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May 20, 2009

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Pacific Gas and Electric Company's Comments on the California Air Resource Board Staff's Proposed Criteria for Compliance Offsets in a Cap-and-Trade Program

Dear Chairman Nichols and Executive Officer Goldstene:

Pacific Gas and Electric Company ("PG&E") welcomes the opportunity to provide these preliminary comments in response to the California Air Resources Board (ARB) Staff's April 28, 2009 workshop on Criteria for Compliance Offsets in a Cap-and-Trade Program. We appreciate ARB's efforts to begin the process for defining eligible categories of offsets.

A. PG&E Recommends That ARB Survey And Adopt The Best Of The Pre-Existing Offset Protocols Including The Climate Action Reserve Protocols

PG&E recommends that the ARB review policies and procedures already established in the offset market, such as the Climate Action Reserve, rather than replicating this work. For example, the Climate Action Reserve (Reserve) has developed and continues to develop protocols through a transparent stakeholder process. The Reserve already has established how these protocols may be used in other regions of the US and is starting to address protocols in Mexico, including addressing additionality where regulatory frameworks differ. Rather than spending resources trying to determine additionality, how to define an offset, or how to apply protocols across geographic boundaries, the ARB should adopt the best of the pre-existing protocols, which have already addressed and resolved these questions. The eligible categories of offsets should be added to or modified over time based on experience.

For offsets to fulfill their potential as a means to achieve AB 32's GHG emission reduction goals in a cost-effective manner, sufficient supply must be available. Regardless of the limits placed on offsets for compliance use, the ARB should ensure that there are a sufficient number of approved protocols that could yield an adequate supply of offsets eligible for compliance purposes, at least 30% of the cap. When adopting the existing standards, the ARB should evaluate potential supply so as to not restrict the cost savings potential of offsets.

PG&E believes that there should be one central organization, similar to the Reserve in the voluntary market, which will issue the offsets regardless of where they occur. Project developers would submit their projects along with a certification report from an independent certifier approved by the state to this central organization. The ARB would then review the projects and the certification report, accept them if they meet the state criteria and issue the offsets. The ARB would be able to ensure enforcement of its protocols through the independent certification and offset issuance process. The location of the project, whether in-state or out-of-state, should not be a factor in ascertaining whether the project complies with the appropriate protocol. As the protocols and certification process will be rigorous, there is no need for California to have separate agreements with the government agencies where offset projects are located.

B. PG&E Encourages The ARB To Expedite The Issuance Of Offset Protocols To Ensure That Complying Entities Have Access To High-Quality Offsets

PG&E encourages the ARB to expedite the issuance of offset protocols that will be eligible to generate offset credits. The current regulatory uncertainty associated with compliance offsets is delaying investments in projects that could contribute to our State's emission reduction goals. PG&E's experience with the development of offset protocols indicates that significant time is required to develop a protocol, initiate a project, have the project independently certified, and have the certification accepted and offset credits issued. For example, it took the Reserve 1.5 years from the time work was initiated on the landfill methane gas capture protocol to the time of issuance of offsets from a project. That was under the best circumstances. In the case of forestry, it took approximately 6 years for the development of the first forest projects. Finally, while the protocols for livestock methane management and urban forests have been developed, no GHG emission reduction offsets have been issued to date.[1/]

Given the long lead time required to implement offset projects, this delay could limit options for complying entities in the first AB 32 compliance period which is precisely when offsets could be particularly important due to the more limited availability of alternative low-carbon technologies.

ARB staff have indicated that they plan to propose their recommendations related to offsets to the Board as part of the broader Cap-and-Trade Regulation. This means that offset developers and investors will not have the requisite regulatory certainty they need to proceed until November of 2010 and consequently offsets may not be available in time to be used in the first compliance period. PG&E strongly recommends that ARB find a way to provide the regulatory certainty needed for offset developers to start investing in offset projects today. Emissions reductions will occur earlier and the overall cost of the AB 32 program will be reduced.

C. Additional Criteria Could Restrict The Development Of The Offset Market

PG&E supports the use of offsets that meet rigorous quality standards which ensure that they are real, permanent, additional, verifiable and enforceable. During the April 28th workshop, ARB staff noted that for ARB to accept offsets credits issued by other systems that those offsets would

1/ Climate Action Reserve database. Downloaded May 7, 2009.

need to meet the AB32 specified criteria (listed above) and that ARB may choose to establish added criteria as well. PG&E notes that overly complicated and restrictive offset rules could limit the development of the market and inhibit emission reduction opportunities that would not have otherwise occurred. If developers find California rules too confusing or inconsistent with WCI offset rules or other widely recognized protocols, they may not develop projects for the California market that could comply with California protocols. The segmentation of the market rules will mean that developers will have a hard time taking advantage of lessons learned from previous projects or grouping projects for economies of scale, driving up offset costs.

