BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Order Instituting Rulemaking to Implement the Commission's Procurement Incentive Framework and to Examine the Integration of Greenhouse Gas Emissions Standards into Procurement Policies.	R. 06-04-009

COMMENTS OF EL PASO NATURAL GAS COMPANY AND MOJAVE PIPELINE COMPANY ON ISSUES RELATING TO GHG ALLOWANCE ALLOCATION ISSUES IN THE NATURAL GAS SECTOR

In accordance with the "Ruling Requesting Comments and Noticing Workshop on Allowance Allocation Issues" of the Administrative Law Judge, dated October 15, 2007 (Ruling), El Paso Natural Gas Company (EPNG) and Mojave Pipeline Company (Mojave) submit their joint comments on the allowance allocation issues relating to greenhouse gas (GHG) emissions in the natural gas sector.

Introduction and Background

The EPNG and Mojave pipeline systems provide over 30% of the natural gas consumed in California.[1] The two companies are subsidiaries of El Paso Corporation (collectively, "El Paso"), which is organized around two core businesses—pipelines and exploration and production. El Paso's pipeline group operates a network of nearly 43,000 miles of pipeline, comprising over 20% of the interstate gas pipeline infrastructure in the country. El Paso has operations in over thirty (30) states and several federal jurisdictions.

El Paso currently helps satisfy, and will continue to meet, California's growing demand for clean-burning natural gas through its extensive network of natural gas pipelines and future natural gas projects. As a Climate Action Leader™ and member of the California Climate Action

[1] EPNG and Mojave are interstate pipelines subject to federal rather than state utility jurisdiction. However, we will continue to cooperate with state agencies such as the Commission as appropriate.

Registry (CCAR), El Paso has been in the forefront of efforts to address the concerns being expressed by public and governmental stakeholders over the issue of GHGs.[2]

Summary of Comments

EPNG's and Mojave's comments on the specific questions in the Ruling are set forth in Attachment "2" hereto. Substantially identical comments are also being filed with the California Energy Commission (CEC) in its Docket No. 07-OIIP-01. In summary:

- With respect to additional criteria in designing a GHG emissions program for the natural gas sector, we urge the Commission to consider the following principles:
    - Realistic balance of fossil fuel demand with AB32's goals and targets.
    - Recognition of current regulatory and legal structure and minimizing disruption of the basic regulatory/legal framework of the energy markets.

- We support 100% free allowance allocation for the natural gas transmission sector, if regulated. An auction would unnecessarily increase costs to consumers and create a variety of difficult legal and regulatory issues and uncertainties.

- The Commission should be assured that regulated entities like interstate transmission companies will not have an opportunity to realize "windfall profits" if granted allowances at no cost.

- We support an output, or intensity-based, allocation scheme, with periodic updating to account for efficiencies created by companies. This will ensure equitable distribution between companies, sectors and fuel sources. Furthermore, it will also advance deployment of higher efficiency technologies while reducing emissions and will minimize the amount of fossil fuel combusted.

- We support a minimum set-aside of 5% of the total allowance pool for new facilities that need to be built to meet our nation's energy needs. Such set-asides followed with a periodic output-based updating of the allowance distribution scheme will ensure an equitable mechanism, encouraging energy efficiency and emissions reduction while sending the right price signals to the market.

- We strongly favor clarity in the regulatory process as it relates to development of an allocation mechanism under a cap-and-trade program. The Commission should fully realize the magnitude of the administrative burden to the regulators and regulated entities when designing such structures, while accounting for the fact that most entities are in their infancy with respect to assessing climate change impacts and strategies. Other provisions, including

[2] El Paso's additional leadership credentials in GHG matters are summarized on Attachment "1" hereto.

transparency, collusion/hoarding and compatibility with existing energy markets are additional factors that need to be considered.

- Specifically with respect to interstate natural gas transmission companies, we urge the Commission to consider the "real world" regulatory, legal, technical and market challenges affecting gas supply and transmission to/in California. We also encourage inclusion of specific emissions trading design elements like banking and borrowing.

