequestration projects to be issued Early Action Offset credits while not requiring those projects to transition to the Compliance Offset Protocol.

Compliance Offset Protocol – U.S. Forest Projects. Requirement To Terminate Relationship With Voluntary Offset Program Is Confusing And Could Disqualify Certain Early Action Projects.

The intent behind the requirement in the Forest Protocol for voluntary projects to meet "all legal and contractual requirements to allow it to terminate its project relationship with the voluntary offset program" is confusing and could pose unintended consequences. As written, it would require an Early Action project that does not plan to transition (as allowed under 95990(d)(1) and (h)(5)(A)) to terminate its contracts with the Climate Action Reserve and with all parties to whom they have sold their credits. This language as written could eliminate Early Action projects in California from participating in the cap-and-trade program and conflicts with the language in 95990. PG&E recommends that this language be modified as follows:

> "If the offset project was an offset project in a voluntary offset program, other than the Climate Action Reserve, the offset project can demonstrate it has met all legal and ~~contractual~~ protocol requirements to allow it to terminate its project relationship with the voluntary offset program and be listed using this compliance offset protocol."

A Market Monitor Is Critical To The Success Of Cap-And-Trade And Should Be Included In The Regulation.

PG&E appreciates that ARB has issued an RFP for a market monitor as part of overall auction design and implementation. We believe the regulation should specify the authority and duties of the market monitor to include the responsibility of certifying auctions in a timely manner. As discussed in our last set of comments, PG&E recommends that the certification of the auction allow up to seven days for ARB and the market monitor to review the auction and associated calculations, review participant/group behavior or scan for other suspect activity, and certify results (similar to RGGI) prior to consummation of any trades from that auction.

Thank you for the opportunity to submit these comments. We look forward to continuing our work with the ARB and all concerned stakeholders to ensure the successful implementation of AB 32.

Very truly yours,

/s/

John W. Busterud

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