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CALIFORNIA ENERGY COMMISSION
COMMENTS OF PACIFIC GAS AND ELECTRIC COMPANY (U 39 E) ON ALLOWANCE ALLOCATION ISSUES UNDER AB 32

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I. INTRODUCTION

Pursuant to the ruling of the Administrative Law Judges dated October 15, 2007 (ALJs' Ruling), Pacific Gas and Electric Company (PG&E) provides its comments on the allocation of greenhouse gas (GHG) emissions allowances under AB 32. PG&E's comments are organized as follows: (1) An executive summary of PG&E's overall comments; (2) Responses to Questions 1- 26 in the ALJ's' Ruling.

II. EXECUTIVE SUMMARY OF PG&E'S COMMENTS ON ALLOCATION OF ALLOWANCES FOR GREENHOUSE GAS EMISSIONS UNDER AB 32

The allocation of GHG emissions allowances should be designed to achieve two over-arching objectives: (1) In order to speed the transition to a low-carbon economy, achieve sustained and significant long-term GHG reductions; and (2) Mitigate the costs incurred by customers to achieve these long-term GHG reductions. PG&E believes that other criteria used to design the allocation of emissions allowances, including the criteria cited by the MAC, also may be considered but should be supportive of these two over-arching criteria.

Using these two objectives, PG&E recommends that, without regard to the point of regulation chosen for AB 32, emissions allowances should be allocated to Load Serving Entities (LSEs) for the benefit of their customers. This is because LSE customers will bear the ultimate costs of meeting the sustained GHG reduction goals of

AB 32, and therefore those customers should receive the value of the allowances used to achieve those reductions.

PG&E also supports the "first seller" point of regulation for AB 32, and therefore recommends that the allowances allocated to LSEs be auctioned off, in whole or in part, under the supervision of an independent entity, in order to provide a market-based, economically efficient and transparent means of establishing the initial price of allowances under a cap-and-trade regulatory system.

In the electric and gas sector, the most equitable methodology by which to allocate emissions allowances, and the one we believe will speed the transition to a low carbon economy, is to do so based on an output metric. For example, allocating allowances to LSEs based on sales, adjusted for verified customer energy efficiency savings, recognizes the investments made by utility customers who have already paid for increased supplies of low carbon energy or for aggressive energy efficiency and demand response programs. At the same time, an output-based approach encourages LSEs who have not made these early investments on behalf of their customers to find the most expedient and cost-effective means of doing so as soon as possible. An output-based approach encourages energy efficiency, recognizes early action and we believe is consistent with the recommendations the State has made on national climate change policy.

Finally, PG&E recognizes that there are multiple public policy objectives that may be considered for the use of allowance allocations. PG&E has long advocated for a broad-based cap-and-trade program, which will result in the creation of a new and valuable commodity – the carbon emissions allowance. PG&E is not prepared to make

recommendations at this time regarding these other policy objectives and potential recipients for the value or revenues from allowances. We look forward to engaging with the ARB, CPUC, Energy Commission, and other stakeholders in a discussion of these other potential objectives.

However, for the electric and gas sector, we believe that, at a minimum, the most equitable and effective way to meet the overarching objectives of speedy and sustained greenhouse gas reductions at reasonable cost to the customers who pay for those reductions, is to allocate emissions allowances to LSEs on behalf of their customers, and to use the revenue generated by the sale of these allowances to mitigate customer costs, under the supervision of the CPUC and the governing-bodies of publicly-owned utilities, respectively. We believe that the CPUC and the governing bodies of local publicly owned utilities are uniquely equipped and have well developed public processes to supervise the use of the emissions allowance revenues in the most effective and efficient manner and to meet the specific needs of customers and communities these LSEs serve.

PG&E's detailed responses to the specific questions are provided below.

