



**Pacific Gas and
Electric Company®**



**SOUTHERN CALIFORNIA
EDISON**

An EDISON INTERNATIONALSM Company

April 30, 2009

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Officer
California Air Resources Board
1001 "I" Street
Sacramento, CA 95814-2828

**Re: Pacific Gas and Electric Company's and Southern California Edison
Company's Comments on the California Air Resource Board Staff's
Proposed Quantitative Limit on the Use of Offsets**

Dear Chairman Nichols and Executive Officer Goldstene:

Pacific Gas and Electric Company ("PG&E") and Southern California Edison Company ("SCE") appreciate the California Air Resource Board ("ARB") staff's effort to address offsets in the cap-and-trade rulemaking. PG&E and SCE urge the ARB, however, to reconsider the initial proposal in the Scoping Plan to limit the use of offsets in the cap-and-trade program.

Assembly Bill ("AB") 32 directs the ARB to design greenhouse gas ("GHG") emission reduction measures to meet statewide emission limits "in a manner that minimizes costs and maximizes benefits for California's economy."^{1/} Real, permanent, verifiable, quantifiable, enforceable, and additional offsets can play a critical role in containing costs for California businesses and consumers and help keep the State on the long-term emission reduction path envisioned by AB 32 at the lowest overall cost to California's economy.

The cost containment benefits of offsets to California businesses and consumers are especially important given the downturn in the State and national economies and the possibility that the costs of the AB 32 GHG reduction program may be significantly higher than current estimates. Indeed, the use of high quality offsets is a critical consumer cost containment mechanism in the Scoping Plan in the event that current estimates of cost and compliance achievement prove inaccurate.

In addition, the electric sector, particularly the investor-owned utilities ("IOUs"), have State-adopted goals for development and deployment of new low-carbon technology in the areas of renewable energy and energy efficiency. These policy goals, coupled with the already significant achievements of the IOUs in both these areas (as well as other challenges, such as developing needed transmission for new renewables and quick-start natural gas-fired

^{1/} Cal. Health & Safety Code § 38501(h).

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Director
April 30, 2009
Page 2

generation), require that offsets be a viable option to assure the utility sector's, and the State's, ability to meet GHG cap-and-trade limits.

ARB's proposal to severely restrict the amount of offsets that can be used in the cap-and-trade program could prove inconsistent with the goals of AB 32 to maximize emission reductions in a cost-effective manner.^{2/} The proposed limit of 49% of emission reductions represents only about 2% of the emissions cap in the first compliance period. This unnecessarily restrictive limit on offsets will increase the cost of the State's emission reduction program by restricting obligated entities' access to cost-effective emission reduction opportunities, and consequently, may impede the State's ability to achieve its AB 32 goals.

PG&E and SCE strongly urge the ARB to forego setting quantitative limits on the use of offsets at this time, and instead turn expeditiously to the challenge of developing viable and practical offset rules, guided by the development of crediting early voluntary GHG reduction projects to get California-based real world offset experience. If offsets are going to play a meaningful role in the State's AB 32 program, the ARB should act now to give offset project developers and obligated entities the certainty they need to begin working on offset projects.

The ARB should first establish by rule a clear set of protocols for approving offset projects independent of any restrictions on offsets. In addition, we urge the ARB to evaluate collectively, through economic cost-benefit analysis, all cap-and-trade elements that affect customer costs including cap level, trajectory, allowance allocation, and cost containment mechanisms, including offsets, before determining whether and to what extent offset limits may be appropriate. At a minimum, the ARB should either demonstrate the need for quantitative limits to assure reductions in an electric sector already subject to State policy goals or defer the adoption of any quantitative offset limits for five years and then assess whether such limits are needed.

A. Offset Limits Restrict Access to Cost-Effective GHG Emission Reduction Opportunities and May Impede the State's Ability to Reach its AB 32 Goals.

