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*By E-Mail and Electronic Submission (*http:www.arb.ca.gov/lispub/comm/bclist.php*)*

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

Re: Proposed 15-Day Modifications to the Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation

Dear Madame Chairman:

Calpine Corporation ("Calpine") appreciates the opportunity to provide these comments on the California Air Resources Board's ("CARB") Proposed 15-Day Modifications (hereinafter, "15-Day Modifications") to the Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, California Code of Regulations ("Cal. Code Reg."), tit. 17, sections ("§§") 95800 *et seq*. ("Cap-and-Trade Regulation" or "Proposed Regulation").

I. INTRODUCTION AND SUMMARY: THE PROPOSED REGULATION DISCRIMINATES AGAINST AND BETWEEN ENTITIES WITH A LARGE COMPLIANCE OBLIGATION AND NEEDS TO BE AMENDED

Calpine is a long-time advocate for low-carbon and renewable energy resources and has consistently supported state and federal carbon legislation. Calpine applauds CARB's efforts to develop the first economy-wide cap and trade regime to regulate emissions of greenhouse gases and address climate change. Calpine believes that putting a price on carbon emissions will encourage investment in efficient and low-emitting generating sources.

Calpine is the state's largest independent power producer, the state's largest provider of renewable energy and we own and operate the state's largest fleet of combined heat and power facilities. In the aftermath of the energy crisis, Calpine did exactly what California regulators called for: We invested more than $5 billion in California to add more than 4,000 MW of clean, efficient generating capacity and we are currently spending over another $1 billion to construct two new energy centers in the Bay Area, one of which is the first in the nation to accept federally-enforceable greenhouse gas emissions limits.

However, it is because of our considerable investment in providing clean, reliable power to California that the Proposed Regulation would discriminate against us and put us at a competitive disadvantage. For example, Calpine is the holder of several long-term contracts with private parties for the sales of electricity and steam from combined heat and power facilities that do not provide for recovery of allowance costs. Unlike a regulated utility, Calpine cannot simply seek approval to pass its allowance costs along to its customers. Additionally, starting in 2013, Calpine will have a compliance obligation of approximately 10 million metric tons per year; but due to our sheer size and the fact that we are not a regulated utility and will not receive free allowances, our ability to manage our risks under the proposed regulation will be severely restricted.

Calpine is a strong advocate for low-carbon rules at both the federal and state levels and we commend Chair Nichols, the CARB Board Members, and staff for their continued efforts to work with stakeholders since the Board's approval of the Proposed Cap-and-Trade Regulation this past December. Calpine seeks to work cooperatively with CARB to ensure the success and viability of the Cap-and-Trade program. To be successful, among other things, the regulations must not discriminate between large and small obligated entities and provide a competitive advantage for Investor Owned Utilities. Following is a summary of our comments on the 15-Day Modifications to the Proposed Cap-and-Trade Regulation, with a detailed discussion of these comments at Section II below:

- The Proposed Regulation's 10% purchase limit needs to be increased to accommodate the size of large independent generators such as Calpine, which may realistically need to purchase more than 10% of the available allowances in any auction to meet their compliance obligation. The Proposed Regulation also provides an unfair exemption from this purchase limit for the investor-owned utilities ("IOUs"), which would place independent generators at a competitive disadvantage.

- The Proposed Regulation's holding limit would further put independent generators at a competitive disadvantage to the utilities they serve, preventing large generators such as Calpine from taking advantage of the flexibility afforded by multi-year compliance periods and only requiring covered entities to surrender 30% of their emissions in any year. Calpine suggests that CARB expand the limited exemption so that it would include the entirety of a covered entity's prior year's emissions, without first requiring the allowances to be deposited into the entity's compliance account.

- Calpine opposes the Proposed Regulation's new "beneficial holding relationship" because it further exacerbates the competitive disadvantage between independent power producers and IOUs by providing that IOUs' holding of allowances for their long-term contract generators will count against the holding limit of the generator. Calpine is disappointed that CARB would provide the utilities so much flexibility to manage their carbon risk and abide by the auction purchase and holding limits, while providing no such flexibility to the generators who are actually subject to a compliance obligation.

- The 15-Day Modifications failed to address the problem faced by generators with long-term contract that do not allow for recovery of GHG allowance costs, even though staff was instructed by the Board upon its approval of the Proposed Cap-and-Trade Regulation this past December to do so.