III. RESPONSES TO QUESTIONS

3.1. Evaluation Criteria

Developing evaluation criteria may help the Commissions analyze the issues surrounding emission allowance allocation issues. For example, the final report of the Market Advisory Committee (MAC) includes a discussion of emission allowance distribution and recommends that California should "strive to distribute allowances in a manner consistent with fundamental objectives of cost-effectiveness, fairness, and simplicity," and should "distribute allowances in a manner that advances the following principles," which are copied and numbered below:

Q1. Please comment on each of the criteria listed by the MAC. Are these criteria consistent with AB 32? Should other criteria be added, such as criteria specific to the electricity and/or natural gas sectors? In making trade-offs among the criteria, which criteria should receive the most weight and which the least weight?

PG&E generally supports consideration of the MAC report criteria for evaluating allowance allocation issues, but subject to two over-arching objectives that should govern all emissions allocation policies. The two overall criteria PG&E recommends are: (1) ***"In order to speed the transition to a low carbon economy, achieve long term sustained GHG emissions reductions."*** and (2) ***"Mitigate the costs incurred by customers to achieve these long term, sustained GHG reductions."*** In addition, PG&E also recommends that a key procedural criterion for allocation policy be "Leadership and linkage with other regional and federal programs." This criterion is very important for California in the national and global arenas, because the development and design of a market for AB 32 allowances will be the key determinant of whether California can successfully link its cap-and-trade program with other regional, national and international allowance and emissions trading markets.

With these objectives in mind, PG&E agrees that the other criteria cited by the MAC may be considered to the extent they support these objectives.

3.2. Basic Options

These questions should be answered for both the electricity and natural gas sectors

If your recommendations differ for a load-based or deliverer/first seller point of regulation in the electricity sector, or for the natural gas sector, explain why.

Q2. Broadly speaking, should emission allowances be auctioned or allocated administratively, or some combination?

The choice of an allocation methodology—an auction or administrative allocation—should consider equity as well as economic efficiency. How emissions allowances are allocated, regardless of whether the value of such allowances are distributed through an auction or by administrative decisions, will significantly affect the

distribution of economic costs and incentives associated with meeting California's greenhouse gas emission targets.

This is because creation of a cap-and-trade program will create a new and valuable commodity – the carbon emissions allowance. We believe it is wholly appropriate to use these allowances to help achieve the overarching objectives we have listed above, speedily achieving long-term GHG reductions and effectively mitigating the customer costs of achieving those reductions. To achieve these objectives, the allowances should be allocated to LSEs for the benefit of their customers using an output-based metric, because it is the retail electricity and gas customers who will bear the lion's share of the costs of complying with the GHG targets. Under this approach, as discussed in more detail below, PG&E recommends that the allowances be auctioned under the oversight of an independent third-party in a transparent manner. A well-designed auction can reveal an early price that attracts investment to GHG reducing technologies, projects and related activities, as well as fairly and transparently internalizing the cost of carbon into electricity prices. The use of the revenues from the auction would then be supervised by the CPUC and the governing boards of the local publicly owned utilities, respectively.

For the natural gas sector, the considerations are similar. The costs of compliance will be borne by the LSEs' customers, and therefore the customers should be the recipient of the value or revenues from the allowances regardless of the point of regulation.

Q3. If you recommend partial auctioning, what proportion should be auctioned? Should the percentage of auctioning change over time? If so, what factors should be used to design the transition toward more auctioning?

In terms of a specific proportion that should be auctioned, PG&E is not prepared to recommend a specific proportion at this time, but the considerations raised in Q1 and Q2 provide a guide for overall auction design, including the proportion of overall allowances that should be auctioned. Under PG&E's recommended approach, in which the point of regulation is the first seller, an independent third party will oversee auctioning on behalf of LSEs' customers. Then, under oversight of the CPUC or governing board of the local public owned utility, the proceeds of the auction are used to mitigate customer costs and maximize benefits in a way that is most useful to those customers and communities. PG&E understands, for example, that it may make sense for a portion of the allowance value or auction revenues to be used to facilitate larger scale investment and R&D for the electric and natural gas sectors in a manner that also provides benefits to customers or for other purposes. However, because retail customers will bear the majority of the costs of the program the auction revenues should focus on those things that will help to mitigate costs, directly or indirectly, and maximize benefits to consumers.

