BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Address Natural Gas Distribution Utility Cost and Revenue Issues Associated with Greenhouse Gas Emissions.	)))))	R.14-03-003 (Filed March 13, 2014)

PREHEARING CONFERENCE STATEMENT OF THE INTERNATIONAL EMISSIONS TRADING ASSOCIATION

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PREHEARING CONFERENCE STATEMENT OF THE INTERNATIONAL EMISSIONS TRADING ASSOCIATION[1]

Re: Natural Gas Distribution Utility GHG Procurement

In accordance with the Rules of Practice and Procedure of the California Public Utilities Commission (the Commission) and the *Order Instituting Rulemaking to address Natural Gas Distribution Utility Cost and Revenue Issues Associated with Greenhouse Gas Emissions* (OIR), issued 19 March 2014, the International Emissions Trading Association (IETA) offers the following comments in advance of the Prehearing Conference.

I.

Introduction and Summary

The OIR includes a preliminary scoping memorandum, which indicates that this proceeding will address: 1) orders directing how each natural gas corporation should track and recover costs associated with Cap-and-Trade compliance; 2) rules and limits governing how natural gas corporations should procure Cap-and-Trade compliance instruments; 3) rules governing the use of potential revenue resulting from the sale of allowances that ARB may allocate to natural gas corporations on behalf of ratepayers; 4) forecasts of natural gas corporations' 2015 Cap-and-

[1] The views expressed in IETA's comments represent the consensus view of the majority of members, and do not purport to necessarily represent each individual member company's position.

Trade-related costs; and 5) conclusions about the potential need, scope, and administrative structure of outreach and education activities related to the impacts of the Cap-and-Trade Program on natural gas end-use customers.[2]

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. Our 130 member companies include some of California's, and the world's, largest corporations—including leaders in power, oil & gas, mining, cement, aluminum, chemical, pulp & paper, and investment banking. IETA also represents a broad range of global leaders from the industries of: data verification and certification; brokering and trading; offset project development; legal and advisory services. In California, IETA supports the development of an environmentally effective and liquid carbon market, bringing to bear extensive experience from the participation in cap-and-trade programs around the world.

As a membership organization focused on the development and efficient operation of environmental markets, IETA will contain its comments in this OIR strictly to the second point of the scoping memorandum: the rules governing how natural gas corporations should procure Cap-and-Trade Compliance instruments.

IETA's comments are summarized in the following bullets points:

- The Commission should enable greater flexibility for natural gas utilities to optimize the economic efficiencies inherent in ARB's Cap-and-Trade program so as to reduce the costs to ratepayers[3];
- The performance of ARB's Cap-and-Trade program to date suggests that market transparency, liquidity, and maturity have sufficiently developed to enable the Commission to expand the degree of flexibility afforded to natural gas utilities in

[2] OIR, p. 16

[3] IETA contends that greater flexibility for both electric utilities and natural gas utilities would benefit ratepayers and thus will explore the possibility of providing similar comments during the upcoming 2014 Long Term Procurement ("LTPP") proceeding in support of increasing the procurement flexibility of the electric utilities.

procuring compliance instruments while effectively addressing concerns over unnecessary costs being borne by ratepayers.

II.

Discussion

<u>3.1 Issues, 2. Purchasing Rules, b. What rules and limits should govern how natural gas corporations acquire Cap-and-Trade compliance instruments?[4]</u>

IETA appreciates the importance of the Commission enacting safeguards with the intention to protect ratepayers from unexpected consequences of natural gas utilities participating in the Cap-and-Trade market. However, IETA believes that limiting procurement activities (such as the limits on procurement for electric utilities) goes beyond what is necessary to protect ratepayers – and in fact may have the adverse effect of increasing costs for ratepayers. While a sufficient level of safeguard for ratepayers should be in place, this protection should not come at the expense of preventing natural gas utilities from optimizing the cost efficiencies inherent in the regulatory design of a Cap-and-Trade market.