Conclusion

EPNG and Mojave support the Commission's efforts to develop recommendations to present to the California Air Resources Board (CARB) as it implements AB 32. We believe that any GHG regulation must incorporate a market-based cap-and-trade program with linkages to functioning and transparent trading markets. The determination of reasonable, technically sound emissions cap and allocation mechanisms are central to the success of such a program and must be balanced with national economic and competitive conditions. Properly designed and deployed, a cap-and-trade regime can offer the most cost-effective emission reduction strategies while balancing economic growth and providing additional incentives for the use of the best available technologies.

As a certified Climate Action Leader,™ we want to work with California in its efforts to reduce GHG emissions while continuing to ensure that adequate supplies of competitively-priced natural gas will flow to the state.

Respectfully submitted,

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ATTACHMENT "1"

EL PASO'S GHG LEADERSHIP CREDENTIALS

El Paso has been actively participating in national and international policy discussions and has instituted internal guiding principles on the issue of global climate change.[3]

El Paso has been a member of the CCAR since 2006. In June 2007, El Paso became the first natural gas transmission company to file an emissions inventory covering all applicable GHGs, including methane, N_2O and CO_2. On July 16th of this year El Paso became the first natural gas company to certify its emissions and earn the status of Climate Action Leader. Indeed, we are also the first CCAR member to report and certify an emissions inventory for 2006.[4] Later this year, El Paso intends to register its 2006 GHG emission estimates under DOE 1605(b) requirements.

El Paso maintains leadership positions at the Interstate Natural Gas Association of America (INGAA) on GHG and in the development of the INGAA Greenhouse Gas Emissions Estimation Guideline for Natural Gas Transmission and Storage.

El Paso has been invited to be a member of The Climate Registry's Advisory Committee.[5] The Climate Registry was established as a nonprofit organization in May 2007 and is now comprised of 39 states, three Native American tribes, two Canadian provinces, and one Mexican state. Governors, secretaries, tribal leaders, and premiers have signed a Statement of Principles and Goals endorsing the Registry and each has designated a representative to sit on the organization's Board of Directors. As part of the Advisory Committee, El Paso will provide

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[3] El Paso's first internal (2004) GHG inventory was completed in 2005. El Paso's 2005 GHG inventory for the pipeline group successfully underwent a third-party verification process. In addition, El Paso has produced a corporate GHG Inventory Management Plan and a pipeline GHG Inventory Technical Manual, and is in the process of developing a GHG Information Management System.

[4] El Paso's 2006 entity-level emissions report is available at http://www.climateregistry.org/CARROT/public/reports.aspx.

[5] El Paso was nominated for this position by California Environmental Protection Agency.

input on technical elements associated with The Climate Registry's design and implementation and may also provide feedback on broader policy issues that could affect the organization's support of state and provincial climate programs.

El Paso is part of the Natural Gas Protocol Workgroup facilitated by the CCAR and the World Resources Institute (WRI) with the goal to produce a guidance document and protocol for estimating GHG emissions from Natural Gas Transmission, Storage and Distribution sectors. The protocol and calculation tool(s), which will be developed through a stakeholder workgroup process, will supplement the *California Climate Action Registry's General Reporting Protocol*[6] and the WRI/World Business Council for Sustainable Development Greenhouse Gas Protocol - A Corporate Reporting and Accounting Standard.[7]

[6] http://www.climateregistry.org/docs/PROTOCOLS/GRP%20V2-March2007_web.pdf.

[7] http://www.ghgprotocol.org/templates/GHG5/layout.asp?type=p&MenuId=ODg4&doOpen=1&ClickMenu=No.

ATTACHMENT "2"

COMMENTS ON SPECIFIC ALLOWANCE ALLOCATION ISSUES

Response to Question 1: Comments on Criteria Established by the Market Advisory Committee (MAC)

1. Introduction

El Paso supports an economy wide cap-and-trade greenhouse gas regulatory structure. El Paso believes that a sector-specific, phased approach is most appropriate, with thresholds, regulatory mechanisms and possibly schedules tailored to the unique circumstances of each sector. Initial regulatory efforts should focus on the sectors that can provide the greatest emission reductions, most reliably, at the lowest cost, and with the least economic disruption. GHG emission programs should be developed and implemented sector-by-sector and include the most appropriate combination of market-based programs, technology development/incentives and voluntary programs.