Q4. How should new market entrants, such as energy service providers, community choice aggregators, or (deliverer/first seller system only) new importers, obtain emission allowances, i.e., through auctioning, administrative allocation, or some combination?

Under a first seller point of regulation, if a generator or First Seller is the new market entrant, they will procure the required allowances through the auction along with all other incumbents. Having auctions on a relatively frequent basis will provide these new entrants opportunity to acquire allowances. In addition, PG&E expects that a secondary market will emerge when a sufficient volume of allowances are in the market.

Under a load-based cap, LSEs should have the same policies apply in terms of

allowances made available for customer benefit through allocation to the LSEs and then subsequent auction. In order to avoid penalizing programs and policies that have already achieved significant GHG reductions, the allowances should be allocated based on current retail sales and adjusted for incremental customer energy efficiency and for changes in retail sales over time. In addition, allowances should be available through sufficiently frequent auctions or a secondary market.

3.3. Auctioning of Emission Allowances—General Questions

These questions assume that some or all emission allowances are auctioned, and should be answered for both the electricity and natural gas sectors. If your recommendations differ for a load-based or deliverer/first seller point of regulation in the electricity sector, or for the natural gas sector, explain why.

Q5. What are the important policy considerations in the design of an auction?

PG&E recommends that careful consideration be given to the design of an auction. Auctioning of allowances is a commercial activity with the purpose of achieving specific policy objectives. PG&E recommends the same policy objectives identified in the response to Q1 apply to auctioning of allowances. Further, PG&E recommends revenues received from an auction should flow as discussed in response to Q2. In addition, PG&E believes that prices revealed in any auction should be transparent to the public. Finally, access to allowances in an auction should be nondiscriminatory. In the context of a first seller auction, this means that investor-owned utility generation, publicly-owned utility generation, and merchant generation should have equal access to allowances under an auction, under the same terms and conditions.

Q6. How often should emission allowances be auctioned? How does the timing and frequency of auctions relate to the determination of a mandatory compliance period, if at all?

In PG&E's view, it may make sense to have smaller and more frequent auctions. Such an approach may enhance longer-term price discovery, minimize the adverse outcome associated with any one auction, better accommodate the business plans of complying entities and support a secondary market.

All allowances of a particular vintage should be auctioned prior to the beginning of the compliance period. In other words, all allowances with a beginning date of 2012 should be auctioned prior to 2012. This feature supports market liquidity and price stability. The timing and frequency of auctions should be independent of the length of the mandatory compliance period.

Q7. How should market power concerns be addressed in auction design? If emission allowances are auctioned, how would the administrators of such a program ensure that all market participants are participating in the program and acting in good faith?

PG&E's recommendation on independent oversight and non-discriminatory terms and conditions for the auction provided in response to Q6 should also help mitigate market power. Additionally, because emissions allowances are commodities, the design of the auction should include regulatory and market rules that are used in commodities markets to prevent market manipulation and anti-competitive practices. Finally, the auction design should consider providing for on-going independent oversight and surveillance.

Q8. What criteria should be used to designate the types of expenditures that could be made with auction revenues (including use to reduce end user rates), and the distribution of money within those categories?

PG&E supports using the overarching objectives identified in the response to Q1 as a guide for allocating auction revenues. As noted in response to Q2, PG&E supports

consideration of other objectives, including supporting development of GHG reducing technologies, but only if such objectives can be demonstrated to provide significant direct or indirect benefits to LSE customers.

Q9. What type of administrative structure should be used for the auction? Should the auction be run by the State or some other independent entity, such as the nonprofit organization being established by the Regional Greenhouse Gas Initiative?

The auction should be administered by an independent entity, which could include a governmental entity such as the ARB, provided that the entity possesses or obtains necessary expertise in auction design and implementation.

