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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: Second Proposed 15-Day Amendments 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") Second Proposed 15-Day Amendments (hereinafter, "Second 15-Day Amendments") 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

Calpine is a long-time advocate for low-carbon and renewable energy resources and has consistently supported state and federal carbon legislation. 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 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.

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. Throughout this rulemaking process, Calpine has praised CARB Staff, both in our meetings with Staff and Board members and in our written submissions, for their groundbreaking efforts and responsiveness to our comments. We understand that much time was lost when CARB Staff had intended to work directly with regulated entities to develop solutions to the remaining issues, but was precluded from doing so due to uncertainty created by the lawsuit concerning the Scoping Plan's compliance with the requirements of the California

Environmental Quality Act ("CEQA"). As a consequence, CARB Staff did not get to conduct workshops on critical issues or engage the parties in open meetings concerning these issues, before proposing the two 15-day packages issued this summer. The result is that critical issues to Calpine have not been addressed in either 15-day package.

Calpine appreciates Staff's responsiveness on a number of issues and their efforts to work with many stakeholders to craft a rule that can be successfully implemented starting on January 1, 2012. If CARB cannot address our remaining concerns prior to issuing the final rule at its October hearing, CARB should commence another rulemaking at the earliest opportunity in 2011, to be completed in 2012, prior to the beginning of the first auction.

Following is a summary of our comments on the Second 15-Day Amendments to the Proposed Cap-and-Trade Regulation:

- *Holding Limit*: The Proposed Regulation's holding limit needs to be increased because it will deny the largest emitters in the State the same flexibility afforded smaller covered entities, *i.e.*, requiring surrender of only 30% of an entity's 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.

- *Beneficial Holding Relationship*: Calpine appreciates the changes that CARB staff made to the beneficial holding relationship provisions, so that generators under contracts with utilities need to confirm that the utility is authorized to act on its behalf prior to any beneficial holding by the utility counting against the generator's holding limit. Given the stringency of the holding limit, Calpine's primary strategy for compliance is likely to involve retirement of nearly all of the allowances obtained for any particular facility into its compliance account soon after they are purchased. However, Calpine cannot rely upon this strategy with respect to allowances held by utilities because Calpine will have no control over such allowances while they remain within the possession of the utility. Because the utility can hold such allowances for up to a year, Calpine is concerned that its holding limit could be consumed entirely by utilities' beneficial holding on its behalf, in which case Calpine would be precluded from obtaining the allowances it needs for its other facilities. In light of this, Calpine believes that the beneficial holding provisions should be revised so that beneficial holdings will not count against the holding limit of either the utility or the generator, so long as the generator confirms that it will transfer the allowances to a compliance account as soon as it receives them from the utility.

- *Auction Purchase Limit*: Calpine appreciates the increase in the auction purchase limit from 10 to 15 percent (%). However, this increased limit will still place significant constraints on Calpine's participation in auctions, possibly causing it to participate in every auction and bid at higher prices than it otherwise would to assure it obtains all the allowances it needs. Calpine maintains, consistent with our prior

comments, that the auction purchase limit should not be a "one-size-fits-all" limit, but should be based on a covered entity's compliance obligation.

- *Long-Term Contract Generators*: CARB Staff still has not addressed the problem faced by electric and combined heat and power ("CHP") generators with long-term contract that do not allow for recovery of GHG allowance costs. In many cases, the industrial customer purchasing steam and power from the CHP facility will be receiving a free allocation of allowances, even though it will experience no increase in its energy costs. While CARB Staff hope that this problem will be completely resolved through bilateral contract negotiations, Calpine would urge CARB to revise the final regulation to ensure that allowances that would otherwise be freely allocated to an entity that purchases electricity and/or steam pursuant to a contract that does not allow the generator to recovery its allowance costs will be given to the generator instead.

II. DISCUSSION

A. The Second 15-Day Amendments Fail To Address Calpine's Concerns About The Constraints The Holding Limit Will Impose Upon The Largest Entities In The State; If CARB Cannot Address Our Concerns In The Final Regulation, It Should Commence A Rulemaking To Do So As Soon As Possible.

