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ARB's Cap-and-Trade Website

Mr. Steven Cliff
Chief - Climate Change Markets 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's Proposal to Link California and Quebec's Greenhouse Gas Cap-and-Trade Programs

Clerk of the Board:

Pacific Gas and Electric Company ("PG&E") is pleased to submit these comments on the Air Resources Board's ("ARB") proposal to link the California and Quebec Greenhouse Gas ("GHG") cap-and-trade programs. PG&E believes a well-designed, multi-sector cap-and-trade program linked with other jurisdictions is critical to ensuring a robust and liquid market. We view linkage with Quebec as an important first step. We look to the ARB and California to continue to move quickly toward additional linkage opportunities, while also ensuring that linkage occurs in a manner that recognizes California's decades-long effort to increase energy efficiency and secure renewable energy resources. We also encourage ARB to continue to ensure that linkage and cross-market rules are coordinated so as not to limit compliance flexibility and cost-containment measures ARB has included as part of its program.

I. INTRODUCTION.

PG&E's detailed comments on the proposed linkage between California's and Quebec's cap-and-trade programs are set forth in Section II below. At the outset, however, the following summarizes the issues we believe to be of critical importance in assuring that the California and Quebec programs are harmonized and linked effectively:

- **PG&E Supports ARB Staff's Proposal to Limit Access to California's Allowance Price Containment Reserve to Entities with a Compliance Obligation under California's Cap-and-Trade Program.**

- **Market Simulations During 2012 are Essential and Will Help Ensure That the California and Quebec Programs are Properly Harmonized.**

- **Beneficial Holding Requirements, Holding Limits, and Account Management Restrictions Should Be Modified to Put California Complying Entities on a Level Playing Field with Their Quebec Counterparts.**

- **Allowances Purchased from a Linked Jurisdiction Should Remain Fully Fungible for Compliance Purposes.**

- **Without the Timely Adoption of Additional Offset Protocols and Added Compliance Flexibility, Linkage with Quebec May Put a Strain on the Already Limited Supply of Offsets Available in the First Compliance Period.**

II. DISCUSSION.

A. PG&E Supports ARB Staff's Proposal to Limit Access to California's Allowance Price Containment Reserve to Entities with a Compliance Obligation under California's Cap-and-Trade Program.

PG&E supports ARB staff's recommendation to prohibit Quebec entities from purchasing from California's allowance price containment reserve. The allowance price containment reserve is an essential mechanism in the cap-and-trade program to reduce the likelihood of high and volatile allowance prices. As we have noted in prior comments on the cap-and-trade regulation, allowing entities without a cap-and-trade compliance obligation in California to purchase from the reserve may accelerate depletion of the reserve and compromise the price protection that the reserve provides.

B. Market Simulations During 2012 are Essential and Will Help Ensure That the California and Quebec Programs Are Properly Harmonized.

PG&E supports ARB's intent to conduct market simulations prior to the start of the program as expressed in resolution 11-32.[1/] As we have noted in our prior comments on the cap-and-trade regulation, we see significant value in testing and better understanding potential market outcomes under different conditions. Specifically, simulations could allow for an assessment of how the

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1/ ARB Resolution 11-32 directs "the Executive Officer to contract with an external entity and work closely with regulated entities and other stakeholders to evaluate potential market conditions, trading dynamics, the Allowance Price Containment Reserve, and other key design features of the program prior to the beginning of the compliance obligation on January 1, 2013" (ARB Resolution 11-32, October 20, 2011).

market functions in response to the behavior of market participants and identify a range of expected market outcomes. Through such testing, ARB will be able to gain valuable insights with respect to market design and pursue any necessary modifications, if possible, prior to commercial and financial commitments being made in the first two auctions in 2012.

The linkage of the California program to Quebec only adds to the importance of timely simulations that can help inform and shape the specific contingency measures included in the regulation. Sophisticated market simulations will help ARB determine which provisions of the regulation need to be harmonized with the Quebec regulation based on the potential for market gaming or other unintended consequences. Market simulations can assess potential outcomes under base case scenarios, or alternative scenarios of high growth and/or shortcomings of program measures, under which the California and Quebec economies may generate more emissions than in the base case modeled by WCI and in which the Allowance Price Containment Reserve has a significant probability of being depleted.

C. Beneficial Holding Requirements, Holding Limits, and Account Management Restrictions Should Be Modified to Put California Complying Entities on a Level Playing Field with Their Quebec Counterparts.