3.4.1. Administrative Allocation of Emission Allowances

Various methods have been proposed and discussed for the administrative allocation of emission allowances. The following potential methods could be used:

a. Grandfathering: "A method by which emission allowances are freely distributed to entities covered under an emissions trading program based on historic emissions." (MAC report, p. 93.)
b. Benchmarking: "An allowance allocation method in which allowances are distributed by setting a level of permitted emissions per unit of input or output" (e.g., fuel used or sales to customers (pounds (lbs)/megawatt-hour or lbs/million British thermal units (MMBtu)). (MAC report, p. 90.)
c. Updating: "A form of allowance allocation in which allocations are reviewed and changed over time and/or awarded on the basis of changing circumstances (such as output) rather than historical data (such as emissions, input or output). For example, allowances might be distributed based on megawatt-hours generated or tons of a product manufactured." (MAC report, p. 96.)
d. Other: Such as population (lbs of carbon dioxide (CO2)/customer or lbs CO2/capita), or cost of compliance (based on retail provider supply curves of emission reduction measures, or a comparable metric).

Answer each of the questions in this section, first, for a load-based system in the electricity sector and, second, for a deliverer/first seller system in the electricity sector. If your recommendations differ for a load-based or deliverer/first seller point of regulation, explain why.

Q10. If some or all allowances are allocated administratively, which of the above

method or methods should be used for the initial allocations? If you prefer an option other than one of those listed above, describe your preferred method in detail. In addition to your recommendation, comment on the pros and cons of each method listed above, especially regarding the impact on market performance, prices, costs to customers, distributional consequences, and effect on new entrants.

PG&E supports the distribution of allowances for the benefit of electricity and gas consumers, while promoting investment in new technologies or programs that also benefit customers and the communities we serve. Households and businesses at the end of the energy supply chain will ultimately bear the costs—in the form of higher energy prices—of a greenhouse gas cap-and-trade program. Therefore, as discussed above, consumers should be entitled to the value inherent in the allowances in order to partially compensate for the costs of the program. PG&E views this policy issue as being independent of the point of regulation, because compliance costs will flow through to customers regardless of the point of regulation. Allocating allowances to LSEs on behalf of their customers will achieve this objective. We believe this approach is also consistent with the State of California's recently issued "Recommendations for Federal Climate Policy," which suggests that the allowances go to the "entities that are most able to deliver key social benefits." ("State of California Recommendations for Federal Climate Policy," page 2.)

To implement this approach, PG&E recommends distributing allowances to load-serving entities (LSEs) based on their proportionate share of retail electricity sales, adjusted for incremental Customer Energy Efficiency (CEE) savings, starting with the first year of compliance. This method of allocation supports early action and recognizes the investments made by customers, such as PG&E's in long-standing CEE programs and more recently instituted renewables solicitations, which have avoided the release of

greenhouse gas emissions to the atmosphere and resulted in an already low carbon emissions portfolio for the customers on whose behalf these investments have been made. The State of California can show leadership in the federal debate on this issue by adopting an output-based allocation methodology. California as a whole is a low carbon state, relative to the emissions profiles of other states, and therefore support for an output-based approach will provide substantial benefits to California as well as California businesses and consumers.

A grandfathering approach, based on historic emissions, has the opposite effect on all fronts. It does not recognize investments made in zero or low carbon technologies, and it provides an incentive to delay such activities in the hope of accumulating more allowances. Recommending and adopting such an approach for AB32 would de-position California relative to other regions in the design of a federal program, delaying the transition to a low carbon economy and inequitably allocating costs to the State of California and its citizens. As the State recently noted in its recommendations on federal climate policy, "Free distributions based solely on historic emissions will only serve to reward the biggest polluters at the expense of consumers and penalize early leadership." ("State of California Recommendations for Federal Climate Policy," page 2.]

PG&E supports an updating, output-based allocation methodology, whereby CARB would update on an annual basis the allocations to LSEs to reflect changes in their customer base and to encourage a continued, aggressive focus on CEE programs. For example, allocations for compliance year 2012 could be made early in 2011 based on retail sales in 2010 and CEE savings in 2010. Allocations for compliance year 2013

would be made early in 2012 based on retail sales in 2011 and CEE savings in 2011 from programs initiated after passage of AB 32, and so on.

