NYSE CPN

CALPINE CORPORATION

4160 DUBLIN BOULEVARD
SUITE 100
DUBLIN, CA 94568
925.557.2224 (M)
925.479.9560 (F)

April 13, 2012

By E-Mail and Electronic Submission (http://www.arb.ca.gov/cc/capandtrade/comments.htm)

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

Re: Draft of Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms to Allow for the Use of Compliance Instruments Issued by Linked Jurisdictions (March 30, 2012)

Dear Madame Chairman:

Calpine Corporation ("Calpine") appreciates the opportunity to provide these written comments on the California Air Resources Board ("CARB" or the "Board") March 30, 2012 Discussion Draft entitled "Amendments to the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms to Allow for the Use of Compliance Instruments Issued by Linked Jurisdictions" (hereinafter the "Discussion Draft"). Calpine looks forward to working with CARB Staff to facilitate needed amendments to the Cap-and-Trade Program Regulation (Cal. Code Reg., tit. 17, §§ 95800 *et seq.*) ("Regulation") and assure a successful launch of the first compliance period in 2013.

I. INTRODUCTION: SEVERAL CRITICAL ISSUES NEED TO BE RESOLVED PRIOR TO THE FIRST AUCTION IN NOVEMBER 2012 AND BEFORE LINKING WITH QUEBEC

Since 2001, Calpine has invested over $6 billion to become the state's largest independent power producer, the state's largest provider of renewable energy and owner of the state's largest and most efficient fleet of combined heat and power ("CHP") facilities. Because of the size of our fleet, Calpine is also one of the state's largest obligated entities covered under cap-and-trade.

The size of Calpine in the Cap-and-Trade market cannot be overstated. The chart attached as Exhibit A, which recently appeared in the publication *California Energy Markets*,[1] depicts greenhouse gas ("GHG") emissions of power producers throughout the State based on CARB's 2010 data. As illustrated by this chart, due to no more than our sheer size in the California energy market and our investment in a fleet of the lowest emitting, highest efficiency gas-fired power plants and CHP facilities, Calpine will have one of the largest compliance obligations of any covered entity.

[1] *California Energy Markets*, Energy NewsData Corp., Mar. 2, 2012, No. 1170, at 8.

Further, Calpine is unique among large obligated entities in that unlike every other large obligated entity, Calpine will not receive any free allowances and will, instead, be required to purchase all of its compliance instruments from the market. Nonetheless, Calpine has been and continues to be a long-time advocate of low-carbon regulation at the federal and state level, including California's Global Warming Solutions Act, Assembly Bill ("AB") 32.

While CARB's adoption of California's Cap-and-Trade Regulation is groundbreaking, several critical issues, including allowance holding limits and auction purchase limits, need to be addressed prior to the first auction slated for November 2012. Although CARB Staff's proposed amendments to the Regulation would alter the allowance holding limits and auction purchase limits provisions, the underlying problems that are unique to Calpine remain unresolved. *See* Discussion Draft §§ 95911, 95920 (proposing changes to auction purchase limit and allowance holding limit provisions of the Regulation). Additionally, Calpine's concerns are further exacerbated by the proposed amendment to remove the beneficial holdings provisions of the Regulation altogether, leaving no clear mechanism for investor owned utilities ("IOUs") to procure allowances on behalf of contracted power generators. *See* Regulation § 95834 (stricken in Discussion Draft). Finally, Calpine notes that staff still has not proposed amendments to address the situation faced by cogenerators subject to fixed-price contracts that do not provide for recovery of GHG allowances costs.

As discussed below, Calpine strongly urges the following changes to the Regulation:

- CARB should retain, <u>but revise</u>, the beneficial holdings provisions so that allowances held by a utility on the generator's behalf count against the holding limit of neither the utility nor the generator. Alternatively, if the beneficial holdings provisions are removed from the Regulation completely, the Discussion Draft's proposed amendment to the limited exemption from the allowance holding limit should be expanded, so that it also authorizes the Executive Officer to increase an IOU's limited exemption by the number of allowances purchased and held on behalf of contracted generators.

- Because serious and substantial questions remain about the impact that a one-size-fits-all holding limit will have on the largest covered entities, CARB should not apply the holding limit during the first compliance period (2013-2014) to any covered entity or entities linked by a corporate association whose annual compliance obligation exceeds the holding limit.

- The Discussion Draft's proposed current vintage auction purchase limit of 40% for the IOUs (rather than the 15% auction purchase limit that applies to covered entities generally) should likewise be applied to all covered entities whose compliance obligations are greater than the allowance holding limit.

