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Ms. Claudia Orlando
California Air Resources Board
1001 I Street
Sacramento, CA 95812-2828

Re: Panoche Energy Center LLC Comments on Staff Proposals
Air Resources Board Workshop on Legacy Contracts -- May 1, 2013

Dear Ms. Orlando:

On behalf of Panoche Energy Center LLC ("Panoche" or "PEC"), we would like to thank the Air Resources Board ("ARB" or "Board") for holding its Staff Workshop on May 1, 2013, to present proposals to address issues identified in ARB Board Resolution 12-33. In particular, ARB Staff (staff) circulated a proposal to provide transition relief to "legacy contracts" and identified three options for providing such relief. Staff requested that interested parties submit comments on the staff proposal and any other relevant issues no later than May 21, 2013. PEC hereby provides its comments for staff's consideration.

As stated more fully below, PEC is a large natural gas peaking plant with a tolling contract for the exclusive sale of electric power to Pacific Gas & Electric Company ("PG&E") that was executed in March 2006 ("PEC PPA"). PEC's GHG compliance costs are unrecoverable under the terms of the PEC PPA. PEC's comments are limited to the staff proposals concerning relief for generators with legacy contracts, including PEC and similarly situated generators. PEC generally supports staff's proposals for providing transition relief with minor changes to accommodate the unique nature, and importance, of peaking unit facilities.

First and foremost, PEC strongly opposes staff's proposal to exclude from the instant proceeding consideration of transition relief for those generators with legacy contracts with investor-owned utilities ("IOU"). As PEC will explain, excluding generators with legacy contracts with IOUs from the instant proceeding has no support in fact, creates significant policy inconsistencies and constitutes an improper delegation of authority by ARB to the CPUC. As recognized by Resolution 12-33, the ARB Board seeks to treat all such contracts consistently. Consistent treatment of generators with legacy contracts can only be assured by uniform action of ARB because ARB is the only agency with authority to allocate allowances and determine compliance. The California Public Utilities Commission ("CPUC") has only a consultative role

in implementation of AB 32 as to the electric sector. The CPUC has no authority to allocate allowances or otherwise provide any form of transition relief comparable to what ARB is considering here.

1. BACKGROUND

Board Resolution 12-33, issued September 20, 2012, states: "WHEREAS, entities with legacy contracts that were entered into prior to AB 32 may not have an appropriate mechanism for recovery of carbon costs associated with the Cap-and-Trade Regulation:…" The Resolution further states: "BE IT FURTHER RESOLVED that the Board directs the Executive Officer to develop a methodology that provides transition assistance to covered entities that have a compliance obligation cost that cannot be reasonably recovered due to a legacy contract." The Executive Officer is further directed to work with the CPUC to ensure all contracts are addressed consistently with the anticipated regulatory amendments now proposed by ARB staff for later this year. The Resolution does not direct the Executive Officer to cede any authority to the CPUC, nor does it suggest ARB should not address all legacy contracts.

As explained at the Workshop, legacy contracts are defined by staff to be a contract entered into before AB 32 was signed (September 2006) and where the contract does not allow for the pass-through of the costs of GHG compliance down to the purchaser(s) due to provisions in the contract. **PEC strongly supports these foundational policy directions, and appreciates the simplicity and clarity they bring to this proposal.**

Staff has consistently expressed a preference for renegotiations between parties to these legacy agreements as the primary solution. However, the Board Resolution and many of the workshop participants, supported by the passage of the two years during which negotiations have been direct or encouraged, make clear that renegotiation of legacy contracts is not a viable option for many legacy contracts holders. PEC's legacy contract with PG&E firmly fits within that subgroup. Thus these proposed rule amendments are needed – and needed very soon. PEC's regulatory obligation has already begun and increases each time the facility is directed by PG&E to rapidly fire up and support California's renewable goals and its ever increasingly variable electricity grid.