PG&E believes that an output-based approach will encourage new entrants to bring to market low and zero emissions energy supply options and technologies more rapidly than under an historical method that ostensibly delays action.

Q11. Should the method for allocating emission allowances remain consistent from one year to the next, or should it change as the program is implemented?

As indicated above, PG&E supports an allocation to LSEs based on their proportionate share of retail electricity sales, adjusted for CEE savings. This methodology should be used throughout the life of the program. This approach supports a key objective – speeding the transition to a low carbon economy to achieve sustained reductions in GHG emissions – because allowances are not based on the emissions profile of a utility's portfolio. For the natural gas sector, the same principle applies.

Q12. If new market entrants receive emission allowance allocations, how would the proper level of allocations be determined for them?

If allowances are allocated to LSEs based on retail sales, adjusted for CEE, allocations to new electricity providers, such as Community Choice Aggregators, could be flowed through based on recent recorded electricity sales to the specific customers or group of customers leaving or returning to utility service. In the case of municipalization, a similar adjustment and transfer of allocations could take place using the same retail sales methodology. For the natural gas sector, the same approach could be used.

Q13. If emission allowances are allocated based on load/sales, population, or other factors that change over time, how often should the allowance allocations be updated?

PG&E supports the annual updating of allowance allocations to reflect the most recent data available. This also applies to the natural gas sector.

Q14. If emission allowances are allocated based on historical emissions ("grandfathering") or benchmarking, what base year(s) should be used as the basis for those allocations?

PG&E does not support the distribution of allowances based on historical emissions, either to generators or to LSEs, because as the State of California has stated regarding federal legislation, "Free distribution based solely on historical emissions will only serve to reward the biggest polluters at the expense of consumers and penalize early leadership." State of California Recommendations for Federal Climate Policy, page 2.) Historical-based allocations reward facilities with high emission rates, and penalize those that have made investments in and whose customers have paid for low- and zero-carbon technologies. In addition, establishing a methodology for allocating allowances to LSEs based on historical emissions would require regulators to undertake a complicated and probably controversial task: Assigning the responsibility for emissions from each merchant generator or short-term import to a particular LSE. This process is likely to be contentious in cases where there is no "line of sight" between a generator and an LSE, perhaps due to "system sale" contracts or delivery through a pool. The deliverer/first-seller approach eliminates this line of sight problem for all in-state generation and minimizes line of sight problems for imports as transactions do not need tracking after instate delivery occurs.

PG&E does not have a specific proposal as to a base year, but prefers more recent years to reflect more recent data, and to update this over time. PG&E also recommends that multiple years or weather adjustments be considered, to take into

account weather- and precipitation-based volatility and changing market dynamics

For the natural gas sector, the differences among years and emissions rates will not vary as much as in the electricity sector. However, any year used for grandfathering historical emissions for the natural gas sector should adjust for utilities' previous investments in energy efficiency in the natural gas sector.

Q15. If emission allowances are allocated based initially on historical emissions ("grandfathering"), should the importance of historical emissions in the calculation of allowances be reduced in subsequent years as providers respond to the need to reduce GHGs? If so, how should this be accomplished? By 2020, should all allocations be independent of pre-2012 historical emissions?

If allowances are initially allocated based on historic emissions, this approach should be phased out rapidly, prior to 2020. Otherwise, the benefits of low cost coal will continue to be enjoyed by customers of high emitting utilities at the expense of customers of low emitting utilities well into the compliance period, ostensibly delaying investments in low-emitting supply options, such as renewable generation and energy efficiency.

While more analysis may be required for the natural gas sector, it is possible that there is relative uniformity in emissions rates (including giving effect to utility CEE programs) and limited opportunity to switch to lower greenhouse gas emitting fuels. However, there needs to be analysis conducted on this matter, particularly as it relates to ensuring that savings associated with Customer Energy Efficiency can be adequately captured using other than an output-based approach.

