June 26, 2012

Mary D. Nichols, Chairman
California Air Resources Board
1001 "I" Street
Sacramento, CA 95814

SUBJECT: CAP AND TRADE AUCTION PROCEEDS: ALLOCATE FUNDS TO ADDRESS IMPACT OF CAP-AND-TRADE REGULATION ON SPECIFIC CHP FACILITIES

Dear Madame Chairman:

Background

The California Cogeneration Council (CCC)[1], is an ad hoc association of natural gas-fired cogenerators located throughout California, and has actively participated in each phase of the Cap and Trade regulation ("the regulation") rulemaking. We have the most diverse combined heat and power (CHP) membership as it relates to the treatment of CHP by the regulation. All member projects emit above the 25,000 metric tons CO_2e threshold and therefore face significant compliance obligations. Our member facilities range in size from 18 MW to 240 MW, and are integrated into schools, hospitals, food processors, paper manufacturers and other diverse California businesses. Some facilities supply thermal energy and electricity to Covered Entities that will receive free allowances because the industrial process they serve has been identified as being at risk of leakage, while other facilities provide thermal and electrical energy to Covered Entities with a process that is not subject to a leakage risk (e.g. heating and cooling of educational institutions). In both cases the owner of the CHP facility must bear the significant costs associated with those emissions. Additionally, in the case of a CHP facility that is owned by an entity other than the consumer of its thermal or electrical output, whether they serve a trade exposed industry or not, may have no ability to pass through, or recover its GHG compliance costs from hosts due to third-party contracts that were executed many years prior to the passage of AB 32.

When the Air Resources Board (ARB) adopted the cap-and-trade regulation at the December 16, 2010 Board meeting, Resolution 10-42 was issued. With respect to CHP, the resolution states,

BE IT FURTHER RESOLVED that the Board directs the Executive Officer to review the treatment of combined heat and power facilities in the cap-and-trade program to ensure that appropriate incentives are being provided for increased use of efficient combined heat and power.[2]

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[1] Members of CCC own and operate more than 30 different combined heat and power (CHP) projects in California that collectively generate about 1,300 megawatts (MWs). CCC member projects are "qualifying facilities" (QFs) that sell power to the IOUs under the provisions of the Public Utilities Regulatory Policies Act (PURPA) of 1978.

[2] Air Resource Board Resolution 10-42 dated December 16, 2010, at page 11, http://www.arb.ca.gov/regact/2010/capandtrade10/res1042.pdf

The CCC is concerned that not only does the regulation not, "ensure appropriate incentives", but it in fact penalizes some early adopters of CHP. Throughout the development of the regulation we proposed solutions to these inequities but since none of those measures were adopted, we now request that auction proceeds be used for this purpose.

The treatment of CHP facilities under the regulation is an issue of significant importance if the state is to make progress toward Governor Brown's Clean Energy Jobs Plan goal to "develop 6,500 MW of combined heat and power over the next 20 years," i.e. by 2030.[3] This trajectory for CHP development is also consistent with the California Air Resources Board's 2008 Scoping Plan adopting a CHP goal of an additional 4,000 MW of installed CHP capacity by 2020 as a key measure to reduce the state's emissions of greenhouse gases.[4]

Recommendation: On a case-by-case basis, allocate a portion of the auction proceeds to address the inequities the cap-and-trade regulation has created for some CHP facilities.

Specifically, a portion of auction proceeds should be applied to CHP facilities that fall into one or more of the following three categories:

- ✓ **Legacy Contracts**
  The design of the cap and trade regulation is predicated on the assumption that carbon costs will be borne in part by the end user / consumers through appropriate pricing of the "product" produced by covered entities thus providing an incentive to reduce emissions. But this is not the case where contractual agreements do not contain cost recovery provisions. "Legacy contracts" (some of which were signed in the 1980s) contain no cost recovery provision between the host facilities and the operators of "third party" CHP facilities. Consequently the third party CHP owner faces stranded costs in terms of the emissions associated with the thermal, and in some cases retail electricity provided to the host application. Examples include both "non-leakage" facilities such as universities and prisons, **and** energy intensive trade exposed (EITE) industrial facilities. EITE's will receive free allowances, but this relief may not be passed through to the CHP facility if the steam/electricity contract between the host and CHP owner does not provide for GHG cost recovery. We continue to believe that allocating free allowances (or delaying the compliance obligation) as a transitional measure until the contract expires is the simplest and least burdensome solution, but in the absence of that policy being adopted we recommend using auction proceeds to correct this inequity.