D. Specific Comments On Criteria Discussed At The April 28th Workshop

Direct versus Indirect Reductions

PG&E supports direct reduction eligibility for sectors outside of the cap. Indirect emission reductions have the potential to be double counted because they have complicated ownership issues in regards to GHG emission reduction claims and are reductions that are generally regulated under the cap (e.g. energy efficiency).[2/] Indirect reductions can be effectively addressed in other ways.

Geographic Eligibility

It is imperative that a sufficient supply of high quality offsets is available to help keep costs to customers low, especially in the first compliance period of the program while also realizing effective GHG emission reductions. PG&E supports the Waxman-Markey approach which allows a 50/50 split on domestic and international offset use. Of equal importance is linkage with other systems throughout the nation to create a fungible cap-and-trade system that benefits Californians.

Currently, California only makes up about 1 percent[3/] of annual GHG emission reductions globally and about 11 percent of the Climate Action Reserve (Reserve) metric tons in the United States.[4/] Of the 45 projects listed on the Reserve as of May 7, 2009, only 13 are in California.[5/] The majority of the Reserve's Livestock Methane projects (nine) and all 21 of the Landfill Methane projects are located outside of California. Establishing broad geographic eligibility of offsets should ensure that: (1) an adequate supply of quality offsets is available; (2) that

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2/ PG&E supports energy efficiency and renewable energy programs combined with assistance for low-income communities. These programs not only benefit low-income communities, but also contribute to GHG emission reductions. The federal stimulus package is providing financial assistance for these programs. PG&E will continue to support projects that enhance employment opportunities for Californians through programs such as weatherizing homes and businesses. PG&E has a long track record in this field and will continue to build on programs that provide assistance to low-income communities.

3/ New Carbon Finance estimates that Reserve reductions account for approximately 10 percent of global reductions. As of May 7, 2009, PointCarbon data shows that California reductions account for 11 percent of Reserve reductions. Therefore, PG&E estimates that California reductions account for 1 percent of the global market (10%x11%=1%).

4/ Point Carbon. Carbon Project Manager North America project database. Downloaded May 7, 2009.

5/ PointCarbon. Carbon Project Manager North America project database. Downloaded May 7, 2009.

California's cap and trade system, including offsets is harmonized with emerging regional and national cap-and-trade markets.

Ownership rights:

Is the entity with operational control of an emission reduction project the owner of the offsets?

As a result of PG&E's experience with our ClimateSmart™ program, PG&E has learned that each project may take its own form and structure. In any event and with any project structure, it is necessary for an owner of offsets to have clear, written evidence to the ownership of the emission reductions and the rights to sell and transfer the emission reductions.

Depending on the type of project and the ownership or financing structure of the project, the right to own or convey the offset may be established by contract, conservation easement (or an equivalent restriction on real property) or written acknowledgement by any party that may have a rights in the offset project or underlying real property where the project is located. Again, the fundamental issue is that a buyer of offsets has evidence of the original ownership right to the offsets and a clear chain of title demonstrating ownership of any subsequent owners or rights holders. It is important to allow flexibility in the structure of ownership and financing depending on the project type.

Should ownership of compliance offsets be freely transferable?

Compliance offsets should be freely transferable, provided that a reliable tracking system for offsets is established and required for use by buyers and sellers of offsets. The system should track creation, ownership, transfers, and retirement of offsets. For example, the Reserve has established such a tracking system including unique serial numbers for GHG emission reductions that allow for transparency. Transparency then results in a fluid market, where compliance offsets are freely transferable and tradable.

Accounting for uncertainty and accuracy in calculating emission reductions

PG&E supports using conservative estimates in accounting for uncertainty and accuracy in emission reductions. Accounting for uncertainty could include a conservative baseline, an additionality methodology with an adequate margin of safety, and the use of conservative assumptions. These conservative estimates can adequately address any uncertainties associated with a specific offset project type, and will encourage the development of high quality offset projects.

Ensuring Permanence

PG&E supports a 100-year crediting period for sequestration projects to secure permanence consistent with the standard set by the United Nations International Panel on Climate Change for GHG emission reductions from forestry projects.[6/]

Verification

PG&E supports certification of offsets by an independent, third-party certifier to ensure delivery of real emission reductions in accordance with project protocols. Financial markets function in a similar fashion, where independent, third-party auditors certify accounting information.

