CALIFORNIA COGENERATION COUNCIL
A Combined Heat and PowerAssociation

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August 11, 2011

Clerk of the Board
California Air Resources Board
1001 "I" Street
Sacramento, CA 95812

Comments of the California Cogeneration Council on the Modified California Cap-and-Trade Regulation

Clerk of the Board,

These comments are offered on behalf of the California Cogeneration Council (CCC)[1], an *ad hoc* association of natural gas-fired cogenerators located throughout California. CCC projects serve on-site electrical and thermal loads at industrial, commercial, and institutional facilities across the state and are located in the service territories of California's three major investor-owned electric utilities (IOUs). The CCC represents a significant share of the distributed combined heat and power (CHP or cogeneration) projects now operating in California.

Due to the design of California's Cap and Trade Regulation ("the regulation"), the treatment of CHP facilities under the regulation is not immediately obvious, which has resulted in confusion among owners and operators of facilities trying to interpret how the regulation impacts their operations. The regulation includes in the list of "covered entities" operators of facilities with a cogeneration process, but allocates allowances based upon industrial sectors and leakage risk, not specifically the facility processes. A CHP facility may provide the thermal and retail electricity at one of these industrial sites, or at a commercial or institutional location that has not been identified as being at risk of leakage. Consequently the economic impact of the regulation, as currently designed, may affect operators of CHP facilities differently, based upon a range of circumstances. As a result of allocating allowances to the industrial sector, and not the load, the regulations may discourage installation of CHP at some locations. Some CCC members are concerned that the complexity of the regulation and the requirement to participate in auctions will result in costly administrative overhead and uncertainty, particularly for some of the smaller CHP operators who are required to participate.

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

[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.

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]

The CCC is concerned that not only does the modified regulation **not**, "ensure appropriate incentives", but it in fact penalizes some early adopters of CHP. The treatment of CHP facilities under the regulation is an issue of significant importance as CCC members evaluate the regulatory landscape of California, and consider their options under the CHP Program Settlement Agreement.[3] These options include whether to continue operations in California and seek new contracts[4] for existing facilities, sign contract amendments adopting an energy payment calculation based on perceived exposure to GHG risk, repower existing facilities, and develop new projects. It has been our hope that the new CHP State Program, which is a result of the Settlement, and is structured around the ARB Scoping Plan CHP Emissions Reduction Measure[5], will encourage investment in upgrading facilities and spur the development of new facilities. Our fear is that the regulation, as currently designed, does the opposite.

The CCC expects individual member companies whose operations fall under Table 8-1 of the regulation to provide comment on issues they may have with the benchmarking principles. These comments focus on two global issues regarding the treatment of CHP, and we also propose language revisions to a few generic provisions. CCC comments concern the following:

(i) Legacy steam and retail electricity contracts with no provision for GHG cost recovery;
(ii) CHP facilities where the thermal energy emissions are below the threshold of 25,000 $MTCO_2e$;
(iii) Recommended changes to attestation and enforcement provisions; and
(iv) Energy Efficiency and Co-Benefits Assessment.

I. Legacy Contracts with no provision for carbon cost recovery

The design of the cap and trade regulation is predicated on the assumption that carbon costs will be borne by the end user / consumer through appropriate pricing of the "product" produced by covered entities, but this will not be the case where contractual agreements do not contain a cost recovery provision. The CCC recognizes that there are several types of legacy contracts that do not provide for GHG cost recovery. There may be more, but those brought to our attention include,

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

[3] CCC is a party to the QF CHP Settlement Agreement approved by the California Public Utilities Commission (CPUC) in Decision 10-12-034.

[4] The term "contract" in this context includes Power Purchase Agreements with utilities, as well as steam (and retail electricity) contracts with industrial hosts.

[5] As referenced on pages 43-44 of the "Approved Scoping Plan" adopted by ARB at its December 11, 2008 Board meeting.

1. Power Purchase Agreement (PPA) between generator and utility,
2. Steam (and in some cases retail electricity) agreement, between a CHP facility and thermal host,
3. Tolling agreement between a generator and a utility,
4. Agreement between a generator and a marketer selling power into the electricity market.

