March 16, 2018

Rajinder Sahota
Chief, Climate Change Program Evaluation Branch
California Air Resources Board
1001 I Street – P.O. Box 2815
Sacramento, CA 95812

Re: Gas Utility Group Comments on the March 2018 Cap-and-Trade Workshop

Dear Ms. Sahota:

These comments are respectfully submitted on behalf of investor-owned, natural-gas distribution utilities (IOUs): Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCalGas), San Diego Gas & Electric (SDG&E), Southwest Gas Corporation, and publicly-owned natural gas distribution utilities (POUs) serving the Cities of Long Beach, Palo Alto and Vernon. All of the above utilities are referred to collectively as the Gas Utility Group (GUG) or Utilities. The GUG appreciates this opportunity to comment on the California Air Resources Board's (CARB) March 2, 2018 workshop which presented Staff's preliminary discussion draft for potential changes to the Post-2020 Cap-and-Trade Regulation (Workshop). The GUG provides comments on the following topics: 1) Allowance Allocation for Natural Gas Utilities; 2) Price Ceiling; 3) Price Containment Points; 4) Banking of Allowances and Holding

Limits; 5) Offset Credits; 6) Allocation and Distribution of Allowances; and 7) Eligible Uses of Allowance Proceeds. The comments below address each of these topics:

1. Allowance Allocation for Natural Gas Utilities

While post-2020 Cap Adjustment Factors (CAFs) were not specifically addressed in the Workshop, they are relevant to allowance allocation and critical to the protection of residential households and businesses of California from harmful economic impacts. Board Resolution 17-21 (BR 17-21) directed CARB Staff to work with natural gas utilities to "evaluate and propose, as necessary, post-2020 program amendments to ensure adequate rate payer protection…." To enable the goal of BR 17-21, the GUG feels that the rate of allowance allocation decline, as administered through the CAFs, should return to the current level of approximately 2% per year for the following reasons:

- A significant cost burden for many customers of municipal utilities already exists. For example, customers of the Vernon Public Utilities pay a 5 cents-per-therm surcharge, City of Long Beach customers pay a 4 cents-per-therm surcharge, and City of Palo Alto customers pay 2.6 cents-per-therm surcharge. The electric sector is recognized for their additional cost burden from the Renewable Portfolio Standard and other mandates through an allowance allocation methodology that accounts for these impacts. Natural gas utilities currently do not receive such recognition.

- Natural gas utilities are making significant and material steps towards decarbonizing their pipelines which require significant investment. For example, in 2016 the City of Palo Alto approved a Carbon Neutral Natural Gas Plan which set in motion a strategy to achieve carbon neutrality for the gas supply portfolio. All Palo Alto gas customers pay a 4 cent-per-therm surcharge in addition to any Cap-and-Trade compliance charges. Placing additional customer costs on top of these efforts is counter-productive.

- Natural gas use in commercial and industrial applications has reached high efficiency and has limited opportunities for additional end-use improvement. These consumers are then faced with higher prices without any obvious ways to reduce their demand.[1]

- The Public Utilities Commission's recent Proposed Decision (R.14-03-003) does not allow the return of allowance revenue as a climate credit to any ratepayer other than residential households. This offers no relief to small businesses who will bear an increasing impact from cap-and-trade compliance costs, making the CAF more important as a tool for mitigating the rising costs of the transition to a low-carbon economy for those small business customers.

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[1] See California Climate Change Center, *Price Impact on the Demand for Water and Energy in California Residences*, (CEC-500-2009-032-F) (2009) and Bernstein, M.A., Griffin, J., *Regional Differences in the Price-Elasticity of Demand for Energy*, National Renewable Energy Laboratory, (Subcontract Report NREL/SR-620-39512) (2006).

In alignment with the BR 17-21 directive, we urge CARB to re-establish the previous allowance allocations for natural gas utilities that has been applied for 2015-2020. This change is critical to protect utility customers from economic hardship and to gradually introduce cap-and-trade costs as the state strives to meet its ambitious greenhouse gas reduction goals.

2. Price Ceiling

The GUG supported the establishment of a price ceiling in AB 398 because it provides certainty that helps compliance entities make practical, long-term investments in emissions-reduction technologies. A price ceiling will also ensure that allowance prices do not exceed a level that would result in a pause or end to the Program, which would jeopardize California's ability to achieve its emissions reductions goal. CARB is proposing a range for 2030 of $81.90 to $150 in 2015 dollars which equates to $92 to $169 in 2021 and $110 to $202 in 2030 based on a 2% inflation rate. We believe the proposed ceiling price range is too high and the justification for the highest value, which is one voluntary corporate carbon price that may not even be used in the United States, is not sufficient support. Similarly, rather than using just one study on the Social Cost of Carbon (SCC), CARB should look at the balance of research on SCC, which is reflected in the 2016 US Government SCC. The GUG recommends that the CARB-proposed low end of the range ($92 and $110) should be the high end of the range and the new low end should be between $62 and $80 to meet the following goals that the Legislation laid out in AB 398:

- To avoid adverse impacts on resident households, businesses, and the state's economy.
- To minimize economic and environmental leakage.
- The cost per metric ton of greenhouse gas emissions reduction to achieve the statewide emissions targets established in Sections 38550 and 38566.