Enforceable

PG&E believes that enforceability can be established through the development of protocols and the independent certification of projects. Using the model developed by the Reserve, project developers would submit their projects along with a certification report from an independent certifier to a central organization such as the Reserve. The ARB would then review the projects and the certification report, accept them if they met the state's criteria and issue the offsets. The ARB would be able to ensure enforcement of its protocols through the independent certification and offset issuance process.

Additionality

Offset additionality should be addressed through the project protocol development process. Independent, third-party certifiers would certify the offsets that satisfied the requirements set forth in the appropriate protocol. All offset projects should be additional to existing regulations and sector-based common practices. Technology and barrier criteria can be adequately addressed through the protocol development process.

Financial additionality is not appropriate for project development because it is subjective. The challenge with a financial additionality test is that financial additionality is difficult to prove and inherently subject to manipulation. For example, the hurdle rate[7/] a project chooses is not standard and varies based on the risk a project developer is willing to take.

Similar to comments above, baseline establishment should be addressed in a project protocol. A standardized methodology is lower cost (less cost to evaluate individual project baselines) and less subject to subjective interpretation.

6/ "IPCC Special Report on Land Use, Land-Use Change And Forestry." Section 5.3.4.1. First released for COP 6 in The Hague, November 2000; prepared and published to web by GRID-Arendal in 2001.

7/ A hurdle rate is the required rate of return in a discounted cash flow Return on Investment (ROI) or Internal Rate of Return (IRR) analysis, above which an investment makes sense and below which it does not. Also called required rate of return. www.invention2venture.org/ourresources/glossary/

If a project protocol is not available, PG&E supports the use of project specific tests of regulatory additionality and common practice in order to ensure high quality offsets.

Crediting period options:

5-10 years for non-sequestration type projects

If projects are only allowed short crediting periods, it is likely that the market will experience early saturation of offset projects. This would be problematic for compliance in Phase 2 and 3 of the cap-and-trade market. In addition, a 10-year crediting period is critical to some projects to enhance project revenue and enable project developers to secure valuable debt financing for projects. PG&E recommends that project sponsors be allowed at least a 10-year crediting period, with the option to re-evaluate for renewal based on criteria including the extent to which the activity has become a common practice in that sector.

30-100 years for sequestration type projects

As previously stated, PG&E supports a 100-year crediting period for sequestration projects to secure permanence consistent with the standard set by the United Nations International Panel on Climate Change for GHG emission reductions from forestry projects.[8/]

Future Regulation:
Projects could cease to be additional the date the new regulation enters into force or Projects could cease to be additional when a regulation is passed and it is established that it will go into effect

If future regulations mandate GHG emission reductions that have previously generated compliance offsets, projects should cease to be additional the date the new regulation enters into force and until such time as reductions are required to be implemented. Offsets generated prior to the effective date of the new regulation would be fully recognized. This would give project developers and buyers certainty in the offset market.

Hybrid approach to additionality

Focus on standardized assessments but include some project-specific tests

As previously mentioned, PG&E supports a standardized assessment of additionality, including regulatory and sector-based common practice criteria, through a transparent and public protocol development process. Similarly, project-specific additionality criteria should include regulatory and common practice test.

8/ "IPCC Special Report on Land Use, Land-Use Change And Forestry." Section 5.3.4.1. First released for COP 6 in The Hague, November 2000; prepared and published to web by GRID-Arendal in 2001.

Hybrid approach to establishing baselines

Use standardized baseline methodologies but allow some project-specific factors to be accounted for

PG&E agrees with ARB staff in that a standardized baseline methodology established through a protocol development process results in high quality offsets. If a project protocol is not available, project specific tests of regulatory additionality and common practice should apply in order to ensure quality offsets.

Transparency

PG&E supports a transparent process with confidential treatment for key commercial terms including price. Transparent and public protocol development processes as well as the public tracking of offset creation, ownership, transfers, and retirement will ensure robust development of an offset market.

Thank you for the opportunity to provide these preliminary comments in response to the California Air Resources Board (ARB) Staff's April 28, 2009 workshop on Criteria for Compliance Offsets in a Cap-and-Trade Program. Please do not hesitate to contact me at (415) 973-6617 if you have any questions regarding these comments.

Very truly yours,

/s/

John W. Busterud
JWB:kp

cc: Mr. Kevin Kennedy
Ms. Brieanne Aguila
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Mr. Steve Cliff