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Eileen Hlavska, Lead Staff
Elizabeth Scheehle, Manager
California Air Resources Board
1001 "I" Street, Sacramento, CA, 95812

Subject: Comments of the Natural Resources Defense Council and Environmental Defense Fund on the June 3, 2013 Cap-and-Trade Program Natural Gas Suppliers Workshop

The Natural Resources Defense Council (NRDC) and Environmental Defense Fund (EDF) appreciate the opportunity to comment on the staff presentation and utility proposal presented at the June 3, 2013 Cap-and-Trade Natural Gas Suppliers Workshop.

NRDC and EDF applaud the Air Resources Board's (ARB) ongoing commitment to examine and resolve key design features of the cap-and-trade program through an open and public process. ARB's commitment to a stakeholder-driven, participatory process has been a hallmark of its approach to implementing AB 32, which has helped put California on course to meet the 2020 greenhouse gas (GHG) emission reduction target. We look forward to remaining engaged on this issue and the other key cap-and-trade rulemaking items that are before ARB this fall.

I. INTRODUCTION

The GHG emissions associated with natural gas combustion will comprise the third largest emitting sector under the cap in 2015, behind only transportation fuels and electricity generation. Allocating allowances from the natural gas sector will therefore have significant implications not only for natural gas suppliers and end users, but for other covered sectors under the cap and the market as a whole. ARB must remain mindful of these effects as it develops an allowance allocation approach.

Overall, we support an allocation framework that resembles the approach ARB employed for the allocation of allowances from the electricity sector to the investor-owned utilities (IOUs). Under that approach, the value of allowances is dedicated exclusively for the benefit of electricity customers, but regulators determine how allowance value is returned to customers through a public process. We note there are fundamental differences between the coverage of natural gas and electricity under the cap that may warrant modifications from the electric-IOU framework. While the mechanics may differ, it is the underlying objectives achieved through the allocation framework that ultimately matter.

Accordingly, we first present our recommendations on principles ARB should employ to guide its decision-making on an allocation framework for natural gas suppliers. We then assess the Joint Utility proposal against those principles.

II. General Principles to Guide the Allocation of Allowances from the Natural Gas Sector

We strongly support the policy objectives outlined by staff at the workshop, including encouraging GHG emission reductions, maintaining equity and consistency among participants and sectors under the cap, and ensuring consistency with California's long-term climate and clean energy goals.[1] We offer the following principles as guideposts to ensure the allocation methodology achieves those objectives.

A. Dedicate the Value of Allowances in the Natural Gas Sector Exclusively for Natural Gas Utility Customers

We support allocating allowances to the natural gas distribution utilities *exclusively on behalf of their customers* and subject to a transparent public process to determine how allowance value is returned to customers. Similar to ARB's approach for allocating allowances from the electric sector, allocating allowances to the gas utilities would dedicate allowance value exclusively for the benefit of customers. This would ensure allowance value is available to cushion bill impacts, prevent adverse impacts on low-income customers, provide transition assistance, and help foster engagement and support for the cap-and-trade program and AB 32 broadly by providing a direct benefit to millions of customers.

ARB must ensure, however, that decision-making on *how* allowance value is provided to customers is done transparently and does not undermine other objectives identified by staff for the treatment of natural gas under the cap. Allocating allowances to the utilities with no strings attached (as they currently propose) would not ensure equity and consistency with other sectors under the cap, for example, as ARB could not ensure the utilities would preserve a carbon price signal in natural gas rates.

B. Manage Customer Bill Impacts By Providing Transition Assistance and Reducing Customer Exposure to Price Volatility

Consistent with the guiding principle ARB has employed for allowance allocation for all sectors under the cap, we support an approach that provides transition assistance to entities where the incidence of carbon pricing is expected to fall. In the natural gas sector, the incidence will fall on end use customers, as the utilities will pass through compliance costs in rates.[2] By providing an allocation of allowances to the gas utilities on behalf of their customers, ARB can ensure allowance value is available to mitigate impacts on customers as they transition into the cap-and-trade program and take steps to reduce their emissions.

We also strongly encourage ARB to prevent adverse impacts on low-income households. Unlike electricity rates, the provisions of Senate Bill 695 (Kehoe, 2009) will not shield low-income households[3] from seeing a carbon price signal in natural gas rates. While this is consistent with one of the

[1] ARB, "Suppliers of Natural Gas: Background and Options," slide 12 (June 3, 2013), available at: http://www.arb.ca.gov/cc/capandtrade/meetings/060313/natural_gas_suppliers_workshop_presentation.pdf.

