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Ms. Lucille Van Ommering
California Air Resources Board
Office of Climate Change
1001 I Street
Sacramento, CA 95814

RE: June 22, 2010 Workshop on Cost Containment in a California Cap-and-Trade Program

Dear Ms. Van Ommering:

San Diego Gas and Electric Company (SDG&E) and Southern California Gas Company (SoCalGas) appreciate the opportunity to submit this written input on cost containment mechanisms discussed at the June 22, 2010 workshop that will lead to changes in the Preliminary Draft Regulation (PDR) for a California Cap-and-Trade Program, issued November 24, 2009. SDG&E and SoCalGas strongly support including cost containment elements in the final Regulation. The goal should be to support accurate long-term price signals and reduced volatility to encourage long-term investment in cost effective GHG-reducing technologies.

SDG&E and SoCalGas support the concept of a price collar in the cap-and-trade program along the lines summarized at the end of the June 22 workshop. The use of a price floor assures that short-term price fluctuations do not deter long-term investment in GHG reductions by covered entities. And developing a reserve to support a price ceiling can protect customers from unanticipated shortages and resulting price spikes if implemented properly. The ideal would be a price ceiling set sufficiently high to avoid impacting long-term price of carbon necessary to attain the goals of AB 32,

but to assure short-term price fluctuations do not collapse the market similar to the events of the Electricity Crisis in California.

The comments below are divided into three sections discussing each of the cost containment elements discussed at the workshop: a price floor, a price ceiling, and the characteristics of a reserve to draw from if the market hits the price ceiling.

PRICE FLOOR

SDG&E and SoCalGas support a "hard" price floor to assure that short-term price fluctuations do not deter long-term investment in GHG reductions by covered entities. Low cost GHG reductions from the cap-and-trade program should not be missed at the same time the State is spending on higher priced complementary policies. Further, the use of a price floor creates less pressure on ARB to get 2012 expected GHG emissions "just right." If the economy does not expand as forecasts would suggest in 2012, the price floor preserves the long-term price incentive at the start of the program. The floor price would be established by setting an auction reserve price at a level that would send a reliable minimum price signal to compliance entities and the green technology community. There are a number of approaches to establishing the floor price and its escalation over time. SDG&E and SoCalGas would recommend that ARB consider floor prices being considered in national legislation and the expected market price from ARB economic modeling in determination of the initial price floor.[1] The floor price should be less than the expected market price and should gradually increase with inflation over time.

PRICE CEILING

SDG&E and SoCalGas would support a "hard" price ceiling for symmetry reasons, but recognize that the ceiling must be a "soft" ceiling in order to preserve environmental integrity (unless ARB were to allow unlimited use of offsets). Instead, a "soft price ceiling" would have a maximum price that would remain in place until a reserve of allowances used to keep the price at the ceiling is exhausted, at which point the price could rise further. Ideally, the price ceiling would be set sufficiently above the long-term carbon price so that it would not have a material impact on the long-term price signal,

[1] ARB, Updated Economic Analysis of California's Climate Change Scoping Plan, Table 23, has an expected price of $21/MT in 2020, suggesting a $12/MT price in 2012 with a base 7% growth rate (footnote to table 18) or a $17/MT price with a 3% inflation rate.

but would dampen short-term fluctuations caused by weather, unexpected generation outages, or unexpected high economic growth. The price ceiling could be incorporated into the market by ARB by setting an auction maximum price at a level that would assure compliance entities access to allowances at that set price.

There are a number of approaches to establishing the floor ceiling and its escalation over time. ARB should consider the expected market price from ARB economic modeling, the behavior of prices in an equally rigorous market such as the EU ETS, national cap-and-trade program proposed price ceilings and California's marginal abatement curve in determination of the initial price curve.[2] The price ceiling should be more than the expected market price and should gradually increase with inflation over time.

Depending on the market prices and the level of the reserve, ARB may want to revisit the level of the price ceiling at the end of each compliance period to determine if it is needs to be adjusted upward beyond inflation adjustments for the next compliance period to maintain the reserve. Any adjustment should be based on new information on the use of the reserve in the compliance period and on the cost of GHG reductions.

RESERVE

SDG&E and SoCalGas are in agreement with the stakeholders at the June 22 workshop that a Reserve is a preferred method to implement a soft price ceiling. ARB could manage it as part of the auction process or set up a separate "window" as proposed in the American Power Act discussion draft where compliance entities could come to acquire allowances. The Economic and Allocation Committee recommended a single-round, sealed-bid, uniform price auction as simple to operate. It would be relatively straightforward to use an allowance reserve to moderate auction clearing prices with such an auction format. Or if the allowances auctioned were insufficient to meet demand at the price ceiling, the auctioned allowances could be prorated among bidders and compliance entities could come to the window to acquire allowances needed for compliance. The latter approach may be

[2] The Stanford Project developed a Marginal Abatement curve for California that was presented at the August 13, 2009 EAAC meeting by the Economic Modeling Subcommittee. The ARB goals could be met with measures less than $35/MT based on the curve. This dollar value equates to $28/MT in 2012 at 3% inflation rate.

preferred in order to limit access to the reserve to compliance entities without restricting access to the auctions and to provide more flexibility as to when the reserve can be accessed.