Q16. Should a two-track system be created, with different emission allowances for deliverers/first sellers or retail providers with legacy coal-fueled power plants or legacy coal contracts? What are the factors and trade-offs in making this decision? How would the two tracks be determined, e.g., using an historical system emissions factor as the cut-off? How should the allocations differ between the tracks, both initially and over time? What would be the market impact and cost consequences to

consumers if a two-track method were used?

Coal plants, including California utilities' shares of out-of-state coal-fired power plants, are a significant part of California's CO2 footprint. EIA data for 2006 (after retirement of the Mohave coal plant) indicate that such plants produced about 12% of California's electricity generation, but 40% of the CO2 emissions. Because of the need to rapidly transition to low-carbon energy sources and achieve sustained, long-term GHG reductions, a two-track system which allows higher emissions by "legacy coal plants" should be rejected.

Q17. If emission allowances are allocated administratively to retail providers, should other adjustments be made to reflect a retail provider's unique circumstances? Comment on the following examples, and add others as appropriate:
a. Climate zone weighting to account for higher energy use by customers in inclement climates, and
b. Increased emission allowances if there is a greater-than-average proportion of economically disadvantaged customers in a retail provider's area.

PG&E recommends allocating allowances based on a retail provider's proportionate share of retail sales, adjusted for CEE. This approach would effectively capture disparities in the State's climate zones, and should not require further adjustment. In terms of disadvantaged customers, a sales-based allocation provides an opportunity to address the needs of low- and middle-income households by considering apportioning the allowance value across a range of programs and priorities, including low-income assistance, rebates, and energy efficiency programs. Each LSE, subject to PUC or Board oversight and public input, can pursue the right combination of policies for their customers and their communities. Therefore, the proportion of economically disadvantaged customers in a retail provider's area should not require further adjustment. PG&E believes this is also appropriate for the natural gas sector.

Q18. Should differing levels of regulatory mandates among retail providers (e.g., for renewable portfolio standards, energy efficiency investment, etc.) be taken into account in determining entity-specific emission allowance allocations going forward? For example, should emission allowance allocations be adjusted for retail providers with high historical investments in energy efficiency or renewables due to regulatory mandates? If those differential mandates persist in the future, should they continue to affect emission allowance allocations?

As discussed above, PG&E recommends allocating allowances to LSEs based on their proportionate share of current (not historical) retail sales, adjusted only for CEE. By adjusting a retail provider's sales for demonstrated CEE savings, the right market signals are provided by fully recognizing investments in energy efficiency – which can provide for some of the most effective and lowest cost near-term reductions throughout the state, particularly in those areas that have not pursued energy efficiency aggressively to date. Also, by allocating based on current sales, rather than historical emissions, those that have already made significant investments in, and paid for, renewables and other low-carbon technologies will avoid being penalized. Assuming that allowances are allocated base on retail sales, there should be no need for adjusting an LSE's allocation based on differing regulatory mandates. These adjustments are inherent within our recommended approach. Finally, PG&E prefers a simpler approach for allocating allowances, which would reduce the administrative costs as well as the potential for unintended consequences and inequities. Therefore, PG&E cautions against adopting any of the exogenous adjustments cited in Q 16- 18. PG&E believes this is also appropriate for the natural gas sector.

Q19. How often should the allowance allocation process occur? How far in advance of the compliance period?

CARB should distribute allowances 2-3 years prior to the applicable compliance period. This will allow sufficient time for allowances allocated to LSEs to be made

available through an auction to facilitate compliance planning by first sellers and generators. A well structured auction will ensure that allowances are available to regulated entities. PG&E believes this is also appropriate for the natural gas sector.

Q20. What are the distributional consequences of your recommended emission allowance allocation approach? For example, how would your method affect customers of retail providers with widely differing average emission rates? Or differing rates of population growth?

Regardless of the point of regulation, a cap-and-trade scheme may lead to higher electricity prices, and therefore the distributional consequences of allowance allocation are extremely important. Under a First-Seller approach, the wholesale electricity price will include the CO2 cost of the price-setting generator. Under a load-based approach, clean generators will negotiate bilaterally with LSEs for contract prices that reflect the value of their "clean power", including both the market price of electricity and the CO2 compliance costs LSEs avoid by buying clean power. In either case, allocation of allowances to LSEs for the benefit of their customers based on current output or sales will ensure that the value and revenues resulting from the sale of allowances are matched with the both the investments made by customers in low carbon resources in the past and the costs incurred by customers to further reduce emissions going forward.

