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**Hand Delivered**

December 14, 2010

Kevin M. Kennedy, Ph.D.
Assistant Executive Officer – Climate Change
California Air Resources Board
1001 I Street
Sacramento, CA 95814

ARB Board of Directors
c/o Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, CA 95814

**Re: High Desert Power Project's Comments on the Air Resources Board's October 28, 2010 Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulations – Proposal for Limited Relief for "Locked-In" Electrical Generators**

Dear Dr. Kennedy and Board Members:

This letter provides the **final comments** of High Desert Power Project, LLC ("HDPP") to the ARB Board on the "Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulations" ("the Cap-and-Trade Rule"), adding Article 5 (§§ 95800 *et seq.*) to Title 17 of the California Code of Regulations. HDPP appreciates the opportunity to comment on the Cap-and-Trade Rule, as well as the Air Resources Board's consideration of these and other comments provided by HDPP to ARB staff.

## Executive Summary

HDPP owns and operates a new, modern, highly efficient California natural-gas fired combined cycle powerplant (the "HDPP Plant"). It is located near Victorville, California and serves the Southern California electricity market. It has a nominal capacity of 830 MW.

As reported under current ARB GHG reporting regulations (17 CCR §§ 95100 *et seq.*), the HDPP Plant produced 4,163,516 MWhr of power and emitted on average of 863 pounds of $CO_2e$ per MWhr of GHG during 2009. This GHG emission rate is 22% below the 2007 GHG performance standard of 1100 pounds of $CO_2e$ per MW established by the CEC that applies to any baseload generation, regardless of capacity, supplied under a covered procurement to a Publicly Owned Utility. See 20 CCR § 2902.

HDPP is preparing to participate in the ARB's GHG auction for electric generators under the ARB's Cap-and-Trade Rule. We believe that we can compete and provide cost-effective and low-emitting electric power to the California market under the ARB's Cap-and-Trade Rule with one critical exception: unlike some other electrical generators, we cannot pass the cost of GHG allowances to the markets during 2012 due to a locked-in power sales contract, as explained further below.

To cure this fundamental inequity, we have prepared two alternative solutions and presented them to ARB staff:

1. The ARB Board should now provide clear limited relief now for HDPP and similarly "locked-in" generators until they are no longer "locked-in" to fixed price or fixed formula contracts; **or**
2. The Board should now provide clear direction to the Executive Officer to work with "locked-in" generators, CEC and other stakeholders during the first half of 2011 to provide appropriate, limited relief in the final Cap-and-Trade Rule before the Executive Officer sends it to OAL.

Our proposal is described in greater detail in the attached Discussion Draft, which we provided to ARB staff on December 6, 2010.

## How the ARB Proposal Affects HDPP

Under the ARB's proposed Cap-And-Trade program, covered GHG-emitting entities can only continue to operate if they obtain and surrender GHG allowances during three-year compliance periods, starting in 2012-14. The ARB's proposed "cap" limits GHG emissions for covered entities in California. It allows only a limited amount of GHG emissions each year, and no additional GHG emissions beyond that amount would be permitted.

Covered entities that fail to surrender sufficient GHG allowances following a compliance deadline will have 30 days to comply or face enforcement action. Under the proposed Cap-and-Trade Rule, enforcement action could include suspension or revocation of registration for a covered entity, resulting in a complete shutdown of operations, or ARB could pursue penalties and injunctions for operating without the required GHG allowances. HDPP plans to operate in full compliance with the final Cap-and Trade Rule.

HDPP will operate the High Desert power generation plant under a pre-existing, fixed price contract entered in 2006. The HDPP Plant will be a covered entity under the proposed Cap-and-Trade program, and will therefore be required to surrender GHG allowances during the three-year compliance periods, starting in 2012. Under the proposed Cap-and-Trade Rule, the HDPP Plant could only comply with the "cap" by obtaining allowances from the proposed GHG auction or in the GHG allowance market.[1]

The ARB's proposed Cap-and-Trade program will affect the various segments of the electricity sector differently. ARB proposed that some covered entities, such as Publicly Owned Utilities ("POUs") and Investor Owned Utilities ("IOUs"), would receive direct (i.e., free) allocation of GHG allowances. However, for independent electricity generators, such as HDPP, ARB staff assumed this part of the electricity sector could pass-through 100% of the cost of the allocations to the wholesale power market (see ISOR, Appendix J, J-10) and therefore proposed that wholesale electricity generators be required to purchase all GHG allowances from auction from the outset of the program in 2012. Wholesale electricity generators would not receive any direct (i.e., free) allocation of allowances, starting in 2012 (see ISOR, Appendix J, J-16).