Sale of Allowances By the Reserve

SDG&E and SoCalGas support the use of the window to make allowances from the reserve available to the compliance entities with restrictions on their use. Once purchased, the reserve allowances should be retired immediately toward the purchaser's GHG obligation so that it cannot be sold or transferred. Allowances acquired from the reserve should be limited to a fraction of a compliance entity's total compliance obligation to assure compliance entities do not wait until the end of the fixed compliance period to acquire allowances.

Size of the Reserve

The size of the Reserve should be large enough to protect against price spikes in the final year of a fixed compliance period due to unexpected weather, nuclear plant outages, or high economic growth. ARB should use historical GHG emissions data adjusted for economic growth in the size of the California economy to determine potential annual swings in GHG of capped entities to determine the size of the reserve.[3]

Funding of the Reserve

SDG&E and SoCalGas support initially funding the reserve from the GHG reductions from the ARB Scoping Plan Business as Usual (BAU) case caused by early actions and the recession. Specifically, the stakeholder proposal at the workshop was for the initial funding to come from the difference between the 2012 forecasted emissions in the ARB Scoping Plan and the most recent estimates of the 2012 GHG levels taking into account the recession and early actions.[4] This proposal seemed acceptable to most stakeholders at the workshop.

The initial funding of the reserve can be supplemented or replenished in several ways. One source would be unsold allowances from the auction. If the bids presented at an auction result in a clearing

[3] Data from the ARB December 14, 2009 workshop would indicate something on the order of 15-20 MMT for the narrow program and 20-25 MMT for the broad program based on annual deviations and the fact that the California economy is 50 percent larger than it was in 1990s.

[4] Some adjustment to the ARB Scoping Plan BAU forecast is required to include the 20 percent RPS in the BAU case. Data from the Scoping Plan (page I-29) is available for this purpose.

price equal to the price floor, the number of allowances sold at that auction may be less that the full amount to be auctioned. The unsold allowances could be transferred to the reserve, supplementing the allowances placed in the reserve due to the difference between the emissions level in the absence of the recession and early action and the expected 2012 emissions level.

A second source of replenishment of the reserve would be through increased use of offsets. If compliance entities access the reserve, there could be an obligation for the entities to provide to the reserve an equal amount of offsets at cost. That is, the compliance entities would acquire offsets and submit the offsets to the reserve and receive compensation at cost for the offsets.[5] Increasing the use of offsets through the reserve would maintain the environmental integrity of the cap-and-trade program while providing some price volatility protection.

To allay concerns of some stakeholders, offsets used to replenish the reserve should be constrained to maintain the goal that no more than 49 percent of GHG reductions come from offsets. Because of the way ARB implemented the 49 percent limit on the use of offsets in the PDR, the 49 percent limit is 49 percent of GHG reductions from 2012 levels of economic activity, not from the 2012- 2020 BAU scenario. In effect, the ARB is allowing 49 percent of GHG reductions to come from offsets assuming zero economic growth occurs in the State. Economic growth is, however, one of the key drivers in potentially high prices for allowances as demand for allowances increases relative to supply. Economic growth could be a driver for the price ceiling to be hit and the reserve used, just like continued recession may lead to prices at the price floor. Backfilling the reserve with offsets related to reductions from the BAU forecast provides a source of offsets while still maintaining ARB's limit on the use of offsets to 49 percent of GHG reductions. The reserve limit on offsets could be calculated based 49 percent of the difference between BAU levels and 2012 levels of GHG.[6] Further, the limit could be modified at the end of each compliance period if the BAU growth differs significantly from that expected in 2012.

[5] It would simpler if the reserve acquired the offsets, but ARB has determined it cannot both regulate the offset program and purchase offsets.

[6] A revised BAU could be calculated based on the expected level of GHG in 2012 and growth rates 2012 to 2020 from the Scoping Plan.

A last method of refilling the reserve would be limited borrowing. With fixed compliance periods, there may be end-of-Compliance-period issues if some entities do not acquire allowances in a timely manner and if there are last year unexpected economic events.[7] If the reserve were to be depleted in this end-of-compliance period, it is possible that appropriately priced offsets may not be immediately available in sufficient quantities if ARB does not allow linking to other offset trading programs. In this case, borrowing by the reserve should be allowed. To avoid merely moving stringency from one compliance period to the next, the borrowed allowances should be replaced with offsets when they become available.

Thank you for the opportunity to comment.

Sincerely,

[7] SoCalGas and SDG&E are still concerned with the end of period effects associated with fixed compliance periods given the potential for last year weather, unexpected nuclear outages, or high economic growth. ARB should consider optional rolling compliance periods as mentioned in prior Sempra comments. That is, as soon as one year's compliance is verified for a regulated entity, the year drops off and a new vintage year is added to the three year compliance period.