Our specific issue concerns CHP projects with agreements in #2 above. In most cases, these agreements run in parallel with the facility's utility PPA, and consequently were signed many years prior to the passage of AB 32. Under the regulation, the Operators of such CHP facilities face stranded costs in terms of the emissions associated with the thermal, and in some cases retail electricity production of the facility, until the expiration of these agreements.

In the ARB, "Notice of Public Availability of Modified Text and Availability of Additional Documents", the staff has provided a summary of the proposed modifications to the regulation. In section HH, describing modifications to section 95892, staff refer back to the Initial Statement of Reasons (ISOR), noting that some generators and industrial steam producers have reported that some existing contracts do not include provisions that would allow full pass-through of carbon costs associated with cap-and-trade. It goes on to say, "Staff is evaluating this issue to determine whether some specific contracts may require special treatment on a case-by-case basis. In several cases, staff is aware and encouraged that parties are in the process of, or already have negotiated new contracts to resolve this issue."

The CCC has provided ARB with a list of affected members, and to our knowledge, none of our member companies has successfully renegotiated one of these contracts. The problem is that the Buyer has no incentive to agree to open the contract for renegotiation and accept costs that under their current contract they have no obligation to bear.

This issue is not limited to CHP in industrial sectors that may be receiving an allocation of free allowances based on product or energy use benchmarks. Legacy contracts also exist in non-leakage exposed sectors, for example, universities and prisons, and the Buyer of the CHP energy is not a covered entity under the regulation. These and other CHP facilities were developed in the 1980s in response to federal and state energy policies designed to encourage increased installation and operation of CHP. New state regulations should not be structured in such a way as to undermine those existing contracts as this will send the wrong signal to investors considering new development of efficient CHP, and modification to existing facilities.

There does not appear to be a universal solution that will resolve this problem. However, this may be a transition issue. When the commercial agreement between Buyer and Seller expires, surely any new agreement will include carbon cost recovery provisions. A significant number of CHP QF PPAs will be expiring in the next five years, which seems to imply the pool of affected projects with this specific legacy contract issue may reduce in size in the near future.

The CCC recommends that the ARB staff continue to evaluate each legacy contract on a case-by-case basis and provide some sort of special treatment. This may involve an allocation of free allowances, or perhaps an exemption from the regulation for a period of time. The reference point for staff in considering solutions should be Resolution 10-42, i.e. the regulation should include appropriate incentives for increased use of efficient combined heat and power. Leaving these facilities to face stranded costs will be a disincentive to continued operation, particularly at those sites where owners were previously planning to make considerable investment to repower their existing facilities.

II. Thermal Energy Emissions Inequity

Section 95811 identifies the entities to which the regulation applies, and section 95812 describes the inclusion thresholds for covered entities. For the operator of a cogeneration facility, the applicability threshold is 25,000 metric tons or more of CO_2e per data year. For a CHP facility the total emissions can consist of the emissions associated with three separate products:

(i) Wholesale electricity,
(ii) Thermal energy, and
(iii) Retail electricity.

Collectively, if the emissions from all three energy products exceed the 25,000 metric tons, then the CHP facility is included under both the mandatory reporting regulations and the cap-and-trade regulation.

The regulation also states that at the start of the second compliance period in 2015, the natural gas sector will be covered by the regulation. This means that those facilities that combust natural gas, but are currently below the applicability threshold, will face costs beginning in 2015 for the associated emissions because suppliers of natural gas will have a compliance obligation in the second compliance period. Consequently, in the first compliance period, except in the case of a facility that is an opt-in covered entity pursuant to Section 95813, facilities that use boilers instead of CHP, for which total emissions associated with the facility are less than the 25,000 metric ton threshold, have no compliance obligation. However, a CHP facility where the emissions associated with the thermal energy are less than 25,000 metric tons, does have a compliance obligation in the first compliance period. This unequal treatment highlights the issue CCC and many other CHP advocates raised with the regulatory agencies when development of the cap and trade regulation first began. Even though the installation and operation of efficient CHP results in less overall emissions than compared to the alternative, i.e. a standalone boiler and electricity from the grid, the CHP facility is responsible for more onsite emissions than just the boiler, and consequently will end up with a greater compliance obligation, if the policy rules are not carefully designed. In this situation an early adopter of CHP is actually penalized for using CHP instead of a boiler because the CHP facility bears a compliance obligation in 2013 and 2014 while the site with the boiler does not.