IETA believes the appropriate amount of flexibility to afford natural gas utilities will include permitting them to purchase Cap-and-Trade compliance instruments not only through ARB auctions, competitive solicitations, and Commission-approved exchanges, but also deal in the bilateral over-the-counter trading market. In addition, natural gas utilities should be permitted to purchase options, swaps, and derivative products within the context of an overall regulatory approach that includes safeguards for ratepayers.

Providing flexibility in procurement rules will allow natural gas utilities to see and access more of the market, which will help reduce overall costs to ratepayers. In addition, greater flexibility in procurement rules will enable them to more effectively hedge price risk presented by gas and carbon price volatility between California's quarterly auctions.

A. The Cap-and-Trade market is sufficiently mature to support procurement by natural gas utilities.

[4] OIR, p. 11.

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Based on the performance of the Cap-and-Trade market to date, the Commission should re-assess its original concerns at the beginnings of ARB's Cap-and-Trade program regarding the risk and maturity of the market, as described in the rules governing electric utility purchases of Cap-and-Trade compliance instruments. In the more than three years since the Cap-and-Trade market first started trading, the over-the-counter (OTC) market has matured to provide the necessary transparency into market pricing and liquidity, as well as deliver important real-time data on market moving news and events.

The secondary market for California Carbon Allowance (CCA) futures contracts has matured significantly since trading began in August 2011 on the Intercontinental Exchange (ICE). Today there are approximately 40 active participants with CFTC reportable positions in the market and clearing trades via the ICE.

To date, a total of 115,797 futures contracts have traded on ICE representing 115,797,000 tons. The monthly average volume in 2013 was more than 3 million tons, and liquidity has developed throughout the curve including current year and future year vintages.

B. Natural gas utilities should be able to access a greater amount of the overall market liquidity.

A significant portion of the trading activity in the market to date occurs in the OTC market. In fact, 77% of traded CCA futures volumes on ICE were executed OTC via brokers[5]. Excluding natural gas utilities from OTC-cleared markets effectively shuts them out from three-fourths of the market liquidity, which presents added execution risk and limits their opportunities for lower-cost compliance procurement. IETA believes natural gas utilities should be provided access to both the ICE screen and OTC markets in order to effectively hedge carbon price risk and access larger volumes of compliance instruments per transaction. Participants, such as the natural gas utilities, that have significant volumes to procure (or sell) could be disadvantaged if not permitted access to the OTC markets, resulting in higher costs that ultimately will be borne by the ratepayers.

[5] Over the period of time since the launch of the ICE contract on 29 August through 1 April 2014.

Providing natural gas utilities the flexibility to use the OTC market, as well as the ICE screen, to procure CCAs futures in a liquid, exchange-cleared market should help reduce the cost ratepayers will bear over time. Using the OTC-cleared market and the exchange to procure CCAs will also provide a more effective means by which natural gas utilities can hedge their exposure to compliance instrument price increases. While quarterly auctions are a good source of supply, their relative infrequency may not allow gas utilities optimal liquidity to hedge as they incur compliance obligations from the purchase and sale of natural gas between the auctions.

C. Use of swaps, options, and other derivatives within an overall regulatory approach would aid in price risk management by gas utilities.

At this time, IETA believes the CCA options market is liquid enough for the natural gas utilities to participate in such market. Price volatility is at historic lows in the current CCA price environment, but the purchase of options could present an effective means to protect against potential significant events that could impact on prices, such as the decommissioning of a major nuclear plant. The Commission should consider permitting the use of CCA options for natural gas utilities as an effective way to reduce risk and cost to ratepayers. A total of 36,642,000 million tons of options have traded on CCAs since they began trading on ICE in 2011. Of that, nearly 35 million or 95% have been traded in OTC market.