The Commission has invited comments on eight (8) principles established by the MAC in designing a cap-and-trade program. *El Paso urges the consideration of two additional principles:*

- Realistic balance of fossil fuel demand with AB32's goals and targets.
- Recognition of current regulatory and legal structures and minimizing disruption of the basic regulatory/legal framework of the energy markets.

An economy-wide cap-and-trade regulatory program should avoid creating disincentives for additional supplies of natural gas to flow to the state of California. Further, there are major legal, regulatory and commercial hurdles that need to be considered in developing an emissions allocation mechanism with respect to interstate natural gas pipelines. Accordingly, any allowance allocation mechanism to be adopted should be tailored to the current legal and regulatory structures governing natural gas and electricity markets.

In order to assist the Commission in considering these additional, extremely important

considerations, El Paso below provides a brief overview and outlook of the natural gas markets in California and our thoughts on the appropriate point of regulation in the natural gas sector. *In addition,* El Paso recommends that the Commission consider the October 29, 2007 declaration of the International Carbon Action Partnership (ICAP), to which the State of California is a signatory.[8] The ICAP's stated goal involves the "establishment of a well-functioning global cap and trade carbon market." Hence, measures and principles considered in this proceeding should match the stated ICAP goals.

2. Overview and outlook regarding California's natural gas markets

The state of California uses approximately 6 Bcf/d of natural gas, which is consumed to heat homes, generate electricity as well as for many industrial and commercial uses. Approximately 8.5 Bcf/d of interstate pipeline capacity is connected to the state. Liquefied natural gas (LNG) supplies are supposed to begin arriving soon in the Baja of Mexico that could provide additional gas supplies to California.[9] And there are mandates requiring at least 20% of the energy needs of the state by 2010 be supplied by renewable sources. This seems to suggest an energy system in balance with many choices. However the state has been complacent recently regarding energy needs, not realizing that there are a number of dynamic drivers that are constantly evolving and not to the benefit of California. These drivers are: natural gas supply; LNG; natural gas electric generation; east of California demand; pipeline capacity and efficiency standards.

California is at a critical crossroads in planning its long-term energy future. As part of the

[8] http://www.icapcarbonaction.com/declaration.htm

[9] Although the Costa Azul facility is officially classified as having a regasification capability of 1 Bcf/d, it should be kept in mind that only roughly half of its output will be available to serve the Southern California market. The balance of the output will remain in Mexico. And industry news reports suggest that, due to tightness in the available LNG supply, it is unlikely that the Costa Azul facility may be running at levels well below its capacity until at least 2012.

AB32 GHG regulatory process, careful, resourceful and realistic planning will be required to meet California's energy needs. El Paso respectfully submits that the best approach is to use a risk-mitigating mix of available fuel sources, that include fossil fuels like natural gas and renewable energy sources as a hedge against an uncertain future and the uncontrollable dynamics of a fast-moving marketplace.

El Paso strongly believes that this Commission, and the CEC in conjunction with the CARB, should also encourage pipeline expansion and new gas supply from the Rockies into California. Due to its clean-burning emissions profile and the ability to immediately construct and implement natural gas technologies (including natural gas-fired generating units in the electric sector), we strongly believe that natural gas is the "bridge" to meet AB32's 2020 climate challenge.[10] As explained in our Prehearing Conference Statement,[11] there are many projections of a need for an additional pipeline(s) or a pipeline expansion(s) out of the Rockies in the year 2010 on the order of 1 Bcf/d. In order to assure that California's near-term energy needs will be met, gas producers (whose contract commitments will likely determine which pipelines are constructed to serve which demand areas) should be encouraged to seek destinations in California and to serve California, not elsewhere.

Conversely, California must be careful not to inadvertently create disincentives for additional gas to flow into the state. Specifically, if the state's GHG reduction program places significant additional costs on the natural gas delivered by the interstate pipelines, gas suppliers will have in the incentive to move their gas to areas extrinsic to California that are not burdened by such costs. Among other things, such costs would make it is less likely that pipeline capacity

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[10] *See also*, e.g., "Coal's Doubters Block New Wave of Power Plants," Wall Street Journal article of July 25, 2007 [Quoting FERC Commissioner Marc Spitzer as stating that "{g}as is the bridge fuel" that will be needed if planned coal-fired generation plants are not built.]