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[1] The HDPP Plant may also be able to obtain GHG offsets, but the proposed rule limits offsets so severely that the HDPP Plant could not operate at commercial levels with GHG offsets.

Unfortunately, the HDPP Plant currently has a fixed price contract to sell electricity from the period of February 2011 through December 2012. At the time the contract was entered in 2006, it was not anticipated – and could not reasonably have been anticipated – that HDPP would need to purchase over 1.5 million GHG allowances in 2012. Because HDPP has no mechanism to pass through the carbon costs of the proposed Cap-And-Trade program, HDPP would bear the entire cost of purchasing GHG allowances at a public auction to cover their compliance obligations, unlike other electric generators.

If HDPP were to purchase all GHG required allowances for calendar year 2012 through auction at the price levels contained in the proposed Cap-and-Trade Rule, the 2012 cost could range from approximately **$16 - $80 million** (at the floor or reserve prices in the proposed Cap-and-Trade Rule §§ 95911, 95913). Costs could be even higher if HDPP Plant dispatch increases in 2012. For many generators that are unable to pass through these costs, the added costs of purchasing GHG allowances could be punitive, could severely impact the generator economically and could even result in some cases in a suspension in operations to deal with this financial crisis which would adversely affect electric reliability in the State. 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 they developed or proposed the California Cap-And-Trade program.

## Proposed Solution

HDPP requests that the Board at its December 16, 2010 Board hearing adopt language to provide direct allocations for the first compliance period (which runs through 2014) where an affected independent energy generator can show, to the satisfaction of the Executive Officer, that it can not pass-through the cost of purchasing allocations due to the existence of a fixed price contract. Our attached December 6, 2010 proposal (updated 12/14/10) describes this proposal in greater detail.

Alternatively, the Board should give discretion to and direct the Executive Officer to work cooperatively with independent energy generators to modify the Cap-and-Trade text approved by

the Board, in consideration of our proposal. We suggest adding the following language to the Board Resolution to be adopted on December 16, 2010:

> "WHEREAS, some California electrical generators have reported that some existing power sales contracts do not include provisions that would allow full pass-through of cap-and-trade costs. These contracts pre-date the ARB's development of a proposed California cap on GHG and a proposed market-based compliance mechanism regulation. Many of these contracts may be addressed through the recently announced combined heat and power settlement at the California Public Utilities Commission but some may not be addressed. Staff continues to gather information, consult with CPUC, CEC, the California ISO and affected stakeholders and to evaluate this issue to determine whether some electrical generators may require special treatment for a limited period on a case-by-case basis;
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> * * *
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> "BE IT FURTHER RESOLVED, that the Board authorizes and directs the Executive Officer to meet and confer during the first quarter of 2011 with California electrical generators that provide power to the California market subject to existing power sales contracts that do not include provisions that would allow full pass-through of cap-and-trade costs and, as appropriate, to provide special treatment in the final regulation to those affected generators, such as making direct allocations to those affected generators for the first compliance period (which runs through 2014) if an affected generator can show, to the satisfaction of the Executive Officer, that it can not pass-through the cost of purchasing GHG allowances due to the existence of a fixed price or fixed formula contract;"

## Other Issues

Given the severe, unjustified and unforeseen impacts of the currently proposed Cap-and-Trade Rule on HDPP and similarly situated electrical generators during 2012 and later years, ARB should study and address the following issues before finalizing the Cap-and-Trade rule as proposed:

- ARB's essential premise in developing the Cap-and-Trade Rule provisions for electrical generators is that they can pass through the costs of GHG allowances purchased at auction under the Cap-And-Trade Rule. This premise is not correct, for electrical generators like HDPP, as the staff suspected. The ARB staff should now quantify the effects of "locked-in" contracts over time; develop alternatives for addressing this issue; consult with the CPUC, CEC, California ISO, the affected electrical generators and other affected stakeholders; and develop a solution that complies fully with the provisions of AB 32, the cost-containment and other principles adopted by the Board in approving the Cap-And-Trade Rule and the other provisions of the final Cap-And-Trade Rule to be developed during 2011 by the Executive Officer.

