INDEPENDENT ENERGY PRODUCERS ASSOCIATION

September 27, 2011

Comments of the Independent Energy Producers Association On CARB's Proposed Regulation to Implement the California Cap-and-Trade Program [Release Date: September 12, 2011]

The Independent Energy Producers Association ("IEP") submits these comments on the California Air Resources Board ("CARB") Proposed Regulation to Implement the California Cap-and-Trade Program (released September 12, 2011). IEP represents over 26,000 MWs of installed, non-utility, independently owned generation resources in California. IEP supports the goals of AB 32 and offers these comments in conjunction with previous comments on the Cap-and-Trade Regulation.[1]

I. General Comments:

IEP has worked with CARB to develop an efficient and effective Cap and Trade Program to reduce carbon emissions while remaining particularly focused on ensuring a competitive, level playing field within the electric sector. However, there are still a few outstanding issues in the proposed regulation that create potential discriminatory impacts on independent power producers (IPPs). Specifically, discriminatory impacts in the cap and trade program occur where IPPs are treated differently in comparison to other participating entities (i.e. investor owned utilities, publicly owned utilities, etc). The Board needs to act on these issues.

First is an unresolved issue related to a limited group of independent generators and combined heat and power (CHP) facilities that entered into contracts prior to the enactment of AB 32 that do not have a reasonable means to recover the cost of greenhouse gas ("GHG") emission allowances required for their continued operation. As discussed in the specific comments below, absent explicit recognition and assistance from CARB, these IPPs, unlike all other obligated entities, are subject to a GHG compliance cost under the cap and trade regulation that cannot be passed through or recovered under the existing terms of the contract. *IEP requests that the Board explicitly recognize, through a Board resolution, this discriminatory outcome on IPPs as a remaining issue that needs further attention before the program effectively begins with the first auction in 2012.*

Second, the regulation should be revised to avoid discriminatory impacts on independent generators as it relates to auction purchase limits. Specifically, Utility-Owned-Generation (UOG) will not be subject to the same auction purchase limits as independent generators, which

[1] See IEP's Comments on July 27, 2011 Version of the Regulation at: http://www.arb.ca.gov/lists/capandtrade10/1488-iep_comments_on_carb_c_t_15_day_lang_8-11-11--final.docx ; See also IEP's Comments on the October 28, 2010 Version of the Regulation at: http://www.arb.ca.gov/lispub/comm/bccomdisp.php?listname=capandtrade10&comment_num=123&virt_num=111

creates a skewed competitive playing field amongst competitors. In order to avoid this discriminatory outcome between IPPs and UOGs, the utilities exemption from the purchase limit should be removed.

Similarly, CARB has essentially exempted the utilities from the holding limit provision through the creation of a new "beneficial holding relationship" which affords the IOUs significant flexibility in managing their contractual obligations and requires the purchased allowances to count against the IPP's holding limit; although, they may not physically take ownership for up to one year. This holding limit, as currently drafted, puts independent generators at a competitive disadvantage to IOUs.

Finally, the unique emission factor that will be applied to the generation supplied from Bonneville Power Administration (BPA) could create a preference for out-of-state resources over in-state resources and also create a disparity between resources that are imported into California. This default emission factor for BPA fails to recognize the interconnected nature of the Western Interconnection and treats some resources differently irrespective of their actual emissions profiles. In order to foster a stable, competitive environment that is not discriminatory among resources (both in state and out of state), the emission factor for imported resources should accurately reflect the emissions profiles of the resources that are imported.

In addition to these issues laid out above, several other provisions in the regulation need further revision to ensure that the cap and trade program runs as efficiently and effectively as possible. These include clarifying the definitions for Resource Shuffling, Electricity Importers, and Electrical Distribution Utilities; better aligning the new requirements for a Renewables Portfolio Standard (RPS) Adjustment with the requirements of the RPS program; and ensuring that the untimely surrender obligation does not punish obligated entities that are in compliance with the cap and trade program.

II. Specific Comments:

1. The Proposed Regulation Creates Discriminatory Impacts on IPPs with Respect to Pre-AB 32 Contracts without a Means for GHG Cost Recovery.

IEP remains concerned that the cap-and-trade regulations do not address the treatment of existing contracts, executed prior to the passage of AB 32, that do not have a reasonable means of recovering the cost of GHG allowances required for their continued operation. In general, obligated entities under the cap and trade program (e.g. IOUs, publicly owned utilities, industrial entities, refineries, etc.) are to be allocated free allowances to compensate them for the negative impacts of the GHG program on their market positions, regardless of whether they have a market in which they can pass along to consumers the costs of GHG allowances.