[2] ARB, "Appendix J – Allowance Allocation," p. J-10 (Dec. 2010), available at: http://www.arb.ca.gov/regact/2010/capandtrade10/capv4appj.pdf.

[3] Customers enrolled in the California Alternate Rates for Energy (CARE) program.

fundamental objectives of the cap-and-trade program (that the price of carbon be reflected in all goods and services in the California economy to encourage cleaner and more efficient choices), low-income households already spend a disproportionate amount of their income on energy costs and will bear a disproportionate impact from carbon pricing in the general economy. Under any allocation methodology, ARB should ensure allowance value is available to offset impacts on low-income households.

C. Provide Allowance Value to Customers in a Manner That Rewards Ongoing Energy Efficiency Improvements and Conservation to Reduce GHG Emissions

The manner in which allowance value is returned to customers will have ramifications not only for the incentives created by carbon pricing to lower GHG emissions and encourage clean energy alternatives, but for the public's reception to and engagement with California's climate programs. Indeed, the considerations identified by staff to guide the treatment of natural gas under the cap – encouraging GHG reductions, maintaining equity and consistency among sectors, advancing California's long-term climate and clean energy goals – all hinge on how allowance value is ultimately provided back to natural gas end users.

A "volumetric return," for instance, where customers receive allowance value in direct proportion to their natural gas usage, undermines each of the above objectives. First, it blunts the incentive to reduce end use consumption (and associated GHG emissions) by tying usage directly to allowance value. This penalizes customer efficiency and conservation by lowering their share of allowance value, and conversely rewards higher consumption levels. Second, a volumetric return either completely mutes the carbon price signal in natural gas rates (if the utilities are long on allowances relative to their compliance obligation), or largely mutes the price signal (if the utilities are short on allowances). If other sectors under the cap face a higher carbon price, this could lead to suboptimal investment decisions among fuels. Finally, by dampening the incentive for businesses and consumers to find the most efficient and cost-effective means of reducing emissions, a pure volumetric return undermines California's ability to meet its long-term climate and clean energy goals.

Accordingly, if allowances are allocated directly to the utilities on behalf of their customers, we strongly recommend ARB and other state regulators ensure that allowance value is returned to customers in a manner that preserves the carbon price signal in natural gas rates. Preserving the carbon price signal both rewards future customer efficiency and conservation efforts (by separating allowance value return from usage) and provides an additional incentive for customers to take steps to reduce their GHG emissions. As staff identified at the workshop, reductions in natural gas use in response to a price signal alone may be able to achieve as much as two-thirds of the natural gas sector's GHG emission reductions under the cap.[4]

III. Comments on the Joint Utility Proposal

The Joint Utilities propose that ARB directly allocate allowances to natural gas distribution utilities in proportion to their anticipated compliance obligation out to 2020, less the cap decline factor.[5] Like the

[4] ARB, "Suppliers of Natural Gas: Background and Options," slide 14 (June 3, 2013), available at: http://www.arb.ca.gov/cc/capandtrade/meetings/060313/natural_gas_suppliers_workshop_presentation.pdf.

[5] Joint Utilities, "Gas Utility Presentation: ARB Workshop on Gas Allowances Allocation," (June 3, 2013), available at: http://www.arb.ca.gov/cc/capandtrade/meetings/060313/gas_utility_presentation_june_3.pdf.

publicly-owned electric utilities, the gas utilities request authority to submit allowances directly for compliance, with no requirement to monetize or otherwise aggregate allowance value to be returned to customers though a separate public process. The proposal is largely unchanged from the Joint Utilities' submission to ARB in 2010, except the utilities now request a full (100%) administrative allocation. In 2010, the utilities proposed a 90% allocation that they could use directly for compliance, with the 10% remainder subject to consignment at auction and the resulting proceeds set aside for customer energy efficiency and clean energy.[6] The utilities project that even with a full administrative allocation they will be net short allowances in 2020 by roughly 10%, which will operate to provide a carbon price signal in rates for their customers.

We offer the following comments on the Joint Utility proposal assessed against the principles identified above.

A. The Proposal Does Not Provide Sufficient Oversight, Transparency or Accountability with Regard to the Allocation of Allowance Value to Natural Gas Customers

As staff noted at the workshop, at $15/ton, the inclusion of natural gas emissions under the cap in 2015 will generate $800 million in allowance value.[7] This is a significant public resource that demands a robust public process.