- As directed by the Board and consistent with the Quebec program, which provides a free allocation for fixed-price electric contracts and steam supplies, the Discussion Draft should be revised to assure adequate resolution of the situation faced by cogenerators that cannot recovery allowance costs from their steam hosts.

II. DISCUSSION

A. CARB Should Amend The Beneficial Holdings Provisions Or Adopt An Appropriate Replacement For The Beneficial Holdings Provisions That Allows IOUs To Procure Allowances On Behalf Of Contracted Generators

CARB Staff was correct to propose the beneficial holding relationship provisions so utilities could purchase allowances for generators that are dispatched by the utilities. While Calpine was generally supportive of the intent of the beneficial holdings provisions, it expressed concern that allowances held on behalf of generators would be applied to generators' (rather than the utilities') holding limits.[2]

Because the allowances would count against the holding limit of the generator, even while they remained in the possession of the utility for up to a year, the generator would have had no ability to deposit them in its compliance account and thereby qualify for the limited exemption from the holding limit. As a consequence, a large generator could realistically have its entire holding limit consumed by beneficial holdings acquired on its behalf by the IOUs. This would effectively bar the generator from participation in future auctions and procurement of allowances from the secondary market, until such time as the utility actually transferred the allowances to the generator and the generator had then deposited them in its compliance account. For a generator such as Calpine, which operates facilities subject to long-term tolling contracts with the IOUs, as well as its own merchant fleet (which sells power into the wholesale power markets), this would mean Calpine could conceivably have no clear path to obtain allowances for its merchant fleet, as well as those contracted facilities for which the utility was not providing compliance instruments.

As Calpine has previously expressed, the holding limit should be based, not upon some arbitrary formula representing a percentage of the overall allowance market, but on the size of a covered entity's compliance obligation. Barring such a change, however, Calpine continues to believe that this issue could be resolved simply by not counting allowances held pursuant to a beneficial holding relationship against either the generators' or the utilities' respective holding limits.

Alternatively, if CARB decides to remove the beneficial holdings provisions from the Regulation, CARB should expand the proposed amendment that would allow covered entities to apply for an increase in the limited exemption to the holding limit (to the extent they anticipate increases above their prior year's emissions) by also allowing IOUs to apply for an increase in their holding limits for purchases of allowances made on behalf of contracted generators. These proposals are described in more detail below.

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[2] *See* Letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Public Workshop to Discuss Linking the California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation to Western Climate Initiative Jurisdictions, February 17, 2012 ("February 2012 Comments"), 6-7, available at: http://www.arb.ca.gov/lists/feb-3-link-wci-ws/7-2-17-2012_calpine_comments_re__cap_and_trade_workshop.pdf.

1. The Beneficial Holding Limit Provisions Should Be Retained And Revised To Allow IOUs To Procure Allowances On Behalf Of Contracted Generators

Given the burdens caused by the holding limit,[3] CARB needs to ensure that the largest covered entities have an adequate means of procuring the allowances they will need to meet their compliance obligation and, in the case of the IOUs, that they can also procure on behalf of contracted generators. Thus, while Calpine was concerned with certain aspects of the beneficial holdings provisions, it did not advocate for the deletion of these provisions in their entirety. Rather, Calpine proposed a pragmatic solution by proposing that allowances held by an IOU on a contracted generator's behalf would not count against the holding limit of either the utility or the generator, so long as the generator confirmed that it would transfer the allowances to its compliance account within three days of receipt from the utility.[4]

Pacific Gas & Electric ("PG&E") also expressed concerns with aspects of the beneficial holdings provisions, but likewise did not advocate that CARB delete these provisions in their entirety. Given that generators and utilities alike have not proposed deleting these provisions, CARB Staff should continue to work with utilities and generators to appropriately modify the beneficial holdings provisions, both to provide the same flexibility to generators and utilities alike and to ensure that neither party gains a competitive advantage over the other. Calpine continues to believe that CARB Staff should convene the impacted parties in a workshop-like forum to discuss these issues and arrive at a solution for how the beneficial holdings provisions can be appropriately modified. The delay in addressing the beneficial holdings provisions, or some replacement thereto, is causing significant uncertainty regarding how generators will comply with the Regulation, and, as described below, may undermine the efficiency and stability of the GHG allowance market.