In order to ensure equal treatment, the CCC recommends 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.

We recommend that section 95812 be amended as follows:

(c) The requirements apply as follows:
(1) Operators of Facilities. The applicability threshold for a facility is 25,000 metric tons or more of CO_2e per data year. <u>In the case of a cogeneration facility where the emissions associated with the useful thermal energy are below the threshold of 25,000 metric tons of CO_2e per data year, and in the absence of the cogeneration facility there would be no compliance obligation, the emissions attributable to the thermal energy from</u>

that facility will not be included in the covered entity's compliance obligation in years 2013 and 2014.

An indirect consequence of this exemption for the first compliance period may be the resolution of some portion of the legacy steam agreements previously discussed. The ARB staff should review their database of legacy steam agreements applying this proposed threshold exemption which is approximately 376,923 MMBtu of steam in an 80% efficient boiler.

III. Proposed changes to Verification and Enforcement Provisions

The following changes are recommended regarding specific provisions of the regulation:

(i) Attestation

In §95832 (a)(6) and (d), we propose that the language regarding the attestation of the authorized account representative be consistent with the ARB Mandatory Reporting Regulation (MRR) regarding certification, which point to the USEPA Mandatory Reporting of Greenhouse Gases Rule[6] regarding certification of the GHG emissions report.

Section 95102 (66) of the ARB MRR states:

"Certification" or "certify" refers to the procedure in 40CFR §98.4(e), as required for reports submitted to ARB under this article.

The EPA reporting rule at §98.4(e)(1) includes the language, "to the best of my knowledge and belief…". We recommend that this language be added to the end of the sentence in (a) (6), and reinserted in (d). This will ensure consistency between all three related regulations.

(ii) Violations

In §96014 (c), we propose that the word, "knowingly" be inserted at the end of the lead-in sentence, as follows:

(c) It is a violation to submit any record, information or report required by this article that knowingly:

This will make it clear that it is a violation when someone intentionally misleads the ARB in terms of the actions listed in (1) through (4) of that subsection, as compared to the situation when simply a mistake has been made.

(iii) Untimely Surrender Obligation and Compliance Obligation for Under-Reporting

The relationship between §95857, §95858, and the enforcement provisions of the mandatory reporting regulation is not clear. It appears that an entity could be penalized twice for the same infraction. We recommend that ARB clarify the linkages between the regulations, and make it clear that an entity is penalized only once for a legitimate violation.

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[6] 40 CFR §98.4 (e)(1)

In §95857 (b) (1) the quantity of excess emissions is calculated and in (4) it states when the untimely surrender obligation is due. However, it appears this section is missing a notification step between the calculation and the time of the surrender. If the notification step needs to be added or is in another provision, we recommend that ARB clarify this in this subsection.

In §95857 the entity's compliance obligation for untimely surrender is calculated as four times the entity's excess emissions, and the consequence of not meeting that obligation is set out in new subsection (c). It includes in the calculation a reference to the number of violations under §96014. In §96014 (b) it states that a separate violation can be for each day or portion thereof after the end of the Untimely Surrender Period that each required compliance instrument has not been surrendered. The impact of these new revisions to both sections appears to be excessive.

IV. Energy Efficiency and Co-Benefits Assessment for Large Industrial Sources

ARB invited comment on its proposal to **require** identified low cost onsite reductions at large industrial sites, pursuant to the energy efficiency assessments required under the Energy Efficiency and Co-Benefits Assessment for Large Industrial Sources regulation.

The CCC is opposed to such a requirement and argues that the design of the cap and trade regulations (declining cap and increasing cost per ton of carbon over time) incents large industrial sources to take cost-effective actions to reduce carbon emissions. The assessment required under this regulation will no doubt help to identify improvement projects, but the Operators of these facilities are best qualified to determine the most cost-effective way to reduce emissions. A cap and trade program should set the performance standard, and then allow the market to determine how best to achieve the goals. This extra layer of "command and control" defeats the purpose of such a market mechanism as cap and trade.

V. Conclusion

We encourage the ARB to consider our comments in light of the direction in Resolution 10-42 to incentivize increased use of CHP through the cap-and-trade program, and are available to discuss these issues at your request.

Yours sincerely,

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