- Calpine supports the changes CARB made to the Proposed Regulation to clarify that emissions from geothermal generating units are exempt from the compliance obligation.

- The Proposed Regulation's definition of "resource shuffling" is overly broad and could operate as a strong disincentive to future dispatch and contracting of highly efficient out-of-state resources with emissions lower than the default emissions rate for unspecified power.

II. DISCUSSION

A. The Proposed Regulation's 10% Limit On Purchases In Any Auction Should Be Increased To Reflect The Size Of Affiliated Generators In California And To Avoid Putting Independent Generators At A Competitive Disadvantage To Investor-Owned Utilities

The Proposed Regulation sets an auction purchase limit for covered entities and opt-in covered entities of ten percent (10%) of the allowances available in any auction conducted during the first compliance period. Proposed Cal. Code Reg., tit. 17, § 95911(c)(4)(A). While Calpine understands the need to prevent market manipulation, Calpine's covered entities in California could realistically need to purchase more than 10% of available allowances just to cover their compliance obligations, depending upon the amount of allowances that the publicly-owned utilities ("POUs") consign for auction.

Based on 2010 emissions from existing facilities and the addition of two new generating facilities, by 2013 Calpine's annual compliance obligation will be over 10 million tons. By subjecting Calpine to an auction limit that could realistically be lower than our total compliance obligation, the Proposed Regulation could force us to obtain allowances from the secondary market or the Allowance Price Containment Reserve at a significantly higher cost than available from the general auction. In addition the purchase limit of 4% for non-covered entities is excessive in the light of the 10% limit for covered entities. If several non-covered entities purchase their limit, it could limit the amount of allowances available for purchase by large covered entities and force these covered entities to purchase allowances on the secondary market at a higher cost. The auction purchase limit means that large generators like Calpine will likely need to participate in every auction, just to assure that they can obtain sufficient allowances. As a result, the proposed auction limit could place large generators such as Calpine at a significant competitive disadvantage.

Calpine recommends that the auction purchase limit for covered entities during the first compliance period generally be kept at 10% of the total number of allowances available any given auction, but with an opportunity for any covered entity or group of covered entities with a corporate association to exceed this limit, so long as its total purchase of allowances of any vintage year does not exceed 125% of its average annual verified emissions during the preceding three calendar years, plus, for any entity with less than three years' reported emissions data, an additional amount that represents a reasonable estimate of the entity's anticipated emissions during that calendar year. This would allow large affiliated entities, such as Calpine, to satisfy their anticipated compliance obligation through purchases at auction, while still avoiding the potential for covered entities to engage in market manipulation by purchasing an amount of allowances grossly in excess of their anticipated compliance obligations for any calendar year.

In addition, Calpine believes that the Proposed Regulation would provide an unfair exemption from this auction purchase limit for the IOUs, which would discriminate against independent power producers such as Calpine. According to the Initial Statement of Reasons ("ISOR") for the Proposed Cap-and-Trade Regulation, IOUs are exempt from this purchase limit because, unlike POUs, IOUs cannot use their direct allocation of allowances for their own compliance obligations. *See* ISOR, II-38 ("ARB proposes to exempt the investor-owned utilities from the purchase limit because entities do not receive a direct allocation that they can use for their own compliance needs."). However, IOUs are no differently situated than independent power producers in this regard. Thus, under the Proposed Regulation, the IOUs would be allowed to acquire more allowances than they need for their own compliance obligations, which they could then either sell at an inflated price to independent power producers needing them to meet their own compliance obligations or use to gain leverage in bilateral power procurement negotiations. Further, the IOUs would not need to participate in every auction. Calpine believes this betrays the design principle that the proposed cap and trade regulation should not discriminate between utility and independent power producers. Accordingly, Calpine recommends revising the Proposed Regulation to delete this exemption for IOUs, as shown by the proposed language below.

For the IOUs, rather than provide them a "blank check" to buy as many allowances as they wish in any auction for their own generation and their long-term contract generators, we would recommend that the IOUs be allowed to buy up to 125% of the verified emissions for any covered entity with which they have established a beneficial holding relationship, where both the utility and the generator have informed CARB of the utility's intention to acquire and hold allowances on behalf of the generator, as described in more detail in our comments in section C below.