PG&E's proposal is equitable to retail providers with varying emissions rates. It is true that low emitting utilities will receive a greater proportion of allowances relative to higher emitting utilities. It is also true, however, that these same low emitting utilities will have fewer low cost GHG reduction opportunities because they already have taken advantage of those opportunities.

On the other hand, high emitting utilities will have a greater quantity of lower cost emission reduction opportunities within their own portfolio, namely the ability to

reduce high emitting sources in their portfolio and increase CEE and low and zero-carbon supply side resources.

In summary, a broader set of distributional impacts should be considered, beyond simply the amount of allowances allocated to each LSE. Actions taken or not taken in the past by each LSE and its customers should be considered, including those which led or did not lead to a low emissions portfolio and different opportunities for future reductions.

Q21. Would a deliverer/first seller point of regulation necessitate auctioning of emission allowances to the deliverers/first sellers?

PG&E recommends distributing allowances to LSEs for the benefit of their customers, who will ultimately bear a significant share of the costs associated with a cap-and-trade program. The allowances then would be distributed to first sellers as complying entities through an auction that ensures that the value of the allowances are available as an offset against the costs of the allowances which customers ultimately pay for through their electric rates. The revenues generated from the auction would be held for the benefit of LSEs' customers. Additional details on allocation policy are provided in the responses to Q 2 and Q 10, and on auction design in the response to Q 5- 7.

Q22. Are there interstate commerce concerns if auction proceeds are obtained from all deliverers/first sellers and spent solely for the benefit of California ratepayers? If there are legal considerations, include a detailed analysis and appropriate legal citations.

Whether a particular form of regulation under AB 32 violates the Commerce Clause depends to a great extent on the factual circumstances surrounding the regulation. In the case of expenditures of revenues obtained from the auction of emissions allowances, it is not clear that limiting the expenditures of those revenues to programs

that solely benefit "California ratepayers" would discriminate against out-of-state sources of greenhouse gas emissions in favor of in-sate sources. This is because, as a factual matter, presumably both in-state and out-of-state entities would be required to obtain allowances through the same auction process and bear the same burden of obtaining emissions allowances through that auction, regardless of the disposition of the proceeds that result from the auction. However, if the expenditure of the revenues were directed at programs that benefit only in-state power sellers, or otherwise discriminated against out-of-state sellers in the programs funded by the revenues, then it is more likely that the discrimination would be considered per se discriminatory and unlawful under the Commerce Clause. For a more detailed description of the legal principles that would apply under the Commerce Clause, see PG&E's August 6, 2007, comments on legal issues in this proceeding.

Q23. If you believe 100% auctioning to deliverers/first sellers is not required, explain how emission allowances would be allocated to deliverers/first sellers. In doing so, answer the following:
a. How would the amount of emission allowances given to deliverers/first sellers be determined during any particular compliance period?
b. How would importers that are marketers be treated, e.g., would they receive emission allowance allocations or be required to purchase all their needed emission allowances
through auctions? If allocated, using what method?
c. How would electric service providers be treated?
d. How would new deliverers/first sellers obtain emission allowances?
e. Would zero-carbon generators receive emission allowance allocations?
f. What would be the impact on market performance, prices, and costs to customers of allocating emission allowances to deliverers/first sellers?
g. What would be the likelihood of windfall profits if some or all emission allowances are allocated to deliverers/first sellers?
h. How could such a system prevent windfall profits?

As PG&E explained in its response to a similar question in its August 6, 2007, comments on the first seller approach, PG&E supports the distribution of electric sector

CO2 allowances to load serving entities for the purpose of mitigating the costs of the program to California's electricity consumers, while promoting investment in energy efficiency programs and greenhouse gas reduction technologies, and using an allocation methodology that recognizes early actions and speeds the transition to a low carbon economy. PG&E also supports the use of auctions to make these allowances available to first sellers.