While far from perfect, the beneficial holdings provisions of the Regulation acknowledge that the IOUs are in the best position to correlate dispatch decisions with carbon cost signals and manage, on a portfolio basis, the carbon risk for the generating resources under their control. Absent the beneficial holdings provisions, the IOUs may have no means to procure allowances on behalf of

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[3] *See* Letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Proposed Regulation to Implement the California Cap-and-Trade Program, December 9, 2010 ("December 2010 Comments"), 16, available at: http://www.arb.ca.gov/lists/capandtrade10/253-carb_letter_re_cap-and-trade_20101209.pdf; Letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Proposed 15-Day Modifications to the Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, August 11, 2011 ("August 2011 Comments"), 6-7, available at: http://www.arb.ca.gov/lists/capandtrade10/1450-8-11-2011_calpine_comments_re_proposed_15-day_modifications_to_proposed_ca_cap_on_ghg_emissions.pdf, 6-7; Letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Second Proposed 15-Day Amendments to the Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, September 27, 2011 ("September 2011 Comments"), 3-4, available at: ttp://www.arb.ca.gov/lists/capandtrade10/1658-9-27-2011_calpine_comments_re_proposed_15 day_modifications_to_proposed_ca_cap_on_ghg_emissions.pdf; February 2012 Comments, 3-4.

[4] *See* September 2011 Comments, 6; February 2012 Comments, 7.

both their own generating resources and unaffiliated generators for which the IOUs have contractual dispatch rights. Thus, the utilities could simply decide that, for those contracts where the utility has the right to either procure allowances or reimburse the generator for its own allowance procurement costs, it would procure no allowances. This could result in inefficient allowance procurement decisions, not in the least because the IOUs are in the best position to accurately estimate which generating units will be dispatched to meet demand based on their relative thermal efficiency, cost and, as a consequence of the Regulation, GHG emissions.

Additionally, the IOUs are afforded substantially greater flexibility under the Regulation to procure allowances from the GHG auction. Under the current Regulation, the IOUs are completely exempt from the auction purchase limit for current vintage allowances, while all other covered entities are subject to a 15 percent (%) auction purchase limit for current vintage allowances. Under the Discussion Draft, the IOUs would be subject to a 40% auction purchase limit for current vintage allowances. In contrast, large covered entities, like Calpine, whose compliance obligation is much larger than any IOU (as illustrated by the attached Exhibit A), are subject to the 15% limit, and may need to participate in every auction and acquire allowances at the maximum percentage authorized by the Regulation, just to obtain sufficient allowances to cover their compliance obligations. Undoubtedly, this could influence such generators' bidding strategies and limit their ability to procure the least-cost allowances. It could also require them to place bids at levels assured to exceed the auction clearing price, which could artificially raise that clearing price for all auction participants. Such market distortions would not reflect the true price of carbon and could jeopardize the integrity of the overall allowance market.

For these reasons, removal of the beneficial holding relationship provisions—absent an alternate mechanism for IOUs to procure allowances on behalf of contracted generators—will severely hinder the proper functioning of the allowance market. It is no excuse to suggest that the Compliance Instrument Tracking System Service ("CITSS"), as currently designed, cannot account for the additional information associated with beneficial holdings. If CITSS cannot be immediately augmented to accommodate this information, then CARB should consider further evaluating the appropriateness of the holding limit and refraining from its application to the largest generators during the first compliance period, as suggested below.

Rather than remove the beneficial holdings provisions completely, Calpine proposes that the allowances held by a utility on the generator's behalf count against the holding limit of neither the utility nor the generator, so long as the generator confirms that it will transfer the allowances to a compliance account within three days of receipt of such allowances from the utility.[5] Specifically, Calpine proposes that the existing Regulation's beneficial holding relationships provisions be retained, with the following modifications:

§ 95834. Disclosure of Beneficial Holding Relationships.

. . .

[5] *See* September 2011 Comments, 6; February 2012 Comments, 7.

(b) Disclosure of Beneficial Holding.

. . .

(4) In the case of an electric distribution utility holding allowances on behalf of a second registered entity with whom it has a contract for the delivery of electricity pursuant to section 95834(a)(3), such allowances will not count against the holding limit of either the electric distribution utility or the second registered entity, so long as the second registered entity confirms upon submitting the confirmation required by section 95834(b)(2) that it will transfer the allowances to a compliance account within three (3) days of receipt from the utility.

2. Alternatively, CARB Should Amend The Limited Exemption To The Holding Limit To Allow IOUs To Purchase Allowances On Behalf Of Contracted Generators

In the absence of the beneficial holdings provisions, CARB should adopt language permitting electric distribution utilities to utilize the limited exemption to the holding limit to purchase allowances on behalf of contracted generators without requiring the utilities to transfer those allowances into their compliance accounts.