Calpine has previously commented on the Proposed Regulation's holding limit, which 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.[1]

In the First 15-Day Amendments, CARB revised the holding limit provisions substantially, but failed to provide any relief from the restrictions this would place on the largest independent generators' ability to manage their allowance portfolio. Instead, CARB created a new "beneficial holding relationship" to afford the investor-owned utilities significant flexibility in managing their own contractual obligations, while still complying with the holding limit. In the Second 15-Day Amendments, CARB has again provided no relief from the constraints that the holding limit will impose upon Calpine and other large emitters within the State. We look forward to CARB's response to Calpine's prior comments on the problems associated with the Proposed Regulation's holding limit and will not repeat those comments in any detail here. We provide the following brief summary of our concerns below.

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[1] *See* letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Proposed Regulation to Implement the California Cap-and-Trade Program, December 9, 2010 ("December 2010 Comments"), available at: http://www.arb.ca.gov/lists/capandtrade10/253-carb_letter_re_cap-and-trade_20101209.pdf, 16-17; letter to Hon. Mary D. Nichols, Chairman, from Kassandra Gough, re: Proposed 15-Day Modifications to the Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, August 11, 2011 ("August 2011 Comments"), available at: http://www.arb.ca.gov/lists/capandtrade10/1450-8-11-2011_calpine_comments_re_proposed_15-day_modifications_to_proposed_ca_cap_on_ghg_emissions.pdf, 7.

In establishing the limited exclusion for allowances deposited in a covered entity's compliance account, CARB is, in effect, increasing the annual surrender obligation for the largest entity's, so that it will be significantly greater than the 30% provided by the Proposed Regulation. *See* Proposed Cal. Code Reg., tit. 17 § 95855(b). This is unfair and will place a large generating entity like Calpine at a significant disadvantage to smaller competitors. We appreciate the changes CARB staff made to the beneficial holdings relationship to require that both the principal and agent must confirm the existence of a beneficial holding relationship prior to an agent's holding on behalf of its principal counting against the principal's holding limit. However, we still believe that it is fundamentally inconsistent with the intention of requiring only a 30% annual surrender obligation to so drastically limit the largest entities' ability to manage their compliance obligations by requiring them to surrender a substantially greater percentage of their emissions each year. We do not believe CARB has sufficiently evaluated the impact that this could have on allowance prices within the State.

As we previously noted, the First 15-Day Amendments include 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). However, by rejecting our earlier proposals for how CARB could increase the holding limit, CARB is already in effect imposing this sanction on the largest emitters, for no reason other than that they are large. We do not believe CARB has provided any justification or rationale for so disadvantaging the largest entities within the State by imposing such a *de facto* sanction on them.

As we previously conveyed, we are disappointed that CARB should provide so much flexibility for the investor-owned utilities ("IOUs") with regard to the auction rules and, in particular, the holding limit and auction purchase limit, but should provide no such flexibility to the actual entities which are subject to the compliance obligation. *See* August 2011 Comments, 8-9. We believe that the holding limit should not be "one size fits all", but should be tailored to a covered entity's compliance obligation and have proposed two prior solutions that would increase the size of the holding limit or the limited exemption based upon a covered entity's compliance obligation.

The solution we recently proposed in our August 2011 Comments on the First 15-Day Amendments would provide a simple way for CARB to amend the Proposed Regulation to alleviate the burden the holding limit would place on the largest emitters in the state. *See* August 11, 2011 Comments, 7. Our suggested change would amount to no more than the deletion of two lines from the Proposed Regulation (consisting of only seventeen words) and would, as a consequence, increase the limited exemption so that it included an entity's prior year's emissions, even before the allowances were transferred to its compliance account.

We continue to believe that this change could be easily accomplished with little controversy and without impeding CARB's goals of preventing market manipulation. If CARB cannot make this change before sending the final regulation to the Office of Administrative Law ("OAL"),

however, we would strongly urge the Board upon approving of the final regulation on October 20, 2011, to instruct Staff to undertake a new rulemaking at the earliest opportunity to address our concerns, prior to the first auction's occurrence in 2012.

B. The Beneficial Holding Provisions Should Be Revised So That Beneficial Holdings Will Not Count Against The Holding Limit Of Either A Utility Or A Generator Where The Generator Will Transfer The Allowances To Compliance Accounts Upon Receipt

Calpine previously commented on the First 15-Day Amendments' new provision creating a "beneficial holding relationship", which allows an electric distribution utility to acquire and hold allowances on behalf of its long-term contract generators, with the allowances counting against the holding limit, not of the utility, but of the generator. *See* August 2011 Comments at 7-9. Calpine explained how these changes provided the IOUs substantial flexibility to manage their contract obligations and carbon risk, while providing no such flexibility to the generators who are actually subject to the compliance obligation. *Id.* Calpine also explained how, under many contracts governing such liability for allowances, the generator might not even know whether the utility had elected to acquire allowances on its behalf, before it had done so. This could pose serious problems for generators in assuring they remained in compliance with the holding limit.