[11] *Prehearing Conference Statement of El Paso Natural Gas Company and Mojave Pipeline Company on Issues Relating to GHG Emissions in the Natural Gas Sector* dated July 26, 2007.

will be built to move new Rockies supplies to California, exacerbating the state's looming supply tightness.

El Paso urges Commission to recommend that the CARB adopt a cap-and-trade program with a realistic balance of fossil fuel demand to meet AB32's goals and targets, and to not create disincentives for additional natural gas supplies to flow to California.

3. Point of regulation in the natural gas sector

Emissions control programs have mostly focused on the point of emissions (downstream) where emissions can actually be measured and where they can be controlled. Emissions cap and trade programs based on the point of emission have been highly successful and cost effective.

Some GHG regulatory proposals have suggested moving the point of regulation to the point of energy production (upstream), processing or transportation (midstream). The primary intent of this is approach to allow regulation of a small number of upstream/midstream points to induce emission reductions at a large number of downstream sources through the imposition of a carbon fee at the upstream point. For example, implementing a cap or a fee on petroleum products at the refinery would be intended to create a price signal that would induce reduce gasoline consumption by consumers. Or, an upstream cap or fee on fuels would be intended to create a price signal to ultimately induce reduced electricity consumption.

While such systems seem simpler and, theoretically, may be equally as effective as other programs, there are so many market inefficiencies and institutional barriers to this kind of pure economic response that they may well be unworkable in practice. Certainly it is well established that price signals that rationally should drive extensive energy efficiency investment at the consumer level are not at all effective for a large number of reasons. These same barriers would be likely to limit the effectiveness of an upstream program.

In addition, as explained in our July 26, 2007 comments,[12] a California effort to regulate the natural gas sector at the interstate pipeline level would create enormous regulatory complications that could threaten the timely implementation of any GHG reduction program indefinitely. Moreover, as explained below, even the prospect of such a program being implemented could cause new gas supplies to be directed to areas outside California.

Downstream regulation has been proven effective for the large stationary sources that should be the core of the GHG reduction program. Other sectors should be addressed through a hybrid system of different types of programs such as efficiency codes, standards and incentives and offset programs, discussed below. California should not try to force-fit all sectors and sources into one unproven regulatory structure.

In summary, it is very critical for the Commission and the CARB to clearly understand the supply and constraints of the natural gas markets in California and also the regulatory/legal complexities related to the point of regulation issue with respect to interstate natural gas transmission companies. It is highly recommended that, in order to meet AB32's implementation deadlines and targets, the Commission should incorporate the realities of these constraints in its final recommendations to the CARB. We urge the Commission to incorporate the need to balance AB32's goals with current regulatory/legal and supply constraints surrounding natural gas as a governing principle in developing cap-and-trade regulations.

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[12] *See* note 11 above. Also, El Paso provided comments to the draft MAC report on this point of regulation issue. *See* http://www.climatechange.ca.gov/events/2007-06-2_mac_meeting/public_comments/MAC%20Cap%20and%20trade%20El%20Paso%20Comments_061507__FINAL_Ecopy_.pdf

Response to Questions 2-4: Comments on whether allowances should be allocated or auctioned.

1. Introduction

El Paso strongly supports 100% free allocation of emission allowances for natural gas pipeline transmission companies. Our comments are focused on a national level rather than a California only cap-and-trade program. However, we urge the Commission to consider these comments since a national GHG regulatory scheme in the future is likely and the Commission, as well as the CEC and the CARB, has expressed a desire to foster development of a California program that can be integrated into a regional and national system.

In a cap and trade program, the tradable allowances must be distributed to affected entities in some way. These allowances represent the currency of the trading program and have significant value. In a tradable allowance program covering the total national GHG inventory of approximately 7 billion metric tonnes of GHG emissions, the total value of the allowances, at an allowance price of $13/tonne, would be $91 billion per year.[13] The distribution of this economic value is obviously a critical component of the program design.