CARB's Discussion Draft proposes a new process, whereby a covered entity can petition the Executive Officer ("EO") to adjust the limited exemption to the holding limit based on evidence of an increase in emissions over the previous year. Discussion Draft § 95920(d)(3). If CARB does not retain the beneficial holding provisions with appropriate revisions, as described above, Calpine would propose to expand upon the process provided by draft section 95920(d)(3)(A), so that an electric utility could petition the EO to increase its limited exemption to the holding limit by the number of allowances the utility is holding on behalf of another covered entity with whom it has a contract for the delivery of electricity.

The purpose of the limited exemption is to assure that covered entities can obtain the number of allowances needed to assure compliance. The Discussion Draft's proposed procedure for obtaining an increase in the limited exemption is intended to assure that, where a covered entity's prior year's emissions do not adequately reflect its entire compliance obligation, it can nevertheless procure adequate compliance instruments. Consistent with those goals, our proposed revision would appropriately expand the limited exemption, so that utilities could also procure allowances on behalf of contracted generators whose dispatch they control and for whom they have therefore agreed to assume financial responsibility for GHG emissions. This adjustment to the limited exemption, if accepted by the EO, would apply, even though the allowances so held by the utility would not (and indeed could not) be transferred to its compliance account (given that they will ultimately be transferred to the generator actually subject to the compliance obligation).

Accordingly, Calpine proposes the following amendments to the Discussion Draft:

§ 95920. Trading.

...

(d) The holding limit will be calculated for allowances qualifying pursuant to section 95920(c)(1) as the sum of:

...

(1) The number given by the following formula

...

(2) A Limited Exemption from the Holding Limit is calculated as...

...

(3) Petition to Adjust the Limited Exemption.

(A) Prior to October 1 of any year, a covered entity may submit to the Executive Officer evidence demonstrating (1) an increase in emissions for that year over the previous year or (2) that the covered entity is an electric distribution utility holding allowances it has acquired on behalf of a second registered entity with whom it has a contract for the delivery of electricity and request a temporary increase in the limited exemption until verified data for that year are available. In the case of an electric distribution utility holding allowances on behalf of a second registered entity pursuant to § 95920(d)(3)(A)(2), the limited exemption shall include, upon the approval of the Executive Officer, the number of allowances that the utility has acquired on behalf of the second registered entity, regardless that the allowances will not be transferred to the electric distribution utility's compliance account, as would otherwise be required by § 95920(d)(2)(A) to qualify for the limited exemption.

(B) The amount of the increase must be at least 250,000 metric tons CO2e on an annualized basis.

(C) The Executive Officer will review the evidence and determine whether an adjustment is needed.

(D) If an adjustment is granted, then the limited exemption for that covered entity will be increased immediately by the amount determined by the Executive officer.

(E) When the verified emissions data are received for the year for which an adjustment was granted, the Executive Officer will use the verified emissions value when calculating the limited exemption.

This proposal would achieve CARB's goal of harmonizing the Regulation with Quebec's cap-and-trade program while not unduly burdening utilities, ratepayers, and contracted generators.

The underlying concern of the holding limit—preventing market manipulation—is simply not present when a utility is procuring allowances to reimburse a contracted generator for the generator's GHG emissions resulting from electricity delivered to the utility. Indeed, the California Public Utilities Commission ("CPUC") is poised to impose limitations on the IOUs' procurement of allowances, whereby the utilities will be restricted to procurement within certain minimum and maximum percentage "bands" of their anticipated annual compliance obligations.[6] The CPUC's procurement limitations will adequately ensure that the IOUs are not hoarding allowances, such that the holding limit should no longer be necessary to avoid market manipulation by the utilities.

B. CARB Should Adopt An Interim Exemption To The Holding Limit, For The Duration Of The First Compliance Period, For A Corporate Association That Has A Direct Compliance Obligation Greater Than The Holding Limit

As we described during the Cap-and-Trade rulemaking,[7] the allowance holding limit would dramatically limit the ability of Calpine to fully utilize the flexibility mechanisms the Regulation otherwise provides to covered entities, including unlimited banking of allowances and three-year compliance periods. The holding limit also effectively increases the 30% annual surrender obligation in section 95855 for large entities because large entities *must* transfer allowances in excess of the holding limit from their holding account to their compliance account, both to avoid penalties and assure participation in future auctions. This *de facto* penalty on the largest covered entities will be compounded upon linkage to Quebec's cap-and-trade program, given that the existing Quebec regulation includes no annual surrender obligation.[8]

Under AB 32, CARB must rely upon the best available economic and scientific information when adopting regulations to reduce GHG emissions.[9] Throughout the rulemaking, however, CARB Staff has inappropriately relied upon a *single report* by a consultant to the Western Climate Initiative ("WCI") Markets Committee to conclude that holding limits are necessary to prevent market manipulation and that such limits are common in commodity markets.[10] As described in Calpine's previous comments,[11] the WCI Report concludes that the recommended holding limit should *not* apply to entities with compliance obligations, and that holding limits in

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[6] CPUC, Proposed Order Instituting Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term Procurement Plans, R. 10-05-006, at 54.