Further, the GUG feels that it is important to use a relevant and defensible price ceiling to protect from threatening the long-term viability and support for the Cap-and-Trade Program within the Western Climate Initiative (WCI) and other jurisdictions with which it might link in the future. CARB staff has stated in public forums that they do not anticipate the program ever reaching the price ceiling. Many of the existing reductions have come from complementary measures, which are not enough to meet California's targets. We believe hitting the price ceiling is a real possibility as the projected emissions start reaching the cap and jurisdictions that are close to being net short of allowances like Ontario are linked with California. Failure to consider that possibility when setting the price ceiling is not prudent in protecting the state's households and businesses. The GUG looks forward to discussion with CARB and other stakeholders on an appropriate level for the price ceiling throughout this rulemaking process.

In response to CARB's request for feedback on the timing and the mechanism for sales at the price ceiling, the GUG recommends a process similar to the Reserve Sale process (i.e., to be offered quarterly if the preceding auction settlement price is greater than or equal to 60% of the ceiling price, and at least once a year prior to a compliance event). The GUG disagrees with CARB's proposal to require an entity's holding account to be empty of compliance instruments valid for surrender before being allowed to purchase price ceiling instruments. In addition, the

GUG believes that the sales should take place annually in mid-October just prior to the November surrender deadline. We agree with CARB on depositing purchases directly in compliance accounts.

3. Reserve Tiers (formerly Price Containment Points)

In addition to a price ceiling, the GUG supports the establishment of two lower Reserve Tiers (RTs) as directed by AB 398. These RTs provide an important opportunity to help contain costs, which could rise very quickly in the post-2020 period once allowance demand exceeds supply. In addition, the RTs could be used to send appropriate market signals, mitigate extreme price volatility and provide a trigger point for the Legislature and stakeholders to review the program parameters.

The RTs would be more effective if spaced somewhat evenly between the floor price and ceiling price, rather than being clustered together near the ceiling. If the RTs are placed too close together or too close to the ceiling price, we fear they would be ineffective and fail to act as a brake on short-term price spikes as intended by the authors of AB 398. The risk is that policy makers might intervene and suspend the program due to price spikes rather than evaluate and refine with a more gradual price trajectory, thereby mitigating potential risk to households, businesses and the viability of the program.

Staff's proposed RTs as described in the Price Concepts Paper are both too high and too close to any effective price ceiling point. Furthermore, it appears that Staff is using the current program's Allowance Price Containment Reserve prices to guide the *lowest* RT tier. This is contradictory to the direction of AB 398, which requires the *price ceiling* to consider the APCR, not the RTs. Doing so skews the pricing structure upward in a way we believe was not intended by the authors of AB 398.

For the reasons stated above, the GUG suggests that CARB start by setting the Price Ceiling and the Auction Reserve price first, then determining the two RT prices. One possible method of setting the RT prices is to take the difference between the Price Ceiling and the Auction Reserve Price and simply set Tier 1 at the sum of the Auction Reserve Price plus ~35% of the difference and Tier 2 at the sum of the Auction Reserve Price plus ~65% of the difference.

In addition, the GUG believes that in order for the RTs to be effective they must have sufficient volume. In the Workshop, Staff requested feedback on where the Allowance Price Containment Reserve (APCR) allowances and unsold allowances should be placed. One possible way to help achieve adequate volumes in the RTs is to transfer APCR allowances and unsold allowances into the RT reserves. Therefore, the GUG recommends that the 52.4 MMT that CARB planned to add to the post-2020 Reserve be placed in the RTs. Placing these allowances in the RTs would increase their effectiveness in mitigating rising allowance prices and help ease the transition to higher prices. The GUG will continue to explore other possibilities as well.

The GUG recommends a similar process as mentioned above for the price ceiling, for the sale of allowances at the RTs.

4. Banking of Allowances and Holding Limits

At the workshop, CARB requested stakeholder feedback on additional factors to consider in determining potential modifications to banking rules. The GUG supports flexible banking rules and recommends that existing rules be extended post-2020. If, however, modifications to the banking rules are considered, the GUG reminds CARB that compliance obligation forecasts are not equal to actual verified emissions. Variability between forecasts and actuals would not be a problem if the auctions made the appropriate vintage allowances available for purchase after final verification emissions were known. Without banking, entities/sectors with more volatile outputs/emissions will have more limited compliance options.

CARB should also consider whether changes to the holding limit are necessary now that the Cap-and-Trade Program extends beyond 2020. The extension of the Program creates the opportunity to evaluate whether or not the existing holding limit supports the additional program period. The GUG would appreciate consideration for increasing an entity's holding limit, since this could help reduce market volatility as the cap declines.