The only exception to this rule is the treatment of IPPs, which are all required to obtain allowances via an auction.[2] For many IPPs this approach is acceptable as they have mechanisms available to recover or pass through the costs of GHG allowances. However, for a small subset

[2] **UOG also is required to enter the same auction as IPPs to acquire the allowances they need as an Obligated Entity, but the California Public Utilities Commission typically allows the IOUs to recover the prudent costs of operating UOG from ratepayers. Presumably, the IOUs will also be permitted to recover the costs of GHG allowances required to operate UOG from ratepayers.**

of IPPs operating under existing contracts, currently no viable mechanisms exist within their existing contract structures to recover the cost of the GHG allowances they must obtain to comply with the Cap and Trade (C&T) program. This lack of specific consideration in the cap and trade regulation regarding generators caught in these specific circumstances raises serious equity and consistency concerns.

Both CARB and other agencies have noted the need for appropriate treatment of this limited group of contracts, yet to date, no remedy has been provided. Recognition of this issue dates back to the early work of the Market Advisory Committee. More recently, CARB itself acknowledged the problem in its Initial Statement of Reasons for the cap-and-trade program as well as subsequent summary documents for previous versions of the regulation.[3] However, the most recent version of the regulation provides no consideration of this issue whatsoever.

CARB Staff has indicated its preference for resolution of this issue through contract renegotiation between contract counterparties; however, the counterparties to the IPPs have no incentive to renegotiate these contracts as these will be the only generation resources for which the electricity purchaser does not incur a carbon cost. A counterparty's ability to avoid these costs enables the buyer to garner windfall profits from the sale of the electricity in a market where the Market Clearing Price ("MCP") contains a GHG value.

In the case of tolling agreements where a utility can call on or effectively "run" the generator, the utility will have an incentive not to renegotiate the contract. In fact, the utility has a perverse incentive to run such a generator more because the generator, without the ability to include cost recovery for GHG allowances in its price, will appear relatively cheaper than resources that include the cost of GHG allowances in their price, either through contract price or the wholesale market price. This distortion of the GHG price signal could lead to increased GHG emissions, contrary to the objectives of the cap-and-trade program (e.g. if a higher-emitting resource is dispatched ahead of a lower-emitting resource solely because the higher-emitting resource's price does not reflect the cost of GHG allowances).

In addition to the counterproductive emissions impacts, failure to address these contracts will also undermine CARB's policy for freely allocating allowances to the distribution utilities. The utilities get free allocation under the assumption that ratepayers incur GHG costs when the utility purchases power at wholesale, under bilateral contracts or through the utility's own compliance obligation for UOG. If the utility can avoid the GHG costs for some contracts, then it should not be receiving free allocation to cover the costs of GHG from generation resources with contracts that do not allow them to pass through the cost of GHG allowances. Since the utilities will receive direct allocation for costs they will not bear under long-term contracts, the fundamental emission reduction and cost allocation principles (i.e. CARB's policy rationale for direct allocation to the distribution utilities) will be undermined.

To avoid these detrimental impacts on the program, ***IEP requests that the Board explicitly recognize this problem and through Resolution provide affirmative direction that CARB will continue to evaluate the issue <u>and</u> provide a remedy for these affected IPPs before the first auction in 2012.*** Specifically, CARB should create a place for these affected IPPs to receive free allowances by reducing utility or industrial sector allocations when those allocations account for GHG emission costs that the utility did not incur due to a contract that was (1) executed

[3] See the Initial Statement of Reasons (footnote 22); The Notice of Public Availability, issued July 25, 2011.

before the passage of AB 32, and (2) that has no ability to recover GHG allowance costs. Alternatively, in instances where the counterparty does not receive free allocations, CARB should state that it will evaluate amendments to direct the compliance obligation to the entity (such as a marketer) that is able to recoup the GHG costs.

2. The Regulation Should be Revised to Avoid Discriminatory Impacts on Independent Generators Through Application of the Auction Purchase Limits.

The utilities' exemption from the purchase limit should be deleted. The purchase limit on allowances applies to all regulated entities, except electrical distribution utilities. Distribution utilities that purchase allowances to cover their own compliance obligation should be treated the same as any other entity subject to a compliance obligation. Specifically, independent generators directly compete with UOG and this preferential provision could provide an unfair advantage to UOG, especially as allowances become scarcer in the later years of the program. This limitation could also create a skewed competitive playing field where utility distribution companies can obtain more allowances than they need for their own compliance obligation, only to sell back to their IPP competitors when prices are high. When applying the purchase limit to covered entities in a non-discriminatory manner, the purchase limit must be established such that all covered entities face equivalent opportunities to buy (or not buy) out of the auction allowances necessary to meet their compliance obligations.