PG&E and SCE strongly support the use of quality offsets as an indispensable tool in abating GHG emissions in a cost-effective manner, and as a practical pathway to compliance with cap-and-trade limits for obligated entities. There should be no need for limits on the use of offsets for compliance purposes as long as the offsets meet rigorous quality standards implemented by the ARB. Such limits could undermine the benefits of offsets by restricting access to cost-effective GHG reduction opportunities, and thus needlessly increase the cost of

^{2/} See *id.* §§ 38501(h), 38560, 38562(a), 38562(b)(1).

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Director
April 30, 2009
Page 3

compliance with AB 32.^{3/} By limiting obligated entities' ability to reduce emissions in a cost-effective manner, restricting offsets could also jeopardize the State's ability to reach its AB 32 GHG reduction goals, particularly if the expected reductions from the ARB's programmatic emission reduction measures do not achieve anticipated levels of reductions.

ARB's proposed offset policy is most restrictive in the early years of the AB 32 cap-and-trade program. However, it is this period in which the cost of the program is most uncertain. As an example, price volatility was substantial during the initial years of market operation in the European Union Emissions Trading Scheme. Limiting offsets could leave the State with insufficient options for effectively managing unexpectedly high emission reduction costs. Market design that moderates cost uncertainty while maintaining a sustainable emission reduction path supports California's economic and environmental goals. Offsets are a key element in striking this balance.

One argument put forward to restrict offsets is that such limits ensure that capped entities implement emission reduction measures. However, ARB has already addressed this concern for the electric sector by adopting programmatic measures in the Scoping Plan. In fact, the California Public Utilities Commission ("CPUC") and California Energy Commission ("CEC") noted that:

... sources within the electricity sector may have limited opportunities to obtain short-term GHG reductions at levels significantly larger than those associated with the programmatic energy efficiency and renewable energy measures recommended . . . For these sources, the use of high-quality offsets could provide an alternative compliance option....^{4/}

Accordingly, limits on offsets are not needed to ensure that entities in the capped sectors reduce their own GHG emissions. Indeed, as discussed in further detail below, electric utilities may have few, if any, cost-effective options to reduce their emissions after implementing the programmatic measures included in the Scoping Plan. Thus, the electric utilities' ability to make use of verifiable offsets is critical to achieving GHG reductions at a reasonable cost to customers.

^{3/} For example, a recent CRA International study commissioned for Chevron Corporation estimated that geographic restrictions on the use of offsets in California's cap-and-trade program could cost the State 300,000 jobs and decrease Gross State Product by almost 1%. CRA International, *The Role of Offsets in Enhancing the Cost-Effectiveness of AB32*, CRA Project No. D10810-00, April 23, 2008, p. 2, available at http://www.crai.com/uploadedFiles/RELATING_MATERIALS/Publications/Consultant_publications/Impacts_of_Offsets.pdf.

^{4/} *Final Opinion on Greenhouse Gas Regulatory Strategies*, CPUC Decision 08-10-037, October 16, 2008, p. 273 (emphasis added). Citation is to CPUC version of the decision.

B. Restrictions on Offsets May Create a Compliance Risk for Electric Utilities.

Transitioning the already comparatively carbon-efficient California economy to an extremely low-carbon future will take time for research, development, and deployment of new low-carbon technologies. Offsets offer a buffer to provide near-term GHG reductions while making the transition to these newer low-carbon technologies. This is particularly true in the California electric sector, in which utilities are already implementing aggressive energy efficiency programs and undertaking comprehensive efforts to bring new renewable energy projects into operation.

The IOUs are adding renewable resources to their portfolios as quickly as possible, but challenges remain. These challenges include difficulties in planning, permitting, and constructing the major high-voltage transmission lines required to interconnect new renewable resources. In addition, adding renewables which are intermittent by nature requires support from operationally flexible natural gas-fired generation. In Southern California, a barrier to the siting of operationally flexible generating facilities currently exists due to the lack of availability of conventional pollutant offsets for valid air permits. This is especially critical given the potential statewide prohibition on using once-through cooling water at existing load-following natural gas-fired facilities, many of which also support integration of intermittent renewable power.