- ✓ **"But for" CHP Facilities**
  The operation of efficient CHP results in less **total** emissions to the atmosphere than compared to the alternative, i.e. a standalone boiler and electricity from the grid, however, the CHP facility is responsible for more **onsite emissions** than just the boiler, and consequently will end up with a greater compliance obligation. In this situation an

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[3] See item #7 of http://www.jerrybrown.org/sites/default/files/6-15%20Clean_Energy%20Plan.pdf . Also see page 133 of the CEC's *2011 IEPR*.

[4] CARB Scoping Plan, at pages 43-44. This plan is available at http://www.arb.ca.gov/cc/scopinplan/document/adopted_scoping_plan.pdf

early adopter of CHP is actually penalized for using CHP instead of a boiler because the CHP facility incurs a compliance obligation in 2013 and 2014 while the site with solely a boiler that emits less than 25,000 metric tons CO_2e does not.

In order to ensure equal treatment, the CCC recommended in previous comments to ARB[5], that where onsite CHP results in emissions greater than the applicable threshold as compared to using a boiler to provide steam needs, and the total emissions of the facility, **but for CHP** would be less than the 25,000 metric tons threshold, the emissions associated with the steam should be exempt from the facility's compliance obligation until the second compliance period when natural gas is included in the cap and trade program.

Since that policy was not adopted in the regulation, we now recommend that auction revenues be provided to those facilities **but for CHP**, would not have the compliance obligation in the first compliance period. Without this correction, the regulation becomes a barrier to the installation of new CHP, as described in the U.S. Department of Energy comments submitted to the California Energy Commission 2012 Integrated Energy Policy Report (IEPR) CHP workshop.[6]

- ✓ **Transition Assistance**
  Several panelists at the ARB May 24th public meeting pointed out that facilities are faced with dual costs – first finding the funds to meet their compliance obligations and second, sourcing the capital to invest in major restructuring and repowering of their facilities to reduce GHG emissions. In the near term, a portion of auction proceeds should be provided as transition assistance to CHP facilities switching their operations from a GHG intensive fuel (e.g. coal), to a cleaner, less GHG intensive emitting fuel, e.g. natural gas and renewable generation. The CCC recommends that the auction proceeds be used to provide grants or project loans for this transition assistance.

Recommendation: Leverage auction proceeds to invest in R&D of technologies that will assist facilities in lowering GHG emissions

The CCC agrees with other commentators at the May 24th meeting that one of the greatest challenges is finding **affordable**, leading edge technology that will actually reduce GHG emissions in a timeframe to meet the requirements of the declining cap. The CCC recommends that a portion of the auction proceeds be invested in research and development projects with the objective of ensuring the most innovative and effective technologies for reducing GHG emissions can reach the market as soon as possible and not be cost prohibitive.

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[5] 8-11-11 CCC Comments on the July 2011 modified cap-and-trade draft regulation, found at: http://www.arb.ca.gov/lists/capandtrade10/1441-8-11-11_ccc_comments_15_daymodifiedcapandtraderegfinal.pdf

[6] U.S. DOE Pacific Region Clean Energy Application Center comments dated March 9, 2012 and found at this link: http://www.energy.ca.gov/2012_energypolicy/documents/2012-02-16_workshop/comments/US_Department_of_Energy_Pacific_Region_2012-03-09_TN-64101.pdf

Finally, we note that CHP facilities under the Quebec cap and trade regulation that California plans to "link" to, do not face these inequities. For example, a CHP facility that provides steam for **any** type of application, is considered an "activity eligible for an allocation without charge of GHG emission units", in other words, free allowances[7]. Similarly, Legacy Contracts in Quebec, signed before January 2008, are also eligible for free allowances. It is ironic that the Quebec program rather than the California program appears to have been designed with Resolution 10-42 in mind, i.e. "to ensure that appropriate incentives are being provided for increased use of efficient combined heat and power".

Since the California cap-and-trade program neither allocates allowances nor provides exemptions to address the unequal treatment of some CHP facilities, the CCC recommends that ARB and the legislature consider applying a portion of the auction proceeds to correct these inequities.

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Cc: ARB Board Members
Senator Fran Pavely
Robert Weisenmiller, Chairman, California Energy Commission
Michael Florio, Commissioner, California Public Utilities Commission
Edie Chang, ARB
Steven Cliff, ARB

[7] Sections 39, 40, 41 and Appendix C, Part 1, Table A of Quebec's "Regulation respecting a cap-and-trade system for greenhouse gas emission allowances", available at this link: http://www.mddep.gouv.qc.ca/changements/carbone/reglementPEDE-en.pdf