[7] *See* December 2010 Comments, 16; August 2011 Comments, 6-7; September 2011 Comments, 3-4.

[8] *See* Regulation respecting a cap-and-trade system for greenhouse gas allowances (hereinafter, "Quebec Regulation") §§ 20-21, *available at:* http://www.mddep.gouv.qc.ca/changements/carbone/reglementPEDE-en.pdf.

[9] Health & Saf. Code § 38562(e).

[10] Initial Statement of Reasons ("ISOR"), Summary of Section 95920(b)(3), IX-104; Jeffrey H. Harris, *Western Climate Initiative Markets Committee Report on Holding Limits* (2010) (hereafter, "WCI Report").

[11] *See* February 2012 Comments, 4-5.

other market contexts *exempt* commercial entities engaged in the market for *bona fide* hedging purposes.[12] Thus, the WCI Report simply does not support the conclusion for which CARB relies upon it in applying the holding limit to prevent covered entities from engaging in legitimate hedging activity.

Notwithstanding any risk of market manipulation or speculation, CARB has not addressed the substantial risk that holding limits will increase market inefficiencies. Significantly, holding limits can result in reduced market liquidity and, consequently, impair price discovery. As described in the Legislative Analyst's Report ("LAO") report, overly restrictive holding limits prohibit participants from acquiring or using allowances for legitimate business purposes. In particular, participants would be burdened with having to find multiple buyers or sellers because any single party would be limited in what they could hold. Given this limitation, "their ability to 'correct,' through their trading transactions, for prices that they thought were too high or too low, including price changes due to price manipulation, would be limited."[13] This result can contribute to greater price volatility, thereby reducing legitimate hedging opportunities and increasing costs to consumers and ratepayers.

CARB Staff has overstated the potential for "hoarding" of allowances or "market gaming". As noted in the LAO report, many commodities trading markets function well without any holding limits. Supply and demand fundamentals and other macroeconomic factors—not speculation—are the most significant factors driving commodity markets. Thus, concerns about market manipulation are sufficiently addressed by the physical and financial transparency built into the Regulation, as opposed to the arbitrary application of holding limits.

Calpine recommended that CARB, as part of this linkage rulemaking, undertake a more rigorous evaluation of the basis for applying the holding limit equally to both covered and non-covered entities alike.[14] Unfortunately, CARB has not yet done so. Further, by completing a linkage with another jurisdiction, CARB might be foreclosing the possibility for future amendments, given the difficulties inherent in amending and harmonizing multiple jurisdictions' regulatory programs at some future date. CARB also appears unwilling to adopt Calpine's proposal that would amend the limited exemption from the holding limit to include all of a covered entity's emissions reported during the preceding calendar year, prior to retirement into a compliance account.[15]

Given the negative consequences that an unprecedented holding limit could have on the new allowance market, Calpine urges CARB to adopt an interim measure to shield entities with the largest compliance obligations from the harsh results produced by the holding limit for the duration of the first compliance period; *i.e.*, until CARB has had an adequate opportunity to

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[12] WCI Report, 13, 17.

[13] LAO Report, *Evaluating the Policy Trade-Offs in ARB's Cap-and-Trade Program*, 23.

[14] *See* February 2012 Comments, 5.

[15] *See id.* at 5-6.

evaluate the theories underpinning the holding limit and witness its actual application to smaller entities who will not be so greatly constrained by it.

Calpine's proposed revisions to the Discussion Draft are as follows:

§ 95920. Trading.

...

(b) Application of the Holding Limit.

(1) The holding limit will apply to each entity registered as a covered, opt-in covered, or voluntarily associated entity pursuant to section 95830. However, during the first compliance period (2013-2014), the holding limit will not apply to a corporate association, as defined in section 95833, that has a compliance obligation for each year greater than the holding limit for allowances of the corresponding vintage year.