In past trading programs under the Clean Air Act, all or nearly all of the allowances have been distributed for free to the regulated entities. However, recent proposals for GHG programs have questioned this basic point – i.e., whether or not to distribute allowances for free to the regulated entities. This alternative approach would require the regulated entities to pay up-front for the allowances required to cover their emissions. In this case, regulated entities would be required to pay $91 billion dollars per year for the allowances.

Much of the impetus for adoption of a model that requires the up-front purchase of allowances via an auction is due to the distributional effects of the allowances especially in circumstances in which electric generators are able to produce power at competitive rates.

[13] This calculation assumes that there will be an economy wide cap-and-trade program covering all sectors.

Competitive generators can be expected to simply add the cost of purchased allowances to their prices, and thus recover the cost. However, they could also add the market value of freely allocated allowances to their prices. In this case, some regulators believe that such generators would be getting a "windfall," since they would be recovering the value of allowances that were given to them for free. This is driving a change in attitude towards the appropriate method of allocation. Several states in the Regional Greenhouse Gas Initiative are leaning towards requiring the affected entities to purchase all of their required allowances. On the federal side, a recently proposed legislation[14] would begin with free allocation in 2012 of about 76% of the available allowances with the remaining 24% to be auctioned. By 2036, 27% of the available allowances for that year would be allocated at no cost and the remaining 73% would be auctioned.

2. Interstate pipelines and allowance allocation mechanisms

Interstate natural gas pipeline are fully rate regulated by the Federal Energy Regulatory Commission (FERC) under Natural Gas Act. Rates are based on a pipeline's costs (including a return on investment). Thus, if an interstate pipeline did not incur a cost it may not include an amount for such item in rates. Conversely, pipelines must be permitted an opportunity to recover all their prudently incurred costs. So if an interstate pipeline incurs costs, FERC generally will permit those amounts to be included in the pipeline's rates to be recovered from its customers.

It should therefore be clear that natural gas pipelines would not have an opportunity to receive a "windfall" from the free allocation of allowances. That is because freely allocated allowances would not be eligible for recovery in rates as an item of cost. On the other hand, if California were to require that interstate pipelines purchase emission allowances (setting aside for the moment the legal issues associated with state regulation of interstate commerce), the

[14] America's Climate Security Act of 2007 (S2191).

pipelines would certainly seek to recover such costs in their rates. Rate recovery would simply increase the cost of gas to consumers. And rate recovery might be in the form of a rate payable only on deliveries to California. That would further disadvantage California in obtaining new gas supplies (e.g., new Rockies expansion), since it would make California a relatively higher cost destination for gas deliveries than other areas of the country. This is precisely what California must avoid at this critical time for new energy infrastructure and supplies.[15] Thus, emission allowances should be allocated for free to at least the interstate pipeline sector.

3. Frequency of allowance allocation mechanisms and new entrants

Another issue is the frequency of allocation. Some proposed programs allocate the allowances once and forever to the existing entities based on their recent performance. This has two negative aspects:

- New facilities can never get an allowance allocation.
- The allocation is not adjusted for changes in operation. Facilities that shut down continue to get the same allocation forever. Facilities that increase utilization do not get any increased allocation.

El Paso believes that the best way to address this is for the allocations to be periodically redistributed based on recent operation. In addition, new facilities should be eligible for a special allowance set-aside until they have a sufficient baseline to receive allowances under the main program. This is highly important for the natural gas sector and its increasing role as the provider of the "bridge fuel" to an eventual carbon constrained environment in the next decade.

This still leaves the issue of how allowances should be allocated. Some programs distribute allowances based on historic emissions, however this tends to reward historic high

[15] If FERC were to not allow recovery of such allowance costs for some reason, then the likelihood of protracted litigation over the validity of the California regulations increases, a fight that could cloud the whole program with uncertainty for years.

emitters and penalize those with low emissions. El Paso believes that allocation should be based on some measure of productive output, such as historic throughput. This appropriately rewards companies that have historically invested in efficiency and emission reductions.

