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HIGH DESERT POWER PROJECT, LLC

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December 6, 2010

Steven S. Cliff, Ph.D.
Manager, Program Development Section
California Environmental Protection Agency
Air Resources Board
Office of Climate Change
1001 I Street, P.O. Box 2815
Sacramento, CA 95812

Re: *"Existing power sales contracts" – limited relief for "locked-in" generators*

Dear Mr. Cliff:

We own and operate the High Desert Power Plant (HDPP) and understand that HDPP will be regulated during the first and later compliance periods under the ARB's October 28, 2010 proposed Cap-And-Trade rule. We believe that HDPP can comply with the rule as proposed except during 2012.

HDPP is locked into a 2006 power sales agreement, as described in detail to ARB staff, through the end of 2012. In 2009, HDPP produced 4,163,516 MWh – all of which was sold into the California power market – and is expected to generate at a similar or higher level in 2012. It emitted 1,629,226 metric tons of CO_2e during 2009 and thus is expected to emit that much or more GHG in 2012. HDPP's 2009 GHG emissions equated to 862 pounds (or 0.39 metric tons) of CO_2E per MWh, well below the GHG emission performance benchmark recently established by the CEC, and we expect its low emitting performance to continue in 2012.

However, under the ARB's October 28, 2010 proposal, HDPP would receive no GHG allowances, would have to purchase over 1.6 million GHG allowances at auction in 2012 but would have no way to recover or "pass through" its GHG allowance costs. Depending on the auction prices in 2012, the costs could far exceed $16 million (at $10 each) and even approach $80 million (at $50 each). Costs could be even higher if plant dispatch increases in 2012. These costs would cripple this plant. It could result in a quick failure of the plant economically and even in a suspension in operations to deal with this financial crisis. We do not believe that the Legislature intended this result when it enacted AB 32, that the Governor intended this result when he signed AB 32, that the ARB Board intended this result when they adopted the AB 32 Scoping Plan or that ARB staff intended this result when the developed or proposed the California Cap-And-Trade program.

Attached is a draft proposal to remedy this very substantial problem. Under the attached proposal, HDPP would receive from ARB the allowances needed during 2012 to cover its "locked-in" power sales during 2012 – but would receive no free allowances in excess of its actual GHG emissions for 2012 for electricity generated and delivered under the locked in power sales agreement. In 2013 and later years, HDPP would no longer require or receive free allowances from ARB – but would participate in the electric generation auction like all other wholesale power generators.

We appreciate your consideration of this solution. Please contact me or our counsel, Michael Barr at 415-983-1151, to further discuss this solution and find an acceptable and early solution.

Sincerely,

Bradley K. Heisey

Bradley K. Heisey
Vice President

Attachment

Draft Proposal for Limited Cap-And-Trade Relief

California Combined-Cycle Natural Gas Electricity Generators Not Capable of Passing-through Carbon Costs under Existing Contracts

1. The Problem and Unintended Consequences

Some California generators sell power under electricity contracts that do not allow the pass-through of the costs of acquiring GHG allowances during the early years of the California Cap-And-Trade program. These contracts were lawfully entered before the proposed Cap-And-Trade compliance periods and they continue into the first compliance period (and perhaps beyond) - but they expire at fixed terms.

ARB's proposed Cap-And-Trade program excludes electricity generators from the allocation of free allowances, based on the assumption that all electricity generators are capable of passing these costs through the wholesale power market. This assumption appears to be generally correct. However, this assumption is not correct for some generators for some years— for the reason stated above – with potentially severe, unintended consequences to the affected generators and California energy markets.

Without a mechanism to pass-through GHG allowance costs, these "locked-in" generators would have to purchase allowances to cover their compliance obligations – but, unlike other generators, they could not pass the costs through the California energy markets to the utilities.

These costs will vary depending upon the price of allowances and the levels at which the affected power plants are dispatched by the contract customers, but could easily total from $16 million to $80 million per year for a nominal 750 MW combined-cycle power plant. These costs would place an enormous financial burden on the generator which could adversely affect the generator's ability to fund plant maintenance activities, to purchase fuel, to compete with other generators, to generate electric power for California consumers, and even to remain in business.

2. Proposed Solution

ARB should cap the affected generators but allocate "free" allowances in a limited amount for a limited time to electricity generators located in California whose existing contracts do not allow the pass-through of Cap-And-Trade allowance costs. After the "lock-in" period, the covered generator would participate in the GHG auction like all other generators.

The amount of free allowances allocated should be determined by applying current GHG emission benchmarks for electricity generation located in California. During the first compliance period (2012-2014), the benchmark for electricity generating power plants should be the GHG emission performance standard adopted by the CEC in 2007, which is 1,100 pounds (0.5 metric tons) of CO_{2e} per megawatt hour (MWh) of electricity. See 20 CCR § 2902.

