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Steven Cliff, Ph.D.
Chief - Climate Change Market Branch
California Air Resources Board
1001 I Street
Sacramento, CA 95812-2828

Re: Pacific Gas and Electric Company's Comments on the Air Resources Board Workshop to Discuss Cost Containment in the Cap-and-Trade Program

Dear Dr. Cliff:

Pacific Gas and Electric Company (PG&E) welcomes the opportunity to submit these comments on the Air Resources Board's (ARB) Workshop to Discuss Cost Containment in the Cap-and-Trade Program. PG&E has been a long-time supporter of Assembly Bill (AB) 32 and California's Cap-and-Trade Program. PG&E also supports legislative and regulatory action at the regional, national, and international level to reduce greenhouse gas (GHG) emissions. These policies must focus on achieving emission reduction goals through the use of cost-effective measures in order to prove sustainable and be replicated worldwide. PG&E further believes that market-based mechanisms, such as California's Cap-and-Trade program, must protect regulated entities and their customers against unsustainable prices and extreme volatility resulting from either market manipulation or shifts in fundamental market forces and dynamics.

I. INTRODUCTION

PG&E appreciates staff's efforts to fulfill the requirements of Board Resolution 12-51. The paper released by staff prior to the workshop and the presentations provided by the panel of market experts demonstrated a balanced and comprehensive study of the cost containment options. PG&E agrees that markets are unpredictable by nature and the likelihood of prices exceeding the upper bounds of the acceptable price range (defined as the highest tier of the allowance price containment reserve (APCR)) is non-trivial. PG&E also recognizes that if prices were to exceed acceptable levels, the larger objective of AB 32, namely to serve as a model for managing future GHG emissions globally, would be seriously jeopardized. Fortunately, mechanisms are available to guarantee to market participants that prices will not exceed the third tier of the APCR without compromising the environmental integrity of the program.

PG&E therefore supports modifying the Cap-and-Trade Regulation to make available additional allowances as described in Table 1 of ARB's "Policy Options for Cost Containment Response to Board Resolution 12-51, June 25, 2013" paper. PG&E finds this approach consistent with part C of the Joint Utility Group's (JUG) proposal and with the opinions expressed by the Emissions Market Assessment Committee (EMAC) and other experts. While ARB's policy options suggest that an unlimited quantity of allowances be made available, it is widely understood that the demand for these allowances would be limited by the emissions of covered entities not otherwise matched by compliance instruments.

PG&E's detailed comments on the staff proposals are detailed in Section II below. The following summarizes the key issues:

- Essential Supporting Principles Are Needed for an APCR Replenishment Strategy
- Improvements Should Be Made to Existing Cost Containment Mechanisms
- Qualifications for Reserve Auction Participation Should Not be Modified
- PG&E Supports the Joint Utility Group (JUG) Cost Containment Proposal

II. DISCUSSION

A. Essential Supporting Principles Are Needed for an APCR Replenishment Strategy

PG&E has long supported the inclusion of an auction price ceiling in California's Cap-and-Trade program. The written and oral comments provided by ARB staff and market experts at the workshop also suggest the need for an auction price ceiling. Key points from those comments are summarized below to indicate that an auction price ceiling would improve the Cap-and-Trade program while maintaining the environmental objectives of the program.

- The supply curve for additional emission reductions is expected to be steep, particularly in later years. This could lead to rapid and unforeseen increases in market prices[1]
- There is a non-trivial possibility that market prices could remain elevated for a period of time sufficient to exhaust the current supply of allowances in all three tiers of the APCR[2]
- If market prices were to exceed the highest tier of the APCR, political support for the program would likely erode, jeopardizing the long-run viability of the market[3]
- It is critical that cost-containment provisions are established in advance and clearly communicated to the market[4]

[1] "Forecasting Supply and Demand Balance in California's Greenhouse Gas Cap and Trade Market" by Elizabeth M. Bailey et. al., March 12, 2013
[2] Section 2.2 of ARB's "Policy Options for Cost Containment Response to Board Resolution 12-51, June 25, 2013" paper; and slides 3 and 6 of presentation by Dr. James Bushnell: "Defending the Price Containment Reserve: Benefits and Options"
[3] Page 2, first paragraph of Dr. Dallas Burtraw's written comments on the cost containment workshop dated June 25, 2013
[4] Slide 5 of presentation by Dr. James Bushnell: "Defending the Price Containment Reserve: Benefits and Options"; pages 4 and 5 of Dr. Dallas Burtraw's written comments on the cost containment workshop dated June 25, 2013

- Sending a clear and credible signal to the market that prices cannot exceed the highest tier of the APCR reduces the probability that the current supply of allowances in the APCR will be exhausted[5]
- The APCR "cannot, by itself, fix a long-run imbalance between supply and demand"[6]

B. Improvements Should Be Made to Existing Cost Containment Mechanisms

PG&E appreciates the diligent efforts of ARB to incorporate a variety of cost containment features into the Cap-and-Trade program. However, several of the existing cost containment mechanisms could benefit from modifications to improve their ability to contain costs.