4. Conclusions and recommendations regarding Questions 1-4

Due to the fact that regulated entities like natural gas pipelines will not have an opportunity to realize "windfall profits," to minimize the risk of creating costly disincentives for new gas to flow to the state and to avoid potential protracted delays in implementing a GHG allowance program, El Paso recommends that, to the extent that California seeks to regulate interstate natural gas pipelines under a cap and trade program, they should receive 100% free allocation of allowances. The allowances should be allocated based on throughout or some other measure of productive output. They should be reallocated every few years and there should be a set-aside for new sources.

Response to Questions 5-9: General Questions on Auctions

1. Important policy considerations (general)

In general, an auction allocation scheme has been touted to have many theoretical benefits and some reports conclude that it "meets business opposition in practice."[16] Some of these reports over-simplify the real world business risks and practices. A June 2001 study by the Congressional Budget Office (CBO),[17] essentially concludes that "[g]iving the permits away could also achieve equity goals if policymakers distributed the allowances to firms and households in proportion to their share of the cost of the cap on carbon emissions." That is, despite the societal and distributional advantages of auctions touted by economists, it is unclear that these postulated advantages will actually materialize in the real world.

A recent report commissioned by the International Emissions Trading Association[18] outlines several policy considerations considering "real world complexities" associated with auctions. Another recent report commissioned by the New York State Energy Research Development Authority (NYSERDA)[19] outlines several important criteria in designing an auction system. These include:

i. Lowering administrative and transaction costs;

ii. Transparency and efficiency of the program;

iii. Avoiding collusion and providing appropriate price signals;

iv. Reducing price volatility;

v. Appropriate distribution of revenues from auction; and

vi. Compatibility with energy markets.

While we do not endorse either of the above two cited reports, El Paso strongly

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[16] *The Business of Climate Change II*, John Llewellyn and Camille Chaix, Lehman Brothers, September 20, 2007.

[17] *An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions*, June 2001

[18] *Complexities of Allocation Choices in a Greenhouse Gas Emissions Trading Program*, September 2007.

[19] *Auction Design for Selling CO2 Emission Allowances Under the Regional Greenhouse Gas Initiative*, October 2007

recommends that interstate natural gas pipelines, if regulated under a cap-and-trade program, be provided free allowance allocations. Most of these reports are macro level reports and do not highlight industry specific concerns or issues. We have attempted to outline the complexities associated with an auction system in the interstate natural gas pipeline group above.

Another area of concern is the practical feasibility of designing a comprehensive cap-and-trade system in a very short period. While several northeastern states have signaled their commitment to a 100% auction system, we urge the Commission to consider the following practical implementation issues with an auction system for a cap-and-trade regulatory scheme.

A. Development of an auction system with basically very limited real practical experience

There is very limited experience in the United States with auctions of emission allowances under a cap-and-trade program and none of them include a 100% auction scheme. There is a very limited (2.8% of the allowances) auction mechanism in the Acid Rain Program. The second example is from Virginia's NO_x Budget program where about 5% of Virginia's 2004 and 2005 vintage allowances were auctioned. Even in this limited auctioning experience, the allowances were sold at prices higher than the over-the-counter prices.

It took El Paso over two years of extensive research and development to arrive at a certifiable grade emissions inventory. To deal with complexities associated with auctions and ensure compliance (i.e. development of internal processes, methodologies, controls, etc.) in an extremely short period, based on only theoretical ideas from economists, will be extremely challenging. The Commission should also be cognizant of the relative inexperience of the staff at various agencies dealing with such a program. This inexperience both for industry and the governmental agencies implementing the program should not be underestimated.

B. Administrative concerns

An entirely new administrative structure has to be created whether under a free allowances or auctioning system. However, with an auction system, a separate structure needs to be created with respect to implementing proceeds from the auction revenues (including possibly tax reforms) to realize some of the theoretical benefits.

In addition, any auction rules should include transparent rules to limit abuse (i.e. hoarding of allowances) and collusion by "non covered" entities (i.e. firms without any compliance reduction obligation). We urge the Commission to consider this important aspect in the recommendations to the CARB. It is important to realize the motivation by these "non covered" entities in such a program. It is our belief that inclusion of these non-covered entities into such program could create significantly higher auction and secondary market allowance prices for CO_2 Budget Sources. Such entities will be in direct competition with covered entities (i.e. companies with reduction/compliance obligations) for the same auction allowance and such firms therefore may be motivated only to realize the financial arbitrage between the auction price and the secondary market price. This may also result in higher allowance prices and therefore costs of compliance.