5. Offset Credits

The GUG continues to support offset projects that provide real, additional, quantifiable, and verifiable GHG emission reductions. These projects can provide reductions from uncapped sectors like agriculture and forestry, and in some cases, these emission reductions can be achieved at lower cost than other GHG emission reductions, reducing the overall cost of the Cap-and-Trade Program and thereby its economic impact on California consumers. While AB 398 reduced the overall usage limits of offset credits for compliance entities from the current level of 8% to 4% between 2021 and 2025 and 6% between 2026 and 2030, we urge CARB to take a less restrictive view of the geographic source of offsets. We are encouraged by Staff's preliminary proposals provided in the Workshop materials. It will be important to the viability of offset credits as an effective compliance vehicle to define "Direct Environmental Benefits" in a sensible way that is not overly restrictive to the burgeoning offset market nor too burdensome to enforce.

6. Allocation and Distribution of Allowances

Certain stakeholders are concerned with the fact that covered emissions have been lower than the annual caps in the Regulation, referring to this as "overallocation." The GUG does not view this as a failure, but as a success of the Cap-and-Trade program. The state is on track to achieve the 2020 emissions target early. We agree with ARB Staff's thinking on this issue in that the program is working as intended and that any modifications warrant more thoughtful and in-depth evaluation. We also share Staff's concerns that making the market more stringent would only penalize covered entities for early action in reducing greenhouse gases and incent them to only do the minimum. Additionally, restricting the market, as some stakeholders have suggested, would introduce future allowance scarcity, and in doing so, increase prices today for compliance entities and consumers. Furthermore, the jurisdictional linkages of Quebec and Ontario are anticipated to bring further demand on total available allowances, resulting in further tightening of the market.

Available analyses, such as the report from the University of California Energy Institute[2], generally project that allowance demand will exceed supply sometime before 2030, even when including the purchase of previously banked allowances. When this occurs, prices will increase, and could increase dramatically. Permanent removal of allowances from the market restricts supply, accelerating the date that allowance prices will increase. While cumulative in-state emissions will be lower, compliance costs will be higher, and at higher prices, economic leakage, emissions leakage, and greater negative impacts to households are likely to occur.

Similarly, CARB's proposal to remove an additional 2% (23 MMT) of budget years 2026-2030 from the regular auctions in response to AB 398's change in the offset usage limits is premature since the program could be short on allowances and such a removal could inadvertently push prices to the ceiling sooner. CARB established allowance budgets for the post-2020 Program in its 2017 rulemaking at a time when the offset usage limit for the program was 8%. The Legislature lowered the offset usage limit from 8% to 4% in 2021-25 and back up to 6% for 2026-30. In both 5-year periods, the offset usage limit is getting more restrictive relative to the policy in place when CARB originally established the post-2020 allowance budgets. This is not at all analogous to the change in the offset usage limit from 4% to 8% to account for the removal of allowances to fill the APCR, which was intended to maintain relative stringency (i.e., by expanding offsets supply in response to fewer allowances being made available to the auctions) in the face of changes to the allowance budgets.

In the current situation, the Legislature has acted to increase the stringency of the Program, and in response, CARB is proposing to further increase the stringency by removing allowances from the post-2020 budgets. Instead, CARB should consider expanding the post-2020 allowance budgets to balance out the lower offset usage limit. At the very least, CARB should not exacerbate the Legislature's action to tighten the post-2020 program via offset usage limits with further actions to remove allowances from the post-2020 market.

7. <u>Eligible Uses of Allowance Proceeds</u>

Staff proposed specific language in the Preliminary Discussion Draft that restricts electric and natural gas utilities from using allocated allowance proceeds for activities other than as described. In particular, the additional language proposed in Sec. 95893(d)(3) restricts the use of allowance proceeds to the programs set forth in Sec. 95892(d)(3)(A)-(D) of the electric utility section without providing for natural gas specific measures such as renewable natural gas or near-zero emission vehicles. The GUG feels that this language is overly prescriptive and only considers uses applicable to the electric sector. By limiting eligible GHG reduction approaches, CARB is "picking the winners" and thus excluding other potentially viable technologies. Other solutions and technologies need to be encouraged and funded as a variety of GHG reduction

[2] Severin Borenstein, James Bushnell, and Frank Wolak, "California's Cap-and-Trade Market Through 2030: A Preliminary Supply/Demand Analysis" (July 2017) Working Paper 281.

approaches will benefit all who want to reduce carbon emissions. The GUG recommends broadening the language to include allowable uses of the funds for any and all greenhouse gas reducing strategies and programs, inclusive of procurement of renewable gas, funding renewable gas infrastructure, and other natural gas-related GHG reduction measures.

In conclusion, the GUG believes that the viability and health of the post-2020 Cap-and-Trade program can be strengthened by the appropriate application of the modifications directed by AB 398 and BR 17-21, including further consideration of natural gas allocation. Again, the GUG thanks CARB for this opportunity to comment on the Workshop, and we look forward to additional dialogue. Please contact the members of the GUG if you have any questions or concerns about these comments.

Sincerely,

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