Like the allocation methodology for electric-sector allowances, the utility proposal dedicates allowance value from the natural gas sector exclusively for the benefit of customers (not shareholders). As noted above, this approach can ensure the value of allowances is available to mitigate cost impacts where they arise, provide transition assistance, and prevent adverse impacts on low income customers. In its current form, however, we are concerned the utility proposal masks important decisions that will have a significant impact on achieving staff's stated objectives. For instance, the ability to submit allowances directly for compliance operates as an implicit volumetric return of allowance value. In that scenario, the utility is using allowance value to prevent natural gas rates from rising to reflect the carbon price. That is directly at odds with ARB's stated policy objective related to allowance value return,[8] as it blunts incentives to reduce consumption and associated GHG emissions, and penalizes more efficient users relative to a scenario where the full range of allowance value is returned to customers independent of usage.

B. The Proposal Largely Masks the Carbon Price Signal in Natural Gas Rates and Raises Important Policy Questions Relative to the Treatment of Other Sectors Under the Cap

By preserving only a fraction of the carbon price in natural gas rates, the utility proposal raises important policy questions relative to the treatment of other fuels under the cap. Natural gas competes with other fuels regulated under the cap for various applications, including space and water heating, transportation, and use in various appliances. Relative to gasoline and diesel, natural gas will win out under the cap even if the full price of carbon is reflected in natural gas rates, as on a combustion basis

[6] ARB, "Appendix J – Allowance Allocation," p. J-61 (Dec. 2010), available at: http://www.arb.ca.gov/regact/2010/capandtrade10/capv4appj.pdf.

[7] ARB, "Suppliers of Natural Gas: Background and Options," slide 13 (June 3, 2013), available at: http://www.arb.ca.gov/cc/capandtrade/meetings/060313/natural_gas_suppliers_workshop_presentation.pdf.

[8] ARB, "California's Cap-and-Trade Program: Final Statement of Reasons," p.2307 (Oct. 2011), available at: http://www.arb.ca.gov/regact/2010/capandtrade10/fsor.pdf.

natural gas emits substantially less. But relative to electricity the comparison is closer, and ARB must be careful to avoid creating a preserve incentive that cuts against advancing the state's aggressive electrification goals.

As the utilities have noted, in practice electricity rates will not reflect the full cost of carbon. Under the terms of the California Public Utilities Commission's (CPUC's) final decision on the allocation of allowance value to electricity customers of the IOUs, allowance value will be returned directly to emissions-intensive trade-exposed (EITE) customers, small business customers, and households.[9] For upper-tier residential customers, the return will be purely volumetric, completing masking any carbon price signal. The decision likewise recommends an allocation to small business customers in rates, although the final details of the proposed return are still pending.

The decision was clear, however, that preserving the carbon price in electricity rates was the Commission's guiding principle in developing the allocation methodology.[10] The Commission only deviated from the principle where other statutory constraints prevented a fair apportionment of costs and benefits (as in the case of upper-tier residential customers), or statute mandated that the Commission provide a direct allowance return to certain customer classes (as in the case of small business customers).[11] Those issues are not present in the case of natural gas. Likewise, the Commission is proposing to use the 'low' assistance factor to discount the return for small businesses.[12] As all non-EITE and small business customers will see the full carbon price in rates from the start of the program, the upshot of the CPUC's decision is that all non-EITE commercial customers will see a substantial portion of the carbon price reflected in electricity rates starting in 2015. Compared to the Joint Utility proposal, customers could therefore see a higher carbon price reflected in their electricity rates than natural gas rates over the course of the program.

IV. CONCLUSION

We look forward to continuing to engage with ARB staff, the Joint Utilities, and other stakeholders on this important issue. Thank you for considering our comments.

Sincerely,

Alex Jackson
Legal Director, California Climate Program
Natural Resources Defense Council

Tim O'Connor
Director, California Climate Initiative
Environmental Defense Fund

[9] D.12-12-033, "Decision Adopting Cap-and-Trade Greenhouse Gas Allowance Revenue Allocation Methodology for the Investor-Owned Electric Utilities" (Dec. 20, 2012), available at: http://docs.cpuc.ca.gov/PublishedDocs/Published/G000/M040/K631/40631611.PDF.
[10] Id. at 4 ("we are guided principally by a desire to maintain the carbon price in rates and therefore ensure that the price of goods and services reflects the full cost of carbon in order to send the clearest signal to ratepayers to make the most efficient economic decisions.").
[11] Following passage of the budget trailer bill, SB 1018.
[12] D.12-12-033, "Decision Adopting Cap-and-Trade Greenhouse Gas Allowance Revenue Allocation Methodology for the Investor-Owned Electric Utilities" (Dec. 20, 2012), available at: http://docs.cpuc.ca.gov/PublishedDocs/Published/G000/M040/K631/40631611.PDF.