In addition, the Purchase Limit currently establishes a ceiling of 15 percent of the allowances offered per auction. While this proposal would have little, if any, impact on relatively small emitters of GHG, such a proposal for relatively larger emitters or those with corporate associations may create constraints on their ability to choose which auctions to enter, when to purchase allowances from the auction, etc. In recognition of these disparate impacts on Covered Entities, the Purchase Limit should generally remain at 15% of the allowances offered for auction; however, for large covered entities or a group of covered entities with a corporate association, CARB should set the Purchase Limit for these entities such that it recognizes different magnitudes of compliance obligations. IEP believes that this adjustment may only apply to a very small subset of covered entities or a group of covered entities with a corporate association. This amendment should be made to the regulation prior to the first auction in 2012.

3. The Holding Limit Should Address the Magnitude of an Obligated Entity's Compliance Obligation and Not Discriminate Among or Between Obligated Entities.

The holding limit, as currently proposed, unfairly limits the ability of large obligated entity's such as large independent generators to use the flexible compliance mechanisms provided by CARB, including unlimited banking of allowances. As a result of this limitation, some large entities will have to surrender enough allowances to meet their total annual emissions, rather than using the flexible compliance period to decide when to submit their allowances, in order to avoid exceeding the holding limit. IEP notes that CARB here again essentially exempted utilities from this provision through the creation of a new "beneficial holding relationship" which affords the IOU's significant flexibility in managing their contractual obligations and requires the purchased allowances to count against the IPP's holding limit; although, they may not physically take ownership for up to one year [Section 95834(b)(3)]. This puts independent generators at a competitive disadvantage to IOUs. In addition, the regulation recognizes that limiting an entity's flexibility is punitive because it authorizes the Executive Officer to impose sanctions on registered entities that violate the provisions of the Cap-and-Trade Regulation, including increasing the annual surrender obligation for a covered entity. Thus, as proposed, the holding limit imposes this penalty on large generators (and not IOUs) for no other reason than their sheer-size.

While IEP shares CARB's concerns regarding hoarding, market manipulation, etc, there needs to be a mechanism in place to address the compliance needs of large obligated entities where the current holding limit potentially creates discriminatory impacts, with respect to flexible compliance instruments.

In order to compensate for these disparate impacts on obligated entities, CARB should adjust the holding limit calculation for large obligated entities to reflect the different magnitudes of compliance obligations among obligated entities. IEP requests CARB amend the regulation prior to the first auction in 2012 so that the holding limit is tied to the size of an obligated entity's compliance obligation.

4. Bonneville Power Administration's Emissions are Calculated Dissimilarly from Other Imported Resources

Bonneville Power Administration is defined as an Asset Controlling Supplier under the proposed Cap and Trade Regulation that is assigned a specified source emission factor by ARB for the wholesale electricity procured from its system and imported into California [Section 95802(a)(14)]. As IEP understands it, BPA has a unique default emissions factor that is substantially less than the factor applied to all other unspecified imports. According to Section 95111(b)(3) of the MRR, BPA has a default system emission factor that is twenty percent of the default emission factor for unspecified sources. This specific emission factor for BPA fails to recognize the interconnected nature of the Western Interconnection and treats some resources differently irrespective of their actual emissions profiles. Accordingly, ARB should adopt a single default emission factor for all unspecified purchases, and thereby effectuate similar treatment for imported power. Furthermore, in order to foster a stable, competitive environment that is not discriminatory between resources (both in and out of state), CARB should ensure that imported resources, for specified and unspecified power, accurately reflect the emissions profiles of the resources that they represent.

5. The Definition for Electricity Importer Should be Clarified in a Follow-Up Rulemaking Before the Start of the Cap-and-Trade Program.

The cap-and-trade definitions for "electricity importer" were substantially revised in the September 12, 2011 version of the cap-and-trade regulation. The definition provides that the importer is the purchasing and selling entity ("PSE") on the physical path where the delivery point is in California [Section 95802(a)(87)]. IEP remains concerned that there are instances when the PSE on the e-tag does not correctly identify the entity that owns power as it crosses the State's borders. Moreover, the definition no longer refers to having "title" to the power or that the downstream entity will be the importer when CARB does not have jurisdiction over the seller. These additional changes make application of the definition to real-world power transactions far less clear. IEP believes that these provisions require further revision to specifically address circumstances when e-tags do not accurately reflect the title to power as it crosses the California border. This issue should be explicitly recognized by the Board as an area that will be addressed in a subsequent rulemaking prior to the start of the cap-and-trade program.

