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December 14, 2010

Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Wellhead Electric Company, Inc. Comments On October 28, 2010 Proposed Regulation To Implement The Cap-and-trade Program.

Dear Board Members,

Wellhead Electric Company, Inc. ("Wellhead") is pleased to offer the following comments on the Proposed Regulation to Implement the Cap-and-Trade Program (hereinafter "Proposed Regulation"). Wellhead is keenly interested in these regulations due to its relationships, through common ownership and the provision of management services, with nine generating projects operating in California. Wellhead's primary concern is the issue of greenhouse gas ("GHG") cost recovery mechanisms in power purchase agreements ("PPAs") signed before AB 32 was enacted. We have met with California Air Resources Board ("CARB") staff to discuss Wellhead's proposed modification to the proposed Cap-and-Trade regulations which are included as "Attachment 1." The proposed modifications would ensure both equitable GHG cost recovery treatment for the affected projects and that utility dispatch decisions explicitly consider GHG impacts. In addition to this issue with pre-AB 32 contracts, there are two issues CARB should address where the Proposed Regulations either could cause problems under post-AB 32 contracts or make incorrect presumptions regarding the ability of generators to recover GHG costs from the California Independent System Operator ("CAISO") administered markets.

In the Initial Statement of Reasons ("ISOR") in support of the Proposed Regulation, CARB staff points out that there may be a class of generators that do not have a mechanism, contractual or otherwise, to recover GHG costs. "Some generators have reported that some existing contracts do not include provisions that would allow for full pass-through of cap-and-trade costs." (ISOR, p. II-32 at n22). In addition to the financial hardship, the inability to pass through these costs will distort the economic dispatch order, undermining the purposes of the cap-and-trade program, which is to implement the required AB 32 reduction of GHG emissions. These "counter to AB 32" impacts will occur because pre-AB 32 contracts without GHG cost recovery will cause less efficient generators (i.e., higher heat rate thermal units that emit more GHG per kWh produced) to appear less costly in the economic dispatch order of the purchasing utility because there are no GHG costs included.

CARB Should Evaluate Pre-AB 32 Contracts On A Case-by-Case Basis.

Whether a contract includes such a cost recovery mechanism should be evaluated by asking the following questions:

1. Was the contract entered into or its pricing provisions amended after the effectiveness of AB 32 (December 31, 2006)? If the answer is yes, then the parties should be presumed to have considered GHG cost risk.
2. Does the contract contain a "change of law" provision that provides for a re-open opportunity in the event that by virtue of new law or regulation in which case the parties will meet and confer/renegotiate to maintain the balance of risks and benefits? If the answer is yes, then the contract has a mechanism to directly consider new costs and risks such as those that are the result of GHG regulation.
3. Does the contract provide an explicit accounting for and pass-through of GHG costs? Prior to AB 32, contracts like that were rare, but if the answer is yes, then the parties have directly considered GHG cost risks.
4. Does the facility owner make the decision whether to generate and deliver energy to the purchaser? If the answer is yes, then the project has the ability (a mechanism) to take GHG costs into consideration when deciding whether to generate energy.
5. Does the contract provide for energy payments that are measured by a competitive market that allows bidders to include GHG costs? If the answer is yes, the purchase agreement has a payment mechanism that includes appropriate GHG costs. As CARB staff correctly points out "[b]ecause the price of electricity in the [CAISO] wholesale electricity market will reflect the cost of those purchased allowances, staff expects that independent generators will incorporate their cap-and-trade compliance costs into their bids in the wholesale power markets." (ISOR at II-32). For other pre-AB 32 contracts, GHG costs "may be addressed through the recently announced combined heat and power settlement a the California Public Utilities Commission." (ISOR footnote 22 at II-32

If the answer to all of these questions is "no", there is no need for further investigation; the particular generator's contract clearly does NOT provide a mechanism for appropriate recovery of GHG costs. For Fresno Cogeneration Partners, LP (one of the generators with which Wellhead has a relationship), the answer to each of the questions is "no." This project operates under an agreement where the purchasing utility makes the dispatch decision and pays for delivered energy based on: i) start-up costs; ii) a fixed heat rate, iii) the cost of natural gas fuel, and iv) a fixed variable operating and maintenance expense. The price paid is independent of and does not include any consideration of GHG or any other new or emerging cost components. This project, accordingly, precisely fits the case CARB staff recognized.