PG&E is a party to, and actively supports, the JUG Proposal (attached), which outlines several modifications to existing cost containment features that would reduce the likelihood that market prices would exceed acceptable levels without degrading the environmental integrity of the program. PG&E would like to expand on a few of those items here.

- Banking – Every compliance entity or opt-in compliance entity is subject to the same holding limit, regardless of the size of that entity's compliance obligation. The one-size-fits-all holding limit restrains the cost containment benefits of banking due to the inflexibility imposed on entities with large compliance obligations. PG&E maintains that increasing compliance entities' holding limit by some amount relative to each compliance entity's compliance obligation would improve the cost containment effectiveness of banking without jeopardizing the environmental integrity of California's Cap-and-Trade program.

- Offset supply – Current offset supply is expected to fall short of the 8% usage limit for total compliance obligations. PG&E maintains that expanding the number of offset protocols eligible for California's Cap-and-Trade program and hastening the creation of offset credits would substantially improve the cost containment benefits of offsets without jeopardizing the environmental integrity of California's Cap-and-Trade program.

- Offset usage limit – Exhaustion of the full 8% usage limit by all regulated entities is very unlikely, even if adequate offsets are available to the market because the offset usage limit is applied to each compliance entity and compliance period separately. Therefore, any compliance entity that does not to use the full amount of offsets available to it in any particular compliance period cannot be made up in a subsequent compliance period or by another compliance entity. PG&E maintains that relaxing the constraints on offset usage across compliance periods and between compliance entities, without increasing the total offset usage limit, would improve the cost containment effectiveness of offsets without jeopardizing the environmental integrity of California's Cap-and-Trade program.

[5] Slide 2 of presentation by Dr. James Bushnell: "Defending the Price Containment Reserve: Benefits and Options"
[6] Slide 7 of presentation by Dr. Brian C. Murray: "Comments on Modified Price Containment Options for California"

PG&E reiterates its position that changes to existing cost containment mechanisms would be helpful, but alone they are inadequate to ensure market prices do not exceed the highest price tier of the APCR.

C. Qualifications for Reserve Auction Participation Should Not Be Modified

PG&E appreciates Quebec's participation in the June 25th workshop. Quebec's Cap-and-Trade regulation limits participation in reserve sales to regulated entities without compliance instruments in their general (holding) accounts for the current compliance period. This approach would not work for California electric utilities due to their tolling agreements with counterparties, through which a utility has agreed to purchase compliance instruments on behalf of such partners. If electric utilities were required to "zero out" their holding accounts to participate in an APCR sale, they could be at risk of either over-transferring compliance instruments to tolling partners, or over-transferring compliance instruments to their compliance accounts, leaving them unable to fulfill their contractual obligations to tolling partners. In addition, because allowances purchased from the APCR are deposited directly into an entity's compliance account, electric utilities would be unable to transfer any APCR allowances to tolling partners, and would thus be required to purchase additional allowances on the secondary market, at prices likely higher than the APCR, to fulfill their contractual obligations to tolling partners.

D. PG&E Supports the Joint Utility Group (JUG) Cost Containment Proposal

PG&E supports the JUG proposal as a thorough and thoughtful approach to achieving ARB's objective of ensuring that, even under stressed market conditions, allowance prices will not exceed 3rd tier APCR levels while maintaining the environmental integrity of the program. The JUG proposal proposes a list of measures to enhance the supply and circulation of compliance instruments in the market – promoting market liquidity. In particular, PG&E views the measures triggered by the depletion of the 3rd tier of the APCR as an essential backstop in the event all other measures, in combination, prove unsuccessful. In this situation, funding through the sale of additional allowances would be dedicated to find and fund projects or measures that will achieve additional emissions reductions. This element of the JUG proposal ensures the continued success of the cap and trade market even under stressed market conditions and, through the additional funding that would be raised if the backstop was utilized, the means to preserve the environmental integrity of the program.

III. CONCLUSION

Thank you for the opportunity to submit these comments. PG&E encourages ARB to carefully review these suggestions and adopt the recommended changes before pursuing further action. We look forward to continuing our work with ARB to ensure the successful implementation of the Cap-and-Trade Program.