This interim measure would avoid the worst impacts of the holding limit while providing CARB the opportunity to see how the holding limit—unprecedented in its inclusion in a GHG emissions trading system—operates in practice. The proposal would not increase the risk of market manipulation, as entities with compliance obligations greater than the holding limit will be buying allowances to comply with the Regulation, rather than to game the market. In essence, this proposal would accomplish the goals suggested by the one report upon which CARB purports to base the holding limit: it would provide an exemption for *legitimate hedging activities* of covered entities. Calpine urges CARB, therefore, to consider this prudent alternative to an across-the-board holding limit upon the commencement of the first compliance period in 2013.

Finally, Calpine requests that CARB reassess the proposed amendments' change to the holding limit calculation for future vintage allowances purchased at advance auctions.[16]

C. The Auction Purchase Limit Of 40% That CARB Proposes For Electrical Distribution Utilities Should Apply Equally To Other Large Covered Entities

[16] Discussion Draft § 95920(e). According to the proposed amendments, allowances purchased at the advance auction that have a vintage year greater than the current year would be calculated for each vintage year separately according to the same formula that applies to current vintage allowances, using the current budget year for the "Annual Allowance Budget." Discussion Draft § 95920(e). Thus, under the proposed amendments, the holding limit for 2015 allowances sold at advance auction in 2012 would be 6.5375 million metric tons of CO_2e, based on the allowance budget of the linked jurisdictions for 2012. For purposes of this section, "Annual Allowance Budget" should be calculated based on the linked jurisdictions' budget for the year from which the allowances are purchased at advance auction, in which case the limit on 2015 allowances purchased at advance auction would be 13.3275 million metric tons of CO_2e.

The proposed amendments would apply a 40% auction purchase limit to IOUs. Discussion Draft Amendments § 95911(d)(4)(B). Calpine believes this is a step in the right direction because it levels the playing field between IOUs and large independent generators vis-à-vis auction purchases. However, the disparate treatment between IOUs and large independent generators still has no principled justification.

As Calpine has previously commented, the auction purchase limit of 15% on current vintage allowances poses significant limitations on Calpine's and other large generators' ability to purchase sufficient allowances in the auctions to satisfy their compliance obligations. Moreover, this "one-size-fits-all" limit for non-IOU covered entities will deny the largest entities the same flexibility afforded to other entities, who will not be forced to participate in every auction and bid at prices certain to exceed the settlement price, just to assure they can procure sufficient allowances to meet those obligations.

As illustrated by the attached Exhibit A, Calpine's direct compliance obligation will be greater than any of the IOUs. Given CARB's willingness to accommodate the large compliance obligations of IOUs, Calpine recommends that CARB apply the same 40% auction purchase limit to other covered entities that have compliance obligations greater than the holding limit. Calpine therefore proposes the following changes to the Discussion Draft:

§ 95911. Format for Auction of California GHG Allowances.

...

(d) Auction Purchase Limit.

...

(4) For the auction of current vintage allowances conducted pursuant to section 95910(c)(1):

(A) The purchase limit for covered entities and opt-in covered entities will be 15 percent of the allowances offered for auction;

(B) The purchase limit for electrical distribution utilities and corporate associations, as defined in section 95833, that have compliance obligations greater than the corresponding holding limit will be 40 percent of the allowances offered for auction; and

(C) The purchase limit for all other auction participants is four percent of the allowances offered for auction.

The language in draft section 95914(d) ("Application of the Corporate Association to the Auction Purchase Limit") should likewise be amended to reflect this equitable change.[17]

Calpine's proposal would strike the right balance between preventing market manipulation by entities seeking to game the market, without imposing unworkable restrictions on entities with large compliance obligations (like IOUs and independent generators) that are only attempting to comply with the Regulation. Calpine therefore urges CARB to apply the 40% auction purchase limit to non-IOU covered entities that have compliance obligations greater than the holding limit.[18]

D. As Directed By The Board And Consistent With The Quebec Regulation, CARB Staff Should Assure Adequate Resolution Of The Situation Faced By Cogenerators That Cannot Recover The Cost Of Allowances From Their Steam Hosts

As described in CARB's Scoping Plan, CHP or cogeneration facilities represent a highly efficient, environmentally preferable alternative. Thus, CARB made expansion of CHP a significant component of California's efforts to reduce GHG emissions and address climate change.[19] In light of this mandate, the Board directed CARB Staff "to review the treatment of CHP facilities in the Cap-and-Trade program to ensure that appropriate incentives are being provided for increased use of efficient combined heat and power." Resolution 10-42, 11. While the issue of allocations for cogeneration facilities is not directly implicated by CARB's linkage with Quebec, we note below that Quebec has squarely addressed this issue in its regulation. And because of its impacts on the continued viability of CHP generators, Calpine would ask CARB Staff to address this issue in their revisions to the Discussion Draft, so this issue is resolved prior to the first auction in November 2012.