§ 95911. Format for Auction of California GHG Allowances.

. . .

(c) Auction Purchase Limit.

(1) The auction purchase limit is the maximum number of allowances offered at each quarterly auction which can be purchased by any entity or group of entities with a disclosable corporate association pursuant to section 95833.

(2) The auction purchase limit will apply to auctions conducted from January 1, 2012 through December 31, 2014.

(3) For the advance auction of future vintage allowances conducted pursuant to section 95910(c) the purchase limit is 25 percent.

(4) For the auction of current vintage allowances:

(A) The purchase limit for covered entities and opt-in covered entities will be 10 percent of the allowances offered for auction, except for any covered entity or group of covered entities with a corporate association, which may purchase an amount of allowances in excess of 10 percent during any auction, so long as the total purchase of allowances of any vintage year does not exceed 125 percent of the entity's or group of entities' average annual verified emissions during the preceding three calendar years or, in the case of an electrical distribution utility acquiring allowances on behalf of second registered entity with whom it has established a beneficial holding relationship pursuant to section 95834(a)(2), 125 percent of the second entity's verified emissions during such three calendar years, plus, for any entity with less than three years' reported emissions data, an additional amount that represents a reasonable estimate of the entity's anticipated emissions during that calendar year; and

(B) ~~The purchase limit does not apply to electrical distribution utilities receiving a direct allocation of allowances pursuant to section 95892(b) and subject to the monetization requirement pursuant to section 95892(c). This provision shall not be interpreted to exempt said electrical distribution utilities from any other requirements of this article; and~~

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

....

As an alternative to the foregoing proposal, CARB could adopt a substantially higher auction purchase limit, such as the 25% limit applicable to Regional Greenhouse Gas Initiative ("RGGI") states.[5]

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[5] *See, e.g.*, DOER CO_2 Budget Trading Program Auction Regulation, 225 Code of Massachusetts Regulation § 13.06(8) ("No bidder, including any affiliate or agent of such bidder, shall purchase more than 25% of the allowable allowances in any one auction to ensure a fair and competitive outcome for an auction."), available at: http://www.mass.gov/Eoeea/docs/doer/rggi-auction-reg-final.pdf; Auction Notice for CO_2 Allowance Auction 10 on December 1, 2010, RGGI, Oct. 5, 2010, § 7.2.3 ("The maximum number of CO_2 allowances that any Applicant, or group of associated applicants, may bid for in a single auction is 25% of the CO_2 allowances offered for sale in that auction."), available at: http://www.rggi.org/docs/Auction_Notice_Oct_5_2010.pdf.

B. The Proposed Regulation's Holding Limit Must Be Increased So That It Does Not Limit Larger Generators' Ability To Take Advantage Of the Flexibility Afforded By Unlimited Banking And Three-Year Compliance Periods

As we commented on the Proposed Regulation last December, the Proposed Regulation includes a holding limit that would dramatically limit the ability of large affiliated generators, such as Calpine, to utilize the important flexibility mechanisms otherwise provided, including unlimited banking of allowances and three-year compliance periods. *See* Proposed Cal. Code Reg., tit. 17 § 95920. In the 15-Day Modifications, CARB has revised the holding limit provisions substantially, but has failed to provide any relief from the restrictions this would place on the largest independent generators' ability to manage their allowance portfolio. CARB has, however, revised the holding limit through creation of a new "beneficial holding relationship" to afford the IOUs significant flexibility in managing their own contractual obligations. As will be discussed, Calpine believes this is unfair and puts the largest independent generators at a competitive disadvantage to IOUs.

The Proposed Regulation affords a limited exemption from the holding limit for allowances deposited in a covered entity's compliance account up to its most recent year's reported emissions. As currently drafted, this limited exemption would effectively nullify the flexibility afforded by limiting the annual compliance obligation to only 30% of the previous year's emissions. *See* Proposed Cal. Code Reg., tit. 17 § 95855(b). In other words, the largest independent generators would need to transfer substantially more than 30% of their annual compliance obligation to their compliance accounts each year to avoid exceeding the holding limit. This would unfairly deny the largest generators the same flexibility afforded to other generators and would therefore place them at a competitive disadvantage. Further, the holding limit would severely restrict the ability of the largest generators to bank allowances for use at a later time, which could forego the important early reductions gained by allowing unlimited banking of allowances.