Entities such as PEC are waiting for the next necessary step in providing needed transition relief for these last agreements where the covered entity does not have a means to pass through the Cap and Trade program's fundamental policy price signals to the end-use consumers. Good faith negotiations failed long ago, now it is time for ARB to resolve one of the program's last lingering issues.

ARB has consistently recognized that a cornerstone of California's climate program is to pass on price signals of the cost of carbon and carbon reduction efforts to consumers - and has specifically intended to NOT harm generators by stranding them with compliance costs. Failure to provide relief will certainly harm if not cause total project failure for some legacy contracts, such as PEC.

a. <u>Panoche Energy Center LLC and Pacific Gas & Electric Company and the PPTA</u>

PEC is a 400 MW peaking plant near Firebaugh, California with a tolling agreement with PG&E for use up to 5,000 hours per year. The Power Purchase and Sale Agreement ("PPTA") was entered into on March 26, 2006, well before the basic framework of the final enrolled version of AB 32 existed. The PPTA was also executed and approved a full two years before the outline of the current Cap and Trade program was made public.

PEC is owned and funded by institutions, retirement funds and cities, among others. The PPTA was drafted and its terms dictated by PG&E. Because it is a tolling agreement, PG&E provides the natural gas and dictates the use of the facility (dispatches the power) as needed. PEC is a captive generator which merely operates an engine that turns natural gas into time-sensitive peaking electric power. The source of the facility GHGs is through combusting of the natural gas provided and paid for by PG&E at its sole direction. PEC operates the facility, but PG&E controls the timing, frequency, duration, and intensity of its use.

PEC's engines are state-of-the-art, with the highest level of efficiency, thus creating lower emissions of GHGs as compared to other peaking power plants. However, as the electrical generator, the Cap and Trade regulation is very clear that PEC is the "covered entity" and has the compliance obligation. But as stated above, PEC's obligation is based totally on the decisions made by PG&E as the controlling dispatcher of the facility.

PEC was a known and identified facility when PG&E filed with ARB a CPUC form that identified its load and future GHG emissions. That information was used when determining free allowance allocation levels to PG&E. In that filing, PG&E identified PEC as a generation source to serve its load. Subsequently, PEC responded to an ARB survey requesting data "for existing contracts without a mechanism for GHG cost recovery" and provided data on the PEC plant and operations.

b. <u>PEC's PPTA Meets Proposed Eligibility Criteria</u>

It is clear that the PEC PPTA legacy agreement meets the staff criteria. It was fully executed in March 2006, well before AB 32 was signed. It has not been modified or amended,

nor has ownership changed. However, most importantly, PEC cannot reasonably pass on compliance costs due to nonspecific generic contract restrictions.

PEC did not price any program costs into its bid nor can it pass on these costs as some others may be able to do. Indeed, PG&E concedes in pleadings to the CPUC that PEC cannot reasonably recover Cap and Trade program costs due to its general contract limitations which states that the price of power in the PPA provides for "full payment" of PEC's costs. It is uncontroverted that PEC is both subject to compliance costs and does not have a way to pass its new AB 32 GHG costs along to PG&E and its ratepayers.

Further, as PEC stated in pleadings and filed declarations, it is clear that there was no extensive discussions between PG&E and PEC on GHG issues during PPTA negotiations. Panoche and PG&E did not actively negotiate GHG cost issues in coming to terms on the PPTA. The PPTA does not specifically mention GHG emissions, does not specifically state that GHG compliance costs are a cost that Panoche agreed to bear, nor at the time the parties signed the PPTA did either side have any way of knowing what any future laws governing GHG emissions might say, or what the potential cost could be.

If PEC is required to purchase allowances at the rate equal to the last auction settlement price, its costs would be increased by approximately $2.2 million in the first compliance year. This amount will increase as GHG compliance costs rise with each quarterly auction. Even the threat of having to bear the costs has led rating agency Standard & Poor's recently (February 25, 2013) to issue a ratings outlook revision that drops the facility's financial outlook from stable to negative. This action has direct implications for PEC and its institutional investors.