Very truly yours,

/s/

Mark C. Krausse

cc: Rajinder Sahota, via email (rsahota@arb.ca.gov)
Emily Wimberger, via email (ewinberg@arb.ca.gov)

06/20/13

Joint Utilities Cap and Trade Cost Containment Proposals

The following recommendations constitute essential components of a robust cost containment structure that should be adopted as a single package. The recommendations fall into three categories, described below. It is important to implement multiple (if not all) measures from each category in the 2013 amendments to the Cap and Trade Regulation. Doing so will provide needed certainty to the regulated community and the market that there are mechanisms in place to ensure prices do not exceed the third tier of the allowance price containment reserve (APCR).

A) Measures which take effect now and gradually over time reduce the likelihood of prices rising above the APCR in the future by: 1) reducing demand for compliance instruments; 2) increasing the supply of compliance instruments; and 3) ensuring that compliance instruments are accessible in the marketplace.

B) Measures that, when triggered, would quickly alter compliance instrument demand/supply dynamics and constrain upward pressure on market prices for a period of time. An example trigger is a percentage level of depletion of the APCR.

C) Measures that, when triggered, would keep allowance prices at the third tier of the APCR regardless of current demand, while preserving the environmental integrity of the Cap and Trade Program over time.

A) Potential measures that could be implemented now to reduce the likelihood of prices rising above the APCR in the future:

1. Approve more offset protocols to increase the supply of offsets.
2. Exempt offsets from projects within California from the 8% offset limit.
3. Allow each covered entity to carry over any unused portion of its 8% offset limit, to use for future compliance.
4. Address constraints imposed by the current holding limit.
5. Hold an additional auction after the end of each compliance period:
   - Redistribute allowances between auctions to allow for one additional auction per compliance period, and/or acquire allowances for auction per B2 below.
   - This auction should be held between September 1 of the year following the end of a compliance period, when verification statements for prior-year emissions are due (section 95103(f) of the MRR), and November 1, when compliance entities are required to demonstrate compliance (section 95856(f)(1) of the Cap and Trade Regulation).
6. Provide allowances to electrical distribution utilities to cover emissions from electrification of transportation and distributed fuel uses in California.
   - Each allowance provided to EDUs for electrification represents significantly greater reduction in transportation and distributed fuel sector demand for compliance instruments, lowering demand in comparison to supply.
   - This proposal would be limited to electrification that is incremental from the date this measure is adopted and can be reliably measured.

B) Potential measures that would take effect when a specified trigger is reached (e.g. the APCR is 40% depleted) to quickly alter compliance instrument demand/supply dynamics and constrain upward pressure on market prices for a period of time:

1. Unused offset proposal:
    - ARB would track the number of offsets used for compliance (cumulatively) compared to the number of offsets that would have been used if every covered entity exhausted its 8% limit.
    - The difference between the two numbers would be the "8% offset shortfall."
    - When the trigger is reached, ARB will announce an increase in the maximum level of each entity's offset usage for the current compliance period. The increase will be calculated to ensure that, if all covered entities surrender offsets up to the new higher level, the 8% offset shortfall will be used up but not exceeded.
    - If the 8% offset shortfall is not used up in that compliance period, a new offset level will be calculated for the next compliance period.
2. Compliance account proposal:
    - When the trigger is reached, allow covered entities the flexibility to transfer surplus allowances from their compliance account to their limited use holding account.
    - This allows entities that have built up a bank of allowances in excess of their compliance needs to re-inject those allowances into the market.
3. Limited borrowing proposal:
    - When the trigger is reached, allow covered entities to surrender for compliance allowances with vintages of the current year and the following year (not applicable post-2020).
4. Offset geographic scope proposal:
    - When the trigger is reached, increase the number of compliance-grade offsets by expanding the geographic scope of the approved offset protocols to North America.
5. Offset project start date proposal:
    - When the trigger is reached, increase the number of compliance-grade offsets by changing the Offset Project Commencement date in sections 95973(a)(2)(B) and (c) of the Cap and Trade Regulation to an earlier date.

C) Potential measure that would be triggered only if and when the third tier of the APCR is depleted, to keep prices at the third tier level, while preserving environmental integrity:

Allowance-offset proposal: Upon depletion of the highest tier of the APCR, the Executive Officer will make available (through the APCR sale mechanism) additional allowances, in excess of the cap, necessary to satisfy the demand of compliance or opt-in compliance entities at the price set for the highest tier of the APCR in the relevant year. The Executive Officer will use the funds raised by the sale of additional allowances to reduce GHG emissions, with the intent that emissions reductions will be equal to or larger than the number of additional allowances sold.

The options available to the Executive Officer for reducing GHG emissions include, but are not limited to, one or more of the following:

- Commission a third party to obtain and retire high-quality offsets not otherwise eligible to satisfy the compliance obligations of compliance entities.
- Commission a third party to purchase and retire allowances from emissions trading programs outside of California and linked jurisdictions.
- Commission a third party to invest funds in emission reduction projects outside the capped sectors.
- Mandate emission reductions in sectors not covered by the Cap and Trade Regulation.