Despite these difficulties, the IOUs are aggressively pursuing renewable projects. To facilitate the State's AB 32 emission goals in the near-term, however, the IOUs must have access to real, permanent, verifiable, quantifiable, enforceable, and additional GHG offsets. Offsets will allow the IOUs to reduce emissions in the near-term while providing the time to address the challenges to renewable development and siting of needed flexible generation.

C. Offset Policy Should Be Addressed in Conjunction with Other Market Design Elements.

PG&E and SCE believe that offset limits and allowance allocation cannot be evaluated or determined in isolation from the cap level, trajectory, and other important market design features. Without other cap-and-trade design elements in place, it is not possible to know how much offset restrictions will cost California consumers and businesses. Setting an arbitrary offset quantity limit with other policy issues unresolved and without the requisite analysis serves only to increase emission reduction costs, possibly impeding efforts to successfully address global warming in a cost-effective manner, as required by AB 32.

PG&E and SCE believe that any quantitative limit, including ARB staff's proposed limit of 49% of annual emission reductions required under the cap-and-trade program, is unduly restrictive, especially in the early years of the California cap-and-trade program. Under ARB

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Director
April 30, 2009
Page 5

staff's proposal to use 2012 emissions to determine reductions, a 49% limit makes less than 5 million metric tons of offsets available to the electric and industrial sectors in 2014, the end of the first compliance period, which is only about 2% of the emissions cap in that period.

The proposed offset quantity limit is restrictive compared to other cap-and-trade proposals. For example, the Waxman-Markey federal climate change and energy discussion draft would establish a broader and more comprehensive national cap-and-trade program. The Waxman-Markey draft would allow covered entities to meet 30% of their compliance obligations through the use of qualified offsets in the early years, and a greater percentage in later years.^{5/} The Waxman-Markey proposal may serve as a useful starting point for discussion, but even that limit may be too restrictive for less comprehensive cap-and-trade programs such as the Western Climate Initiative ("WCI") or a California-only program. A comprehensive national market that is much broader in scope may not experience the same magnitude of price volatility as a narrow market, such as a WCI or California cap-and-trade program that covers only the electric and industrial sectors in the first compliance period. The narrower the market, such as a two-sector, California-only market, the greater the need for offsets and other cost containment mechanisms.

When it approved the Scoping Plan, the ARB directed that the cap-and-trade rulemaking include the following issues: the initial cap level and the rate of decline over time; the potential offset supply within and outside California; and the economic and co-benefit effects of offset limits.^{6/} Likewise, the CPUC and CEC determined that while

. . . a quantitative limit on the use of offsets may be desirable to ensure additional reductions from sources subject to the cap . . . [T]he appropriate level of offsets should be determined relative to the scope and liquidity of the cap-and-trade market, as well as the emissions targets. Additional modeling work may be needed to determine an appropriate level of offsets for the cap-and-trade program.^{7/}

Accordingly, PG&E and SCE recommend that ARB staff examine the full economic costs and benefits of a cap-and-trade market through modeling and scenario analysis. To assist in this effort, PG&E and SCE encourage the ARB to convene a panel of independent experts to provide recommendations on the cost implications of ARB staff's proposed cap, trajectory,

^{5/} Waxman-Markey Discussion Draft, American Clean Energy and Security Act of 2009, March 31, 2009, Section 722(c).

^{6/} ARB, Resolution 08-47, *Climate Change Scoping Plan*, December 11, 2008, pp. 9-10.

^{7/} *Final Opinion on Greenhouse Gas Regulatory Strategies*, CPUC Decision 08-10-037, October 16, 2008, p. 274 (emphasis added).

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Director
April 30, 2009
Page 6

allowance, and offset policies, in addition to the allowance and auction issues ARB has already identified.