A key feature of Wellhead's proposal is that GHG allowances allocated to a purchasing utility be redirected to suppliers under PPA's that do not provide for appropriate recovery of GHG costs. As discussed in the meeting, this approach does not require any change to the existing power contract and ensures that the purchasing utility, that has dispatch control, accounts for GHG allowance costs (along with all its other considerations) in their dispatch decision. Failure to provide for the purchasing utility's use of the allowances would almost certainly result in the purchasing utility dispatching a facility when lower GHG emitting

facilities were available (because the GHG impact would be invisible to the purchasing utility). This outcome would directly contravene and thwart the basic purpose of AB 32.

CARB's Regulations Could Cause Generators To Not Receive Appropriate GHG Cost Recovery

Wellhead is also concerned that if CARB is not careful about the precise wording of its regulations, it will create an entirely new class of generators that do not have appropriate GHG cost recovery. A number of existing power contracts that do have GHG cost recovery mechanisms contemplate that the seller will purchase any required allowances and that such costs will be reimbursed by the purchaser. However, language included in both Southern California Edison and San Diego Gas & Electric proforma Power Purchase Agreements (which are publicly available on the utility web sites as part of RFO activities) contemplate that such costs will be paid to the regulatory authority imposing the compliance requirement. Specifically, the PPAs state that:

> *"[Utility] shall reimburse Seller for [GHG costs] .... after [Utility's] receipt from Seller of documentation ....(iv) that the [GHG cost] was imposed upon Seller by an authorized Governmental Authority in which the Generating Unit is located, or which otherwise has jurisdiction over Seller of the Generating Unit; (v) that Seller has paid the agency identified under (iv) the full amount of the [GHG cost] for which Seller seeks reimbursement from [Utility], ...*

Since the regulations are creating the framework where a third party(ies) may auction the allowances, the regulations have the potential to create a new class of generators that do not receive appropriate GHG cost recovery due solely to the allowance sales framework CARB is creating. To avoid this unintended outcome, CARB must either: i) be the entity that receives the payments for all GHG allowances purchased from an authorized auctioneer in complying with the regulations; or ii) make it very clear in the regulations that allowance costs procured from an authorized auction process shall be deemed to be procured from CARB for all purposes in a contract with provisions comparable to the proforma power purchase agreement language cited above.

Payments From CAISO Markets Do Not Always Include Appropriate GHG Costs

Wellhead is also concerned that the Proposed Regulations do not adequately account for some of the intricacies in how the CAISO administers the market. The Proposed Regulation and ISOR assume that generators selling power to the wholesale markets will be able to recoup GHG compliance costs by including such costs in their bid prices. In general, CAISO market participants receive compensation at a rate no less than the price bid into the applicable market. However, there are certain exceptions where payments from the CAISO for energy dispatched by the CAISO do not include any consideration of GHG costs. This occurs when the CAISO dispatches a resource at minimum load or out of economic order (normally for reliability reasons). In these cases, the market rules assure the generator of receiving compensation that covers their cost of providing the generation dispatched by the CAISO. However, the current CAISO process does not include consideration of any GHG costs incurred by the generator in responding to these CAISO dispatch instructions. If the CAISO does not modify its market compensation process to account for a generator's actual GHG costs in these situations, the

proposed regulations will create yet another class of generators without appropriate GHG cost recovery.

Wellhead appreciates the opportunity to provide these comments and a proposal to resolve out concerns. Wellhead also thanks staff for their attentiveness to these concerns.

Sincerely,

Douglas E. Davie
Vice President

Attachments: 1 - Wellhead comments previously provided to CARB staff

CC
Douglas K. Kerner, Esq., Ellison Schneider & Harris

CARB should include the following amendments to its cap-and-trade regulation. Wellhead's recommended changes are **bold and underlined**.