The free allowances would only be made for the first Cap-And-Trade compliance period (2012-14), unless extended by further ARB Board action based on how the program works during the first compliance period. No banking or monetization of these allowances would be allowed.

Eligible generators would be defined in ARB's final Cap-And-Trade regulation to include a facility with one or more power sales contracts executed before [November 24, 2009[1]], that govern the facility's electricity sales and provide for sales at a price (whether a fixed price or a price formula) for electricity that does not allow for recovery of the costs of compliance with the limitation on greenhouse gas emissions under the ARB's Cap-And-Trade regulation.

The owner or operator of the power plant would cease to be eligible to receive "free" GHG allowances when the contract expires, is terminated or is materially amended in a way that changes the price (whether a fixed price or price formula) for electricity, the quantity of electricity sold under the contract, or the expiration or termination date of the contract.

To be eligible to receive "free" GHG allowances, the owner or operator of a "locked-in" generator would have to submit the following information to the Executive Officer within 60 days after the effective date of the final ARB Cap-And-Trade rules, and also not later than [September 30][2] of each vintage year for which the generator wishes to receive GHG emission allowances:

(A) Identify each owner and each operator of the facility.

(B) Identify the units at the facility and the location of the facility.

(C) Certification by the designated representative that the facility meets all the requirements of the definition of a "locked-in" generator.

(D) The expiration date of each "locked-in" electricity sales contract.

(E) A copy of each "locked-in" electricity sales contract, to be submitted to ARB as confidential business information.

Not later than 30 days after a facility or a contract ceases to meet the eligibility requirements for distribution of "free" GHG emission allowances, the designated representative of such facility must notify the Executive Officer in writing when, and on what basis, such facility or contract ceased to meet such requirements.

3. <u>Rationale for Limited "Free" Allowances for "Locked-In" Electrical Generators</u>

In developing its approach for the Cap-And-Trade program, ARB has attempted to create incentives to reduce emissions, to treat all covered entities fairly and equitably, to protect electric utility customers, to protect industry and to prevent leakage.

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[1] To be determined. November 24, 2009 was the date that ARB released the PDR for a California Cap-And-Trade Program.

[2] To be determined.

This proposed limited free allowance provision for "locked-in" electricity generators would serve ARB's goals of fairness and equity in the Cap-And-Trade program. If they do not receive this limited relief, electricity generators with "locked-in" power sales would face massive costs that they could not pass through, <u>unlike other generators</u>. As described above, the "locked-in" generators would face new regulatory compliance costs that are new and highly disproportionate to any prior regulatory costs. Neither the Legislature or Governor anticipated that AB32 would impose such costs -- and not allow them to be passed through. Neither did the ARB Board when it adopted the AB32 Scoping Plan or the ARB staff when they proposed the PDR for a Cap-And-Trade Program in 2009.

Also, the Legislature, Governor and ARB clearly desire to create incentives to invest in technology that <u>lowers</u> GHG emissions. The Cap-and-Trade program should not punish low GHG-emitting plants. If all wholesale generators are required to purchase allowances through the auction, the end result would be that some high-efficiency, low emissions plants are punished while <u>less</u> efficient, but <u>higher</u> GHG emitting plants are not. Instead, the program should provide incentives for the reduction of GHG emissions through the use of benchmarks that recognize more efficient power plants, such as the most efficient, new combined cycle natural gas plants.

The California power market would continue to receive the power from the "locked-in" generators. In consultation with CEC and CPUC, ARB could determine the appropriate deductions from the aggregate annual free allowance pool during the early years of the program. ARB, also in consultation with CEC and CPUC, could also adjust its future allocations of free allowances during each compliance year to achieve equity among the utilities and generators during each compliance year. Of course, the relief provided should only extend to the amounts of power "locked-in" for the "lock-in" period – and should expire when the contracts expire, terminate or are materially amended.

ARB should estimate the aggregate allowances allocated to "locked-in" generators during each year of the Cap-And-Trade program. The amount will diminish as the "lock-in" contracts expire. During the initial years when the aggregate amount is highest, the effect on the overall Cap-And-Trade and AB32 programs should be minimal since the program is designed to phase in gradually during those years. When the pace of GHG reductions increases in later years under the Cap-And-Trade program, the aggregate allowances allocated to "locked-in" generators also diminishes due to contract expirations.

Finally, the U.S. Senate, when considering a similar Cap-And-Trade program, included specific allowance relief for "locked-in" generators. The Senate provision include both IPPs and cogenerators. In light of the cogeneration settlement in California allowing cogenerators to pass-through GHG allowance costs directly to their utility counter-parties, it appears that ARB need not address the issue for some or all California cogenerators. However, the ARB should provide allowance relief for other "locked-in" California generators that are not covered by the settlement, on appropriate and fair terms.