D. Entity, Supply, and Reservation Limit Proposals Create Unnecessary Uncertainty.

Offset policy mechanisms should support a robust, transparent, liquid market that ensures price competition and certainty for project developers and complying entities. The proposed offset limit restricts market liquidity, and necessitates corrective policies which have their own limitations. Because projects would qualify on a first-come, first-served basis, the supply limit proposal could create uncertainty for offset project developers who have long-term development horizons. The supply limit could also result in high offset project prices because the cost-effective reduction opportunities would not necessarily be the first projects to enter the market. While the entity usage approach would create more certainty for offset developers and might promote market entry of more cost-effective offset projects, it would not promote the level of price competition needed to bring the lowest-cost reduction opportunities to the market. The reservation approach may provide more certainty for offset developers. However, this alternative is unlikely to moderate costs because the sum of the reservation cost and the offset project cost may very likely result in little or no overall savings to complying entities.

In summary, the alternatives proposed are unlikely to bring the best offset projects to California at a reasonable cost because the proposed overall offset limit is too restrictive. Furthermore, the supply and price effects of the supply limit, entity usage, and reservation proposals are merely theoretical in the absence of analysis. As stated earlier, PG&E and SCE believe that economic analysis should precede any decisions about specific market design elements.

E. If Offsets are to Play a Meaningful Role in the Implementation of AB 32, the ARB Needs to Expedite the Issuance of Offset Protocols.

The ARB should take immediate action to expedite the issuance of offset protocols by rule. Developing protocols and approving offset credits will send an important signal to offset project developers who often require substantial lead time to implement projects. Regulators should give entities the certainty they need to start engaging in offset projects immediately, prior to the launch of the cap-and-trade market. Project development over the next few years is needed to secure near-term emission reductions and give complying entities access to offsets in the early years of the cap-and-trade program. PG&E and SCE believe that the ARB's near-term focus should be the development of an offset protocol rulemaking to promote project development. ARB should also act to encourage voluntary early action reductions and develop offset protocols to ensure an adequate supply of offsets by 2012.

Ms. Mary Nichols, Chairman
Mr. James Goldstene, Executive Director
April 30, 2009
Page 7

PG&E and SCE would like to be able to engage in offset projects as soon as possible. Engaging in projects early is necessary to meet the ambitious AB 32 goals. AB 32 directs the ARB to “[e]nsure that entities that have voluntarily reduced their greenhouse gas emissions prior to the implementation of this section receive appropriate credit for early voluntary reductions.”^{8/} This provision would appear to support early action regardless of whether it is within the capped sectors. These protocols should be available well before the cap-and-trade program commences, and entities should be able to bank offsets for compliance once the cap is in effect.

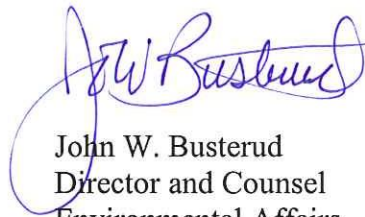
F. Conclusion.

PG&E and SCE appreciate the opportunity to comment on ARB’s proposal on offsets. Please contact us if you have questions about these comments or if we may be of further assistance.

Very truly yours,



Michael M. Hertel
Director
Corporate Environmental Policy
Southern California Edison Company



John W. Busterud
Director and Counsel
Environmental Affairs
Pacific Gas and Electric Company

MMH/JWB/CK/kp/bd

cc: Mr. Kevin Kennedy, Chief - Program Evaluation Branch, Office of Climate Change
Mr. Michael Scheible, Deputy Executive Officer
Mr. Brian Turner, Assistant Executive Officer – Federal Climate Policy
Ms. Lucille Van Ommering, Manager – Program Evaluation Branch, Office of Climate Change
Mr. Sam Wade, Air Pollution Engineer - Program Evaluation Branch, Office of Climate Change

^{8/} Cal. Health & Safety Code § 38562(b)(3).