D. The OTC offset market offers natural gas utilities greater options for procurement.

California Air Resource Board-approved California Carbon Offsets (CCO) are an important tool in the compliance toolbox for natural gas utilities, which can allow for lower-cost compliance – savings that can be passed down to ratepayers. With lower cost compliance in mind, IETA believes natural gas utilities should maximize their 8% offset quantitative limit as provided under the Cap-and-Trade program. As for procurement, IETA believes the utilities would best optimize this opportunity given flexible access to the bilateral market to procure CCOs.

At present, offsets do not trade via exchange and therefore present credit and counterparty risk. Recognizing the need to properly manage such risks as an inherent part of OTC transactions, IETA believes that natural gas utilities should be allowed greater access to the bilateral market to locate the best price and terms while appropriately managing these risks.

As mentioned, key reason for the inclusion of offsets in the cap-and-trade program is their ability to provide for a more flexible (and potentially cheaper) means of compliance with an entity's annual obligation. Requiring tight restrictions on how natural gas utilities can procure offsets has the effect of undermining these benefits and ultimately making offsets less effective in reducing costs for ratepayers. Like any forward off-take contract, the ability of a natural buyer to commit to purchase a commodity delivered over a number of years matches well with the need of offset project developers to demonstrate bankable revenue streams in order to implement a project. The Commission should enable natural gas utilities to contract directly with project developers and operators – doing so, will incent more offset projects, and provide more opportunities for natural gas utilities to procure low-cost offsets and pass savings on to ratepayers. The current rules, as implemented for electric utilities make this difficult.

With respect to the issue of liability for offset invalidation risk[6], the premium currently being charged for "golden" CCOs (where the seller of the CCO takes on the invalidation risk) is high in comparison to the benefits received. The risk associated with offsets where the buyer assumes the liability can be managed more cost-effectively through portfolio management and potentially the use of insurance products or derivatives. As such, IETA believes that natural gas utilities should have the authority to purchase CCO3s and CCO8s[7], managing the invalidation risks internally, and not be limited to purchasing solely "golden" CCOs.

c. Should these rules and limits governing acquisition of compliance instruments for natural gas corporations mirror those adopted in D.12-04-046 for electric utilities?

The decision by the Commission in connection with electric utility procurement of GHG compliance instruments should be reassessed in light of the market performance and growing maturity. Currently, it presents unnecessary and burdensome restrictions on procurement as

[6] It should be noted that ARB has designed rigorous procedures that are already in place to ensure the quality of CCOs (including CCO3s and CCO8s) before their issuance in the first place, and thus the risk of invalidation is very low.

[7] A CCO8 refers to an offset with an 8-year invalidation risk borne by the buyer; a CCO3 refers to an offset with a 3-year invalidation risk borne by the buyer.

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described above. The rules and limits adopted in D.12-04-046 do not allow for the procurement on GHG instruments in the secondary OTC market.

Based on the data provided above, this limitation restricts market access, reduces optimal liquidity and potentially raises costs for electricity ratepayers. The restrictions adopted in D.12-04-046 on the electric utilities should be reconsidered at the next LTPP proceeding, and likewise the Commission should not burden natural gas utilities with restrictions that mirror the D.12-04-046. IETA would be pleased to become a party to the LTPP proceedings and provide input at the next possible opportunity.

III.

Conclusion

For the reasons stated above, IETA respectfully requests the Commission adopt an approach to Cap-and-Trade compliance instrument risk management and procurement that affords the natural gas utilities a greater degree of flexibility. Such flexibility to utilize the OTC market, where most of the liquidity resides, will enable natural gas utilities to more effectively manage price risk and reduce overall compliance costs thereby reducing costs to California ratepayers. IETA believes that this can be done in such a way as to adequately ensure that ratepayers are not subjected to unnecessary increased costs. Thank you for the opportunity to submit these comments. We look forward to any questions or comments you may have on these recommendations.

Respectfully submitted,

By: ____*/s/ Robin Fraser*_______

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