2. STAFF PROPOSALS

a. Eligibility Criteria

In the May 1 workshop materials, Staff put forth eligibility criteria for transition relief as follows:

- Legacy contracts are to be defined as those executed before AB 32 was signed into law in September 2006;
- Contracts remain in place and have not been subsequently amended;
- That relief be provided only for such contracts to the extent of the portion of emissions where GHG costs cannot be reasonably passed through to the purchaser;

- The subject covered entities would be required to submit "annual attestations" stating that GHG costs under the legacy contract remain stranded with the entity and are not passed down to consumers.

PEC strongly supports each of these elements.

To be consistent with its stated policy and prior actions, it is necessary that ARB protect legacy contracts from the costs of the Cap and Trade program. Such relief must be applied to **all** eligible legacy contracts, including those involving an IOU. ARB has exclusive authority over issuance and allocation of allowances, and has never demonstrated a sound policy reason for not addressing all legacy contracts. Though IOU counterparty contracts were referenced as being "referred to the CPUC process" (slide 22), neither the Staff Proposal (slide 23) nor the Proposed Eligibility Criteria (slide 25) cite a continued ARB involvement in this process to ensure consistent results. To the contrary, the CPUC has shown, as recently as earlier this month, that it is not willing to address legacy contracts on an individual facility or, presumably, a generic basis.

ARB must resolve this issue once and for all in its upcoming regulatory amendment package.

b. Proposed Options

Staff provided three options to determine the allocation of necessary allowances. In each case, 2015 vintage allowances would be provided, leaving it up to the covered entity to ensure compliance with First Compliance Period obligations. Additionally, all options assume a decline in the allowances awarded by the Cap and Trade "decline factor."

Staff summarizes the policy pros and cons for each of the calculation methodologies. Since PEC is not a cogeneration operation, our comments will only address the electricity portion of the proposals.

Option 1 uses the existing regulatory electricity generation benchmark for the allocation calculation. This benchmark is not appropriate for a peaking facility.

Option 2 would calculate allocations based on historical usage of the facility. This option is also inappropriate for a peaking facility, especially one operating under a tolling agreement. Past operation is not reflective of future operations, which are determined by the Buyer (PG&E) for PEC.

Option 3 seeks to establish a more site-specific allocation methodology. This option is the most workable for peaking units such as PEC. **Of these options, PEC supports Option 3.**

c. **Additional Considerations**

Staff also proposed that potential entities should apply and submit contracts to ARB for it to determine if eligible for legacy contract relief is warranted. **PEC does not oppose this requirement, but believes the attestation requirement is fully adequate.**

It was noted that if a customer of nonreimbursed steam or electricity is receiving an industrial allocation, an adjustment would be made to the customer's allocation during the true-up. This is not applicable to PEC.

3. ADDITIONAL STAFF QUESTIONS

In addition to the eligibility criteria and staff proposals, additional responses were requested to the following questions:

- Are there other considerations (pros/cons) to the options?
- Any comments of preference for the staff proposal or alternate options?
- Are the proposed benchmarks appropriate?
- Should peaker plants be addressed with a different methodology?
- Are there other eligibility criteria that should be considered?
- Should staff consider the allocation of allowances to legacy contracts other than electricity and steam generation (assuming same criteria/provisions)?

PEC has addressed several of these questions already and has highlighted them in bold above, but would also like to comment on the unique nature of peaking power plants. Peakers are critically important to the stability of the electricity grid and allow GHG reductions through the ever-increasing use of wind and solar renewable resources. The GHG reductions associated with those new resources dwarf the emissions profile of the PEC plant.