While the recent NYSERDA report reviews auction issues, it is once again important to realize the practical challenges in developing complex rules addressing several aspects of a program within the limited time frame required to meet the AB32 deadlines. Most companies are in the infancy stage of developing climate change strategies – including conducting a basic GHG inventory of their emission sources. To address complex issues, such as the proper design of auction systems, without fully understanding the complexities and with only theoretical concepts is a recipe for disaster.

Future carbon programs should be designed with a clear understanding of practical implementation issues – including technical, business, regulatory and political consideration.

We urge the Commission to apply a balanced thought process in this important debate and not consider theoretical reports under an "ideal" environment.

2. Important Policy Considerations For Natural Gas Transmission Companies

Under a 100% auction program, pipelines or the regulated entity would be responsible for purchasing allowances in an "auction" to cover its emissions. We have previously identified some of problems associated with any requirement that interstate pipelines purchase allowances (whether through an auction or other allocation method). Some additional important policy questions as related to interstate pipelines include:

- To what extent can a state lawfully impose charges on interstate pipelines that affect their rates, which are exclusively subject to regulation by the FERC?
- Would such a program be pre-empted by the regulatory scheme under the Natural Gas Act and/or constitute an undue burden on interstate commerce?
- How would a California GHG regulatory program attempt to ensure that each volume of gas delivered in the state (and therefore emissions) is only counted once, while minimizing administrative costs and ensuring compliance?
- Should both interstate and intrastate pipelines be included? How would coverage be defined?

As we have outlined previously, many of these issues can be avoided by a carefully-designed GHG program that employs a 100% free allocation concept and a 'downstream' point of regulation of the natural gas sector.

3. Banking and borrowing should be included in California's GHG policy

The importance of effective banking/borrowing has been outlined in many reports. In fact, the lack of a robust banking provision in the RECLAIM program has been cited as a contributing factor to the suspension of the RECLAIM program.[20] Banking and borrowing reduces the compliance costs and introduces flexibility in corporate strategies with respect to technology deployment, capital turnover, asset optimization and the vagaries of the weather and force majeure situations. The latter is extremely important in the natural gas sector, as we strongly believe that natural gas is the "bridge" solution to a lower carbon intensive fuel economy. It is important to note that banking/borrowing have limited impact on the distribution of allowances, however they are important tools to mitigate price volatility and provide long term price signals.

4. Conclusions and Recommendations on Questions 5-9

In summary, we urge the Commission to carefully consider the regulatory, legal and technical challenges in developing an allowance allocation mechanism for the natural gas sector. The challenges include a host of technical, regulatory and legal concerns. Considering these "real world" complexities for the natural gas sector in a carbon constrained environment, a 100% allowance allocation system should be adopted - especially for the first decade of carbon limits.

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[20] *Economics Pollution Trading for SO_2 and NOx*, Resources For Future, Dallas Burtraw, David A. Evans, Alan Krupnick, Karen Palmer, and Russell Toth, March 2005,

Response to Questions 10-20 and 26: Administrative Allocation of Emission Allowances to the Natural Gas Sector:

1. **Administrative Allocation of Emission Allowances – Methodology and New Sources**

As explained above, if regulated, El Paso highly recommends 100% free allocation of allowances to rate regulated entities like interstate natural gas pipeline systems.

The Commission has several methodologies to choose from as the basis for the distribution of allowances, including grandfathering, benchmarking, updating or other intensity-based metrics. Some programs distribute allowances based on historic emissions (i.e. grandfathering), however this tends to reward historic high emitters and penalize those with low emissions. *El Paso believes that allocation should be based on some measure of productive output, such as historic throughput.* This appropriately rewards companies that have historically invested in efficiency and emission reductions.

Another issue is the frequency of allocation. Some programs allocate the allowances once and forever to the existing entities based on their recent performance. This has two negative aspects:

- New facilities can never get an allowance allocation.
- Allocation is not adjusted for changes in operation. Facilities that shut down continue to get the same allocation forever. Facilities that increase utilization do not get any increased allocation.