Notably, the 15-Day Modifications include new provisions that authorize the Executive Officer to impose sanctions on registered entities who violate any provision of the Cap-and-Trade Regulation. The possible sanctions include, "[i]ncreas[ing] the annual surrender obligation for a covered entity or an opt-in covered entity to a percentage of its reported and verified or assigned emissions above the 30% obligation pursuant to section 95855". *See* Proposed Cal. Code Reg., tit. 17, § 95921(f)(2). But, in effect, the holding limit and its limited exemption for allowances deposited in an entity's compliance account already imposes this penalty on a large generator such as Calpine, essentially requiring it to surrender more than 30% of its total emissions each year to its compliance accounts, just to assure that it can both obtain the allowances it needs during the quarterly auctions and avoid exceeding the holding limit. The fact that early surrender of allowances has now been proposed as a possible sanction for violating the rule only serves to underscore how unnecessarily punitive the holding limit would to Calpine.

Calpine believes that its concern with the holding limit could be resolved if the limited exemption were extended to include all of a covered entity's emissions reported during the preceding calendar year, prior to retirement into a compliance account. Thus, the holding limit would equal the amount of allowances derived through application of the formula appearing at subsection 95920(d)(1), plus the entity's verified emissions in the prior year. Accordingly, Calpine would propose the following revisions to the Proposed Regulation's holding limit:

§ 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:

(A) The limited exemption is the number of allowances which are exempt from the holding limit~~ after they are transferred by a covered entity or an opt-in covered entity to its compliance account~~.

....

C. The Beneficial Holding Relationship Created By The 15-Day Modifications Would Put Independent Generators With The Actual Compliance Obligation At A Competitive Disadvantage To The Utilities To Whom They Sell Power

The 15-Day Modifications include a new provision that only exacerbates the competitive disadvantage imposed on larger generators through application of a "once size fits all" holding limit: The 15-Day Modifications define a "beneficial holding relationship" to include an electric distribution utility's purchase of allowances on behalf of its long-term contract generators. *See* Proposed Cal. Code Reg., tit. 17, 95834(a)(2). The 15-Day Modifications then provide that, "application of the holding limit will treat beneficial holding by an agency as part of the holding of the owner." *See id.*, § 95920(h). As drafted, Calpine believes the beneficial holding provisions would allow the electric distribution utilities to claim beneficial holding on behalf of their long-term contract generators, even when the utilities have not actually committed to acquire the allowances on their behalf. This would make it difficult, if not impossible, for large independent generators to avoid violating the holding limit, while also assuring that they acquire sufficient allowances during the quarterly auctions to meet their compliance obligations.

In Calpine's experience, in most cases where an electric distribution utility has agreed to assume carbon liability for power generated pursuant to a long-term contract, the contract provides that the utility may satisfy its obligation with respect to carbon either by compensating the long-term contract generator for its purchase of allowances, typically at no more than the auction clearing price, or by providing the allowances to the generator or directly to the governmental authority (if allowed under the relevant cap-and-trade rules). Further, the contracts typically afford the utility substantial flexibility to choose how and when it will satisfy this obligation, often providing that the utility may make its election (either to compensate the generator for its allowance cost or to provide allowances directly to the entity or the governmental authority) after the fact. Thus, under most contracts, the long-term contract generator may not know, at the time when allowances are auctioned, whether it will need to purchase the allowances itself or whether the utility will obtain adequate allowances to cover its anticipated dispatch of the facility.

Notwithstanding that the contracts typically afford so much flexibility to the utilities, these agreements will, in most cases, likely be found to qualify as "an agreement to serve as the agent in a beneficial holding relationship" with a long-term contract generator. *See id.*, § 95834(a)(2). Indeed, the Notice of Public Availability of Modified Text and Availability of Additional Documents ("Notice") acknowledges that the contracts it intends to address do not actually specify which party will be responsible for providing allowances. According to the Notice, CARB is proposing the beneficial holding relationship as a means to facilitate the utilities' acquisition of allowances under those "contracts which may not explicitly determine which party to the contract has the responsibility to surrender compliance instruments." Notice, 7.