Since the inception of California's Cap-and-Trade program, CARB Staff recognized that some generators have contracts that do not include provisions that allow for full recovery of allowance

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[17] Discussion Draft § 95914(d)(3)(A) – "The total purchase limit for the association is 15%, unless some of the included covered entities are electrical distribution utilities or corporate associations, as defined in section 95833, that have compliance obligations greater than the holding limit, in which case the purchase limit is 40%."

[18] The auction purchase limit for future vintage allowances should be reassessed as well. This limit – 25% of the allowances offered in any advance auction – applies equally to all entities, even those without compliance obligations. Cal. Code Reg., tit. 17, § 95911(c)(3); Discussion Draft § 95911(d)(3). There is no principled reason for non-covered entities to be able to purchase 25% of future vintage allowances when these entities have no compliance obligations under the Regulation. At a minimum, CARB should apply a much lower limit for non-covered entities' purchase of future vintage allowances, just as it does for the current vintage purchase limit.

[19] *See* Climate Change Scoping Plan: A Framework for Change, CARB, December 2008, 44 (recommending measure no. E-2, "Increase Combined Heat and Power Use by 30,000 GWh").

costs.[20] Recognizing this issue and the Scoping Plan's goal to increase the use of combined heat and power, CARB Staff committed to "work with interested stakeholders to ensure proper treatment under the regulation of . . . combined heat and power facilities with pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse emissions." Resolution 10-42, Attachment B, 8. Then, upon finalizing the Regulation, the Board directed CARB Staff to address the issue of long-term contracts with industrial hosts that do not allow for a pass-through of the costs. Specifically, CARB Staff was directed to "monitor progress on bilateral negotiations between counterparties with existing contracts that do not have a mechanism for recovery of carbon costs associated with cap-and-trade for industries receiving free allowances pursuant to section 95891, and identify and propose a possible solution, if necessary." Resolution 11-32, 12.

To-date, Staff has proposed no such solution, but has instead taken the position that it is the responsibility of the contracting parties to resolve this problem. Staff has therefore encouraged the parties to renegotiate these types of agreements.[21] Should such negotiations fail, Staff has held out the prospect of facilitating negotiations between the parties.[22] Calpine would welcome CARB Staff's assistance in this regard.

Consistent with CARB Staff's recommendation, Calpine has worked diligently with its counterparties to renegotiate contracts where possible. In cases involving the IOUs or where the contract was already undergoing amendment, Calpine has amended the contract to address the parties' respective obligations for compliance with the Regulation. However, a number of remaining fixed-price contracts provide no similar opportunity for renegotiation.[23]

As suggested by Calpine previously, CARB should amend the Regulation to address this problem by providing a direct allocation of allowances to generators subject to long-term contracts that provide no mechanism for recovery of allowance costs only until such time as the

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[20] *See* ISOR, II-32, n.22 ("Some generators have reported that some existing contracts do not include provisions that would allow full pass-through of cap-and-trade costs . . . Staff is evaluating this issue to determine whether some specific contracts may require special treatment on a case-by-case basis."); *see also* ISOR, Appendix J, "Allowance Allocation," J-16, n.15.

[21] *See* Final Statement of Reasons ("FSOR"), Response to Comments D-62, 357; G-24, 514; I-104, 654; I-118, 1568; I-120, 1572-73; I-131, 1588-89; I-50, 2153-2156.

[22] FSOR, Response to Comment I-50, 2156 ("For parties that have not been successful with renegotiation, we will provide support by facilitating discussions between parties so that they too will be able to support a successful program.").

[23] Calpine disputes the suggestion made by CARB Staff in the FSOR that these contracts reflected the risk of GHG regulation. *See* FSOR, Response to Comment I-50, 2153 ("[g]enerally, we believe contract negotiation discussions included which party would bear future costs, and the price agreed upon in the contract reflected this risk."). Contrary to CARB Staff's suggestion, Calpine's long-term contracts to supply steam from its CHP facilities were negotiated as early as the 1980's—well before a program to regulate carbon emissions was ever contemplated.

existing contract expires or is substantively amended.[24] Indeed, the Quebec Regulation provides just such an allocation for fixed-price electric power contracts executed before January 1, 2008, as well as for steam suppliers.[25] This follows the example of both the proposed legislation passed by the House of Representatives in 2009 and existing emissions trading programs in the U.S., all of which provide for a special exemption or free allocation for long-term contracts that do not allow for recovery of allowance costs.[26] We continue to believe that CARB should follow these examples and provide a direct allocation to generators subject to such contracts.