- Based on the HDPP situation, the auction mechanism as currently proposed in the Cap-and-Trade Rule conflicts from the outset of the program with AB 32's requirement that any ARB regulations be designed "in a manner that is equitable, seeks to minimize costs and maximizes the benefits to California..." H&S Code § 38562(b)(1). For the outset in 2012, the proposed Cap-And-Trade program would distribute most GHG allowances for free, while requiring other entities like HDPP to purchase GHG allowances through the auction. It now appears that most electrical generators that purchase GHG allowances either had contracts that allowed them to pass the costs of GHG allowances through to the markets in 2012 – or benefitted from subsequent government decisions allowing utilities to pay such costs in 2012, unlike HDPP and similar generators. Requiring HDPP or similar generators to purchase GHG allowances without the ability to pass through GHG allowance costs would place an inequitable burden on certain sectors and certain industries during 2012, in conflict with AB 32 and the principles underlying the proposed Cap-And-Trade program as approved by the Board.

- ARB's proposed Cap-and-Trade Rule appears to impose an unauthorized "regulatory fee" on electrical generators that cannot pass through GHG allowance costs. California law requires that any "levy, charge or exaction of any kind" be passed by a two-thirds majority of the Legislature. See Cal. Const., art. XIIIA. The recently passed Proposition 26 excludes a regulatory fee from the definition of a tax – but only if the charge is imposed for the reasonable regulatory costs to a state or local government for issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement and adjudication thereof. ARB has not established that the proposed uses of the revenue raised from the Cap-And-Trade auction are reasonably related to, or limited to, the administration of the Cap-And-Trade program. ARB has suggested such broad uses for auction revenue unrelated to administration of the program such as technology and community grants and ratepayer relief. In addition, the ARB's cost of running the proposed GHG allowance auction or distributing "free" GHG allowances will not approach the projected revenue from the Cap-And-Trade auctions for 2012 and probably not for later years, either. Thus, the auction provision should be enacted by the Legislature, with a 2/3 vote, rather than be imposed by regulation by ARB.

- Based on the HDPP situation, ARB's CEQA review of the proposed Cap-and-Trade Rule is deficient with respect to 2012 if ARB adopts the Rule as proposed. ARB has not determined the economic or environmental effects of requiring "locked-in" generators like HDPP to purchase 100% of their GHG allowances through the proposed auctions at the outset of the program in 2012, with the resulting potential loss of relatively low-emitting MWh of energy production in California and replacement by higher GHG-emitting electrical generators from the outset of the Cap-and-Trade program in 2012.

- The proposed Cap-And-Trade Rule also raises substantial and novel federal questions under the Federal Power Act and Commerce Clause. In adopting the Cap-And-Trade program, ARB is clearly attempting to address a global issue, which will significantly burden interstate and international commerce in electricity from the outset in 2012. More specifically, the Federal Power Act preempts states from regulating the transmission and

sale of electric energy at wholesale in interstate commerce. See 16 U.S.C. § 824. ARB's proposed Cap-And-Trade program effectively regulates the transmission and sale of electric energy at wholesale in interstate commerce by imposing the cost of purchasing GHG allowances at auction on electric energy from HDPP, which is subject to the Federal Power Act as an "exempt wholesale generator."

## Conclusion

HDPP appreciates the opportunity to provide comments to the Board and ARB staff on the proposed Cap-and-Trade Rule, and asks that the Board either address the "locked-in" generator problem itself at its adoption hearing on December 16, 2010 – or direct the Executive Officer to work cooperatively with "locked-in" electric generators before July 1, 2011 to modify the approved regulations to provide appropriate relief from the unanticipated burden of purchasing allocations without the ability to pass-through those costs. We look forward to working cooperatively with the Executive Officer and ARB staff to develop modifications to the regulations as suggested by the proposed program elements contained in the attached Discussion Draft.

Sincerely,

Bradley K. Heisey
Vice President

Attachment

**Discussion Draft 12/6/10**
**Update 12/14/10**

# 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[2]], 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][3] 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.

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

[3] To be determined.

(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. Rationale for Limited "Free" Allowances for "Locked-In" Electrical Generators

In developing its approach for the Cap-And-Trade program, ARB has generally 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.

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, unlike other generators. 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 lowers 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 less efficient, but higher 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 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.

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 included 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 consistent with AB 32 and the principles followed by ARB in adopting its Cap-And-Trade program.