To accommodate the utilities' interest in obtaining allowances on behalf of their generators without violating the holding limit, the 15-Day Modifications provide that any allowances obtained by utilities on behalf of its generators count, not against the utility's own holding limit, but against that of the generator. *See* Proposed Cal. Code Reg., tit. 17 § 95910(h). By providing that the utilities can hold allowances on behalf of their long-term contract generators, without those allowances counting against the utilities' own holding limit, the Proposed Regulation would put long-term contract generators such as Calpine in a situation of great uncertainty. The utilities could hold allowances, purportedly on a particular generator's behalf, with the allowances so held counting against the holding limit of that generator, even though the generator exercises no control over the allowances and the utility may not have actually committed to provide the allowances to the generator. Indeed, under the beneficial holding provisions as currently drafted, the utility might even subsequently decide, based upon the market price for allowances, that it makes better sense for it to sell the allowances purportedly held on the generator's behalf on the secondary market, and then compensate the generator for its own acquisition of allowances, but at no more than the auction clearing price.

According to the Notice, "ARB has held extensive discussions with electric utilities on this issue, and is requesting comment on whether the proposed requirements address this concern." Notice, 8. Calpine is disappointed that, as a result of its extensive discussions on this topic, CARB has again proposed a solution that favors the utilities and would put independent generators such as Calpine at a competitive disadvantage. Just as in the case of the purchase limit, CARB is affording the utilities nearly unfettered flexibility to manage their contractual liability for carbon, while providing no such flexibility to independent generators. Under many contracts, the utilities have not even obliged themselves to actually obtain allowances, but have preserved the maximum flexibility to decide, based upon market conditions, whether they actually want to acquire allowances on behalf of their long-term contract generators or compensate the generator for its own acquisition instead. It is doubly ironic that CARB would provide so much flexibility to assist the utilities in managing the constraints imposed upon them by the auction purchase limit and holding limit, while providing *none* to the long-term contract generators *who are actually subject to the compliance obligation*.

In our view, the problem with the 15-Day Modifications is due to the fact that, as currently drafted, the requirements for establishing a beneficial holding relationship are vague and do not mandate that the agreement establishing the beneficial holding relationship actually require the utility to provide allowances. Nor do they require the utility to specify how many allowances it will be holding on behalf of any particular generator. Without requiring that the utilities actually identify how many allowances they intend to hold on behalf of any particular generator in the disclosure, the Proposed Regulation would leave independent generators without sufficient information to assure that they can both obtain sufficient allowances during the quarterly auctions (so as to avoid later needing to purchase them at a higher cost from the Allowance Price Containment Reserve or secondary market) and abide by the holding limit.

Calpine believes the only solution is that a utility's beneficial holding on behalf of a long-term contract generator may only be counted against the generator's holding limit where the agreement establishing the beneficial holding relationship provides, not merely for "eventual transfer" of the allowances from the utility to the generator (*see* § 95834(a)(2)), but where both parties have informed CARB in advance of the auction that the utility will, in fact, be providing allowances to the generator in an amount sufficient to meet its compliance obligations and the number of allowances it will hold for this purpose. Accordingly, Calpine proposes the following changes to the beneficial holding provisions and the corresponding holding limit provisions:

§ 95834. Disclosure of Beneficial Holding.

(a) A beneficial holding relationship exists when:

...

(2) An electrical distribution utility and a second registered entity with whom it has a contract for the delivery of electricity informs ARB that ~~it has~~ they have established an agreement for the utility to serve as the agent in a beneficial holding relationship pursuant to section 95834(a)(1)(A) to purchase and hold allowances for the eventual transfer to ~~a~~ the second registered entity ~~with whom it has a contract for the delivery of electricity~~ for the sole purpose of supplying the second entity with compliance instruments to cover emissions resulting from satisfying the electricity contract.

(A) This disclosure must be made to ARB prior to any such purchases, and must include the terms of the contract governing the eventual transfer and a statement by the utility confirming its intention to transfer to the second entity the required number of allowances needed to fulfill the second entity's compliance obligations under sections 95855 and 95856 prior to the time they are due.

. . . .

§ 95920. Trading.

. . . .

(h) The application of the holding limit will treat beneficial holding by an agent as part of the holding of the owner, provided that, in the case of an electric distribution utility beneficially holding allowances on behalf of a second registered entity pursuant to section 95834(a)(2), the electric distribution utility and second entity have informed ARB in the disclosure required by said section 95834(a)(2) of the number of allowances that will be held on the second entity's behalf.

