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*e-filing to ARB's Cap-and-Trade website
e-mail to kmkenned@arb.ca.gov*

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California Air Resources Board
1001 I Street
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**Re: Pacific Gas and Electric Company's Comments on the Air Resources Board's
June 22, 2010 Workshops**

Dear Dr. Kennedy:

Pacific Gas and Electric Company ("PG&E") is pleased to submit these comments on the Air Resources Board's ("ARB") June 22, 2010 Workshop on Cost Containment Options in a California Cap-and-Trade Program and Update on Offsets and Linkage in a California Cap-and-Trade program. We want to thank both the ARB for holding workshops focused on cost containment and the Nicholas Institute for Environmental Policy Solutions for facilitating both the morning and afternoon sessions.

**A. PG&E's Comments on Cost Containment Options in a California
Cap-and-Trade Program**

As an insurance policy for our climate and our customers, PG&E strongly supports a cost containment mechanism focused on allowance prices with an upper price threshold and a lower reserve price. As a result, we appreciate staff's consideration of soft price collar options as a cost containment mechanism in the California cap-and-trade program. We offer the following comments in response to the cost containment concepts discussed during the morning session of the June 22nd workshop.

1. Cost Containment Objectives

ARB presented the following objectives for a cost containment mechanism (Slide 4) at the June 22nd workshop:

- Cost containment mechanisms must reduce the risk that unacceptably high costs are incurred

- Mechanisms should be transparent and should not create market uncertainty
- Mechanisms must not compromise the environmental integrity of the program
- Mechanisms should preserve the ability to link with other rigorous cap-and-trade programs.

Similarly, PG&E has developed key objectives associated with a cost containment mechanism which are substantially aligned with ARB's:

- Environmental integrity - achieve long term sustained emission reductions
- Price assurance - provide assurance that ceiling price will not exceed defined threshold and floor price will not fall below a certain threshold
- Quantity assurance - provide assurance that a sufficient supply of compliance instruments are always available.

Both ARB's and PG&E's objectives highlight the importance of developing a mechanism that preserves the environmental integrity of the program and prevents excessive volatility in the market. A mechanism that is transparent and limits uncertainty is particularly important due to the characteristics of the wholesale electricity market. The wholesale electricity market clears several times every day. It relies on bids by electricity suppliers that track each supplier's variable costs, such as the cost of natural gas as power-plant fuel. GHG allowance costs will also be variable costs for gas-fired power plants. If the spot market for allowances is insufficiently liquid or lacks transparency, generators may be unable to submit cost-reflective bids. PG&E views this as a serious risk in a small market and therefore agrees with ARB that the mechanisms under consideration must be transparent and designed in a way to limit this type of market uncertainty.

2. Cost Containment Mechanisms

PG&E views the implementation of a "price collar" as essential to help limit overall program costs via the upper price threshold while simultaneously providing incentives for investments in low carbon technologies via the price floor. PG&E agrees with staff's approach for implementing a soft price floor (Slide 7), consisting essentially of a minimum bid price in auctions of allowances. For the soft price ceiling, PG&E supports the use of a strategic reserve with a "window", at which an entity with a compliance obligation may purchase compliance instruments at any time at the ceiling price.

PG&E believes that the reserve is the best of the three soft price ceiling mechanisms that staff outlined in the workshop (Slide 8). Specifically, we are unsure of how the future vintage allowance approach would work given that the proposal does not address the situation in which the price trigger is exceeded and a complying entity does not possess any future vintage allowances.

Step 1: Create and Fill the Reserve

In prior comments, PG&E has advocated that the strategic reserve be initially populated with future vintage allowances. At the June 22nd workshop, stakeholders introduced other proposals for creating the reserve which would not rely on borrowing allowances from future periods, out of concern that borrowing would tighten the cap in future years. PG&E is open to considering and supporting other approaches to create the reserve which fit within our cost containment principles. One promising option, mentioned by Staff, would be that use of the reserve would trigger an increase in the allowed use of offsets equal to the number of allowances brought in to replenish the reserve.

In any event, PG&E believes that key considerations for determining the initial size of the strategic reserve include: (1) typical fluctuations in California's GHG emissions, (2) the time needed to refill the reserve, (3) the possibility of market manipulation, and (4) the uncertainty in the business-as-usual projection used to set the 2012.