PG&E is concerned that the current proposed beneficial holding requirements do not provide sufficient flexibility to electrical distribution utilities to procure compliance instruments on behalf of certain counterparties with which it has contracts for the delivery of electricity. PG&E is also concerned that the holding limit will not enable it to procure sufficient compliance instruments on behalf of certain counterparties with which it has contracts. Further, the proposed holding limit prevents entities with a large compliance obligation from being able to sufficiently hedge future obligations. PG&E believes that both the beneficial holdings and holding limit sections of the regulation should be amended to resolve these concerns. Further detail is provided below.

1. Beneficial Holdings.

PG&E appreciates that ARB has recognized the need to allow electrical distribution utilities to claim a beneficial holding relationship under certain circumstances to enable them to procure allowances on behalf of certain counterparties. While the beneficial holdings language of Section 95834 allows for the compliance instruments held by an agent to count against the holding limit of the principal, the requirements in Section 95834(b)(2) may result in an agent having to acquire compliance instruments before it has knowledge of the principal's actual annual compliance obligation. There are several factors beyond our control regarding whether a given facility will be dispatched (and therefore emit) making it impossible to accurately forecast a given facility's emissions and, therefore, procure on a per facility basis. For example, factors such as weather, seasonal and daily demand fluctuations, hydro availability, and plant outages impact the operation of a facility. For these reasons, it is not unusual for a facility's output to vary by roughly a factor of three from one year to the next.

Given the variability in dispatch, timing requirements related to beneficial holdings are of significant concern. The allowance auctions occur in advance of the reporting by facilities of emissions at a time when a facility's generation is unknown. Electrical distribution utilities will forecast compliance obligations on a portfolio basis. However, parsing out the exact production on a facility level cannot be done until after emissions are reported and verified which will occur well after compliance instruments for the current vintage are sold through the auction. Providing ARB with notification of how to parse out auction purchases in advance of these calculated emissions could result in stranded allowances. Under the current approach, it is possible that an agent could be obliged to transfer more compliance instruments to the principle than its contract for the delivery of electricity requires.

As ARB works to link with Quebec and harmonize the two programs' regulations, we recommend changes to ARB's regulations to resolve the aforementioned concerns and allow California entities flexibility to comply with the holding limit requirements. We propose the following changes and clarifications to the current ARB regulations:

(1) To satisfy the "prior to purchase" disclosure requirements detailed in Section 95834(a)(3) of the regulations, entities should simply provide a list to ARB of potential entities for whom we may purchase and hold compliance instruments ("Disclosure List") without having to disclose specific quantities to be purchased. The Disclosure List would establish the beneficial holdings relationship for purposes of compliance with the regulations and would be provided prior to submitting any transfer requests for beneficial holdings. The Disclosure List would be updated as needed to add additional entities with which there is a beneficial holding relationship, as well as remove entities where the relationship is no longer in effect;

(2) Upon initiating a transfer request to ARB, the agent will designate a quantity of compliance instruments as beneficial holdings to be transferred within one year. The quantity of compliance instruments included in the transfer request will not count toward the agent's holding limit. Within one year of initiating the transfer request, the transfer request will be completed by the agent with serial number specification and quantity to be

completed by the agent with serial number specification and quantity to be transferred to each specific principal. After confirmation by each principal, the compliance instruments will be transferred to the principal's account. Once the transfer is complete and compliance instruments have been transferred, they will count toward the principal's holding limit; and

(3) To ensure that the holding limit flexibility recommended above is only used to support entities with a physical compliance obligation, transfer requests for compliance instruments designated as beneficial holdings must be transferred to the compliance account of the principal in the beneficial holdings relationship.

This simple process provides ARB with information on beneficial holding relationships and transfers of compliance instruments while providing the intended and necessary relief to a complying entity's holding limit so they may comply without being disadvantaged as compared to entities in linked jurisdictions.

2. Holding Limits.

During the February 3rd workshop on linkage, ARB proposed that the holding limit calculation established in the regulation use an annual allowance budget equivalent to the total number of allowances issued in the linked programs or an aggregate "base" value. While an aggregate "base" value would modestly increase the holding limit in California by a few hundred thousand tons (~320,000 mtCO2e), Quebec's holding limit would increase from about 1 million to about 2.7 million. This would provide Quebec entities disproportionate flexibility in holding compliance instruments as compared to California entities, which raises concerns regarding the ability of Quebec entities to procure and hold large volumes of compliance instruments relative to their obligation.