In the Second 15-Day Amendments, CARB has amended the beneficial holding provisions, so that the principal in the beneficial holding relationship (*i.e.*, the long-term contract generator) needs to confirm that the agent (*i.e.*, the utility) is authorized to act on its behalf, before any allowances acquired by the agent will be counted against the holding limit of the principal. *See* Proposed Cal. Code Reg. tit. 17 §95834(b). Calpine previously commented that, under the First 15-Day Amendments, a utility could possibly claim it had a beneficial holding relationship with a generator and thereby cause any allowances held on the generator's behalf to be counted against the generator's holding limit, even where the utility had no intention of actually transferring the allowances to the generator. *See* August 2011 Comments, 8. In response, CARB has also made clear that, where an entity is claiming a beneficial holding relationship, such that the allowances held by the agent will count against the holding limit of the principal, the allowances must actually be transferred to the principal within one year after the agent acquires them. *See* Proposed Cal. Code Reg. tit. 17 §95834(b)(3). While these changes assure that an entity cannot unilaterally claim a beneficial holding relationship for purposes of avoiding the holding limit, we are concerned that it still grants too much flexibility to the utilities and would severely disadvantage independent generators.

As we previously conveyed, Calpine will have a very difficult time managing its allowances in compliance with the holding limit due to the fact that CARB has imposed a "one-size-fits-all" holding limit on covered entities. As suggested by our prior comments, Calpine's strategy for complying with the holding limit will likely rely largely upon transferring substantially greater than 30% of its annual compliance obligation to its compliance accounts each year, almost as soon as the allowances are purchased. However, we will not be able to rely upon this limited exemption (for allowances transferred to our compliance accounts in an amount up to our prior year's emissions) to manage allowances held on our behalf by a utility for the simple reason that

we will have no control over those allowances prior to the time they are transferred to us. We can realistically envision a scenario where Calpine's holding limit is consumed almost wholly by emissions held on its behalf by utilities for up to a year, leaving Calpine no room to participate in auctions and acquire the allowances it will need for its other facilities. This not only betrays the principles of fairness between utilities and independent generators, it also poses the risk that Calpine could be completely closed out of any auctions due to utilities' beneficial holdings on its behalf.

We propose the following solution to this problem: If, as proposed by CARB, a utility is claiming a beneficial holding relationship on behalf of a generator with whom it has a contract, the allowances will not count against the holding limit of either the utility or the generator, so long as the generator confirms that it will transfer the allowances to a compliance account within 3 days of receipt from the utility. If CARB cannot make this change prior to sending the final regulation to OAL this October, we would ask CARB to undertake a rulemaking at its earliest opportunity to further consider this issue, so it can be resolved prior to the first auction's occurrence in 2012. Our proposed language is as follows:

§ 95834. Disclosure of Beneficial Holding Relationships.

...

(b) Disclosure of Beneficial Holding.

...

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

C. While Calpine Appreciates The Increase In The Auction Purchase Limit, Calpine Still Believes That The Auction Purchase Limit Should Be Based On A Covered Entity's Emissions

Calpine previously commented that the proposed auction purchase limit of 10% was too low and could realistically preclude it from obtaining all the allowances it needs at auction, which could require it to purchase such allowances from the secondary market at a potentially higher price. *See* December 2010 Comments, 12-16; August 2011 Comments, 3-5. In response, in the Second 15-Day Amendments, CARB has increased the auction purchase limit to 15% of the amount of allowances available in an auction. *See* Proposed Cal. Code Reg., tit. 17 § 95911(c)(4)(A). While Calpine appreciates the increase CARB has made in response to its prior comments, the auction purchase limit will still pose significant limitations on Calpine's ability to purchase in the

auctions. Calpine will likely need to participate in every auction and will need to assure that its bids are high enough to purchase the maximum allowable allowances so that it can simply meet its compliance obligation.