In PG&E's view, auctions and an accompanying secondary market provide multiple opportunities to first sellers to procure needed allowances. Difficult allocation decisions can be completely or largely replaced by auctions. New entrants also would have multiple opportunities to procure needed allowances.

PG&E fully expects that the full market price of emissions allowances will flow through to customers for virtually all of the carbon-based generation serving California's customers. Any allocation of allowances to generators would not likely affect this market price and thus would very likely result in only increased profits for the generators.

Q24. With a deliverer/first seller point of regulation, should administrative allocations of emission allowances be made to retail providers for subsequent auctioning to deliverers/first sellers? If so, using what allocation method? Refer to your answers in Section 3.4.1., as appropriate.

Yes, as PG&E explained in its oral presentation at the August 21, 2007, en banc hearing on the first seller approach, emissions allowances should be distributed to LSEs for the benefit of their customers . These allowances then can be made available for subsequent auctioning to generators/first sellers. The allocation method for such distribution should be based on each retail provider's current sales to its retail customers. Please refer to responses to Q 2 and Q 10 for further details.

Q25. If you recommend allocation of emission allowances to retail providers followed by an auction to deliverers/first sellers, how would such an auction be administered? What kinds of issues would such a system raise? What would be the impact on market performance, prices, and costs to customers?

As indicated in the response to Question 23, above, PG&E supports the initial distribution of electric sector CO2 allowances to load serving entities for the benefit of California's electricity consumers, with the allowances then being distributed to complying entities (i.e. first sellers through an auction). We would emphasize that the LSEs would not retain the economic value of the allowances, nor could the LSEs withhold the allowances from the market, driving up the price of allowances. LSEs would not profit in any way from the sale of allowances to complying entities. The value and revenues associated with the allowances allocated to the LSEs would be reserved directly for the benefit of the LSEs' customers and communities; i.e. those that ultimately bear the costs of the program.

The CARB, with support from the CPUC and local governing boards of municipal utilities, would have oversight authority to ensure that LSEs satisfy the requirements of the program. An independent entity could administer the auction or series of auctions. All allowances allocated to LSEs for the benefit of their customers would be made available in these auctions. The auctions would be structured to provide equal and non-discriminatory access to all first sellers, including investor-owned utilities, local publicly-owned utilities, and merchant generators and marketers. A secondary market may emerge, which help complying entities with compliance planning and management. For further details, please refer to responses to Q 5-7.

3.5. Natural Gas Sector

Q26. Answer each of the questions in Section 3.4.1. except Q16, but for the natural gas sector and with reference to natural gas distribution companies (investor- or

publicly-owned), interstate pipeline companies, or natural gas storage companies as appropriate.
Explain if your answer differs among these types of natural gas entities. Explain any differences between your answers for the electricity sector and the natural gas sector.

See responses to earlier questions.

Q27. Are there any other factors unique to the natural gas sector that have not been captured in the questions above? If so, describe the issues and your recommendations.

PG&E prefers a programmatic approach to greenhouse gas reductions in the natural gas sector. There are aspects of the natural gas sector that are unique and present different regulatory design issues and challenges than the other sectors, and therefore issues regarding technological and economic feasibility and adoption of emissions limits and emissions reduction measures should be considered separately from electric sector issues. In contrast to other emission sources, natural gas consumption and related greenhouse gas emissions for non-electricity applications have shown very little growth or even declined since 1990. Gas utilities can also promote conservation and efficiency, but they have virtually no ability to substitute low carbon alternatives to natural gas.

3.6. Overall Recommendation

Q28. Considering your responses above, summarize your primary recommendation for how the State should design a system whereby electricity and natural gas entities obtain emission allowances if a cap and trade system is adopted.

See executive summary, above.

IV. CONCLUSION

For the reasons stated above PG&E recommends that the CPUC and Energy Commission adopt and recommend the policies on allocation of emissions allowances under AB 32 as described in PG&E's comments.

Respectfully Submitted,

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