When harmonizing the two programs, we recommend the holding limits be adjusted proportionally, per the two jurisdictions' cap-and-trade programs, to ensure that modifications to the holding limits do not disproportionately benefit one jurisdiction over the other. Alternatively, if ARB is not able to modify the beneficial holdings section as described above, PG&E recommends that ARB revisit the holding limit established in Section 95920 to provide the necessary flexibility to procure compliance instruments on behalf of its utility-owned and contractual obligations.

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3. Flexibility in Managing Compliance Accounts.

Several parties attending the linkage workshop noted that ARB's plan to create separate accounts for each separate covered facility makes it difficult to comply with the holding limit, as well as use the limited exemption to the holding limit to its full benefit. Given these concerns and those expressed above with respect to beneficial holdings and holding limit, we also recommend that the cap-and-trade regulation be modified to allow complying entities to move compliance instruments between all compliance accounts over which they have control. Alternatively, ARB could allow entities to use one set of accounts to pertain to the entity's total compliance obligation and total compliance instrument inventory.

D. Allowances Purchased from a Linked Jurisdiction Should Remain Fully Fungible for Compliance Purposes.

PG&E recommends that ARB amend the cap-and-trade regulation to specify that compliance instruments purchased from a linked jurisdiction are fully fungible for compliance purposes even if a linked jurisdiction subsequently modifies its program or ceases to be linked with California. Market participants need assurance that compliance instruments will be given "full faith and credit" by California provided that the issuing jurisdiction was linked with California when the instrument was originally issued.

E. Without the Timely Adoption of Additional Offset Protocols and Added Compliance Flexibility, Linkage with Quebec May Put a Strain on the Already Limited Supply of Offsets Available in the First Compliance Period.

PG&E believes that the use of high quality offsets is an effective cost containment tool and an essential part of a successful cap-and-trade program. Multiple studies have shown that the costs of the cap-and-trade program are much higher without a robust supply of high quality offsets.

PG&E supports the addition of Quebec to the cap-and-trade market. However, we believe linkage puts a strain on an already limited supply of offsets in the first compliance period. This is due to the lack of current offset protocols and the lead time to develop offset projects once the protocols are approved. Assuming that all offset projects in the first compliance period are verified and issued tons under the current ARB protocols or early action offset protocols, PG&E's model forecasts about 26 million metric tons ("MMT") of offsets that will be available in the cap-and-trade market. The Quantitative Usage Limit in the first compliance period in California is approximately 28 MMT, and Barclay's Bank estimates that the inclusion of Quebec increases the limit to around

31 MMT.[2] Without the approval of additional protocols, the supply of offsets will not be able to meet the demand, and the cost containment objectives of offsets will not be realized.

Unfortunately the approval of additional protocols may not be sufficient because the lead time to develop a new offset project is significant. Based on information from the Climate Action Reserve, it takes an average of between 121 and 717 days to go from project listing to first issuance. The first project for a new protocol typically takes even longer to go from listing to first issuance. Even if the ARB or Quebec approves additional protocols, there may not be sufficient time for those projects to enter the market in time for the first compliance period.

Because there will be an insufficient supply of offsets at the outset of the program, PG&E requests that the Quantitative Usage Limit apply to a complying entity's total compliance obligation from January 1, 2013 through the current compliance period. This will allow time for the offset market to develop projects while maintaining the current cap on the use of offsets. Even if projects will not be able to deliver offsets within the first compliance period, PG&E strongly urges both the ARB and Quebec to quickly adopt additional protocols. PG&E also encourages Quebec to quickly adopt the ARB protocols as written.

Finally, PG&E recommends the ARB and Quebec adopt the Climate Action Reserve's Nitric Acid Production and Coal Mine Methane protocols, as well as the American Carbon Registry's Protocol for Conversion of High-Bleed Pneumatic Controllers in Oil & Natural Gas Systems. These protocols show the greatest potential of quickly delivering high quality reductions.

Thank you for the opportunity to submit these comments. We look forward to continuing our work with the ARB and all concerned stakeholders to ensure the successful implementation of AB 32.

Very truly yours,

John W. Busterud

JWB:kp:bd

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[2] "Carbon Flash – Due North, Quebec Cap and Trade", Barclays Bank Commodities Research, February 9, 2012.