CALIFORNIA COGENERATION COUNCIL
A Combined Heat and PowerAssociation

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September 27, 2011

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

Comments of the California Cogeneration Council on the 2nd 15-day Modified California Cap-and-Trade Regulation and the 2nd 15-day Modified Mandatory Reporting Regulation

Clerk of the Board:

The California Cogeneration Council (CCC)[1], an ad hoc association of natural gas-fired cogenerators located throughout California, has provided comments on each phase of the Cap and Trade regulation ("the regulation") rulemaking. The majority of issues we have raised with the Air Resources Board (ARB) have not been addressed in the second 15-day modifications to the Cap and Trade Regulation ("the regulation") and rather than repeat these concerns, we refer you to our comments filed on August 11, 2011. Specifically, we continue to be concerned that the modified regulation does not, "ensure appropriate incentives" to encourage increased use of combined heat and power (CHP), as directed in Resolution 10-42.

Our comments focus on the following issues:

(i) Legacy steam and retail electricity contracts with no provision for GHG cost recovery;
(ii) Compliance obligation exemption for NAISC code 92811 facilities, should be applied to cogeneration facilities providing steam and electricity to NAISC code 92811 facilities;
(iii) Lack of transparency in product-based emissions efficiency benchmarks; and,
(iv) Modifications to the Mandatory Reporting Regulation (MRR) definitions.

I. Legacy Contracts with no provision for carbon cost recovery

Since October 2010, the CCC has provided detailed comments to the ARB concerning the treatment of CHP facilities in the regulation, including confidential project data regarding legacy contracts that do not provide for GHG cost recovery.

[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.

Under the regulation, the operators of "third party" CHP facilities face stranded costs in terms of the emissions associated with the thermal, and in some cases retail electricity, provided to the host application under such legacy steam and/or electricity contracts.

The CCC, along with many other stakeholders, has repeatedly described the problem and proposed a variety of solutions. We were disappointed to see that the second 15-day modified rule remained silent on this issue. While parties can attempt to renegotiate existing contracts to enable cost recovery, the reality is that the CHP operator has no leverage in those discussions. Consequently a backstop is essential and in these comments the CCC offers another possible solution that would more accurately allocate allowances to the electricity sector, and preserve a set-aside of allowances for resolving the CHP legacy contract issue.

The CCC agrees with the ARB staff proposal to allocate 89 MMT of allowances to the electricity distribution utilities (EDUs) based on the 2008 reported emissions pursuant to the ARB Mandatory Reporting Regulation (MRR) associated with electricity procured from non-CHP generators and importers of electricity. The CCC also agrees that the EDUs should be allocated allowances associated with electricity purchased from CHP generators. The CCC does not agree, however, that the CHP allowances should be based on the proposal by the Joint Utility Group (JUG). The CCC recommends instead that the allowances attributed to CHP should be based on the same MRR data used to calculate the 89 MMT from non-CHP sources. The value of the auction proceeds from these allowances should be distributed to consumers of electricity in a manner that does not discriminate against any supplier, including the supplier of electricity from a cogeneration facility that is consumed directly by an end user located on-site or on an adjacent parcel.

The CCC further proposes that a portion of the remaining emissions reported from cogeneration should be made available as allowances for transition assistance to address the thorny and still unresolved issue of legacy contracts for CHP facilities that have no means to pass through the additional cost of AB 32 compliance. CCC agrees that negotiation between a CHP producer and its thermal or electric energy host is the preferred method to resolve the issue of legacy contracts; however there must also be a backstop for those situations in which negotiation is unsuccessful. This backstop should be designed to incent the affected parties to reach agreement rather than to rely on the backstop.

Pursuant to the MRR, each entity that reports GHG emissions associated with cogeneration as its primary or secondary sector, has already provided ARB with the data necessary to distribute emissions from cogeneration between wholesale electricity sold to an EDU for resale, electricity consumed by an end-user pursuant to California Public Utilities Code Section 218(b) and thermal energy consumed by a host. Allowances equal to 90 percent of the emissions associated with wholesale purchases of electricity should be allocated to the EDUs in addition to the 89 MMT associated with non-CHP sources. The source of data for emissions associated with purchases from CHP facilities would then be consistent with the source of data for electricity from non-CHP sources. The quantity of allowances available for allocation to EDUs and to the two special-use holding accounts described below will be subject to the cap adjustment factors in Table 9-2.

Allowances equal to 90% of the remaining emissions from cogeneration should then be deposited into two special-use holding accounts under the control of the Executive Officer; one account reflecting emissions from retail electricity to address transition issues associated with legacy contracts for retail electricity and the other account for emissions associated with thermal energy. Beginning with budget year 2013, a cogeneration facility with a compliance obligation that is a party to an agreement to sell **thermal energy** to a non-affiliated thermal host that was executed prior to January 1, 2006 and does not allow the seller to recover GHG compliance costs, may apply for transition assistance. That application must include (i) a copy of all contracts dealing with the purchase and sale of thermal energy and (ii) an affidavit certifying (a) that the submitted contract(s) are a complete and accurate record of all relevant agreements between the parties, (b) that the parties have entered into good faith negotiations to revise the contract(s) to allow for the pass through of GHG compliance costs, and (c) the parties are unable to reach agreement. Copies of contracts may be submitted with a request for confidential treatment.