The way to address these concerns is for the allocations to be periodically redistributed based on recent operation. In addition, new facilities should be eligible for a special allowance set-aside until they have a sufficient baseline to receive allowances under the main program. An example of new source set-asides is contained in the proposed America's Climate Security Act of 2007 (S2191), where "new entrants" (i.e., operational after 2008) would receive allowances equal to their annual output (generation) times the average emission rate of plants that went on line during the 5 years prior to enactment. While the bill is silent on the set-aside

percentage, El Paso recommends at least 5% of the total allowance pool be set aside for new facilities that need to be built to meet California's energy needs. Such set-asides, followed with a periodic output-based updating of the allowance distribution scheme, will ensure an equitable mechanism encouraging energy efficiency and emissions reduction while sending the right price signals to the market.

With respect to the allocation methodology, it is highly desirable to have the same consistent methodology year-to-year through 2020. This is mainly to ensure price and compliance certainty. As mentioned earlier, any cap-and-trade program will add tremendous administrative burden on both the regulated entity and the governmental agency. Most companies are at their infancy with respect to addressing climate change issues. The Commission, CEC and CARB undoubtedly appreciate the complexities involved in designing a program to cover a cap-and-trade program. However, any methodology considered should be incorporated into the final regulations only after careful consideration of the principles outlined by the MAC and the additional principles highlighted previously in these comments.

2. Conclusions and Recommendations on Questions 10-20

In summary, El Paso recommends that, to the extent that interstate pipelines are regulated under a cap and trade program, they should receive a 100% free allocation of allowances. The allowances should be allocated based on throughout or some other measure of productive output. They should be reallocated every few years and there should be a set-aside for new sources of at least 5% of the total allowance pool. A consistent allocation methodology should be adopted through 2020.

Response to Questions 21-25: Emission Allowances and Point of Regulation – Natural Gas Sector

El Paso's response to Questions 21-25 of the Ruling, as it pertains to the natural gas sector have been addressed in previous sections of these comments.

Response to Question 27: Unique Factors with respect to the Natural Gas Sector:

Specific issues related to the legal, regulatory and market conditions with respect to the natural gas sector in general and interstate natural gas transmission companies have already been addressed in previous sections.

Response to Question 28: Summary of Recommendations

In summary, El Paso recommends:

- With respect to additional criteria in designing a GHG emissions program for the natural gas sector, we urge the Commission to consider the following principles:
    - Realistic balance of fossil fuel demand with AB32's goals and targets.
    - Recognition of current regulatory and legal structure and minimizing disruption of the basic regulatory/legal framework of the energy markets.

- We support 100% free allowance allocation for the natural gas transmission sector, if regulated. An auction would unnecessarily increase costs to consumers and create a variety of difficult legal and regulatory issues and uncertainties.

- The Commission should be assured that regulated entities like interstate transmission companies will not have an opportunity to realize "windfall profits" if granted allowances at no cost.

- We support an output, or intensity-based, allocation scheme, with periodic updating to account for efficiencies created by companies. This will ensure equitable distribution between companies, sectors and fuel sources. Furthermore, it will also advance deployment of higher efficiency technologies while reducing emissions and will minimize the amount of fossil fuel combusted.

- We support a minimum set-aside of 5% of the total allowance pool for new facilities that need to be built to meet our nation's energy needs. Such set-asides followed with a periodic output-based updating of the allowance distribution scheme will ensure an equitable mechanism, encouraging energy efficiency and emissions reduction while sending the right price signals to the market.

- We strongly favor clarity in the regulatory process as it relates to development of an allocation mechanism under a cap-and-trade program. The Commission should fully realize the magnitude of the administrative burden to the regulators and regulated entities when designing such structures, while accounting for the fact that most entities are in their infancy with respect to assessing climate change impacts and strategies. Other provisions, including transparency, collusion/hoarding and compatibility with existing energy markets are additional factors that need to be considered.

- Specifically with respect to interstate natural gas transmission companies, we urge the Commission to consider the "real world" regulatory, legal, technical and market challenges affecting gas supply and transmission to/in California. We also encourage inclusion of specific emissions trading design elements like banking and borrowing.