As we previously proposed, we believe the auction purchase limit should not be a "one-size-fits-all" limit, but should be based on an affiliated entity's average annual verified emissions during the preceding three calendar years, plus some additional amount for facilities without three years of emissions data. *See* December 2010 Comments, 15-16; August 2011 Comments, 5. We continue to believe that CARB should not impose a one-size-fits-all holding limit, but should instead allow affiliated entities with larger compliance obligations to purchase the entirety of their obligation from the auction. As we previously noted, CARB has completely exempted the IOUs from this purchase limit, even though they are no differently situated with respect to their need to acquire allowances than independent generators. Calpine is disappointed that CARB has provided so much flexibility to the IOUs, but none to independent generators or other covered entities who are subject to large compliance obligations.

If CARB cannot make changes to the Proposed Regulation prior to finalizing it this October consistent with our earlier proposals, Calpine would ask CARB to undertake a rulemaking as soon as possible to address this issue prior to the first auction's occurrence in 2012.

D. Neither 15-Day Package Addresses The Situation Faced By Long-Term Contract Generators That Cannot Recover the Cost of Allowances From Their Customers; If CARB Cannot Address This Issue In The Final Regulation, It Should Commence A Separate Rulemaking To Address It At The Earliest Opportunity

Calpine is disappointed that CARB has again failed to address the situation faced by long-term contract generators that cannot recover the cost of allowances from their customers under contracts initially entered into prior to the passage of the Global Warming Solutions Act (Assembly Bill ("AB") 32).

As we previously noted, 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] In light of this mandate, "the Board direct[ed] the Executive Officer [in Resolution 10-42] 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.

[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").

As we previously noted, however, in many cases industrial facilities qualifying for free allowances under the Proposed Regulation purchase power and steam from a cogeneration facility pursuant 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 AB 32 with a CHP generator, even though it will receive a direct allocation from CARB to address potential leakage concerns. Given the anticipated increase in operating costs associated with purchase of allowance, the CHP facility would, in many cases, have little incentive to continue operating and could very realistically decide to just shut-down. Such a result would not only undermine the Scoping Plan goal of increasing CHP throughout the State by 4,000 MW of CHP capacity, it could result in a net reduction of that amount.

Given this possible outcome and the Scoping Plan's goal, CARB staff committed prior to approval of the Proposed Regulation in December 2010 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. However, in both the First 15-Day Amendments and the Second 15-Day Amendments, CARB Staff has failed to propose any regulatory provisions that would alleviate the extreme economic burden imposed upon long-term contract generators that cannot recover allowance costs from their customers. Instead, Staff noted the concern in the Notice accompanying proposal of the First 15-Day Amendments and suggested that this problem should be resolved through bilateral contract negotiations.[2]

We understand that CARB Staff may have been reluctant to propose regulatory language that could frustrate ongoing efforts between long-term contract generators and their counterparties to resolve this issue, independent of any resolution within the final regulation. However, by failing to include *any* mechanism to address this problem in either set of 15-Day Amendments, CARB Staff has not only failed to carry out the Board's instructions to address this issue, but may have frustrated any realistic chance that this problem will be successfully resolved by long-term contract generators and their counter-parties. Should the final regulation not address this issue and instead award free allocations to industrial entities purchasing steam or power pursuant to

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[2] The Notice accompanying the First 15-Day Amendments provided as follows:

> 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

long-term contracts that do not provide for recovery of allowance costs, those entities will have little to no incentive to assume some share of responsibility for the generator's allowance costs.

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, particularly given CARB's failure to address the issue in either package of 15-Day Amendments. 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. As we previously proposed, none of the allowances provided for such assistance could be sold or otherwise used by the generator to experience some windfall in profits. *See* December 2010 Comments, 6-10.

At the very least, we believe CARB must revise the Proposed Regulation so that, where entities that would receive an allocation for industrial assistance will experience no increase in their energy costs due to a pre-AB 32 contract, the allowances will not be awarded to that entity, but will be given to its counter-party instead. If CARB cannot incorporate provisions addressing long-term contract generators into the final regulation, we strongly urge the Board to instruct Staff to address this issue in a separate rulemaking to be commenced at the earliest opportunity in 2012.

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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

Kassandra Gough
Director, Government and Legislative Affairs

cc: James Goldstene, Executive Officer
Edie Chang, Chief, Planning and Management Branch, Office of Climate Change
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