§ 95802(a)<u>(153). "Pre-AB 32 Power Purchase Agreements" means a power purchase agreement for the sale of electricity to an electric distribution utility, which was originally executed on or before December 31, 2006 and does not provide a mechanism for recovery of greenhouse gas compliance costs. A Pre-AB 32 Power Purchase Agreement shall not include a power purchase agreement that, after the effective date of this article, has expired, is terminated, or is amended to change any of the terms governing the price or amount of electricity sold pursuant to the agreement or the expiration date of the agreement. Whether a power purchase agreement qualifies as a Pre-AB 32 Power Purchase Agreement shall be subject to review by the Executive Officer to ensure compliance with the preceding requirements.</u>

§ 95892. Allocation to Electrical Distribution Utilities for Protection of Electricity Ratepayers.

(a) Reserved for allocation to electrical distribution utilities.

(b) Transfer to Utility Accounts.

(1) Investor owned utilities. The Executive Officer will place allowances in the limited use holding account created for each electrical corporation.

(2) Publicly owned Electric Utilities. At least 90 days prior to receiving a direct allocation of allowances, publicly owned electric utilities will inform the Executive Officer of the share of their allowances that is to be placed:

(A) In the publicly owned electric utility's compliance account, or

(B) In the publicly owned electric utility's limited use holding account.

(c) Monetization Requirement. Each calendar year, an electrical distribution utility must offer for sale at auction all allowances in a limited use holding account that were issued:

(1) from budget years that correspond to the current calendar year; and

(2) from budget years prior to the current calendar year.

<u>(3) The electrical distribution utility shall set aside allowances for each calendar year in an amount sufficient to satisfy the compliance obligation of any covered entity attributable to generation of electricity purchased by the electrical distribution utility pursuant to a Pre-AB 32 Power Purchase Agreement, as defined in Subarticle 2. These allowances shall be set aside prior to each auction that the electrical distribution utility offers allowances for sale. If the verified emissions attributable to the Pre-AB 32 Power Purchase Agreements exceed the amount of allowances set aside by the electrical distribution utility, the electrical distribution utility shall obtain the remaining amount of allowances from the next quarterly auction, or through the Allowance Price Containment Reserve. The electrical distribution utility shall transfer the required amount of allowances to the covered entity from which it purchases electricity under the Pre-AB 32 Power Purchase Agreement no later than 30 days before the covered entity's annual and triennial compliance obligation.</u>

(d) Limitations on the Use of Auction Proceeds.

(1) Proceeds obtained from the monetization of allowances directly allocated to a publicly owned electric utility shall be subject to any limitations imposed by the governing body of the utility and to the additional limitations set forth in section 95892(d)(3) below.

(2) Proceeds obtained from the monetization of allowances directly allocated to investor owned utilities shall be subject to any limitations imposed by the California Public Utilities Commission and to the additional limitations set forth in section 95892(d)(3) below.

(3) Auction proceeds obtained by an electrical distribution utility shall be used exclusively for the benefit of retail ratepayers of each electrical distribution utility, consistent with the goals of AB 32, and may not be used for the benefit of entities or persons other than such ratepayers.

(A) Investor owned utilities shall ensure equal treatment of their own customers and customers of electricity service providers and community choice aggregators.

(B) To the extent that an electrical distribution utility uses auction proceeds to provide ratepayer rebates, it shall provide such rebates with regard to the fixed portion of ratepayers' bills or as a separate fixed credit or rebate.

(C) To the extent that an electrical distribution utility uses auction proceeds to provide ratepayer rebates, these rebates shall not be based solely on the quantity of electricity delivered to ratepayers from any period after January 1, 2012.

(e) Reporting on the Use of Auction Proceeds. No later than June 30, 2013, and each calendar year thereafter, each electrical distribution utility shall submit a report to the Executive Officer describing the disposition of any auction proceeds received in the prior calendar year. This report shall include:

(1) The monetary value of auction proceeds received by the electrical distribution utility.

(2) How the electrical distribution utility's disposition of such auction proceeds complies with the requirements of this section and the requirements of California Health and Safety Code sections 38500 et seq.