6. **The Resource Shuffling Provisions have been Improved, but Still Require Further Clarification.**

IEP commends staff for responding to stakeholder concerns about the lack of clarity in the resource shuffling provisions. Sections 95802(a)(251) and 95852(b)(2) have been modified to remove the specific activities constituting Resource Shuffling, as well as the reference to fraud. The remaining portion of the definition states that resource shuffling is a "plan, scheme, or artifice to receive credit based on emissions reductions that have not occurred, involving the delivery of electricity to the California grid." While the current revisions are an improvement, the application of the Resource Shuffling provisions in their current form will still cause significant confusion among regulated entities. Without clarification, regulated entities will not know when otherwise legitimate market transactions would be perceived as avoiding an emissions obligation, and thus constitute resource shuffling. In light of the fact that the current language is unclear and still creates a level of uncertainty, IEP requests that CARB identify these provisions as an area that will be subject to further rulemaking activity before the start of the program.

7. **The Amendments to the Definition of "Electrical Distribution Utility" are Broad Enough to Unintentionally Include Electric Generators.**

The amendments made in the September version of the Cap and Trade regulation defines Electrical Distribution Utility as an "entity that owns and/or operates an electrical distribution system…" [Section 95802(a)(85)]. While IEP does not believe that it is CARB's intent to incorporate electric generators into the definition of "Electrical Distribution Utility," the proposed amendments to this definition would include anyone that owns and or operates a gen-tie for purposes of generation interconnection (i.e. an electric generator). In order to remedy this effect, IEP recommends returning to the specific language that was previously drafted in the July 2011 version of the cap and trade regulations, or alternatively creating a more narrow definition that would not capture individual generators, but that would solely speak to IOUs, publicly owned utilities and electrical cooperatives.

8. **The RPS Adjustment Provisions Should be Better Coordinated with the RPS Program.**

The September 12th version of the regulation deletes reference to replacement electricity, and instead provides for an RPS Adjustment [Section 95852(b)(4)]. For an importer to avoid the compliance obligation for ancillary services supporting a firming and shaping agreement, it must demonstrate that a REC was retired in the same year that the RPS adjustment is claimed. This limitation is one example of how the new requirements may be inconsistent with the current RPS program and potentially the rules under development at other public agencies, including the California Public Utilities Commission (CPUC) and the California Energy Commission (CEC). IEP notes that the CPUC and the CEC are currently considering how to deal with these types of transactions for compliance with the 33% RPS and there is concern that the timeframe for retiring RECs between the RPS and the C&T program may not be the same. This inconsistency could detrimentally impact the intended functioning of the RPS markets. IEP therefore requests that CARB commit to evaluate how the RPS program matches up with CARB's cap-and-trade regulation and make changes over the next year, where necessary, to be consistent with the RPS program.

9. The Untimely Surrender Obligation Penalizes Entities that are in Compliance with the C&T Program by Creating Allowance Supply Constraints.

While the amendments made to the regulation now allow for up to one fourth of an entity's compliance obligation for untimely surrender to be filled with ARB offset credits, rather than solely with GHG allowances [Section 95857(a)(4)], the framework of the untimely surrender obligation still penalizes entities that are in compliance with the cap and trade program by creating allowance supply constraints.

Currently, the cap-and-trade regulation requires that covered entities that do not retire the requisite number of allowances for their triennial compliance obligation will be subject to an "untimely surrender obligation" for the shortfall. The untimely surrender obligation is four times the shortfall and must be satisfied by submitting allowances or offsets in order to satisfy the untimely surrender obligation. As a result, there will be significantly more demand in the auction for allowances, creating upward pressure on prices. Due to the high allowance prices resulting from this heightened demand in the auctions, covered entities that are in compliance with the cap-and-trade program will inappropriately be penalized, in the form of higher prices for GHG allowances, for the actions of others who were not in compliance.

To avoid penalizing complying entities, CARB should require the entity subject to the shortfall to obtain allowances for its compliance obligation (i.e. 1/4 of the untimely surrender obligation), thereby avoiding the price effect of increased demand for allowances and maintaining the integrity of the "cap." On the other hand, the same entity should be required to meet the rest of the penalty (i.e. 3/4 of its untimely surrender obligation) via a financial payment, based on the auction clearing price, to be paid to the Air Pollution Control Fund.

In Conclusion, IEP thanks the CARB for the opportunity to comment on the September 12, 2011 version of the Cap and Trade Regulation. IEP believes that many of the concerns raised above can be remedied by a Board Resolution directing CARB to take further action on these important issues before the program begins with the first auction in 2012.

Respectfully Submitted,

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