Steps 2 and 3: Define Conditions for Releasing and Choose a Release Mechanism

PG&E recommends that allowances and/or offsets be available for purchase from the reserve at any time, at a pre-set ceiling price. This approach involves the use of a "window" for releasing the allowances or offsets. The window provides price certainty and could help limit potential market uncertainty associated with the daily transactions of the electricity markets as described above. Further, the price certainty and continuous availability associated with the window can also help minimize possible distortion of the allowance market. To the extent that the strategic reserve with a window helps deter market manipulation, liquidity and price discovery should be enhanced.

PG&E recommends the following additional features for consideration by ARB:

- **Eligible Entities**
 - Only complying entities would be allowed to draw allowances/offsets from the strategic reserve.
- **Restrictions on Allowances and Offsets**
 - Complying entities must retire all allowances/usable offsets in its possession before withdrawing from the strategic reserve.
 - Complying entities not obligated to purchase maximum amount of offsets (e.g. 4%) before accessing strategic reserve.
- **Drawing from the Reserve**
 - Complying entities step up to the window
 - Complying entities receive an allowance or offset (e.g. a compliance instrument) from the window
 - ARB places the allowance/offset in that complying entity's retirement account
 - Complying entity places the equivalent of the ceiling price in an ARB AB32 account for each allowance or offset received

Step 4: Options to Replenish the Reserve

In prior comments, PG&E recommended that complying entities purchase an allowance from the reserve at the ceiling price and that ARB use that revenue to backfill the reserve with offsets. ARB has since indicated that it is not considering this approach, therefore we are evaluating alternatives including ARB's concept set forth in Slide 16.

B. PG&E's Comments on ARB's Update on Offsets and Linkage in a California Cap-and-Trade Program

PG&E strongly believes that the use of high quality offsets will help California to achieve the emission reduction objectives of AB 32 while containing costs to the California economy. PG&E appreciates Staff's update in the June 22nd afternoon workshop on the development of the offset program and provides the following comments focused on timing of protocol development and volume of offset supply considerations associated with ARB's approach.

PG&E is concerned with the timeline for the adoption of offset protocols and the forecast supply of offsets. Limited offset supply and cost uncertainty is likely to create excessive and avoidable volatility in the allowance and electricity markets. Protocols need to be in place so that a sufficient supply of offsets is available prior to any auction and no later than January 1, 2012 because the cost of GHG emissions will be priced into electricity bids at the beginning of the first compliance period. As noted in Section A. 1., PG&E believes that certainty and supply are needed to enable the electricity market to submit cost-reflective bids.

An adequate supply of different types of offsets is also critical to avoid high offset prices. In the supply forecast for ARB protocols, more than 90% of ARB-issued offsets would come from Ozone Depleting Substance projects developed by a handful of suppliers. Therefore, ARB's forecast is not likely to provide adequate volume and diversity to ensure cost containment, particularly in the first compliance period. PG&E is concerned that offset prices will be rapidly driven to the allowance price – negating the cost containment benefit that offsets are intended to provide. In addition, if only one or two of the forecast projects fail to deliver their forecast volume, there will not be enough supply to meet the market demand, even at the 4% limit.

To provide timely and adequate supply of offsets, PG&E proposes that ARB link with the Climate Action Reserve (CAR) and Western Climate Initiative Partners before the first allowance auction. Additionally, we recommend that ARB expeditiously evaluate Clean Development Mechanism (CDM) protocols and link with CDM projects soon thereafter. Linking with the CAR alone will provide access to another five project types within the United States – coal mine methane capture, composting, landfill methane capture, nitric acid production and organic waste digestion. By including CDM projects (even if hydrofluorocarbon and hydropower projects are excluded), ARB can further increase the supply to meet the demand during the first compliance period.

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Further, PG&E encourages ARB to address offset supply options by accepting landfill offset projects. Although some believe that excluding landfill offsets from California's cap-and-trade program would encourage other states to adopt landfill regulations, PG&E believes that including landfill offsets in California's cap-and-trade program could actually *encourage* the development of regulations in other states. Rather than eliminate projects at the outset, the ARB should consider revising protocols to raise the performance standard as practices become "business as usual." Early actors will then get the financial benefit of reducing GHG emissions before such actions are common or required in their region or state. Additionally, with the creation of the CAR Organic Waste Composting Project Protocol, PG&E believes there is an opportunity for the state to encourage landfill projects to capture the methane emissions that are currently going to the atmosphere from historic waste disposal practices while encouraging waste management companies to develop or expand composting programs.

Thank you for the opportunity to present these comments. Please do not hesitate to contact me at (415) 973-6617 if you have any questions regarding these comments or if we may be of further assistance.

Very truly yours,

/s/

John W. Busterud

JWB:kp

cc: (all via email)
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