D. CARB Must Propose 15-Day Modifications Addressing The Situation Faced By Long-Term Contract Generators That Cannot Recover the Cost of Allowances From Their Customers

In Attachment B to Resolution 10-42, CARB staff committed to "work with interested stakeholders to ensure proper treatment under the regulation of any electricity generators or combined heat and power facilities with pre-AB 32 long-term contracts that do not allow for pass-through of costs associated with greenhouse gas emissions." Resolution 10-42, Attachment B, 8. In Resolution 10-42, the Board directed staff to "[m]ake the modified regulatory language set forth in Attachment B, with such other conforming modifications as may be appropriate, available for public comment for a period of 15 days." Resolution 10-42, 10. Thus, the Board has directed staff to publish 15-day changes that address the concerns raised with respect to long-term contracts that do not allow for recovery of costs associated with GHG emissions.

Staff still has not published such language, but, rather, provides the following explanation of its intention in the Notice:

> As detailed in footnote 22 of the Initial Statement of Reasons for the cap-and-trade regulation, 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. 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. Staff believes that bilateral contract negotiations would provide the best resolution of this issue. Should contract renegotiation not be possible in all cases, staff will continue discussions with counterparties to consider how this issue should be resolved in the regulation.

Notice, 19

Calpine is encouraged by staff's intention to continue evaluating how this issue should be resolved in the final regulation. Calpine is also encouraged by the inclusion of a definition of "long-term contract" in the 15-Day Modifications, which, upon revision so that it also addresses contracts for the sales of steam, could provide a starting-point for resolving this issue in the final regulation. *See* Proposed Cal. Code Reg., tit. 17 § 95802(a)(150). However, Calpine disagrees with the Notice's suggestion that this problem can be resolved through bilateral negotiations in all cases. Pursuant to the Board's instructions in Resolution 10-42, staff cannot rely upon the speculative assumption that all contracts will be renegotiated, but must publish proposed 15-day changes that address this issue at the earliest opportunity.

As Calpine detailed in its December comments on the Proposed Regulation, unlike an IOU or a publicly-owned utility ("POU") that can recover costs associated with emissions allowances from its ratepayers or a merchant generator that can recover such costs through the market price of electricity, long-term contractor generators can be severely impacted by the requirement to purchase emissions allowances. Further, long-term contractor generators do not exercise control over when their facilities can be dispatched, but must operate whenever called upon by their customers who are exercising their contractual rights. In light of the potential impacts that this could have on long-term contract generators, all existing and proposed GHG regulatory programs have sought to address this problem by providing some form of transitional relief to long-term contract generators.[1] The reason existing and proposed GHG regulatory programs have all sought to address this issue is clear: Rather than provide a constructive price signal to encourage lower emitting generation, imposing allowance costs on long-term contract generators would simply be punitive, given that their customers can continue dispatching them without experiencing any increase in price associated with the costs to purchase GHG allowances; those costs would be borne solely by the long-term contract generator and would, in many instances, likely make its continued operation uneconomic.

The problem is particularly acute for generators selling electricity and/or useful thermal energy to nearby or collocated industrial operations under long-term contracts. These combined heat and power ("CHP") or cogeneration facilities represent a highly efficient, environmentally preferable alternative to meeting industry's energy needs. For this reason, CARB has made expansion of CHP a significant component of its overall Scoping Plan, which targets an increase of 4,000 MW of installed CHP capacity within the State by 2020.[1] This measure is intended to displace approximately 30,000 gigawatt-hours ("GWh") of demand from other power generation sources, resulting in a targeted reduction of 6.7 million metric tons of CO_2e in 2020. *Id.*

In Resolution 10-42, "the Board direct[ed] 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". Resolution 10-42, 11. However, in many cases industrial facilities qualifying for free allowances under the Proposed Regulation purchase power and steam from a cogeneration facility pursuant

[1] *See* letter from Kassandra Gough, Director, Government and Legislative Affairs, Calpine Corporation, to Hon. Mary D. Nichols, Chairman, CARB, re: Proposed Regulation to Implement the California Cap-and-Trade Program (Dec. 9, 2010) (comment log no. 224), 4; *available at*: http://www.arb.ca.gov/lispub/comm/bccomdisp.php?listname=capandtrade10&comment_num=253&virt_num=224.