By their very nature and necessity to ramp up quickly, the emissions profile of a peaking power plant differs from that of a cogeneration unit or a combined-cycle power plant. The use of a site-specific benchmark is more appropriate than the existing benchmark in the regulation. If ARB wishes to use a standard non-site-specific benchmark, PEC recommends that a peaker-specific benchmark be established.

a. **Point of Compliance Alternative**

Though not included in the staff presentation, there was considerable discussion about a potential alternative strategy that involved moving the point of compliance upstream to the fuel providers for, among others, peakers with tolling agreements such as PEC. This strategy has

significant merit. By moving the compliance obligation to a point upstream of the legacy contract in question (assuming identical eligibility criteria), ARB would have removed many of the issues on the table and assigned responsibility to the real cause of the emissions. Further, natural gas providers will already incur an obligation under the program, and therefore have the mechanisms in place to purchase allowances and pass along the cost of the fuel to the ultimate consumers. As was mentioned in the workshop, this potential solution cannot start until 2015, and therefore ARB would still need to provide transition relief for the First Compliance Period.

There would be many benefits to changing the compliance obligation point to an upstream natural gas provider of a legacy contract. The fundamental policy considerations (eligibility and such) could be identical to those used to determine transition relief in 2013-2014. **PEC would support this concept.**

4. POLICY AND LEGAL ISSUES ASSOCIATED WITH STAFF PROPOSALS

a. No Policy or Legal Justification Exists to Limit Relief Based on the Identity of the Buyer

Staff proposes to limit transition relief only to legacy contracts which do not include an investor-owned utility as the purchaser. The staff presents no reason why such deferral is either appropriate or needed. Thus, there is "no rational basis" for the distinction and it must be rejected as a matter of policy and law.

The transition relief options provided in the staff paper concern the issuance of allowances in 2015 to cover the years 2013, 2014 and 2015. Only ARB can grant that relief and issue such allowances. The CPUC clearly has no authority to provide such relief. Resolution 12-33 requires that the CPUC act in a way that is not inconsistent with the relief that ARB may determine appropriate. However, the CPUC cannot act in a way consistent with the transition relief options for legacy contracts for the simple reason that it does not have the power to do so.

b. ARB Cannot Delegate Its Authority to CPUC

It is a rubric of regulatory law that an agency cannot delegate its authority to another agency or individual. In this instance, ARB has the exclusive authority to issue allowances or reallocate such allowances. The CPUC's authority is limited to advising ARB on how the program may be adopted (which role it has completed) and determining the allocation and use of revenues from the sale of free allowances by investor-owned utilities.

The CPUC can approve allowance sales revenues to be used to cover the allowance responsibilities of a generator, as it did for San Diego Gas & Electric Company and the Otay Mesa generating station filed amendment. However, it is clear that the CPUC cannot order any

of the options outlined by staff as to allowance allocation, is apparently now unwilling to order the Otay Mesa outcome, nor is any relief it can order specifically comparable to ARB staff's options.

c. ARB Cannot Defer Action in Reliance on Settlements Where Purchasing Parties Are Not Negotiating

The ARB staff again states its preference for a settled resolution of the issues. As was demonstrated fully at the workshop, IOUs and other counterparties are just not willing or able to negotiate these issues. Wishes do not make facts – and the two years already dedicated to settlement have been unsuccessful while the program (and its compliance obligations) have already started. The most directly comparable situation to PEC is the Otay Mesa amendment approved by the CPUC which provided FULL relief to the generator, while relief under Option 3 can potentially only get close to full relief.

Time has passed for referral to negotiating efforts, as compliance and expenditure of significant funds now immediately face legacy contract holders. Only the transition relief described by the staff can allow legacy contract holders to meet obligations in 2013 and 2014 without serious economic repercussions.

For the foregoing reasons, PEC supports providing relief to ALL legacy contract holders using the eligibility criteria provided in the staff proposal. Of the options presented, PEC supports Option 3 and, depending on the details, could support moving the compliance obligation upstream as the preferred option.

If you have any questions, please give me a call at 415-291-7430, or Jon Costantino at 916-552-2365.

Sincerely,

/s/ David L. Huard

David L. Huard

cc: Mary Nichols-Chairman
Sandy Berg-Board Member
Virgil Welch-Chairman's Advisor
Richard Corey-Executive Officer
Cynthia Marvin-SSD Division Chief
Edie Chang-SSD Asst. Division Chief
Steve Cliff-Branch Chief
Elizabeth Scheele-Manager