At the very least, the Cap-and-Trade Regulation should be amended so that, where entities receiving an allocation for industrial assistance will experience no increase in their energy costs due to a pre-AB 32 contract, the allowances will be awarded, not to that entity, but to its counterparty instead. CARB Staff held out the prospect of just such a rulemaking upon finalizing the Regulation, saying CARB is "still considering withholding allowances from [energy-intensive/trade exposed steam hosts] that do not face carbon costs in cases where long-term contracts prevent thermal energy sellers from recovering these costs."[27] Calpine strongly encourages CARB Staff to continue monitoring the counterparties' negotiation efforts and to revise the Discussion Draft to address this issue, so it does not remain unresolved at the time of the first auction in November 2012.

* * * *

[24] December 2010 Comments, 3-10; August 2011 Comments, 10-12; September 2011 Comments, 7-9.

[25] *See* Quebec Regulation, App. C, Pt. 1, Table A (providing for eligibility for an allocation without charge for, *inter alia*, "[e]lectric power generation sold under a contract signed prior to 1 January 2008, that has not been renewed or extended after that date, in which the sale price is fixed for the duration of the contract, with no possibility of adjusting the price to take into account the costs relating to the implementation of a cap-and-trade system for greenhouse gas emission allowances" and "[s]team and air conditioning supply").

[26] *See* December 2010 Comments, 4.

[27] FSOR, Response to Comment I-104, 655.

Calpine looks forward to working with the Board and Staff to improve the proposed amendments to the Regulation and address these outstanding issues. Please feel free to contact me with any questions or concerns regarding these comments.

Thank you for the opportunity to submit these comments.

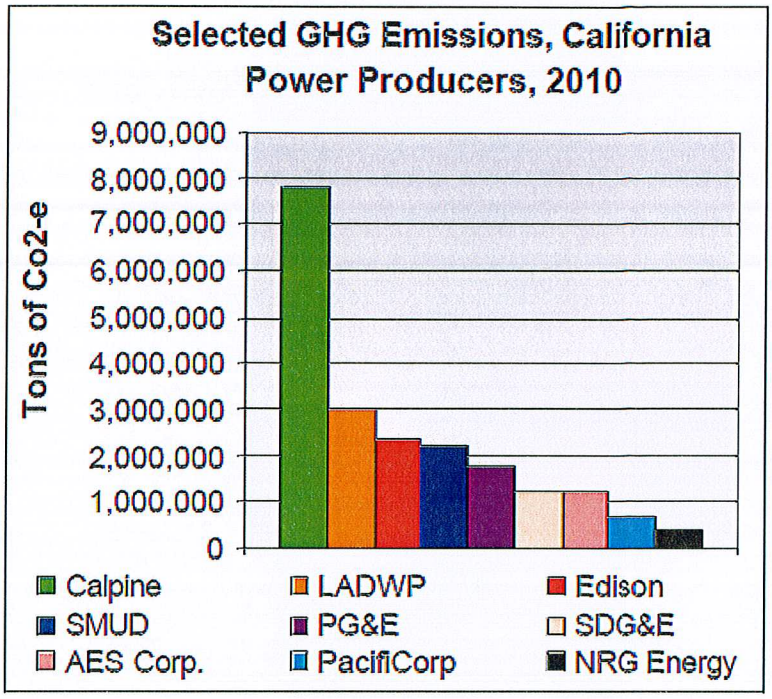
Sincerely,

Kassandra Gough/MEO

Kassandra Gough
Director, Government and Legislative Affairs

cc: James Goldstene, Executive Officer
Edie Chang, Chief, Planning and Management Branch, Office of Climate Change
Steven S. Cliff, Ph.D., Chief, Climate Change Markets Branch, Office of Climate Change
Ray Olsson, Lead Staff, Office of Climate Change
Claudia Orlando, Air Pollution Specialist, Office of Climate Change
Rajinder Sahota, Manager, Market Monitoring, Office of Climate Change
Holly Geneva Stout, Esq., Senior Staff Counsel, Office of Legal Affairs

Exhibit A



Fossil-fuel sources below 25,000 metric tons of CO_2-equivalent each year, and geothermal and biomass emissions, were excluded from the data.
Source: CARB 2010 emissions reporting data.

Source: *California Energy Markets*, Energy NewsData Corp., Mar. 2, 2012, No. 1170, at 8