[1] 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").

to a contract that does not provide any means for recovery of the cogeneration facility's allowance costs. As a consequence, the industrial host will experience no increase in its energy costs due to a fixed price in a contract that pre-dates AB32 with a CHP generator, even though it will receive a direct allocation from CARB to address potential leakage concerns. In these cases, it would be patently unfair to provide the allocation to the industrial facility and provide no assistance to the CHP generator. In many cases, the CHP facility would have little incentive to continue operating and could very realistically decide to just shut-down. Such a result would obviously undermine the goal of increasing CHP throughout the State. For this reason, we do not believe CARB could have possibly intended for industrial facilities to experience a windfall of free allowances where the CHP generator is contractually bound to continue delivering electricity and steam at a fixed price.

Calpine is endeavoring to work with its counter-parties to address this situation via bilateral contract negotiations. However, we are not hopeful that we will be able to resolve the situation in all cases. We are particularly concerned that, unlike regulated utilities who may have strong regulatory incentives to assume carbon liability, industrial hosts under cogeneration contracts, faced with potential rising energy costs, will simply be unwilling to reopen their existing contracts to assume some portion of the cogenerator's costs. We continue to believe that the best way to address this problem is through a direct allocation of emissions allowances to generators subject to long-term contracts that provide no mechanism for recovery of allowance costs. This would merely provide transitional assistance until such time as the existing contract expires or is substantively amended, as reflected by the specific language we proposed in our December 2010 comments. However, we are open to working with CARB staff on other solutions, such as attestation requirements that would preclude covered entities or opt-in covered entities from receiving any free allocation for industry assistance per section 95891, unless the entity affirms that it does not purchase power or steam from another covered entity (other than an electrical distribution utility) and, where it does, both the industrial facility and its provider of electricity and steam certify that they have appropriately allocated responsibility for any costs attributable to GHGs between themselves. We look forward to staff's publication of 15-day changes to address this situation and will provide comments on any proposals at that time.

E. The 15-Day Modifications Appropriately Exclude Emissions From Geothermal Generating Sources From The Compliance Obligation, Although The Paragraphs Should Be Renumbered In The Final Regulation

The 15-Day Modifications address the concerns Calpine previously expressed regarding potential applicability of the Cap-and-Trade Regulation's compliance obligation to geothermal generating units. The Proposed Regulation now clearly excludes geothermal generating sources from the compliance obligation. *See* Proposed Cal. Code Reg., tit., 17 § 95852.2(a)(9). Calpine appreciates the changes reflected by the 15-Day Modifications. However, because of an apparent error in the numbering of the relevant paragraphs, geothermal generating units, asphalt blowing at refineries, mobile equipment and well-site centrifugal and reciprocating compressors all appear to be classified as subcategories of combustion of biomass-derived portion of biomass-derived fuels. *See id.*, § 95852.2(a)(9)-(12). Clearly none of these categories of emissions fit within the category of biomass combustion emissions. Calpine believes CARB's intent is clear in the 15-Day Modifications to exempt each of these categories, although the paragraphs were inadvertently numbered incorrectly. In the final rule, each of paragraphs (9) through (12) of section 95852.2(a) should be renumbered as their own independent subsection (b) through (e); what currently appears as subsection (b) should then be renumbered as subsection (f).

F. The Definition Of Resource Shuffling Is Too Broadly Worded And Should Be Revised So As Not To Prevent Cleaner Out-Of-State Facilities With Emissions Lower Than The Default Emissions Rate For Unspecified Power From Reporting A Lower Rate For Sales To California

As Calpine previously described in our comments on the proposed 15-day modifications to the Proposed Amendments to the Mandatory Reporting Rule ("MRR"), Cal. Code Reg., tit. 17, §§ 95100 *et seq*., the prohibition on resource shuffling and the requirements for specification of sources of imported electricity could operate as a strong disincentive to sale of power into California from existing out-of-state facilities with emissions of GHG lower than default emissions rate for unspecified electricity. Our comments on the 15-day modifications to the MRR dealt with the requirements for specification of power under the MRR. These comments on the Proposed Cap-and-Trade Regulation will focus on problems with the definition of "resource shuffling".