Upon review and verification of the application and all supporting documents, ARB staff will approve the application and request that the Executive Director transfer allowances to the applicant equal to 75% of the compliance obligation of the applicant attributed to thermal energy. Additional requests may also be submitted for compliance years 2014 and 2015; however the maximum number of allowances that may be allocated for budget years 2014 and 2015 will be 50% and 25%, respectively, of the compliance obligation associated with thermal energy for that budget year. No further allowance allocations associated with transition assistance for legacy contracts will be made after budget year 2015. Transfers by the Executive Officer to the registered holding account of the applicant will be made by November 1st of the year following the year in which the compliance obligation was created.

For any budget year in which the quantity of transition assistance allowances approved for all applicants exceeds the quantity of allowances allocated to the special-use holding account, the available quantity of allowances will be allocated on a pro rata basis. Any allowances in the special-use holding account in excess of the allowances approved for transition assistance in any budget year will be designated for sale at auction pursuant to Section 95870(f).

In the special case of a thermal host of an applicant approved for transition assistance that is eligible for EITE assistance pursuant to Section 95870(e), an appropriate adjustment will be made to the counterparty's EITE allocation for that budget year to avoid a windfall gain by the host.

The CCC proposes a comparable provision in the regulation to address legacy contracts between a cogeneration facility and a non-affiliated host for the sale of **electricity** pursuant to Public Utilities Code Section 218(b) in which there is no provision for the seller to recover AB 32 compliance costs.

II. Compliance Obligation Exemption for Military Facilities

In Section 95852.2 (c) at page A-106, a new exemption has been inserted:

(c) Additional Exemption. The operators of facilities with the NAICS code 92811 are exempt from compliance with this article through December 31, 2013.

We interpret this to mean that military facilities are exempt from compliance obligations through December 2013. The CCC recommends that this exemption be extended to the emissions attributed to thermal energy or electricity sold to any exempted entity by a third party CHP facility that provides thermal energy or electricity to military facilities, to ensure equitable treatment. If a military operation, such as the Navy, is exempted from the compliance obligations in the cap and trade regulation, then the CHP facility providing the thermal energy or electricity to the Navy, but owned by another entity, will not be able to pass through its compliance obligation for those commodities provided to the Navy. The operator of the CHP facility should not face stranded costs as a result of this exemption.

The CCC also recommends that the compliance obligation exemption in Section 95852.2 be extended to state institutions such as universities and prisons. Where a third party CHP operator is supplying the thermal and/or retail electricity, then the compliance obligation for the emissions associated with the energy purchased by the host state entity should be exempted from the cap and trade regulation until the end of 2013.

III. Lack of Transparency in Development of Product-Based Emissions Efficiency Benchmarks

Table 9-1 of the regulation lists product-based emissions efficiency benchmarks (Ba) for numerous activities. The development of individual benchmarks has not been a transparent public process due to the use of commercially sensitive data provided by the affected industries. The CCC appreciates the need for confidentiality, but is concerned that the lack of transparency prohibits validation of the data used to develop these benchmarks. For example, it is impossible to determine if all, some, or none of the benchmarks include steam imported from an off-site CHP unit as an input to the benchmark.

In the 2nd 15-day modified regulation, the energy-based allocation calculation methodology in Section 95891 (c) was modified to clarify that the CHP exclusion in the “steam consumed” term applies only to steam produced from CHP units on-site. Allocations for on-site CHP are captured in the FConsumed terms, and steam imported from an off-site CHP unit is included in the SConsumed term. It is not clear if these same principles apply to the product-based emissions efficiency benchmarks calculation methodology. Since the off-site CHP unit is not involved in the benchmark development, there is no opportunity for the off-site CHP owner to validate the data that may or may not be used in the calculation and are being attributed to that CHP unit.

While the “electricity sold” term appears to include all power exported or sold from a facility, it is not clear if electricity sold not to a utility, but rather to a host pursuant to Public Utilities Code Section 218(b), is included in the product-based benchmark for any particular industrial activity.

The CCC recommends that the ARB explicitly state how CHP outputs produced both onsite and offsite are treated in terms of each type of benchmark. Such transparency is particularly

important if the outputs are treated differently for different activities. If the thermal or electricity produced offsite by a third party is included in the benchmark calculation, the third party CHP owner should be given the opportunity to validate the data being attributed to their facility. This is important from the perspective of negotiating third party agreements to include cost recovery of the GHG emissions associated with the energy sold to the thermal/electricity host.

IV. Changes to Definitions

There appear to be inconsistencies between definitions in the MRR and the cap-and-trade 2nd 15-day modifications. Unfortunately, many of the new definitions in the MRR were not added to the cap-and-trade regulation and in other cases the cap-and-trade definitions were not conformed to the new or revised MRR definitions. Due to limited time to review both regulations in detail, we are unable to provide a complete list of our concerns, but offer the following examples. We suggest that the MRR staff convene a conference call of affected parties to explain the proposed changes and ensure that they are consistent with other federal and state legislation, and ultimately are workable.

(i) Definition of Cogeneration – should be the same in both regulations, and should not be inconsistent with federal legislation, e.g. the Public Utility Regulatory Policies Act (PURPA) and the Federal Power Act (FPA). The definition in the cap-and-trade regulation requires “onsite” generation, and in the MRR definition the word “onsite” is struck. Before we can provide constructive comment we need an explanation of why the requirement was added to both definitions and then in only one regulation was deleted.

(ii) It is unclear why MRR Definitions (206), (207), and (209) have been inserted only in the MRR but omitted from the cap-and-trade regulation. These definitions could be helpful in addressing ambiguities in the cap and trade regulation associated with the use of the terms “on-site” and “off-site”.

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. The CCC and its member companies are available to discuss these issues at your request.

Yours sincerely,

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Executive Director

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