Calpine operates two highly efficient combined-cycle natural gas-fired generating facilities located outside of California that frequently sell power into California on the day-ahead market, in Hermiston, Oregon and South Point, Arizona. Calpine is concerned that the definition of resource shuffling could be interpreted too broadly and thereby act as a strong disincentive against future dispatch and contracting of these low emitting out-of-state resources. In particular, we are concerned that the focus on whether an out-of-state generating resource "historically served California load" could be interpreted to suggest that, if existing facilities like Hermiston and South Point are dispatched to serve California with greater frequency as a result of implementation of the proposed Cap-and-Trade Regulation, Calpine and its affiliate and/or counter-party who imports the power from these facilities into California could be found to have committed unlawful resource shuffling. We do not believe that this was CARB's intention in prohibiting resource shuffling. Indeed, the entire goal of a well designed cap-and-trade regime should be to incentivize increased dispatch from the lowest carbon resources, regardless where they are located. Calpine has been and remains a strong supporter of CARB's rulemaking efforts in part because it anticipates that, by putting a price on carbon emissions, the Cap-and-Trade Regulation could result in increased sales of power to California from its fleet of gas-fired sources, including at times when, under current market conditions, they may not be operated due to the disparity between the price of coal and natural gas.

Calpine is concerned that the proposed definition of "resource shuffling" defines unlawful behavior based, not on a covered entity's own sales of power with an emissions rate lower than the default rate for unspecified power, but upon some other unaffiliated entity's sale of higher-emitting power that would have otherwise served California to another jurisdiction. Thus, the definition hinges on whether, during the same time when power with a lower rate is delivered to

California, power with higher emissions is delivered elsewhere, to a non-linked jurisdiction. *See* Proposed Cal. Code Reg., tit. 17, § 95802(a)(245)(A). As an initial matter, the mere fact that an out-of-state facility such as Hermiston or South Point delivers power to California more frequently in the future provides no evidence to support the conclusion that higher-emitting power is now being delivered elsewhere to jurisdictions not linked through the Western Climate Initiative. Indeed, it could very well be that the higher-emitting generating sources simply did not operate at the same levels as they historically have, which could be the direct result of price signals as a result of the implementation of the Cap and Trade Regulation.

Clearly, the definition of resource shuffling cannot hinge on speculation about the behavior of unaffiliated entities, when the intent of the prohibition on resource shuffling is to proscribe any scheme by a covered entity or group of affiliated entities to game the system by delivering cleaner power to California and dirtier power elsewhere. Moreover, because the operator of the low-emitting facility would have no information concerning operation of higher-emitting resources not under its own or its affiliate's control, it would have no ability to assess with any reliability whether increased delivery of power to California from its lower-emitting units did, in fact, displace higher-emitting power and, if so, the ultimate destination to which power from those higher-emitting resources was delivered. As a consequence, Calpine believes it would be difficult, if not impossible, for the operator of the lower-emitting unit to certify that it has not engaged in activity that may fall under the overly broad definition of "resource shuffling".

To clarify that the prohibition on resource shuffling was not intended to apply to circumstances where existing facilities that have historically served California deliver more power to California in the future, Calpine is proposing the following changes to the definition of resource shuffling:

§ 95802. Definitions.

(a) Definitions. For purposes of this article, the following definitions shall apply:

....

(245) "Resource Shuffling" means any plan, scheme, or artifice to receive credit based on emissions reductions that have not occurred, involving the delivery of electricity to the California grid, for which:

(A) An emission factor below the default emission factor is reported pursuant to MRR for a generation source that has not historically served California load (excluding new or expanded capacity)~~.~~ ~~A~~<u>a</u>nd, during the same interval(s), electricity with higher emissions was delivered <u>by the same covered entity or any entity with which it has a direct or indirect corporate association</u> to serve load located outside California and in a jurisdiction that is not linked with California's Cap-and-Trade Program<u>; provided, however, that nothing in this paragraph shall be deemed to prohibit reporting a lower than the default emissions factor pursuant to the MRR</u>

for increased deliveries of electricity to California, in MWh per year, from a generating source that has historically served California; or

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Calpine looks forward to working with the Board and staff to ensure that timely and successful implementation of the Proposed Cap-and-Trade Regulation. 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
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